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## Funding reform – an introduction

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### Summary

This chapter introduces a series of issues around reform of the local government funding system, and sets out my objectives for reform.

My recommendations on funding reform are guided by a series of broad objectives, in the context of the wider vision of place-shaping local government described in earlier chapters. Reform will often need to strike a balance between competing aims, and take account of tensions between different parts of the funding system.

Achieving a change in the balance of funding is not of itself a driving objective of this Inquiry. Recent changes to schools funding demonstrate that altering the headline balance of funding may have little impact on local authorities' freedom to set locally appropriate spending plans, and can in some circumstances reduce their ability to do so. Instead it is important to focus on the underlying causes of pressures on local budgets, and to ensure flexibility and accountability in both tax and spending at the local level.

Tax policy should have regard to a set of general principles for good taxation, and should consider the elements that contribute to a good local tax. Taxes on property (and land) have particular advantages as local sources of revenue.

There is however no 'golden key' to reform of local government funding. Reform will require a series of complementary measures, implemented over time, both to deal with the immediate challenges facing the funding system and to pave the way for wider choices in the future.

### OBJECTIVES FOR REFORM

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6.1 I have said that my overriding objective is to enable all local authorities to become strong, effective, place-shapers; confident in their role and direction, actively engaged with citizens and communities, and ready to contribute to our development as a prosperous, cohesive and fair society.

6.2 In that context, reform of the local government funding system should aim to do two things. Firstly, funding reform should complement my recommendations on changes to the role and function of local government. Secondly, it should address those aspects of the current funding system which may act as a barrier to local choice and effective place-shaping, including those elements which contribute to strained central-local relations, or undermine public trust in local government.

6.3 Funding reform has the potential to contribute to the empowerment and renewal of local government in England. However, it is also important to recognise the limitations of what can be achieved through reform of local government finance. No reform can alter the reality that local government (indeed all government) is about making tough choices, and dealing with competing demands on finite resources. As I set out in my May report, *National prosperity, local choice and civic engagement*, it is my strong view that many of those tough choices are best made locally, through engagement with local people to achieve the best possible fit between their ambitions for local services, what they are prepared to pay for through taxes and charges, and what they are

prepared to do for themselves. Funding reform must underpin a world in which councillors can both engage the community in that conversation and respond to what they hear.

6.4 With those things in mind, my objectives for reform of local government funding are consistent with those for reform of local government as a whole. My work on the role and function of local authorities has convinced me of the importance of:

- greater local **flexibility** and choice;
- stronger national and local **accountability** based on clearer responsibilities; and
- better **incentives** for local government.

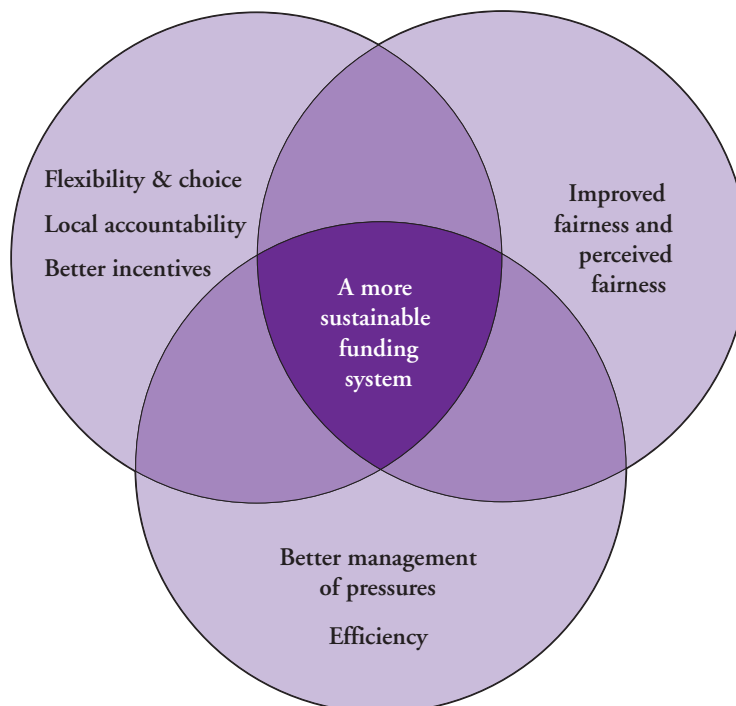
6.5 I am also clear that any reform of local government funding must, as a basic requirement, ensure that councils have access to the necessary funds to deliver against a sensible set of expectations and promises, and that they are able to spend them in a way which ensures the best value for money. To that end, I will be looking at reforms which promote:

- **efficiency** in local tax and spending; and
- better **management of pressures**.

6.6 Finally, funding reform must address the crucial issue of fairness, to ensure that the right balance is struck between the interests of different groups, and to underpin the future viability of the funding system.

6.7 I believe that by using these objectives to shape a package of reforms, we can ensure local government finance is sustainable not just in the immediate future but for the long term.

Chart 6.1: Objectives for reform



6.8 As set out in Chapter 4, some of these objectives are best pursued not through reform of the tax system as a discrete entity, but through wider reform to create greater flexibility for local authorities to direct resources to local priorities, to tailor services, and in doing so, to manage the inevitable pressures on their finances. The recommendations in that chapter reflect the fact that for reform to deliver a sustainable funding system, it must consider expenditure as well as taxation.

6.9 This chapter and the ones that follow will focus on the revenue side of the equation, as follows:

- the rest of Chapter 6 will discuss some general principles on tax policy and local taxation in particular;
- Chapter 7 will discuss the elements of local revenues that come from direct taxes and charges on local residents and service users;
- Chapter 8 will consider the business contribution to local government finances; and
- Chapter 9 will look at the way central government uses national revenues to fund local government.

6.10 I have also considered the implications of my recommendations for the other parts of the United Kingdom. A discussion of the implications is provided in a separate section at the end of the report.

### Tensions and trade-offs

6.11 It will be important, in arriving at a series of reforms, to consider how different objectives for reform may pull in different directions. The current funding system represents a particular balance between the objectives I outline above. I will explore where, in my view, a rebalancing is called for.

6.12 Important judgements include:

- what is the right balance of fairness between different groups of taxpayers?
- who do we want to target support (in the form of reliefs and benefits) towards?
- what is the right balance between taxpayer subsidy and user-charge?
- do we want a simple system for the sake of accountability, or a more complex one for the sake of fairness or local flexibility?
- how much equalisation between areas is appropriate, and how far would we be prepared to reduce it to improve the incentives acting on local government?
- which is preferable in local funding: buoyancy, or stability?

6.13 The recommendations that follow will aim to be clear about where I have taken a judgement on these issues, and where they remain open as political choices for government in future.

### Reform and the balance of funding

6.14 The reform objectives outlined above do not take finance as their starting point, but rather they are informed by the kind of place-shaping local government that we want to see. For some,

the list should also include an objective to change the balance of funding between central and local government, making local authorities more reliant on locally raised revenues and less dependent on funding from central grants.

*In our view, the calibration of the balance of funding [is one] important factor for the strategic role of local government. A significant increase in the proportion of expenditure that is raised locally would assist in the revitalisation of local democracy and its strategic role.* (Chartered Instituted of Public Finance and Accountancy)

I have considered the arguments for this but have not included ‘changing the balance of funding’ as a separate objective for reform, for the reasons that follow.

6.15 The Balance of Funding Review argued in 2004 that the proportion of revenues raised locally was important for two reasons. Firstly, they considered that the centrally-weighted balance of funding at the time resulted in heavy dependence on central grant, which weakened local accountability. This picked up the argument advanced by Layfield in 1976 that “the first requirement of a financial system for local government is accountability: whoever is responsible for incurring expenditure should also be responsible for raising the necessary revenue.”

6.16 Secondly, the Review argued for a shift towards local revenues to lessen the so-called ‘gearing effect’, which they explained as follows:

*Local authorities’ dependence on Government grant means that for every one per cent increase in spending they need, on average, to increase council by four per cent, a ‘gearing ratio’ of 4:1 ... Because of the gearing effect, comparatively small spending pressures can lead to some big increases in council tax for individual taxpayers.<sup>1</sup>*

6.17 I agree that accountability for local decisions, including decisions about tax, is an essential part of meaningful local government. Equally, it is important that the finance settlement does not put local authorities in a position where local choices about tax rates are continually overridden by external pressures. However I have some doubts about whether changing the balance of funding would, of itself, solve these problems.

**Tax as a basis  
for local  
accountability**

6.18 There is no consensus around the importance of local taxes for locally accountable government. For example, the report of Sir Peter Burt’s independent Local Government Finance Review Committee in Scotland recently argued that accountability does not pertain only to taxation.

*To us, the principal distinction between local government and local administration does not turn solely on the extent or otherwise of tax-raising powers. Accountability depends on how well the services delivered by the local authority meet the community’s needs and the power that the authority has to prioritise and shape local services, as well as to deliver them.<sup>2</sup>*

6.19 The Scottish Executive itself is a good example of accountability that does not rest on tax-raising powers. While the Executive does have a limited power to vary the standard rate of income tax, as yet this has not been used. Instead the Executive’s accountability attaches to its spending decisions and its legislative powers on devolved matters. Its autonomy from the UK Government is based not on fiscal independence, but in the constitutional settlement set out in the Scotland Act 1998.

6.20 The position of local authorities in England is rather different: they do raise taxes, and should rightly be accountable for them as well as for their spending decisions. As discussed in Chapter 3, accountability for council tax is highly confused, and the division of central and local

<sup>1</sup> *Balance of Funding Review – Report*, ODPM, 2005.

<sup>2</sup> *Local Government Finance Review Committee, Scotland, A Fairer Way*, 2006.

responsibility for the spending it supports is unclear. However, it is not obvious that a new or larger local revenue stream would of itself create greater independence from central government. Indeed, greater responsibility for painfully accountable revenue-raising, if it came without greater discretion about the services and outcomes being pursued, might be the worst of all worlds.

**The impact of the ‘gearing ratio’**

6.21 Similarly, the ‘gearing’ problem may in fact be a secondary issue: a symptom of the limited scope councils have to manage spending pressures, rather than the root cause of those pressures. The New Local Government Network have suggested that in some circumstances, changes to the balance of funding or ‘gearing ratio’ (the proportion of the total budget that is raised locally) will not have the desired effect on either local accountability or local discretion over budget increases. For example, changes that notionally reduce the weight of central funding in the system will have little impact on gearing if local authorities are still restricted in their ability to prioritise and cannot exert a deciding influence over the level of budget increases.

*The gearing ratio is a symptom of a deeper failing. It is the lack of local discretion and flexibility that must be removed.*<sup>3</sup>

6.22 I agree that finance reform should aim to tackle the underlying objective of greater local flexibility to deal with pressures, and that focusing on the gearing ratio itself might not achieve the right result. This view is informed by the fact that the ratio itself is susceptible to different definitions. Council tax represents a different proportion of total revenues depending on what classes of income are included, and importantly, recent changes to schools funding show clearly that altering the ratio may do very little to relieve pressures on council tax.

**Schools ring-fencing and the new balance of funding**

6.23 In the past, funding for education was provided to local authorities as part of their Revenue Support Grant (RSG). Over the years however it became increasingly earmarked for schools spending, and in 2006-07 was formally ring-fenced as Dedicated Schools Grant (DSG), allocated directly to authorities by the Department for Education and Skills, rather than through the Revenue Support Grant system run by the department for Communities and Local Government.

6.24 Since specific grants are traditionally omitted from the definition of local budgets used to assess the balance of funding, the removal of Dedicated Schools Grant appears, on the face of it, to radically alter the composition of local budgets. The balance of funding has, on the face of it, changed in local government’s favour: council tax now provides around half of all local revenue, in theory reducing the gearing effect by half.

**Table 2: Balance of funding before and after ring-fencing of Dedicated Schools Grant<sup>4</sup>**

	2005-06 Pre-DSG £ billion (%)	2006-07 DSG removed £ billion (%)
Council tax	21.0 (32)	22.0 (51)
Business rates	18.0 (27)	17.5 (41)
Revenue Support Grant	26.7 (41)	3.5 (8)
Total	65.7	43.0

Source: Public Expenditure Statistical Analyses 2006, and Budget 2006.

6.25 Yet my discussions with local authorities do not suggest that this change in the gearing ratio has made pressures feel any lighter. Indeed, pressures may now be more acute, since local flexibility

<sup>3</sup>New Local Government Network, *Pacing Lyons: a route map to localism*, 2006.

<sup>4</sup>Balance of funding here defined as in the Balance of Funding Review 2004: council tax as against business rates and RSG.

over budgets has been further reduced by the introduction of a new ring-fence. It may be that the pressures which have driven council tax increases were not driven by schools spending anyway – that area has seen generous support from many local authorities and from central government, and its funding was heavily protected even before ring-fencing, and could not generally be diverted to other services.

6.26 I recognise that the Government’s decision to ring-fence schools funding was not taken in isolation, but was the culmination of a longer process aimed at reflecting education’s status as a national priority. Education funding was already being ‘passport’ directly to schools, reflecting ministers’ concern that announcements of new funding for schools should feed through to them directly. Ring-fencing may have been the natural conclusion of that process. However it has undeniably reinforced a world in which local communities’ flexibility to determine spending plans continues to be highly constrained.

6.27 The example of DSG ring-fencing shows that gearing is not, of itself, the cause of pressures on council tax; it is rather a symptom of, and a way of expressing the nature of that pressure in relation to council tax and the wider budget. Changing the wider budget without changing the pressure does not make any real-world difference to council taxpayers, who are still faced with the same percentage increase in their bills.

6.28 The key question for this Inquiry is therefore not “how can we alter the gearing ratio”. Instead the primary concerns are: understanding where pressures come from; being clear where central government has some responsibility for them as well as local government; and asking what options are available locally for managing them. My recommendations will consider the impact of change not just on the headline balance of funding, but on the wider financial flexibility that councils need in order to be able to manage pressures and be accountable for the decisions they make about spending levels and tax rates.

### The principles of good taxation

6.29 My objectives for reform are rooted in my analysis of what needs to change in order for local government to become more empowered and effective. Any tax change must of course also take into account the wider impact of tax policy on the UK’s economic stability and competitiveness, and on the government’s fiscal balances. These are primarily matters for central government, and beyond the scope of this Inquiry. However my recommendations will have regard to some other general principles on taxation, which should apply equally to local as to national taxes.

6.30 Broadly speaking, taxes can serve two purposes: raising revenue, and providing incentives to alter behaviour in line with policy objectives. The balance of these two purposes will differ between taxes. For example, duty on cigarettes or alcohol may have as a key objective reducing consumption of those goods, but will also represent a source of revenue, whereas the design of income tax systems will generally seek to raise revenue, while minimising the impact of the tax in terms of discouraging people from working.

6.31 Despite the significant changes to the structure of local taxes over the past twenty years, both council tax and business rates exist, in their present forms, primarily to raise revenue, and together support a large proportion of local authority spending. I have received a number of submissions arguing that other policy objectives might be integrated into these local taxes: for example, supporting environmental policy by offering homes and businesses a financial incentive to install energy-efficient features. I will consider some of these measures in the chapters that follow. However I am clear that my recommendations must leave local government with an adequate and sustainable revenue base, and that revenue generation is likely to remain the central

purpose of the main local taxes. I will look at whether supplementary sources of revenue might be used to influence behaviour or create incentives to support wider policy.

6.32 Beyond this, recommendations on taxation will consider the impact of change in terms of:

- economic efficiency – avoiding unintended consequences, including those which impact unacceptably on the taxbase itself, minimising negative tax competition, and ensuring macroeconomic stability is not compromised;
- equity – so that taxpayers in similar circumstances pay similar amounts (horizontal equity) and differences in circumstances are reflected in tax liabilities (vertical equity); and
- administrative value for money – so that the compliance costs of paying or collecting a tax are not unacceptably onerous.

6.33 Of course, balancing these objectives requires political judgment: good taxation should follow these principles but tax setting will never be a wholly objective, value-neutral process. For example, deciding what sort of equity to aim for is a matter of judgement. Taxing on the basis of ‘similar circumstances’ might reflect income, wealth, property value, business turnover or other factors, and might be assessed in a single year or over time and between generations. In making my recommendations, I will aim to be clear about where they leave room for such political judgements (at national or local level) to be made by those elected to that responsibility.

### What makes a good local tax?

6.34 Within these broad parameters it is also necessary to consider which taxes are particularly suited to local control. Submissions to the Inquiry have suggested a wide range of possible sources of supplementary revenue for local authorities, and it is beyond the scope of this report to do justice to them all in detail. In focusing my analysis on a few lead options, and weighing their suitability, I have been guided by some general criteria on what makes a sensible local tax.

**Breadth and evenness of the tax base** 6.35 If a local tax is to operate primarily as a revenue-raising tool, it may be desirable that the tax is broadly based, so that a large section of the local population are liable to pay. This provides less scope for individuals and businesses to avoid tax, and may help ensure that citizens’ preferences about service provision are also informed by their willingness, as taxpayers, to meet the costs of services. It can also ensure that local authorities’ revenue streams are less subject to cyclical or structural changes in society and the economy, creating more certainty about future revenues.

6.36 It may also be desirable that the taxbase is spread relatively evenly across the country, minimising the need for equalisation between areas. It is a matter for judgement how much variation is sustainable: for example taxbases for council tax are relatively variable between areas, but council tax does still provide substantial revenues for all local authorities.

**Tackling local externalities** 6.37 There is a strong case for local fiscal instruments where they can be targeted in ways that deal with locally-concentrated problems, especially those which are not apparent in the market cost or price paid (what economists term ‘externalities’). This particularly applies to taxes that are aimed at changing behaviour. If the problems, or the actions necessary to solve them, are unlikely to respond to local taxation, then they should properly be targeted through other means. For example problems such as congestion might respond to local financial incentives. Others may require action on a wider scale; for example packaging of consumer goods, which may not be so susceptible to action at local authority level. In some circumstances, it might be appropriate that use of a local



tax is concentrated in only some areas, for example, where it aims to change behaviour in particular groups, or to deal with an externality that is not present everywhere.

**Avoiding distortions** 6.38 Local taxation should operate in a way that minimises distortions, particularly where locally variable taxation might create unfair competition between different areas. Ideally, local taxes should be levied on taxbases which cannot migrate easily (property being a good example), and which avoid creating perverse incentives.

6.39 For example, sales taxes operate successfully at the local level in some countries, including in many cities in the United States. However, there is not a tradition of variable sales taxes at the level of English local authorities, and it would be reasonable to ask whether, at that spatial level, they might create some unwelcome effects, such as creating incentives for particular kinds of retail developments, or altering traffic patterns between areas with different tax rates.

6.40 In practice, the UK's existing tax on consumption of goods and services, Value Added Tax (VAT), is subject to a number of restrictions in European Union law and could not be legally adapted to allow for local variation. Any local sales tax would therefore need to operate alongside VAT, which introduces a range of wider questions about the appropriate balance of different taxes in the national economy and on particular goods and services, which is a matter for ministers. In light of these obstacles, I have not pursued local sales taxes as an option in this report.

### Land and property taxation

6.41 In the chapters that follow I consider a number of different types of tax that could contribute to local government revenues. Two of the most important local taxes (council tax and business rates) are both forms of land and property taxation, and are examined more fully in Chapters 7 and 8. In order to set that discussion in context it is useful to summarise the benefits and drawbacks of these types of tax, based on the very wide literature on these issues.

**Taxation of economic rent** 6.42 Most economists would agree that there is a strong case for levying taxes on land. Land is in fairly fixed supply, and much of its value will therefore be what economists call 'economic rent', which can be taxed without altering the incentives to use the land.<sup>5</sup> The fact that much of the value of land is the result not of the actions of the owner, but the activity and investment of the wider community – for example, by providing transport connections, desirable schools or accessible markets – makes the case for such taxation even stronger. Taxing only the value of the land, not the use to which it is put, or the buildings and other improvements constructed on it, could also ensure that there is no distortion created by the tax system between the types of activity that might be undertaken on the land.

6.43 Land value taxes have been proposed on a number of occasions in the past, perhaps most notably in the Budget of 1909, because of these advantages. A number of groups, from the Land Value Taxation Campaign to the British Retail Consortium, supported the idea of a land value tax in their submissions to the Inquiry. For example, the BRC argued that:

*Land Value Tax (LVT) has a number of advantages. These include not distorting behaviour in the same way as taxes on income and profits do, LVT's potential effectiveness in incentivising the efficient use of land (as all land would incur a charge even when it was not being used for productive activity) and taxing land values could also enable local governments to profit from some of the increase in value as a result of a prosperous local economy.*

<sup>5</sup>Economic rent is a complex economic concept and definitions vary. Broadly speaking it means the difference between the return made by a factor of production (i.e. land, labour or capital) and the return necessary to keep the factor in its current occupation.



- Taxing property to widen the tax base** 6.44 There are also some arguments in favour of taxing the property built on the land, as well as its basic value as land. In general, taxes should be applied to as broad a base as possible in order to reduce the tax rate needed, and thus the potential distortions created. Taxing the value of improvements as well as land values can help to expand the size of the property tax base, and a number of land value taxes used around the world actually levy a tax on improvements for this reason.<sup>6</sup> On the negative side, however, the taxation of the value of property as well as the land value could distort activity by discouraging investment in development and improvements.
- Economic stabilisation** 6.45 Well-designed taxes on the use of land and property can in theory contribute to the stability of the property market, and thus to the stability of the economy overall. With a flat rate tax on up-to-date property values, tax bills would tend to increase during periods of growth, and fall during downturns. In an upturn, the cost of consuming a particular amount of property would therefore tend to increase, reducing demand for it, and motivating property owners to make full use of their property (for example by renting out a room). In a downturn, the opposite would occur, helping to soften the impact, and these effects should reduce the magnitude of changes in property prices.<sup>7</sup>
- Reducing other taxes** 6.46 Raising tax revenues through land and property taxes has the additional advantage that it could allow for reduced taxes on profits and incomes, thus reducing the disincentive to effort and success that such taxes can create.
- Administrative advantages** 6.47 There are also a number of advantages to land and property taxes from an administrative perspective, related to the fact that land and property are in the main immobile, and relatively straightforward to identify for taxation purposes. As a result, they are difficult to avoid and cost-effective to collect because those liable to tax cannot move their property elsewhere to avoid taxation, or hide their property to evade taxation. Indeed, some tax experts argue that the ability of large multinational companies to reduce their liability to taxation on their profits by moving profits between different countries will make property taxes increasingly important in the future because they are less easy to avoid.
- 6.48 A further advantage cited is that the yield from property taxes is predictable and stable, due to the fact that the tax base can be measured reasonably easily and is unlikely to change rapidly from year to year. This is particularly true of council tax in its current form; other property taxes, particularly if they reflect changes in actual property values, might fluctuate more.
- Advantages as local taxes** 6.49 Land and property taxes are used around the world as local taxes, and there are a number of reasons for this. The relative simplicity of assessment and collection and the difficulty of evasion, mentioned above, are all important. In addition, taxing property locally has the advantage that it can provide a strong connection between the tax people pay and their residence in an area. Taxes on property value reflect residents' (and owners') financial stake in a community and its prosperity, and their interest in local services and investment, which themselves impact on the desirability of property in a given area.
- 6.50 There can be tensions between the different possible purposes of land and property taxes. For example, the regular revaluations needed if the tax is to remain up-to-date may make bills and revenues less predictable for taxpayers and tax authorities, and create administrative costs, and the variable rates of tax needed to fund local authorities' different spending choices could be in conflict with the consistent rate of tax desirable to perform a market stabilisation function. These tensions need to be borne in mind when considering reforms.

<sup>6</sup>NERA Economic Consulting, *Options for Reforming Local Government Funding*, Lyons Inquiry, 2005.

<sup>7</sup>Muellbauer, J., *Property, Land and Taxation after the Barker Review*, 2004.

## FRAMING A PACKAGE OF REFORM

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6.51 As set out in Chapter 3 there is, I believe, a strong and growing case that change is necessary. The ‘no change’ option is itself a painful one: the pressure on local services, on council tax as the only local tax, and hence on council tax payers, will not disappear and may indeed sharpen in some areas as growth in total public spending slows down in the coming years. I believe there is enough evidence to justify action to make the finance system more sustainable into the future.

6.52 However, although it is true that the status quo is problematic, it is very clear that there are no easy options for change, and no simple ‘golden key’ that will unlock the problems of the funding system. Taking the pressure off council tax, or reducing the burden on a group of taxpayers, implies a cost to some other group or part of the system. If less tax is collected locally, then either services must be cut back, or other taxpayers must contribute more, either through local or national taxation. Any change in taxation creates ‘winners’ and ‘losers’, with those who pay more tending to react much more strongly to change than those who benefit. Deciding whether any change is acceptable is therefore a highly political decision.

6.53 Efficiency will always have a part to play in getting the balance of tax and spending right, and I wholeheartedly endorse the push for greater efficiency and value for money in local spending. However, it is not clear that efficiency gains alone can absorb the pressures on local government in the medium term, or at least not without some cuts to services which may run counter to local preferences. The question, then, is what wider structural changes to the finance system may be necessary.

6.54 My central proposition is that a mosaic of changes, implemented over time, is the best way to move forward. My work has convinced me that no single change could of itself deliver a sustainable finance system. And, given the tensions I outline above, a package of complementary measures will be crucial if we are to balance the impact of change on different groups in an acceptable way.

6.55 Equally, I believe that a developmental approach to reform is the right way to proceed. While a ‘big bang’ reform has been urged by some, I think that this would be unacceptably disruptive, and unlikely to find the public support which would be critical in order to create space for ministers to successfully pursue reforms. In that context, the difficulty of agreeing a single package might lead to those reforms which could otherwise be made quickly being delayed.

6.56 In the following chapters I will examine a range of options for reform of the local government finance system. In doing so I will outline the changes that I think should be implemented in the short term to address the most urgent problems in the system, but also with a view to paving the way for greater ambition in future. Chapter 10 will draw together my recommendations to show how a developmental model might allow for reform to be taken forward over time.