

Options for Local Government Finance: An Economic Approach 2005



Options for Local Government Finance: An Economic Approach

A Report for the
County Councils Network

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Introduction

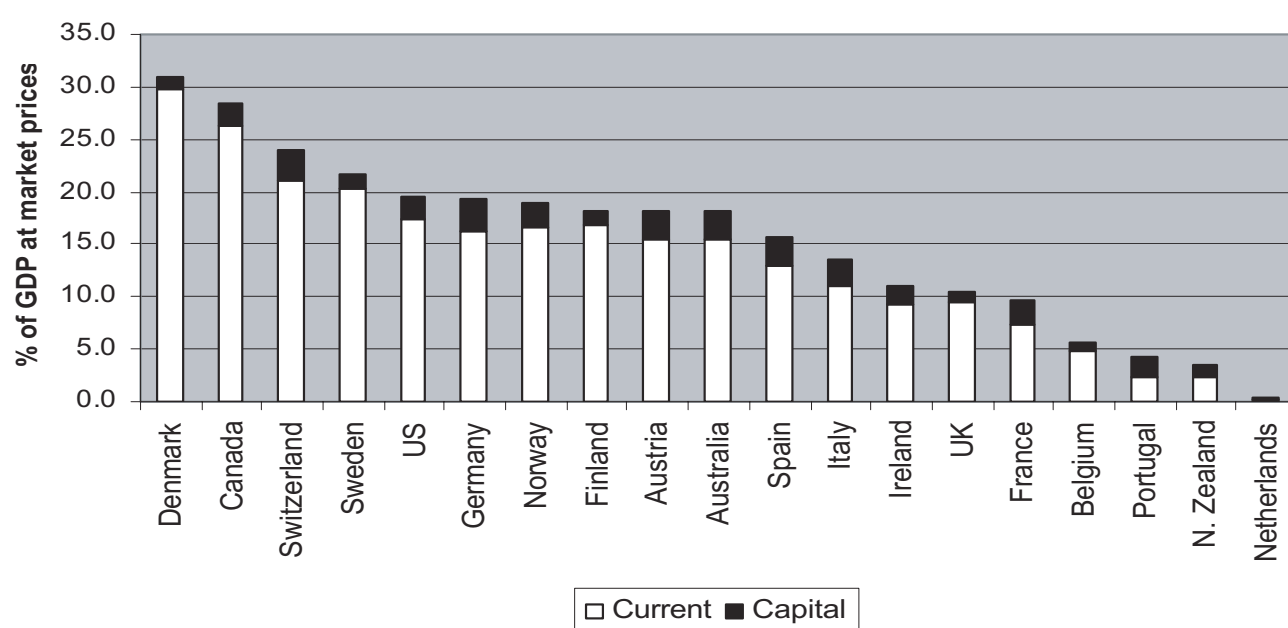
This paper adopts an economist's approach to review the range of revenue streams available for financing local government. The paper is structured as follows:

- **Section 1** uses an international perspective to discuss the scale of local spending in the UK and the main current sources of finance.
- **Section 2** discusses alternative rôles for local government and their financial implications.
- **Section 3** explores five basic issues in taxation.
- **Section 4** gives a brief overview of subnational taxes in OECD countries.
- **Section 5** considers the most common local domestic taxes and appraises them in line with ten key criteria.
- **Section 6** gives a similar but briefer analysis for the most common local business taxes.
- **Section 7** looks at some minor local taxes.
- **Section 8** considers the assessment of needs under formula spending shares.
- **Section 9** presents some conclusions for different scenarios.
- **Section 10** suggests some issues for discussion

1 The scale of local government finance

Local authority spending in the UK accounts for about a quarter of total government spending, and about 10% of GDP¹. This is lower than the level of subnational government spending in most OECD countries, as shown in Fig 1, which covers 19 of the original 24 OECD members². The average level of subnational spending in these countries is 15% of GDP. This average is enhanced by the inclusion of some federal countries, which tend to be relatively decentralised; but even for the unitary countries, the mean is about 12.5%, suggesting that they tend to be more decentralized than the UK. Fig 1 also shows that capital spending accounts for a relatively low share of spending by UK local authorities.

Fig. 1: Subnational spending as % of GDP



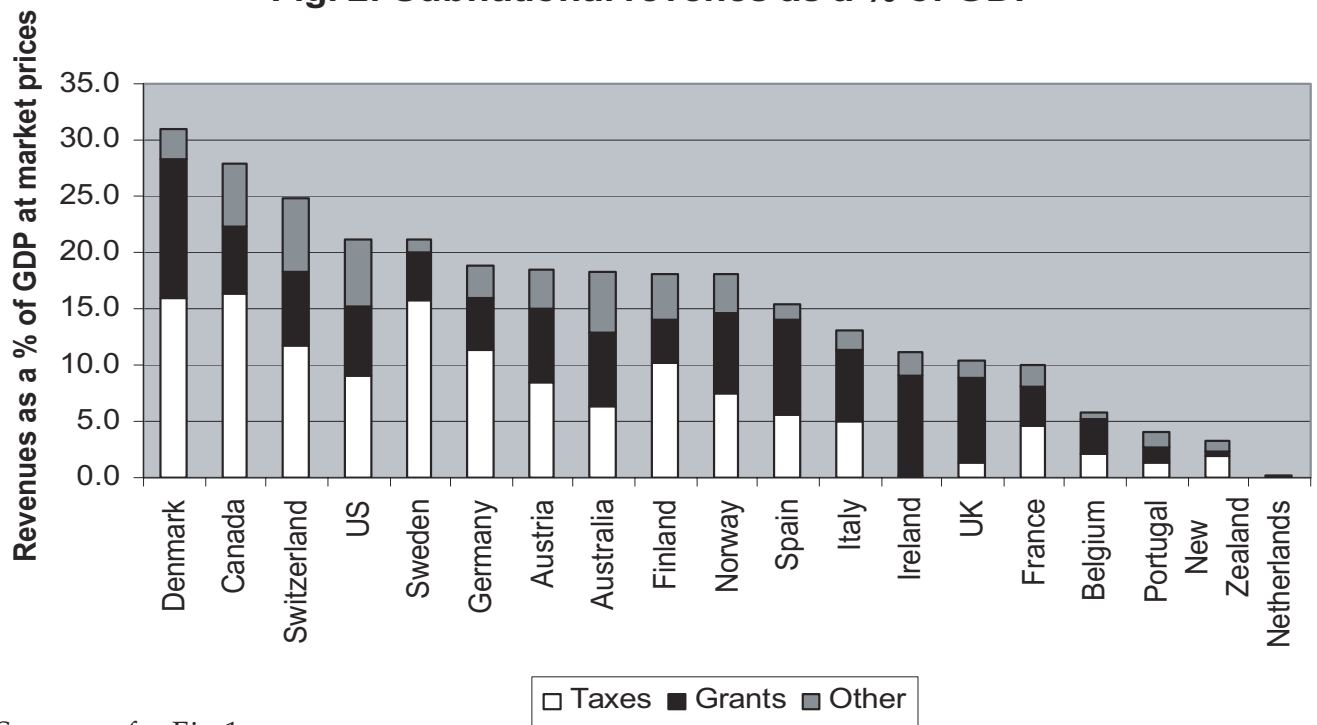
Source: IMF, Government Financial Statistics Yearbook 2004, data for latest available year, ranging from 1997-2001.

Fig 2 looks at subnational revenues in relation to GDP. It divides these into tax revenues, grants and other revenues. It shows that UK local authorities receive relatively little revenue from local taxation. Indeed, subnational taxes account for a lower percentage of GDP in the UK than in any other country apart from Ireland and the Netherlands.

¹ ODPM (2004b) shows local government expenditure in the UK as 8.77 per cent of total domestic expenditure on goods and services at market prices for the calendar year 2003.

² Five countries are omitted: Japan, Greece and Turkey because comparable data are not available, and Iceland and Luxembourg because their populations are so small.

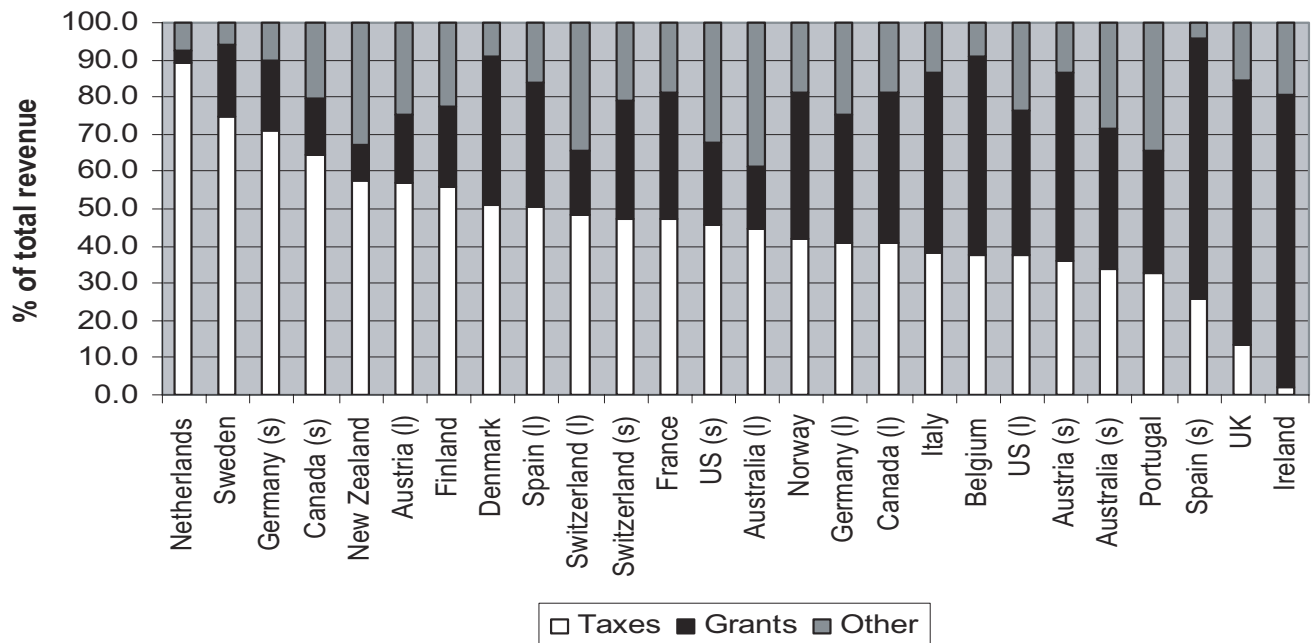
Fig. 2: Subnational revenues as a % of GDP



Source: as for Fig. 1.

The lowly status of local taxation in the UK is illustrated in another way in Fig. 3. Here, there are two bars for each federal country, one for states (s) and one for local authorities (l). It can be seen that UK local authorities receive an appreciably smaller share of their revenue in taxes than applies in any other tier except local authorities in Ireland.

Fig. 3: Revenue sources for states and local authorities



Source: as for Fig. 1

2 Alternative rôles for local government

Although some countries, such as Ireland and the Netherlands, decentralise very little public spending, most countries decentralise a substantial proportion. But the rôles which lower tiers perform with their different spending functions vary over a wide spectrum. At one end of the spectrum, they have substantial autonomy, and at the other end they are largely agents of the central government. Until the 1960s, UK local authorities perhaps felt they were closer to the autonomous end with most of their services. Today, they perhaps feel they are closer to the agency end with almost all their services, and there are clearly some activities which are purely agency functions, such as handling housing benefit. It is arguable that these different ends of the spectrum require very different sources of finance, as discussed below.

2.1 Largely autonomous services

There are several arguments in favour of decentralizing some government services and giving the lower tiers responsible a substantial degree of autonomy. The arguments for this form of decentralization include the following:

- It allows the quality and quantity of service provision to vary between areas in accordance with local preferences. In contrast, central provision is likely to lead to uniformity rather than variety.
- It allows people who do not like the service provision in their areas to migrate elsewhere.
- It is likely to facilitate more variety, experiment and innovation in service provision. In turn, this will facilitate comparisons between different modes of service provision.
- Having more than one tier gives electors more opportunities to signal their preferences.
- Having more than one tier means that each elected representative needs to supervise fewer services and so can be better informed about them.
- Having more than one tier may help electors evaluate the costs of each tier's services, although this is possible only if each tier has perceptible taxes that relate to that tier's costs.

For services where these arguments are accepted, there is a case for having the majority of revenue coming from taxes where the authority has some control over the tax rate, and the minority of revenue from grants. The reasons for this include the following:

- Local authorities need substantial tax power to avoid the problems of gearing whereby, say, a 10% rise in local taxes leads to only a 2.5% increase in local spending - as is the case in the average English local authority. Voters do not face this situation with anything else they spend money on, and may well be confused. (In principle, the problem could be avoided by paying higher grants to local authorities that raise their tax rates; but no government is likely to adopt this, because it will seem to encourage overspending.)
- If local authorities rely substantially on grants, or even on taxes whose rates they cannot set, then they can spend the money inefficiently and yet blame the resulting poor services on under-funding.
- Local politicians, bureaucrats and voters may take more care with money that is raised locally at rates they set than with money that has been given to them or that is raised at rates outside their control.

- When a government pays grants, it may well feel that it should control how grant receipts are spent, as it is accountable to its national taxpayers for this money. It can be argued that the expensive apparatus of best value and CPA is only in place because of a need for accountability for high central grant and would not be needed if local authorities were largely responsible for raising their own taxation (Watt, 2004). High central funding may also be a barrier to meaningful development of freedoms and flexibilities.

In an extreme case, if local authorities were given complete control over services, then it is arguable that all their revenue should come from local taxes. Indeed, this situation arises with almost all services provided by town and parish councils. Usually, however, there is a case for some central control, on the grounds that actions by one authority have some impact on non-residents. In turn there is a case for some central finance in the form of grants, which represents a contribution by non-residents.

2.2 Agency services

It is hard to construct a strong case for local authorities providing services on a purely agency basis. For example, why on the one hand is housing benefit administered by local authorities, whilst on the other hand job-seeker's allowance is administered by local offices of the central government? Certainly agency functions are likely to confuse local voters, for they find that these functions are entrusted to their local authority, yet neither their elected representatives nor they as local voters have any control over them. It is arguable that the falling turnouts at local elections stem from a widespread perception that local authorities have become almost purely agents and that local electors have no impact.

If, despite the weight of these arguments, the government does seek to have local authorities provide services on an agency basis, then it is arguable that most of the revenue should come from grants. There are two main reasons for this:

- The central government is likely to take a more responsible view about how much local expenditure to require if it has to raise the money itself.
- Local voters will be confused if they have to pay local taxes to local politicians who actually have negligible discretion over how that money may be spent.

Ideally, the grant for an agency function should be a specific grant that covers the cost of the service concerned and that is effectively ring-fenced to prevent it being used elsewhere. But if the grant is based on actual costs, then perhaps it should meet a shade under 100%, to encourage local authorities to exert proper financial control.

2.3 Mixed services

Sometimes governments adopt a mixed approach to local services, and argue that they work in partnership with local authorities. So these are 'mixed' services, with a mix of central and local control. Here, there is a case for dividing the revenue roughly equally between grants and taxes.

Although a mixed approach of partnership has an appealing ring, it can lead to confusion and conflict if the central government has a mandate for one policy while the local authority has a mandate for the other. Some major examples include decisions over selection by schools, decisions over selling council homes, and much of the basis for best value and comprehensive performance assessment.

2.4 Rôle changes over time

In the 1890s, some 23% of the total local revenue in the UK arose from grants and 77% arose from local taxes. At that time, local authorities probably felt that they had a fair measure of autonomy over most services. By the 1950s, tax revenues accounted for slightly less revenue than grants and perhaps people began to see most local services as mixed. From the 1990s, taxes have tended to raise less than a quarter of the combined sum from taxes and grants, and perhaps most services are seen as towards the agency end of the spectrum.

If the moves from autonomy to agency had been the result of a wide feeling that this was appropriate, then one could laud the changes in the ratio of taxes to grants. But it is at least arguable that the falling share of taxes has resulted from a reluctance of central government to find buoyant³ local taxes, and that the resulting increase in grants has led to greater government intervention: after all, it is reasonable for the person who pays the piper to call the tune. So, before any policy decisions are made about different local taxes or grants, some consensus needs to be made about whether the present constraints on local autonomy are the cause of, or the effect of, shrinking local taxes.

2.5 Redistribution

It may be noted that decentralized spending tends to concern the provision of services rather than welfare benefits. There is a widespread feeling that subnational government should not get closely involved with redistributing income via benefits, or indeed with redistributing income via progressive taxes. The argument is that decentralizing redistribution would not result in the degree of redistribution in each area according with local wishes. Rather, if any area wanted to be more redistributive than the least redistributive area, then it could drive its richer taxpayers away and attract in welfare beneficiaries, and so find its position untenable.⁴

³ The buoyancy of a tax refers to its ability or otherwise to rise in pace with incomes or inflation or costs – see King, 1984, p. 213.

⁴ Interestingly, though, there has recently been some move towards decentralizing redistribution in the US.

3 Five key issues in local taxes

Suppose it is decided that local authorities should raise at least some revenue in taxes. There are several possible taxes, and a choice must be made against a range of criteria. But before exploring these criteria, in sections 4-6, it is helpful to consider five underlying issues.

3.1 Ability-to-pay approach or benefit approach?

There are two basic approaches to deciding how to share the burden of taxes between members of society: these are the ability-to-pay approach and the benefit approach.

The benefit approach sees taxes as being analogous to prices charged for using a service. Those who receive more benefit from a service, it is argued, should pay more. Financing roads by tolls or petrol taxes gives some link between benefit received and tax paid, as peoples' contributions will rise as their use goes up.

Even so, it can be argued that charging tolls for uncongested roads is inefficient as it discourages use, although use of uncongested roads is not costly. Property taxes also have some attributes of the benefit approach, because local residents pay them and are also likely to be the recipients of most of the local services that they finance.

The problem with the benefit approach is that it is often difficult to identify the benefits that individuals receive from public services. In the private market, benefit received is quite accurately indicated by expenditure through the market mechanism, but when services are provided collectively, this information is not available. Indeed, a judgement that the price mechanism will not work for certain services, or is inappropriate, is often the reason for public sector provision in the first place.

The ability-to-pay approach to taxation bases peoples' tax bills on the resources they possess. To take a simple intuitive example, suppose a group of people want to work together to construct a small river dam. The benefit approach would share out the work in relation to how the benefits of the construction of the dam - in terms of flood protection and irrigation etc. - were distributed among the group. In contrast, the ability-to-pay approach suggests that the stronger and fitter members of the group should do relatively more of the work, as each unit of work will be easier for them. In practice, incomes are frequently used as a measure of peoples' ability-to-pay, although it is not a perfect measure. To illustrate one way in which income may be a poor measure, suppose a person likes a lot of leisure and only works three days a week to get an income of £20,000 a year; does this person have only the same ability-to-pay as someone who works five days a week to earn the same income? Most people would not think so, but the use of income as a measure of ability to pay would mean that they would receive the same tax bill.

Does the banding of the council tax make it a benefit tax or an ability-to-pay tax? There would be an element of the benefit approach if people in higher band homes consume more local services than people in lower band homes: for example they may generate more refuse for collection. But for most services the link is weak or may even be the reverse. The justification for banding is probably more connected to ability-to-pay considerations. However, seeing council tax as being an ability-to-pay tax brings to mind some familiar criticisms. For example, old people on modest incomes in large houses may have much less ability to pay than their council tax bandings would suggest.

In short, whilst council tax is doubtless more of an ability-to-pay tax than a benefit tax, it does not measure ability to pay very well.

3.2 Progressive taxes versus regressive taxes?

A further question in relation to ability-to-pay is that of how precisely tax payments should vary with ability to pay. Suppose ability-to-pay is measured by peoples' incomes, then one possibility would be to make peoples' tax bills proportional to their incomes. The two other possibilities are to make peoples' tax bills rise less than proportionately to their incomes – this is called a regressive system – or rise more than proportionately to their incomes – this is called a progressive tax system. It is widely accepted that taxation should be proportional or progressive rather than regressive, because each pound paid by the rich is probably less of a sacrifice than each pound paid by the poor. The more marked one believes this difference in sacrifice is between the rich and the poor, the more one will want to move in the direction of progressive taxation.

3.3 Shared taxes

It was argued above that, for financing genuine local services, local authorities should have access to some tax revenues where they have some control over the tax rates. However, some countries allow subnational

authorities to secure large tax revenues while having no discretion over tax rates at all. They do this by using a system known as tax-sharing. Among the best known examples of tax-sharing are those in Austria and Germany, which cover the states as well as municipalities and the central government. A country can have several shared taxes with different percentages of each tax going to local authorities.

In Germany, for example, set percentages of the yields of income tax, corporation tax and value added tax accrue to the central government, the states and local authorities, the percentages varying between the three taxes. These three taxes account for about 75 percent of Germany's total tax revenue. In the case of income tax and corporation tax, the revenue accruing to a tier of subnational government is apportioned between the authorities in that tier in proportion to the amount of tax raised in each authority. But the states' shares of value added tax is apportioned between the states in proportion to their populations.

The main advantage of a shared tax is that it is a relatively cheap way of securing tax revenues for lower tier authorities. Collecting a shared tax costs little more than collecting an equivalent central tax. The only additional cost that is incurred when a tax is shared is the cost of obtaining data for the allocation formula, such as ascertaining the tax yield or population of each area.

Although tax sharing has some administrative advantages, it is entirely unsuited to a system where local voters are expected to make choices about the expenditures they wish to make, taking into account the cost of these decisions as signalled by local taxes. With shared taxes, local authorities cannot determine their own tax rates, so they cannot set service levels in accordance with local wishes. This may not be a problem in Austria and Germany, because these countries see states and local authorities as existing chiefly to provide services on a substantially uniform basis everywhere. Effectively, then, they see states and local authorities as acting on an agency basis. However, if the UK sees the rôle of local authorities in many services as providing local solutions to local problems in the light of local preferences, then tax sharing is unsuitable, because it is geared to uniformity rather than local choice.

Another problem with tax-sharing is that the UK central government might well see the shared tax revenues as part of its own revenues which it is giving away, and in this case it may want as many controls as it would want with grants. This problem is reduced in Austria and Germany because the shares of the shared taxes that go to the lower tiers typically have some constitutional guarantee, so that the central governments there cannot easily see these shares as part of their own revenues that they are giving away. But there are no such constitutional guarantees in place for the UK.

3.4 Macroeconomics

Sometimes governments and others say that they would be willing to have more locally set taxes, except that such taxes would make it harder to control total demand, and so harder to have successful stabilization policies. This argument is weak both in theory and in practice.

To see the theory, suppose that local tax and grant financed spending is about 10% of GDP, which is rather higher than in the UK. And say that local authorities raised their spending by a tenth, that is by 1% of GDP. If they financed this with higher taxes, then households' disposable incomes would fall by 1% of GDP. Typically, households would then reduce their household spending by about 0.9% of GDP and their saving by about 0.1%. So the overall rise in total spending would be a 1% rise in local spending, minus the 0.9% fall in household spending, which is a trivial 0.1% of GDP, or about 1/1000th (Fender and Watt, 2002).

To see what happens in practice, one study attempted to see whether the countries with the most subnational tax power performed badly (King and Ma, 1999a and b). The study considered the period 1984-95 and divided the OECD countries into 11 centralized ones, where subnational taxes accounted for under 12% of total taxes, and 12 decentralized ones, where subnational taxes accounted for over 20% of total

taxes. In that period, inflation averaged 4.6% in the decentralized countries, well under the 10.8% in the centralized ones. And unemployment averaged 5.6% in the decentralized countries, well under the 10.0% in the centralized ones. Maybe central governments in the centralized countries try to take all decisions over central and subnational spending, so in turn maybe they ‘overload’ themselves and do badly.

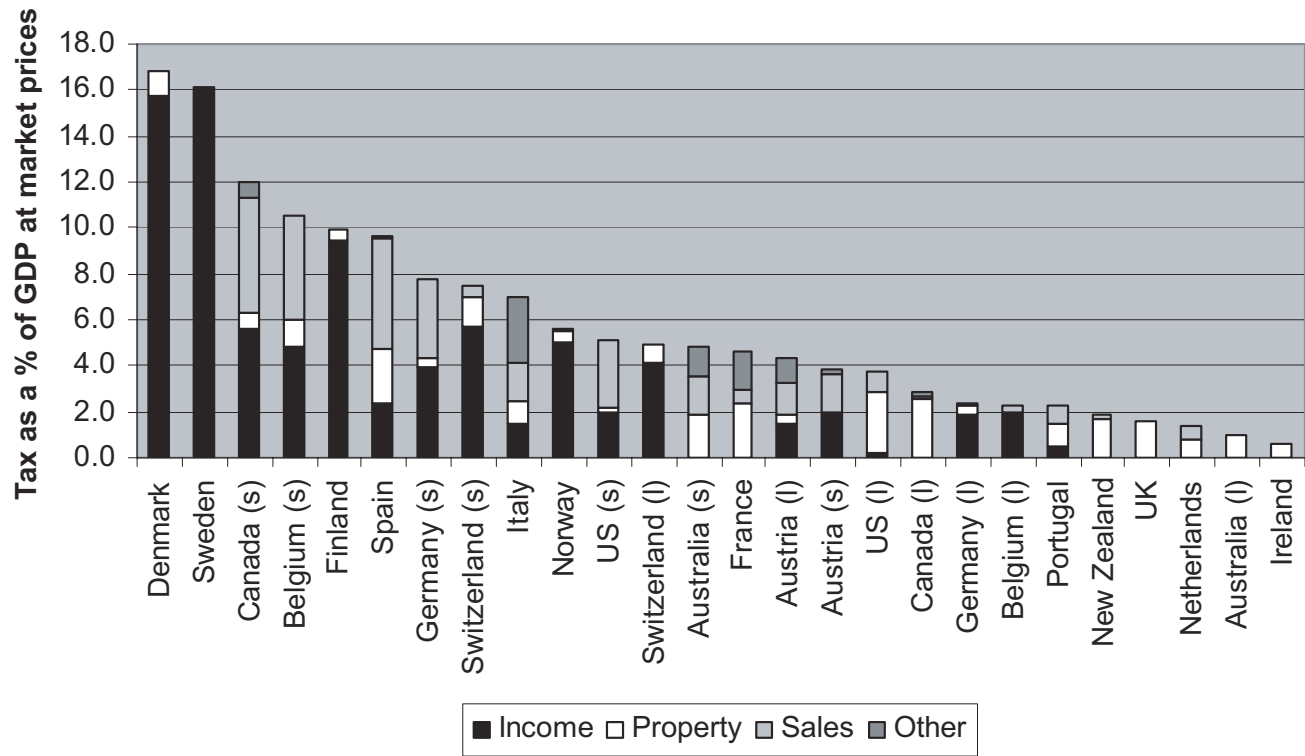
3.5 **The balance between domestic taxes and business taxes**

The benefit approach to taxation supplies some guidance on the question of the balance between domestic and business taxes. For it is arguable that the total yield of local business taxes should relate to the benefits received by businesses, whilst the total yield of local domestic taxes should relate to the benefits received by households. As most local services, such as education, are chiefly concerned with benefiting households, it is arguable that local domestic taxes should raise perhaps 80-85% of the total, with perhaps 15-20% coming from business taxes.

4 **Overview of subnational taxes in the OECD**

The following three sections, sections 5-7, consider individual local taxes. It is useful to precede that discussion with a quick look at the subnational taxes used in the OECD. The yields of the main taxes are shown in Fig4 as percentages of GDP.

Fig.4: Subnational taxes as a % of GDP



Source: OECD Revenue Statistics, various years. The figures are for 2002, except for Portugal which is 1999.

There are a few noteworthy points about the choice of subnational taxes in OECD countries.

- Income taxes, property taxes and sales taxes are the most common.
- Local income taxes are of exceptional importance in Scandinavian countries.
- Local property taxes tend to be important in English speaking countries.
- Although local sales taxes are quite common, their form of implementation very rarely allows local authorities any discretion over tax rates as noted in section 5.10.⁵

Some countries levy 'other taxes'. The most common 'other taxes' are payroll taxes: these exist in a pure form in Australian, Austria and Canada. The most sizeable 'other taxes' are the business taxes in France and Italy, which account respectively for 1.6% and 2.9% of GDP; but each of these business taxes has as its base a mixture of two or more of payrolls, profits and property, so neither is really an altogether different type of tax. Australia's states have yet another 'other tax' in the form of licence duties on retail outlets such as such as filling stations and liquor stores; sometimes the states make the licence fee proportional to the outlet's turnover, and in such cases these fees effectively become sales taxes by another name.

5 The main local domestic taxes

It is clear from Fig4 that the highest yielding subnational tax is an income tax. Allowing that some countries operate this tax at both state and local levels, the average yield at subnational level across the 19 countries is about 4.5% of GNP. Some of this, about 0.4%, arises from taxes on corporate incomes, but the great bulk of it, 4.1%, arises from taxes on individual incomes. Income taxes come well ahead of property taxes, which account for an average of 1.4%, and it should be noted that perhaps only around half of property tax yields arise from domestic property.⁶ Taxes on goods and services raise rather more than property taxes, at 1.6%.

Perhaps the maximum yields are more instructive than the averages. The highest yield for an income tax is 16.1% of GDP in Sweden, all of it on personal incomes. The highest yield for a property tax is 3.3% in Canada, say about 1.8% for domestic property,⁷ and the highest yield for sales taxes is 5.1%, also in Canada. No other domestic taxes raise significant yields, except social security contributions in Austria, which account for about 0.4% of GDP.

It is clear that three taxes stand out as popular local taxes: property taxes, income taxes and sales taxes. This section looks at these three taxes and sees how they measure up against a range of criteria that are often used to appraise local taxes. It should be stressed at the outset that there is no perfect local tax. Equally, however, there is no perfect central tax. So, just as central governments should seek to rely on the least unsatisfactory central taxes, local authorities should rely on the least unsatisfactory local taxes.

⁵ Introducing a local sales tax for the UK would need to meet EU rules – see LGA (2004 p. 6)

⁶ There are no OECD data giving the share of property taxes accounted for by domestic property.

⁷ We are informed by François Vaillancourt that there are no official Canadian data on this, but households are thought to pay around 55% of the total property tax yield and hence around 1.8% of GDP in this tax.

5.1 Adequacy of the tax yield

We have seen that the UK's local authorities spend around 10% of GDP. If it is desired to put most of their services on a reasonably autonomous basis, and so finance this spending with over half the revenue coming from taxes, then their tax yield needs to be, say, at least 6% of GDP; and we have argued that most of this should come from domestic taxes. OECD experience suggests that if this yield was to be achieved with just one tax, then it would have to be a local income tax. The highest yielding property taxes produce only 3.3% of GDP. The UK had a figure around 4% with domestic rates in the 1980s, and despite the opposition to the poll tax, a key reason for replacing domestic rates then was a feeling that property taxes were too high.

However, if there was a willingness to accept two local taxes, then OECD experience suggests that there would be a chance of raising an adequate yield without having a local income tax, by instead having a combination of a property tax and a sales tax. But it would be easier to use an income tax with either a property tax or a sales tax.

5.2 Equity – or the fairness of the tax burden

It may be wondered why people will accept a higher yield with income taxes than property taxes. The answer is that it is generally felt that high yielding taxes should relate to taxpayers' abilities-to-pay, and incomes are a better indication of abilities-to-pay than property values. Spending levels, too, are probably a better indication of abilities-to-pay than property values, which suggests that a high sales tax may be more acceptable than a high property tax. But it should be noted that a sales tax would hurt the poor much more than an income tax from which they are exempt, and indeed it would hurt the poor more than the council tax, where they are eligible for council tax benefit.

Of all the property taxes in the OECD, the council tax is probably the one that makes most adjustment for ability-to-pay, for not only are there welfare benefits for poor taxpayers, there are also discounts for single adult homes and student homes; and in future there may be discounts for pensioner homes. But no matter how much tinkering of this sort arises, there will always be the problem that some people with high incomes happen to live in low property value areas, and vice versa. Low income citizens in London might well wonder why, in addition to having to use larger shares of their income to buy property, they are then deemed more able to pay property taxes than people in low property value areas.

5.3 Spread of the tax yield

In England, the Office of the Deputy Prime Minister (ODPM) operates an equalization scheme. Essentially, it assesses the needs of each local authority, after allowing for receipts of specific grants, and it also works out how much the authority will receive from the uniform business rate. It also works out how much the authority would receive from the council tax if it set it at an assumed national standard level. It pays a grant to finance the rest.

So, other things being equal, areas with low tax bases tend to get high grants and vice versa. It might therefore be imagined that it does not matter that some areas have higher tax bases than others. However, there are several problems with a very unequal tax base.

- Low base areas will suffer from major gearing problems, especially if the overall local tax base is low

- If the overall local tax base is high, then high base areas may warrant negative grants which, though justified, may prove very unpopular. Perhaps they would not be introduced. In that case, these areas will have a very favourable position compared with other areas. This was certainly the case in London when business rates were a local tax.
- The fact that some authorities will be heavily dependent on grants may result in the government wanting to control how they spend their grants; in turn, it may feel inclined to impose similar controls over all authorities.
- The more equalization there is, the more taxpayers in high tax base areas will subsidize those in low tax base areas through the central tax and grant system. Unless the tax is an income tax, this could well lead to low income areas subsidizing high income areas. For example, with the council tax, low property values in Newcastle-upon-Tyne result in it receiving much more favourable grants from the ODPM than West Devon. Yet incomes in Newcastle are actually higher than in West Devon.

The council tax base is actually quite evenly spread, owing to the open-ended nature of the top band. Table 1 shows that in 2004-05, the highest base per head was in the City of London, with the equivalent of 0.64 Band D properties per head. This was little more than double the figure of 0.26 in the lowest base area, Leicester. And London's share of the total base in England was 16.50%, not greatly above its population share of 14.84%.

Table 1: Distribution of local council tax and income tax bases, 2004-05

Council tax base (Band D homes per head)			LIT base (Taxable income per head, £)		
	Base	Base:mean		Base	Base:mean
Mean base	0.35	1.00	Mean base	9,428	1.00
Five highest bases			Five highest bases		
City of London	0.64	1.80	City of London	174,744	18.53
Westminster	0.63	1.79	Kensington and Chelsea	37,969	4.03
Kensington and Chelsea	0.57	1.62	Westminster	28,220	2.99
Isles of Scilly	0.53	1.51	Richmond-upon-Thames	22,730	2.41
South Bucks	0.49	1.39	Chiltern	21,306	2.26
Five lowest bases			Five lowest bases		
Knowsley	0.28	0.78	Stoke-on-Trent	5,208	0.55
Manchester	0.28	0.78	Easington	5,103	0.54
Nottingham	0.27	0.77	Manchester	5,095	0.54
Easington	0.27	0.77	Leicester	5,078	0.54
Leicester	0.26	0.74	Barrow-in-Furness	4,932	0.52
London as % of total base	16.50		London as % of total base	19.53	

Sources: Council tax figures from ODPM. Income figures derived from Inland Revenue Statistics, various years.

As there is no local income tax at present, there are no firm data for the base in each area. However, using Inland Revenue data for average incomes of income tax payers, and applying current allowances and exemptions, it is possible to estimate the taxable income in each area. This data uses small samples, so we have taken weighted averages for three years to try and reduce the problems of small samples. Table 1 shows that, leaving aside the idiosyncratic City of London, the highest taxable incomes per head, in Kensington and Chelsea, were nearly eight times as high as those in the lowest area, Barrow-in-Furness. And London's share of the total base in England was 19.53%, well above its population share of 14.84%.

Whilst the spread of income tax is, nevertheless, arguably acceptable, it would be improved if there was some form of cap. Taxable incomes for local tax purposes might for example, be confined to the first £100,000 of taxable income.

With a sales tax, the spread would naturally depend on exactly which items were taxed. Assuming it was broadly based, and bearing in mind that poorer people tend to spend a higher proportion of their incomes than richer people, one might be tempted to predict that the base would be a little more evenly spread than an income tax. However, the tendency for people to do a lot of their shopping in major cities would greatly favour them and could result in a much more uneven base than would apply with a local income tax.

5.4 Buoyancy

Local authorities often object to property taxes on the grounds that the value of the base tends to remain static, aside from new building. So the tax rate must be raised annually to keep up with any rises in price levels. Local authorities often claim that voters have illusions and mistake rises in tax rates for real increases in spending, and hence blame local authorities for extravagance. Much the same would occur with specific sales taxes fixed at so much per litre or packet etc. This problem is avoided with an income tax and with a percentage sales tax. It could even be avoided with a property tax if there was some form of annual revaluation; but this might prove costly if there were many appeals each year.

However, from an economic perspective, it is not clear that a lack of buoyancy is a problem. For people may suffer more illusions with an income tax or a percentage sales tax whose real yield rises in times of economic growth without any rise in tax rates. People may be unaware how much their real tax payments rise each year. If people have this sort of illusion, then it might be expected that local expenditure growth would be most rapid in countries with the most buoyant local taxes. Evidence from the United States suggests that state spending there does indeed rise most rapidly in states where there are buoyant income taxes. There is less evidence in Europe, but it may not be entirely coincidental that the two EU countries shown in Fig.1 to have the highest local spending in relation to GDP, Denmark and Sweden, are shown in Fig.4 to have the highest local income taxes in relation to GDP.

In short, it is hard to decide whether buoyancy is good, bad or a matter of indifference.

5.5 Certainty

Ideally a tax should afford certainty to taxpayers over what tax they owe, when it is due, and how they need to pay. Since council tax has been introduced, there has been comparatively little dispute over the bands that homes have been placed in. A local income tax would have a high degree of certainty if it were piggy backed onto national income tax as suggested by, for example Isaac (1992). A local sales tax would also offer high certainty.

In addition, a local tax should ideally give a predictable revenue to a local authority, once it has set its tax rate. A local property tax does well here, as uncertainty arises only from slight fluctuations in new properties,

empty properties and default rates. But with an income tax or a sales tax, the actual amount raised may differ significantly from what was forecast if the local economy performs better or worse than expected. Local authorities may face difficulties if they raise less revenue than they forecast. Some countries, like Norway, give no help to authorities in this position, except to let them borrow temporarily to make up the shortfall; authorities who borrow for this reason must set higher tax rates in the next year to repay the loans.

Some other countries offer more protection. For example, in both Denmark and Sweden, the central governments collect all income taxes and actually pay each local authority the sum it expected to receive on the basis of its forecast, instead of paying it the revenue actually collected from its residents. In Denmark, any difference between the amount that the government raises in an authority and the amount which it pays to that authority is regarded as a loan from the central government to the local authority or vice versa; these loans are all repaid two years later with interest under an arrangement known as a 'true-up'. In Sweden, any difference between the aggregate amount that the government raises and the aggregate amount that it pays is added to, or subtracted from, the grants that it pays local authorities two years later, the grants all being adjusted by an equal per capita basis.

5.6 Convenience

A local sales tax and a local income tax would both be relatively convenient for the taxpayer, with sales tax being collected from retailers or wholesalers on the buyer's behalf, and the bulk of income tax being collected by PAYE. Council tax can be collected by direct debit which is a convenient method.

5.7 Low administration and compliance costs

Sales taxes tend to have the lowest costs, as they are collected by sales outlets which are relatively small in number compared with the total of individual taxpayers. However, value added taxes have higher compliance costs than other sales taxes, owing to administrative complexity. Property taxes are often claimed to have low costs, but data on them often understate the true costs by ignoring the costs of periodic revaluations.

Conversely, income taxes are often claimed to have high costs, but they also have the highest potential yield, so the costs may be lower as a percentage of the yield. CIPFA (2004, p. 36) provides evidence that the relative cost of administering an income tax is lower than that of administering council tax. It argues that Inland Revenue statistics

"show that the collection cost as a percentage of the yield has improved since 1992, from 2.1% to 1.4% in 2001-02. This equates to a total UK cost of £2.48 billions for administering all Inland Revenue duties, and compares with our estimate of the equivalent cost of Council Tax collection in the same year of £0.6 billions. Council Tax Revenues would need to account for more than half of local authority Net Revenue Expenditure before the cost of collection could approach the same sort of ratio of cost to yield as achieved by the IR on the collection of personal income tax."

Also, whereas a property tax may be used only by local authorities, an income tax will almost certainly be used by the central government as well, so the marginal cost of collecting one on behalf of local authorities as well may be relatively modest.

5.8 Promoting efficient spending levels: visibility and perceptibility

Ideally, local taxes should help produce a situation where local authorities spend at the correct levels: that is, they should spend more so long as the benefits to taxpayers of extra spending exceed the cost of extra taxes. However, this criterion is unlikely to be met if local taxes are invisible or imperceptible, so that local voters do not know how much they are paying in tax.

Domestic property taxes are often highly recommended in terms of being very visible. A local income tax would be less visible, as most taxpayers would have it deducted before they actually received their income. A sales tax would be least visible, as taxpayers would find it difficult to ascertain how much tax they paid over a year.

However, it is worth asking whether it is any less acceptable for local authorities to have imperceptible taxes than the central government.

5.9 Promoting efficient spending levels: tax exporting

Tax-exporting occurs if the burden of a tax falls partly on non-residents. The result is that local services are effectively subsidised by non-residents. This may lead to excessive spending. There may be a significant problem with exporting in the case of a local sales tax, as many shoppers in a given local authority may be non-residents. However, there is little or no problem with tax-exporting in the case of domestic property taxes and personal income taxes.

Of course, some local services do benefit non-residents, particularly perhaps commuters, other day-visitors, and night visitors, so some exporting does seem acceptable; but it could be argued that non-residents typically pay far more than their due share through the grants system.

5.10 Low distortions when tax rates vary

Ideally, local taxes should not distort people's behaviour, but such distortion is a danger when tax rates differ markedly between local authorities. In particular, it is important to avoid giving people incentives to shift the tax base from one authority to another.

Tax-base migration can be serious with sales taxes, if local authorities have discretion over the tax rate. This is because people have an incentive to live in areas with high tax rates and good local services, but then to go and do their shopping in areas with low tax rates. This problem can be significantly reduced if local sales taxes levied at varying rates are confined to large authorities. Indeed the main OECD examples of subnational sales tax rate setting arise with Australia's states and Canada's provinces, many of which are larger than England.

Tax-base migration should be less serious with local income taxes. For if tax rates relate closely to service levels, then people may willingly pay higher local taxes in order to get better local services. However, local income taxes may make local services seem very costly to those on high incomes, and very cheap or even 'free' to those on low incomes. So the former may tend to vote for low service levels and migrate to areas with poor services, and vice versa. The problem of the rich could perhaps be addressed by some upper limit on the level of income that local authorities could levy taxes on; in effect, this would cap local income taxes on those with high incomes in an analogous sort of way to the open-ended top band of the council tax.

Property taxes perhaps score best on this criterion, especially the council tax on account of its open-ended upper band. But insofar as council tax benefit may pay up to 100%, poor people may pay no council tax,

and may therefore be tempted to vote for high services and also to migrate to high service authorities. Arguably, council tax benefit should operate in such a way that it never paid 100% of someone's bill.

5.11 A summary

As section 5 has covered many disparate issues, it seems useful to summarize the main points, and this is done in Table 1. This table should really be read with the text since, in itself, it is naturally rather over-simplified.

6 The main local business taxes

Although, as shown by Fig4, income tax is the highest yielding subnational tax, with an average yield across the 19 countries shown of 4.5% of GDP, the vast bulk of that sum comes from personal incomes, and on average only about 0.4% of GDP comes from subnational taxes on business incomes. This figure of 0.4% would be slightly enhanced if the relevant profit shares of the business taxes in France and Italy were added in. Even so, the average yield of business income taxes is almost lower than the average yield of business property taxes, which probably account for around half the yield of property taxes and so around 0.7% of GDP. The pure payroll taxes in Australia, Austria and Canada put the average yield of payroll taxes at around 0.2% of GDP, and this figure would be slightly enhanced if the relevant payroll shares of the local business taxes in France and Italy were added in.

Table 2: Key points in the selection of domestic taxes

	Local income tax	Council tax	Sales taxes
Adequacy of yield based on OECD experience	High potential	Limited with any property tax	Modest potential
Equity	Good	Modest, but council tax benefit helps	No protection for the poor.
Spread of the yield	Probably satisfactory, but a cap on high income would help	Good	Might greatly favour areas with major shopping centres
Buoyancy, assuming this is desirable	Good	Poor unless there are regular revaluations	Good
Certainty	Good	Good	Good
Convenience	Good	Medium	Good
Admin. costs etc.	Low if piggy-backed	Medium	Low
Visibility	Modest	Highly visible	Almost invisible
Exporting of tax burden	No problem	No problem	Much exporting by major shopping areas
Distortions if tax rates vary	Probably little problem	Probably little problem	Could be problems with shopping areas

As with domestic taxes, the maximum yields may be more instructive than the averages. The highest yield for a business income tax is 1.5% of GDP in Switzerland. The highest yield for a property tax is surely Canada, with up to 1.5% of GDP, and the highest for a payroll tax is 1.3% in Australia. No business tax that uses a different base from these raises a significant yield.

It is clear that three taxes stand out as popular business taxes: business property taxes, profit taxes or payroll taxes. This section looks at these three taxes and sees how they measure up against the criteria that are often used to appraise local taxes.

6.1 Adequacy of the tax yield

We saw in Section I that the UK's local authorities spend around 10% of GDP. If it is desired to put most of their services on a reasonably autonomous basis, and to finance this with over half the revenue coming from taxes, then the yield needs to be, say, at least 6% of GDP. However, arguably business taxes need account for, say, only up to a fifth of this, say 1.2%.

This target of 1.2% is exceeded by the highest subnational business income tax, in Switzerland, by the highest subnational property tax, in Canada, and by the highest subnational payroll tax, in Australia. So, arguably, any one of these three taxes would be sufficient on its own, at least if it was levied at relatively high rates by OECD standards. Incidentally, the target of 1.2% is well exceeded by the 1.7% that applies to the UK's business rates, which were formerly a local tax.

6.2 Equity – or the fairness of the tax burden

As business taxes are levied on businesses, their equity implications are often ignored. However, all taxes are ultimately paid by people, and it is pertinent to consider who really pays these business taxes. This is a very complex issue, but it is likely that with any tax on business profits, property or payroll, some of the burden will be borne by shareholders in the form of lower profits, some by employees in the form of lower wage rates, and some by customers in the form of higher prices. Thus the biggest impacts will tend to fall on those who have the highest ability-to-pay in terms of having high business ownership, high wage rates and high spending levels. So, even though this is a brief description of a very complex topic, it is unlikely that a full analysis would point to serious equity problems.

6.3 Spread of the yield

The only business tax for which data on bases are available at local authority level are business rates. However, there are data on profits and payrolls at the level of the 30 English NUTS 2 districts (NUTS stands for Nomenclature of Units for Territorial Statistics). Table 3 compares the bases of all three taxes for these 30 multi-authority areas.

Non-domestic rates are very unevenly spread. Table 3 shows that in 2004-05, the highest base per head was in Inner London, with a rateable value of £2,963 per head. This was over five times the figure for the lowest base district, Cornwall and the Isles of Scilly. London's share of the total base in England was 26.76%, almost double its population share of 14.84%. The main problem arises with Inner London which actually has 17.66% of the base but only 5.64% of the population.

As there is no local payroll tax or profits tax, there are no firm data for the base in each area. However, using official data, it is possible to make some estimates for the NUTS 2 districts. These data show value added and compensation of employees working in each district. Subtracting the latter from the former should indicate profits. Assuming a local profits tax applied to all profits, then the distribution of yields would be as indicated in Table 3. As with business rates, the highest yield would be in Inner London. But this is under three times the lowest figure which arises in Merseyside. London's share of the total base in England was 18.63%, appreciably above its population share. Again the main problem is Inner London which has 9.95% of the base. However, this tax is clearly much less unequal than business rates.

Table 3 also shows what the distribution of the yield from a local payroll tax would be if it was applied to all compensation of employees. The table shows that the highest taxable incomes per head, again in Inner London, were about five and a half times as high as those in the lowest area, Cornwall and the Isles of Scilly. London's share of the total base in England was 24.19%, while Inner London's was 15.74%. Thus this tax is less unequal than business rates.

It is clear that these three taxes are unequally spread. However, suppose business taxes were levied at a level commensurate with the benefits that businesses derive from local services. Then it would be perfectly acceptable for the yield to be highest in areas with the most businesses. But some research would be needed to see which of these three taxes best captured the relative costs to local authorities of providing business services.

6.4 Buoyancy

Corporate income taxes and payroll taxes are likely to be reasonably buoyant, in that the base tends to rise in line with incomes and prices. So even at constant tax rates, the yield will rise over time. Conversely, a tax on business property will lack buoyancy unless there are frequent revaluations. However, it is hardly material whether business taxes are buoyant or not if businesses do not have a local vote.⁸

⁸ If they did have votes, then there might be concerns with buoyant taxes because businesses might not know how rapidly their real payments were rising, and with unbuoyant ones because businesses might not know how little their real payments were rising; and limited knowledge may lead businesses to vote inappropriately.

Table 3: Distribution of bases for three possible local business taxes, 2004-05

Non-domestic rates (rateable value per head, £)		Base	Base: mean
Mean base		945	1.00
Five highest bases			
Inner London		2963	3.13
Berkshire, Buckinghamshire & Oxfordshire		1,189	1.26
Bedfordshire & Hertfordshire		984	1.04
Outer London		958	1.01
Cheshire		953	1.01
Five lowest bases			
Lincolnshire		629	0.67
Lancashire		628	0.66
Devon		623	0.66
Tees Valley & Durham		615	0.65
Cornwall & Isles of Scilly		584	0.62
London as % of total base	26.76	Inner London as % of total base	17.66

Profits tax (tax base per head, £)		Base	Base:mean
Mean base		5,152	1.00
Five highest bases			
Inner London		9,092	1.76
Berkshire, Buckinghamshire & Oxfordshire		7,905	1.53
Bedfordshire & Hertfordshire		6,708	1.30
Cheshire		6,160	1.20
Surrey E and W Sussex		6,157	1.20
Five lowest bases			
Cumbria		3,692	0.72
Cornwall & Isles of Scilly		3,342	0.65
Tees Valley & Durham		3,341	0.65
S Yorkshire		3,189	0.62
Merseyside		3,086	0.60
London as % of total base	18.63	Inner London as % of total base	9.95

Payroll tax (compensation of employees per head, £)**Base****Base:mean****Mean base**

9,692

1.00

Five highest bases Inner London

27,074

2.79

Berkshire, Buckinghamshire & Oxfordshire

12,546

1.29

Bedfordshire & Hertfordshire

10,123

1.04

Cheshire

9,996

1.03

West Midlands

9,520

0.98

Five lowest bases

Tees Valley & Durham

7,102

0.73

Shropshire & Staffordshire

7,069

0.73

Dorset & Somerset

7,067

0.73

Devon

7,018

0.72

Lincolnshire

6,957

0.72

Cornwall & Isles of Scilly

4,828

0.50

London as % of total base

24.19

Inner London as % of total base

15.74

Sources: Rateable values form ODPM. Compensation of employees taken from, and profits derived from, Vincent, 20003.

6.5 Certainty

As the location of business property is not open to doubt, and valuation is tractable, local business rates score well on certainty for taxpayers. However, local business income taxes are subject to major difficulties in apportioning between different authorities the profits of multi-area firms; ultimately, some more or less arbitrary formulae have to be used. Similar difficulties may arise, but on a smaller scale, with local payroll taxes.

Local business property taxes also score well in terms of certainty for local authorities. But, like local taxes on domestic incomes and sales, local taxes on business incomes and payrolls may produce significantly different yields from those expected if the economy in an authority has an unexpected turn. However, this difficulty could be addressed with similar devices to those discussed in section 5.5 in the case of domestic taxes.

6.6 Convenience

As all these business taxes are administered collectively for relatively few taxpayers, compared with domestic taxes, they score well, per pound raised, on convenience.

6.7 Low administration and compliance costs

As these local business taxes yield more per taxpayer than local domestic taxes, they should have significantly lower administration and compliance costs in relation to the revenue raised.

6.8 Promoting efficient spending levels: visibility and perceptibility

The argument for having visible local taxes is to help voters understand the cost of the local services that they enjoy so that they make informed choices about the level of local services. As businesses do not have votes, the perceptibility of business taxes does not matter.

6.9 Promoting efficient spending levels: tax exporting

As already noted, the incidence of business taxes is shared in unclear proportions between owners, employees and customers. So for any individual business, some of the incidence of any local business tax is almost certain to be exported. However, the non-residents who face some of the burden also get some benefits from the services which the local authority provides for the business. So it is reasonable for some of the burden to be exported. Problems would arise only if disproportionately large or small shares of the tax were exported.

Given the uncertainty of how far the burden of each possible business tax is exported, and also how far the benefits of local services to businesses are exported, it is impossible to say whether one or other business tax is particularly commendable or unsatisfactory. The probability is that, if the total burden of business taxes was commensurate with the total value of the local services that businesses enjoy, then tax-exporting these taxes would not be a matter for much concern.

6.10 Low distortions when tax rates vary

It is often feared that business will migrate from areas with high rates of business taxes, whether the base be profits, payrolls or property. However, it should be noted that the benefits which businesses derive from local services may typically be greater in areas with high tax rates. If so, then the incentive for businesses to leave these areas will be reduced. Probably the main conclusion here is that it might be unwise to make business taxes cover more than the benefits to local businesses of local services.

Quite aside from business migration, there could be a further problem with payroll taxes if rates vary between areas. This problem is that workers might be tempted to live in areas with high tax rates and good services, but to work in areas with low tax rates, so that not much of the tax was passed on to them in lower wages. Again, however, this problem would arise only if local business taxes more than cover the cost of local services provided for businesses; otherwise, an area with high business tax rates will not be subsidising its residents, so a high payroll tax will not make it a more tempting place to in which to live.

6.11 A summary

The text has explained that some of the criteria for appraising local taxes cause no problems with business taxes, provided that these are levied at levels which roughly cover the cost to local authorities of providing businesses with services. Assuming this is the case, Table 4 summarises the key points from the discussion. This table should really be read with the text, since in itself it is naturally rather over-simplified.

⁹ If they did have votes, then it is arguable that they should face visible taxes. Presumably it is the owners who would vote, and they would take account of the levies made on them which, whether based on property, payrolls or profits, would be clearly visible. And even though the burden of these taxes does not fall wholly on the owners, as some passes to employees and customers, the visibility would give owners a clear idea of the cost of local services.

Table 4: Key points in the selection of business taxes

	Profits tax	Property tax	Payroll tax
Adequacy of yield based on OECD experience	Adequate	Adequate	Just adequate
Equity	Obscure and hard to determine, but almost certainly acceptable		
Spread of the yield	Concentrated in business areas. Unclear at present which one's base best reflect the costs to local authorities of services to businesses.		
Buoyancy	Yes, and not a problem	No, but not a problem	Yes, and not a problem
Certainty	Medium	Good	Medium
Convenience	Good	Good	Good
Admin. costs etc.	Good	Good	Good
Visibility	Not an issue, assuming there is no business vote		
Exporting	No serious problems, providing business taxes cover only the cost of local authority services for businesses		
Distortions	No serious problems, providing business taxes cover only the cost of local authority services for businesses		

7 Some other local taxes

Few countries, either in Europe or elsewhere, have tried to raise large revenues from local taxes other than those discussed in sections 5 and 6. The two main examples are not very promising, and are as follows:

- The former poll tax in the UK. This was a tax whereby all adults in a given area had to pay the same amount of local tax. It was widely felt to be unfair and was soon abandoned.
- The natural resource revenues used by the Canadian provinces. The trouble with using these revenues at a local level is that they favour some authorities greatly at the expense of others. As a result, there is a risk that there will be large variations in service levels between areas, unless large equalization grant schemes are introduced.

The other possibility for a major local tax would be a land value tax, also known as site value rating, introduced to replace council tax and business rates. Foster et al (1980, p. 458) provide a detailed history and analysis of the approach. There is a brief discussion in LGA (2004, p. 7-9). The attraction of land value tax is that the supply of land is fixed and that the rent it generates may be taxed without affecting its supply. In contrast if the structures on the land are included – a property tax – then there will be a disincentive to invest in structures (housing and factories and shops etc.). A shift from a property tax to a land tax might therefore be expected in the long run to lead to more housing and development. Recent advocates of land value tax include Mclean and McMillan (2003) and Muellbauer (2005) suggests that Uniform Business Rates should be moved in the direction of land value. Although land value tax has been strongly advocated it was not taken up as a viable option by the balance of funding review.

There are some other minor taxes that could be of interest, particularly those on motorists. For example, local authorities have the power to charge for road use. London has introduced congestion charging, and there are small schemes at Cambridge and Durham. Edinburgh's residents voted against a scheme in February. The government is currently conducting trials on a scheme for tracking motorists with a view to possible charges.

Otherwise, there do not seem to be many promising taxes. The Report on the Balance of Funding Review (ODPM, 2004) considered a number of possible new local taxes, including localising the stamp duty on houses, site value taxes, local green taxes, localised vehicle excise duties, and local tourist taxes. The Review concluded by stating that

"although some of these smaller taxes and charges might be pursued for particular policy reasons and might improve links with stakeholders, we have concluded that none of them could achieve a significant shift in the balance of funding" (ODPM, 2004, p. 53).

The Review reached a similar conclusion with small local sales taxes.

8 Formula spending shares

The ODPM estimate a total formula spending share, or FSS, for each authority. Any suggestion that FSS figures represent the actual needs to spend for local authorities has always been resisted as an insult to notions of local autonomy, and the government is careful to claim that FSSs reflect only relative needs. However, their use in grant calculations does implicitly make them measures of absolute needs. Once an authority's FSS is determined, as its need to spend net of specific grants, the ODPM estimate how much revenue it would receive if it set the council tax at an assumed national standard level, and how much it will receive from business rates, and then pays a revenue support grant equal to the difference. The aim is that if local council taxpayers across England all paid a total council tax equal to the recommended total, then they could all enjoy comparable levels of services.

This description throws up two key questions. First, how important is the aim? Would it matter if people paid different amounts of tax for comparable services?

Secondly, how well does FSS measure needs? Unfortunately, the concept of true need is a slippery one, and it is hard to say how far FSS captures it. But it is worth exploring a related question: does FSS have surprising effects in terms of which areas end up gaining and losing through the system?

This section takes each question in turn.

A commentary on the aim

Take two taxpayers, Alpha and Beta, who live in different authorities, A and B, and who live in similar band homes. And assume that authorities A and B have the same rate of council tax, so that Alpha and Beta pay the same amount of local tax. Suppose the government made no attempt at equalisation. Then Alpha and Beta could face very different levels of local services, even if their authorities were comparably efficient. There are three reasons for this.

- A might have a much higher tax base per head than B, with more high band homes and fewer low band homes. So similar council tax rates will raise more money per head in A.
- A might need fewer units of output per head to secure the same level of services. For example, it might have a smaller child population and so need fewer school places per head.
- A might have lower costs for units of output. For example, wage rates might be lower in A, so that it can secure the services of teachers and other staff for smaller sums of money.

If any of these circumstances arise, Alpha might enjoy superior services to Beta for a similar tax rate. So there is an equity problem. Moreover, people might want to migrate from B to A, and any such migration would use up resources. For these reasons, the UK government uses a form of equalization. It allows that B needs to spend more, by giving B a higher FSS. And it allows that B could raise less revenue if it set the council tax at the recommended rate. The result is that it pays B a higher grant.¹⁰

There is much to be said for this arrangement, and it is arguable that the UK makes more effort at equalization than other countries. This is perhaps partly because of the low local tax yield in relation to spending and the ensuing gearing issue. To see this, suppose the government allocated revenue support grant on a per capita basis, like national non-domestic rates. Then even if A and B differed only slightly in resources or spending needs, the gearing problem means that there could be sharp differences in their tax rates if they sought to provide services at similar levels.

However, there is a telling counter-argument to equalization in the case of differences in costs. Suppose it really does cost more to provide services in B than A. Then it would save the country resources if people did move from B to A. So there is case for not subsidising B, as this subsidy would encourage people to stay put. Of course, this argument against equalization has to be weighed up against the equity arguments in favour, but it is an issue that needs more discussion than it usually gets

This issue is particularly important in the case of the area cost adjustments that are used to raise the FSSs of local authorities in London and some authorities elsewhere, mostly in the south-east. Take London for example. The argument is that local authorities there have to pay higher wages to attract employees to live there, chiefly because property prices are so high. So these authorities are given higher FSSs and thus secure higher grants. These grant subsidies make London a more attractive (or less unattractive) place to live, so they encourage more people to live there. So they put upward pressure on property prices and in turn force up the wages that must be paid to persuade local authority workers to live there.

In short, it is arguable that by allowing for these area cost adjustments in its FSS calculations, the government ends up paying grants that are largely financed by taxes on people living elsewhere to make the underlying problem in areas like London worse. Also, it does seem a little odd that the government uses its taxes and grants to channel funds from low wage areas to high wage rate areas, and it is doubtful if this occurs in any other OECD country.

¹⁰ It is occasionally argued that the problem actually solves itself. The argument is that if A and B are initially on an equal footing, and then B's tax base falls, or its needs or costs rise, so that its local tax rate rises or its services deteriorate, then some people will want to migrate from B to A. But at once property values will fall in B, and conceivably they will fall to the extent that migration is no longer attractive, and to the extent that the total cost of homes plus local services is the same in each area. However, property values may not adjust fully, for it is only land values that will adjust, and land has other uses which mean that its price is not dependant solely on residential demand. Also, existing home owners in B will hardly be impressed to be told that they need not worry about the rising local taxes or deteriorating services, because this is offset by a fall in the value of their homes. Thus this argument is discussed more in the theoretical literature than by practitioners.

It may be noted that these area cost adjustments only became important when business rates ceased to be a local tax. Previously, London authorities had enjoyed large business rates revenues and hence had been able to supply services at lower tax rates than applied in many other authorities. The loss of this tax threatened to push up the burden on local taxpayers, and there is a suspicion that the adjustments were introduced more to prevent local tax rates rising to the levels that would be needed for high similar service levels elsewhere.

The authorities which gain and lose

To see which areas gain and lose, this discussion considers the 30 NUTS areas rather than individual authorities. This means that the whole of England can be covered on a modest sized chart.

Fig.5 shows with a series of black bars the relative position of each area in terms of its council tax base. More strictly, it shows the relative number of Band D equivalent homes per head of population. Thus the base is highest in Surrey and Sussex, and lowest in South Yorkshire. The base is just about average in Cornwall and the Isles of Scilly and in East Anglia.

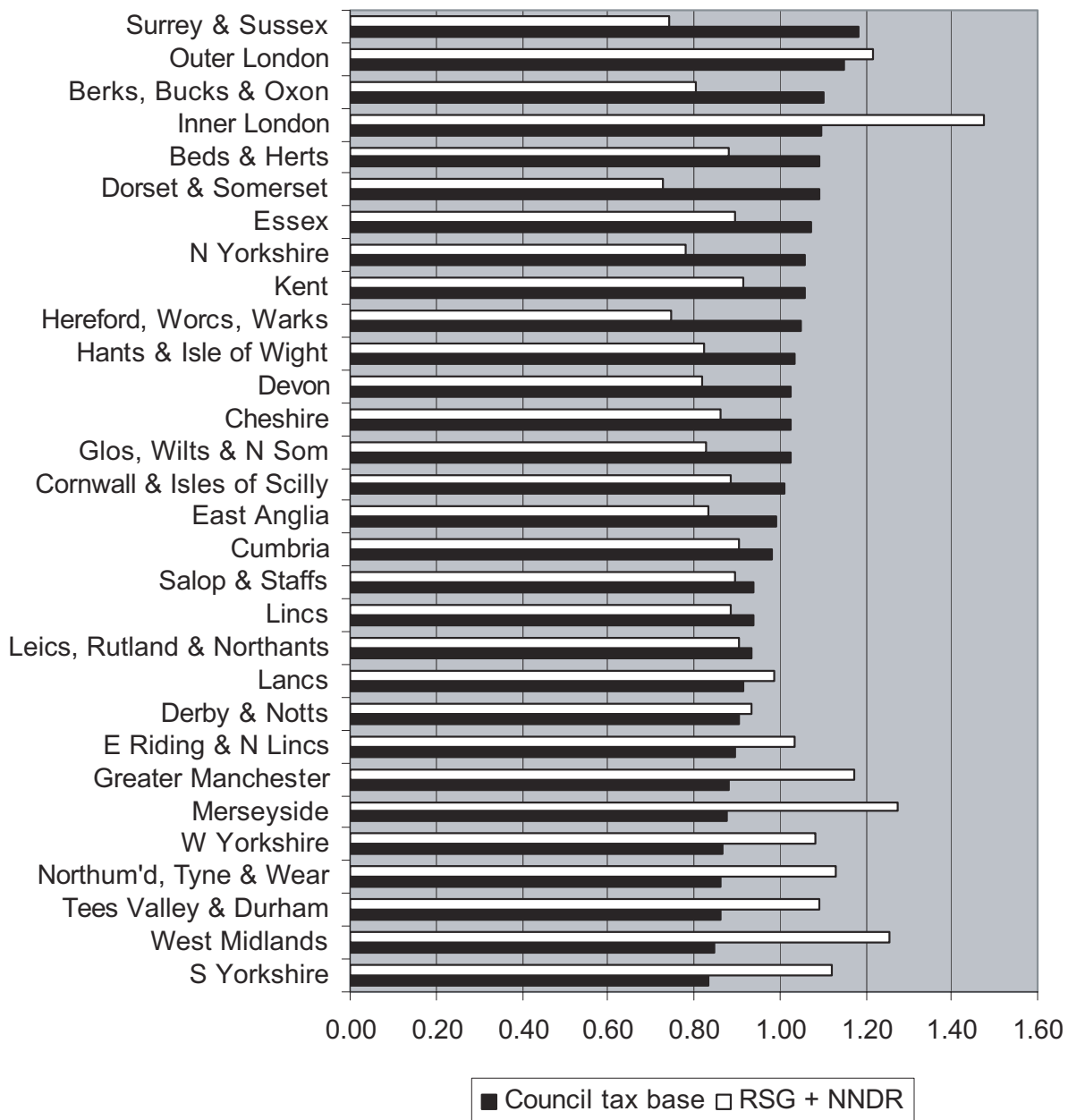
Fig.5 also shows with a series of white bars the relative position of each area in terms of its government support per head from the national non-domestic rate and revenue support grant. As the former is paid equally to all areas, the differences in the white bars arise solely because of differences in the latter.

As one aim of government intervention is to help low resource areas, one would expect to find the longest white bars arising in areas with the shortest black bars, and vice versa. So it is rather surprising to find that two of the longest white bars arise at the top for Inner London and Outer London. Of course, one would expect the lengths of the white bars to reflect needs and costs as well as resources, but the help to London is extremely high. Also, it is interesting that the London and the six metropolitan areas are among the few areas with white bars longer than the mean of 1.0. The only others are the urban area of the Tees Valley and the East Riding and North Lincolnshire.

It is also interesting to see how far the system diverts resources from low income districts to high income districts. This is done on Fig. 6 which repeats the white bars of Fig.5 but replaces the black bars with a new set that reflect taxable incomes in each district.

The tax system takes far more from high income people than low income people. So it might be expected that high income areas would tend to do badly with equalization grants. But Fig.6 shows that local authorities in high income urban London have very high grants, despite having high incomes. It is only high income rural areas, such as Berkshire and Surrey, which receive low grants. Conversely, it would be expected that low income areas would tend to do well from equalization. Fig.6 shows that this is true for low income urban areas, such as South Yorkshire, which receive relatively high grants. But low income rural areas, such as Cornwall and Devon, get relatively low grants.

Fig.5: Relative council tax bases and government support

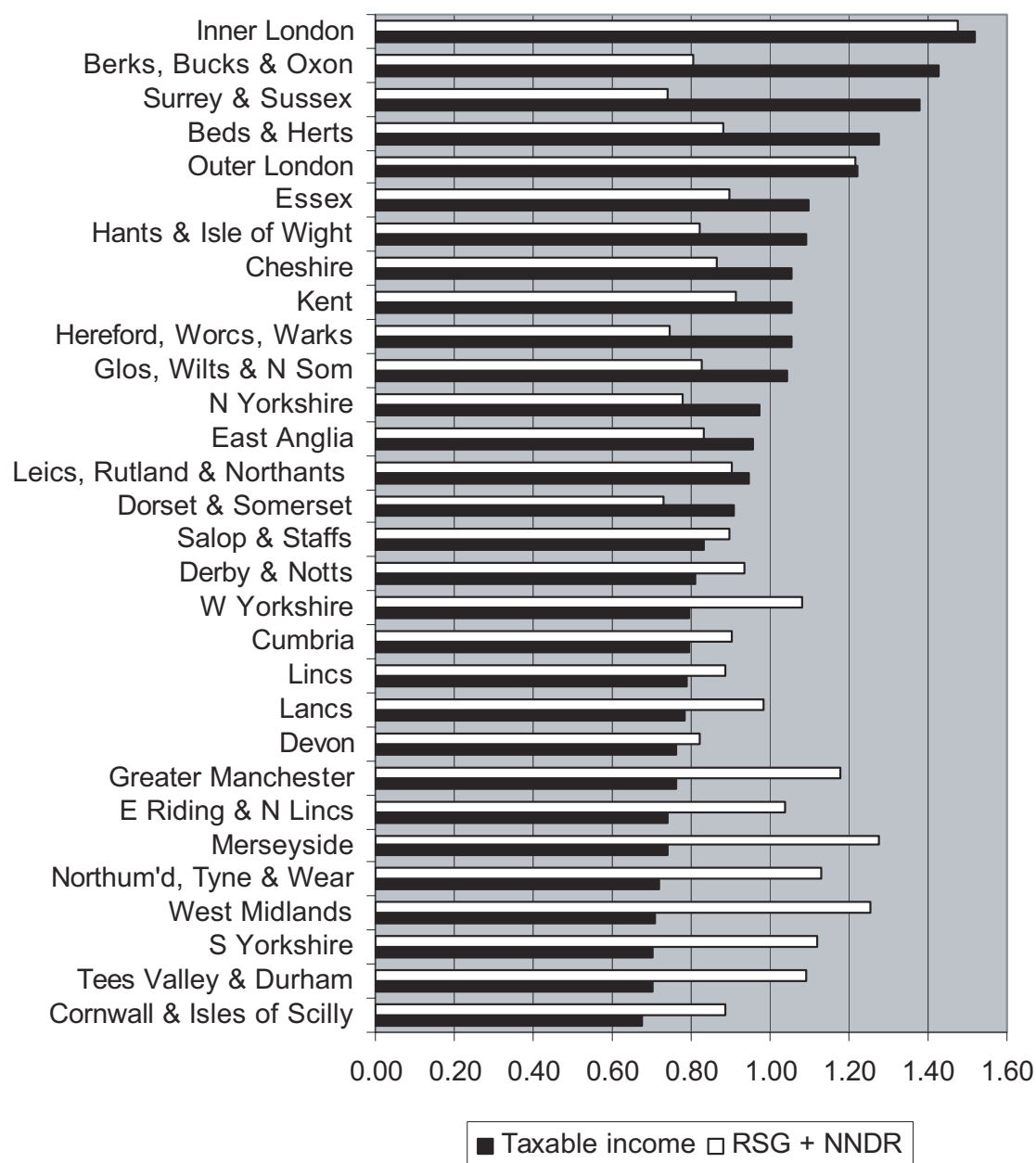


In short the system redistributes funds almost entirely from those rich areas that happen to be rural to those poor areas that happen to be urban. Perhaps urban areas do have greatly higher needs, so that the system is working in an appropriate way; but perhaps they don't.

9 Conclusions for different scenarios

As stated in section 2, the appropriate way of financing a tier of local authorities depends on the rôle which they are expected to perform in relation to their various services. In this context, we can identify three scenarios and three suggested schemes of finance, as follows.

Fig.6: Taxable incomes and government support



9.1 A scenario where most local authority services are seen as largely autonomous

In this case, it is arguable that local authorities should receive most of their finance from taxes, and that most of their taxes should fall on households. This could be done in three ways.

- First, it could be done by combining a local property tax, say the council tax, with a local sales tax. But the problems of allowing local authorities to vary their sales tax rates make this tax an inappropriate one in the scenario currently under consideration.
- Secondly, it could be done with a single local tax, provided that was a local income tax, for this is the only tax capable of raising an adequate yield on its own.
- Thirdly, it could be done by retaining the council tax, and reducing local dependency on central finance by replacing much of central grant by a local income tax.

Administratively, the second option is the easiest, as there is then only one local tax to collect. But there is an argument for the third option which arises from the fact that any changes to the system of local finance will create gainers and losers. The gainers and losers will cancel out financially in a revenue neutral change, but they do not tend to cancel out politically, as the voices of the losers tend to drown out the gainers.

The second option, of replacing the council tax by a local income tax, will mean raising the overall level of income tax in the country; so this is a major change that would create a strong form of the gainers and losers problem. So there is a case for the third option, of retaining the council tax, and then, at the same time as introducing a local income tax, reducing the central income tax, as the central government will need less revenue to pay out less grants: this will change the balance of funding but result in a much smaller gainers and losers problem.

If either the second or third option was used, so that a local income tax was introduced, we would suggest that consideration be given to the following:

- Having some upper cap on taxable incomes for local income taxes.
- Having some arrangement to insure local authorities against unpredictable yields.
- Having the tax collected by the Inland Revenue along with central income taxes.

We would also suggest that there is a case for a local business tax with a total yield that reflects the total value of the benefits of local services provided for businesses. If such a local business tax was introduced, then a local property tax, profits tax or payroll tax would all be feasible, although a profits tax has the major problem of allocating the profits of multi-authority firms between different authorities. Given the choice between a payroll tax and a property tax, we note that the former would have some uncertainty of yield, which could be addressed in a similar way to that of a local income tax, as outlined in section 5.5, and that the latter has the more unequally distributed tax base. Incidentally, the current yield of the national non-domestic rate may well exceed the value of local services provided to businesses, so if a local property tax was chosen, then only part of this tax would need to be moved to local control.

Incidentally, if a local payroll tax was introduced, then it might be best simply to rename employer's national insurance contributions as a payroll tax, and allow local authorities to raise some of them for themselves. But the collection of both the central and local part could be undertaken by the Inland Revenue.

We would also make the following additional points:

- If a local income tax was the only domestic tax, then poor people would pay no local taxes; the same applies with the council tax and 100% relief for the poor. It would be worth seeing whether poor exempt people tend to vote for high service levels. If so, perhaps there should be some small additional tax alongside a local income tax; and perhaps there should not be 10% relief with the council tax.

- There is nothing in theory or practice to indicate that this degree of tax decentralization would have adverse effects on the control and performance of the UK economy.
- There is a case for seeing whether the FSS formulae are biased against rural areas.
- There is a case for reappraising the need for area cost adjustments.

9.2 A scenario where most local authority services are seen as agency functions

In this scenario, local authorities need very little tax revenue. The chief need arises to allow them to make some minor adjustments to central policies. The current tax arrangements would seem broadly adequate, but we consider possible revisions to this tax adequate here.

9.3 A scenario where most local authority services are seen as mixed

We expressed concern about mixed services as they may lead to conflict between the central government and local authorities. However, in this scenario, if local authorities are to raise about half their revenue in taxes, that is about 5% of GDP, and if most of this is to come in taxes on households, then our conclusions are very much as in section 9.1. The only difference would be a need to set a local income tax and a local business tax at lower rates.

9.4 Specific issues raised by the Lyons Inquiry

The Lyons Inquiry terms of reference asked it to undertake the following¹¹:

1. make recommendations on how best to reform council tax, taking into account the forthcoming revaluation of domestic property;
2. assess the case both for providing local authorities with increased flexibility to raise additional revenue and for making a significant shift in the current balance of funding;
3. conduct thorough analysis of options other than council tax for local authorities to raise supplementary revenue, including local income tax, reform of non-domestic rates and other possible local taxes and charges, and possible combination of these options;
4. consider the implications for the financing of possible elected regional assemblies.

We have covered questions one to three above (question four was not included in the CCN brief to us), but it is worth summarising some key points for each of these three questions in turn.

9.5 The council tax

Compared with other property taxes, the council tax has much to commend it. In particular, it makes some concessions to ability-to-pay, and the impact on the most valuable homes is limited by the open-ended to band. Its main limitation is that, as the sole local tax, it cannot be expected to raise enough revenue to give local authorities much financial autonomy. However, if it is to be reformed, the following deserve consideration:

¹¹ See <http://www.lyonsinquiry.org.uk/>

- Have frequent revaluations to get round the lack of buoyancy and the agonies of major changes when very periodic revaluations occur.
- If there were one of two more bands at the top end, it might be possible to raise a little more revenue and present the tax a little more favourably on an ability-to-pay basis.
- There seems no need for special treatment for London, given that it is already well protected by the banding arrangement.
- The way in which tax payments vary across the bands could be revisited, perhaps with an analysis of the average incomes of households in different bands.

9.6 The balance of funding

As indicated in section 9.1, there is a case for a major shift in funding if it is felt that local authorities should perform their functions with a substantial degree of autonomy. Perhaps, though, education and social services are being more perceived as agency functions; but if so, it might well be asked if this is a result of rising government help or genuine desire for uniformity.

Incidentally, the fact that the Lyons Inquiry's third question – addressed in section 9.8 – concerns extra taxes, implies that it is not persuaded that local authorities are essentially agents. Perhaps the situation would be clear for government, local authorities and voters if functions which are predominantly agency functions were removed from local authorities, to indicate that the remaining local functions were essentially local.

9.7 Local taxes

Assuming that there is a desire to raise local tax revenue, and hence towards seeing local authority functions as autonomous, or at least mixed, our conclusions are as indicated in sections 9.1 and 9.3

10 Issues for discussion

This paper has presented a wide ranging discussion of possible options for future arrangements for local government finance. Whilst there are many permutations of possible changes and a consequent range of complex effects of such changes, a number of broad issues can be distilled from the analysis above which members may wish to discuss.

Firstly there is the broad question of whether the purpose of local government is to design and administer local services to fit in with the tastes of local residents or to provide an agency function for provision of local services to uniform national standards. On the one hand there is the view that "Needs vary from locality to locality and the richness of that variety can rarely be captured in the uniformity of national standards of provision (Jones and Stewart, 1983, p 5) whilst on the other hand there is the view that sees richness and variety as representing a "postcode lottery," to be avoided at all costs. Members may wish to consider which of these views they see as being the more appropriate, and whether the same judgement applies to all local services or whether diversity is to be more valued in some services and uniformity more valued in others.

Secondly, as discussed above, a view on uniformity versus diversity links to the question of whether local authorities are best seen as agents of central government or agents of local choice, and in turn to whether as agents of central uniformity the balance of funding should be from the centre or whether as agents of local choice the balance of funding should swing to more local finance. If it is judged that the balance of funding should shift to more local sources, should the mechanism (as discussed on p. 21) be

1. Adding a sales tax to council tax
2. Replacing council tax with a local income tax
3. Retaining council tax but introducing local income tax to replace a sizeable portion of central grant?

A third issue is whether the appropriate principle for designing taxation should be on the basis of benefits received, or in line with ability-to-pay. Members may wish to consider how they view this question. A view that taxation should be based on ability to pay would suggest amongst other things a more extensive and progressive banding of council tax and the introduction of local income tax.

A final issue concerns the apparent effect of formula spending share bringing high grant to “high income urban London” (p. 19) and whether area cost adjustments are unjustified as suggested by the “counter-argument” of page 19 in that they appear to use money from taxes on people living elsewhere to make costs in high cost areas higher.

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Appendix

The main text has omitted some issues that often arise with property taxes and income taxes. The appendix lists these: we could incorporate any into the main paper, gives some

Property taxes

1. It must be decided precisely what the tax base is, who will do the assessments, and who will collect the tax. It may be best for the central government to supervise the general rules. But unless the central government is sharing in the tax, it may be best to leave collection to local authorities because they will have an incentive to collect as much revenue as possible.
2. It must be decided how frequently valuations will occur. In general it is best to have frequent valuations in order to keep the tax up-to-date and to make the impact of revaluations on individual properties modest. With computer technology, annual revaluations are feasible.
3. The tax base usually comprises the value of the land and buildings but not anything else.
4. The tax base may be annual values or capital values. It is best to use as the base the alternative for which there are the most available data as this will aid frequent revaluations. Thus if most homes are owner-occupied, it would be best for this tax to use capital values as the base. Most countries tend to use capital values.
5. It must be decided who will pay the tax on rented property, the owner or occupier. When the tax is paid by owners, they probably pass much of the burden on to occupiers through increases in rents. Most countries tax the owner to make the tax invisible to the occupier, but in terms of visibility it is better to tax the occupant, as in the UK. Also, to help poor people, there may be a system of rebates. It is harder to help poor tenants if the tax is paid by owners who pass much of it on than if it is paid directly by occupiers.

Income taxes

1. It must be decided who will do the assessments and the collection. As the central government will be raising income tax revenues for itself, there is much to be said for allowing it to do both. Such an arrangement is sometimes called using a 'piggy-back' tax for local authorities. (LGA, 2004, 7)
2. It must be decided whether investment income will be taxed as well as earned income. It may be administratively hard to include investment income; if so, investment income could be taxed at a uniform rate equal to the average local income tax rate, and then its revenue distributed to each local authority on, perhaps, an equal per capita basis. It is administratively convenient to tax just earned income at basic rate - see CIPFA (2004) - although some have criticised this approach as favouring the rich. However, overall distributional concerns can always be addressed through the national income tax system.
3. It must be decided whether an individual local authority should set a single tax rate or whether it should set a set of tax rates that rise with income. The objection to a single rate, say x percent of taxable income, is that the local component of an income tax will not be very progressive; it will secure progressiveness only because people below a certain income level may be exempt. On the other hand, allowing local authorities to set a variety of rates would be to allow them to play a significant part in redistribution which, for reasons outlined in section 2.5, is an activity that should be primarily performed by the central government; also, it could result in high income citizens facing a very high

marginal tax rate when central and local rates are added together. A compromise arrangement is to allow a local authority to tax a fixed proportion of the sum that each of its residents will pay in central income tax. Thus a local authority might set a rate of 15 percent and require all residents to pay sums equal to 15 percent of their central income tax bills. In this way, higher rate taxpayers will pay higher fractions of their taxable income in local income tax than will lower tax rate payers.

