9 The funding system and incentives

Summary

This chapter argues that the current grant system should be re-balanced to improve incentives for local areas to grow their tax bases. This could offer a direct financial benefit to local communities which are weighing up difficult decisions over residential or economic growth. Along with the other benefits that growth may provide, a financial incentive that allowed authorities to retain more of the extra tax raised locally as a result of their efforts could go some way to compensating local communities for any wider costs.

The chapter examines a number of possible options for reform to link funding more directly to the local tax base. However, it is very difficult to create such incentives in the current 'four block' grant distribution system. Therefore more substantial reform may be needed.

The chapter also explores ways to improve the transparency of the funding system by seeking ways to reflect more explicitly the shared nature of revenues coming from central and local government which support local services. It considers options for the assignment of part of a national tax such as income tax to local government.

Depending on how it is designed, an assigned tax could not only help to improve transparency by making it clearer that a proportion of national taxation also contributes to local services but might also pass on some buoyancy from the national tax base to local government, which could help to keep pressure off council tax.

There are some disadvantages: any income from buoyancy of a tax assigned to local government would not then be available to support central government priorities delivered through agencies other than local government. Also, local government might have to bear the risk that income tax revenues (unlike council tax) can fall in a recession – they are not necessarily buoyant in every year. This raises questions about the capacity and willingness of local government to manage with a fluctuating and unpredictable tax base.

The chapter concludes that:

- the grant system should be changed to introduce incentives to support growth and, in the short term, the Local Authority Business Growth Incentives scheme should be simplified; and
- in the short term, better information should be provided on the extent to which nationally collected taxes are used to support local services in addition to council tax. In the medium term the Government should consider a more formal direct assignment of part of income tax to support local services.

INTRODUCTION

9.1 This chapter considers ways to make the funding by central government of local public services more transparent, and to improve the incentives it creates for local government. These reforms should support the desire for a stronger, clearer and more mature relationship between central and local government which is at the heart of my recommendations on a new constitutional settlement in Chapter 10.

9.2 The first section examines ways of reforming the grant system to clarify its aims and improve incentives on local authorities to be more self-reliant in expanding their tax bases. The second section examines ways of sharing revenues to improve public understanding of how local government services are funded, to improve accountability and enhance confidence in local government.

INCENTIVES, EQUALISATION AND GRANT

9.3 Chapter 3 argued that grant is at the centre of the relationship between central and local government. It examined the effects on incentives of the equalisation process which, while having aims that I support, acts to control the effects of differences in local tax bases and growth. The effect of this is that while local authorities see it as a core part of their concern to pay attention to local prosperity, and the needs and future prospects of its citizens and its local areas, there are no coherent or systematic financial incentives that encourage growth either for them or, more importantly, for their communities.

9.4 There is a strong case for equity and stability to remain key objectives of the grant system. Equity – pursued in the current system through the equalisation processes – is important to ensure that communities with high levels of socio-economic need or low tax raising abilities are not left behind. Indeed there are economic arguments that public resources are better targeted at such areas as they can have more of an impact on the outcomes which are national priorities than if distributed to affluent areas.

9.5 I have also argued in previous chapters that a degree of stability in the funding system is essential to allow local authorities to plan. Having said that, I am concerned that the focus on stability – pursued in the current system through grant damping – appears to be over-emphasised due to central government's concern about council tax levels. A more effective solution would be to deal with the pressure on, and public concern about, council tax through proper reform rather than using other parts of the system to control the pressure on the tax.

9.6 However, in order for local authorities to be able, and encouraged, to perform their place-shaping role to the full, I believe that a further objective needs to be considered for the funding system: providing financial incentives for local authorities and communities to promote economic prosperity and residential growth, and to take into account their benefits and costs fully.

9.7 Financial incentives should give local authorities more reward for owning and growing their own tax bases without such growth being immediately equalised away, and enable them to benefit from growth more directly, either in terms of population or more business activity in their areas. Such changes would, as argued in Chapter 3, support areas in taking action to respond to the social and economic pressures on our country and align the incentives they face more closely to these objectives.

9.8 My proposals are not intended to dramatically reduce equalisation, or to increase stability in a way that impacts on local government's ability to plan. Rather I want to find a way to provide space – at the margins, but with enough weight to change local government behaviours – to incentivise local government to grow their tax bases and crucially enable local communities to receive some reward for allowing their area to develop and grow.

9.9 I recognise that there may be concerns about such incentives benefiting areas which are growing at the expense of needy areas. The distinction may be more appropriately made on the differing ability of areas to grow, rather than just their current level of need. Some of the most deprived areas of the country including Manchester and areas of East London have experienced major increases in residential and business development as shown in Table 9.1 below.

Table 9.1: Authorities with largest growth in council tax and business rate tax bases, 1999-2004

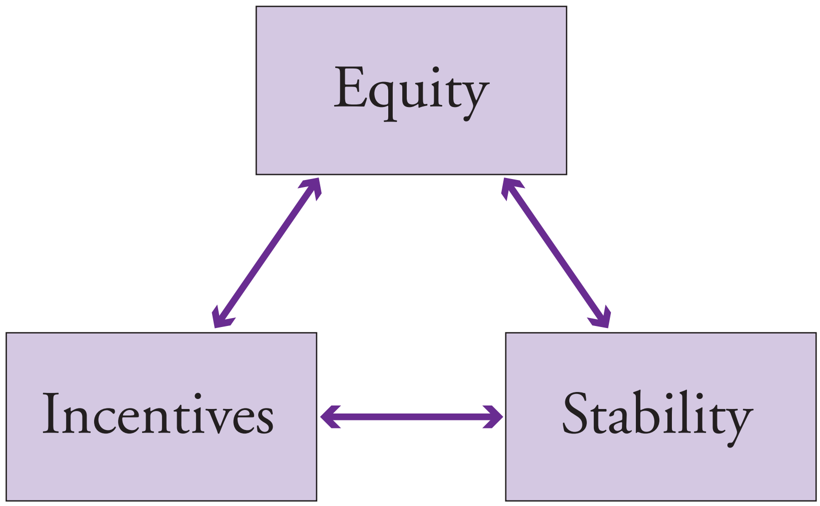
Largest council tax base growth	Largest business (rateable value) growth
Tower Hamlets	Westminster
Westminster	Tower Hamlets
East Riding of Yorkshire	City of London
Hackney	Camden
Lambeth	Birmingham
Leeds	Southwark
Manchester	Leeds
Milton Keynes	Milton Keynes
Islington	Sheffield
South Gloucestershire	Hillingdon
Wandsworth	Islington
Bradford	Bristol
Liverpool	Hounslow
Newham	Manchester
Wakefield	Nottingham

9.10 In contrast, it is unlikely that some of the less well-connected and more economically weak areas of our country will see such change unless there is concerted policy effort – beyond changes to the grant system – by national and local government. Ensuring that support for these types of area does not fall away is one of the main reasons that I have discussed changes in terms of marginal, rather than whole-scale terms. I explore in the more detailed discussion of particular incentive schemes, a method by which the degree to which the incentive impacts on different types of area could be controlled. In the design of any eventual scheme there will need to be decisions made on where the resource to fund incentives should come from. If the choice was between equalising less, or damping less, I would favour the latter. As, in principle, I believe that with proper reform the pressure can be taken off council tax and in pragmatic terms, the authorities who will find it most difficult to grow are already not the main beneficiaries of damping which impacts most positively on more affluent areas.[1]

[1] See Annex E for a further discussion of this issue.

9.11 In summary this will mean the grant system balancing three aims, as set out below.

Chart 9.1: A balanced system of grant distribution



Incentives

9.12 Providing incentives to grow local tax bases could serve three purposes, they could:

- aid a more balanced decision making process, because financial benefits for the community could be used to compensate those affected either through improved services or reductions in tax bills. In this sense incentives could help to rebalance the costs and benefits of economic or housing growth by providing clearer local benefits to offset the costs of this growth, such as additional congestion and pressure on services – to the current residents;
- help to influence local authority behaviour in general by providing a more direct relationship between local authority finances and the health of the local economy through its investment to make the area attractive to businesses and also to attract a good skills base of local employees to the area; and
- provide a potential source of revenue which could be used for local investment in growth-enabling measures, such as infrastructure, which may need long-term planning and greater certainty over funding mechanisms.

9.13 It is important to note that all of these relate to long-term issues: planning and development decisions, relationships with and support to the business community and making investments to secure long-term gains. Incentives are therefore required which can operate on long timescales and which are sufficiently clear and transparent to enable councillors and local communities to understand their potential benefits. It is also important that any revenues from incentives should not be ring-fenced, nor have restrictions on their use. The costs of growth impact on different communities in different ways, and therefore local authorities and local communities should be able to use the financial benefits as they wish, whether that be to support investment, to provide additional services, or to meet other priorities.

Mechanisms for providing incentives

9.14 Incentives for local authorities need not be introduced through changes to the grant system. The Government could, for example, allocate specific reward grants to authorities on the basis of local changes in any indicator it chooses, including housing or economic growth. Indeed, as set out in Chapter 3, this is the approach it has chosen in recent years to respond to the identified problems caused by a lack of local incentives to support growth.

9.15 The Barker Review of Housing Supply identified housing growth as an area where new incentives are required for local authorities. Following this, the Government has consulted on a new Housing and Planning Delivery Grant (HPDG), which will allocate funds to 'reward' authorities for housing growth. In relation to business and economic growth more widely, the Government introduced the Local Authority Business Growth Incentives (LABGI) scheme in 2005, intended to distribute around £1 billion over three years to reward local authorities for growth in business rate revenues above pre-determined thresholds.

9.16 As the discussion of alternative and more systematic incentives below sets out, there are different ways of delivering incentives beyond special schemes such as LABGI and HPDG. Such schemes are steps in the right direction as they emphasise incentives although they remain controlled by central rules rather than supporting local decision making processes. This may be particularly the case for LABGI which has some specific drawbacks.

9.17 The criteria used to allocate resources through LABGI are complex – though they need not be in principle. This means that they are not transparent and are open to being amended and revised, as policy makers seek to refine the incentives provided and the pattern of distribution of resources. While such objectives may be valid, complexity and changes to criteria have reduced the ability of local authorities to predict their likely gains from the scheme, constraining the degree to which they are able to make decisions that rely on future financial benefits being realised and making it difficult to demonstrate the benefits to their citizens.

9.18 A key property of a good incentive scheme is predictability which provides a clear relationship between the effort and reward. However, LABGI includes special equalisation arrangements which blunt its incentive effect and add a further layer of complexity. The complexity and special nature of this scheme means that it produces a new set of transaction and compliance costs which falls most heavily on central government.

9.19 However, there are other issues that apply more generally to incentives that are delivered through special schemes:

- they reinforce the sense that authorities are following Government wishes and being rewarded. More systematic incentives could open up processes for local government to make the right local decisions, based on the local costs and benefits, and responding to general economic and social pressures; and
- reflecting the Spending Review cycle, grants are usually only allocated on a one to three year basis. This means that they are less likely to be able to motivate long-term changes in behaviour, or influence decisions which take more than three years to have an impact, as there is no guarantee that the scheme will continue to exist to provide the financial benefits expected.

9.20 Together, these can limit the extent to which specific reward schemes will actually influence authorities' long-term plans and decisions. This is of particular concern when we are seeking to influence decisions related to development and infrastructure planning, which are by their nature usually long term. LABGI, while welcomed by many stakeholders in principle, has suffered particularly from criticism that it is too short-term to influence behaviour, and too complex to be transparent and predictable, particularly given concerns about managing its distributional impact. Complex specific grants based on ministerial priorities can also reinforce a particular type of central-local relationship in which local authorities have to wait for central government judgments rather than basing change on the needs and aspirations of their local communities.

9.21 Incentives rooted in the wider system of local government finance could have the potential to be a more constant feature of local-central relations and could over time embed a different relationship between authorities and their tax base, creating better incentives to support growth and prosperity. However, particularly with the current grant system, the creation of such incentives is not straightforward. I have considered a number of illustrative options for council tax and business rates, all of which are based on the current government model of grant distribution – the 'four-block' model.

The four-block model

The distribution of national resources to local government impacts on all local authorities. No local authority in England is independent of central resources and indeed it can be considered an aim of the distribution system that all areas get a positive grant. However, the other key aim in distributing national tax resources is equalisation of needs and local tax resources.

Equalisation is the process by which national resources are used to supplement local revenue to support areas with high socio-economic needs and/or low local tax-raising potential. It is this process which requires the distribution of grants to local government to be based on detailed formulae and processes which allow these two elements to be identified.

The current English model of equalisation is recognised as one of the most complex in the world, and seeks to achieve one of the highest levels of equality compared to other advanced nations. Equalisation in England can be traced at least as far back as 1929, when block grant was introduced. The process developed in later decades, with the introduction of an explicit Exchequer Equalisation Grant in 1948.

Equalisation calculations have usually involved an 'approved' measure of expenditure which involves an assessment - based on demographic, economic and social data – of the appropriate share of revenue spending for each local authority, within a fixed national total. Similarly, account has usually been taken of a local authority's capacity for raising tax locally. In recent years, this has been done by using information on each authority's tax base and multiplying it by an assumed national average council tax for the appropriate class of authority. The capacity for raising other income – such as fees and charges – is not taken into account.

The current model was introduced for 2006-07 onwards. Its aim was partly to get away from what the Government regarded as the widespread misinterpretation of some of the components of the previous system, particularly that it was allocating resources based on actual rather than relative need.

The core components of the current system are four blocks carrying out the following roles in distributing Revenue Support Grant and redistributed business rates:

1. The **Relative Needs block** takes account of the variation in spending needs across authorities, covering the major services which they provide. As with the previous system, formulae are used to quantify relative, rather than absolute, spending needs, based on various factors which affect local authorities' costs locally. The national Relative Needs Amount for 2006-07 was £14.82 billion which was allocated to give each local authority a separate figure.
2. The **Relative Resource block** is a negative figure which takes account of each local authority's capacity for raising money locally through council tax. The total Relative Resource Amount for 2006-07 is -£5.13 billion. This is calculated to give a separate figure for each local authority. It can then be set against the Relative Needs Amount to give a further figure for each local authority which takes into account their relative needs and relative resources.
3. The **Central Allocation block** is the amount left in the overall grant pot for local authorities once account has been taken of the Relative Needs and Relative Resources of each authority. It totals £11.19 billion for 2006-07 and is allocated on a 'per head of population' basis. There was no exact parallel to the Central Allocation block in the previous system.

4. The **Floor Damping block** is self-funding (i.e. sums to zero nationally). It reallocates the amounts calculated in the previous three blocks to ensure that each authority receives a guaranteed minimum percentage increase in grant over the comparable figure for the previous year. Different minimum percentage increases are set for different groups of authorities. In practice, floor damping has a significant effect for many authorities, eclipsing large changes in grant that would otherwise result from applying the first three blocks.

Grants calculated under the four-block model depend upon a combination of analysis and the exercising of policy and political judgment. Judgment is applied in the following areas:

- in setting the national control totals for each category of services;
- in some of the relative needs formulae, such as those for Environmental, Protective and Cultural Services; and
- in setting the level of the damping floors.

Further details of the four-block model are given in Annex A.

Council tax incentives

9.22 The Inquiry team modelled three different methods for changing the way grant is equalised for council tax base, in order to provide an incentive to grow the numbers of properties in an authority's council tax base.

Partial equalisation

9.23 The first method is 'partial equalisation'. Effectively this means disregarding a proportion of an authority's tax bases when calculating their grant. In theory, this would provide stronger incentives for growth because a part of council tax revenues would be 'retained' and not offset by grant reductions.

9.24 However, my modelling showed that in practice this option would not produce any change in authorities' grant allocations. This is because the current way the grant system is administered does not treat each authority separately, but allocates a fixed pot of grant between them, based on the relative size of their council tax bases. Scaling back authorities' tax bases to make them appear smaller would have an equivalent impact on all authorities, so would not change their relative standings, it would therefore not affect the amount of grant received, and would have no effect on financial incentives.

Differential equalisation

9.25 The second option I have looked at is 'differential equalisation' – disregarding part of the tax base only for certain classes of authority. In theory this would mean that resource equalisation could be used to create stronger incentives to grow the tax base in designated housing growth areas, for example.

9.26 Ultimately however, such a mechanism would be relatively complex, and subjective judgements would need to be made on the degree to which different classes of authorities would have their tax base disregarded. I am cautious about such schemes since this could be open to regular amendment in light of changing policy priorities – in much the same way as a specific grant. Authorities could benefit or lose out according to the priority given by ministers to different types of council, rather than according to their own approach to growing the tax base. It would not therefore have the key benefit of promoting a different relationship between central and local government, and might become similar to 'just another needs formula' or another specific grant. In practice it might even be less transparent than most specific grants, further weakening any incentive effects.

Equalising for 'lagged' tax bases

9.27 Finally, I have considered equalising for 'lagged' tax bases, similar to the proposal by Kate Barker in her report on housing supply – that is, basing the 'relative resource allocation' on data from previous years.[2] This should mean that authorities whose tax base is growing still receive grant according to their older, smaller tax base, resulting in more generous funding for growing authorities than would otherwise have been the case. Authorities which have the fastest rate of growth would expect to have the greatest benefit from this scheme. Those with slower rates of growth and a shrinking tax base would lose out in relative terms.

9.28 Of the options modelled, this appears the most viable within the constraints of the four block grant system. The modelling suggests that if grant had been allocated in 2006-07 on the basis of tax base figures from three years ago, the distribution of funding would have been rather different overall. In particular, it suggests:

- a modest shift in grant away from metropolitan areas (-0.4 per cent overall) to shire areas (+0.2 per cent overall);
- a more significant shift in grant from Outer London (-1.1 per cent) to Inner London authorities (+1.1 per cent), whose tax bases have grown more quickly on average over the three years; and
- a modest benefit, overall, to the Government's designated Growth Areas (+0.2 per cent).

9.29 However, while the modelling shows that an incentive of this kind would be technically feasible, it would still require some significant changes in the way the government approaches grant settlements. Most significantly, it would require a different treatment of 'damping', as indeed would any incentive scheme, in order for the incentives to take effect. The current system of damping is designed so that grant changes are controlled by putting in 'floors' below grant decreases and scaling back increases in other authorities' grants by applying 'ceilings' to their grant increases to pay for it.[3] Such damping can override the effects of equalisation for both resources and needs, eliminating any incentive effect. Stronger incentives would require a political choice to reconnect authorities with their tax bases, even if this means moving away from the aim of stability that is currently prioritised through damping.

9.30 Providing some levels of protection for areas of declining population and high need is, rightly a concern of central government. As set out in Chapter 3, there are concerns that the current focus on stability is driven more by a concern to control council tax increases. I am concerned that the solution to pressure on council tax should – and can – be dealt with on its own terms rather than affecting other parts of the system and limiting positive reforms such as the introduction of financial incentives.

9.31 Once issues about the extent of damping are resolved, a practical solution for the current system may be to allow incentives to impact after damping had, taken place for all other factors; essentially to add a fifth block to the grant distribution system. This would, however, require the impact of damping to be more predictable then it currently is – perhaps moving to being announced along with the three year settlement – allowing local government to focus on gaining more of the benefit from the extra tax base they create rather than the degree of damping.

[2] Barker, K., *Review of Housing Supply: Delivering Stability: Securing our Future Housing Needs,* 2004

[3] An example of the impact of damping can be seen in 2006-07, when 71 out of the 150 local authorities with responsibility for personal social services were protected by the 'floor' which was set at guaranteeing all such authorities a minimum 2% increase for this aspect of their budget. Further detail about damping is set out in Annex A.

9.32 There is a question about how fire and police authorities should be treated under any incentive scheme. On the one hand, it could be argued that they are less connected to either residential or economic prosperity than councils. On the other hand growth – residential or commercial – would stretch police and fire services. In this regard these organisations might also be more supportive of development if the costs on their services were offset to some degree and I believe that they should be subject to any incentive as well.

Business rates incentives

Local Authority Business Growth Incentive Scheme

9.33 The Government has already introduced the LABGI scheme to provide better incentives for business rate growth through increases in the number of properties. Most stakeholders, including both local authorities and the business community, have welcomed the scheme in principle. More than 300 local authorities benefited in the second year of the scheme, receiving over £300 million between them. However, its complexity and short-term nature are felt to reduce the incentive effect of LABGI, though the scheme is only in its second year.

9.34 A significant part of the scheme's complexity can be ascribed to the objectives the Government set when designing it. The Government wished to develop a scheme which would:

- give all local authorities an incentive to maximise local economic growth;
- provide incentives that are consistent with its aims for growth in all regions of the country and reductions in the persistent gap in performance between regions; and
- distribute resources in a way which reflects relative performance not relative circumstances.

9.35 As a result of these objectives, LABGI attempts to redistribute resources for policy reasons at the same time as providing a growth incentive based on the size of the tax base, and in seeking to do so has become extremely complex. It does this through the use of historical growth rates to set each local authority a target growth rate that they have to meet before they receive incentive payments. Those target rates are calculated using the average historical growth rates for eight groups of authorities (with authorities with similar historical growth rates grouped together). This approach means that authorities with historically high growth need to continue to grow quickly if they are to receive incentive payments, and that those with historically low growth have a less difficult target to meet before they are rewarded.

9.36 It may be that now those targets are set and known, the system will become more effective, as it is clearer to authorities what level of performance they have to meet to gain revenues. However, it will still suffer from the fact that it is only a short-term scheme, constrained to the time horizon of government grants, and is still not closely linked to changes in the tax base so blunting its impact on local decision-making and producing a confused incentive.

Improving incentives

9.37 I strongly support the Government's objective, to which the LABGI scheme is intended to contribute, to provide better incentives to local authorities to support economic prosperity, and the use of the business rates system as a way of doing so. However, reform to the current system is required to deliver a more transparent and long-term incentive scheme.

9.38 One issue that needs to be considered is whether the present attempt to use the LABGI scheme both to provide financial incentives that are applicable to all authorities, and to create a 'fair' distribution of resources, makes it too complex and unpredictable, and weakens the incentives it provides. It would be worth considering whether to separate the incentive element of the scheme from the desire to provide a reward for all areas. That would tend to give greater benefits to areas with high levels of growth and high value properties than the LABGI scheme does. In doing so it would help to develop much clearer and more transparent incentives.

Simplified LABGI

9.39 A number of the drawbacks of LABGI could thus be addressed through substantially simplifying the way in which local allocations are calculated, by removing the historical basis for calculations, and allowing local authorities to keep all, or a proportion of growth. This would address concerns about the arbitrary and unpredictable nature of rewards. It would still, as with the current system, ensure that no local authority actually lost resources as a result of the scheme, since it would still be paid out as a grant (though some authorities would get less than they might have done under the current LABGI system and others may gain more).

9.40 Such a system would help to provide clearer short-term incentives to authorities. It would not achieve the objective of creating a more permanent link between authorities' tax base and their income as the grant available would still be dependent on central government decisions as to the level of resource to be distributed through the scheme.

Property value-linked incentives

9.41 No simple reforms would enable LABGI to provide long-term incentives to enhance the value of properties in an area. At present the only additional revenue received (in real terms) from business rates comes from new properties being added to the rating list. There would be considerable merit in finding ways for local authorities to benefit from growth in the value of properties in their area as well as from the number of properties. That would give them an incentive to consider the wider business environment, and the needs of existing as well as potential new businesses. It might also provide the opportunity for authorities to invest in projects which enhance the value of properties in the area (for example new transport infrastructure in an already developed area) whereas the incentives under existing models are likely to be geared more towards unlocking new land and the construction of new properties.

9.42 Two further options I have considered could provide value-linked incentives and be made a more inherent part of the overall system.

Partial assignment of business rates

9.43 One option would be to explicitly share the business rates tax base or revenue between the local authority and national government – a partial assignment, or partial localisation, of the revenues (but without the power to change the tax rate). Rather than pay all of the business rates collected locally to central government, authorities would keep a proportion of the money and have their grant from central government reduced. From then on local authorities would be responsible for their share of the tax, and could benefit (or lose) from changes in revenues at the local level, including those created from the increased value of properties identified during revaluations.

9.44 My analysis shows that up to 16 per cent of business rates revenue (with the City of London excluded) could be retained at local level without leaving any authority 'over-funded' in the first year of such a scheme. For this proposal to provide clear incentives, it would then be necessary to maintain the local share at 16 per cent, and not to take changes in the local share of revenues into account when setting government grant.[4]

9.45 Under this system, authorities would gain increased resources over time if their tax revenues grew, and authorities with a falling tax base would lose in cash terms. If no additional resources were provided for the overall local government funding system, then there would also be some authorities that lost relative to the current system, depending on how the growth in revenues would otherwise have been allocated through the grant system.

[4] For such a system not to alter funding levels in its first year, the maximum amount of revenue that could be assigned to individual local authorities is determined by the point at which one authority becomes fully self-funding from council tax and its share of business rates. Up to that point Revenue Support Grant can be reduced to compensate for any increased business rates revenue, and thus ensure that – in the first year of the scheme – no authority is better or worse off.

9.46 This option has the advantage of being clear and transparent, and could in theory be separated out from the rest of the grant distribution system, providing a new, explicitly local tax base not subject to equalisation. It could also be maintained from year to year without the need for government decisions about how much money to allocate to providing incentives.

9.47 However, though there might be some transparency benefits, the total value of the incentives provided might well be lower than is currently being provided by the LABGI scheme. LABGI is intended to provide £1 billion over three years, whereas a 16 per cent share of growth in revenues over the period from 2004-05 to 2006-07 would have totalled under £450 million.

Lagged retention of business rates

9.48 Another option would be to adjust the operation of the business rates system so that local authorities keep the proceeds of growth in the business rate base for a fixed number of years, before eventually paying it into the national pot. A local authority's required contribution to the national pool would be based, not on the amount of revenue they had collected in that year (as now), but on the revenue they had collected a number of years before, as described in the lagged tax base model for council tax incentives. That would mean that if an authority had managed to grow the tax base in the intervening period, they could keep that additional resource for local spending and investment but that, if there was decline or low growth, they could lose resources either in absolute or relative terms as described, again, in the option of lagging council tax bases.

9.49 This approach would have some advantages in terms of transparency, as local authorities should be able to identify the amount of money that they would expect to pay in to the national pot in advance, and thus use any growth for their own purposes. It would present some challenges to local authorities, in that they would have to forecast their growth in revenues and compare that with the amount they needed to pay to the pool. This would produce a level of uncertainty, particularly in the early years, as they might not know until the end of the year whether their forecasts were right or not.

Constraints within the current system

9.50 These options could be pursued further as the Government develops proposals for the future of business rates incentives following the LABGI scheme. However, the current business rates system creates significant challenges for such schemes because of the national cap on revenues and the way that the national multiplier is calculated, as explained below. Consideration of the more radical forms of incentives described here would need to be considered alongside other changes to the business rates system.

9.51 As discussed in Chapter 8, at the national level increased property values do not lead to additional revenues being collected. This is because the multiplier is recalculated after each of the five-yearly revaluations (the next one is due in 2010) to maintain the overall yield in real terms. Increases in property values are used to reduce the overall tax rate for all businesses (and conversely, during downturns in the property market, the tax rate will rise). This feature of the system means that there is no additional business rates revenue at a national level arising from increased property values that could be used to give local authorities more of a benefit from any growth in the tax base that they may create.

9.52 The cap on yield also means that the revenues raised from business rates in a given local authority area are apt to change substantially at revaluation, so that the possible benefits from an incentive scheme would be much less easy for individual local authorities to predict. This would reduce the degree to which the scheme could provide effective incentives for long-term decision making. This is explained further in the following box.

The impact of the national cap on local revenues and incentives

The revenues collected in a local area from business rates are – simplifying the system substantially – the result of applying the national tax rate (the business rate multiplier) to the tax base (total rateable value).

In a simple system with a fixed tax rate, at a revaluation, if property values have increased then the total revenues raised in the area will also increase – the same tax rate is applied to a larger amount of total rateable value in the area. If the authority retained a proportion of revenues, this would provide an incentive for it to seek to bring about an increase in the value of properties in the area.

However, under the current business rates system, the tax rate falls if the national tax base rises, in order to raise the same overall revenue in real terms. The impact on revenues in any one area will therefore depend on the change in property values across the rest of the country, because it is changes elsewhere that will determine whether the multiplier falls, rises or stays the same.

In the example below there are only two areas in the country, both with the same initial tax base. By the time of revaluation both areas have seen increases in property values. Both might expect to gain some revenues as a result of this success. However, because the national multiplier is reduced to maintain the yield at a national level, from 45 pence in the pound to 40 pence, the revenues raised in area B fall. The revenues in area A rise, but not by as much as might otherwise have been expected. The fact that for each authority the impact is determined partly by what happens somewhere else, makes it harder to predict what will happen to their revenues.

	Local area A	Local area B	National
Rateable value	1000	1000	2000
Multiplier	0.45	0.45	0.45
Revenue raised	450	450	900
After revaluation			
New rateable value	1175	1075	2250
New multiplier	0.40	0.40	0.40
New revenue raised	470	430	900
Change on previous	20	–20	0

9.53 In the short term, reform of LABGI seems likely to be the most effective way to continue to provide incentives to local authorities, though even here decisions will need to be made about how the scheme should operate at the time of a revaluation. In the longer term, this analysis adds weight to the options for longer term reform of business rates set out in Chapter 8, including considering a future localisation of the tax or setting a fixed national tax rate.

Recommendation 9.1

In the short term, the Government should simplify Local Authority Business Growth Incentives scheme in order to provide sharper incentives. Reform should focus on providing transparency and predictability through reducing the emphasis on distributional objectives.

Recommendation 9.2

In the longer term, the Government should consider wider reforms to business rates, such as localisation, which would make it possible to design longer-term incentives for local authorities.

Conclusions

9.54 Table 9.2 summaries the options I have considered for introducing tax base incentives into the local government finance system.

Table 9.2 Summary of incentive schemes

Council tax base incentive schemes	Business tax base incentive schemes
Partial equalisation	Simplified LABGI
Differential equalisation	Partial assignment of business rates
Lagged retention of growth from council tax	Lagged retention of growth from business rates

9.55 Improving the incentives facing local authorities is a crucial aspect of changing behaviours and bringing about stronger local decision making. As the above analysis demonstrates there is potential to introduce incentives into the grant system to ensure better reward for growing both residential and business tax bases. However, the current design of the grant distribution system through the four-block model, based as it is on relative measures of tax raising capacity, means that it is difficult to implement such schemes for residential growth through council tax. Incentivising authorities through business rates, as well as dealing with the constraints placed on them by the interaction with the national cap on the multiplier, will mean changes to the way in which Formula Grant is calculated as allowing authorities to keep growth will either mean that further resources are needed from national taxation, or a more constrained level of grant in the overall pot. This means, therefore, that changes to the grant system would need to be considered to accommodate incentives on business rates.

9.56 A choice needs to be made about whether to continue to develop special schemes, or to consider wider changes to the grant system to enable incentives to be built in. I very much support the second of these. There needs to be a much stronger and longer-term link between local authorities' tax bases and the revenues they receive if they are to face strong incentives and rewards to grow the housing stock or the local economy. Both of these goals are key to enable local authorities to take on place-shaping roles on behalf of their local communities.

9.57 Reviewing grant distribution was not part of my remit and therefore I have not devoted time to reviewing in detail this aspect of the local government finance system. It was only through attempting to improve the incentives facing local authorities that I have concluded that the current design of the grant distribution mechanism is acting as a barrier to doing so.

9.58 During this consideration of incentives attention must be paid to making sure that local authorities – and their communities – would be able to understand the incentive being offered to them. Time must be taken to consider the clarity of messages on issues to do with:

- what actions will secure positive reward;
- the size of the reward and over what timescale; and
- the consequences of not acting.

Recommendation 9.3

The Government should consider ways in which the incentives in the grant system could be improved. In particular it should focus on:

- how far the grant system should be re-balanced to accommodate a greater focus on incentives;
- what changes will need to be made to the current grant system to support residential property tax base incentives;
- how to deliver business rate incentives, and whether these should be funded through additional resources or through redistribution within the current grant total; and
- clarity of messages to local authorities to ensure that they understand, and therefore can act on, any incentives.

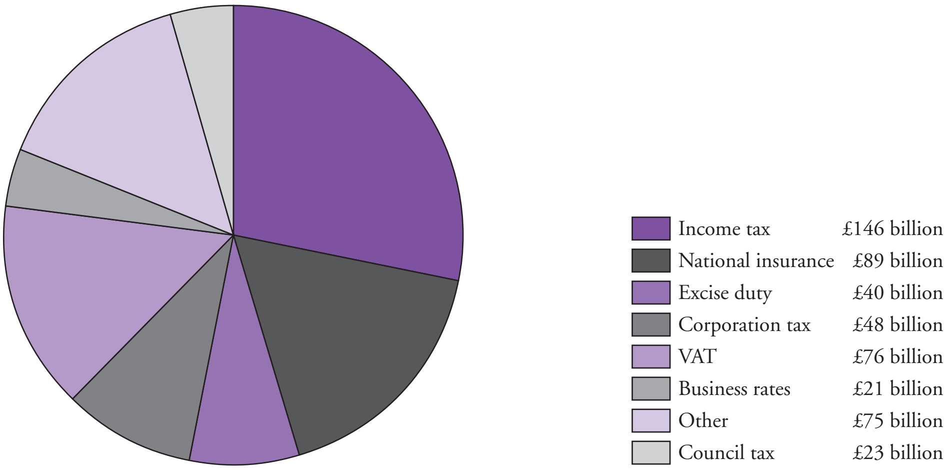
SHARED REVENUES TO SUPPORT LOCAL SERVICES

How local services are funded

9.59 As set out in Chapter 3, local authorities derive part of their funding from council tax, but the majority from sources of revenue that are not in local control. Chart 9.2 shows what contribution different taxes make to the totality – local and national – of public finance. Council tax is used directly for local services. All business rate revenues plus funding derived from other general revenues such as income tax, VAT and corporation tax go towards Formula Grant which is the other major element of funding for local services. The total amount of grant to local government is decided by central government as part of its regular Spending Reviews. That total is then shared between authorities according to a set of formulae owned by the department for Communities and Local Government but contributed to by other policy departments. A sizeable proportion, 23 per cent of revenue is given to local government in the form of ring-fenced and other specific grants which may have conditions attached.[5]

[5] See Chapters 3 and 4 for a fuller discussion of this issue together with recommendations for lessening the impact of such grants so giving local authorities more flexibility to manage pressures and deliver services in line with local priorities and needs.

Chart 9.2: Contribution of different tax revenues to public finances, 2006-07



Source: Pre-Budget Report 2006, HM Treasury.

9.60 Formula Grant is commonly referred to as the 'central' part of local authorities, funding. However, in reality, this funding is not central government money but citizens' and businesses' money, collected by central government and distributed by them to local government, who are then responsible for spending it alongside council tax. This is an important distinction, and often missed by both local government, who may lobby ministers for more grant without adequate reference to the impact on taxpayers, and by ministers and their departments who, at the extreme, may view grant as a gift to local authorities which entitles them to a high degree of control. As set out in Chapter 3, these perceptions of funding can result in an adversarial relationship between central and local government, where different layers of government often complain about and blame each other for actual or perceived injustices and failings in the funding system. In that context, it is difficult for the public to understand how local government is funded or, to see who is responsible for decisions about tax and spending.

Shared revenues to support local services

9.61 Chapter 3 argued that there is a need for greater clarity about local and central responsibilities so that local communities can better understand who to hold to account for tax and spending decisions. Greater clarity is also needed about who is paying for public services. There are some services which are clearly driven by a national promise and there is a case, in principle at least, for arguing that these should be funded from national taxation to make clear that central government is, in some sense, responsible for these services. In some instances, these are appropriately supported through specific grant, though these are too great a feature of the current financing of local authorities. Conversely there are issues that are rightly local, in principle, and so in theory would best be delivered from local resources. In practice, the effect of such a simple split between responsibilities would be very difficult to achieve and could lead to greater inflexibility in local government finance.

9.62 As recognised in Chapter 4, there are also many service areas where it is not possible to distinguish clearly between national and local responsibilities. Such services can be considered a shared responsibility and, given this, there is benefit, in terms of accountability, in such services being funded more explicitly from a shared source of revenue.

9.63 I am particularly interested in such an option if it improves the poor public understanding of the costs of services (which as Chapter 3 sets out is low at the current time), of how they are funded and of the degree to which national taxation supports local services. A system which was more transparent, and enabled citizens and local businesses to better understand how their taxes pay for services, should make it easier to manage expectations and pressures and to have a more honest discussion about them, both locally and nationally.

9.64 Such clarity would illuminate some potentially difficult issues. For instance, as set out in Chapter 3, many people believe that council tax pays for the majority of local services but also feel that it does not represent value for money. There is, therefore, a risk that greater clarity about the actual cost of services will come as a shock to some, unless balanced by an equal understanding of the full range and value of public services delivered through local government. However, without this knowledge, local government's ability to engage with their communities to discuss priorities and trade-offs is limited as there will be unrealistic expectations about what can be afforded.

Assigning taxes

9.65 These concerns, about accountability, clarity, and central-local relations, have led me to consider an assigned form of taxation which would set out more explicitly the current reality that many local services are paid for by a shared source of revenue. If designed correctly this could clarify how local services are funded.[6] This is an issue that I have been considering for some time, and on which the New Local Government Network has done some interesting and useful work.[7] It was not an option that was considered in depth by the Balance of Funding Review and therefore may appear to some readers as a new option. However, as set out in Chapter 1, assigned revenues were an important part of local government funding at the end of the nineteenth and beginning of the twentieth centuries. It is also a form of local government funding that is used elsewehere in the world. For example: in Germany, income, corporation and sales taxes are used jointly by federal, state and municipal governments; and in Austria, a number of federal taxes are allocated for use by local government according to population.[8]

Types of assignment

9.66 Taxes can be assigned either at the national level, so that a proportion of an overall national tax is allocated to support local services, or at the local authority level, where a proportion of a national tax collected in each local authority area is assigned to the relevant local authority. For either of these options decisions will need to be made as to whether the proportion of the tax that is assigned is fixed over time or variable over time. The next sections of this chapter discuss national assignment and local assignment in more detail.

Stewardship of the tax system

9.67 Before starting on the detail of assignment, I consider it important to stress that central government would remain responsible for the overall stewardship of the taxation system. Assignment would not change this, but would impact on the relationship between local and central government.

[6] International evidence suggests that if designed incorrectly assignment with complex tax systems and various levels sharing tax bases could confuse accountability. Loughlin, J., and Martin S., *Options for Reforming Local Government Funding to Increase Local Streams of Funding: International Comparisons,* Lyons Inquiry, 2005.
[7] New Local Government Network, *Pacing Lyons: a route map to localism,* 2006.
[8] King, D., *Report on Statistical Work for the OECD Network on Fiscal Relations Across Levels of Government,* OECD, 2005.

What is assignment?

An assigned revenue is a national tax stream which is dedicated, in its entirety or in part, to a particular purpose – in essence a form of tax hypothecation. Business rates are an example of an assigned national tax, in that the rates and bases are set nationally, but are used in their entirety to support local spending through Formula Grant.[9]

Assignment does not change the amount of tax that anyone pays. At its simplest, it is more about how nationally controlled taxation is used. At the current time most national taxation – income tax, VAT, excise duties, stamp duty, corporation tax and many other major tax revenues – is paid to central government and is treated as a single pot of money, which is then used to pay for public services. This approach maximises national government's ability to direct taxation to its current priorities and respond to pressures in how it manages and allocates public expenditure. In doing so it retains more flexibility to prioritise spend rather than simply raise taxes or borrowing.

With an assigned tax there is greater clarity about the use of particular revenues, including which taxes are assigned to support particular activities. In some ways this is similar to National Insurance Contributions which support the National Health Service and other forms of social insurance.

The analysis of assignment

9.68 The following sections examine a range of options for assignment of taxes to local government. Given that assignment would represent a radical departure from the current system of local government finance, the analysis I present is in the main illustrative. It includes some interesting findings which will be of use to any future work on assignment. However, the main aim of this discussion is to stimulate thinking and debate about whether assignment could be a viable and positive part of the funding system for local government in the future, as a supplement or partial replacement for council tax.

9.69 All the analysis that follows is based on assigning two amounts of revenue: £3.4 billion and £13.1 billion. In the analysis of a national fixed assignment these are equivalent to assigning 3 per cent and 12 per cent of 1996 income tax respectively.[10] In the analysis of a local fixed assignment this equates to some 7 per cent and 28 per cent of starting rate income tax.[11]

9.70 I will discuss the reasons for basing my analysis of national assignment on income tax revenue and local assignment on starting rate tax later in this chapter. However, to aid understanding it is important at this juncture to explain the rationale for choosing £3.4 billion and £13.1 billion. The first represents the 2006-07 amount of Revenue Support Grant, that is the element of Formula Grant that is paid from general national taxation rather than business rates. The second is what Revenue Support Grant might have been if schools' funding had not been ring-fenced only in Revenue Support Grant, but had instead also taken part of business rates. This has an in-principle appeal to me, as I consider it a better reflection of what businesses would expect their rates to be used for, rather than being used as the major source of revenue for equalisation.

Buoyancy

9.71 In addition to the potential transparency benefits of assignment, I have become interested in it because, depending on how it is designed, it could enable local government to access a

[9] In recent years business rates have been increasingly used to equalise resources for high need and low tax base authorities, which has produced concerns – as outlined in Chapter 3 – about the relationship between businesses and local authorities.

[10] The way the model works is to assign £3.4 billion and £13.1 billion as their equivalent proportions of income tax in 1996-97 and then apply the real changes in income tax yield in the 10 subsequent years to illustrate the impact of assignment.

[11] The local fixed assignment modelling is based on forecasts rather than historic time series. The reasons for this are explained in Annex E.

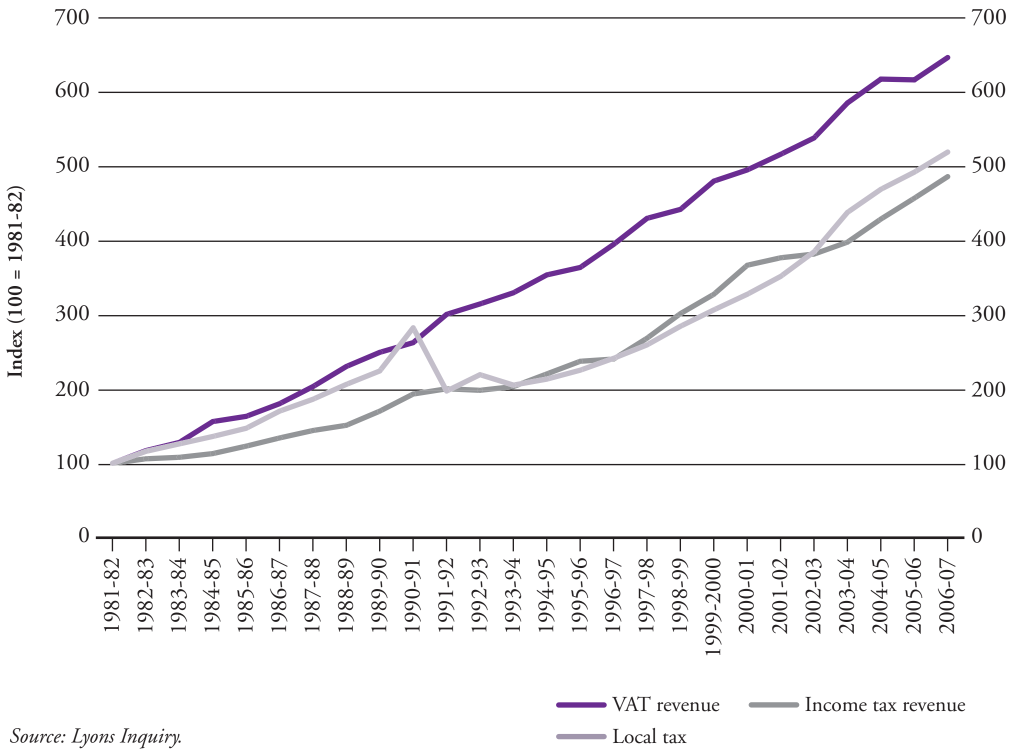
buoyant source of revenue. In tax terms, buoyancy refers to increases and decreases in yield from a tax caused by 'automatic' changes in the tax base, either in terms of the numbers of tax units, or in the value of the tax base. Many national taxes are designed to have buoyant revenues, and some tend to grow every year – for instance income tax and VAT – because incomes and consumer sales tend to grow each year and tax is paid as a proportion of these figures. Conversely, there are downside risks associated with buoyant taxes, as there can be slower or negative growth in specific tax revenues either through specific shocks to tax bases (for example, from fraud) or through broader impacts on the economy (for example in the event of a downturn). Buoyancy also comes from the design of national taxes as central government reforms them to keep pace with economic and political developments, including making changes to limits and rates, and wider policy changes to move the overall burden of taxation to change behaviours rather than raise revenue. These could have year to year implications for the value of any assigned revenues and could result in decreases in the value of income taxes. This presents a further risk for local government of having grant linked to specific tax receipts.

9.72 Council tax is not a naturally buoyant tax and, apart from when there is major residential development, council tax rates must be put up every year if revenues are to grow even in line with inflation. If local government 'owned' a buoyant source of revenue, then in years when its revenue from that source was increasing at a faster rate than the pressure on local tax, it could be used to offset pressure on council tax or relieve funding pressures on services.

Comparing increases in buoyant taxes to local taxation

9.73 There have been increases in yield from local tax almost every year since 1981. As discussed above this has been achieved through annual increases in the rate of local tax. Such increases are very apparent to tax payers. Income tax and VAT have risen at least in line with, and at times faster than, local tax. By contrast, however, these increases have been, for the most part, achieved through buoyancy, so that in general tax payers do not feel that they are paying more.

Chart 9.3: Growth in income tax and VAT compared local taxation, 1981-82 to 2006-07



Source: Lyons Inquiry.

National assignment

National assignment

Under national assignment a proportion of a national tax - such as income tax or VAT - would be allocated to replace some or all of the grant allocated to local government.

This assigned proportion of tax could be fixed over time, for example, each year three per cent of the yield from income tax could be assigned to local services. As the yield from income tax varies over time, this would mean that a different amount of money would be available to local services each year.

In tax jargon this variation is called the 'buoyancy' of the tax as on average it rises each year. So, for instance a fixed national assignment of income tax would allow any benefits from the buoyancy of the tax to support local services.

The level of the assigned proportion of a tax could also vary year on year, to reflect choices about the amount of national taxation that should be used to support local services. For example, in one year it might equate to three per cent of income tax revenues, but in the next year, if there was an increase in the amount of national taxation that central government decided should be used to support local services, it might equate to 3.5 per cent of income tax.

Potential effects of a national assignment

9.74 Table 9.3, sets out the main effects of national assignment, depending on whether the assigned proportion of the tax is fixed or variable over time. This would be one of the key decisions in moving to an assigned form of taxation. It determines whether the changes are aimed at being clear about the actual contribution of national taxation to support local services (which would be the focus of an assignment that is variable over time) or whether they have the additional aim of capturing the buoyancy of a tax stream for local government.

Table 9.3: Potential effects of national assignment depending on whether proportion of assigned tax is fixed or variable over time

	Fixed over time	Variable over time
National assignment	Greater transparency Local government access to a buoyant tax stream Constraints on central government's control over, and use of, national taxation Local government revenues partially reliant on fluctuating tax base	Greater transparency

9.75 A fixed assignment that is designed to allow local government to retain automatic increases in revenue from any positive buoyancy of the tax, would potentially enable authorities to use this to offset pressure on council tax or relieve funding pressures on services. There may be benefits to central government in such an approach. For instance, it could reduce the need for central government to deal with the impact of council tax, either through one-off support to specific groups such as pensioners, or through annual, painful exercises to find money from existing central government budgets to try to keep council tax down through extra grant to local government.

9.76 All forms of assignment would have transparency benefits, because they provide greater clarity over how services are paid for. This would be of benefit to both central and local government, as well as enabling communities and citizens to better understand how their local services are financed.

9.77 Fixed assignment would have disadvantages for central government in that it allocates any gains from growth (or losses from reduction) in the assigned tax base to local government, so constraining central government's room for manoeuvre. Any additional revenue through buoyancy provided to local government from assigning a fixed amount over time would be 'lost' to central government and could not be spent on other national services. This would need to be balanced against how far central government chose to devolve additional functions to local government.

9.78 Access to buoyant taxes would expose local government revenues to fluctuations both in terms of predictability and in actual tax yield, which would be a particular concern at times of economic downturn, both for local and central government. Essentially a small element of the risk which is currently being borne by central government over the economic cycle could, in the case of fixed assignment, be transferred partly to local government. This is an issue that is returned to in considering implementation issues below.

An assigned tax that is variable over time

9.79 Introducing a form of assignment that is variable over time may be considered a limited option, as it does not improve the buoyancy or incentives in the local government finance system; it would still be for central government to determine the level of resources allocated to local government. However, it would provide a greater degree of transparency over how local services are actually funded – with a more direct recognition that it is tax payers' money that is being used rather than an abstract notion of central resources – and it better clarifies the actual costs of services which, as set out above, could help to enable a more realistic and effective level of engagement with local communities.

9.80 In essence, a variable assignment option could be introduced through an annual statement that set, out the amount of national taxation that supported local services. This could be done at either a national aggregate level or at a local authority level. There would obviously need to be consideration as to how this was best communicated, with an option being to ensure that council tax bills make clear the extent to which national, as well as local taxes, are used to support local services. This could be presented as the proportion of the relevant national tax that is raised in each local authority, which has benefits in that it reinforces the link to the local area. An alternative would be to present the amount as a proportion of overall national taxation, which is a simpler calculation but omits any reference to the local tax base.

Designing a fixed national assignment

9.81 Key questions in considering a national assignment option that is fixed over time are how many taxes to assign, and which are the most appropriate for assignment.[12] Assigned taxes, ideally, need to be buoyant, large and have a broad tax base. This last criterion is important as to ensure that the tax is paid by a sizeable proportion of the population so that there is a good understanding of the tax and a strong sense that most people are contributing.

9.82 I commissioned analysis based on assigning revenue from income tax. I decided to concentrate on a single tax for the sake of clarity and simplicity. Both income tax and VAT fit the criteria for assignment as they are generally buoyant, widely paid and sizeable forms of taxation. However, there are currently some practical concerns about VAT being more unpredictable than income tax due to recent evasion and non-compliance. More importantly, research and representations to the Inquiry gave a strong sense that people consider income tax to be a fair tax from which to pay for local services. Assigning income tax could be expected to have a greater resonance with the public than VAT.

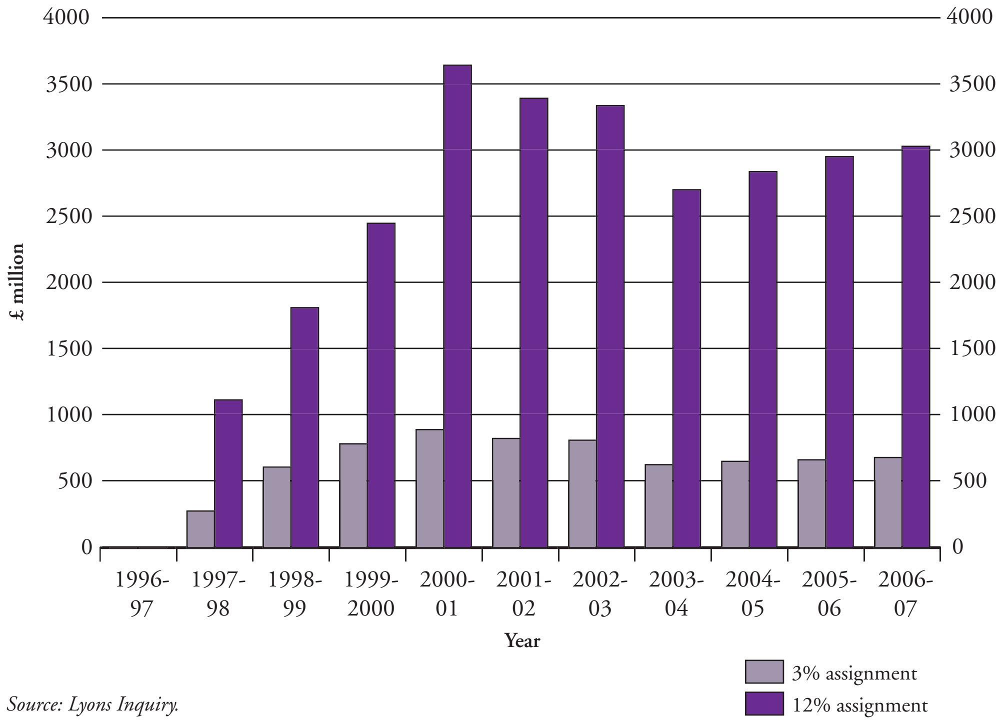
Potential impact on local revenues

9.83 If there had been a direct assignment of income tax to local services in 1996-97 the buoyancy in income tax over the ten years since then would have provided benefits to local government in the form of additional revenue compared with Formula Grant in that period. This is shown in Chart 9.4 which shows the additional revenue from assigning different proportions of income tax. This further shows that the greater the proportion of revenue assigned, the greater the 'return' for local government in terms of buoyancy supplying additional revenue.

9.84 It is important to stress that this is not 'free money' but would represent a transfer of control over the buoyancy from the assigned tax from central government to local government. If central government wanted to recoup the buoyancy to maintain the same overall level of revenue and funding to all other it would need to increase the national rates of income tax or other national taxes.

[12] The technical issues associated with designing and modelling a fixed national assignment are covered in depth in Annex E.

Chart 9.4: Extra revenues from assigning 3% and 12% of income tax in 1996-97



Source: Lyons Inquiry.

Implementation of a national fixed assignment

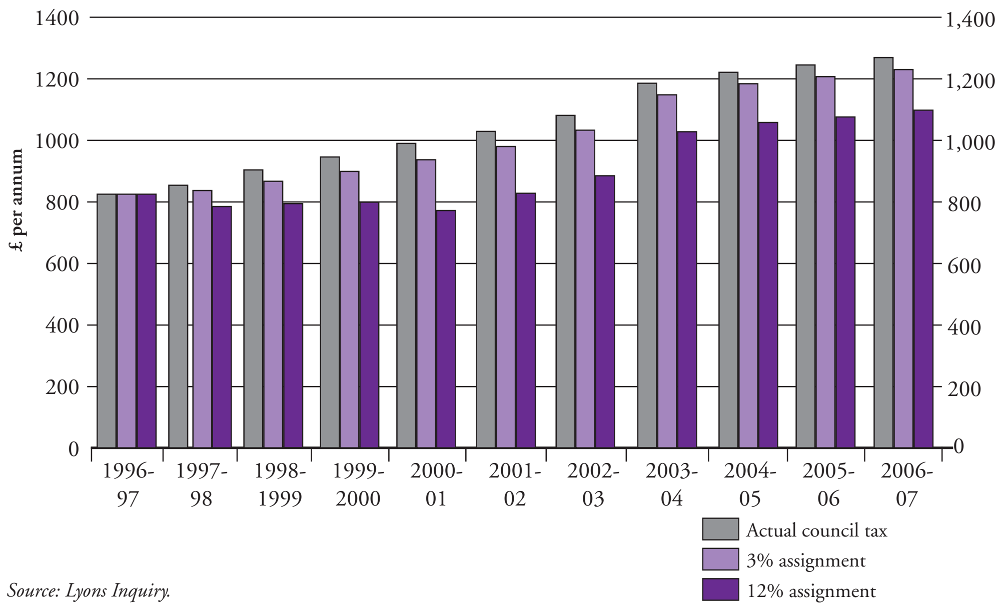
9.85 A national fixed assignment would be a major departure from the current system by which local authorities receive funds from national taxation. It would require some major practical and behavioural changes on the part of both local authorities and central government, and could also have implications for local taxpayers. These are discussed below.

Use of additional revenue

9.86 Local authorities would need to consider how to use any additional resources from buoyancy to best meet the needs and aspirations of their local communities. The different purposes to which these resources could be put will be extremely varied. However, as an illustration I have commissioned analysis to understand what the impact of an assignment could be if local authorities chose to use any additional resource, in full, to offset pressure on council tax.

9.87 If there had been a fixed assignment of income tax in 1996-97 there could have been lower council tax bills in each of the ten years since then. As Chart 9.5 shows, the larger the assigned proportion of income tax the greater the effect. For example, in 2001-02 actual average band D council tax bills were £989 per year. Assigning three per cent of income tax could have lowered this by £53 per year while and assigning 12 per cent of income tax could have lowered bills by £218. As set out previously this is not 'free' money; any lower rises in council tax result from the transfer of resources – in the form of buoyancy – from central to local government. This would mean lower central government investment in other services.

Chart 9.5: Actual average band D council tax bills compared to estimated bills under different levels of income tax assignment



Source: Lyons Inquiry.

Accessing a fluctuating source of taxation

9.88 If it was decided to implement a national assignment based on income tax, consideration would need to be given to how local authorities could best manage the fluctuations that are inherent in such a tax base.

9.89 One option would be for local authorities to vary the rates of council tax to offset the fluctuation in the assigned income tax. However, the analysis I commissioned showed that this could result in major fluctuations in council tax.[13]

9.90 I am clear that such fluctuations would need to be managed given people's existing concerns about council tax increases. Whatever method was eventually chosen its aim would be to 'smooth' large changes between years. In the short term this may be a task for national government, but this task could be transferred to local authorities in the medium term as their experience of working with an assigned tax develops.

Changes in central-local relations

9.91 A national fixed assignment would mean central government losing some control over the buoyancy from a source of national taxation. This is only likely to be achieved as part of an ambitious 'new deal' which sought to change the relationship between central and local government. If central government was willing to pursue a national fixed assignment, it might argue with some force that local government should, for its part, be more self reliant and less concerned about the

[13] The modelling work conducted for the Inquiry shows that if council tax was used to offset the variability in the revenue from an assigned income tax there would be a lot of variation in yield from one year to the next reflecting the pattern of growth in income tax. In years of good growth in income tax yields, the model shows small percentage increases in council tax: for example, in 1999-2000 and 2000-01. In years of more limited growth in income tax yield, the model shows very sharp increases in council tax – higher than any actual increase: for example in 2002-03 to 2003-04. This is caused by council tax compensating for the low income tax revenue increases, but is also partly driven by previous small and negative percentage increases in council tax, meaning that the level of revenue available to local authorities is lower than would have been the case if council tax had been rising more quickly. It is also the case that the larger the proportion of funding assigned, the more significant the volatility and fluctuation in terms of its overall impact on local authority finances. Further details are given in Annex E.

detail of the grant settlement. A more constructive relationship between local and central government would also be required to reflect the shared interest they would have in a common tax.

Funding new mandates

9.92 There is a further question of whether the percentage of assigned tax should alter if the functions that local government are responsible for change, to reflect the fact that the shared revenue is supporting more or fewer services. I believe there would still need to be consideration of the need for central funding of new mandates, and whether and to what extent central government could expect any of the buoyancy from assignment to contribute to them. It would be important that this was the subject of agreement between central and local government.

9.93 Questions such as how best to get the balance right over these issues could be decided as an aspect of the new constitutional settlement between local and central government, discussed further in Chapter 10.

Distribution of additional revenue

9.94 There are also questions about how any additional revenue from buoyant taxes should be distributed to local government. I can see that there are strong in-principle arguments for this revenue continuing to be allocated according to a nationally determined process of grant distribution. I would strongly contend, however, that wherever possible this should be in the form of unhypothecated grant that is, therefore, under local rather than national control.

Local assignment

Local assignment

Under local assignment a proportion of a national tax – such as income tax or VAT – collected in each local authority area is assigned to each local authority, replacing some or all of the differing levels of grant they receive from central government. These differing levels of grant reflect the fact that each local authority receives different amounts of revenue from national taxation depending on the needs of their communities and how far they can raise their own resources from council tax.

Again there would be a choice over whether this assignment should be a proportion that is fixed over time, that is the same proportion of the tax is available to the local authority year-on-year ,so enabling any buoyancy in the tax to be captured locally.

Fixing the proportion of tax that is assigned at the local level could also produce incentive effects for local authorities to grow their local tax base, since they would keep a proportion of any growth in yield, and would also face the consequences of a shrinking tax base. For instance, if a fixed amount of income tax was assigned to each local authority, then the local authority could also keep this proportion of any increase in the tax base collected in its area. For example, if an authority had been assigned five per cent of the income tax collected in its area, it could keep five per cent of any growth caused by new jobs or increased incomes.

Alternatively, the amount that each local authority received in assigned tax could be varied year-on-year. This would, as is set out in the box above on national assignment, express the actual

Potential effects of a local assignment

9.95 As shown in Table 9.4, fixed and variable local assignments have much the same effects as national assignment. The important difference is that a local assignment that is fixed over time also offers an incentive effect, as local authorities would be able to keep part or all of any revenue that is produced from growing or protecting the relevant tax base. The nature of this incentive effect would depend on which tax base was assigned. For example: assigning income tax would give an incentive around job creation or protection whereas if it was possible to locally assign VAT based on the site of sales it would give local authorities an incentive to increase sales of goods or services.

Table 9.4: Potential effects of local assignment depending on whether proportion of assigned tax fixed or variable over time

	Fixed over time	Variable over time
Local assignment	Greater transparency Local government access to a buoyant tax stream Incentives on local communities and local government to grow local tax bases Constraints on central government's control over, and use of, national taxation Local government revenues, partially reliant on fluctuating tax base	Greater transparency

Designing a local fixed assignment

The best tax for local assignment

9.96 As with national assignment, I believe a local assignment should ideally be based on a single tax. It would produce the greatest clarity for local communities, and also would help to give clear messages to local communities about what the incentive effects of assignment would be. This differs somewhat from NLGN's work, which has as its starting point the local assignment of a wide range of taxes. Such an approach is attractive from the perspective of the local community having the first 'slice' from a wide range of nationally controlled taxes, but was outweighed by my concerns about the need for clarity to the tax payer.

9.97 In determining the best tax for local assignment all the national assignment criteria apply: the tax must be sizeable, buoyant and paid by a large proportion of the population. In addition, consideration needs to be given to how evenly yield is spread across different areas of the country, to prevent major differences in the impact of assignment on local finance. Finally, the tax base needs to be one that is based on something which enhances well-being if local authority attempts to increase it are successful so it creates the right incentive effects. This also assumes the tax base is something upon which local authorities can have a positive effect.

9.98 I have again chosen income tax as the best tax base on which to examine local fixed assignment in more detail. This is because it has clear and more positive incentive effects, in that and assigning part of this tax base could encourage local authorities to create or protect local jobs and incomes. VAT was the only other form of taxation that was seriously considered, but this raised a number of concerns in relation to the rate of VAT not being uniform across all goods and services, which could lead to local authorities competing to attract businesses from sectors with high VAT revenues to the detriment of businesses from other sectors. There were also challenges with local assignment of VAT regarding whether it would be conducted on an area of residence or an area of purchase basis.

Assigning the starting rate of income tax

9.99 The starting rate band of income tax best meets the criteria for an evenly spread tax base on which local assignment could operate, as all people that have taxable incomes above the personal allowance will pay this rate.[14] Analysis for the Inquiry also suggests that starting rate tax has been quite buoyant.[15]

[14] New Local Government Network, *Pacing Lyons: a note map to localism,* 2006

[15] This compares to the concerns about the buoyancy of the more modest basic rate tax raised in the discussion of local income tax in Chapter 7.

Assigning to area of residence or area of employment

9.100 In locally assigning a local income tax, there is an important question as to whether it is done on the basis of the taxpayers' area of residence, or their place of employment. Some taxpayers will live in one local area and work in another. I recognise that such a decision is open to debate and that assigning income tax based on the area of residence could have the effect of encouraging some authorities, particularly those that are close to major conurbations, to attract tax payers to live in their areas rather than create or protect jobs.

9.101 However, as set out in the discussion of local income tax in Chapter 7, I consider that basing a tax on the area of residence helps to retain local accountability to residents and link tax to the interests of residents in local services. The decision to assign starting rate of income tax, rather than basic or higher rate tax, would limit any incentive for local authorities to attract taxpayers but not jobs. This is because an incentive based on starting rate tax will apply equally to both low and high earning taxpayers, and low income groups are less likely to commute long distances for work, and so are more likely to work in their area of residence.[16]

Type of authority

9.102 Following the same logic as in my consideration of a local income tax, I have limited local assignment to upper tier and unitary authorities, as these are responsible for the majority of spending on local services.

Dealing with divergence between areas over time

9.103 A key decision in implementing local assignment which is fixed over time is how to deal with the divergence in local authorities' tax bases which may occur over time. In principle there should be no equalisation for assigned revenues to allow the incentive effect of a local fixed assignment to act on the behaviours of local authorities. For this reason the analysis presented here has not included any equalisation.[17] I believe, however, that in practice government will need to strike a balance between the equalisation that is needed to support areas with high socio-economic needs and low tax bases against its negative impact on the incentive effects.

Outcome of a local fixed assignment

9.104 In summary, my analysis of the impact of a locally-assigned income tax shows that even assigning a relatively high proportion of starting rate income tax, and applying an optimistic forecast of growth at the local level, only has a small impact. Not all local authorities gain and all changes, both positive and negative, are very small.

9.105 Assigning 28 per cent of starting rate income tax as discussed above, using an optimistic forecast model, alleviates pressure by 2007-08 on council tax for 38 per cent of authorities by an average of 0.5 per cent. The impact on bills of such an assignment would be minimal, equating to a saving of some £5.00 on an average band D bill. Assigning the more modest amount of seven per cent of starting rate income tax produced, on the optimistic forecast model again, additional revenue also for 38 per cent of local authorities. If this was all used to offset pressure on council tax it would provide an average saving of 0.13 per cent per year.

[16] Harding, M., and Robson, B., *A Framework for City-Regions*, ODPM, 2006.

[17] The model does attempt to limit divergence by, at the time of inception, preventing any local authority from receiving more money through assignment of starting rate income tax than it would receive from the current levels of grant. The Inquiry's analysis is based on applying the same proportion of starting rate income tax across all local authorities, and this is determined by fixing the proportion assigned at the highest percentage which could be assigned before any authority received more than they would have otherwise received in grant. This requirement does place major constraints on the design of a local assignment.

Implementation issues

9.106 Implementing a fixed local assignment could present challenges to our current system of income tax. Some of these are similar to those for local income tax, such as the requirement for HM Revenue and Customs (HMRC) to be able to assign the tax revenue to the appropriate authority (and how to deal with in-year changes in tax band or people moving areas). This and other implementation issues are similar to those involved in a full local income tax and are discussed in detail in Chapter 7. The overall conclusion is that changes to support a local income tax, and therefore a local assignment, would be feasible but with significant costs and would require careful and lengthy preparation.

Conclusions

9.107 My analysis of local assignment, based on the relatively restrictive parameters that I have set, shows that it has a limited buoyancy effect.

9.108 However, this does not mean I consider that a locally fixed assignment based on starting rate income tax is an unattractive option. Even with the restrictive parameters that I have set, the incentive effects still remain. While these are not exceptionally large each job a local authority created would produce a receipt of a percentage of the starting rate which in 2006-07 was £2,150 per year. Therefore, a seven per cent starting rate assignment would equate to approximately £150 per job, and a 28 per cent assignment would mean about £600 per job accruing to the local authority. There is a question about whether this would be large enough to change a local community's attitudes to growth and local government behaviour, though it is equally worth noting that if incentives are too large that can raise problems as well, as they can distort decisions excessively. It may be that these incentives are unlikely to change behaviour in relation to individual jobs, but they could influence decisions that relate to large employers and could go some way to compensating the community for economic expansion.

9.109 In addition, a move to funding local services, even to a limited degree, through an alternative form of fluctuating taxation could be a first step to helping local authorities to become accustomed to having more than one tax base at their disposal and developing their skills in managing a fluctuating form of tax. Both of these could provide useful experience relevant to the consideration of possible local income tax options if considered at a later date.

Assignment recommendations

Variable assignment

9.110 As an immediate step, a form of variable assignment could be introduced to improve understanding of how local public services are financed. As set out above, this should be in the form of an annual statement to local residents setting out the amount of national taxation that is used to support local services, in addition to what they pay in local taxation. This could be done at the national aggregate level or at a local authority level. The former would be the easier option but not would not have the benefit of a specific relevance to each local authority. Such a statement could also include information on what is spent in total on different services in the area so that citizens can gain a better sense of the cost of services.

9.111 There are many ways in which this could be communicated and I look to local and central government to come up with creative ways of achieving this aim. The obvious route is to use the council tax bill or the accompanying leaflet to convey this information. However, the information that can go on these documents is currently prescribed by regulations which would need to be relaxed so that local authorities could use council tax bills and accompanying leaflets to convey this information if they chose.

Recommendation 9.4

The Government should relax the regulations that govern the information that can be included on council tax bills and the accompanying leaflet. This is to enable local authorities to use this communication route, if they chose, to make clear:

- the level of national taxation that they each receive to support local services set out in absolute amounts; and
- how that is used to support the overall expenditure on services in that area.

A fixed national assignment

9.112 A fixed national assignment is an attractive option to me as it better reflects the current processes by which local services are resourced, through both national taxation and council tax. As set out in the discussion of the implementation of a national assignment, it could also precipitate a new relationship between central and local government, based on a change in mind-set in both. It would mean ensuring that local government was equipped to cope without significant central support in managing a buoyant, but fluctuating tax base, in return for the sector becoming more self-reliant. It would also require central government to give up some control over elements of national taxation in return for a more mature local government sector that looked less to central government to resolve local funding issues.

9.113 Recognising that such changes will take some time to be implemented my recommendations on a fixed national assignment are more for the medium term. Realistically they could not be implemented until after the current Comprehensive Spending Review period, at the earliest.

Recommendation 9.5

The Government should consider, in the medium term, assigning a fixed proportion of income tax to support local government services. This would need to be done in the context of a new constitutional settlement between central and local government providing for greater self-reliance on the part of local government.

Central and local government should agree as to how far buoyancy from assignment should be used to support new mandates and how much central support should be given to local government in times of downturn.

CONCLUSION

9.114 This chapter argues that the way central government supports local services should be re-oriented. Incentives to support growth should be an important element of the grant system, allowing communities to take balanced judgments and receive some financial compensation for growth in their areas.

9.115 Greater transparency over the use of national taxation in delivering local services can also be advanced: in the short term by greater clarity over how far national taxes pay for local services at the current time. Over time this could be developed with the possibility of an element of income tax being directly assigned to local government, which would help to provide greater flexibility to manage pressures (including potentially offsetting pressure on council tax) or to improve local services.

9.116 I recognise that some of these changes will present real challenges to local and central government. It is for these reasons that I have set out these, and my other recommendations, in a developmental framework in Chapter 10, the conclusion to this report.