Local Government Funding

A Local Government Knowledge Navigator Evidence Review

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THE NEED TO KNOW SERIES

This evidence review on **Local Government Funding** is part of the ‘Need to Know’ series, which has been commissioned by the Local Government Knowledge Navigator.

‘Need to Know’ reports are summaries of available research-derived knowledge and evidence relevant to topics that have been identified to the Knowledge Navigator as priorities by local government. They:

- Highlight key areas of relevant knowledge
- Signpost where the evidence can be accessed in more detail, and
- Identify where research investment has potential to meet any gaps identified in that knowledge and evidence base.

THE LOCAL GOVERNMENT KNOWLEDGE NAVIGATOR

The Local Government Knowledge Navigator is a two-year initiative funded by the Economic and Social Research Council (ESRC), and steered by ESRC, Local Government Association and Society of Local Government Chief Executives.

It was launched in January 2013 with the aim of helping local government to make better use of existing national investment in research and research-derived knowledge and evidence, and to influence future research agendas, programmes and investment. The Knowledge Navigator team is Tim Allen, Dr Clive Grace and Professor Steve Martin.

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EXECUTIVE SUMMARY

Local Government is facing a major funding challenge as a result of a combination of political economic and cultural factors. In particular, demand for services has grown and funding has fallen.

There is a call by many to change the local government finance system, and the start of that change can be seen in the devolution agenda. This brings with it huge opportunities, but it is essential that the policies going forward are well thought through if they are to stand any chance of achieving economic growth and fiscal stability in the long term.

For new approaches to succeed it is important that they are based on a solid foundation of high quality evidence-based research. Identifying what works, and having factual evidence to understand the reasons for success, gives the policymaker an essential insight. Whilst there may be constraints around timing and policy change, especially when we look at the speed at which the devolution agenda has developed, the importance of evidence-based research must be acknowledged.

This work demonstrates that the current policy framework has not, and is not, addressing some crucial underlying problems for English local government finance. Existing policy measures do not ensure funding stability for the public sector. This has led to the call now being made for fiscal devolution.

The current approach to Local Government funding is therefore being challenged. Such challenge is necessary if services are to continue to be delivered but this challenge also needs to be well thought through. Answering many of these questions is not easy, especially as the funding solution for one authority is not a solution that necessarily fits all.

Equalisation and redistribution have to be included within any local government funding mechanism and to balance these against incentives and rewards is difficult. Through national policy agendas, central government also has a huge role to play in what services are delivered so it is difficult to imagine that fiscal freedoms will come without conditions. Any renegotiation of the financial position will therefore be complex.

This document seeks to provide the reader with a comprehensive insight into the debates described, and an understanding about why more change is needed, but also an appreciation of why sufficient change has not yet occurred.
1. INTRODUCTION

WHAT IS THE PROBLEM?
Local government funding in England is complex. Over time different sources of funding have been woven into the structure and there is now an intricate system of inter-dependencies between each of the different funding streams. There are a number of criticisms of the system of local government funding system in England and these have existed for some time, the key ones are:

- The level of central control which impacts on the decisions made by local authorities and has led to the increased call for devolution away from Whitehall
- The regressive nature of council tax and the fact that English council tax bands are still based on 1991 property values
- The lack of transparency in the business rates system and the tensions between growth incentives and equalisation
- The short-termism of the Local Government finance settlement, which many argue impacts on investment and decision-making.

WHAT DOES THIS REVIEW SET OUT TO DO?
The objective of this review is to provide an overview and summary of the research and evidence available to underpin and inform the policy debate around funding for local government in England.

The review considers four sources of Local Government funding:

- Council tax
- Central government grants
- Business rates
- Fees and charges.

These elements have been central to the local government funding framework for many years, and in practice the funding each authority receives is mainly dictated by government funding formulas (DCLG 2015). It explores the discussions and debates about the principles that should underpin national funding, the challenges around local taxation, and current policy thinking and public perceptions about the issues with the current funding regime.

Over the last twenty years reports, papers, think tanks and research pieces have identified five key ideas that are frequent subjects for debate amongst commentators. These are:

- **Case for and against fiscal devolution**
  A debate heightened by the Smith Commission proposals for Scotland and the plans for English cities, as well as the public sector deficit reduction programme. This review considers some of the arguments being put forward to support fiscal devolution.

- **Short-term nature of the funding cycle**
  Short-term funding horizons have led many to argue that local government is unable to deliver on long-term growth and policy plans.

- **Council Tax freedoms for Local Authorities**
  Property tax is an essential part of the local government finance system and many commentators including Michael Lyons (2007) endorse the view that it provides a strong connection between the taxpayer and the local community. Recent debate has centred on the issues of revaluation and artificially imposed caps as a result of the referendum levels. The review considers what the consequences of granting increased freedom to local authorities in these areas might be and why central government wants to maintain the status quo.

- **Retention of business rates to increase economic growth**
  With calls to allow local authorities to maintain 100% of the business rates they collect (ICLG 2015), what impact will this have on the allocation of funding and management of risk throughout the local authorities?

- **Funding as a means of encouraging particular behaviours**
  The introduction in 2011 of New Home Bonus is an example of this type of funding. This review examines the evidence on the impact of this highly contentious grant and looks at the analysis that led the NAO 2014 report to observe: “The Department has yet to demonstrate that the new homes it is funding through this scheme are in areas of housing need and the Department’s planned evaluation is now urgent.” (PAC 2013).
Other jurisdictions around the world have different frameworks for funding local government. The review examines both the balance between central and local income sources, as well as the evidence on other approaches to funding.

In order to understand the balance between central and local funding, it is important to remember that finance is one element of a very complicated relationship between local and central government. Local government carries out many functions, some on behalf of central government, and amongst the many voices calling for fiscal devolution and greater localism it is important not to drown out the ones reminding us about the importance of central government direction.

For fiscal devolution to work, central government must be assured that national policies can be delivered locally and be confident that it can actively participate in local decision-making when appropriate. At the same time, local government also has to be satisfied that any national requirements are introduced in a way that allows genuine local consultation. In return for fiscal devolution local government must clearly evidence that it can provide strong and innovative leadership. It must gain and retain the confidence of the public by active engagement and clear performance frameworks irrespective of whether those frameworks are centrally or locally imposed. It must also be seen to work across services to improve delivery and efficiency.

There have been a number of studies since the original Layfield Committee (Layfield 1976) in the 1970s, all of which have influenced the way local government is funded. The review includes a summary of the most influential commissions and reviews, and uses these to draw conclusions on the main options for funding local government in the future.
2. CURRENT LOCAL GOVERNMENT FUNDING SOURCES

This section describes the main local government funding sources.

COUNCIL TAX

Council tax was introduced in 1993, replacing the community charge (the “poll tax”). Council tax is collected from the occupants of all domestic non-exempt properties by the billing authority. Where a property is unoccupied, liability normally falls to the owner.

The council tax bill is based primarily on the value of the property as at 1 April 1991. Properties are placed into one of eight bands between A and H by the Valuation Office Agency. The proportion of tax liability between the various bands is fixed under the Local Government Finance Act 1992.

A system of discounts and exemptions, including a ‘single person discount’ of 25% is in use to reduce the payment where appropriate. For example, most students are disregarded for the purpose of council tax and do not pay anything. The majority of these discounts and exemptions are fixed by legislation, although local authorities have some discretion over discounts on empty properties, under the Local Government Finance Act 2012. These discounts allow the amount of council tax that must be paid to be reduced as a result of different circumstances.

In 2013 as a result of the welfare reform agenda, council tax benefit was replaced by a local council tax support scheme. Under this new arrangement each local authority is required to design its own scheme to provide discounts for those unable to pay the full amount of council tax due to financial circumstances.

The council tax requirement is net revenue expenditure minus external income such as grants and income from retained business rates. The balance is left to be funded by the council tax and the actual council tax is calculated by dividing this amount by the council tax base.

The council tax base is calculated by converting the number of dwellings in each band to band D equivalents. For example, each house in band H is equivalent to two band D houses and each band A house is equivalent to two thirds of a band D house. From this amount, the value of any discounts is subtracted, for example if a single person’s tax discount (equivalent to 25%) is awarded to four houses in the same band, this would reduce the tax base for that band by the equivalent of a single house.

The band D council tax is calculated by dividing the amount to be raised from council tax by the council tax base. The council tax for other bands is then calculated by multiplying the band D council tax by the relative ratio for each band.

COUNCIL TAX INCREASES

Since 2012/13 council tax referendums legislation has applied to local authorities. This means that a council has to determine whether its council tax is excessive according to principles set by the Secretary of State. If so, it is required to hold a referendum. Many within local government see this limitation as a cap on the ability of the authority to raise income as the cost of the process is prohibitive. However, central government consider that this system allows local participation and local accountability and does not in itself prevent increases.

The first referendum under the legislation was held on 7 May 2015 in respect of the police precept in Bedfordshire.

CENTRAL GOVERNMENT GRANTS

The revenue budget is the term used to describe the amount that a council spends on its day-to-day running of services. This includes wages and salaries, property and transport running costs and payments to suppliers.

In addition to the running costs of services, councils have to fund the costs of borrowing money to pay for their capital assets and to meet the costs of certain other local service providers, such as the Environment Agency for flood prevention work, through what are known as levies. Once all these things are taken into account, along with specific grants, the figure known as net revenue expenditure is reached. From the net revenue expenditure figure any use of council reserves is subtracted to get to a budget requirement figure that is then funded from general government grant, non-domestic rates or council tax.

In 2014/15 the amount councils in England were planning to spend on services (net revenue expenditure) was £95bn (IFS 2015) compared to £102.2bn 2013/14. Councils also receive a number of specific grants from central government to support central government priorities. Schools funding is an example of a ring fenced grant.

Revenue Support Grant (RSG) is the grant paid by government to support councils’ general expenditure. RSG is now funded out of the central share of business rates. There are no restrictions on how it is to be used (within a council’s legal powers) and the amount each local council will receive is set out in the local government finance settlement.
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The local government finance settlement is announced annually and sets out the amount of funding local government will receive for the following year from central government. It also provides provisional figures for future years. A provisional settlement announcement is made in December, with the final settlement being announced following consultation in early February. There is usually little change between the provisional and the final settlement figures.

In 2013/14, settlement funding assessments replaced formula grant as the central announcement in the settlement. The assessments are comprised of locally retained business rates and revenue support grant. The value of Revenue Support Grant is calculated by subtracting the amount of locally retained business rates from the settlement funding assessment.

BUSINESS RATES

Business rates are collected from all non-domestic properties by the billing authority (the local authority, with the responsibility to collect business rates falling to the district council in two-tier areas).

Until 2013 business rates was a national scheme where all of the income raised through the collection of business rates was pooled nationally and redistributed via central government. Whilst there was a considerable amount of money collected through business rates (in excess of £20bn) the mechanism of national pooling and allocation meant that local authorities did not have a direct correlation between what they collected locally and how much they received from the national pot.

Under the Business rate retention scheme introduced in April 2013, the risk of non-collection of business rates is shared 50/50 between central and local government and there is a further split of the risk within local government between the preceptor and billing authorities. This results in an increased incentive to maximise business rate collection as well as an increased incentive to grow business rates as there is also a mechanism which allows additional income to be retained.

The Business rates retention scheme permits local authorities to keep a proportion of the increase in business rates, from a baseline based on their revenue between 2010 and 2012. This retention in most cases will not exceed 50% but two pilots for 100% were announced in the Budget and these will be subject to a set of more strenuous rules.

HOW BUSINESS RATES WORK

Business rates bills are based on the rateable value of the non-domestic property, set by the Valuation Office Agency, multiplied by the ‘multiplier’ or poundage.

For example:

Rateable value: £20,000
Multiplier: 48.2p in the pound
Business rates liability: £20,000 * 0.482 = £9,640 p.a.

There are some reliefs available on business rates, including small business rate relief; charitable relief; rural rate relief; and a series of short-term reliefs.

Properties’ rateable values are based, broadly, on their annual rental value. The last revaluation of rateable values came into effect on 1 April 2010, based on rental values on 1 April 2008. The difference between actual rents and rateable values becomes greater as the time since revaluation grows.

The Valuation Office Agency (VOA) is responsible for valuing non-domestic properties. Most properties appear on the local rating list, which is maintained by the VOA’s valuation officer for each billing authority area. A copy of the local rating list is held by the authority.

The central valuation officer also maintains a central rating list, which includes the valuations for properties prescribed by the Secretary of State in England and the National Assembly for Wales, such as those relating to utilities (e.g. gas and electricity). The billing authority must put the local rating list on public display.

The levels of business rates are governed by the setting of the multiplier and properties’ rateable values. The Local Government Finance Act 1988 provides for the multiplier to be increased by the level of the Retail Price Index in the September before the relevant financial year, unless the Treasury determines otherwise. In 2014 the Chancellor uprated the multiplier by 2%, lower than the RPI in September 2013 (3.2%).

The concept of business rates retention has generally been welcomed by local authorities. However, one of the effects of the scheme is greater volatility in local authority income from year to year, as income is based on actual business rate revenue, rather than a distribution from the central pool which is fixed at the outset of the financial year. This will require local authorities to develop stronger financial controls and risk analysis capacity, particularly with regard to appeals against business rates. Where payments are refunded because of successful appeals, under the previous system, this risk was shared in the central pool of business rate revenue. The LGA estimated that some 17.5% of total business rates revenue was subject to appeal in 2013-14, with some councils seeing up to 45% of revenue affected.

In March 2015 the government launched a Business Rate Review (HMT 2015) as a response to criticism of the system. This criticism is considered in Chapter 4.
FEES AND CHARGES

English councils have legal powers to charge for the services they provide and to recover the costs of providing those services in certain cases, but there are rules governing the amount of money that can be raised and the way that it can be spent.

At a time when funding reductions and rising demand for some services are presenting councils with difficult choices, the use of charging to support service expenditure is becoming increasingly important. In 2011/12, English councils’ income from charging was £10.2bn. This was about 10% of their total service expenditure (Audit Commission 2013).

The list of services that local authorities are able to charge for is extensive, and includes the following:

- nursery and early years services;
- school meals;
- social care;
- transport services;
- environmental health;
- sports and leisure;
- arts and heritage;
- car parking;
- planning;
- building control;
- licensing;
- burials and cremations;
- commercial waste.

Whilst for many councils total income from fees and charges was less than half the amount raised through council tax in 2011/12, income from these sources exceeded council tax in one in three district councils (32%) and one in five London boroughs (21%).

The types of charges and the amount of money generated vary between the different types of council, but the motivation behind charging is often of more interest to the public. Charges can be made in order to improve a service, reduce the financial loss of the budget overall or as a means of implementing council policy.

‘In setting charges, councils must take into account the impact on the service user. They must also understand the contribution charges make to their council’s overall financial position.’ (Audit Commission 2013)

Means testing can be important in the determination of charges for services, and its implications were originally considered in the Beveridge Report (1942). In their 2013 publication on charging, the Department of Health provided clear guidance on how councils may charge for non-residential social service care, but did not make any presumption that they will charge for non-residential social services.

However, increasing pressure on resources within local government has tended to make means testing a way of making limited resources stretch further.

An illustration of the debate around charging can be found when there is a conversation about the joining together of health and social care. The benefits of joint delivery can be evidenced and there is a common goal to deliver joined-up services around this model. The devolution of health and social care in Manchester is an excellent example of how support for joint working is moving forward. However, the basic principle that people have the right to free NHS care is not a principle that is adopted for social care and so there is a fundamental divide around how funds can be managed and income raised: one service has the ability to rationalise expenditure through budgetary control and decision-making on allocation whereas the other is demand-led.

Flat-rate charging is generally applied to services where there is a need for transparency and clear understanding of the charge. Car parking is the most commonly cited charge of this type, and is often a subject for local scrutiny. It is recognised that this does vary considerably between authorities, with councils such as Westminster able to charge higher rates than most other places. This is also one of the areas where the fundamental economic principles of supply and demand come into play. In most cases, where supply is fixed, charging a higher fee until demand is reduced to the level of supply is common practice, as this maximises income and encourages the best use of resources. However, in setting fees and charges, local authorities have a more complex set of factors to consider than merely relative supply and demand. Public interest, affordability and legislation all play a part too.

High car parking charges may deter shoppers from using a local high street, but other problems emerge if there are no parking charges. Similarly, charges for leisure and sports facilities are often the result of contract negotiations between the council and the service supplier combined with the desire to ensure full utilisation of the facilities. However, over-charging may result in wider issues for the local area. Therefore maximising income is only one of the factors to consider in relation to public sector fees and charges.

‘Whatever the value of the charge or fee, when councils recover some or all of their service expenditure by charging, they can use the income to: sustain those services (releasing funds for other purposes); improve those services; and/or reduce the need for funding from other sources, such as council tax or reserves’ (Audit Commission 2013).

The recent progressive reductions in central government grants have resulted in an increasing need for local authorities to rethink how they use the money raised from fees and charges. However, their ability to reconsider their fees and charges strategy is limited by the statutes that are in place to govern these charges. In some cases, local authorities have little power to vary the charge and, in the worst case scenario, are limited to a fee that does not cover the cost of the service provided.
3. PRINCIPLES OF TAXATION

This section considers the principles that should underline any form of taxation, as well as the more specific issues that arise with local taxes in order to provide an overarching understanding of the factors underlying the design of all systems of taxation.

**GENERAL PRINCIPLES**

Taxes are levied for two primary purposes by governments - either purely to raise revenue, or to act as an incentive for certain behaviours, as in the case of duties to reduce consumption of tobacco and alcohol.

Consideration of taxation in terms of its revenue raising gives rise to a different set of principles that are particularly relevant when taxation is prescribed and the individual has little short-term discretion over behaviours to influence its level. The Lyons Inquiry (Lyons 2007) used three key criteria against which to assess its proposals:

- **Economic efficiency** - avoiding unnecessary consequences, especially any that impact on the tax base itself, minimising negative tax competition and avoiding negative impact on overall macroeconomic policy;
- **Equity** - ensuring that taxpayers in similar circumstances pay similar amounts (horizontal equity) and that differences in circumstances are reflected in tax liabilities (vertical equity);
- **Administrative value for money** - the compliance costs of paying or collecting a tax are not unacceptably high compared to the tax yield itself.

The debate about the equity of property taxes largely centres around whether council tax and non-domestic rates are taxes on income or on wealth. Some evidence emerging from the business sector suggests that they would see more equity in a tax on business turn-over rather than property size (CBI 2013). However, there has been little challenge to the argument that locally collected council tax, when compared to the collection of income tax, is an administratively efficient form of taxation with a low relative collection cost.

The use of taxation to provide incentives is complex, and has not been a focus of extensive research or reviews of local taxes in order to provide an overarching understanding of the factors underlying the design of all systems of taxation.

**LOCAL TAXATION PRINCIPLES**

Arguments about the balance between central and local funding often make the assumption that the populations of local taxpayers and beneficiaries of services are co-terminous. However, because of commuting patterns and increasing ‘choice’ within public service delivery, this assumption is not necessarily sound. With resource equalisation, this argument becomes less relevant as the resource equalisation process takes account of differences between need and tax base.

In a report for the Joseph Rowntree Foundation, Stoker and Travers (2001) set out new centralist and localist approaches to local government finance along with a proposal for a consensus between the two which demands control not over spending but over the delivery of outcomes that achieve social and economic opportunity for all. This would recognise expectations about universal provision in services such as welfare, education, social care and policing, while allowing their delivery and funding to be negotiated between local and central government. Other services would be subject entirely to local discretion and local funding. In addition to the widely accepted principles that apply to all forms of taxation, there may be principles that become even more relevant at a local government level. Stoker and Travers set out four criteria:

- **Transparency** requires that there is a connection between spending decisions, tax raising and voting choices;
- **Equalisation** recognises that a local government finance system needs capacity to give additional resources to an area of high need or with a low taxable base;
- **Flexibility and buoyancy** suggests a need for a mix of revenue-raising powers to cope with contingencies and, in particular, any resource shortfalls; and
- **An holistic approach ensures consistency** between the diverse range of agencies that deliver local services.

Equalisation has long been a feature of the local government finance system with complicated funding formulae being used to distribute resources between individual local authorities based upon indicators of need and the ability to raise taxation. The introduction of localised business rates in 2013/14 has, to some extent, removed full equalisation from the system by fixing re-distribution at a point in time, although it does allow for a ‘reset’ of the whole system after seven years (DCLG 2013).
Promoting an holistic approach to service delivery is a challenge that the taxation system has yet to properly address. Much has been made of the need for public agencies to work together to tackle key local issues, such as troubled families, but this currently relies upon a numerous variety of local and national agencies to manage joint budgets. These joint budgets are sourced from individual agency budgets controlled under different regimes and based upon entirely different spending and resourcing constraints, including funding sources. Stoker and Travers suggest that:

‘Until and unless local authorities and other institutions are given incentives to fund services jointly, there is virtually no chance of achieving consistent and seamless provision.’

The Lyons Inquiry commissioned NERA to carry out a literature review which focused on options for changing the way local government is financed in England. They assessed the options they identified for reform against seven key criteria:

- Economic efficiency and effects on incentives;
- Equity and the redistributive impacts;
- Scope for local authorities to raise a greater proportion of their revenues locally;
- Effects on local accountability, public awareness and democracy;
- Responsiveness to local priorities;
- Flexibility, sustainability and tax buoyancy;
- Administrative burden.

Lyons summarises the aims of a local system of taxation in the diagram that is reproduced in Figure 1 below:

NERA also looked more specifically at the issue of equity and fairness of potential local taxation sources. They suggest that current income is only one measure of a person’s or household’s share of aggregate economic resources, and that alternative measures could include average lifetime or permanent income or total wealth including all forms of property. They acknowledge that this does introduce an issue in relation to those who have substantial property wealth that is not matched by sufficient income to meet the tax liability, and point to systems of deferred payment and discounts used elsewhere to mitigate the impact. Elements of this analysis may be relevant to any council tax reform.
It reflects on the challenges as a result of the degree of centralisation and the increasing pressure on local authority budgets. It also looks at the problems associated with the design and operation of council tax and the discussions around the need to change business rates. The short-term nature of budget funding and the lack of buoyancy within the system are also both considered before looking at the general public’s views on the options for reform of both the council tax and local government funding more broadly.

CENTRALISATION AND FUNDING PRESSURES

The English local government finance system is the most centralised in the world. It is argued by many reports as discussed later that this relationship does not allow local authorities to innovate and flourish. Many local authorities argue that with more freedom and flexibility, they would be better placed to provide services for the public and in a better position to create economic growth and fiscal sustainability.

Centralisation and control at a national level brings with it the benefits of being able to redistribute to those in need and to provide a financial buffer. More localised arrangements must be sufficient to address these needs.

Central government is concerned that the provision of such freedom would see steep increases in taxes (DCLG, Eric Pickles 2014). The counter argument is clear. Local government is accountable to the electorate and unfavourable decisions on tax rises would result in lost elections. The argument that local decisions are best made by local people is championed by many who see this devolution as the way to drive better services and deliver greater financial security to local authorities.

One response to this call for greater freedoms was the signing of the Manchester Agreement (2014), an example of how power can be devolved from Whitehall to local authorities. The box opposite provides a summary of the arrangements. This devolution stops short of fiscal devolution as called for by the Independent Commission on Local Government Finance (ICLGF) and others.

Summary of the Greater Manchester agreement

A new, directly elected Mayor of Greater Manchester will receive the following powers:

- Responsibility for a devolved and consolidated transport budget, with a multi-year settlement to be agreed at the next Spending Review.
- Responsibility for franchised bus services (subject to consultation by Greater Manchester), for integrating smart ticketing across all local modes of transport, and urgently exploring the opportunities for devolving rail stations across the Greater Manchester area.
- Powers over strategic planning, including the power to create a statutory spatial framework for Greater Manchester. This will need to be approved by a unanimous vote of the Mayor’s Cabinet.
- Control of a new £300 million Housing Investment Fund.
- Control of a reformed earn back deal, within the current envelope of £30 million a year for 30 years.
- Take on the role currently covered by the Police and Crime Commissioner.

The Greater Manchester Combined Authority (GMCA) will receive the following powers:

- Responsibility for devolved business support budgets, including the Growth Accelerator, Manufacturing Advice Service and UK Trade and Investment (UKTI) Export Advice.
- Control of the Apprenticeship Grant for Employers in Greater Manchester and power to reshape and re-structure the Further Education (FE) provision within Greater Manchester.
- Control of an expanded Working Well pilot, with central government funding linked to good performance up to a fixed DEL limit in return for risk sharing.
- Opportunity to be a joint commissioner with Department for Work and Pensions (DWP) for the next phase of the Work Programme.
- GMCA and Greater Manchester Clinical Commissioning Groups will be invited to develop a business plan for the integration of health and social care across Greater Manchester, based on control of existing health and social care budgets.

Further powers may be agreed over time and included in future legislation.

4. ISSUES WITH THE CURRENT FUNDING REGIME

This section considers the issues and debates that are currently being had around funding reviews providing a summary to each of the key debates that have emerged around current local government funding regime.
The subject of equalisation and redistribution is a key area for a sustainable finance system. There must be equalisation for the system to support those authorities that are less able to meet their expenditure need. However, this raises the question about the balance between redistribution and incentivisation.

A major part of local government expenditure is driven by duties and targets imposed by central government. As a result the local government finance system has in the past focused on a national distribution of resources to allow a standard set of services to be provided.

This has led to a high degree of focus on the method of distribution of resources and, in particular, the formula. The formula is complex and the methodology is constructed to allow for the equalisation of resources-based on a government designed framework of around need.

If a less centralised approach is to be successfully introduced, it must be accompanied by a debate about service levels. In the ICLGF interim report, this debate took the form of a conversation around “postcode lottery” (ICLG 2014).

Faced with the projected funding reduction on top of the current measures (LGA 2014) as shown in Figure 2 below, this conversation will gain urgency in the coming years. The Local Government Association has provided research work on the changing balance of service funding allowing councils to work through different scenarios (LGA website: www.local.gov.uk).

There are limits to local authorities' ability to raise council tax and business rates to compensate for reductions in central funding. Council tax rises over a specified percentage (2% in 2014-15) are subject to a referendum, and authorities have little control over the amount of business rate revenue raised as business rates are not set at a local level.

As previously discussed, there are a number of ways in which councils can raise additional income through fees and charging. Some of this income can be used to off-set budget deficits elsewhere in the organisation, subject to certain restrictions. However, the amount of money that this allows an authority to generate is likely to be insufficient to address some of the budget deficits expected.

A number of independent reports have documented the increasing financial pressures on local government. The Audit Commission report ‘Tough Times’ (November 2013), suggested that 8% of local authorities “present a current and ongoing financial risk”, and a further 28% “present a future financial risk”. The pressures on many authorities will increase as a result of the Care Act 2014 coming into force in April 2015. This is supported by research which states: “The scope for further savings is now reduced, and at the same time real concerns remain about the affordability of the Care Act”. Grant Thornton’s report ‘2016 Tipping Point?’ (2013) found that a number of councils felt that they would hit a financial ‘tipping point’ around 2016. This might involve being unable to meet the over 1,000 statutory duties placed on local authorities or being unable to set a balanced budget.

Figure 2: Projected Local Authority Funding (ICLG 2014)
BUSINESS RATES

Business rates have moved centre stage in the last two years. As discussed earlier, business rates are an important element of the budget and 50% of business rates collected are retained to balance the already stretched local government purse. Failure to collect the income impacts directly on the ability to spend. £20.5bn in business rates was collected in England in 2013/14.

For this reason, any reform of business rates is extremely important to local authorities. In March 2015, the Government announced a review of business rates (DCLG 2015), recognising the need for change. This is also being run alongside an administrative review which is considering issues such as clearer billing, better information sharing and a more efficient appeals system (DCLG 2014).

Areas that are subject to debate include avoidance (LGA 2014), the review of reliefs such as charity relief, exemptions such as for student dwellings, and, in particular, the treatment of empty properties.

In September 2014, 100 major businesses wrote a letter to government, in which businesses including Boots, Asda, Whitbread, Ladbrokes and Heineken, said: “Business rates are higher than property taxes anywhere else in Europe and are the second highest in the OECD. This is a critical problem for all of British business. Business is interested in the reform of business rates but the preferences suggested by business may at times conflict with those of local government for example some businesses favour the inclusion of turnover as part of the consideration regarding how much business rates are paid.”

Whilst there is a long-term call for change, there is also a short-term need to address some of the funding issues caused by the introduction of the business rates retention scheme. The main criticisms of this scheme have centred on the appeals and the lack of incentive.

At a more fundamental level, local authorities argue for the rights to control business rates in their area. The argument around setting business rates locally is that there would be greater accountability between the local authorities and their businesses. Rates could be increased or reduced in line with local need. Growth of business rates would be rewarded with those willing to invest reaping greater benefits.

However, this approach is of concern to authorities that have less opportunity to grow. SIGOMA Protecting vital services (2015) pointed out that this often benefits the more prosperous at the expense of the poorer authorities.

For these authorities, the realignment of funding levels created by this funding process must be reconsidered. Setting business rates locally may also be of concern to business. The national property federation has expressed concern about the complexity of the current system and the problems its members experience when they receive the locally generated bills reflecting a national scheme. If each authority, even a combined authority, were to operate a local scheme, greater confusion may result.

If local authorities were to set their own business rates, they would be required to face the issue that the current system does not reflect the income made by business. This results in many businesses facing substantial business rates bills which, unlike corporate tax, are not based on income or profit. For this reason, businesses would be looking for any local system to incentivise them to invest and grow. Businesses would therefore argue for change to support this agenda whilst the overall quantum of business rates would still need to be raised.

Below is a list of some of the concerns identified in the business rates review, further details of which will be available in autumn 2015 following the government consultation.

1. Business rates are too complex
2. Business Rates are too high
3. Business rates do not link with ability to pay
4. Business rates do not respond to economic concerns.

COUNCIL TAX DESIGN AND OPERATION

Council tax was introduced in 1991 as a replacement for the extremely unpopular “poll tax”. However problems inherent in its design and the centralised way it has been operated in practice have become increasingly apparent: “Council Tax was identified as one of the major obstacles to efficient and effective local government. The failure to revalue properties mean the tax in England is now levied on the basis of values in 1991. The system has decayed to the point where it lacks credibility with policy makers and the public.” (ICLGF 2014).

Local government commentators argue that local government would be far better placed to control the level and detail of council tax. The response below was sent to the London Finance Commission 2012: “We feel particularly strongly that imposing a 2% referendum cap on council tax increases represents excessive centralisation, and a Council Tax referendum should be triggered by local demand (such as in the USA) and not by central prescription. The costs of holding the referendum are a disincentive whatever the likely outcome, so this does represent “capping by proxy.” (LFC 2012)
However, central government has been concerned by the level of council tax increases for a number of years, and since 2009 has capped rises, as well as encouraging the freezing of council tax by the use of a council tax freeze grant (DCLG 2014). The graph below shows the national average rises in council tax since 1993-94. Average council tax in England rose by 149% in cash terms between 1993 and 2009. However, the graph shows that the level of rises was coming down before the freeze grants were introduced.

Through capping local authorities, central government has been able to control the rise of an unpopular tax, and none of the political parties have outwardly supported its devolution in their manifestos. Indeed in March 2014, Labour confirmed their commitment to capping, and Hilary Benn was quoted as saying: “I am not proposing to change the referendum arrangements because things are very, very difficult for a lot of people.”

NERA Economic Consulting has also looked at options for the reform of council tax, including:

- Increase the number of tax bands: Research suggests that splitting the top and bottom bands of the council tax would allow fairer multipliers regarding how much properties in different bands are taxed relative to one another. This would reduce the extent to which the tax is regressive.

- Introduce regional tax bands: Altering band limits by region would mean that, following revaluation, it becomes less likely that properties in high inflation areas would go up a band compared to similar properties in other areas of the country. It is argued that this should enhance inter-regional equity.

- Combination system: A property tax could be supported by other taxes, such as a local income tax, sales taxes, and local congestion charges. This would improve the revenue raising ability of the local taxation system, but would maintain a stable property tax element.

The fact that council tax does not take into account the ability of the individual to pay is an important issue inherent in its design. Households in lower bands tend to pay a greater percentage of their outgoings in council tax than do households in higher bands. Moreover, the system demands less tax, as a proportion of sale value, from the largest properties: liability of even the most valuable houses in Band H can be no more than three times that of the smallest houses in any given local authority.

The debate over how to address this inequality was one of the factors giving rise to the various proposals for a ‘mansion tax’, involving an additional charge being placed on higher value properties. In 2010, the Liberal Democrats proposed a mansion tax based on 1% of a property’s value above £2m. This threshold would also rise in line with increasing house prices. Under this plan, for example, a property worth £3m would face a charge of £10,000 a year. The party said the tax would raise £1.7bn a year. However, at their 2014 party conference, the Liberal Democrat leader Nick Clegg said that the proposed tax would be incorporated into the council tax system. There was also the Labour proposal, again based on a £2m threshold, where the additional income would have been used to fund the NHS rather than local government.

In response, the Institute for Fiscal Studies (IFS 2014) said that a mansion tax had a “sensible logic underpinning it”. However, it said the idea was misdirected. “Rather than adding a mansion tax on top of an unreformed and deficient council tax, it would be better to reform council tax itself to make it proportional to current property values.”

There has also been consideration of the possibility of a land value tax (LVT) (Mirrlees 2010). A recent article considered the merits of such a tax and concluded that the difficulties such as valuing land separately from what sits on it was not what prevented it from functioning: “The bigger barrier is political. LVTs would impose concentrated costs on today’s landowners, who face a new tax bill and a reduced sale price. The benefit, by contrast, is spread equally over today’s population and future generations. This problem is unlikely to be overcome. Economists will continue to advocate LVTs, and politicians will continue to ignore them.” (The Economist 2014)
MULTI-YEAR SETTLEMENTS

Multi-year settlements were one of the main recommendations in the Independent Commission on Local Government Finance (ICLGF) and one that the local government sector has been calling for. The Commission recommended that the incoming government commits to full and clear multi-year settlements to enable effective long-term planning for local authorities and other public sector services (ICLGF 2015).

Currently, provisional settlements are determined a few months before the start of the financial year, although it should be recognised that in some years, such as 2008/09 - 2010/11, there have been multi-year settlements. This budgetary process gives no security for local authorities and as such impacts on their ability to develop and secure long-term investment programmes. It is also difficult for suppliers of services to offer long-term discounts within contract negotiations as these are often annually based on the settlement.

In the past, the government has been reticent to commit to longer term budgets as this would restrict their flexibility in other areas of public sector spending. However, the government is now working towards enabling greater multi-year certainty in funding for schools and certainty for adult education providers where appropriate, in the context of area-based strategies.

The rest of the local government sector will watch these changes carefully and continue to press for longer term security which is to be expected. HMT will continue to exercise prudence and will be wary about making commitments it would find difficult to keep. In a time of economic decline, central government will not want to spend money that it does not have.

PUBLIC OPINION

In considering the possibility of reforming council tax, public perceptions of the tax would be important. The Institute for Fiscal Studies found that “Council tax is an unpopular tax. There are a number of possible reasons for this. It is highly visible: 88% of tax is remitted by firms, so for the vast majority of people council tax is one of the only taxes they are asked to pay personally.” (IFS 2011)

The Lyons Inquiry commissioned research into public views on local taxation. Surveys were carried out in three waves over the course of the Lyons Inquiry. Some of their key findings around the perceptions of council tax were:

- Respondents felt that local councils should have the greatest control over setting council tax levels (41%), and central government the least (53%);
- Views were balanced as to the role of local residents, with just over a third (35%) feeling they should have the most say, and an equal proportion (35%) feeling they should have the least say;
- Over half (55%) of all respondents felt that people were able to influence how council tax was spent in their local area to a small or a great extent, while close to two in five (38%) did not feel they were able to at all;
- Close to three quarters (73%) of respondents in wave three felt that people should be able to influence how council tax was spent, and over two fifths (45%) would personally like to be involved;
- When asked where funds for local services should come from over half (52%) of all respondents in wave one felt central government and local councils should provide similar amounts of funding for local services, just over one in ten (13%) felt central government should be the main provider of funds using national taxation, and a quarter (25%) felt that local services should be mainly funded by local councils using council tax;
- 37% of respondents in wave three felt that council tax offered good value for money whilst 34% felt it did not. The main reasons given for not giving value for money were the fact that the value of the services did not reflect the amount paid (18%), council tax was high despite poor services (11%), and the services provided were not those that were needed (10%);
- the majority (55%) of respondents believed that basing council tax on property value was unfair to an extent, with a third (32%) considering this to be very unfair. Under a quarter (23%) felt that it was fair, and only 3% considered this to be very fair. For those who felt it was unfair, the key reasons were because they felt it was fairer to base council tax on income/ability to pay (41%).
The survey also dealt with respondents’ views on local income tax. Overall, nearly half felt (49%) there should be a move away from council tax being entirely based on property values, with a third (33%) saying that council tax should be entirely replaced with a local income tax and 16% saying that it should be partly replaced. Just over one in ten (14%) thought that council tax should continue to be based solely on property values.

All three waves of survey respondents were asked about whether they thought local councils should be allowed to offer better quality services to those households that choose to pay more for them. In waves one and three, opinions were very much balanced, with close to half (48% and 46% respectively) saying that local councils should, and similar proportions (48% in both waves) that they should not be allowed to offer better quality services to those who choose to pay more for them.

GfK NOP Social Research undertook a programme of qualitative research for the Lyons Inquiry, in which it investigated public attitudes to the principles behind taxation and testing attitudes to potential options for reform of local government funding. On balance, there was support for reform of the local taxation system. In particular, council tax was seen as being in need of reform. As a general principle, a system of taxation based on income was favoured, as income was seen as the most accurate reflection of an individual’s ability to pay tax. As a result, spontaneous perceptions of local income tax were quite positive, in that it was seen as potentially shifting the emphasis of local taxation from property onto income.

However, there was concern about the idea of local income tax being introduced alongside council tax. It was felt such a system could confuse the public and meet with hostility if it was perceived that the system was not transparent, and if people believed local taxes were being increased covertly. Furthermore, it was felt there might be resistance to any system of local income tax system if it was seen as being detrimental to those groups in society who are perceived as needing help (for example, less affluent working families with children or older people).

The idea of increasing the number of council tax bands was generally welcomed. Although it was acknowledged that this would not remove all the current inequities of the council tax system, reforming council tax was seen as having the following advantages:

- Familiarity, clarity and ease of understanding
- Fairness (those in the least expensive properties would pay less than at present)
- Low cost (the current system would not need to be replaced in full).
INTERNATIONAL APPROACHES TO LOCAL GOVERNMENT FUNDING

Internationally, there are a number of alternative approaches to local government funding. Each has a different impact on the balance between equity, efficiency and responsiveness.

Experience in a number of countries suggests that a combination of different local taxes provides the optimum opportunity to balance all three within a decentralised system of local government funding.

BALANCE BETWEEN CENTRAL AND LOCAL FUNDING

A background study for the Lyons Inquiry by Cardiff University looked at options to increase local funding through a review of international comparators. The diagram below compares tax revenue percentages over which local authorities have some discretion as a percentage of total local revenue excluding borrowing. It shows that, despite having an element of equalisation, France, Denmark and Sweden have local government funding systems where on aggregate around half of taxation is locally controlled.

Cardiff University’s study noted that the overall trend in the western democracies over the last twenty years has been towards increased decentralisation of spending functions. They also provide a summary of the advantages and disadvantages of greater fiscal devolution:

**Advantages**
- Improved local efficiency.
- Greater local policy discretion.
- Enabling local innovation.
- More targeted use of local resources, with gains in both efficiency and effectiveness.
- Enhancing local democracy and accountability.

**Disadvantages**
- Where there are a number of different sources of funding at the local level, increased complexity and loss of transparency.
- Equity costs.
- Difficulties in achieving central government policy goals.
- The potential for economic distortions caused by variations in taxes and tax rates across jurisdictions.
When it comes to equalisation models, the Cardiff University study notes that all European states maintain the ideal of providing similar levels of services right across the territory regardless of the ability of local populations to pay for these services. The opposite of this approach, commonly known in the UK as the ‘postcode lottery’, is where standards of services, funded out of locally-raised revenues, can be higher in wealthier areas than in less well-off areas.

In all European states, the desire to avoid this has given rise to some form of equalisation mechanism, either in the form of vertical transfers from central government paid out of general taxation, as in the UK, or paid from an equalisation fund operated by the local authorities themselves, as operated in Sweden until 2005, and Spain at a regional level. The other extreme is the United States, where there are no such mechanisms and where territorial inequality is more readily accepted.

Travers in his report compares the demands for equalisation/equity with personal income inequality:

Figure 6: Extract from Travers, International Comparisons of Local Government Finance: Propositions and Analysis (2005)

In considering the commitment to a certain level of equalisation in Europe, Cardiff note that some variation in levels of service provision is, nevertheless, increasingly accepted, but this occurs within bounds set by national authorities. They suggest that local tax capacity and needs are balanced best by equalisation mechanisms which involve the local authorities themselves rather than simply the central authorities.

ALTERNATIVE LOCAL REVENUE SOURCES

The main options for alternative forms of local taxation and other revenue sources were examined by NERA Economic Consulting in their work for the Lyons Inquiry. These are discussed in turn below.

Local Income Tax

A local income tax is based on an individual’s total income. It can be levied as a surtax – a supplement to a national income tax in which tax rates may or may not differ by locality – or can be set independently, with rate setting and collection occurring at a local level. The structure of the tax can differ, with a single tax bracket, or multiple tax brackets being used, depending on the degree to which it is desired to create a progressive tax. Where local governments are not given the opportunity to set their own tax rate, this results in an assigned local income tax rather than a true local income tax.

Local income taxes are widely used internationally. Sweden obtains all of its local revenue from an income surtax, while Denmark, Belgium and Spain also use this approach to raise substantial proportions of local government revenue. Sweden operates a system in which an income tax is set individually by local authorities. The rates set by each local authority do not differ significantly. Since reforms in the 1990s, the richest 15% of individuals pay a national income tax as well as local income tax. In the US, local income taxes comprise 3% of overall local government revenue, though they are more important in metropolitan areas. In the 15 largest US cities, income taxes account for almost 12% of own-source revenue.

Local income taxes are broad-based and can raise substantial amounts of revenue as in Sweden. They are also income-sensitive, so that in times of economic growth the amount of income they raise will increase. However, this also means that local income taxes are more volatile than sales taxes and property taxes, but less volatile than business taxes.

A local income tax can create locational inefficiencies if different tax rates are set in different localities. Research in the US suggests that the wealthy elderly are far more responsive to high local income taxes than sales or property taxes, being more likely to move away from an area due to a high local income tax. This causes inefficiency, as not only is the tax base reduced, but those that are most mobile may contribute the most to local revenue and demand the least amount of local government-run services. Countries that operate local income taxes therefore commonly limit the amount of variability in tax rates across localities.
Local Property Tax

Property taxes may comprise a combination of two types of tax, one on property improvements, and one on land or site value. The tax can be levied on these two types at the same or different rates. A number of variants can and have been used though, such as council tax, and land value taxes where the property improvement portion is not taxed.

Property taxes are widely used outside the United Kingdom, France and the Netherlands both obtain over half of their sub-national funding from such a tax. The system used in England, Scotland and Wales is a hybrid as it also involves the characteristics of the people living in the taxed property. The French Taxe d’Habitation is a pure property tax, as is the property tax in the Netherlands. Canada makes substantial use of a localised property tax, as do numerous states in the US. Split-rate systems and land value taxation have been used in some US states, as well as in Australia and South Africa.

Countries that have local governments which rely mainly on property taxes generally have less active local governments (Australia, Ireland), or local governments that depend more on inter-governmental transfers (Canada, US, UK). Out of the four main local taxes used in US states, analysis has shown that the property tax has a lower growth rate than personal income taxes, business taxes, and sales taxes. Though property taxes are less volatile than income and business taxes, they are more volatile than sales taxes.

Property taxes are difficult to evade. It is suggested that costs associated with evasion, administration and compliance are around 30% of tax revenue for federal income taxes in the US, and 20% for state sales taxes, while such costs for a property tax may be only around 2%. However, the administration of property taxes can be problematic. The tax levied on a property is assessed on the basis of the market value of the property. Valuations are costly, and so may be undertaken irregularly (the last ones conducted in England and Scotland were in 1991). The literature also suggests that in reality many discrepancies arise between assessed values and true market values within classes of property, between classes of property, and across different areas of a country.

In theory, a property tax should be progressive, as property owners should be taxed in relation to how much property they own. However, in England for example, property tax is paid by those living in the property, even if they do not own the property. There can therefore be a mismatch between the value of the house and the incomes of those living in it. Furthermore, such a mismatch may occur irrespective of whether the taxpayer is the property owner or just the occupier. In England, (as well as in other countries, such as Canada) discounts are applied to counter this mismatch. The evidence is unclear. Some studies suggest that property taxes can be regressive, while others suggest that in total property taxes are proportional to income, and so may be an equitable way of raising revenue.

Land Value Tax

Land value taxation involves “simply taxing the value of land, while exempting improvements”. This means all land is taxed irrespective of what use it is being put to. Split-rate variants on land taxes can be used, whereby both land and improvements on that land are taxed at different rates. A development tax – whereby land earmarked for development is taxed – is another variant of land value taxation.

The issue of Brazilian property tax was discussed by C. M. De Cesare and L. Ruddock (2003) who commented that “the property tax can be used as an instrument of urban policy for deterring land speculation and for promoting urban development and a rational use of the urban land. Unfortunately, few local authorities in Brazil are making the best use of this powerful instrument.” More than 700 cities worldwide have successfully implemented a split-rate land value tax, including cities in the US State of Pennsylvania, and cities in Australia and Eastern Europe. A split-rate land tax is also used in Denmark.

A property tax focuses on the value of land as well as the value of improvements made on that land. A pure land value tax focuses only on the value of land, and so has a narrower base than a property tax, which is why split-rate systems are commonly seen. This makes land value taxation a substitute for a property tax, and therefore the two systems could be expected to raise similar amounts of revenue. In 1997, under the split-rate property tax system, Pittsburgh derived 45.1% of its own revenue from the property-land tax, while in the Australia land tax revenue made up 5.1% of total state taxation revenue in 1999-2000.

Local Sales Tax

Sales taxes can focus on retail sales, business purchases, or both. The sale of any good or service can be taxed, and decisions can be made easily as to which goods and services should be exempted from tax. Typically food products and medicines are exempted from tax. A sales tax can act as a ‘use’ tax – whereby all goods used in an area must have tax paid on them – or a pure ‘sales’ tax, where tax is simply paid when the goods are sold. Selective sales taxes can also be used. These can be levied on top of, or in the absence of, a general sales tax, typically on goods such as alcohol, motor fuels and cigarettes.

A local sales tax in the form of differing value added tax (VAT) rates between regions would not be in line with EU law. The UK’s VAT system is governed by the 6th EC Directive, which ensures that member states establish similar VAT schemes, both in terms of what can be exempted from VAT, and the VAT rate itself. The Directive forbids variable VAT rates. Therefore a locally variable VAT would almost certainly be illegal under EU directives. The situation is less clear for a direct local add-on to the existing VAT base. It seems likely that this too would be illegal because of legislation dealing with trans-boundary transactions that rests on the assumption of a single national VAT rate.
One option in the UK might be to treat VAT as a form of revenue-sharing, with revenue equivalent to a certain tax rate redistributed to local authorities, though a revenue redistribution mechanism would have to be determined. Germany has a system where VAT is assigned revenue. However, EU obligations dictate that member states contribute money raised from VAT to the EU, which might harm such a scheme’s ability to finance local government.

Alternatively a more restricted local tax on the final sale of goods might be considered, with the tax paid as an add-on at the till. However this would require altering existing consumer laws, as currently retailers must advertise tax-inclusive prices, which would be impossible if different tax rates existed in different localities, given national advertising.

Sales taxes are often used in combination with other local taxes. Many US states levy sales taxes, which in aggregate represent the most important contribution to state tax revenues, at around half of the total. They are the second largest source of local government revenue in the US, following the property tax. Some states have particularly high sales tax revenues. In Texas, where there is no income tax, the sales tax is by far the most important local tax, with general sales plus selective sales taxes making up around three quarters of state tax revenue. In many states, a limit is placed on the add-on taxes that counties and municipalities can apply – in Texas this limit is 2%.

**Local Business Taxes**

Business-specific versions of a number of the main types of tax exist. Corporate income tax, non-residential property tax, franchise tax, utility tax, sectoral tax, taxes on gross sales, and taxes on type of business activity are examples of business taxes that are levied by local governments throughout the world. Many of these have been explored by academics such as John L. Mikesell (Professor of Public Finance and Policy Analysis, School of Public and Environmental Affairs, Indiana University). Whilst these options often attract criticism for being expensive to collect, it is important that they are considered as offering a range of alternatives.

Tourism taxes can also a form of business tax, as they exist in the form either of a tax on service businesses (e.g. hotels), or a differentiated service tax, whereby higher rates are levied on services that are likely to be used the most by tourists (e.g. sports businesses), though it could be argued that these are a form of sales tax rather than business rates. In some cases, the issues related to the levying of individual taxes are the same for business taxes. For example, the locational distortions associated with a personal local income tax also apply to a business income tax. Also, the important factors when considering a property tax – such as the effects such a tax has on land and property development – are also relevant for a business version of the tax.

Most countries that levy a property tax or a local income tax on individuals, also levy a charge on businesses as well. In Canada, the property tax is levied on both residential and non-residential (commercial and industrial) property, with non-residential properties being subject to an extra municipal business tax levied on the basis of assessed value. Sweden includes a corporate income tax as part of the local income tax system it administers, as do numerous US states (KPMG 2014).

Because a business tax can be levied on property, sales, income or simply on existence, there is substantial scope to raise significant amounts of revenue from business taxes. However, evidence suggests that the ability of states in the US to collect taxes on businesses has been diminishing. This may be due to the rise in popularity of the internet coupled with the difficulty of taxing mobile activities, and the difficulty of taxing business-to-business transactions. Other important factors are the cyclical volatility of business taxes, the decline over time of the federal corporate tax base, state policy decisions to reduce corporate tax burdens, and more aggressive corporate tax planning (meaning that firms are becoming more adept at considering the tax implications of different location decisions). These factors could be interpreted as suggesting that the revenues that can be raised by business taxes are limited, particularly if rates vary by locality, as businesses alter their behaviour to minimise their exposure.

Research suggests that business taxes are progressive in nature. However this assumes that none of the tax is passed on to consumers which, in the long-term, may be unrealistic. If the tax is passed on to either employees or consumers, the tax may become regressive, depending on the industry involved.
**User Charges**

User charges are essentially taxes paid for the specific use of a good or service that are publicly provided private goods. This means that the service is “excludable” (unlike a pure public good) and it is possible to identify who is benefiting from the service. They are a popular approach with taxpayers to raising local government revenue because in return for payment individuals receive a definite good or service.

User charges do not have to solely focus on a public service. They can be set at different levels for different consumers, or can be charged for use of a service above a minimum level. Although increasing complexity, such refinements may be necessary to decrease the potential burden of charges on some groups of consumers. They can be levied on the use of public transport, sewerage or sanitation services, parking, parks and recreation, airports, or even the use of the health or education system.

A charge can also be levied on the use of public roads, comprising both a charge on using a public service (road-building is costly), and a charge on negative externalities (congestion and pollution).

User charges are increasingly common internationally. Over the past 20 years, a number of cities in the US have raised more revenue through user fees than from property tax, with user fees contributing over 25% to local revenues. Widespread use of user charges is made in the Swedish health care system, where patients pay flat rate charges for most health services at rates determined by county councils, within statutory ceilings that dictate the total that any individual can pay in one year. Road tolls are common in Italy and France, and the congestion charge in London raises money for public transport. In Germany, the Länder are able to set tuition fees for higher education.

Although user charges can raise substantial amounts of revenue, their use is limited to services that local government can charge for. For example, user charges would not be acceptable for police or fire services. They are harder to apply to services that have community-wide, rather than personal, benefits. Individuals are likely to be less willing to pay, believing they can “free ride” on the payments of others. User charges are also politically or administratively hard to apply if the charge burdens those on low incomes most, or involves high collection costs.
6. **LOCAL GOVERNMENT FUNDING REVIEWS**

There have been a number of separate enquiries and studies into the system of local government funding since the still widely quoted Layfield Committee of the 1970s. This section summarises the key proposals made by these reviews.

**LAYFIELD COMMITTEE 1974-1976**

As a response to the adverse political reaction to large rates rises, the government set up an inquiry into local government finance, chaired by Sir Frank Layfield QC. The Layfield Committee reported in 1976, offering the Government a choice between a more centrally-controlled system of local authority finance and a system with greater local autonomy.

The Committee favoured a significant increase in local financial autonomy and a shift in the balance of funding from central to local sources, to be achieved partly through devolving taxation powers, and, in particular, the introduction of a local income tax.

**BALANCE OF FUNDING REVIEW 2003-2004**

The Balance of Funding Review was set up following the introduction of Council Tax amid concerns about local government financing and, in particular, the gearing effect whereby a 1% increase in budget could lead to a 4% increase in council tax. The Review concluded that 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. It argued that gearing clouded the accountability and transparency of local spending decisions and contributed to unsustainable council tax increases.

The Review acknowledged that whilst there were strong arguments for shifting the balance of funding towards more local funding, this depended upon the feasibility and desirability of any measures which might be used to achieve it. Issues considered included:

- The trade-off between raising a greater proportion of revenue locally and levels of equalisation between different council areas.
- Reform of council tax to address its impact on those on low incomes and the impact of revaluation.
- Supplementing a reformed council tax with either re-localised business rates or a local income tax or a combination of both.

**LYONS INQUIRY, 2004-2007**

Sir Michael Lyons was commissioned in July 2004 by the Deputy Prime Minister and the Chancellor to make recommendations on how to reform the local government funding system, by December 2005. In September 2005, the remit of the inquiry was extended to enable consideration of issues of function. Sir Michael Lyons’ final report was finally published in 2007.

Short-term recommendations included:

- greater flexibility for local authorities to place-shape with less control from the centre - by reducing specific and ring fenced grants, a new power to levy a supplementary business rate in consultation with business, a new power to charge for domestic waste to help manage pressures on council tax, and an end to capping of council tax;
- changes to improve fairness of council tax, recognising that council tax benefit is a rebate, automating the system to ensure £1.8billion in unclaimed benefit helped the poorest households, and raising the savings limit for pensioners to £50,000;
- improving transparency in the funding system by being clear about the contribution made by national taxation, and ensuring a more independent voice to inform Parliament and the public; and
- improving incentives for local authorities to promote economic prosperity and growth, initially through reform of the Local Authority Business Growth Incentives Scheme.

In the medium-term, the Inquiry found that the government should:

- revalue council tax to update the tax base and improve fairness, at the same time reforming council tax by adding new bands to reduce bills for those in the lowest value properties, paid for by increased bills for those in higher value properties paying more;
- consider assigning a fixed proportion of income tax to local government;
- find ways to improve the incentives within the grant system; and
- consider introducing the power to levy a tourist tax if local government made a strong case based on local public support - this would be appropriate only in some areas.
In the longer term, the Inquiry found that future governments could consider more radical reform options such as local income tax or re-localisation of business rates, but these reforms might require greater public support and understanding than currently existed.

**LONDON FINANCE COMMISSION 2013**

The London Finance Commission was initiated by the Mayor and supported by the London boroughs and considered the weaknesses of the existing system. Key recommendations from the Commission were:

**Capital Investment**

- London should have more freedom to invest in its own infrastructure through relaxing restrictions on borrowing for capital investment within prudential rules and devolving revenue streams.
- The Mayor of London should have a responsibility to be a champion of all infrastructure planning for the capital, but should also look wherever possible to delegate powers to London’s boroughs.
- The government should distinguish between borrowing to promote growth or reduce public expenditure and thus be repaid, and other kinds of debt.
- The Mayor and London’s local authorities should determine which Tax Increment Financed (TIF) projects to proceed with, within the prudential borrowing code, with the government starting with a presumption in favour of funding all TIF projects that could demonstrate net gains to the public finances as a whole.
- Borrowing limits for housing purposes for boroughs should be relaxed or removed. Prudential borrowing rules would still apply, as would the rigour of long-term Housing Revenue Account (HRA) business plans.

**Taxation**

- The devolution of housing benefit (or a related share of universal credit) to London should be considered.
- The full suite of property taxes (council tax, business rates, stamp duty land tax, annual tax on enveloped dwellings and capital gains property development tax) should be devolved to London government, which should have devolved responsibility for setting the tax rates and authority over all matters including revaluation, banding and discounts.
- Council tax should be retained as a local tax but London government should be given the power and be required to hold periodic revaluations (undertaken by the Valuation Office, according to national practice), to determine the number of bands, to set the ratio of tax from band to band and to set the tax rate.
- 100 per cent of business rates should be devolved to London government, through an appropriate governance mechanism, including the responsibility for the timing of revaluations. London government should be free to determine such issues as discounts and tax breaks, and should have the freedom to use business rates to undertake ‘enterprise zone’-style interventions.
- At such a time that business rates were wholly retained in London, alongside other property taxes, London government should set the business rate multiplier in London, again in consultation with appropriate stakeholders.
- If business rates were localised in the way proposed then London government should put in place a scheme that would protect ratepayers from any perceived risk of unreasonably high rate increases, in consultation with business.
- If greater powers are devolved to London over time, the assignment of income tax should be considered and should be viewed alongside more effective community budget or ‘single pot’ arrangements.
- London government should be able to introduce smaller new taxes. The government should pass permissive legislation that would make such changes straightforward to implement.

The Commission proposed that new tax powers should be offset by reductions in grant to ensure a fiscally neutral position for the Exchequer.
CITY FINANCE COMMISSION 2011

The City Finance Commission was set up by Birmingham, Manchester and Westminster City Councils and chaired by Sir Stuart Lipton. It proposed ways to promote growth in UK cities, in the context of continuing recession. Its recommendations centred around growth and included:

- proposals for pooled budgets to deliver integrated local services;
- further financial and regulatory freedoms for cities;
- a business rate retention scheme and Tax Increment Financing (TIF) powers.

MIRRLEES REVIEW 2011

The Mirrlees Review was conducted by the Institute for Fiscal Studies (IFS). While not specific to local government, it is of partial relevance in that it described how a modern tax system should look and made recommendations for the reform and simplification of the UK system without arguing for devolution. It argued that council tax is regressive with respect to property values, that it gives an unfair discount for sole occupancy, and that the valuations on which it is based are out-of-date.

INDEPENDENT COMMISSION ON LOCAL GOVERNMENT FINANCE 2015

The Independent Commission on Local Government Finance (ICLGF) was established in May 2014 by the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Local Government Association (LGA). An interim report in October 2014 was followed by final report in March 2015. The Commission was tasked with making recommendations for the reform of local government finance and finding better ways to fund local services and promote better outcomes in England.

The Commission set out its vision for the local government finance system as one that

- Promotes self-reliance and self-sufficiency
- Encourages entrepreneurialism and innovation
- Promotes local decision-making on service delivery
- Is transparent in how it works and in the division of responsibilities between central and local government
- Maintains support for the most vulnerable.

Many of the recommendations in the report were welcomed by others within the sector and the strong call for financial reform received unanimous support across the country.

The area of the report that caused most debate was the call for self-sufficiency within sub-regional groups which is one of the approaches recommended by the Commission. This is a key part of the fiscal devolution discussion currently taking place: “Self-sufficiency does not mean the absence of government grant, but it does mean stability in grant allocations and control over directly raised revenues such that councils can shape the destiny of their area without dependency on central government.” (ICLGF 2015).
7. FUTURE OF LOCAL GOVERNMENT FINANCE

Many would argue that the local finance system should ensure that local authorities have the power and responsibility to raise locally most of the funding for the services which they provide. This would allow greater control over their future and an ability to respond at a local level.

A reliance on just one income stream also weakens local government so it should have more than one tax at its disposal and work to strengthen the other income sources to ensure sustainability for the future. Whilst it is recognised that council tax and business rates will always be income generators local authorities should ensure they maximise other income from fees and charges or by the use of assets, such as the changes currently being seen in the use of pension funds for investment. Legislation should support this innovation not seek to stifle it while also ensuring strong governance and accountability.

The variety of tax rising powers available to local government should include an element of buoyancy such as those available to national government. Buoyant taxes rise automatically with national income and inflation. Council tax and business rates do not reflect this and while in a period of decline this may seem comforting this lack of buoyancy has adverse long term effects on the economic growth of the income. It is also one of the chief criticisms of local authority tax from the public. Again, the stability of income may be less predictable but the advantages of long-term growth may outweigh the challenge.

There are strong calls for a fairer taxing system, with many different views on potential reforms of both council tax and business rates. Council tax is generally seen as a regressive tax, but the key challenge remains that when reforms have to be fiscally neutral there will always be winners and losers. It is also perhaps important to keep some of the very good elements of the current system. Property-based taxes are often easier and cheaper to collect than other types of tax and less easy to avoid.
8. CONCLUSIONS

This Need to Know Review set out to provide an overview and summary of the research and evidence available to underpin the policy debate around funding for local government. It is a complex topic, but the high-level choices are relatively clear.

In conclusion, the fact that changes have to be made is not in doubt. The speed and size of those changes is however the subject for discussion.

Table 1 (below) summarises the key proposals made by the various local government funding reviews. It shows that despite a fairly high degree of consensus between the various studies, the response and the level of action taken subsequently has been relatively limited. The key choice remains the same as when the Layfield Committee reported in 1976 - between a more centrally-controlled system of local authority finance and a system with greater local autonomy. The key dynamic that has altered is the influence of the devolution agenda and the appetite from Whitehall to engage on this agenda.

Perhaps the way that the localisation of business rates was implemented illustrates the two key concerns of central government in implementing a substantially greater level of decentralisation in the local government finance system.

Firstly, the new system was set up to reduce as far as possible the level of distributional change between authorities within overall funding levels. A system of top-ups and tariffs has been implemented to give a starting point for individual councils as close as possible to their funding position under the old system. Any change in local government funding has the potential to create winners and losers and it is the losers that are traditionally the most vocal in their response to the change. Inevitably this leads to political caution over any change that has a significantly redistributive effect.

Secondly, the system allows for the retention of a national control total for local government that can be imposed by Treasury. This reluctance to let go of central financial control is gradually changing although for many the pace of this change is too slow and piecemeal. Methods of equalisation should focus on tackling extreme differences in overall local spending needs, and the capacity to raise taxes locally, but should not seek a level of precision which implies Whitehall second-guessing each authority’s response to local spending requirements.

Table 1: Summary of key proposals made by local government funding reviews

<table>
<thead>
<tr>
<th>Option proposed</th>
<th>Layfield</th>
<th>Balance of Funding</th>
<th>Lyons</th>
<th>City Finance Co’n</th>
<th>Mirrlees</th>
<th>London Finance Co’n</th>
<th>Ind. Co’n on LG Finance</th>
<th>Subsequent Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Income Tax or Devolution of a Proportion of Yield</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>No change although proposed by some parties for further devolution to Scotland.</td>
</tr>
<tr>
<td>Reform of Council tax / Revaluation</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>No change in England, revaluation in Wales, some debate about a ‘Mansion Tax’.</td>
</tr>
<tr>
<td>Re-localised Business Rates along with TIF/LABGI</td>
<td>✓</td>
<td>✓</td>
<td>✓ (LABGI)</td>
<td>✓ (TIF)</td>
<td>✓ (TIF)</td>
<td>✓</td>
<td>Local Authorities as a whole allowed to keep 50% of business rates within overall control total, LABGI (limited grant based scheme) replaced by TIF (although with central control over total approvals).</td>
<td></td>
</tr>
<tr>
<td>Devolution of other Property Taxes</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Land based taxes to be devolved to Scotland.</td>
</tr>
<tr>
<td>Access to new forms of taxation</td>
<td>✓ (Tourist tax)</td>
<td>✓ (smaller new tax)</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Congestion charging introduced in London. No other change.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* With the transfer of additional services
9. REFERENCES

City Finance Commission (2011) www.centrallondonforward.gov.uk
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10. **SUGGESTED FURTHER READING**


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Centre For Cities (2014) *Devolution and decentralisation in the UK: Mapping current and proposed powers and responsibilities to drive economic growth* [www.centreforcities.org](http://www.centreforcities.org)

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