

How local government should be funded

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## How local government should be funded

Thank you very much for your invitation to speak to you tonight. My remarks fall under four main headings: *How local government should be funded*; *Dilemmas of local government finance*; *Grant versus Tax*; and *Property versus Income tax*. Some of these headings are subdivided.

### ***How local government should be funded***

Thinking from first principles, I suggest that a constitution writer would approve of the following two ground rules:

1. The power to spend should be equated with the duty to tax (at least at the margin).
2. The less mobile a factor of production, the more suitable a subject it is for local taxation.

To illustrate principle 1, let's first imagine a square country, Ruritania, divided into four square local government areas, imaginatively called Ruritania NW, Ruritania NE, Ruritania SW, and Ruritania SE. The population is evenly spread across the country; furthermore, so is wealth and income. The people, companies, and properties in each of the four local government districts contain the identical mix of rich and poor.

Fiscal federalism in Ruritania is easy. The national government is responsible for defence, overseas aid, macroeconomic management, and foreign relations, which account for 20% of public expenditure. It levies tax on corporations domiciled in Ruritania, which yields 20% of tax revenue, and exactly covers its liabilities. The four local authorities deliver health, personal social services, social protection, transport, housing, fire, police, environmental protection, trading standards, and waste management. (Oh, and coastal protection too – did I mention that Ruritania is an island and each local authority has an equal share of its coastline?). The local authority functions cost 80% of public expenditure, which is exactly covered by their taxes (the main ones being income tax, property tax, and VAT).

In Ruritania, the power to spend is exactly equated with the duty to tax. Each taxing authority has the power to raise taxes (and spending), or to cut spending (and taxes), according to its citizens' preferences. Northwest could build an opera house and Northeast a network of skateboard parks. Both of them would have to raise local taxes to pay for them. Southwest could close its loss-making municipal art galleries and Southeast could start charging for rubbish to be cleared. Both of them could reduce local taxes. Everybody would know who was responsible for which batch of services, and whom to blame if things went wrong.

England is not like Ruritania. Local authorities differ hugely in wealth, population, area, and physical characteristics. Some of them are single-tier; some are two-tier; some have inter-tier agency arrangements; some participate in joint police or fire

authorities. No citizen and almost no local government professional has a clue which tier delivers which service. Council Tax pays for about 25% of the costs of local government services, but citizens believe it pays for about 75%. The central government, which *does* pay for 75%, attaches strings to its grant, while saying that it is strongly in favour of (new) localism. There is an extensive equalisation programme, which attempts to equalise both for councils' unequal tax base (high in RBKC, low in Easington) and for the relative needs of their citizens (low in RBKC, high in Easington).

So long as wealth and income are unevenly spread, (i.e., presumably, for ever), there will always be an equalisation programme. Therefore for (at least) this reason, it will never be exactly true that each local authority's tax yield equals its spending responsibilities. You can't match taxing power and spending power exactly. The next best thing is to try to match them *at the margin*. This means that if the authority decides to spend a pound extra, it must raise a pound extra in tax; and if it decides to spend a pound less, it has a pound available to give back to local taxpayers.

In theory it should be possible for the centre to give each authority a block grant, while the marginal decisions are up to the authority. Yet the experts have struggled for over a century (beginning with Lord Balfour of Burleigh in 1902) to achieve this, and have all failed. The Poll Tax (Community Charge) was one attempt to bring in the principle of marginal accountability. But, like its successor the Council Tax, it is very highly geared. This means that to increase your spending by 1%, you had to increase your Poll Tax bills (now, your Council Tax bills) by 4% or 5%. And it was not symmetrical. If you reduced spending by 1% you were normally unable to make a 4 or 5% saving in your Poll Tax (Council Tax) bills – those changes depended far more on changes in your block grant from central government than on your own efforts.

Turning to the second principle of Ruritanian fiscal federalism, the central government taxes corporations because they are more mobile than people, and people are more mobile than land or buildings. If companies don't like the tax regime, it is easy for them to move their headquarters and incorporate in a different jurisdiction. It makes sense to tackle this problem by taxing company profits at the national (or indeed international) level. Likewise, people can easily move from one local authority district to another. In Ruritania that would not matter, because the mix of rich and poor is the same in each council area. But imagine an England with local income tax (LIT). All other things equal, Kensington could set a very low rate in the £ for LIT because it has on average a very wealthy population. Easington would have to set a very high rate because it has a poor income tax base – and yet it has to spend more per head. Those who could would move around – the rich in search of a low-tax area, and the poor in search of a high-level-of –social-services area. Up to a point, this movement (known as the 'Tiebout effect') might be a good thing, but beyond that point it would quickly become very destabilising. For this reason among others, I think LIT is a bad idea.

But houses and land just sit there. Land can't move at all. Houses (and other taxable structures such as business premises) can move in the very long run, if people stop building them in unfavourable places and build all the new ones in favourable places. The very fact that they don't move makes them the best base for local taxation.

Therefore I believe that a local property tax should continue, although both Council Tax and Uniform Business Rate have serious structural problems as they stand.

### ***Dilemmas of local government finance***

The *balance of funding and variability of tax bases* discussed in the previous section will always be a problem. Because the rich and the poor are not evenly spread across England (or any other country), it will always be the case that some local authorities will have a more robust tax base than others. This remains true whether the tax base is people (with income tax or VAT or sales tax) or property (with Council Tax and business rates). While some local government services are not more expensive in poor areas (think of coastal defence, for instance, and rubbish collection – or do the rich leave out more rubbish?), others certainly are. Poor areas will always contain more people in need of help from Social Services, and more children with special education needs, than rich ones, for instance.

One reason why the Government's recent Balance of Funding Review was so inconclusive is that it could not get around the stumbling-block of equalisation grants. According to the ODPM, the poorest English authorities, such as Newham, raise only about 10% of their local spending through the Council Tax, whereas the richest authorities, such as St Albans, raise about half. An obvious way to improve the balance of funding would be to restore business rates to local control. They were 'nationalised' in 1990. The central government sets both the rateable value of each non-domestic property (this is done by the Valuation Office Agency, a division of HM Revenue and Customs) and the rate in the £ to be paid by each business (this is done by central government under a promise that it will not increase more than prices in any one year). The proceeds are pooled and then handed back to each authority on an equal per capita basis. The effect is that uniform business rate is no longer a local tax at all as local government has no input to any of its parameters.

But if uniform business rate were simply localised, then prosperous authorities such as St Albans (and presumably Kensington & Chelsea) would be able to raise *more* than they spend. This might lead to rejoicing in Kensington Town Hall. But at least in the rest of the country, and perhaps even there, people would say that the concentration of very high-rateable-value business in Kensington was not *solely* due to the brilliance of the Royal Borough. So it is fair to redistribute some of the tax proceeds from rich places to poor places, which highlights the problem of...

*Getting appropriate incentives into the system.* Local authorities often do not face the true costs and benefits of their decisions. Often it appears to be costless to refuse a planning application, but costly to grant it (because all the neighbours will object and vote against the governing party at the next local election). But refusing a planning application does carry a cost – of the tax income foregone from the development not going ahead. The local tax system needs to be reformed so that authorities are incentivised to broaden their tax bases, and face the true costs of refusing to do things, as well as the true costs of doing them. This implies either localisation of business rate, or, more radically...

*Capturing economic rent.* Most local authorities (maybe not Kensington & Chelsea) have it in their power to multiply the value of land on their patch twentyfold, just by

changing its planning status from agricultural to commercial or residential. And they sponsor the public works (roads, public transport, schools) that make such land attractive to developers. With trivial exceptions, the windfall benefit from these changes falls entirely to developers and their tenants, and not at all to the authority or its citizens who created the value added. The present regime of 'section 106 agreements' that try to capture some of the windfall is cumbersome and arbitrary, The Government has put a proposal for a 'planning gain supplement' out for consultation. This would be a little better than the present s.106 regime, but not much. What is needed is a tax regime that captures some of these windfall gains, which are known to economists as 'economic rent'. The simplest – easy to say, not so easy to implement – would be the taxation of land values. In the final section I suggest a possible scheme.

### ***Grant versus tax***

From what has gone before, it follows that I think that local government should be funded as much as possible by taxation and as little as possible by central government grant. But it is utopian to suppose that central grant could be eliminated. There are two reasons for this. One, already mentioned, is that there will always have to be an equalisation regime. I think that it should try to be less comprehensive, because the more comprehensive it is, the more it is subject to gaming and to arguments about 'needs' and 'area costs', that reflect not true needs or true costs but the interests of those making the argument. Precisely because local authorities are elected, whereas health authorities are not, the grant system seems to work worse for local government. no Minister can resist the temptation of rewarding the authorities, or the class of authorities, that it serves his or her political purpose to reward. And to help the minister, the ODPM and its predecessor departments have always provided tables of 'exemplifications' showing how each council in the country would fare if the grant regime was changed in each of a number of possible ways. The Minister need then only run a finger through the exemplifications and choose a grant regime accordingly.

The other reason why grant funding is inevitable is that central government occupies all the most robust tax bases except real estate, and even half of that. But local government delivers many of the most labour-intensive, and therefore expensive, public services – education, personal social services, police, fire. Central government needs to face up to the dilemma identified by Sir Frank Layfield and his colleagues in their seminal report of 1976 on local government finance: to be honestly centralist (and take over services from local government) or honestly localist (and cede serious taxing powers to local government). Unfortunately, I do not predict that either will happen in the near future.

### ***Property versus income tax***

I have already explained why I think local income tax (LIT) is a rather seriously bad idea. Local sales taxes, common in the USA, are also impracticable in the small local authorities of an urbanised UK. Nice though it might be to imagine all the shops opening on one side of the border between Wandsworth and Lambeth and closing on the other side, it would also be difficult to square with EU law on VAT harmonisation.

By elimination the tax base for local government should remain property. But neither Council Tax nor Uniform Business Rate (UBR or NNDR) is satisfactory. If I were dictator, I would replace Council Tax by an *ad valorem* (that is, proportionate to value) rate – ‘New Rates’. And I would, as suggested above, relocalise NNDR, while basing valuations on land, not the structures on the land – ever since 1909 this has been known as ‘site value rating’.