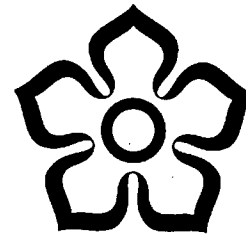


Please ask for: Ciaran Guilfoyle
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Our Ref: MN/CG
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Date: 10 January 2005

*Replied on
28/01/05
/LB.*



**Leicester
City Council**

2/05

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Sir Michael Lyons
Lyons Inquiry into Local Government Funding
Room 3/12
1 Horse Guards Road
London SW1A 2HQ

Dear Sir Michael

Lyons Inquiry into Local Government Funding

I am writing to submit Leicester City Council's views on local government funding in the hope that they will be considered by your Inquiry. What follows is necessarily summary in nature, but I would be more than happy to provide further detail if this were required.

What are the most pressing issues affecting the present system of local government funding?

The City Council believes these to be:

1. The dependence of local government on central government funding, and the problems of accountability this causes.
2. The volatility of funding sources.
3. Measures that damage the underlying principle of equalisation.

1. Dependence on Government Funding

The Council believes that local authorities should be able to generate more of their own revenue, and become less dependent on central government. This is key to local accountability. Such flexibility, however, must not be introduced at the expense of the principle of equalisation.

Local government's overall dependence on central government funding has created the problem of gearing, by which each 1% rise in spending results in a much higher percentage rise in council tax. Leicester's own gearing ratio (according to the 2005/06 provisional settlement) is 5.1:1, making it the highest among the unitaries, and resulting in increases in council tax of 5.1% for every 1% spent above FSS. This gearing magnifies the impact of changes in government grant at local level, creating turbulence which local taxpayers do not understand, and which thereby weakens local accountability.

Grant floors and ceilings were introduced by the Government in order to ease this situation, but as we point out below, these do not benefit high-g geared authorities to the same extent that they benefit low-g geared ones. What is really needed is an overall increase in the sources of local funding available to authorities. This

would widen the base on which unavoidable spending increases would fall, thus lessening the gearing effect and making tax rises more manageable.

2. Volatility of Funding Sources

The City Council shares the Government's desire for long-term financial stability, and we have particularly welcomed initiatives such as three-year Spending Reviews and the three year freeze on formula changes. Such information has allowed us to operate our own three-year budget planning. Nonetheless, predicting future grant levels remains very difficult.

However, such forecasts are difficult when the Government itself strays from its outlined plans. In the last two years significant one-off sums have been injected at very short notice to reduce pressures on council tax. Similarly, conditions attached to specific grants can vary from year to year, as can the quantum. Changes in the method of distribution of these grants are not covered by the formula freeze and this creates further volatility. This does not assist long-term planning, and its affect on council tax is compounded by gearing.

3. Equalisation Issues

Equalisation is the underlying principle of the local government finance system, and the key to its fairness. In essence the equalisation principle dictates that central government grant be distributed among local authorities such that the differences that exist between those authorities (in terms of local resources and the 'need to spend') are erased. The upshot of this is that if all local authorities spent at the level of their FSS then the band D council tax would be the same throughout the country. The City Council is therefore very concerned at the number of changes that have been made to the funding system in recent years that have detracted from the equalisation principle. Such changes have meant that resources have tended to be distributed disproportionately in favour of authorities that already have high taxbases and at the expense of authorities that have a high need to spend.

This is not to say that Leicester has not benefited from these changes. Nevertheless, we believe there may be better ways of achieving these which remain true to the principle of equalisation. In particular there are three funding mechanisms that are not in keeping with equalisation:

- Grant floors and ceilings
- Cash injections to keep down Council Tax
- Local Authority Business Growth Incentives (LABGI) scheme

Grant floors and ceilings were introduced in order to inject a large degree of stability into the local government finance system. Unfortunately, when floors and ceilings (and mid-range scaling back) are applied to the RSG, equalisation is lost: it is no longer the case that if all authorities spent at FSS then band D council taxes would be the same throughout the country. Ceilings and scaling-back affect high-g geared authorities (for whom grant is a much larger proportion of their total income) more than they affect low-g geared ones (who rely much more on council tax income). When Schools funding is removed from mainstream grant in 2006/07 these differences in gearing will become even more acute.

Given this issue, the City Council believes that stability in the local government finance system would be better achieved by damping the FSS, not the RSG. Much of this already takes place through 'data averaging', a commonsensical approach to changes in client numbers. However, when a disruption occurs (say

because of the results of the 2001 census, or because of a large transfer into or out of mainstream funding) stability would be better maintained by applying floors and ceilings to the FSS. We hope that the Lyons Inquiry will consider such a suggestion.

Cash injections to keep down Council Tax have been a feature in both the 2004/05 and the 2005/06 settlements. In 2004/05 £340m was added to the system as one-off funding, and again in 2005/06 some £300m was added. The aim of this funding was clear – to reduce the Government's Assumed National Council Tax (ANCT) to 'low single figures'.

When ANCT is reduced, everyone benefits from an increase in government grant. However, the biggest beneficiaries are the authorities with a large taxbase but a relatively small 'need to spend' (ie. low-g geared authorities). The problem here is that it is the lowest-g geared authorities that can usually spread spending increases over a wider taxbase and thus restrain increases in household council tax bills. Whilst the City Council can appreciate the reasons for central government wanting to show a low increase in ANCT, we believe that council tax increases would be better managed if the additional resources were allocated according to need (ie. FSS) rather than taxbase.

Local Authority Business Growth Incentives (LABGI) scheme is due to commence in 2005. The City Council expects to gain additional resources from this scheme as we currently expect business growth in various quarters of the city.

Nationally the scheme is expected to generate additional resources for local government of £1billion over three years. This appears generous. However, analysis we have undertaken shows that the authorities most likely to benefit from such a scheme are those who already have a very large non-domestic tax base, and who therefore require only a very small percentage increase in growth before they hit their LABGI ceiling. Deprived authorities will have to achieve much higher growth rates in order to obtain the same benefit, and there is no equalisation grant to cover this discrepancy.

The above three mechanisms all stray from the equalisation principle due to the fact that different authorities have different gearing ratios. We therefore believe that the Lyons Inquiry should consider this problem of *relative gearing*, which essentially means that an additional 1% in spend can result in a 2% council tax increase in a low-g geared authority but a 6% increase in a high-g geared authority. There are two complementary methods which could address this problem:

- Resource Equalisation
- Dynamic Equalisation

Resource Equalisation was implemented as a one-off, nil-cost measure in the 2003/04 finance settlement and aimed to realign government assumptions about local spending with actual spending levels. The effect of the realignment was to shift RSG away from authorities having a relatively high taxbase (ie. a rich source of local revenue) back towards authorities having a relatively high need. For Leicester - a high-need city of over 280,000 residents; having one of the highest population densities outside London; with 28 of its wards in the top 10% most deprived in the country; with the highest proportion of ethnic minority residents outside London; and with the highest gearing of all the unitary authorities - this was a welcome development. We would therefore urge the Government to ensure that such a misalignment between assumed and actual spending does not re-occur, and we hope that the Lyons Inquiry would share our view.

"Dynamic Equalisation" is a system whereby authorities with high taxbases would pool some of the additional resources which arise raise council tax which. This idea was mooted by ODPM early on in the Balance of Funding Review. The effect of dynamic equalisation would be to ensure that equivalent spending decisions would have the same effect on council tax throughout the country, and remove the accident of gearing which underlies tax increases. This would be an enhancement to the equalisation principle, designed to make the principle continue working on those occasions when an authority, for whatever reason, cannot spend at FSS. The City Council therefore hopes that the Lyons Inquiry will seriously consider and develop the idea.

How should council tax best be reformed?

The City Council, along with fellow member authorities of SIGOMA, believes that a revaluation of the taxbase is long overdue, and we welcomed the Government's announcement that this revaluation would get underway in 2005. Changes in house prices have changed so much since 1991 that the local government finance system can no longer be based on such prices and still call itself reasonable. In addition to revaluation we would also like to see an increase to the number of tax bands and to the relative weights of such bands. This would serve to make the council tax less regressive.

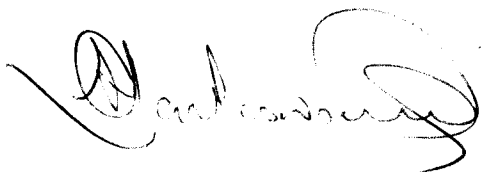
We appreciate that this will have a significant impact on taxpayers, and that this impact will be different in different parts of the country. We recognise that traditional arrangements will be required to deal with this, but do not think that the distributional impact should prevent the revaluation taking place according to normal principles (eg. by regionalising the tax). The distributional impact is in part caused by the delay in the revaluation, which has resulted in taxpayers outside the south-east of England paying more than they should have done.

What is the case for providing local authorities with increased flexibility to raise a larger proportion of their funding locally?

The City Council has lent formal support to the LGA's Balance of Funding 'Combination Option' which, as well as calling for council tax reform, puts the case for a relocalised business rate and a local income tax. These additional sources of income, if equalised through the grant mechanism, would ease the pressure on council tax which currently bears the brunt not only of spending decisions but of all the anomalies caused by other features of the system (to which we have already referred).

We also believe that, in the spirit of localism, central government should trust local authorities to be answerable to their own electorates in matters of finance. Trust is the basis of all democratic government. We hope that the Lyons Inquiry will advance such an important idea in its findings and persuade central government to develop it.

Yours sincerely



 Mark Noble
Chief Finance Officer