

### INTRODUCTION

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**E.1** This annex sets out detailed analysis and a description of the methods used to support the Inquiry's conclusions on incentives and assignment reported in Chapter 9 of the main report.

**E.2** The first two sections of the annex cover incentives for growth in the council tax base and the business rates tax base. The aim is the same in relation to both these tax bases – to incentivise growth by rewarding growth in the tax base with additional funding through the grant system – but the way that they interact with the local government finance system is different, which means that different approaches are required. The final section sets out in detail the analysis underlying some of the options for assignment of income tax.

### COUNCIL TAX INCENTIVES

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#### Types of council tax base incentive

**E.3** Chapter 9 reports on three potential methods of designing incentives based on the council tax base. These are: partial equalisation; differential equalisation; and equalising for lagged tax bases. The aim in each case would be to reward those who grew their council tax bases by ensuring that growth in tax base was not entirely equalised away through the grant distribution system.

**E.4** It is important to note that none of the modelling work was designed to replicate likely local authority responses to the incentives. The results presented here, therefore, show the impact of different incentive options on the tax base and their effect on Formula Grant. In the event of an introduction of an incentive one would expect local authorities' behaviour to change and that in itself could impact on the distribution of incentives and grant between authorities.

#### Partial equalisation

**E.5** Two attempts were made to model the effects of introducing partial equalisation into the current grant system. The aim of partial equalisation would be to enable local authorities to keep some of the gain from growth in tax base, rather than having it fully taken into account in the calculation of grant.

**E.6** The first option scaled down the national Relative Resource Amount (RRA) total so that it took account of only a fixed percentage of authorities' tax bases (e.g. 90%). However, this had a distributional impact only to the extent that the national total for the block decreased relative to the Central Allocation block. This is an unintended consequence caused by the design of the 'four-block' system and while affecting the distribution of grant, it would not provide a clear incentive to grow the tax base.

**E.7** Within the RRA total, every authority's tax base would be scaled down by the same proportion, having no effect on individual RRAs. Halving every authority's tax base, for example, would have no effect on how the growth in tax base is taken into account for any authority through the RRA, and therefore no incentive effect.

**E.8** The second option involved leaving tax bases unchanged, but equalising to a particular tax capacity by reducing or increasing the national total provided for resource equalisation (the RRA). However, this results simply in RRA figures for all authorities being scaled to the same extent thus affecting grant only to the extent that the national RRA total is changed in relation to the other blocks.

**E.9** This demonstrates that the inter-relationships between the blocks in the ‘four-block’ model make it very difficult to alter the RRA without it impacting on other parts of the system in an unintended way. The ‘four-block’ model therefore provides limited scope for varying different aspects of resource equalisation to introduce incentives to local authorities to grow the tax base.

### Differential equalisation

**E.10** To go beyond the consistent scaling down of every authority’s tax base (which was the effect of the ‘partial equalisation’ approach set out above) would require individual authority tax bases to be differentially scaled in some way, so that the extent of variation between authorities was changed. There is, however, technically no single correct way of doing this – the approach would require the Government to make a policy choice about which authorities to advantage, for example seeking to provide additional resources in growth areas or in deprived areas, and adjusting the scaling of tax bases on that basis.

**E.11** However, any further work on such an incentive option would also need to take into account the impact of grant damping. Chapter 9 discussed those authorities that benefit from damping. The 15 local authorities that benefited the most in the 2006-07 settlement were: Surrey, Wokingham, Bromley, Richmond upon Thames, Windsor and Maidenhead, South Bucks, Chiltern, Buckinghamshire, West Sussex, Chichester, Hampshire, Brentwood, Three Rivers, Hertsmere and Hertfordshire.

**E.12** The impact of damping is shown in the following results, which for the purposes of illustration are based on a simple adjustment of each authority’s tax base so that the difference between its tax base per head of population and the national average is half what it was for the 2006-07 settlement. This has the effect of narrowing the extremes of tax base per head across authorities, for example, from 0.257 (Forest Heath) to 0.629 (City of London) to 0.307 to 0.492 respectively.

**E.13** Table E1 shows the impact of this adjustment and shows, before damping, the authorities that would have had the largest increases and decreases in Formula Grant. It then shows that damping would have major impacts on these increases and decreases.

**Table E1: Authorities with the biggest increases and decreases in Formula Grant prior to damping and after damping**

	Difference between actual grant before damping and modelled grant with scaled tax base (%)	Difference between actual grant after damping and modelled grant with scaled tax base (%)
<b>Top 5 prior to damping</b>		
Surrey	74.6	9.9
Windsor and Maidenhead	70.5	26.1
Richmond upon Thames	69.5	21.2
Wokingham	42.5	0.4
Buckinghamshire	43.5	13.9
<b>Bottom 5 prior to damping</b>		
Leicester	-8.0	-4.3
Derby	-8.0	-4.5
Coventry	-8.2	-6.3
Southampton	-8.3	-10.2
Forest Heath	-11.8	-14.8

## Equalising for lagged tax bases

**Introduction E.14** A model was developed to test the impact on the distribution of the 2006-07 Formula Grant of replacing the tax base used in that settlement with one dating from three years earlier, leaving all else constant. This would reward authorities who had grown their tax base, as that growth in tax base (and hence in council tax revenues) would not be taken into account in allocating grant, and they would therefore receive a higher level of grant that they do under the current system. This model shows only what would happen if this model was applied on the basis of historical data – it does not attempt to estimate how local authorities might have changed their behaviour if the incentive had been in place. This model does not increase the total amount of resources in the system, rather, it redistributes the current revenues in a different way.

**Data sets and assumptions E.15** The data sets used were the 2006-07 CLG local government finance settlement, and figures for tax bases for Formula Grant purposes from October 2003. In the model there was no change to the total amount of Formula Grant for 2006-07 and the effects

were measured without damping.

### Impacts on Formula Grant

**E.16** In terms of class of authority the average gains and losses were not large. Inner London boroughs and authorities in shire areas tend to gain as a result of this change, reflecting the faster level of growth in their tax bases, with other metropolitan areas tending to lose overall.

**Table E2: Impact by authority class of lagged equalisation of council tax base**

	<b>Formula Grant for 2006-07 before damping with 3 year tax base lag</b>	<b>Gain from moving to 3 year tax base lag</b>	<b>Gain from moving to 3 year tax base lag</b>
	£ million	£ million	%
<b>London area</b>	<b>9,330</b>	<b>8</b>	<b>0.1</b>
Inner London	2,034	22	1.1
Outer London	1,622	-18	-1.1
Greater London Authority	2,019	0	0.0
<b>Metropolitan areas</b>	<b>7,109</b>	<b>-25</b>	<b>-0.4</b>
Metropolitan districts	4,930	-22	-0.4
Metropolitan police authorities	1,870	-2	-0.1
Metropolitan fire authorities	309	-1	-0.3
<b>Shire areas</b>	<b>12,029</b>	<b>21</b>	<b>0.2</b>
Shire counties	3,632	5	0.2
Unitaries	2,869	13	0.4
Shire districts	1,765	1	0.1
Shire police authorities	3,339	2	0.1
Shire fire authorities	424	0	0.1
<b>Total England</b>	<b>24,814</b>	<b>0</b>	<b>0.0</b>
<i>Total Growth Areas</i>	<i>6,299</i>	<i>12</i>	<i>0.2</i>
<i>Total New Growth points (estimated allocation to local authority areas)</i>	<i>6,846</i>	<i>9</i>	<i>0.1</i>

**E.17** At the individual local authority level, before any damping is applied, areas such as Windsor and Maidenhead and Chiltern would lose the most Formula Grant and Rutland and Richmond upon Thames would gain the most Formula Grant. Table E3 below sets out the biggest percentage increases and decreases in Formula Grant which resulted from lagging the council tax base by three years, and the scale of the gains and losses created by this incentive.

**Table E3: Authorities affected most significantly by lagged equalisation**

Sorted by gain as % of Formula Grant	2006-07 grant before damping with 3 year tax base lag  £ million	Gain from moving to 3 year tax base lag  £ million	Gain from moving to 3 year tax base lag  %
<b>Top 5</b>			
Rutland	6.7	0.6	9.6
Hart	3.3	0.2	5.8
North Dorset	4.3	0.2	4.9
Wandsworth	121.6	5.5	4.7
Richmond upon Thames	18.3	1.3	7.3
<b>Bottom 5</b>			
Croydon	98.3	-3.4	-3.4
Havering	42.2	-1.6	-3.6
Bath & North East Somerset	33.6	-1.7	-4.9
Chiltern	2.8	-0.2	-5.2
Windsor and Maidenhead	10.9	-0.7	-6.0

## BUSINESS RATE INCENTIVES

**E.18** Chapter 9 discusses two models for introducing business rates incentives into the taxation and grant system – a system of lagged contributions to the national business rates pool; and a system of partial local assignment of business rates to the authority in which they are collected. Both would enable local authorities with a growing business rate base to gain extra resources. However, as with previous models, neither tried to predict likely local authority responses to the incentives.

## Lagged contributions to the business rates pool

**E.19** At present, local authorities collect business rate revenues from properties on the local list and pay them into a central pool for redistribution. Under this incentives model, they would continue to do so, but their contributions would be based not on the revenues actually collected in the current year, but on the revenues they had collected in a previous year. Where the tax base had grown in the intervening period, they would therefore receive a financial benefit, and where it had shrunk they would need to find resources from elsewhere to meet the gap.

**E.20** Two variants of lagging billing authorities' contributions to the pool were modelled:

- a 1 year lagged model, with billing authorities making a lagged contribution to the pool, by making 2005-06 contributions in 2006-07; and
- a 5 year lagged model, making 2001-02 contributions in 2006-07.<sup>1</sup>

**E.21** Overall business rates revenues have increased between the years, in both models. The modelling assumes that the collective gain to billing authorities resulting from making lower contributions than they otherwise would have done, is paid for from the national total of Formula Grant for 2006-07, so the model redistributes resources between authorities rather than providing new resources.

### Assumptions and methodology

**E.22** This work made use of the dataset used by CLG in carrying out the calculations for the 2006-07 local government finance settlement. It also used figures for each billing authority's contribution to the national business rates pool for 2001-02 and 2005-06, as reported to CLG on NNDR3 returns.

**E.23** For two-tier shire areas, gains (and losses) were split 50:50 between districts and counties in the modelling. In London and metropolitan areas, all the gains (and losses) were modelled as being kept by the billing authorities.

**E.24** Fire and police authorities, and the Greater London Authority, would receive no share of the revenues. Since the model reduced Formula Grant by the amount of business rates retained locally, so that overall it had no additional cost for the Government (unlike the partial assignment model discussed later), there would be a fall in grant to those authorities who have to pay for the incentives scheme without being able to gain from it. In practice this might not be a desirable outcome and could be altered through making other adjustments to the grant system. This model should be seen as an illustration of a possible scheme rather than a detailed design.

**Impacts E.25** The overall national 'gain' resulting from the lagging of business rates contributions was found to total £1.7 billion between 2005-06 and 2006-07, and £3.2 billion between 2001-02 and 2006-07, with these amounts being top-sliced from the 2006-07 Formula Grant total.<sup>2</sup> This top-slicing was modelled by sharing the reduction

<sup>1</sup> The second variant compares figures across a revaluation, because the 2001-02 contributions were based on 2000 rateable values, whereas the 2006-07 figures were based on those from 2005. As noted in Chapter 9, this has implications for the degree to which this approach would actually provide transparent incentives. For each local authority, the lag is the difference between the contribution to the pool derived from rateable values for 31 December 2000 and the contribution to the pool derived from rateable values at 31 December 2005.

<sup>2</sup> The large gain of £1.7bn between 2005-06 and 2006-07 – compared with one of £3.2bn over the whole period from 2001-02 to 2006-07 – is due in part to a definitional point, because the 2005-06 figures are on an outturn basis. This, unlike the 2006-07 estimates, includes amounts in respect of earlier years, which tend to be negative overall, due to the net effect of downward rateable value changes resulting from appeals.

between Revenue Support Grant and redistributed business rates totals on a pro-rata basis, leaving principal formula Police Grant unchanged.<sup>3</sup>

**E.26** Growing authorities would tend to gain by an incentive of this kind not being required to contribute all their 2006-07 net business rates yield to the pool. Declining authorities – of which there are very few in absolute terms – would in contrast need to have financed part of their contribution from other resources. However, because of the top-slicing of Formula Grant, some authorities lost in relative terms – they would receive less from this model than they would have done had the Formula Grant system continued as normal.

**E.27** Regionally, there would have been large net gains for London and the South East over both the periods modelled and large net losses for the northern regions, as shown in the tables below.

**Table E4: Effect at regional level of one year model**

All figures £m	Gain from business rates	Reduction in Formula Grant	Overall effect
North East	66	-122	-56
North West	213	-256	-43
Yorkshire & the Humber	140	-189	-48
East Midlands	81	-131	-49
West Midlands	103	-199	-96
East of England	174	-130	45
London	507	-390	118
South East	315	-180	135
South West	124	-129	-4
<b>Total England</b>	<b>1,724</b>	<b>-1,724</b>	<b>0</b>

<sup>3</sup> In practice, any method of allocating reductions between Revenue Support Grant and redistributed business rates totals would result in the same distribution in the current system, because they are both distributed in exactly the same way using the four-block model. Only if the amount were distributed partly through principal formula Police Grant would the distribution of grant be substantively different. In reality, ministerial judgements on floor levels under a system of lagged business rates may well have differed from what were under the current system.

**Table E5: Effect at regional level from five year model**

All figures £m	Gain from business rates	Reduction in Formula Grant	Overall effect
North East	119	-224	-104
North West	340	-469	-129
Yorkshire & the Humber	228	-346	-118
East Midlands	198	-239	-41
West Midlands	238	-364	-126
East of England	301	-237	64
London	1,017	-713	304
South East	511	-329	182
South West	204	-235	-32
<b>Total England</b>	<b>3,156</b>	<b>-3,156</b>	<b>0</b>

**E.28** For both one- and five-year models, the greatest net gains by authority class were for Inner London boroughs and shire districts, with some of the biggest losses occurring for metropolitan districts.<sup>4</sup>

<sup>4</sup> Police and fire authorities, including the Greater London Authority, were also shown to be large net losers. This is consistent with their not being able to benefit from the scheme as modelled, whilst still being required to contribute towards it through a reduction in grant.



**Table E6: Effect by class of one year model**

All figures £m	Gain from business rates	Reduction in Formula Grant	Overall effect
<b>London</b>	507	-383	124
Inner London	337	-164	173
Outer London	170	-135	35
Greater London Authority	0	-84	-84
<b>Metropolitan areas</b>	308	-511	-203
Metropolitan districts	308	-409	-101
Metropolitan police authorities	0	-76	-76
Metropolitan fire authorities	0	-26	-26
<b>Shire areas</b>	909	-830	79
Shire counties	305	-299	6
Unitaries	299	-236	63
Shire districts	305	-146	159
Shire police authorities	0	-114	-114
Shire fire authorities	0	-35	-35
<b>Total England</b>	1,724	-1,724	0

**Table E7: Effect by class of five year model**

All figures £m	Gain from business rates	Reduction in Formula Grant	Overall effect
<b>London</b>	1,017	-703	314
Inner London	787	-301	486
Outer London	230	-248	-18
Greater London Authority	0	-154	-154
<b>Metropolitan areas</b>	586	-933	-347
Metropolitan districts	586	-748	-162
Metropolitan police authorities	0	-138	-138
Metropolitan fire authorities	0	-47	-47
<b>Shire areas</b>	1,553	-1,520	33
Shire counties	563	-548	15
Unitary authorities	428	-431	-3
Shire districts	562	-267	295
Shire police authorities	0	-209	-209
Shire fire authorities	0	-65	-65
<b>Total England</b>	3,156	-3,156	0

**E.29** At local authority level, the net effects of lagging contributions between 2001-02 and 2006-07 varied in absolute amounts from a loss of £38 million for Birmingham to a gain of £182 million for Westminster. The following table (Table E8) shows the top and bottom five authorities (ranked by the percentage of their grant that the incentive represents). As this demonstrates, the effects of an unmodified version of this scheme would be very significant for some authorities, who might gain or lose a sum equivalent to more than 100% of their current grant allocation.

**Table E8: Most significantly affected authorities under one year model**

Sorted by % impact on Formula Grant (before damping)	Net effect (£m)	% of grant
<b>Top 5</b>		
City of London	95.6	133.7
Horsham	3.6	76.7
Dartford	4.3	68.2
Crawley	5.8	66.5
South Bucks	1.3	64.4
<b>Bottom 5</b>		
Wear Valley	-0.7	-10.3
Shepway	-0.9	-10.4
Waltham Forest	-11.5	-11.6
South Holland	-1.9	-26.2
West Somerset	-0.9	-32.2

## Partial local assignment of business rates

**E.30** The second illustrative incentives model the Inquiry considered was a variant of the assignment work set out in Chapter 9. This model involved assigning a proportion of locally collected business rates to the local authority in which they were collected, rather than (as happens at present) having all of those revenues paid into the central pool. In the model, forecast future grant allocations did not take into account this local revenue, meaning that a local authority's total revenues would increase or decrease with growth or decline in local business rates revenues.

**Assumptions and methodology E.31** This work made use of the dataset used by CLG in carrying out the calculations for the 2006-07 local government finance settlement. It also used figures for each billing authority's business rates revenues for 2003-04 to 2005-06, as reported to CLG on NNDR3 returns, and on the NNDR1 (provisional) forms for 2006-07.

**E.32** The most significant assumption made in the model is that it uses actual historical data on changes in business rate revenues between 2003-04 and 2005-06 as the basis for its forecasts of changes in revenues for the future. This forecasting means the results of the model are highly dependent on what happened to revenues in those years. As such, the results of the model are intended to be illustrative, rather than a prediction of the future.

**E.33** Another important assumption is that under this model the total resources available to local government grow over time. This is because the model assumes that the grant provided by central government continues to grow at the same rate in the future, despite the fact that local authorities now have a new revenue source from which they can also benefit, namely buoyancy in local business rates. This means that over time total resources (locally assigned business rates and central government grant) grow more quickly than they otherwise would have done (assuming a fixed Spending Review allocation for local government grant).

**E.34** For the purposes of the modelling, the Inquiry team assumed that business rates revenues would grow in the exactly the same way as they have done in the most recent five years and that the remaining grant from central government would continue to growth at about 3 per cent per annum in real terms. From 2006-07 to 2009-10 Formula Grant is therefore forecast to grow by about 9 per cent and locally assigned business rates by about 14 per cent. Growth of business rates in 2010-11 is lower than forecast growth in Formula Grant by about one per cent. Over the period 2006-07 to 2010-11, this model would have required the Government to find additional resources totalling around £426 million in order to maintain Formula Grant increases as well as allowing local authorities to retain some of business rates growth. This model therefore differs from the lagged contributions model discussed earlier, which redistributes within a fixed pot of resources.

**E.35** For two tier authorities half of business rates revenue was assumed to remain with the shire district, and the other half went to the relevant shire county. In London and metropolitan areas, all the gains (and losses) were modelled as being kept by the billing authorities. Police and fire authorities were not included. The City of London was also excluded because of its exceptionally high business rates tax base.

**E.36** All figures are adjusted to 2006-07 prices, in line with the rest of the Inquiry's forecast work on assignment of taxes.

### Calculating the 'tipping point'

**E.37** The model was designed so that in the first year (2006-07) no local authority received more from the combination of government grant and locally assigned business rates than they would do from the normal 2006-07 settlement (before damping). It therefore assumed that, in the first year of the scheme, government grant is reduced by the amount of locally assigned business rates.

**E.38** The 'tipping point' at which one authority's grant is entirely replaced by locally assigned business rates would first be reached for South Bucks District Council which becomes fully locally funded if 16 per cent of business rates are retained locally (in this case, being shared between the county and the district). The model was therefore set to assign all local authorities 16 per cent of local business rates revenues, which totals £2.8 billion. This percentage is assumed to remain fixed into the future so that an authority can benefit from growth in business rate revenues.

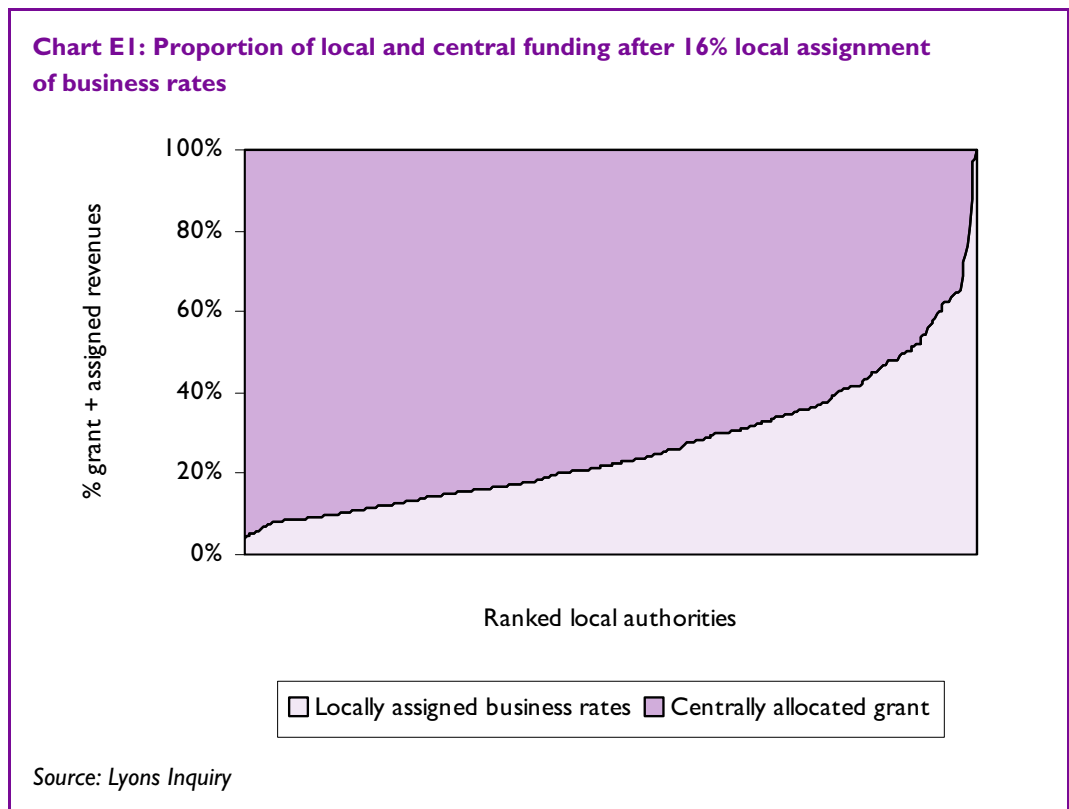
### Proportion of funding from assigned revenues

**E.39** The incentives created by this option are likely to differ between authorities depending on both the size of the local business rates base in absolute terms (how much money is collected each year) and what proportion of their total funding comes from locally assigned revenues. Areas with high tax bases would stand to gain significant additional revenue from even low growth rates. Areas where locally assigned revenues are a substantial proportion of total funding would face the strongest incentives to act; whereas the incentive is dampened for those authorities who have a small tax base and high needs, because they are guaranteed most of their income from central government regardless of how much the business rates tax base grows.

**E.40** The proportion of funding represented by locally assigned revenues would differ between areas. In the model, authorities in Yorkshire and Humber and the North East receive, on average, over 80 per cent of funding from central government grants, with 20 per cent coming from locally assigned business rates, due to authorities in those regions generally having high grant allocations and a lower tax base than other regions, while local assignment represented a higher proportion of resources in the East of England and the South East.

**E.41** By authority class, shire districts and unitary authorities could see the most substantial shift from central grant to funding from locally assigned revenues. This is partly because they have lower grant on average, and so even a low level of locally assigned business rates replaces a higher proportion of grant.

**E.42** At the local authority level, there is significant variation in the amount of funding that assignment of 16 per cent of local business rates represents. For example, in South Bucks 100 per cent of revenues would come from grant and assigned business rates combined, whereas in Lewisham they would only represent only four per cent. The proportion of each authority received from the 16 per cent assignment is shown in the chart below.



**Impacts E.43** The tables below show the additional or reduced revenues that authorities would receive in each of the years of the model, compared to a situation in which existing arrangements for the distribution of grant and business rates continue to operate, on the assumptions detailed earlier in the chapter.

**E.44** London and the South East would have seen the largest increase in funding under assignment of this kind, if previous growth was projected forward. These areas have larger tax bases and have seen relatively better growth in their business rates tax bases. Local authorities in the South East on average have the highest funding from locally assigned revenues.

**Table E9: Additional resources by region from 16% assigned business rates**

All figures £	2007-08	2008-09	2009-10	2010-11
North East	6,226,198	7,676,805	6,071,457	955,676
North West	21,081,413	22,741,573	16,387,876	- 15,039,743
Yorkshire & Humber	11,316,271	9,588,302	4,288,653	- 12,878,316
East Midlands	1,946,847	14,127,019	4,284,377	- 8,880,614
West Midlands	6,623,557	8,504,327	3,003,840	- 15,000,016
East of England	14,955,095	20,851,434	13,265,270	- 3,542,601
London	42,506,702	45,578,412	40,569,456	9,191,975
South East	35,050,591	58,507,549	36,145,164	- 6,662,634
South West	9,629,936	16,554,499	11,606,140	- 11,111,208
<b>Total England</b>	<b>149,336,611</b>	<b>204,129,919</b>	<b>135,622,234</b>	<b>- 62,967,481</b>

**E.45** By authority class, shire districts, metropolitan districts and unitary authorities see the largest increase in funding.

**Table E10: Additional resources by class from 16% assigned business rates**

All figures £	2007-08	2008-09	2009-10	2010-11
Inner London	23,592,421	26,524,550	22,676,433	12,918,026
Outer London	18,914,280	19,053,863	17,893,024	- 3,726,051
Metropolitan districts	30,903,229	41,968,011	26,777,692	- 11,970,636
Shire counties	26,679,695	33,314,760	14,704,445	- 33,321,047
Shire districts	21,121,666	43,751,900	38,635,233	323,500
Unitary authorities	28,125,318	39,516,835	14,935,408	- 27,191,273
<b>Total England</b>	<b>149,336,611</b>	<b>204,129,919</b>	<b>135,622,234</b>	<b>- 62,967,481</b>

**E.46** The tables below illustrate the local authorities most affected – both positively and negatively – in this model of partial local assignment of business rates by showing the model's results for 2007-08 and 2010-11. The authorities who gain vary, and gains and losses can be quite significant as a proportion of their current grant (partly this reflects the decision to split revenues 50:50 between districts and counties, given the

much smaller size of district budgets). This is also extremely sensitive to assumptions about growth in business rates.

**Table E1 I: Illustration of authority level impacts from 16% assigned business rates**

Sorted by change as % of Formula Grant	2007-08			2010-11	
	Change in resources (£)	As % grant + NDR		Change in resources (£)	As % grant + NDR
<b>Top 5</b>					
Wokingham	1,276,613	10.0	Dartford	1,707,489	18.9
Horsham	575,194	9.8	Spelthorne	876,401	14.2
Tewkesbury	448,640	7.9	Harlow	830,983	9.3
Dartford	607,360	7.9	Fareham	613,653	9.1
Windsor & Maidenhead	960,053	7.6	Watford	654,906	8.4
<b>Bottom 5</b>					
Vale of White Horse	123,340	-1.8	West Somerset	335,985	-10.9
Selby	119,049	-1.9	Elmbridge	871,929	-13.6
Harborough	98,244	-1.9	Selby	1,00,5704	-17.6
South Holland	289,666	-3.6	Hart	677,604	-21.1
West Somerset	152,882	-4.9	Windsor & Maidenhead	2,706,754	-24.7

## ASSIGNMENT OF INCOME TAX

**E.47** This section of the annex reports on national and local assignment, both of which are fixed over time rather than variable. It focuses solely on the assignment of income tax, given the potential advantages of this form of taxation for assignment as discussed in Chapter 9.

### A national fixed assignment

#### Assumptions and methodology

**E.48** This model tested the impact of assigning a proportion of income tax over a ten year time series of changes in income tax yield, starting in 1996-97 and running to 2006-07. The impact of the changes in income tax yield were then compared against what

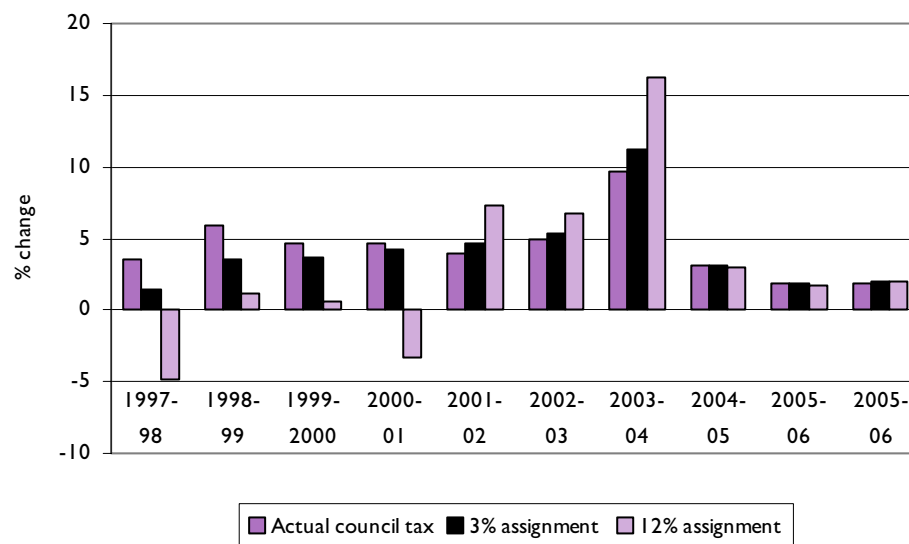
would have happened if there had been no assignment, and local government had continued to receive Formula Grant as now.

**E.49** It was important to provide a consistent basis to compare the impact of buoyancy from assigned income tax against what local authorities would have received under Formula Grant. In order to achieve this, the level of net Aggregated External Finance (AEF) was adjusted to take account of the introduction of Dedicated Schools Grant (DSG). The model estimated spending on schools using DSG in 2005-06 to derive schools' spending in previous years by assuming net AEF growth was at the same rate as schools spend. The estimated spend on schools was then deducted from net AEF in all years prior to 2006-07.

### Further national results

**E.50** As discussed in Chapter 9, if the buoyancy from a national fixed assignment was used to offset pressure on council tax, the variable nature of income tax revenues is such that this could cause year on year fluctuation in council tax. The greater the level of assignment, the greater the fluctuation. This is shown in chart E2.

**Chart E2: Real terms council tax increases: actual compared to impact of offsetting buoyancy from 3% and 12% assignment of income tax**



Source: Lyons Inquiry

## A fixed local assignment

**E.51** A fixed local assignment requires a different form of modelling compared with national assignment since it must take account of two variables: the strength of each authority's income tax base, and the amount of Formula Grant they currently receive. It also differs from national assignment as the 'growth' in income from a local assignment is both from the buoyancy of the assigned tax and from any increase in the tax base. As explained in Chapter 9, a fixed local assignment would enable a local authority to keep a proportion of the revenue from any increase in tax base.

**E.52** It is not possible to control accurately for changes in function at the local authority level. Therefore, the modelling of a local assignment used forecast models of income tax increases based on historic trends projected forward, rather than using an



historic time series, as in the modelling of a national assignment. Any buoyancy from a local assignment is compared against the grant levels from 2006-07, and all forecasts are presented in 2006-07 terms.

**E.53** As described in Chapter 9, the amounts that were used in the modelling of a local assignment were £3.4 billion and £13.1 billion, reflecting the amounts used in the modelling of national assignment. The first represents the 2006-07 amount of Revenue Support Grant, that is the element of Formula Grant that is paid from general national taxation rather than business rates. The second is based on a re-working of Revenue Support Grant as if Dedicated Schools' Grant had been financed from both business rates and Revenue Support Grant, rather than just RSG.

### Benefits of the starting rate of income tax

**E.54** As stated in Chapter 9, it was decided that starting rate income tax was the best form of income tax to use, due to its lack of variability between areas and its relative buoyancy.

**E.55** It should be noted that any positive buoyancy in this tax band is a result both of policy changes and any growth in yield. The policy changes that have affected income tax include the up-rating of taxable bands in line with annual indexation increases. From 2005-06 to 2006-07 the taxable amount of income from the starting rate and basic rate increased by £60 and £840 respectively. It is not possible to disaggregate these effects. However, although the taxable amount of income under the basic rate increased by 14 times as much as the starting rate, the buoyancy of the two for that period were very similar. This suggests that growth in tax base, rather than policy changes in taxable bands, was the main driver in the buoyancy of starting rate tax. Table E12 enables a comparison between buoyancy in all income tax, starting rate, basic rate and higher rate income tax bands from 2000-01 to 2006-07.

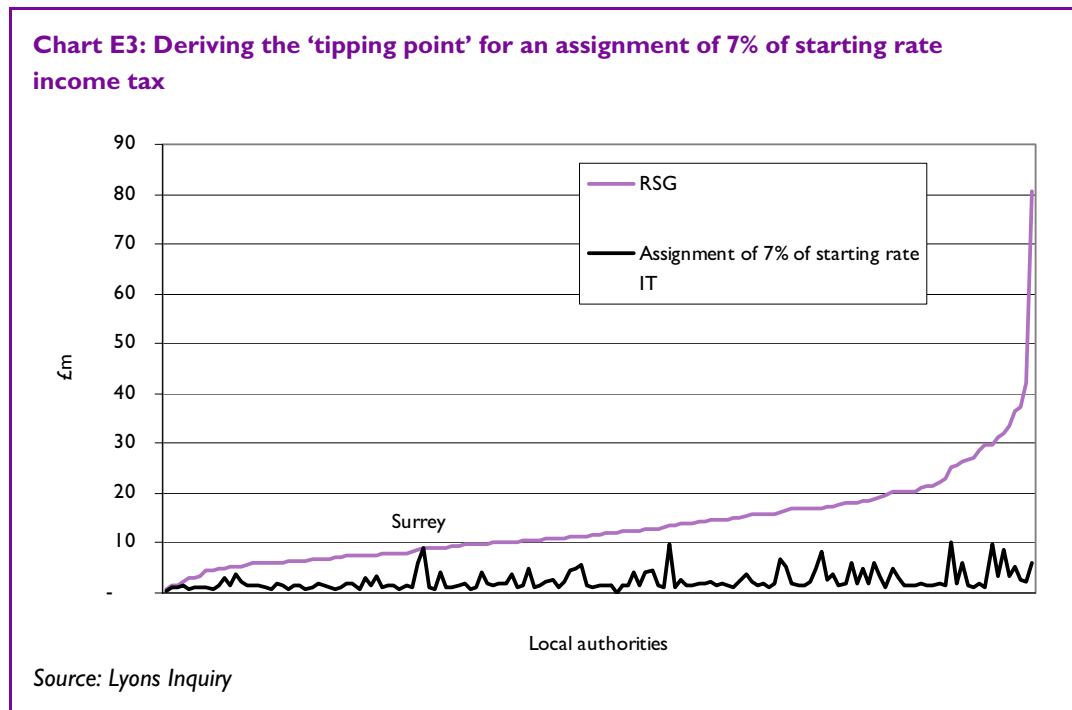
**Table E12: Comparisons of buoyancy of all, starting, basic and higher rate income tax, real increases indexed (2000-01= 100)**

	Starting rate	Basic rate	Higher rate	All income tax
2000-01	100	100	100	100
2001-02	118	100	101	101
2002-03	117	99	96	99
2003-04	113	93	90	89
2004-05	116	97	99	99
2005-06	119	100	103	102
2006-07	121	102	107	105

### Establishing the point at which to set the local level of assignment

**E.56** As set out in Chapter 9, one of the criteria that was applied to the design of a local assignment was that no authority should, in the first year, receive more support than they would have done from Formula Grant in that year. Once this 'tipping point' had been reached this set the level of local assignment for all local authorities. This is a major constraint on the impact of local assignment but one which was considered necessary to control, at least initially, divergence between local authorities.

**E.57** Chart E3 below is a graphical representation of this tipping point for £3.4 billion. This point is reached by comparing the levels of starting rate income tax for each authority against their level of Formula Grant. As is shown in this chart, Surrey is the first authority for which the lowest proportion of starting rate income tax ‘covers’ their Formula Grant. This reflects both that they have a high income tax base and a low level of Formula Grant before damping. The tipping point for an assignment of starting rate income tax equivalent to £3.4 billion is 7 per cent of starting rate income tax and the point for an assignment of starting rate income tax equivalent to £13.1 billion is 28 per cent of starting rate income tax.



### Forecast models

**E.58** As stated above, a forecast model was chosen because replacing an element of Formula Grant at a local authority level historically is not possible as year on year functional changes in Formula Grant makes the data incomparable over time. Forecasting, however, leaves the model highly sensitive to alterations in forecasting methods applied. The results are therefore susceptible to changes accordingly.

**E.59** Two forecast models were developed: first, a ‘classic’ model which developed starting rate forecast projections by mirroring historical real percentage changes in income tax for individual local authorities; and second, an ‘optimistic’ model which projected by mirroring forwards the historical real percentage changes of the local authority with the highest average annual growth in each region from 2003 to 2005 to all local authorities in its region.

**E.60** Further national results of a local assignment are given below based on both the ‘classic’ and ‘optimistic’ model, and the size of the local assignment. This is set out by two date points and discussed in terms of the impact on council tax bills. It shows the extent of variation in impact, both for those authorities which saw an increase in bills on average, and for those which saw a decrease in bills.

**Table E13: Impact of 7 % and 28% starting rate assignment, 2007-08 and 2010 -11**

	Classic forecast model		Optimistic forecast model	
	2007-08	2010-11	2007-08	2010-11
<b>7% starting rate assignment</b>				
Range of changes	-0.14% to 0.20%	-0.13% to 0.90%	-0.37% to 0.21%	-0.57% to 0.29%
Decrease in band D bills:				
- proportion of local authorities affected	34%	6%	38%	89%
- average decrease in band D bill	0.03%	0.06%	0.13%	0.19%
Increase in band D bills:				
- proportion of local authorities affected	66%	94%	62%	11%
- average increase in band D bill	0.05%	0.20%	0.09%	0.07%
<b>28% starting rate assignment</b>				
Range of changes	-0.55% to 0.76%	-0.51% to 3.53%	-1.45% to 0.82%	-2.21% to 1.13%
Decrease in band D bills:				
- proportion of local authorities affected	34%	6%	38%	89%
- average decrease in band D bill	0.11%	0.22%	0.50%	0.72%
Increase in band D bills:				
- proportion of local authorities affected	66%	94%	62%	11%
- average increase in band D bill	0.21%	0.77%	0.33%	0.27%