

2

LOCAL GOVERNMENT FUNDING

MY WORK TO DATE

2.1 This section outlines my work to date in relation to my original remit on local government funding, and sets out some of the key issues which have emerged as I have conducted my research and analysis. In my final report next year I will address the underlying issue of how most appropriately to fund local government services, and make recommendations in the light of my broader work on the role and functions of local government.

Original remit on local government funding

2.2 On 20 July 2004, I was asked by the Deputy Prime Minister and the Chancellor of the Exchequer to consider the case for changes to the present system of local government funding in England.

2.3 My original terms of reference required me to:

- consider, in the light of the report by the Balance of Funding Review, the detailed case for changes to the present system of local government funding;
- make recommendations on any changes that are necessary and how to implement them; and
- take evidence from stakeholders.

2.4 And, in particular, to:

- make recommendations on how best to reform council tax, taking into account the forthcoming revaluation of domestic property;
- 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;
- 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, as well as the possible combination of such options;
- consider the implications for the financing of possible elected regional assemblies; and
- consider, as appropriate, any implications that the recommendations of the Inquiry may have for other parts of the United Kingdom.

BACKGROUND TO THE INQUIRY

2.5 I was originally asked by Ministers to lead an Inquiry into Local Government Funding and to make specific recommendations for possible changes to the balance of funding following the conclusion of the Balance of Funding (BoF) Review in July 2004. The BoF Review considered the various means by which the balance of funding between local and central sources could be changed, particularly through the reform of

council tax, the localisation of business rates and the introduction of a local income tax or other new local taxes.

2.6 The BoF Review was set up in response to concerns, primarily from local government, that the present balance of funding was a problem – particularly in terms of the ‘gearing problem’.

2.7 There are continuing concerns, particularly from the public, and often fuelled by media coverage, about the rate of increase in annual council tax bills, which are frequently above the rate of inflation (peaking in 2003 with an average increase of 12.9 per cent across the country). This has given rise to concerns that too much currently rests on a single tax, and that greater flexibility is required in how local government is funded in order to create a more sustainable system in the longer-term.

2.8 The issue of fairness, in terms of the link to ability to pay, is a further concern that is tightly bound up in the debate over council tax in its current form.

2.9 My work to date has examined these issues in more detail. The purpose of this part of the report is to share the emerging issues from that work on local government funding in order to seek views and test the robustness of some of my analysis so far.

APPROACH TO MY ORIGINAL REMIT

Engagement with stakeholders

2.10 Since my work began, I have met over 200 stakeholders who have provided views and evidence on the issues relating to the local government funding system.

2.11 In particular, I have met with, and received written evidence from representatives of:

- **Local government** – My team and I had regular meetings with the Local Government Association, and I also met the Association of London Government, the Special Interest Group of Metropolitan Authorities (SIGOMA), the County Councils Network, SPARSE and a wide range of councillors and officials from local authorities, including county councils, districts and parishes, police authorities and fire authorities;
- **Regional bodies** – such as Regional Assemblies and Regional Development Agencies;
- **The business community** – including the Confederation of British Industry, the Institute of Directors, the British Chambers of Commerce and the Small Business Council; and
- **Action groups and campaign groups** – such as Help the Aged, Age Concern, Is It Fair? and the London Tenants Federation.

2.12 In addition to regular discussions with ministers, including the Deputy Prime Minister, the Chancellor of the Exchequer and the Minister of Communities and Local Government, I also drew on information and technical expertise available within central government.

2.13 As well as holding over 60 meetings with key stakeholders, I conducted a series of nine events in each of the English regions to meet representatives of groups and organisations interested in the work of my Inquiry to hear their views. I also held an

evidence gathering event in Wales and visited the Local Government Finance Review Committee in Scotland, and the Local Government and Public Services Committee in Wales.

2.14 In total, I have received over 450 written submissions and letters to my Inquiry to date, from a wide range of stakeholders, including those already mentioned, and from members of the public. More detail on my engagement with stakeholders can be found in Annex C.

2.15 I am very grateful for the detailed and thoughtful responses from such a diverse range of stakeholders, which have been of great benefit in conducting my analysis. It serves to illustrate the significant impact that local government has on so many people at so many different levels and the widespread appetite to find answers to the questions I have posed.

2.16 I am now publishing the submissions I have received from organisations in parallel to this report. I am pleased to be able to share this evidence with a wider audience. During the second phase of my Inquiry, as part of a wider public debate on local government role and functions, I would welcome views on the issues raised in the submissions I have received.

Research

2.17 In order to support my work on local government funding, I commissioned five pieces of research to explore my interest in other countries' approaches to local funding arrangements and taxation, and also to explore public attitudes to local government funding and potential changes to local taxation.

2.18 They are:

- *Options for Reforming Local Government Funding to Increase Local Streams of Funding: International Comparisons* – a report exploring the local government finance structures in other countries, and issues around the consequences of such different systems in terms of the advantages and disadvantages of greater fiscal decentralisation. The work was conducted by a team led by Professor John Loughlin at the University of Cardiff, building on their work for the Balance of Funding Review;
- *International Comparisons of Local Government Finance: Propositions and Analysis* – a high level think piece on the key challenges of applying international models to the English system, produced by Professor Tony Travers from the London School of Economics, using the Cardiff work and other pieces of international research;
- *Options for Reforming Local Government Finance: A Report for the Lyons Inquiry Study Team* – a comprehensive literature review of actual and suggested local tax options, by NERA Economic Consulting. This encompassed international examples of local taxes, as well as more theoretical suggestions for change to the council tax;
- Two pieces of **public attitudes** work:
 - first, two waves of focus group work, commissioned from GfK NOP Social Research, that focused on gathering in-depth attitudes to the principles behind local taxation – including understanding of who was

responsible for services – and potential changes to local taxation, for example the introduction of a local income tax alongside council tax; and

- second, survey work commissioned from BMG Research which aimed to quantify people's attitudes to local taxation as well as explore views on who should control local services and taxes.

2.19 In addition, in June 2005, I brought academics and other experts together to critically assess the case for greater devolution of decision making to local government. I thought this an important input into my consideration of the case for change to local-national fiscal arrangements and the potential role for greater local flexibility. Professor Gerry Stoker from the University of Manchester chaired and wrote up the key conclusions from this seminar, which was addressed by a number of academics with established reputations for their thinking and writing on these subjects.

2.20 I am now publishing these research reports in their entirety. A summary of the findings, along with the actual reports themselves, can be found at Annex D.

Modelling

2.21 In order to support my research and analysis, a number of detailed models were developed to illustrate options for reform of the local government finance system. These included a detailed model to assess the impact of possible reforms to council tax in the context of revaluation of house prices for council tax, which was planned for 2007.

2.22 Annex A describes the revaluation models I have used and sets out the results from the modelling work on reform options.

2.23 Annex B provides a more technical description of the models.

2.24 I plan to complete further modelling work during 2006 to inform my final report and conclusions. This will make use of a later and more robust data set of property values from the Valuation Office Agency to update existing illustrations and any further reform options modelled for council tax.

External analytical support

2.25 I am grateful to a wide range of people who provided formal and informal advice on technical issues and the analytical work more broadly. These included a range of external experts, including officers at the Local Government Association, individuals from local government, the Audit Commission, the New Policy Institute and officials from Wales, Scotland and Northern Ireland.

2.26 My team also established a cross-departmental group of technical experts from government to advise on the modelling aspects of the Inquiry's work and the use of government data sets, to ensure that the analytical work was carried out in the most robust way.

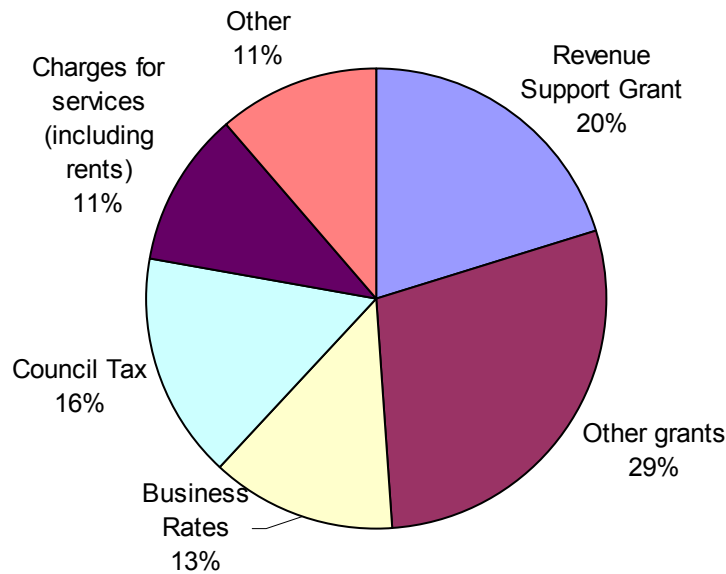
ISSUES TO EMERGE FROM MY ORIGINAL REMIT

Council tax

2.27 Council tax is the only local tax, and is levied annually on the occupier of a domestic property, or the owner of an empty one. It is expected to raise £21bn for local authorities in England in 2005-06, though an estimated £3bn (14%) of this is expected to be paid by Council Tax Benefit. The average Band D council tax is £1,214, and the average bill per dwelling is £1,009, though bills vary significantly across the country.

2.28 Although it has received a great deal of media coverage, council tax is only one part of the local government funding system. It funds just 16 per cent of total local authority income, as shown in the chart below, and accounts for just 5 per cent of national tax income.¹

Chart 2.1: Total gross local authority income by source



Source: 2003-04 figures from ODPM Local Government Finance Statistics

2.29 Since the introduction of council tax in 1993-94 the percentage of revenue expenditure funded locally has increased steadily, as council tax yield has increased at a faster rate than government grants and business rates. In particular the proportion of revenue expenditure funded by council tax rose from 21 per cent in 1993-94 to 25 per cent in 1998-99 and has since remained reasonably constant, whereas the proportion funded through business rates has fallen from 28 per cent to 21 per cent over the same period.

2.30 Further key facts about local government funding are included in the section on key facts and figures in Part 1 of this report.

¹ Previous discussions on local government funding, for example the Balance of Funding Review, have focused on local authority revenue income, and more frequently refer to the 'balance of funding' in terms of revenue expenditure, which includes government grants, business rates and council tax. Under this definition, council tax provides 25 per cent of net revenue expenditure.

Positive attributes of council tax

2.31 Before analysing the problems with council tax, it is worth noting that it has a number of positive features as part of a system of local taxation. This is something that the Balance of Funding Review also emphasised, and only 8 per cent of the local authorities that submitted views to my Inquiry argued that council tax should be abolished (though this was in the context of planned revaluation). It is worth remembering that council tax raises £21bn per annum currently – which would have to be raised from another source if this were not available.

2.32 Basing a local tax on property ensures that the payment of tax is linked to residency in a local area, and also makes the flow of revenue to local authorities relatively stable, predictable and easy to collect. Property occupation and ownership provide a direct link between an individual and the prosperity and desirability of the area in which they live. Across the world local authorities are, almost without exception, funded using some form of property taxation, and this has also always been the case in the UK, except during the time of the Community Charge (or Poll Tax). Although council tax is a hybrid tax, rather than a pure property tax, it shares many of the benefits of a property tax.

Council tax as a property tax

2.33 Council tax is at heart a property tax since the bill is based on the capital value of domestic property. In economic terms it can be seen as a tax on the consumption of the benefit that people receive from living in their property and in their local area.

2.34 I am interested in exploring further the role of council tax as a property tax. This raises complex issues because housing fulfils several roles for most households. A person's property is also their home, a basic necessity, and the centre of their life and location within a community. The increasing trend towards owner occupation in England means that property is also the primary source of wealth for many households, creating a strong link between the housing market and the economy as a whole. Public investment and the quality of local public services can affect the value of a property and a local property tax can also therefore help to ensure that people who own their own houses contribute in relation to the size of their stake in the success of their local community.

2.35 However, council tax was not intended to be a 'perfect' property tax – the link between property value and tax liability is deliberately modified by the banding and multiplier systems so that bills are not completely proportional to the value of the property. The bill for a property in the top band (H) is only three times the bill for a property in the bottom band (A), despite being worth at least eight times as much (in 1991 prices). Since a property cannot be any higher than Band H there is also an upper limit on the amount of tax a household can pay.

2.36 In addition, properties are valued for council tax purposes using 1991 values, which means that tax bills over time may become increasingly poorly linked to the actual value of the property. Council tax has been heavily criticised by some academic commentators who work on the housing market because of these features.²

² Muellbauer, J., *Property and land, taxation and the economy after the Barker Review*, 2004

2.37 The design of council tax also has to fit with the objectives for local taxation, and since this is perhaps its primary role, it is not surprising that council tax does not meet some of the other objectives that might be set for a tax on the consumption of property.

Council tax as a local service charge

2.38 Council tax also has some of the characteristics of a household charge for local services (and is perceived as such by many), perhaps reflecting the legacy of the Community Charge.

2.39 In the vast majority of cases the liability for the tax falls on the occupier of a property, who benefits from local services, rather than the owner. The bands and the system of multipliers also mean every household pays a relatively similar amount of tax regardless of wide differences in property value. Council tax has a range of discounts and exemptions designed to relate tax liability partly to the make-up of the household rather than solely to the value of the property, and there is also a discount for empty properties. I am interested in exploring whether the current pattern of discounts and exemptions is the right one.

2.40 There was some support in my public attitudes research for the number of people in a household or the use of services to be a factor in setting bills. However, there was quite strong resistance to charging for major services (on top of existing arrangements), which is one of the ways in which those who benefit from services could be made to pay for them.

Council tax as a hybrid

2.41 As outlined above, the hybrid nature of council tax reflects a desire to balance a number of potentially competing objectives. These include a welfare objective - the Council Tax Benefit system links the tax bill to ability to pay in terms of income and savings.

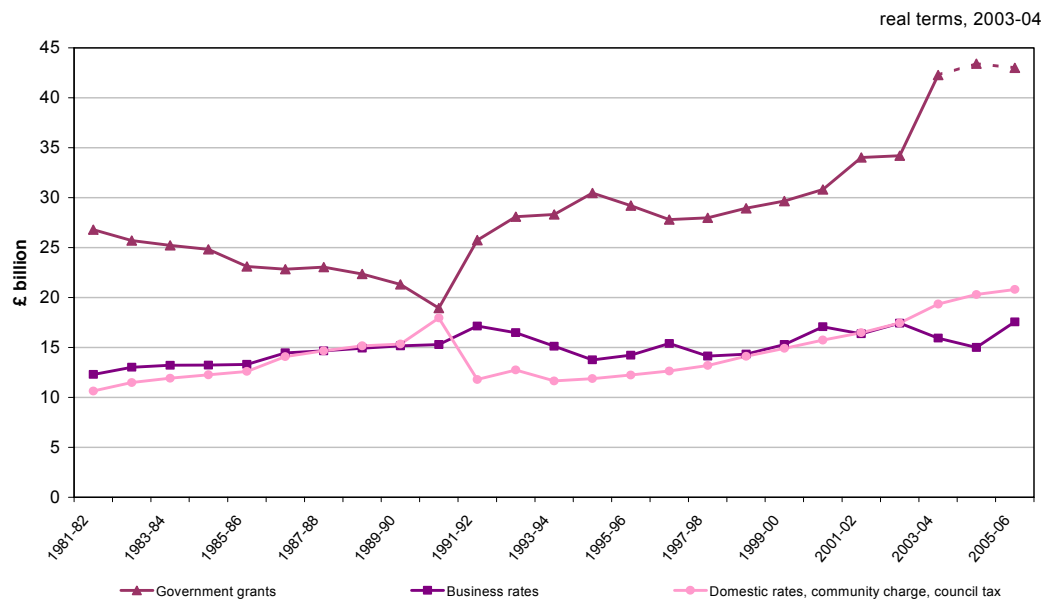
2.42 My work to date suggests that the public do not have a strong understanding of these objectives or of the tensions between them. I am interested in receiving further views on the balance between council tax as a 'fair' source of local taxation and a property tax, and the issues raised by the need to balance these objectives in one tax.

Understanding the problems of council tax

Annual increases

2.43 Since the introduction of council tax in 1993-4, council tax bills have increased annually above the rate of inflation, with the steepest rises in 2003-4, when the average Band D bill increased by 12.9 per cent. Central government grant to local government has increased from £21.7 billion in 1993-94 to £44.1 billion in 2005-06 – an increase of 103 per cent. However, over the same period, council tax has risen from £8.9bn to £21.3bn – an increase of 139 per cent. Although house prices rose even more rapidly – by around 187% - over the same period, a large number of submissions cited the increases in council tax as a significant problem or the main problem. Chart 2.2 shows income from government grants, business rates and domestic taxes (domestic rates, community charge and council tax) over time, at 2003-04 prices.

Chart 2.2: Sources of revenue funding 1981-82 to 2005-06



Source: ODPM, Local Government Finance Statistics

2.44 The Audit Commission investigated the reasons for the particularly high increases in 2003.³ First, spending by councils went up by more than had been allowed for in the grant settlement. Second, the effect of the grant regime – whereby 75 per cent of funding comes from central government – was that each 1 per cent councils added to spending above amounts allowed for in the grant settlement increased council tax by 4 per cent. It noted four causes of increased spending by councils:

- cost pressures such as pay and price increases, increases in national insurance contributions, and increased pension costs;
- additional demand pressures, including, for example, the need to provide social services to increasing numbers of elderly people;
- national policy priorities, such as the requirement to increase funding for schools by an amount determined by government or to meet national waste recycling targets; and
- local policy priorities, such as additional spending on highways.

2.45 It also commented that a number of external pressures operate on councils to increase spending, including public expectations of service improvement, pressure from central government to spend more to meet government priorities, and the role of inspectorates and other regulators in requiring councils to meet more demanding standards.

³ Audit Commission, *Council Tax Increases 2003/04 – Why Were They So High?*, 2003

2.46 Under my new remit I will investigate further possible ways of managing pressures on local services more effectively.

Visibility 2.47 According to the public attitudes research I conducted, council tax is the most visible form of taxation in England. Of those surveyed, 99.8 per cent of respondents were aware of council tax, compared to 98 per cent for income tax and 97 per cent for VAT, despite the fact that in 2003-04 these raised £114bn and £69bn respectively, compared to council tax which raised £19bn (UK figures, net of tax credits and Council Tax Benefit).⁴ This visibility may partly result from the fact that, unlike other taxes, it requires households to make a specific payment or direct debit. Many respondents noted the difference between receiving a bill through the door and having tax removed (more “painlessly”) by an employer or retailer. It may also have been heightened over time due to above inflation increases over a period of years, and increasing media attention.

2.48 Such visibility may sharpen accountability by ensuring people are very aware of annual increases in council tax, which can be easily compared against changes to other indicators such as inflation and pay. The comparatively high increases in council tax bills may have served to raise both public awareness and the unpopularity of council tax still further.

Balance of Funding and gearing 2.49 Council tax is the only significant funding source that local authorities control themselves, but it is actually a relatively small part of the overall resources managed by local authorities. Government grants are the major source of revenue to support local services, and they are usually adjusted to take account of new responsibilities with the aim of compensating for additional costs. However, if local authorities find available funding insufficient to meet their budgets, and if efficiencies and reductions to services cannot close the gap, council tax has to rise to provide the necessary resources. Some submissions I received referred to council tax as playing the role of a ‘pressure valve’ as it is the main option open to local authorities to cover an increase in spending. Fluctuations in grant levels caused by amendments to the formulae which are used to allocate grant between authorities can also have an impact on the council tax an authority sets (though changes to grant are usually damped to prevent large sudden changes).

2.50 On average across all local authorities in England, council tax provides 25 per cent of revenue expenditure. This means that a 1 per cent increase in total spending requires, on average, a 4 per cent increase in council tax if no other revenues are available to help meet this additional spending. This is known as the ‘gearing effect’ and was discussed in some detail by the Balance of Funding Review. It was highlighted by the LGA, and many of the local authorities I spoke to referred to it as a significant problem with the current system.

2.51 I am concerned that this effect can lead to a distorted focus on the marginal pound rather than the total budget of an authority. But changing the balance of funding for an authority will not in itself address the pressures on local services, which come from many sources, including demographic changes, new legal and policy responsibilities of local government, centrally set targets, and rising public expectations. I therefore welcome the opportunity presented by my extended remit to consider these broader issues.

⁴ HM Treasury, *Budget 2005*. These figures are for the UK as a whole and show council tax after the deduction of the amount paid for through Council Tax Benefit

Complexity 2.52 Part 1 outlined the high degree of public confusion around local government funding and what council tax pays for. This may contribute to the difficulties in explaining or obtaining support for council tax rises. The complexity of the system may partly explain that confusion. A highly complex set of formulae is used to allocate grant between authorities, and changes in these can have an impact on the council tax an authority sets (even though changes to grant are usually damped).

2.53 Even the council tax bill itself is not easy for everyone to understand. The complexity of the system, including how each council tax bill is constructed, may partly explain that confusion. A number of authorities are responsible for setting elements of each bill, including district and county councils, fire and police authorities, parishes, National Parks authorities, and waste authorities. Several submissions, and the Audit Commission report on rises, commented that many of the highest rates of annual rises were in the elements raised through precepts.

Fairness 2.54 One of the most common criticisms of council tax is that it is unfair. However, fairness is a complex concept and difficult to define - people can mean a number of different things when they refer to taxes being 'fair' or 'unfair'.

2.55 As a tax on the consumption of property, a 'fair' tax might need to be closely related (or proportionate) to property value. As a charge for local services, people may be concerned with the link between what people pay and what they receive in local services. The Government already also recognises the importance of taking account of ability to pay through the Council Tax Benefit system.

2.56 In commenting on fairness, submissions to the Inquiry have used these concepts and others, including comparisons between what people pay in different areas of the country.⁵ However, in the focus group research, most people thought that the fairest tax is one that is related to an individual's ability to pay, particularly meaning their income. The Balance of Funding Review highlighted the need to address the impact of council tax on those on low incomes (and to optimise the impact of revaluation). In addition, many of the submissions I received criticised council tax because it is not related to an individual's income, except through Council Tax Benefit. I would welcome further views on these issues.

2.57 The importance of this issue in public debate and in generating strong criticism of council tax led me to focus my analysis on ways in which fairness could be improved – particularly in terms of the link with ability to pay.

Council tax and ability to pay: Council Tax Benefit

2.58 Council Tax Benefit (CTB) aims to ensure that council tax liability takes account of ability to pay. It provides a full or partial rebate from council tax for those on low incomes depending on a household's council tax liability, income, and savings. Between 6.4 and 7 million benefit units (single adult or couple, together with any dependent children, considered as one unit for tax and benefit purposes) are eligible in Great Britain, and £2.6 billion per annum is claimed in CTB.⁶

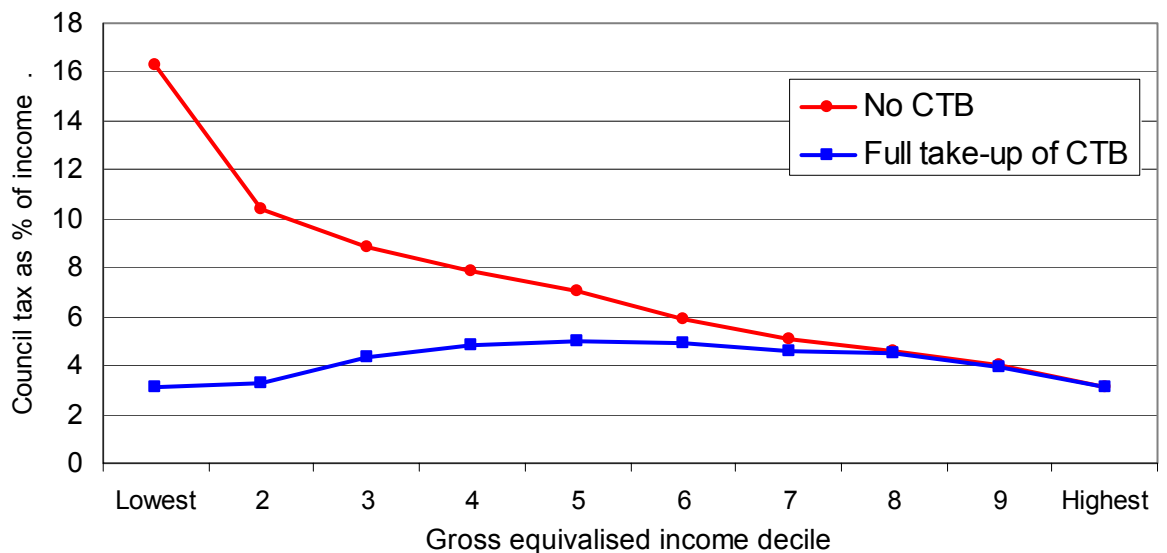
2.59 As Chart 2.3 shows, if everyone entitled to Council Tax Benefit took it up, council tax liability would be a relatively constant proportion of people's income throughout

⁵ For instance, NPI commented on the tax burden as a share of income by band, and queried the 'fairness' of the 1991 distribution of burden between regions, noting that part of the argument for regional banding is to correct the perceived unfairness of the existing structure

⁶ DWP, *Income-related benefits: estimates of take-up, 2002/03*

the income distribution – in fact being relatively progressive to income for those on low incomes and regressive to income only in the upper three deciles. However, the current system of CTB does not achieve this result in practice, mainly because of poor take-up.

Chart 2.3: Council tax as a proportion of net household income after housing costs by income decile, before and after Council Tax Benefit



Source: Lyons Inquiry Analysis

2.60 Of all means tested benefits Council Tax Benefit has the highest number of people eligible, but also the highest proportion of unclaimed benefit. There were 4.1 million recipients of CTB (excluding Second Adult Rebates) in England as at May 2005.⁷ However, take-up of CTB is relatively low; latest figures for 2002-03 show take-up in Great Britain was between 65 and 71 per cent and that the total amount of CTB left unclaimed by entitled non-recipients was in the range of £0.9 billion to £1.2 billion.⁸ The Department for Work and Pensions is taking steps to simplify the process for claiming CTB, and I am interested in examining the extent to which this and other changes might improve take-up.

2.61 Low take-up appears to be a particular problem for pensioners, because only 56-62 per cent of those eligible actually take it up, and pensioners also make up 75 per cent of those who do not claim their entitlement.⁹ The submissions I have received from individuals and groups representing older people suggest that this is due to objections to the terminology of a “benefit” (rather than ‘rebate’), the means test, and also to the savings limits which preclude others, again mainly pensioners, from eligibility to help with tax bills.

2.62 Some commentators also criticise other aspects of the design of Council Tax Benefit, such as the fact that people with savings over £16,000 are not normally entitled

⁷ DWP, *Housing Benefit and Council Tax Benefits Quarterly Summary Statistics*, May 2005

⁸ DWP, *Income related benefits: estimates of take up in 2002-03*, February 2005

⁹ DWP, *Income related benefits: estimates of take-up in 2002-03*, February 2005

to it.¹⁰ Submissions to my Inquiry pointed out that pensioners with savings over the existing limit of £16,000 can pay a relatively high proportion of their income in council tax, particularly those in the lowest income groups. A number of individual respondents to the Inquiry stated that they were paying a high proportion (up to 15 per cent) of their incomes in council tax, though it was not always clear whether they were eligible for or receiving CTB. Research conducted by the New Policy Institute also argues that the boundaries for eligibility for CTB and tax credits are not well matched. The same report suggests that some children living in poverty are in households that are not eligible for CTB.¹¹

2.63 The Balance of Funding Review report concluded that reform of Council Tax Benefit was needed in order to make it a more effective means of mitigating the impact of council tax on those on low incomes. It also recommended that options be explored to improve the take-up of CTB, and noted that this need not wait for structural reform of council tax. These points were also made by the LGA and in number of significant submissions to the Inquiry from local authorities and individuals.

2.64 I will return to the issue of CTB reform and its potential impact upon fairness in terms of ability to pay in greater detail in my final report next year.

Revaluation to improve link to property value

2.65 One of the ways to improve council tax as a property tax would be to update the property valuations on which it is based. The system is currently based on 1991 property values, which are now 14 years out of date.

2.66 At the time my Inquiry was commissioned, the planned revaluation of domestic properties was due to go ahead in 2007. In this context, I have looked in detail at how reforms linked to revaluation might improve the fairness of council tax. The Government has decided not to go ahead with revaluation in 2007. Whilst I understand this decision, I believe that revaluation will be necessary if council tax is to remain credible as a property-based tax in the long term.

2.67 A number of submissions argued that revaluations should take place much more frequently, as carried out in a number of other countries. This was in fact provided for (for both business and domestic properties) in the Rating and Valuation Act 1925 but never successfully followed, with a pattern of delayed revaluations over the past 90 years.¹² The VOA experience of five-yearly business rates revaluations and the use of automated models shows it would be technically possible for revaluations to be undertaken more frequently.

2.68 The Government's commitment not to increase overall revenues from revaluation would have meant that revaluation would rebalance the tax burden away from those properties which had seen slower than average house price growth, and towards those properties which had seen more rapid increases in house prices. Households whose property moved up the bands would, other things being equal, have to pay more in council tax, and households whose property moved down the bands would pay less in council tax.

¹⁰ People with savings over £16,000 do not normally qualify for CTB but there is no upper capital limit for those people receiving the guarantee element of Pension Credit. This is because the guarantee element 'passports' people on to full CTB (less any deductions for non-dependant members of the household)

¹¹ New Policy Institute, *Council Tax Benefit for working age households: a review of the problems and some options for reform*, 2005

¹² House of Commons Research, *Paper 05/73 Council Tax (New Valuation Lists for England) Bill*, November 2005

2.69 In my view the debate over council tax revaluation was hindered by a poor public understanding – including among some national press, and even the trade press in some instances – of how revaluation might work. Concern over potential ‘losers’ from revaluation tended to ignore the ‘winners’ who would benefit from revaluation because their properties had increased in value more slowly than average. However, postponing revaluation also creates ‘winners’ and ‘losers’, as it means those people continue to pay more than they would if up to date house prices were used to determine their council tax.

2.70 Modelling work for my Inquiry was carried out within the context of revaluation planned for 2007 and the need to provide clear recommendations by the end of 2005. I analysed five detailed revaluation and reform options. These are set out in Annex A, and illustrate the possible impacts that could have resulted from a range of different approaches suggested by the Balance of Funding Review and others. The Government’s commitment that revaluation would not alter the total amount of council tax revenue was built into the modelling work.

2.71 I would welcome further views on my approach, in particular on whether the reform options set out in Annex A provide an appropriate and illuminating set of illustrations, and views on the most useful alternatives we might wish to explore.

2.72 During the coming year I will finalise modelling work using actual property valuation data for April 2005 (supplied by the Valuation Office Agency) and the 2006-07 local government funding settlement. Whilst detailed recommendations on revaluation may no longer be appropriate, I want to ensure my recommendations are based on robust analysis which takes account of significant recent changes. I will also consider further options for the longer-term reform and revaluation of council tax.

2.73 The extended timetable and wider remit also enable me to consider a broader set of options, possibly including more radical ones. These might include, for instance, considering possible options for reforming the property tax element of council tax separately from the service charge element, and others suggested by submissions, such as moving to the use of detailed point valuations for properties rather than assigning them to bands. This is what is intended in Northern Ireland, although the context for reform is different there. I will continue to look at the experience of the rest of the UK and other international examples.

Reform options and ability to pay

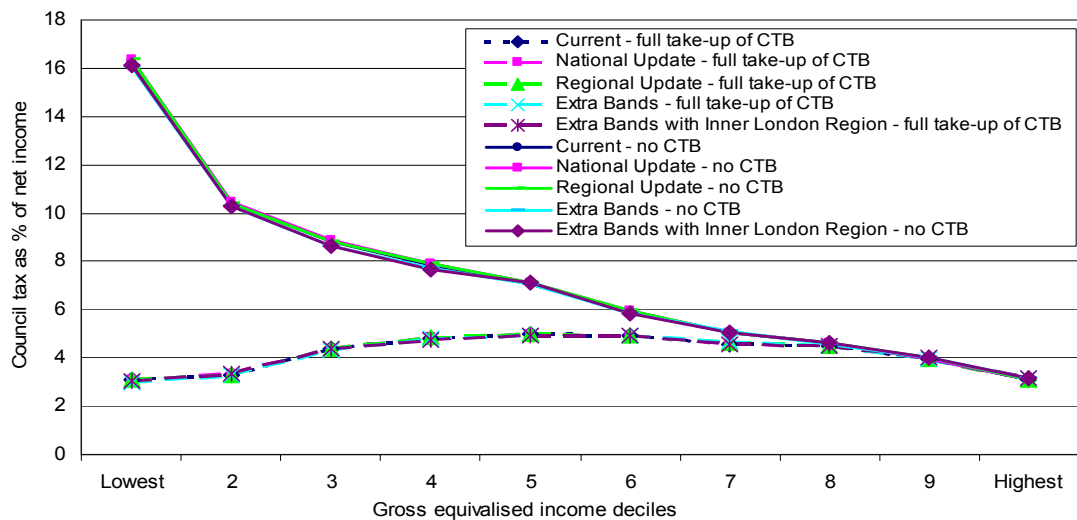
2.74 Many submissions to the Inquiry, including 72 per cent of the local authorities who commented on council tax, supported the introduction of additional bands, mostly on the basis that this would improve the ‘fairness’ of the tax.

2.75 It is argued that adding extra bands would improve the fairness of council tax as a property tax, because it enables council tax to be more precisely linked to property value at the top and bottom. It means that those in the lowest value houses can pay less and that those in the highest value houses pay more. This was welcomed in focus groups.

2.76 However, as shown in Annex A, detailed modelling suggests that adding additional bands would appear not to have a significant impact on fairness in terms of the link to ability to pay as measured by income. Chart 2.4 shows the proportion of income accounted for by council tax liability by each income decile in 2005-6 and under each of the reform options modelled by the Inquiry team. It shows that the picture does

not change significantly under any of the options modelled, either before or after Council Tax Benefit is taken into account.

Chart 2.4: Gross and net council tax as a proportion of net household income after housing costs by income decile, under the current system and after revaluation and reform



Source: Lyons Inquiry Analysis

2.77 This is contrary to expectations. It reflects the fact that people living in houses within a specific band tend to have widely different income levels – people in higher bands may be wealthier by virtue of owning a more valuable house, but will not necessarily have a higher income. So reducing the council tax bill for people in Band A, for example, will reduce the bill not only for some people on low incomes, but also for some on middle and high incomes. In contrast, an increasing tax bill for those in the highest council tax bands will impact on some people with low incomes, as well as those who are at the top end of the earnings scale.

2.78 This suggests that the most direct means of addressing the issue of fairness of council tax in terms of ability to pay is likely to be through reform of the Council Tax Benefit system, rather than through restructuring council tax along the lines I have so far explored. I will examine reform options, and their likely costs (which would have to be met through additional revenues or cuts in spending elsewhere) in my final report.

2.79 Nevertheless, there is a positive correlation between property value and income – though the link is stronger at the higher income levels than at the bottom end of the income distribution.¹³ I am therefore interested in exploring further options to reform the structure of council tax, including the system of discounts and exemptions, which might improve the ‘fairness’ of the tax in terms of how it is perceived and its impact on different people, areas and the economy.

2.80 I would welcome further views on these issues.

¹³ Analysis from the English Household Condition Survey showed a positive and significant correlation between household incomes and property values of 0.4. However, this work also highlighted substantial overlap in property values between all income groups except the richest 10%.

Other taxation and funding issues

2.81 In addition to the extended remit, I have retained my original remit to consider the detailed case for changes to the present system of local government funding. This included the need to examine 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; and the need to assess options to raise supplementary revenue.

2.82 I spent a considerable amount of time investigating the issues surrounding council tax because of the prominence of that tax in public debate, and the original timescale was for the Inquiry to come to conclusions in time to influence the decisions that would have been made as part of the revaluation.

2.83 The other elements of my remit – local income tax, business rates, and other taxes and charges – also sparked great interest from stakeholders and I undertook various pieces of analysis and research on these. I do not intend to go into detail at this stage, as these questions are tightly bound up with issues about the future role and functions of local government. However, there are some points which can usefully be made now in order to inform further debate.

Local income tax

2.84 A number of the submissions I received, including some of the local authorities I spoke to, argued that local taxation should be based on income rather than property value. A local income tax also formed part of the Local Government Association's proposals for finance reforms.¹⁴ My terms of reference asked me only to look at local income tax as an additional local tax, rather than as a replacement for council tax. There has of course also been a national debate on the issue during the General Election campaign because of the Liberal Democrats' policy to replace council tax with a local income tax.

2.85 Both the survey and focus group research suggested that the initial public view on taxation was that linking tax liability to individual ability to pay was the fairest form of taxation. However, when the implications of a local income tax were explored in greater detail in the focus group research there was a greater diversity of opinion on its merits. People were dubious about the idea of having an additional tax alongside council tax to fund local spending (which would be the implication of retaining council tax, as recommended by the Balance of Funding Review), and about the potential effects on different types of households, including working families.

2.86 The work conducted for the Balance of Funding Review and afterwards by CIPFA, and discussions with and submissions from tax experts and employers' representatives, show that it would be possible to introduce a local income tax alongside council tax. It would, however, be a substantial task with associated administrative costs and implications for local authorities, taxpayers and employers, and would require a considerable time to implement.¹⁵

2.87 I will consider these issues further for my final report next year. I would welcome further comments on this issue.

¹⁴ Local Government Association, *The Balance of Funding, a combination option*, 2004

¹⁵ Chartered Institute of Public Finance and Accountancy, *Reviewing the Case for a Local Income Tax*, Balance of Funding Review paper 19, 2004; CIPFA, *Reviewing the Case for a Local Income Tax: Supplementary Report*, Balance of Funding paper 25, 2004; CIPFA, *A Taxing Issue: Local Income Tax Exemplified*, 2005

Business interests and business rates

2.88 Local authorities have an important role to play in promoting the economic development of their local areas. They provide some services directly to businesses, and also manage other services of indirect importance, without which successful business activity could not take place. The role of local authorities was recognised by the businesses and representative organisations I have engaged with, though some were concerned that the priority given to important areas of spending such as transport and economic development had been reduced in recent years because of other pressures on local authority resources.

2.89 The highest profile issue in my discussions, and in a number of submissions, was the question of whether local authorities should have a role in setting business rates. There has been much debate on this subject since business rates were nationalised in 1990, reinvigorated by the work of the Balance of Funding Review, which considered relocalisation as a way of changing the balance of funding.¹⁶ Local government has consistently argued that the freedom to set the business rate should be returned to local authorities, and this forms an important part of the Local Government Association's proposals for changes to local taxation (though they recognise that business rates are currently used in the equalisation system to support services across the country so could not be wholly retained locally without significant other reforms). A large number of businesses and representative organisations, including the Confederation of British Industry and the British Chambers of Commerce, expressed concern that local control of rates would make tax bills less predictable from year to year, and could lead to an increase in the taxes paid by businesses. Some were also worried that local rates would not be an accountable tax because of the lack of a business voice in local authority decision making.

2.90 However, there was a range of views amongst the business community. Some of those I spoke to supported the idea of some local discretion over rates in order to fund investment in transport and road improvements and regeneration activity, provided that businesses were consulted and had a strong influence over how the money was spent. There was also interest in how local authorities could support economic development and business growth more strongly and a welcome for the Local Authority Business Growth Incentives scheme – though some argued that this scheme is too complex. In addition, the introduction of Business Improvement Districts, which allow businesses to choose whether to pay higher rates in return for improved services, was generally seen as a very positive move, though limited in scale.

2.91 Businesses benefit from the actions of successful local authorities, and the investment in public services and infrastructure that they can make. I will continue to explore the interactions between business and local government in many of the areas my remit covers. This will include further consideration of how changes to business rates could improve the ability of, and incentives on, local authorities to support and promote economic development, including looking at current exemptions and discounts.

¹⁶ Confederation of British industry, *Re-localisation of business rates*, Balance of Funding Review paper 18, 2004, and Local Government Association, *Re-localisation of Non Domestic Rates*, Balance of Funding Review paper 17, 2004

Land taxation

2.92 Current UK property taxes – council tax and business rates – tax the combined value of a property and the land on which it stands. Some argue that there would be economic efficiency and equity benefits from taxing the value of the land alone. I received a number of submissions on the subject and also spoke to its proponents.

2.93 These submissions, and NERA's work, highlighted a number of economic arguments in favour of such a tax:

- it would not distort behaviour in the same way as taxes on income and profits because, as there is only a finite amount of land, its supply will not vary if its cost changes. All of the income from it is unearned 'economic rent' (a technical term which refers to the income a factor of production generates above that which it would generate in its next best use) and thus can theoretically be taxed without having an impact on the market;
- it would provide an incentive for the effective and efficient use of land because all land would incur a charge, even when it was not being used for productive activity, thus making the cost to society of its under-use clear to owners; and
- taxing land values can enable some of the increase in value that results from a prosperous economy and public investments to be captured by local government. This can provide an incentive for local authorities to support economic growth and development, and potentially an efficient way of financing infrastructure projects (though other forms of local tax, including property, and corporate or personal income taxes could also be linked to local economic success if they were locally retained).

2.94 There are very few examples of 'pure' land value taxes elsewhere in the world. However, taxes based on separate assessments of the value of the land and the property exist in over 700 cities, including in Australia, the USA and Eastern Europe. Land value taxes have been considered in the UK on a number of occasions, and variants were almost implemented in 1909 and 1931.¹⁷ Vale of White Horse District Council and Oxfordshire County Council have recently conducted detailed and innovative work to study the practicalities and implications of introducing a land value tax in England.¹⁸

2.95 There would be a number of challenges to implementing a Land Value Tax in England. Replacing council tax and business rates entirely would lead to significant changes in household and business tax liabilities. It might have disadvantages as a local tax, since it is linked to the value of the land under the property, not to the number of households using local services. It would also require further work to survey and value all land in the country, as there is currently no national register of land ownership.

2.96 Kate Barker's Review of Housing Supply looked, as part of its work, at the arguments for land value taxation, including a number of more limited types of land tax.¹⁹ One of its recommendations was that the Government should introduce a tax on the increase in value created when planning permission is granted for a development. The Government has now announced consultation on such a tax, the Planning Gains

¹⁷ Connellan, O., *Land Value Taxation in Britain: Experience and Opportunities*, 2004

¹⁸ Oxfordshire County Council and Vale of White Horse District Council, *The Oxfordshire Land Value Tax Study*, 2005

¹⁹ HM Treasury, *Delivering Stability: Securing our Future Housing Needs*, 2004

Supplement, and envisages that local authorities would retain most of the revenue for investment in infrastructure, which could improve the incentives for local government to encourage growth in housing supply. The Barker Review also concluded that a land value tax on derelict brownfield land (which currently faces no tax) might have a role in future in providing incentives for development, particularly where expenditure on remediation and decontamination is required. This line of thinking also raises questions about the justification for the set of reliefs for empty property which exist in the current business rates system.

2.97 I am particularly interested in exploring taxes which could improve the incentives faced by local authorities by providing a link between resources and local development and population change. Whilst the new prudential borrowing powers are an important new flexibility, local authorities may be constrained in making full use of them by current constraints on revenue to finance additional borrowing. Revenues from taxes linked to the success of the local area may provide such revenue streams and enable authorities to make beneficial long-term investments, though they may vary with the economic cycle. I will consider these options further over the next year.

Tourist-related taxes

2.98 It is not only the people who live and pay council tax in an area who benefit from local public services, and local prosperity and success are not dependent on local residents alone. In many areas of the country local economies depend on tourism and the contribution made by the visitor economy. Taxes on tourist activity have been suggested as a way of raising revenue for authorities, and ensuring that visitors contribute to the local public services they use.

2.99 I received submissions and took opinions on this subject from a variety of organisations representing the tourist industry, and from some local authorities, and discussed the issue during my regional events. Tourist taxes were also looked at by the Balance of Funding Review on the basis of a paper prepared by the Local Government Association.²⁰

2.100 The most frequent proposal was for a local tax on hotel and similar accommodation. Such local taxes operate in a number of other countries across the world, including various US states, Austria, the Netherlands and France. The tourist industry expressed a concern that a tax on accommodation would make England a more expensive and therefore less attractive destination for tourists, who might choose to go elsewhere or reduce the length of their visit. This might have adverse effects on the economy. They also pointed out the need to assess any possible distortionary effects and the compliance costs (particularly for small businesses), and noted that some other countries had hypothecated revenues in some way in order to make the tax more acceptable.

2.101 Some stakeholders suggested local sales taxes, which would raise revenue from tourists as well as residents, as an alternative. I also received research commissioned by the Association of London Government on the options for levying taxes on restaurants, entertainment venues and sporting events. Charging and trading powers are another means by which local authorities can raise revenue from tourist activities. Finally, one of the possible rationales for a tourist tax would be to ensure that tourists contributed to the costs they can impose on the local community and the environment. Road pricing

²⁰ Local Government Association, *Vehicle Excise Duty and Tourist Taxes*, Balance of Funding Review paper 26, 2004

schemes might have a role to play in addressing some of these concerns in National Parks and other rural areas where tourists are the primary cause of traffic related congestion and environmental damage.

2.102 I am interested in exploring this issue further, though I have noted that considerable further work would need to be undertaken if new forms of taxation were to be contemplated.

Other taxes and charges

2.103 Experts and stakeholders suggested a number of other taxes and charges, in addition to those mentioned above, as potential sources of revenue for local government. Some of these were also considered by the Balance of Funding Review. They included:

- localising existing national taxes such as Vehicle Excise Duty or corporation tax;
- litter, waste and other environmental taxes;
- congestion/road user charges and other transport related charges;
- payroll taxes; and
- business activity taxes.

2.104 Congestion charging has already been introduced by local authorities in London and Durham, and the possibility of further schemes is being studied in other areas including seven that have received pump priming funding from the Government's Transport Innovation Fund. I am interested in exploring further the extent to which the revenues from such schemes should be retained locally, regionally or nationally.

2.105 Some of these taxes would be capable of providing substantial revenues; others would be of relevance only to a small number of authorities. However, some would be extremely difficult or even impossible to introduce for administrative or legal reasons, for example a general local sales tax or a localised corporation tax. Some might also create incentives to change behaviour in positive ways, for example taxes on litter or waste. I am interested in how this is relevant to the role of local authorities in ensuring the environmental well-being of their local areas.

2.106 The work I will be undertaking on the role of local government will be important in setting a context against which to judge which of these revenue sources might potentially be useful and appropriate for local government in the future. I will return to this in my final report.

User charges for services

2.107 The total amount local authorities receive from sales, fees and charges is significant, with £10.2 billion raised in 2003-4. This is an increase of 55 per cent from the amount raised in 1997-98 and represents around 9 per cent of local authority income from all sources.

2.108 The introduction of user charges for certain services could provide new revenue sources, which could be used to offset council tax revenue. They might also have the potential to increase transparency and accountability at the local level by allowing local authorities discretion over how services should be managed and delivered. This would

give rise to a more transparent line of accountability between the money people pay and the services they receive in return, making local authorities directly accountable to service users.

2.109 Charging for services is a controversial issue with a number of potential advantages and risks. As mentioned earlier, my public attitudes research highlighted a general resistance to charging for key services, though I believe it is potentially interesting as a possible way of improving public understanding of the costs of services, and of managing pressures more effectively. Many local authorities are already charging for some services, and for additional levels of service in some cases. They also have the powers to introduce charging for discretionary services. This remains an issue I intend to explore further and return to in more detail in my final report at the end of 2006. I would welcome views on opportunities for the greater use of charging, and on the drawbacks and advantages of any change.

Equalisation

2.110 The needs for and costs of delivering public services vary in different parts of the country, and the amount of money that local authorities can raise from council tax also vary. One of the ways in which government grant is used is to 'equalise' tax and service levels in different parts of the country by providing the resources necessary for all parts of the country to enjoy an acceptable level of public services. Higher grants are therefore provided to areas with greater needs, higher costs and with a lesser capacity to raise money from council tax. This is through both the revenue support grant equalisation process and through targeted specific grants.

2.111 The current English system has developed in the most part since the introduction of the Exchequer Equalisation Grant in 1948. As discussed in the international research, equalisation systems also exist in most other developed countries, though they vary in terms of their complexity and the amount of money that is redistributed around the country. Some operate by requiring richer authorities to transfer resources to poorer authorities directly, rather than by providing different allocations of central government grant, but the effect is the same. The research highlighted that the English system is one of the most complex in the world, and seeks to achieve a very high level of equality in services, perhaps exceeding that sought by Scandinavian countries, against a background of quite significant variation in needs and resources around the country.

2.112 Equalisation is an extremely important, but highly complex and consequently relatively poorly understood system. It has profound implications for local services, tax rates and the incentives on local authorities, something which was pointed out in the submissions from the LGA, many local authorities and other groups, including businesses. However, there are trade-offs which need to be understood, including:

- Balancing complexity and simplicity - In order to provide resources to the areas that need them, and to take into account the many factors that contribute to local levels of need for services, the grant system has to be somewhat complex. This was fairly widely accepted by those who made submissions to the Inquiry. However, it does mean that apparently technical changes can have substantial implications for the grant received by each authority. This can further hinder public understanding, make grant allocations more difficult to predict, and divert effort away from getting the best from existing resources or seeking to generate more income locally;

- Ensuring effective accountability - The importance of central government grants in local budgets means that local tax rates can be substantially affected by decisions that lie outside the control of local authorities. Since decisions on the formula can lead to substantial changes in the amount of money available, it is difficult for local residents, taxpayers and service users to see a clear link between changes in the council tax they pay and what it buys; and
- Balancing incentives for growth and the redistribution of resources - The grant given to a local authority takes into account the business rates it receives and the amount of council tax it can collect locally. There is little financial gain for a local authority if the number of businesses or houses, or the population of its area increases, or if the success of the local economy or popularity of the area leads to an increase in the value of land and property in it. This means there is little financial incentive for authorities to promote economic development and provides no financial reward for creating a successful and prosperous area, or resources to help respond to residents' concerns. The fact that housing development and economic growth can involve costs for the local community as well as being controversial further exacerbates this problem. This is an issue that the Barker Review addressed in some detail.

2.113 I am particularly interested in exploring the issue of incentives further. The Government has recently introduced the Local Authority Business Growth Incentive scheme to give local authorities some financial benefit from growth in their business rates base. I would welcome views on this scheme and other possible incentive measures and reforms.

2.114 The equalisation process is and will remain an integral part of our local government finance system, but the trade-offs need to be understood in order to understand whether and to what extent changes at the margin might lead to improvements. I would welcome views on these points.

NEXT STEPS

2.115 This report does not exhaustively report on the wide range of analysis conducted by the Inquiry team, nor the full depth and breadth of submissions to the Inquiry so far. I welcome views on my work to date and on the issues raised in this report and will report fully on funding issues in my final report to ministers at the end of 2006.

2.116 I would welcome your views on my work to date and the issues outlined in this report by **Monday 13 March 2006**.

2.117 Specific comments on the modelling work covered in Annex A would be welcome by the **end of January 2006** to inform further technical analysis.

2.118 I would prefer to receive responses electronically where possible. Please send responses by e-mail to: SirMichaelLyons@lyonsinquiry.org

2.119 Alternatively if you are not able to respond via e-mail, please send your response to:

Lee Burge
Room 3.12
Lyons Inquiry into Local Government
1 Horse Guards Road
London
SW1A 2HQ

2.120 It would assist my analysis of the responses if you could set out your comments under the relevant questions or clearly indicate to which paragraphs and/or consultation question they refer.

2.121 All responses will be made public unless confidentiality is specifically asked for. If you wish your comments to be treated in confidence please state this clearly in your response. However, correspondents should be aware that confidentiality cannot always be guaranteed, for example where a response includes evidence of a serious crime. Any automatic confidentiality disclaimer generated by your organisation's IT system will not be respected unless you specifically include a request in the main text of your response. All responses will be included in statistical summaries of comments received and views expressed.