

# Local Government Finance and the 2019 Spending Review inquiry

Housing, Communities and Local Government Committee

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For further information, contact:

Martin Rogers

[m.rogers@thebritishacademy.ac.uk](mailto:m.rogers@thebritishacademy.ac.uk)

The British Academy is pleased to respond to this inquiry. The key points we want to raise are that:

- The ways in which local government is currently financed do not meet the demands placed upon it;
- Council tax and business rates are inadequate for funding local government, not least because the areas with the greatest needs tend to realise the lowest yields;
- Shorter term options for reform include re-banding council tax in order to make it more progressive but over the longer term a tax on land values would be a more effective and progressive alternative;
- Any efforts to devolve taxation need to be treated with caution due to the potential impact this has on the central state's ability to pool and redistribute funds.

## Introduction

1. The British Academy is the UK's national academy for the humanities and social sciences. A Fellowship of over 1,200 of the country's leading academics, the Academy received its Royal Charter in 1902.
2. The humanities and social sciences and those who study them enrich and deepen our understanding of the world around us. Since its creation, the British Academy has celebrated these subjects and demonstrated their contribution to the understanding of humanity, economies and societies.
3. The humanities and social sciences are inescapable if we are to tackle the complex and interconnected challenges facing societies today. Through the connections between our disciplines and those in science and technology, including the life-sciences, we will be better able to understand and shape the great themes of our age such as the future of work, peace, trust, justice and equity, global security, demographic and technological change, respect for diversity and difference amid clashes in ethical and political values.
4. The British Academy has a strong track record in bringing both the expertise of our fellowship and insights from our academic disciplines to bear on public policy issues. This response builds on recent work by the British Academy, most notably [Governing England: Devolution and funding](#). Governing England explored questions about England's governance, institutions and identity. During our work it became clear that many are concerned that devolution cannot achieve a transformation in governance as long as the system for funding public services and local government remains unreformed and highly centralised.

5. This response represents the views of the British Academy, not one specific individual, however Professor Iain McLean FBA FRSE, a Fellow of the British Academy and leading expert on local government finance, was extensively consulted in drawing together this response.
6. In relation to all questions posed, it is well worth considering the detailed evidence available from the Institute of Fiscal Studies, especially at <https://www.ifs.org.uk/research/local-finance>, and more specifically at <https://www.ifs.org.uk/uploads/publications/comms/R154.pdf>.

### Lessons from the history of local government funding in England

7. Changes to local government funding in England have rarely been driven by the needs of local government, but rather by the high politics of the day. This can be seen as early as the 1867 Reform Act which changed the law on compounding rent and rates as an incidental to a franchise extension. More recently, the creation of business rates, the poll tax and its substitution by council tax, were all driven by national, not local, concerns. It is telling that no expert in local government finance was involved in the discussions that led to the poll tax (see [Failure in British Government](#) (Adonis, Butler, & Travers, 1994)).
8. Governments have never faced up to a dilemma posed by the Layfield Report in 1976: to balance needs and resources government must either increase the tax base of local authorities or diminish their statutory responsibilities. To fail to do simply makes local authorities the reluctant agents of central government.
9. Changes to local government funding have been piecemeal and uneven. As a result, councils' spending needs and their tax bases are mismatched.
10. Not only are the tax bases inadequate in aggregate, but they do not match spending needs in any systematic way. For example, well-off elderly people and their families can afford to fund social care privately, so adult social care needs are often highest in the local authority areas with the weakest tax bases. Given that the grant from central government is set to be removed and councils will have to rely solely on what they can raise themselves, this is likely to be increasingly [problematic](#) (Phillips, 2018, p. 45).
11. It is the mismatch between the needs of an area and its ability to raise sufficient funds that has led many councils to [fear for their future](#) (Glover, State of Local Government Finance Survey 2019, 2019). It will likely get [worse](#) without significant change to address this imbalance (Glover, Countdown – one year til the financial cliff edge, 2019).

## The effectiveness of the current funding system, possible changes and lessons from elsewhere.

### The fitness for purpose and sustainability of the current system for funding local government

12. Whilst the current system for financing local government is [widely criticised](#), one positive factor in its favour is that property is the best base for subnational taxation because it does not move and causes relatively few distortions (Rogers & Evans, *How England is funded*, 2018, p. 24). This has been widely accepted by public finance experts since Adam Smith.<sup>1</sup>
  
13. In many other respects the current regime is not fit for purpose and not sustainable:
  - It is not sufficiently progressive to ensure that all taxpayers bear a fair share of the burden;
  - Those places with the weakest tax base have the highest revenue needs;
  - It is subject to significant central direction. Notably, for council tax, authorities have no discretion over the ratios between the bands, nor over the mandatory reliefs and may face sanctions for ‘excessive’ increases;
  - The abandonment of the 2015-17 government’s pledge to re-localise 100% of business rates has left policy on localisation unclear and inconsistent; and
  - Business rates seem to be ill-suited to the internet age without reform.

### Business Rates

14. This last point is worth exploring in greater depth. Business rates may have been suitable when department stores dominated high streets, but the internet now means that businesses worth many billions of pounds can take only the space of a computer. Business rates have failed to move with these times. Now, councils’ [greater reliance](#) on business rates (Rogers & Evans, *How England is funded*, 2018, p. 28) will [incentivise](#) certain types of development, typically large out of town shopping or distribution centres (Paun, 2017, p. 15). This oddity is compounded by the fact that [increases in economic activity are not linked to an increase in yield](#) (Murphie, 2018, p. 58). Further, as Aileen Murphie [has shown](#), there is no correlation between the needs of an area and the amount it gains in business rate yield (Murphie, 2018, p. 57). Yields are decided by [accidents of history](#) and geography rather than the need of their area (Murphie, 2018, p. 54).

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<sup>1</sup> For a wider discussion see [The Politics of Land Value Taxation by Professor Iain McLean](#) in Martin O’Neill and Shepley Orr [Taxation: Philosophical Perspectives](#)

## Council Tax

15. Alongside business rates, councils' main source of self-generated revenue is council tax. This is inefficient for [several reasons](#) (Rogers & Evans, How England is funded, 2018, p. 28):
- It is based on the estimated value of the property in 1991;
  - It is inflexible in that all rates are by law set as a ratio against a single band;
  - It is regressive in that the poorest pay a higher proportion of their income than those who are richer;
  - It is paid by those living in the property, not those who own it – an increasing problem given shortages of affordable property to buy; and
  - It is geographically regressive – poorest areas gain the least from it.

## Possible improvements

16. A recent IFS [publication](#) considers and comes to some sound conclusions around most options for widening the available sources of funding (Amin-Smith, Harris, & Phillips, 2019). In particular, tourist taxes are of questionable value as their yield is trivial and they are no help to the areas with greatest need. The most robust alternative local tax base is local income tax, though this too suffers from mismatch between ability to generate revenue and need.
17. Other options worth considering are:
- In the **short term**, updating council tax by a national re-valuation and re-banding and changing the current ratios between bands to make them more progressive.
  - In the **medium to long term**, a tax on land values could replace the current property tax portfolio (council tax, business rates, Stamp Duty Land Tax, and the component of Inheritance Tax that is levied on property values).

## A note of caution

18. It is important to consider both the total quantum of funding and whether that funding is where it is needed. Any tax devolution (whether council tax, business rates or income tax) risks exacerbating this problem and efforts to devolve taxation must be treated with [caution](#) (Rogers & McLean, Fairness and its many faces, 2018). Government must be mindful of the impact that devolution will have on redistribution. The amount of public spending in each region of England varies greatly. [Treasury figures](#) indicate an average spend in England of around £8,898 per person – from £10,192 per head in London to £8,282 in the East Midlands, £8,155 in the East and £8,111 in the South East (Rogers & Evans, How England is funded, 2018, p. 12). Currently, London and the South East subsidise the rest of the

country as shown by their [net fiscal balances](#) (Office for National Statistics, 2017). Measures that increase devolution reduce the role of the central state as, under the current system, tax revenue is [pooled and redistributed](#) so any further devolution must proceed with care (Phillips, 2018, p. 36).

19. Local government finance has always been a [balancing act](#) between equalisation and incentivising growth (Phillips, 2018, p. 36). Measures which shift the emphasis towards incentives must be considered alongside the need for equalisation and the risk of divergence. Prior to committing to possible further devolution there must be consideration of [how acceptable variation is](#) (Rogers, Devolution and public services, 2018, p. 7). There is [no guarantee](#) that devolution will stimulate economic growth or deliver improved public service outcomes, so greater devolution may need to be accompanied with measures which mitigate its impact (Phillips, 2018, p. 41).

### Lessons from other jurisdictions

#### Wales

20. The then-Finance Minister (now First Minister) in Wales Mark Drakeford commissioned an expert panel to look at options for local taxation reform, including local income tax and Land Value Tax (LVT) which reported as [Reforming the Finance System for Local Government](#) (Drakeford, 2017).<sup>2</sup> Professor McLean has been a member of their expert panel, and although the Welsh Government has not made a decision, it is aware of the issues and has commissioned further research on LVT. Evidence to the panel shows that the effect of adding Band I to council tax in Wales is fiscally trivial.

#### Scotland

21. Scotland has gone further in exploring these issues, with the appointment of the Scottish Land Commission. The following reports are especially useful: <https://landcommission.gov.scot/wp-content/uploads/2018/12/Land-Value-Tax-Policy-Options-for-Scotland-Final-Report-23-7-18.pdf> and [https://landcommission.gov.scot/wp-content/uploads/2018/12/LAND-FOCUS\\_Land-Value-Tax-October-2018.pdf](https://landcommission.gov.scot/wp-content/uploads/2018/12/LAND-FOCUS_Land-Value-Tax-October-2018.pdf)
22. These reports suggest that it would be difficult to switch to full LVT without the registration of all land with permitted uses, which the UK does not yet have. For houses, however, the market is dense. Commercial software and sites (e.g. Rightmove and Zoopla) can use transaction records to generate an estimated value for every property. With appropriate adjustments these data could be used to enable a switch from council tax to a LVT for domestic property.

<sup>2</sup>Please also see <https://gweddiill.gov.wales/docs/dsilg/publications/localgov/181023-finance-update-2018-en.pdf>

## Northern Ireland

23. Northern Ireland retains domestic rates, which are more robust than council tax. Successive governments there have been reluctant to make the tax effort of increasing domestic rates, hence housing in Northern Ireland is arguably currently under-taxed. A future administration in Northern Ireland could try to address this.

## Needs assessments

24. Needs assessments have always been challenging because what counts as a 'need' is highly contested. For many decades, this led to intense political lobbying over the factors and weights to include in Rate Support Grant calculations. The resulting formulae were not reliable, and minor changes to weights could have huge distributional consequences. Wales and Australia have pioneered different approaches, based on a coarser assessment of needs – using fewer predictors, and only predictors that cannot themselves be shaped in the short run by local authorities' decisions.
25. The Independent Commission on Funding and Finance for Wales (2010) proposed a needs model to replace the Barnett Formula block grant. It showed that a needs model with relatively few variables would achieve a fair result for Wales. This technical report is no longer on the Welsh Government's active website but may be available from Senedd.
26. In Australia, the Commonwealth Grants Commission (CGC) has assigned block grants to the states and territories on a complex formula that attempts to calculate their relative needs and resources. Recently, the CGC's model has been criticised by the Productivity Commission as overly complex and it is likely to be simplified (see <https://www.pc.gov.au/inquiries/completed/horizontal-fiscal-equalisation-report> and the reports linked from there). Nevertheless, Australia remains among the best models for a fair equalisation formula.

## The next Spending Review and beyond

27. The most pressing requirement is to adequately balance needs and resources. Several councils are currently under significant financial pressure so this must be a priority. Any **near-term** settlement could include:
- Making the council tax base more robust and more progressive by revaluations and a more progressive banding structure;
  - Deciding whether to proceed with business rates re-localisation; and
  - Producing a simple but robust equalisation formula on Australian lines.

28. In the **longer term**, governments may wish to consider completing the infrastructure on land valuation that is required for a switch from the existing portfolio of property taxes to Land Value Tax.

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