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# LOCAL TAXATION: THE OPTIONS AND THE ARGUMENTS

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## PREFACE

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## **CHAPTER 1**

### **INTRODUCTION**

How should local government in the United Kingdom be financed? From what sources should it draw revenue? How much, for example, of local authorities' spending should be paid for by local taxes, and how much should be financed by central government, using revenues from national taxation? Where revenues are to be derived from local taxation, what would be the most efficient and fair choice of tax for local government to use?

These basic questions have been debated many times before in the UK; the reform of local government finance has rarely been off the political agenda more than a few years during the whole of the post-war period. Yet, at the end of a decade of enormous upheaval in local finances, when major decisions are about to be taken to change yet again the arrangements for local taxation, many important issues and arguments about efficiency and fairness in local taxation appear to be almost submerged by considerations of short-term political and electoral advantage.

In this report we set out the results of an extended investigation of the options for local government taxation, drawing on economic theory, on quantitative modelling of the implications of different reform options, and on a series of discussions with officers and members of the Institute of Revenues, Rating and Valuation about the practical aspects of local taxation.

Many of the issues and arguments we set out in this report have been well-rehearsed before, both in official reports and in wider discussion. There is much, too, that can be learned from the experience of other countries with regard to local taxation. Although each national system of local government is different, the patterns of local revenues that have evolved elsewhere reflect many of the same influences and constraints that operate in the UK. In Chapter 2, therefore, we set the agenda for the subsequent chapters with a brief review of past attempts at reform and official studies, and of the practice of local finance in other European countries.

This suggests that the broad options for replacing the Community Charge are limited to two serious contenders — some form of property tax and a local income tax — although there is much scope for fine-tuning of the details of all three possible taxes. In

addition, there are two wider aspects of local government finance that exert a significant influence on the effects of any chosen local tax on households: the level and pattern of the contribution that is made to local finances in the form of central government grants, and the contribution made in the form of tax revenues derived from business taxpayers.

We discuss these two wider aspects of the context of local taxation in Chapters 3 and 4 respectively, before moving on to a detailed assessment of the criteria for choosing between different local taxes (Chapter 5), and of the advantages and disadvantages of each alternative (Chapters 6 to 8). We review briefly our conclusions in Chapter 9.

## **CHAPTER 2**

### **BACKGROUND TO THE CHOICES**

#### **Historical Background**

Probably the most comprehensive of the various White Papers and reports by Committees of Inquiry into local government finance during the post-war period was by the Layfield Committee, which was set up in 1974 'to review the whole system of local government finance in England, Scotland and Wales, and to make recommendations' (Layfield Committee, 1976, p. xxvii).

One of the immediate reasons for setting up the Layfield Committee was the substantial rate rises that had followed the major structural reforms to local government in the early 1970s. However, there was also a long-term structural problem inherent in local government financial arrangements which the Layfield Committee addressed. Put briefly, throughout the post-war period, central government had pursued a positive policy of growth in local spending. This increased spending had put upward pressure on rate bills and also on government grant contributions. The tendency until the mid-1970s had been for grant to increase at a faster rate than rate contributions, and the proportion of central government grant contributions had grown from just about 40 per cent in the early 1950s to over 65 per cent in the mid-1970s.

The Layfield Committee was concerned about the proportion of local government spending financed by grant income. It argued that a reduced grant proportion would increase local autonomy and accountability. However, a significant fall in grant income would have to be financed by increasing the size of the tax base available to local authorities. The Layfield Committee suggested that one way forward, which would be consistent with the maintenance of a substantial degree of local discretion over taxation and service levels, would be to introduce a local income tax whilst at the same time keeping the rating system (although valuation should move from rateable values to capital values). Layfield argued that the alternative to introducing a new tax base was to keep central contributions relatively high, but that this would be at the cost of greater central direction and control over local government activities. Even so, the committee argued, whichever approach the Government took, central contributions should be



kept below the proportions experienced in the mid-1970s, and at a stable level.

In the event the Labour Government in the 1977 Green Paper decided against the introduction of a local income tax, and argued for a unitary grant system which would allow central government greater control over local authority spending. By the time of the election of a new Conservative government in 1979 no major changes to local government finances had taken place.

In 1981 the new Government published a Green Paper examining possible alternative sources of local authority income. The Green Paper, *Alternatives to Domestic Rates*, considered each of the major alternative local taxes, including a brief and dismissive discussion on a poll tax. However, the outcome was that the Government did not choose to reform the rating system, but rather chose to apply tighter constraints on local authority spending through the grant system and a variety of penalties.

By 1985 the Government began to think again about the overall financial arrangements for local authorities. In Scotland the combination of a revaluation of domestic and business premises (and an overall reduction in grant) had led to a substantial redistribution of the local tax burden towards domestic local taxpayers, and there was a growing campaign of protest. Fear of the consequences of undertaking a similar revaluation in England and Wales (where revaluation was even more overdue), combined with the lack of success with attempts to control local authority spending in England and Wales, led the Government to re-examine local authority financial arrangements. In January 1986 the Government published a Green Paper, *Paying for Local Government*, setting out the proposed reforms to local government finance.

The main priority of the new financial arrangements was to make local authorities more 'accountable' to the electorate. The Government argued that increased 'accountability' would to a large extent move the burden of controlling local government spending away from central government and towards those who paid for local spending.

The changes suggested in the paper, with some minor modifications, became law in the 1988 Local Government Finance Act.<sup>1</sup> In 1990 the following major elements of the Act were

implemented in England and Wales. First, domestic rates were replaced by the Community Charge, a locally-determined poll tax (this was introduced a year earlier in Scotland). Second, local authorities lost their control over non-domestic rate income; central government set a single national non-domestic rate (sometimes referred to as the uniform business rate) which was applied to reassessed rateable values. The revenues from business rates were distributed to each local authority on the basis of the size of its adult population. The third major change was the restructuring of the grant system, consequent on the other changes.

By the time the reforms were introduced in April 1990 they were the subject of considerable political controversy about either the perceived 'unfairness' of the Community Charge or the Community Charge levels set by local authorities. Even with substantial safety netting and transitional arrangements aimed at ameliorating the effects of the introduction of the Community Charge, many households experienced substantial increases in their local tax bills. On average, the revenues raised from local taxation increased by close to 30 per cent in 1990/91 over the previous year.

The immediate response by the Government was to take advantage of its powers in the 1988 Act and impose spending limits on local authorities that were deemed to be spending 'excessively' or whose spending represented an 'excessive increase' over the previous year. In addition more money was set aside to help ease transition and increase, relative to previous years, the amount of central government support to local authorities for the following financial year, 1991/92. The Government also set up a Cabinet sub-committee to examine the new system. Although there was some speculation that the sub-committee would suggest major modifications to the Community Charge, there were eventually only a few alterations to the reforms, none of which was substantial.

By the end of 1990, however, the new Environment Minister, Michael Heseltine, had announced that there was to be a fundamental review of the Community Charge, in which 'no options are ruled in and no options are ruled out'. The review brought about two major announcements in March 1991. The first, in the Chancellor's Budget Speech, reduced the headline Community Charge bills of all local authorities in 1991/92 by £140

— an injection of £4.25 billion extra funding to be financed by an increase in the VAT revenues raised by central government. The Government argued that the reduction in local tax bills would bring local taxation to a level that was 'sustainable' over the longer term. The second announcement was that the Community Charge would be scrapped and be replaced by a combined domestic property and head tax. By 1993/94 local tax bills would be related to the value of a household's property and the number of individuals in the household.

Further details of the proposed new tax became clear when, in April 1991, the Government published a consultation paper entitled 'A new tax for local government'. The consultation paper proposed a new tax called the 'council tax' which would allocate properties into one of seven bands on the basis of their capital value. Each household would receive a single bill. Liability for the tax would fall on the occupier, and tax bills would be related to the number of individuals in a household only to the extent that single-adult households would receive a 25 per cent discount. The new tax would aim to raise as much revenue as was being raised from the Community Charge in 1991/92, and detailed exemplifications were published of the levels of tax that would have applied to each of the property bands in each local authority, had the tax been in operation then.

The major opposition parties have advocated alternative approaches to the reform of local government finance. The Labour Party plan for a modified return to domestic rates. Their aim is to determine a new tax base for rates not based solely on some notion of rental value as before but on a wider number of indicators which will reflect the capital value of a property. The Liberal Democrats have proposed an entirely new local tax, a local income tax, to replace the Community Charge.

It is not only domestic local taxes that are currently being discussed. Policy-makers are also aware of the importance of grants and non-domestic contributions to local authority finances. The relative contributions of both these income sources are important but so are questions concerning the type of grant system and whether local authorities ought to have control over their business income. Both grant and business rates interact with local taxes, and thus their functional relationship with each other is crucial in determining a consistent model of local government finance.

The recent reforms suggested by the Government go beyond the choice of local government taxes. In addition to its proposals for local taxation the Government published a consultation paper outlining its intention to reform the structure of local government. The consultation paper argues that in general the best structure for local government would be a unitary system of authorities. A system of two tiers, the Government argued, causes confusion over which tier of government is responsible for what service and what level of local taxation. In this report, however, we confine our analysis to the present structure of local government — currently a mix of single-tier authorities in London and the metropolitan districts and two-tier elsewhere. However, it is clear that the issues of structure and financing are to some extent linked, and that any future change in the structure of local government may give rise to significant changes in the arguments for particular local authority taxes.

## **European Perspectives on Local Government<sup>2</sup>**

Before examining the alternative tax systems in detail, we conclude this chapter by providing a brief review of the local government finance systems in other European countries. This tends to suggest that there are few significant alternatives beyond those currently prominent in the UK political debate; some form of property tax or local income tax would appear to be the only serious alternatives to the Community Charge. We focus on the structure of authorities, the allocation of functions, and the main methods of financing local government expenditure. In broad terms we find that the structure and function of local government do not vary a great deal from country to country although there are major differences in financial arrangements.

### *Structure*

The most common structural form that local government takes is a three-tiered system. All EC countries of comparable size to Britain have federal states (e.g. Germany) or an upper, regional tier of local government. In France, Italy, Belgium and Spain regional councils have been established during the last 20 years to decentralise state functions and give expression to regional economic and cultural interests. Single-tier systems are only found in Luxemburg, Portugal and Greece, and in the latter two countries the establishment of another tier of local government has been

under consideration. The trend elsewhere in Europe has been toward more decentralisation and an increase in the number of tiers of government; only in Britain has there been active discussion of moves in the opposite direction.

Lower-tier authorities vary widely in size. In many countries, the lowest tier is a unit defined by the boundaries of a settlement, and thus of vastly different size in different areas. Where boundaries are not updated with urban growth this has led to a multiplicity of small authorities in outer metropolitan areas. Although a number of countries have introduced reforms which have consolidated the pattern of local authorities, no other country has created authorities as large as the English districts (Table 2.1).

TABLE 2.1  
Size of Local Governments in Europe

Country	Population	Number of basic units	Average population of basic unit
France	55.85m	36,433	1,533
Greece	9.99m	6,022	1,659
Luxembourg	0.37m	126	2,937
Spain	38.89m	8,022	4,848
Italy	57.34m	8,066	7,109
West Germany*	61.17m	8,409	7,274
Belgium	9.88m	589	16,774
Denmark	5.13m	273	18,791
Netherlands	14.71m	714	20,602
Portugal	10.20m	305	33,443
Ireland	3.54m	32	110,625
Britain	54.29m	457	118,797

\* Since German unification, the Federal system has been extended to the former DDR which will be split into five Länder.

The structure of local government in large urban areas is often more elaborate than that in other areas. There is usually a core city authority and a metropolitan council with a wider area and strategic responsibilities for large-scale services, planning and transport. These councils are sometimes associative authorities elected from lower-tier urban councils, as in Rotterdam, Lille and Copenhagen, and sometimes fully-fledged city-regions like Hamburg, Madrid and Brussels. Britain, since the abolition of the metropolitan counties in 1986, is unusual in having such a fragmented system of urban government.

## *Functions*

A reasonably consistent set of functions is performed by lower-tier local government in EC countries. Typical duties include managing utilities like water and gas, and running amenities and services like cemeteries, fire-fighting, street-lighting, minor roads, and district planning. Functions such as policing, education, and health and social services are often local but with strict central government supervision. In most of Europe, communes have broad discretionary powers to provide services as they see fit, while in Britain and Denmark they can only do what they are specifically permitted to by law.

In contrast, the role played by upper-tier authorities in European countries is less uniform, although in three-tier systems the upper (regional) tier usually has powers over economic development, transport and culture. Middle-tier units and provinces/counties in two-tier systems are often assigned a primary function, rather as in the UK the shire counties' main responsibility is for education. In Denmark, the counties are mainly health authorities, and the French *départements* are concerned with health and welfare. An alternative approach, used in Italy, Germany, Belgium and Spain, is for upper-tier authorities to have broad powers which overlap extensively with those of the communes.

The importance of the functions carried out by local government is reflected in the share of public spending it accounts for. The British proportion, about 26 per cent, is close to the European norm. Denmark is highly decentralised, with 48 per cent of spending at local level.

## *Finance*

Local finance in many European countries has been almost as controversial as in recent years in Britain. The variety of systems used is an indication of how difficult it has been to devise a fair and efficient local tax. Some countries, indeed, do not use local taxes as a significant method of financing local expenditure. In Italy and the Netherlands, less than 6 per cent of local revenue comes from local taxation and there is a corresponding reliance on grants from central government. Ireland's solution to the political problems of rates was the derating of all but commercial and industrial property and a large shift towards grant financing.

In Germany, Spain, Portugal and Luxemburg there is extensive use of 'revenue-sharing' by which a tax is set centrally but a fixed proportion of the proceeds allocated to local government. This system delivers a predictable yield and autonomy over spending decisions but is inflexible regarding the amounts received. Central grants and revenue-sharing allocations in most EC countries are distributed according to various formulas, some of which are even more complicated than in Britain. Grants are also often paid with reference to the contribution to central taxes made by the locality. Except in Italy and the Netherlands, most grants are not earmarked for specific council functions.

While it is possible to make these general observations about European grant systems, local taxes vary widely from country to country, and no clear pattern emerges. However, nearly all countries use property, income or both as a base for their local taxes (see Table 2.2).

TABLE 2.2

**Major Local Government Taxes in Europe**

No major tax	Property tax	Income tax	Both taxes
Italy	France Greece* Ireland Netherlands Portugal* Spain*	Belgium	Denmark Germany* Luxemburg*

\* Taxes revenue-shared in whole or part.

No other major taxes are used, except in the form of revenue-sharing, where the local authority has no control over tax rates. However, many countries also allocate to local government a range of minor revenue sources — motor vehicle licensing, dog taxes, etc.

**NOTES TO CHAPTER 2**

1. The primary legislation which introduced the Community Charge to Scotland in 1989/90 was the Abolition of Domestic Rates Etc. (Scotland) Act 1987.
2. This section draws from Baston and Ridge (1990).

## CHAPTER 3

### GRANTS

#### Introduction

In addition to raising revenue from taxes on the local domestic sector, local authorities in the UK receive substantial revenues from other sources, especially central government grants and taxes on the non-domestic sector. Fees and charges are also levied for certain local authority services. These other revenue sources can interact with local domestic taxes and have a major impact on local authority tax levels. Table 3.1 gives an indication of the relative proportions of revenues from the domestic sector, non-domestic sector and central government grants which financed local authorities' net spending in 1990/91.

TABLE 3.1

#### Proportion of Local Authority Net Revenues

Community Charge	NET REVENUE SOURCES	
	Revenue support grant	Non-domestic income
38% (22%) <sup>a</sup>	31%	31%

<sup>a</sup> Estimated contribution in 1991/92 given in parentheses.

Source: CIPFA, *Community Charge, Demands, Precepts and Rating Statistics 1990/91*.

In this chapter we set out the main reasons for central government contributions to local authority spending, and consider the implications of central government grants under different local tax systems.

#### Reasons for Central Government Grant

The principal reason for central government transfers to local authorities is that the tax revenue sources available to local authorities are, on their own, inadequate to support their expenditure responsibilities. Most taxes are easier for central government to administer than for local government — if only because this avoids the need to allocate the tax base between local authority areas. As a result, allocating taxes to the level of government where they are most efficiently operated may lead to a fiscal imbalance between the tax revenues and expenditures of different levels of government; local authorities may be assigned less revenue sources than expenditure responsibilities. 'Fiscal



imbalance’ of this sort would generally imply a uniform per capita distribution of grant from central government to local authorities.

Grants from central government may, however, also fulfil a number of other functions and objectives. In this section we discuss the following reasons for central government grants to local authorities: (i) grants to reflect ‘externalities’ of local authority spending; (ii) grants which would ensure that local decisions take into account central government preferences for spending on services; and (iii) grants used to equalise local authority resources and needs. Using grant for these purposes may require the use of various different forms of grant, allocated according to a range of criteria.

Grants from central government to local authorities can be split into two main categories — specific grants and general grants.<sup>1</sup> General grants allow the local authority to freely determine how it spends grant on services. Specific grants require the local authority to use grants for particular services.

It is also possible to identify within both grant categories further classes of grant. Both general and specific grants can be broken down into matching and non-matching grants. Non-matching grants are simply fixed lump-sum grants which can be either allocated to a specific service or for general use. Matching grants are generally percentage grants, which reduce the additional costs to local taxpayers of either a specific service or local authority services as a whole as expenditure is increased (Table 3.2).

TABLE 3.2  
Types of Central Grant, with Examples

	NON-MATCHING GRANTS (LUMP-SUM GRANTS)	MATCHING GRANTS	
		Open-ended	Close-ended
Specific grants	e.g. £10,000 for spending on roads	e.g. 50% of local spending on roads	e.g. 50% of local spending on roads up to a maximum of £20,000
General grants	e.g. £10,000 for local spending in general	e.g. 50% of local spending	e.g. 50% of local spending up to a maximum of £20,000

In the following we examine some of the reasons set out above for distributing grant to local authorities, and their implications for the type of grant employed.

### *Externalities*

Externalities arise in local government service provision when a service provided by an authority gives benefits not just to its own inhabitants but also creates benefits for individuals who live outside the authority. Typical examples might be the benefits that non-residents obtain from using roads maintained by other authorities, and from the provision of sports and cultural facilities in neighbouring areas. Given that the local authority in many cases will not be able to charge those receiving the external benefit, it is likely that the authority will provide below the level of service which would be optimal, i.e. that level of service which would be provided if all benefits were taken into account. With many local services there are external benefits for individuals who make use of the facilities provided by an authority but live and pay local taxes elsewhere.

The most appropriate way, in principle, of ensuring that the external benefits provided to non-residents are properly taken into account is through the use of matching grant contributions (reflecting the value of local spending at the margin to non-residents), for the specific services where externalities arise.

### *Minimum Standards*

If central government wishes local authorities to provide a national minimum standard of certain services the ideal grant would be a specific grant which made up the difference between the cost of supplying the service for an authority and the amount of service the authority is prepared to supply. However, this may be impractical. It is unlikely that central government would know what the relevant amount of specific grant to an authority should be, particularly as there are strong incentives for local authorities not to reveal their preferences with respect to the amount of service they would be willing to provide. It has been argued by a number of commentators that in this situation minimum standard provision is best reached by central government allocating 100 per cent specific lump-sum grants (Layfield Committee, 1976; King, 1984). The same conclusion can be reached when considering

service provision that benefits only a minority of a local authority's population. Examples of the former might include financing of statutory requirements in relation to the environment whilst the latter would include central financing of the costs of student grants for higher education or provision for the homeless.

### *Equalisation*

With local tax systems where the total resource base — for example, rateable value — varies substantially from authority to authority or where there are significant differences in the expenditure required to supply a similar level of service, there are strong arguments in terms of equity and economic efficiency for introducing equalisation grants.

Without some form of equalisation grant, local authority tax rates would be determined not only by the level of their expenditure, but also by the tax base to which they had access. A local authority with double the tax base per head of population of an otherwise identical authority would be able to set a tax rate only half that of the other authority. Taxpayers in the two authorities who were identical in all respects, including their tax base (rateable value, taxable income or whatever), would then pay different amounts of tax for the same standard of service.

The equity argument for introducing some form of resource equalisation in these circumstances is based on the view that simply because a local authority is poorly resourced it is 'unfair' that the authority's residents should face substantially higher tax rates or have lower levels of services. This argument is perhaps strongest where the possession of a large local tax base includes some fortuitous element — business rate revenues from a large factory, power-station or airport perhaps. Whether it has the same force when the only tax base available to local authorities is local households is open to debate. In the context of the old rating system, it has sometimes been argued that if the source of differences in local authority tax bases was the difference in the value of housing in different parts of the country, then otherwise identical taxpayers in different parts of the country may have similar properties, but these properties will have different values, and to seek to tax them at an equal *rate* will result in identical taxpayers facing different total tax bills.

In addition to the equity aspects of equalisation there is a further feature related to economic efficiency which arises from an unequal distribution of resources or costs across authorities. The concern is that the differences in tax bills due to differences in local authority resources may induce taxpayers to move between authorities to reduce their local tax payments, particularly if they are in close proximity to each other. Similarly if one local authority found it more expensive than others to provide local services to a given standard, perhaps because it has a greater proportion of elderly people, local tax bills would differ across authorities even though similar levels of service were being provided. Again, in principle at least there would be some incentive to migrate.

Whether a local tax system requires resource equalisation grants is dependent on how taxable resources are distributed within authorities. Typically, local property taxes, local income taxes, profit taxes, etc. will require equalisation. A poll tax, like the Community Charge, uses individuals as its tax base and therefore, given that individuals face the same tax structure across authorities, resource equalisation problems do not arise.<sup>2</sup> However, clearly needs equalisation problems still occur. We shall refer to the issue of equalisation when considering the alternative local tax systems in the following chapters.

## **Capitalisation**

The arguments for fiscal equalisation are complicated to some extent by the possibility that local tax and spending differences could be capitalised into property prices. It has been suggested that if full capitalisation of fiscal disparities takes place then equalisation is achieved automatically, in the sense that a higher local tax burden would be compensated by a lower cost of housing. Barnett and Topham (1980) suggest that equalisation grants can be counter-productive when full capitalisation occurs.

Full capitalisation in the housing market will, however, only occur if the supply of housing is fixed, there is a free market in relation to housing rents, and there is perfect mobility of households. It is questionable whether these assumptions are in any way realistic. In the main, housing supply is not inelastic as there are many opportunities for development throughout the country. Further, households cannot be assumed to be perfectly mobile: other

factors, such as work location, community links and family ties, will determine residence.

A further disadvantage of relying on capitalisation as an alternative to explicit equalisation of local authority needs and resources through central government grants is that it is only effective for as long as the system of local authority finance and spending responsibilities remain unchanged. If, however, functions are transferred between central and local government or the structure of local authority finance is changed, the changes in the needs and resources of different authorities may be unevenly spread across the country. With an explicit system of equalisation, attempts can be made to adjust the pattern of central grants to take account of the changed position of each individual authority. Without explicit equalisation arrangements, any structural changes in local government which alter the relative fiscal position of different authorities are likely to be capitalised into the prices of land and buildings, concentrating the pattern of local gains and losses into immediate asset price adjustments, and imposing capital gains and losses on the current holders of these assets. Equalisation arrangements therefore are not merely useful in ensuring 'fairness' in the current distribution of grant, but can also have an important role to play in maintaining local fiscal stability during periods of structural reform.

### **Grant Arrangements in the UK**

Prior to the introduction of the Community Charge in 1990, the main central government grant to local authorities was the Block Grant. This had four main functions: (i) to equalise local authority needs, through a distribution of lump-sum payments to local authorities, based on a detailed assessment (Grant Related Expenditure Assessment or GREA) by central government of each local authority's spending needs; (ii) to equalise local authority resources, to ensure that all local authorities could set the same rate poundage (i.e. the same tax rate) for the same standard of local services; (iii) to allow local authorities to reduce the rate poundage paid by domestic taxpayers below that paid by business ratepayers, through 'domestic rate relief'; and (iv) in some years, to provide a general incentive for local authorities to reduce their spending. The first and third of these elements of the Block Grant were lump-sum payments, whilst the second and fourth were related to local authority expenditure levels.

In 1990 the Block Grant was replaced by a revenue support grant which is broadly the same as the old needs element in the Block Grant although the factors which determine its level for each authority have changed. The replacement of domestic rates by the Community Charge and the introduction of a uniform business rate (UBR) have meant that the resource element of the old Block Grant system has been removed. This is because changing the tax base from rateable value to eligible adults has disposed of the need to equalise resources.

The changes to the grant system plus the introduction of the UBR change significantly the proportion of local authority revenues over which local authorities have discretion. In 1991/92 the Community Charge will be contributing only 22 per cent towards net spending and 15 per cent toward overall local authority spending. This means that any additional increases in local authority spending above that accounted for in the revenue support grant allocation will have a substantial multiplier effect — or gearing effect — on local taxes. For example, a 5 per cent additional increase in local spending will have an approximately 25 per cent impact on local taxes. Moreover, this also implies that local tax payment will be very responsive to annual changes in the allocation of grant, thereby blurring the relationship between spending and local taxes.

## **Conclusion**

Grants form an important part of the revenues of local government, and play an important role in ensuring equity between local authorities in the financial circumstances and expenditure responsibilities they face. Nevertheless, extreme dependence on central contributions is clearly liable to reduce the ability of local governments to control their own affairs, and may be a source of instability in the levels of local taxation they must levy. The choice of a local tax that can only contribute a small proportion of the revenues required by a local authority can thus have wider and undesirable consequences, both for the relationship between central and local government, and for the stability and predictability of local taxation.

### **NOTES TO CHAPTER 3**

1. For a detailed discussion of grants, their types and their effects, see Gramlich (1977) and King (1984).
2. Although if it was the aim of central government to concentrate on the issue of fairness then the aim might be to equalise tax burdens at every given expenditure level. This approach would require equalisation grants.

## **CHAPTER 4**

### **LOCAL BUSINESS TAXATION**

#### **Introduction**

Until 1990, the rates paid by non-domestic taxpayers were under local authority control; the poundages levied were those levied from local domestic ratepayers, except for the reduction applied to domestic poundages through domestic rate relief. The introduction of the uniform business rate in 1990 has meant that local authorities no longer have control over the income they raise from the non-domestic sector, and businesses no longer face different tax rates in different authorities.

In the 1986 Green Paper the Government put forward the following arguments for removing local authorities' ability to vary business rates:

- (i) locally variable taxes on business between areas had distorted business decisions about investment, employment, and location;
- (ii) business rates undermined local 'accountability' in that they subsidised the cost to the local taxpayer of additional local spending;
- (iii) the uneven distribution between authorities of rateable resources of the non-domestic sector required the use of a resources grant between authorities to compensate for the differences, which blurred public understanding of the link between spending and the local tax bills of households.

In the following we examine in turn each of these arguments. Taken together do they constitute a convincing case against any return to some form of local business taxation?

#### **The Effect on Business of Local Tax Rates**

Two broad approaches have been used to investigate the impact of differences in business rates on business profitability and business location decisions. The first, exemplified by the work of Bennett (1986) and Bennett and Krebs (1988), has been based on calculations of the impact of non-domestic rate differences on the



cost of capital. The second, exemplified by Crawford, Fothergill and Monk (1985), has investigated the statistical association between business rate levels and economic activity measures such as the level of employment.

Bennett (1986) presents estimates of the effects of non-domestic rate levels in 1980 and 1985 on the 'cost of capital' in a range of hypothetical investment projects in high-tax and low-tax localities. The method used is based on King and Fullerton (1984), and provides estimates of the 'fiscal wedge' between post-tax and pre-tax rates of return to an investment. Local rate poundages in the six highest-tax authorities and the six lowest-tax authorities were averaged, and converted into corresponding rates of tax on corporate wealth, ranging from 1.6 to 3.6 per cent in 1980, and 2.1 to 4.7 per cent in 1985.

The results of applying this range of tax rates to investments in the UK tax system are then calculated for two cases, one in which the pre-tax real rate of return is held constant and the effects of the tax system are evaluated on the post-tax real rate of return, and a second case where the post-tax real rate of return is held constant for all projects and the effects of the tax system are evaluated on the pre-tax real rate of return. Overall, evaluated over a range of industries, assets, sources of finance and asset ownership, the range of rate poundages between high-tax and low-tax areas gave rise to a difference in the post-tax real rate of return on additional investments of 0.5 per cent in 1980 and 0.7 per cent in 1985. Alternatively, the range of rate poundages can be seen as requiring differences of between 0.6 per cent and 0.9 per cent in the pre-tax rate of return for the post-tax rate of return to be equalised. These differences, in Bennett's view, are far from trivial, in the context of overall net rates of return to fixed capital of some 4 per cent in UK manufacturing industry in 1980. If there is no shifting or capitalisation of non-domestic rates, these differences would, he concludes, have a 'very significant impact on profitability and the returns to investment in different locations' (Bennett, 1986, p. 47).

Crawford, Fothergill and Monk (1985) reported the results of regression analyses of the change in employment in individual boroughs and districts over the period 1974–81. The study investigated the range of possible influences on employment change, including two measures of the rate burden — the level of rates and the change in rates. In three of the four sectors studied

— manufacturing, retailing, and warehouses — the analysis provided no evidence that either the level of rates or the increase in rates affected the distribution of employment between local authority areas. In the fourth sector, commercial offices, a correlation was found between high levels of rates and below-average growth of office employment, in particular in London and South-East England.

As Smith and Squire (1987) argue, however, much of the concern about the impact of business rates on business profitability and on business location decisions has not taken full account of the likely differences between the formal and effective incidence of business rates. The general level of business rates may be reflected as much in prices as in profits (though Mair (1987) found that the main effect was on profits); and differences between authorities may be capitalised in land and property prices. If business rate differentials have been partly or fully capitalised into land prices, the impact on industrial location over any time period but the very long term may have been very small. It is also necessary to take into account the likelihood that only a proportion of businesses may have any scope for locational choice. Mair (1987) argues that the sectors where rates formed a significant part of costs — distributive trades and utilities — tended to be tied especially closely to particular localities and markets, and thus had little choice about location.

### **Apportioning the Costs of Local Authority Spending**

In 1986 the then Local Government Minister, William Waldegrave, put the Government's position on locally-determined business rates in the following terms:

At present the local business tax in Britain rises exactly in line with the local domestic tax rate. This means that on average for every £1 raised by rates only 40p comes from domestic taxpayers. The non-domestic taxpayers pay the larger share and have no say over the level of taxation or the services provided through it. They merely subsidise and distort the spending preference of those who do have a vote.

(Waldegrave, 1986, pp. 14–15)

In short, the Government's view was that the additional cost of local spending to the local domestic taxpayer was kept artificially low by the contribution made at the margin by business ratepayers, encouraging 'overspending' and undermining 'accountability'.

The 1990 reforms have made sure that domestic taxpayers will pay for additional increases in expenditure by allocating grant from central government on a lump-sum basis and removing the power of local authorities to vary business rate poundages.

The implicit reasoning behind requiring domestic local taxpayers to pay the full marginal cost of additional local spending is an assumption that the benefits from additional spending accrue only to the domestic sector. Jackman (1987) points out, however, that additional local spending will also yield benefits for non-domestic payers. Clearly, businesses derive benefits from certain local authority services, such as refuse collection, roads, police, car parks, etc., and businesses attract non-residents who may also need to use local authority services. Local businesses are likely to derive benefits at the margin from additional local spending, but under the current arrangements face a marginal cost of zero.

These conditions may give rise to exactly the same sort of problems of accountability that the 1986 Green Paper identified in relation to local residents who were not ratepayers. Even though businesses do not vote, there are plenty of ways in which they can articulate their interests over local spending. Does this suggest that there would be a case for the reintroduction of some form of local business taxation?

Possibly the ideal solution to the above problem is to split the marginal cost of local public spending, between the non-domestic sector and domestic sector, in proportion to the marginal benefits received. Jackman (1987) calculated the proportion of benefits received by the business sector in 1986 as approximately 15 per cent.

However, in practice it may be difficult for the relevant interested parties (i.e. business, DoE, local authorities and domestic taxpayers) to agree over an appropriate formula. An alternative solution is to increase the use of charges to the business sector for local authority services. As the number of charges increases — particularly in areas where businesses are unambiguously the sole receiver of services — then the proportion of additional local taxes paid by business would fall which in turn might dampen the difficulties in determining the smaller proportion that business ought to pay at the margin.

Nevertheless, whether charges are increased or not it is apparent that businesses benefit from increased local authority expenditures. It follows therefore that for a more exact concept of 'financial accountability', business should pay in proportion to its benefit.

## **Business Income and Grant Distribution**

In the Green Paper the Government points out that the need for a resource equalisation grant rests mainly on the uneven distribution of *non-domestic* sector rateable resources. The Green Paper claimed that the use of Block Grant to equalise resources was little understood by domestic taxpayers. It is true that the Block Grant system was complicated; however, it had an aim, which was to equalise resources and thus introduce an element of horizontal equity into the *structure* of local taxes. This it did relatively successfully. Households with similar rateable values in different authorities but facing similar levels of service would pay similar local tax bills. In addition changes in the local tax bills were related to changes in local spending patterns.<sup>1</sup>

Nevertheless, the abolition of domestic rates and the transformation of business rates into what is effectively a hypothecated national tax in the 1990 reforms meant that there was no longer a considerable resource base to equalise, and thus the resource element was removed from central government grant allocation. However, there remains a substantial needs-related lump-sum grant, as well as the distribution of business rate revenues to local authorities on a per capita basis. This means that although the average contribution of local domestic taxes to local authority spending is less than 25 per cent, the whole of any expenditure above the assessed level set by central government is fully borne by local domestic taxpayers. This effect, referred to by some commentators as the 'gearing' effect, may have a number of undesirable consequences. One is that local taxation levels become very sensitive to the basis on which central government grant is distributed. Smith and Squire (1986) observed that this would be likely to increase the lobbying activities of local government over the grant allocation, possibly at the expense of activities with greater social benefit, such as improving the efficiency of local service delivery. Ridge and Smith (1990b) demonstrate how errors in the inflation forecasts underlying the grant allocation in 1990/91 had a drastic gearing effect on local tax bills.

## **Conclusion**

The reintroduction of some scope for local authorities to vary the rate of taxation on businesses would be a relatively simple matter. The evidence that doing so would seriously distort business decisions about investment, employment and location is far from compelling, although there is good reason to believe that effects would be felt in certain geographically-mobile activities.

The benefits, too, of reintroducing a locally-variable business rate would be limited; the 'gearing effect' of errors or changes in the grant distribution could as easily be tackled by damping any grant changes. Perhaps the most that could be justified would be a relatively modest contribution at the margin from local business — perhaps of the order of 15 per cent or so of the cost of additional local spending.

### **NOTE TO CHAPTER 4**

1. However, the constant relationship between spending and local tax bills was interrupted by central government attempts to control local authority spending during the 1980s.

## **CHAPTER 5**

### **CRITERIA FOR LOCAL TAXES**

A good local tax should have a number of features, including requirements of administrative feasibility, economic efficiency, equity and accountability. These headings are useful in setting up a check-list for each of the local taxes considered in this report. However, it is unlikely that any single tax will score highly in all areas and there will in fact be some trade-offs. Applying a weight to each of the headings in order to evaluate these trade-offs is a matter of judgement and depends in part on the political priority to be attached to different objectives.

#### **Administrative Feasibility**

Some of the administrative criteria for taxes apply equally to both national and local taxes. For example, taxes should integrate easily with the tax system as a whole, they should not be easily evaded, and they ought to be simple and understandable to minimise the costs to taxpayers of compliance. However, there are also distinct administrative requirements for local taxes, including the following:

- (i) local authorities should be able to determine their tax rates and receive revenues that are positively related to the tax rate;
- (ii) there ought to be no ambiguity over the size and limits of an authority's tax base;
- (iii) the yield from local taxes should be stable and predictable to avoid unforeseen shortfalls in revenue in any given year;
- (iv) the method of administering and collecting the local tax ought to be straightforward and at reasonable cost;
- (v) duplication of administration and collection tasks between central and local government ought to be avoided.

#### **Economic Efficiency**

A tax is efficient in an economic sense when the tax does not unnecessarily distort or modify the choices that individuals (or firms) would have made in the absence of the tax. In other words,

except where policy is aiming to achieve certain changes in behaviour, an efficient tax will be one which is 'neutral' in its effect on individual decisions about labour supply, consumption, investment, employment and location. In relation to local taxes the issue of efficiency must take particular account of the possibility of population mobility between local authorities. It is argued that local taxes may distort households' choices of where to live. If population mobility is substantial then there is in effect little scope for local authorities to provide either redistributive services or ability-to-pay type taxes. For example, in relation to ability-to-pay taxes we know that high-income individuals will have to pay more in local taxes than poorer individuals. In this situation wealthier individuals may move to authorities with the same levels of services provided at less cost (i.e. into an area which has higher taxable resources). By the same argument poorer individuals may move into wealthier local authorities to gain from lower tax bills.

This distortion aside, there is the further difficulty of the decline in authorities' tax base as a result of population migration which would rule out entirely the possibility of using ability-to-pay taxes. As Oates (1972) points out, the movement of wealthy individuals away from some areas would necessitate raising tax rates

which would further hasten the departure of the rich and subsequently provide little advantage for the poor. Consumer mobility would thus not only introduce allocative inefficiencies but would also largely frustrate the attempt to attain a more desirable incidence of local taxes.

(Oates, 1972, p. 132)

The processes described above will only be of significance if mobility is inexpensive, and if local authority spending decisions and tax levels are a major factor in where people choose to live. In practice, population mobility in response to local fiscal factors is unlikely to be high in the UK, given that local authorities are large geographical jurisdictions relative to those in other countries. It follows that the use of income-related taxes cannot, therefore, be ruled out. Further, it is possible to implement equalisation grants once an income-related tax is introduced, thereby also stemming 'fiscal' migration.

## **Equity Issues**

A third aspect of the choice of a local tax is the distribution of the tax burden across different groups of the population, especially

across income groups. The equity characteristics that should be displayed by local taxes — that is, the distributional incidence of the local tax burden — are constrained, from one side, by population mobility. A highly redistributive local tax, as noted above, could encourage better-off taxpayers to move out of the most heavily-taxed areas. However, even if the government is aiming for a high level of income redistribution, this requirement for comparatively non-redistributive local taxes may cause little difficulty, since the distributional incidence of local taxes can be substantially offset by greater progressivity in national taxation.

However, this does not imply that the redistributive incidence of local taxes should be a matter for indifference. There are limits on the extent to which national redistribution can correct a regressive distributional pattern of local taxation. With a heterogeneous local population, some individuals are always likely to prefer less, and some more, of the local service than is actually chosen. Only where distributional considerations are ignored will it be a matter of indifference that poorer residents are compelled, as a result of the majority decision, to 'purchase' larger amounts of local services than they would wish to pay for.

For this reason, highly regressive local taxes would appear to be undesirable at the local level. Variations in the rate at which the tax would be levied mean that poorer residents of high-tax areas would be particularly adversely affected, and it would not be possible to compensate for this in the national tax system. If a tax containing a substantial lump-sum element is chosen, some form of rebating for poorer households is essential (Smith, 1988).

## **Accountability**

Accountability relates to the efficiency of the public decision-making process; do local authority decisions properly take into account the interests of those financing local services and those who use them?

The Layfield Committee Report (1976, p. 240) argued that 'If local authorities are to be accountable they should be responsible to their electorates for both the expenditure they incur and the revenue they raise to finance it, particularly for increases in both'. It argued that accountability would be increased if local authorities were allowed to have greater control over their finances (i.e. less



intervention through the grant system by central government) and suggested extending the tax base to include a local income tax to achieve this. The Layfield Report paid less attention to the number of taxpayers and the relationship between additional spending and taxation, which were the focus of subsequent discussions of accountability in the 1986 Green Paper. This argued that accountability was weakened in the UK system of local government by the fact that 'differences arise among those who vote for, those who pay for, and those who receive local government services' (p. vii).

The Government's main aim was to create 'accountability' in local authority finances in two ways. First, it aimed to create a situation whereby increases in local authority expenditure — beyond that allowed for by central government in its grant allocation — ought to be fully financed by local domestic taxation and not by extra central grant or business taxation. Secondly, the Government aimed to increase the number of local taxpayers — from 18 million to 36 million in England — so that those who voted for the level of local government services paid for them.

Nevertheless, to the extent that accountability concerns the overall efficiency of the public decision-making process, it should not focus solely on the interests of local residents. Efficient public decision-making requires that the interests of non-residents too should be appropriately taken into account. This has two aspects. First, there is the concern that the revenue received by a local authority may be partly contributed by individuals who live outside the authority's boundaries. If this were the case then the additional cost to residents of extra spending would be reduced and there could, therefore, be a tendency to excessive levels of public expenditure.

Second, non-residents may also benefit from local services such as parks, roads, police, etc. for which they do not have to make a contribution. It follows that if local authorities receive revenue only from their residents they are likely to underprovide the economically efficient level of services to both residents and non-residents. If this practice is widespread then there is a strong case for central government to provide a matching grant to local authorities related to the particular services used by non-residents — whatever type of local tax is in place.

## **Conclusion**

In the last three chapters we have set out the criteria for local taxes and the role central government grants and business revenues can take in raising local revenues. In the following three chapters we draw on the issues raised in these chapters to evaluate the main alternative local tax systems.

## **CHAPTER 6**

### **THE COMMUNITY CHARGE**

#### **Introduction**

From the 1990/91 budget year in England and Wales, and a year earlier in Scotland, the Community Charge — a locally-determined poll tax — has replaced domestic rates. The tax is levied on all adults over the age of 18, with the exception of a small number of exempt individuals, such as members of religious orders, diplomats and prisoners. Like domestic rates, the Community Charge has been accompanied by rebate arrangements which can provide benefit payments (Community Charge Benefit) of up to 80 per cent of the gross Community Charge amount, depending on the taxpayer's income and other circumstances.

The introduction of the Community Charge has been smoothed by various transitional provisions, of two main sorts. A system of 'safety nets' has been employed to reduce the impact of the changes in local authority financial resources as a result of the move from the rating system. Those local authorities which had benefited from substantial amounts of Block Grant for 'resource equalisation' purposes were helped through a system of inter-authority transfers to make only a gradual adjustment of local tax levels to reflect the new pattern of grant receipts. It was initially intended that the same gradual adjustment would also apply to authorities gaining from the new allocation of grant, although the requirement for them to contribute to the safety net after the first year was subsequently scrapped. The second transitional provision was a system of transitional relief for individual households through the Community Charge reduction scheme; this effectively limited the amount that any individual household could lose as a result of the transition from rates to the Community Charge to a certain maximum amount. Besides these planned transitional provisions, in the second year of the Community Charge the Government implemented a substantial £140 per head reduction in Community Charge levels in all authorities, financed by an increase in the VAT rate from 15 per cent to 17.5 per cent.

Despite these complex transitional arrangements, the first year of the Community Charge saw substantial changes in the local tax

payments of many households, reflecting not only a redistribution of the burden of local tax payments between different groups of households, but also a very large rise in the total amount of revenue that local authorities sought to raise from the local tax. Compared with the previous year, local tax revenues rose by some 30 per cent, equivalent to a rise of some 22 per cent in real terms. The reasons for this rise have been discussed in detail in an earlier IFS study (Ridge and Smith, 1990a); they appear to include, but by no means are limited to, a decision by some local authorities to accumulate reserves in a year when blame for extra taxation could be deflected onto central government.

As a result of this increase in local taxation, overall about three times as many households were paying more in local taxes in real terms in 1990/91 as were paying less (Table 6.1). In terms of household type multi-occupied households were, predictably, losers, but because of the rise in the average level of taxation, a majority of two-adult households also experienced increases in their real tax payments in 1990/91. However, probably the most substantial redistribution effect, even despite the operation of the safety nets, was regional. Half of all households in the Northern and North-West regions lost significant amounts, whilst in the South-East the proportion of gainers was higher although still less than the proportion of losers. Over the income range, whilst the rebate system provided substantial protection for many in the bottom income group, a high proportion of households in the middle of the income range made substantial losses. A small majority of high income earners paid significantly less in local taxes in 1990/91 compared with 1989/90, although for most households in the top income group the change in local taxes was only a small proportion of their income.

The increase in average tax levels in 1990/91 seems to have been a major factor in the unpopularity of the new tax. From a local authority perspective, however, it had the further disadvantage that it was a particularly difficult and expensive tax to administer. Apart from the difficulties caused by the national campaign of non-payment, the change created substantial administrative burdens which included the upkeep of registers, the number of relatively late changes to the system by the DoE, and the difficulty of collection from chargepayers on full benefit.

None the less although these immediate problems of the

TABLE 6.1

**Households Gaining and Losing in Real Terms from the Introduction of the Community Charge in 1990/91***Percentages of households, England, 1990/91 basis*

Percentages of:	Gain more than 2% of gross income	Gain between 1% and 2% of gross income	Gain or loss under 1% of gross income	Loss between 1% and 2% of gross income	Loss more than 2% of gross income
All households	6	8	46	19	20
One-adult households	17	16	55	7	5
Two-adult households	3	6	48	23	21
Three+ adult households	1	4	29	24	42
<i>Households in:</i>					
Northern and North-West regions	3	5	42	23	27
Greater London	13	13	48	15	11
South-East	9	10	55	14	11
Rest of England	5	7	44	21	24
<i>Households by quintile of gross equivalent income</i>					
Poorest quintile	3	8	58	19	12
2nd quintile	7	8	34	14	39
3rd quintile	8	5	34	23	31
4th quintile	7	7	44	26	15
Richest quintile	8	14	64	13	1

Note: Figures compare Community Charge bills in 1990/91 with rate bills for the previous year, uprated in line with the retail price index, for a sample of 4,530 households in England drawn from the 1986 UK Family Expenditure Survey. Calculated local tax payments are net of rebates, assuming 100% take-up. Row totals may not sum exactly to 100 because of rounding.

introduction of the Community Charge have prompted the review now taking place, it should not be dismissed on the basis of its transitional difficulties alone. It is likely that any restructuring of local finances on the scale of that which occurred in 1990/91 would have some teething troubles. It has been argued by some that if the Community Charge had been given time to settle then it might eventually have come to be accepted as a means of raising local revenues.

In the following sections we therefore consider the basic advantages and disadvantages of using a poll tax such as the Community Charge to raise local revenues. We also analyse some of the suggested modifications and amendments to the tax that have been advocated since its introduction.

### **Economic Efficiency**

Lump-sum taxes like the poll tax are typically regarded to be the most efficient taxes. The main benefits are that their imposition ought not to distort individuals' preferences between different goods and services. This is not to say that the poll tax does not affect behaviour. A lump-sum tax, with the subsequent effect of a loss in income it creates, could cause individuals to work harder or induce individuals to reduce their demands for some goods and services. Although a poll tax may be the most economically efficient tax it is very common to find that a trade-off exists between efficiency and equity.

### **Equity**

In terms of the distribution of tax payments across income groups, the Community Charge was regressive over much of the income scale. Figure 6.1 indicates that although the benefit system worked so that there was some progressivity over the lower income range, at household incomes above the third decile the proportion of household income paid in tax began to fall.

Is such a regressive tax desirable as the only means of financing local government from local residents? One view is that in relation to social and economic policy, the important issue is not whether an individual tax is progressive or regressive but whether the overall nature of the tax system is progressive (Foster, 1986). On this view the distributional incidence of the local tax is unimportant, since

social security rates, income tax allowances and tax rates can be adjusted to compensate.

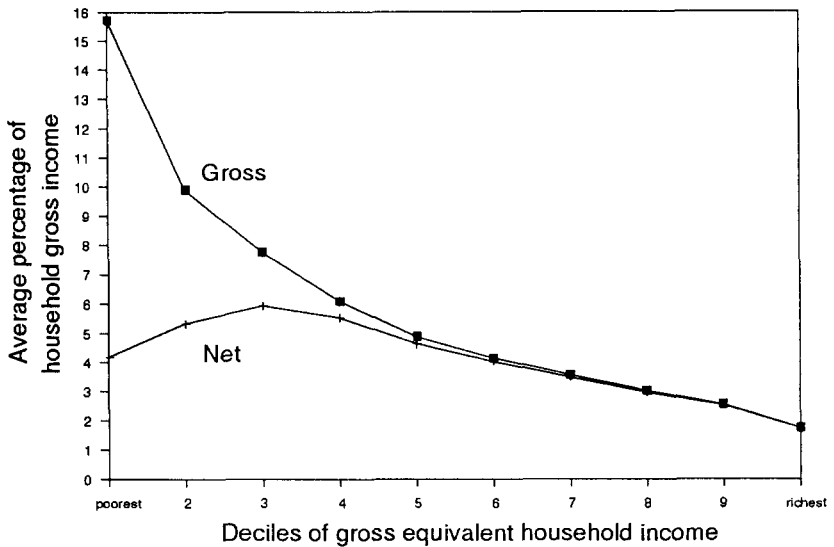


FIGURE 6.1  
Community Charge as a Percentage of Household Income

However, even if a government was prepared to make adjustments to the income tax system, offsetting adjustments could only be made to correct for the distributional effects of local taxes on average (Smith, 1988). Where local authority tax rates differ widely across the country, such average compensation may be inadequate. Households that are at the bottom of the income distribution but live in high-tax local authorities, for example, may face an appreciably higher tax burden from regressive local taxes. Rebates provide an alternative way to modify the distributional burden of a regressive local tax and unlike other forms of compensation can be related to local tax levels. However, they are administratively costly and can involve familiar problems of work incentives, the poverty trap and low take-up.

## Administration

It has always been recognised, both by the Government and by critics, that the Community Charge would be expensive initially, but the Government had argued that over time costs would tend

to fall as teething troubles, such as the disturbances caused by late changes to the system, were overcome. It quickly turned out that there were strong reasons for believing that costs would remain high and certainly higher than the collection costs for the rating system. A number of studies have argued that the high administrative costs of the Community Charge are inherent in the system itself (Ridge and Smith, 1990a; Audit Commission, 1990).

The registration process turned out to be complex and costly. Substantial resources were required not only for the initial registration, but also to keep registers up to date during the course of a year. It was reported that in some authorities annual turnover in the register had reached as high as 50 per cent.

Billing and collection were also expensive activities when compared with the rates. Of course, it was quite natural to expect a doubling of costs of billing and collection since the number of individual taxpayers approximately doubled with the transition from rates to Community Charge. However, in addition to this effect there was also a substantial increase in non-payment and evasion. In most cases, authorities were finding non-payment substantially higher than non-payment under the rates, and in the worst cases non-payment was as high as 20 per cent by the end of the financial year. These large increases in non-payment also had an effect on Community Charge levels in the following year as chargepayers had to make up the loss in revenues. This situation further weakened the relationship between spending and poll tax levels. The conclusion in the first two years of the Community Charge was that it was a difficult and expensive tax to collect and there were fears that the situation could worsen as the tax began to lose credibility.

## **Accountability**

One major aspect of 'accountability' discussed in the Green Paper has nothing to do with the Community Charge. The requirement that as local authorities increase their spending in real terms the tax burden of that extra spending will fall entirely on local taxpayers was achieved through the introduction of the uniform business rate and the system of lump-sum grants. The Community Charge itself did not contribute anything to this outcome.

Also, the attempt to promote accountability by extending the



number of local taxpayers from the 18 million households in England which were previously liable to pay domestic rates to all 36 million adult residents was partly achieved by a measure independent of the Community Charge, the abolition of scope for 100 per cent rebates. This provision, indeed, was introduced a year before the Community Charge, and operated along with the rating system.

The aspect of greater 'accountability' that the Community Charge contributed was through the individual tax bills received by each adult. As Smith (1991a) describes, individual tax bills might conceivably have two sorts of effect — improving the information that individuals have about local authority spending levels, and changing the incentives for them to vote for particular tax and spending levels. The informational advantages of individual billing depend on how close the relationship is between poll tax levels and local authority spending levels. The incentive effects of individual billing depend on households' budgeting arrangements; the assumption that household billing had no effect on the living standards of household members other than the one receiving the bill is unlikely to have been relevant to many households, especially those where some household members have no sources of income of their own, and for these households, individual billing may have little effect on incentives.

In practice, the information communicated about local authority spending levels through the poll tax has been poor. Poll tax levels have been poorly correlated with expenditures in the first two years in England, and instead have been very sensitive to changes in grant provision, safety netting and transitional arrangements. Figure 6.2 indicates that local taxpayers faced a wide range of Community Charge levels for any given level of spending above or below their standard spending assessment (SSA). At their SSA local authorities were assumed to set a Community Charge level of £278. The upward sloping line in Figure 6.2 indicates the Community Charge authorities would have set if there were no transitional elements; deviations of the actual charges set around this line indicate the influence of various transitional factors on charge levels in 1990/91. It could be argued, however, that all these factors, although influential in the immediate future, would diminish over time, thus allowing the informational benefits of the poll tax to eventually come through. However, some measures were unlikely to fully unwind for at least 10 years.

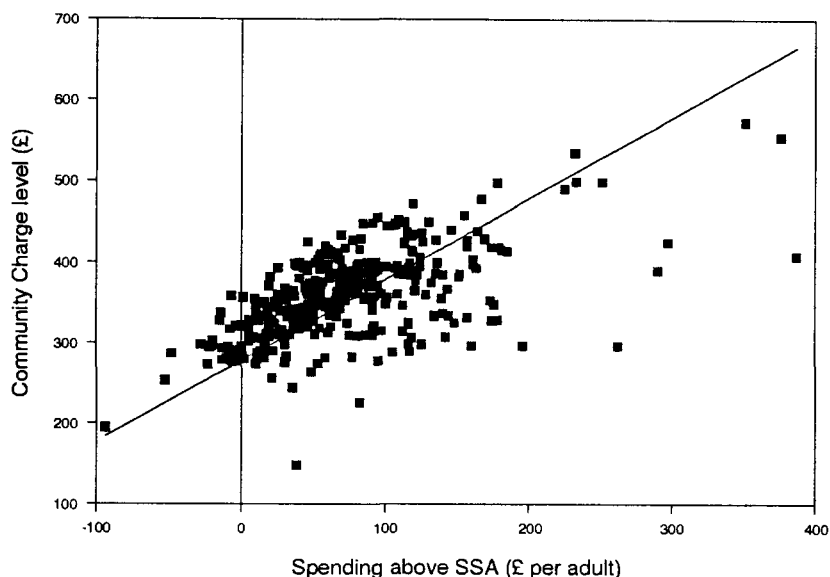


FIGURE 6.2  
Relationship between 1990/91 Community Charge Levels and Spending

However, there is a further aspect of the accountability argument to consider. An area where there has been debate is whether local tax payments should reflect the benefits that are received from local services. Clearly, there might be some concern if those on higher incomes are paying in local taxes more than the benefits they perceive they are receiving from local services. In these circumstances higher-income individuals — if they dominate in an authority — may have an incentive to vote for reduced local spending.

An ideal situation might be to impose a tax that is closely related to the benefits individuals receive from local services. In fact the Community Charge, as its title implies, was an attempt to act like a charge and thus reflect benefits. However, given that the charge for most adults was uniform in an authority, it followed that there was an assumption that benefits were in general distributed uniformly across chargepayers. Benefits of local services, however, are very unevenly distributed across the adult population. Even amongst non-redistributive local services, such as roads, planning, the police, etc., it is not obvious that the distribution of spending benefits is indicated by the number of adults (Bramley, Le Grand

and Low, 1989). The argument that Community Charge payments were related to the benefits that individuals derive from local services is not borne out by the evidence.

## **Modifications to the Community Charge**

There have been a number of suggested modifications to the Community Charge. These include changing the nature of the tax by relating payments to income through a banding system and exemptions. Other changes which keep the Community Charge in its original form include using it in conjunction with some other form of local taxation such as a property tax or local income tax, increasing benefit payments to chargepayers, or increasing overall government grant and increasing national taxes.

### *Banding*

Banding the Community Charge, so that individuals in different income brackets would pay different amounts, would require information about individual incomes which either could be assessed locally (an expensive approach) or would need the local tax system to be integrated with the Inland Revenue so that individual chargepayers can be matched to Inland Revenue records. Kay and Smith (1988), in a study of the various administrative options, indicate that the administrative costs of this type of modification to the Community Charge would be high, and could well exceed those of a local income tax. Further, the perennial problem with any system of banding is that if there are only a few bands then the payments will vary substantially between bands, which is likely to cause annoyance among chargepayers close to the band margins. Banding is also likely to cause poverty traps whereby increases in some individuals' income may lead to them facing high effective marginal tax rates. To avoid these problems the number of bands can be increased, but there is a point when increasing the number of bands would simply result in a system equivalent to a rather lumpy local income tax except that it would be far more costly.

### *Exemptions*

About 2 per cent of adult residents in Britain were exempted from paying the Community Charge. These individuals included disabled people, pensioners and visiting armed forces personnel

and diplomats. Throughout the first year of the Community Charge in England and Wales a number of arguments were put forward which suggested exempting non-working spouses from paying the Community Charge. Non-working spouses would have accounted for about 15 per cent of the revenues authorities received from the Community Charge, i.e. approximately £2 billion.

Although this might have been a popular move it would have contradicted the Government's earlier arguments about the fairness and accountability of the Community Charge. Fairness in the sense of the 1986 Green Paper would have been reduced because people receiving local authority services would not be making any contribution towards them, and accountability would have been diminished because some individuals who vote at local elections would not be contributing to local authority revenues. The gain from exempting non-working spouses would be that the Community Charge would have become slightly more related to ability to pay. In that there would be fewer people to register, the administrative burden and costs would have been slightly improved.

### *Extending Rebates*

A further possibility of relating the Community Charge to income would be to allow for more generous rebates, by extending the rebate system either so that larger rebates were paid or so that more households were included. Figure 6.3 shows two alternative ways of extending the rebate system. The 1990/91 Community Charge rebate scheme is illustrated by the solid line beneath the headline Community Charge line. We can see that households with relatively low incomes received 80 per cent rebate up to an income threshold level at  $t$ . Beyond the income threshold households began to lose rebate at a rate of 15 pence for each additional £1 of weekly income.

Figure 6.3 highlights two ways in which the rebate system could be modified so that a poll tax can be more closely related to income. The first change increases the income threshold, thus extending the income range in which households would be entitled to 80 per cent rebates. This change is represented by line A. The second change is represented by line B. This modification keeps the existing income threshold but works by reducing the rate at which benefit is withdrawn as households' incomes rise. It can be seen

that the ‘generosity’ of the rebate scheme is defined by the threshold and the rate of withdrawal, and can be affected by adjusting one or both of these factors.

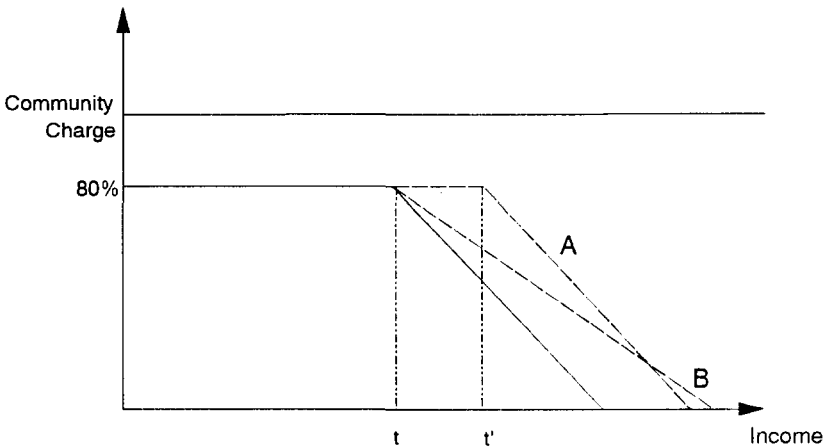


FIGURE 6.3  
Extending Rebate Eligibility

Extending the rebate scheme along these lines has a number of drawbacks. First, it would increase the number of relatively poor households facing a high marginal tax rate. Extending rebates by method B would reduce rates of withdrawal, but greatly increase the number of individuals whose marginal tax rates include an element of benefit withdrawal. Second, extending the scope of rebates would carry substantial administrative costs, of assessing individual entitlements to rebate, and of making payments. Since these costs are, in general, likely to be a function of the number of individuals entitled to benefit rather than the amounts of individual entitlements, option B is likely to increase these costs rather more than option A (Smith, 1991b).

In addition to these objections, extending rebates has the further drawback that it would not address the problem of non-take-up; local taxes would still bear particularly heavily on those who, for whatever reason, did not take up rebates to which they were entitled. Introducing some element of income graduation within the charge itself would avoid this problem.

## Conclusion

Four key features of the switch from rates to the Community Charge seem to have contributed to the hostile reception the new tax received.

- (i) There was a regional redistribution of the local tax burden, with bills rising in the North relative to the South, reflecting the abandonment of the resource equalisation provisions of the Block Grant, which had paid higher grants to areas with low rateable values.
- (ii) The Community Charge in its first year of operation was at a higher overall level compared with rates in the previous year. The average household local tax bill rose by 22 per cent in real terms.
- (iii) Individual billing, intended to promote 'accountability', made the new tax even more conspicuous to some local residents than the rates had been.
- (iv) The costs of administration were high, due to the difficulty of constructing and maintaining the Community Charge register, the doubling of the number of individual bills, and the difficulty of enforcing payment.

Although some of these difficulties relate mainly to the transition to the new tax, it has become clear that the administrative problems of the Community Charge are not simply a short-term phenomenon; in a country without universal population registration, a poll tax is neither easy nor cheap to collect. Moreover, although some of the various schemes that had been suggested for modifying the impact of the Community Charge on particular groups of households might have resulted in a tax better related to ability to pay, none of the modifications would have significantly eased the administration of the tax, and some could have made the administration problems worse.

## CHAPTER 7

### PROPERTY TAXES

#### Introduction

In Chapter 2 we described how local property taxation, besides being the principal source of tax revenue for local authorities in the UK up until last year, was also widely used in many EC countries as a method of raising revenue for local government. In this chapter we examine local property taxation in more detail, using the criteria for judging local taxes outlined in Chapter 5. We shall examine the effects of moving from the Community Charge to a local property tax under alternative equalisation assumptions. In addition, we consider the choice of tax base — i.e. capital value, rental value, site value and alternatives — and also some practical aspects related to the tax base, such as ‘banding’ and ‘beaconing’.

#### Economic Efficiency Arguments for Taxing Property

Since the early classical economists, strong theoretical arguments for the taxation of land have been advanced. Adam Smith (1776), in *The Wealth of Nations*, argued for the taxation of land on the grounds of economic efficiency and equity. The economic efficiency argument was that a tax on land rents could be imposed without any distortionary effect on actual levels of rent paid by tenants. Adam Smith argued that the burden of the tax would be borne entirely by landowners in terms of ‘diminished surpluses’ (lower profits). From the equity viewpoint it was argued that surpluses generally accrued to landlords as a result of ‘incidental circumstances’, and not as a result of private endeavour. For example, a landowner can have little influence over population growth or planning controls, but still benefit from increases in the demand for land and profits that might arise from them.

The arguments for taxing buildings are distinct from those for taxing land. The analysis of property taxation has to take into account that over time buildings can be removed, relocated, or property owners’ capital invested in other assets. That is to say that an economic analysis of property taxation must distinguish between short-run and long-run effects.

Elementary economic theory argues that, other things being equal, a tax imposed on the rent from property will in the short run lead

to diminished profits for property owners and will, therefore, have the effect of reducing property prices. The fall in property value as a result of imposing a tax is called tax capitalisation. In the short run full tax capitalisation is assumed to take place. This implies that the full burden of the property tax falls entirely on the current owners of the property. If property owners are unable to adjust to the changing tax circumstances in the short run, the property tax will not lead to changes in individual decisions, and hence will be non-distortionary.

However, in the long run the non-distortionary argument is weaker. The way that the burden of a property tax is distributed in the longer run can be significantly different from the short-run effects. Firstly, a distinction is drawn between the part of the tax that falls on land and the part that falls on property. Land in the long run remains in fixed supply and hence the short-run analysis is still valid. However, the part of the tax which falls on structures and buildings is treated differently. For example, one view of physical property is to regard it as only one asset in the portfolio of assets its owner may hold. With the post-tax return on physical property lower relative to other assets, property owners will choose to move into other assets, relocate, or invest less in their current stock of properties. The reduction in properties will have the effect of pushing up the rents of property to the point where the increased rents create a sufficient post-tax return for property owners such that they find it profitable to remain in their current locations. There is no tax burden on capital that is movable in the long run. What tax burden there would have been on such property in the short run is now fully passed on to the consumers of property.

Thus far, the analysis has dealt with purely competitive market situations. However, relaxing some of the assumptions allows further insight and indicates some important qualifications. For example, in the private rented sector where there is still some rent control, and with council properties and the Housing Association sector where supply is limited, rents are almost certainly below those that would prevail in the open market. In these cases landlords are in a position where (so long as the rent control legislation allows) they can pass on the full incidence of the tax to tenants — even in the short run.

An additional qualification relates to capitalisation of the benefits of public spending. The previous analysis chose to ignore any



benefits that might arise from the public spending financed by property tax revenues. This feature is important, for if individuals gain benefits from spending these may also be capitalised, but in the opposite direction to the way taxes affect property values. However, spending benefits are unlikely to be as closely tied to particular properties as the tax liability, and so the extent of expenditure capitalisation is likely to be less. Even if the costs of taxation were exactly equal to the benefits from public spending, property values would be more affected by the property tax.

There are, however, further economic arguments for taxing property in Britain. It has been argued by a number of commentators that the British tax system has been too favourable to property (King and Atkinson, 1980; Hughes, 1982). Three of the main ways property is favoured are through

- (i) tax relief on mortgages up to £30,000;
- (ii) the exemption from taxation of imputed income from owner-occupied housing;
- (iii) no indirect taxation of housing consumption.

The first two advantages apply to owner-occupied housing only, whilst the third applies to both rented and owner-occupied properties.

There is a strong economic efficiency argument that a tax on imputed income should be imposed so that a measure of horizontal equity with other forms of income can be reached. That is to say if an individual pays 25p in the pound in tax on income, then for the same level of imputed income from housing they ought to be liable to pay tax at close to the same rate. King and Atkinson (1980) and Muellbauer (1990) propose that the artificially low cost of owner-occupation resulting from the non-taxing of imputed income and the generous mortgage interest relief ought to be removed.

It has also been argued that the absence of tax on the consumption of housing encourages excessive consumption, and that the introduction of a tax on housing consumption would make the overall fiscal system more neutral in its effects on the pattern of household spending (King and Atkinson, 1980; Smith and Squire,

1987). If property is seen as a durable good from which 'housing services' are derived then the tax system ought to concentrate on treating it as if it were a good that is subject to indirect taxation through VAT. In the UK, indirect taxation, with very few exceptions, has for many years been set at a uniform rate of 15 per cent.<sup>1</sup> If this were to apply uniformly to property and the nominal rate of return on housing is 10 per cent a year then the annual tax rate on the capital value of property would be 1.5 per cent. The strength of this argument for property taxation is perhaps somewhat weakened by the fact that a number of other important items of consumption, especially food, domestic energy and public transport, are zero-rated for VAT, and thus, like housing, subject to no tax. The main justification for this zero-rating appears to be a distributional argument, that these goods constitute a significant proportion of the spending of poor households; it is clear that this argument could equally be applied to housing. Nevertheless, as Davis and Kay (1985) and others have argued, the use of the indirect tax structure for distributional purposes is a less effective way of achieving distributional goals than using the revenues from a neutral, single-rate VAT to support poorer households directly.

It is important to remember that each of these arguments does not necessarily extend to the use of varying local tax rates. In fact widely varying tax rates would weaken the case for property taxes on each of these arguments, and giving the power to raise property taxes to local government thus involves a trade-off between, on the one hand, the neutrality of the national tax system and, on the other, the value of employing a property tax for local government finance.

A further concern from the economic efficiency point of view is that whatever tax base is used for a property tax, there is almost inevitably going to be an uneven distribution of taxable resources across local authorities. As we indicated in Chapter 3, an uneven distribution of resources could possibly lead to differences in local tax rates which could encourage people to move, purely for tax reasons. To overcome this problem, equalisation grants would have to be introduced.

Equalisation grants would have the effect of setting tax rates, tax bills or tax burdens at the same level for similar levels of service from the local authorities. If individuals are likely to face the same tax burden for a similar level of service in whichever authority they locate themselves then the 'fiscal' incentives to migrate will have

been removed. However, an interesting by-product of introducing equalisation grants is that if the equalisation applies to tax rates, then tax rates are likely to be more clustered together than if allowed to vary in relation to the size of an authority's tax base. Tax rates clustered together clearly resemble far more the form of a desired national uniform tax rate than would be required for economic efficiency. Similarly, as Smith and Squire (1987) have argued, employing a property tax as part of a two-tax system of local finance (perhaps with the second tax being a local income tax) would lead to less dispersion in local property tax rates than if a property tax were employed on its own.

### **Equity Aspects of Property Taxation**

In the previous section we discussed the short-run and long-run incidence of a property tax. Determining the incidence of a property tax is important when determining how the burden of the tax is related to households' incomes, i.e. whether it is likely to be progressive or regressive. The previous analysis stated that in the long run landlords can pass on the full incidence of the tax to consumers of housing. In the past economists have suggested that this result would imply that property taxes are regressive.

However, this analysis is rather simplified as it does not take into account the fact that local authorities will more than likely be setting different property tax rates. Rather than looking at the effect of property taxation on one authority, a more recent view of property taxation<sup>2</sup> considers the wider effects of movements of capital invested in properties into other local authorities. For example, capital moving from a high-tax authority into low-tax areas will have the effect of increasing the supply of capital in low-tax areas (that is, increasing investment in housing). It follows that as the supply of property increases, rents will fall. Therefore, the return from property in low-tax areas will be lower simply as a result of an increase in property taxes elsewhere. The main point of this argument is that the extra tax on property in one area will have a negative effect on holders of property in all other areas. It is argued that because higher income groups tend to hold property income in greater proportions than lower income groups, local property taxation could be progressive.

Whether local property taxes are progressive or not when all incomes are taken into account is a difficult empirical issue to

resolve. However, what we can do is to consider the relative burden of a local property tax across income groups, by examining the short-run distributional incidence of such a tax.

Figure 7.1 shows that under the old rating system gross domestic rates were a regressive tax, meaning that the proportion of income paid in tax fell as taxpayers' incomes rose. The high degree of regressiveness led the Allen Committee (1965) to argue for the introduction of rate rebates to ameliorate the effect of rates on poorer households. Figure 7.1 shows that when we take account of rebates we see that rates had a mildly progressive region over low income groups but were regressive once rebates stopped taking effect. It does appear that whatever the tax base used for a local property tax, there will be an element of regressiveness about the tax. It is likely, therefore, that to mitigate this regressiveness a substantial rebate/benefit system will have to be employed alongside the local property tax.

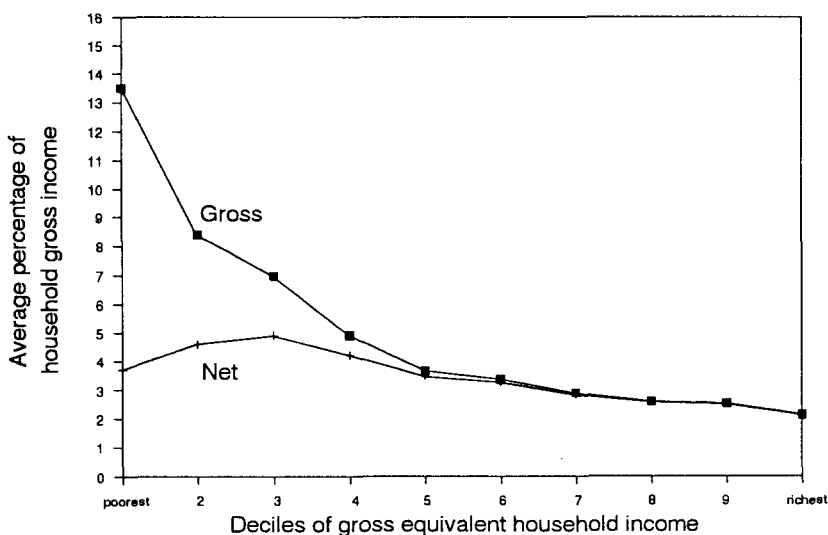


FIGURE 7.1  
Rates as a Percentage of Household Income

## Administration

Some of the strongest arguments (as the 1981 Green Paper recognised) in favour of using property as a tax base for raising

local revenues are the administrative ones. The principal difference between property and other tax bases is that property is in general immovable, and its yield is predictable. Not only is property immovable; it is also to a large degree easily identified and defined. Even where there are reliefs and derating for certain properties, the definitions — although not entirely unambiguous — tend to be clearer than those of different types of income, goods or people.

Further, whether the economy is going through a boom period or is in recession the revenue raised from a property tax will remain relatively stable. The reason for this stability is related to the relative freedom of the taxing authority to choose the tax rate. For example, in a period of high inflation it is fairly easy to increase the yield from property taxes so that revenues remain constant in real terms by increasing the tax rate proportionately. The relative stability of revenues is an important feature of a local tax, given that local authorities have to balance their budgets each financial year. If their tax revenue is buoyant, as might be the case with a local income tax, then in a year when revenues are unexpectedly low the local authorities could encounter financial difficulties with the prospect of an unbalanced budget.

There are a number of additional advantages of property taxes which are prominent at the local level. These were set out in the *Layfield Committee Report* in terms of what the Committee regarded as the ‘classical defence of rating’. In brief, it argued that the main administrative advantages were that:

- (i) there was no difficulty in attributing the yield even to the smallest units of local government, since this yield depends on the physical location of immovable property;
- (ii) the form of tax is relatively simple and understandable, however difficult it may be to comprehend the minutiae of the system;
- (iii) there has traditionally been considerable stability in the operation of the rating system with relatively small changes from year to year;
- (iv) evasion is extremely difficult;

- (v) the cost of maintaining rating is low in proportion to the yield;
- (vi) there are no problems of confidentiality of the taxpayer's personal income or circumstances except in using a rebate system.

Clearly, the case for rates on administrative grounds is very strong and probably not surpassed by any other form of local tax examined in this report.

### **Accountability**

The Layfield Committee maintained that rates enhanced accountability. It argued that rates were a perceptible tax, with the rate demand, expressed either as a lump sum or over shorter intervals, bringing the tax prominently to the notice of ratepayers. Given that rates were perceptible, and because the equalisation system was set so that decisions had to be taken to raise rate poundages on all ratepayers to meet increased costs, the tax promoted accountability.

On the other hand, in the 1986 Green Paper, the Government's main objection to the domestic rating system was that it lacked accountability. The Green Paper, in pointing out that only half the electorate received a bill for local taxes under the rates, argued that there were incentives for those individuals who 'do not pay rates at all' to vote for higher spending. This argument, however, is open to criticism, in particular in the way the Government perceived how tax burdens and incomes are shared within households. Smith (1991a) questions whether the concept of a household of the type where the tax bill 'sticks' with the individual who receives the bill is not an oversimplification. Clearly, there are likely to be many types of household where members of the household decide to share their local tax burden.

### **Replacement of the Community Charge by a Property Tax**

In the following we describe what the effects would be on local authorities and households in England of replacing the Community Charge with a local property tax, assessed on existing rateable values. The analysis is revenue-neutral in that in total local authorities would be raising the same amount of revenue from both local taxes, some £8.7 billion in total, before rebates are taken into

account. This corresponds to the revenues currently being raised from the Community Charge, after the reduction of £140 per head announced in the 1991 Budget, and would imply a country-wide average headline Community Charge of £250 and an average property tax bill of £475.

In Chapter 3 we outlined the economic efficiency and equity arguments for using equalisation grants. Equalisation grants are particularly important in the case of property taxes. Under the rating system more grant was distributed to local authorities which had relatively less rateable value in their areas. In order to develop a formula for distributing grants, central government set out a schedule for rate poundages. As a local authority increased its service provision it could see what rate poundage the Government assumed it would be setting. In effect if all local authorities provided similar levels of service it was assumed that they would be setting the same rate poundages. For local taxpayers this meant that individuals with properties of similar value although living in different authorities (which were supplying similar levels of service) would receive broadly similar rate bills.

Table 7.1 shows the average property tax bill in each of the English regions on two different bases, one with resource equalisation based on rateable value, and the other when no equalisation is assumed. The latter assumption requires that each authority raise the same amount in property tax as it would do under Community Charge. Table 7.1 indicates that the main beneficiaries of a scheme that equalises rateable value in the way described would be the authorities in the Northern regions.

TABLE 7.1  
Average Annual Property Tax Bills

*England, 1991/92 basis*

	Resource equalisation based on rateable value	No resource equalisation
North	395	546
North-West	431	511
Yorks and Humberside	350	552
East Midlands	478	603
West Midlands	402	486
East Anglia	388	412
Greater London	810	589
South-East	500	458
South-West	367	424

The Layfield Committee in its report criticised the above method of resource equalisation, arguing that rateable value was not the best way of measuring taxable resources in an area and that a better approach would take account of personal incomes as well as rateable values. The committee's view was that full equalisation could be carried out on this basis (see also Cripps and Godley (1976)).

In Tables 7.2 and 7.3 we summarise the distributional impact on households of the alternative equalisation scenarios. Table 7.2 shows the gainers and losers of a revenue-neutral replacement of the Community Charge by a local property tax with resource equalisation based on rateable values. Overall, 22 per cent of households will gain and 18 per cent lose from the switch to this form of local property tax, leaving 60 per cent of households neither significant gainers nor significant losers. In examining household composition the gainers are multi-occupied households; over two-fifths of these households are likely to gain from a switch to local property tax. The losers are mainly one-adult households, with again about two-fifths of such households making significant losses.

As would be expected from the results in Table 7.1, households in the North and North-West regions have the most gains with 40 per cent of households experiencing significant reductions in taxation, compared with the Community Charge. The losers are in the South-East and Greater London, both areas with relatively high rateable values. Although in most cases the introduction of a property tax with full equalisation would simply reverse the pattern of gainers and losers from the introduction of the Community Charge, many households in the London authorities, particularly in Inner London, will find their property tax bills relatively higher than they previously experienced under the rates. This reflects the fact that rate bills in the past were kept artificially lower in London by the use of multipliers set by central government.

Across incomes the gainers will tend to be clustered in the lower to middle parts of the income range. The poorest households will not benefit so greatly given that they are already protected from high Community Charge payments through the rebate scheme. The richest households will experience the greatest losses with over 20 per cent of households in the top fifth of households paying significantly more in local taxes.



TABLE 7.2

**Households Gaining and Losing from Revenue-Neutral Replacement of Community Charge by a Property Tax,  
with resource equalisation based on rateable values**

*Percentages of households, England, 1991/92 basis*

Percentages of:	Gain more than 2% of gross income	Gain between 1% and 2% of gross income	Gain or loss under 1% of gross income	Loss between 1% and 2% of gross income	Loss more than 2% of gross income
All households	8	14	60	11	7
One-adult households	1	4	52	22	20
Two-adult households	8	15	67	8	2
Three+ adult households	15	29	49	4	1
<i>Households in:</i>					
Northern and North-West regions	16	24	53	5	3
Greater London	4	5	46	22	23
South-East	2	7	71	13	7
Rest of England	16	17	61	10	4
<i>Households by quintile of gross equivalent income</i>					
Poorest quintile	8	9	66	10	5
2nd quintile	15	21	41	11	11
3rd quintile	11	21	51	9	8
4th quintile	2	17	64	11	5
Richest quintile	0	3	76	15	6

Note: Figures are net of rebates, assuming 100% take-up. Row totals may not sum exactly to 100 because of rounding.

In Table 7.3 we assume that local authorities individually will be required to raise the same amount in revenue from a property tax as they had previously under the Community Charge — in other words, there is no resource equalisation. There is very little difference in the gains and losses by household composition or by income quintile between Tables 7.2 and 7.3. Whether there is full equalisation of rateable values or no equalisation will have very little impact on who gains or loses in terms of type of household or the impact on different income groups. Where there are significant differences is in relation to region. With central government not assisting authorities with a low resource base, and given that these authorities are situated mainly in the North and North-West, it follows that the gains by households in the Northern authorities made in Table 7.2 will be substantially reduced. Conversely, the losses made by authorities in London and the South-East will also be reduced.

## **Valuation**

We have already suggested that there are strong economic reasons for reintroducing a property tax. The economic arguments support a local form of property tax where the valuations of property reflect the economic benefit individuals derive from the occupation of their properties. It is, therefore, crucial that the principles on which any valuation of property is based should reflect this view.

Prior to 1990 the domestic rating system attempted to reflect property value by collecting rental evidence on properties. It was required that the rent at which a property might *reasonably* be let in the open market should be represented by the gross value of a property. Broadly speaking net annual value was derived from the gross value after the costs of repair and maintenance, etc. were taken into account. The rateable value of a property, i.e. the basis of the rating system, was in the general sense the same as the net annual value. However, a considerable difficulty with using rental values, particularly in the post-war period, was the declining body of evidence on rent levels. The reduction in the private rented sector to less than a 10 per cent share of all housing tenure types meant that it was difficult to find rental evidence in certain areas and for certain types of property on which to base the valuations. In addition, ratepayers had difficulty in understanding the valuations on which they were due to pay tax given that in the

TABLE 7.3

**The Implications of Non-Equalisation of the Property Tax Base:  
Households Gaining and Losing from Revenue-Neutral Replacement of Community Charge by a Property Tax  
(without equalisation)**

*Percentages of households, England, 1991/92 basis*

Percentages of:	Gain more than 2% of gross income	Gain between 1% and 2% of gross income	Gain or loss under 1% of gross income	Loss between 1% and 2% of gross income	Loss more than 2% of gross income
All households	7	13	61	12	7
One-adult households	1	3	52	24	19
Two-adult households	7	13	69	8	2
Three+ adult households	15	29	50	3	2
<i>Households in:</i>					
Northern and North-West regions	8	13	55	14	10
Greater London	9	11	58	12	10
South-East	3	10	74	9	5
Rest of England	7	15	59	12	7
<i>Households by quintile of gross equivalent income</i>					
Poorest quintile	8	7	66	14	5
2nd quintile	14	20	45	9	12
3rd quintile	9	18	54	10	8
4th quintile	2	15	66	11	5
Richest quintile	0	3	76	14	6

Note: Figures are net of rebates, assuming 100% take-up. Row totals may not sum exactly to 100 because of rounding.

absence of continual revaluation they were likely to differ substantially from the actual rents paid by tenants.

Alternatives to the rental basis of valuation have been put forward. These include capital value and site value rating which would be alternative forms of assessment reflecting a market situation. Other suggestions attempt to simplify administration by using more *ad hoc* processes; these would include basing assessments on just one indicator or on a basket of indicators. We briefly examine these approaches in the following.

### *Capital Value Rating*

The arguments in support of capital value rating are persuasive. In terms of evidence on values, there is substantial information available to valuers on open-market selling prices. These values would reflect the market situation better than rental values. Further, owners would have a better understanding of the rationale behind capital value assessments, given that they are likely to know roughly the expected open-market selling price of their property. The costs of capital value rating are unlikely to differ significantly from the costs of valuations based on rental values, given that staff requirements and the methods used are unlikely to vary substantially.

None the less capital value rating does have its critics. It has been argued that house prices are too volatile a measure for stable local authority financing, and capital value rating would lead to burdensome taxes on local taxpayers. There are in our view adequate responses to each of these arguments. As far as volatility is concerned, this can be resolved by a valuation method that relates to some historical point, say a year earlier. As for the argument that rising house prices would make a tax based on capital values more burdensome than any other tax, we think the argument is simply mistaken. In the first place, whatever happens to property values, the values are basically being used to share out the burden of paying for local government, and if all values rise equally, the amounts paid by all taxpayers would be expected to remain the same. Rate poundages would be adjusted after each revaluation so that the total amount raised by local authorities from the domestic sector would remain relatively constant. If values rise by different amounts in different places, local taxpayers will find that their tax payments will respond to changes in the distribution of capital values — i.e.

relative changes — and not to changes in the absolute level of capital value.

In discussions of how valuations might be conducted under a new property tax, concepts of ‘banding’ and ‘beaconing’ have been proposed, for two distinct purposes.

First, it has been suggested that the inevitable imprecision of any valuation technique might matter less if, rather than precise monetary valuations, properties were simply one of a limited number of categories, reflecting bands of property value or particular standard types of property. Banding of property values would, in most cases, allow for small changes in the value of properties without any change in the property tax which they would be charged; minor home improvements might thus bear no penalty in terms of extra tax liability. With the beacon approach, typical examples of standard types of property would be chosen as ‘beacons’. Properties would be matched to the relevant beacon, and the appropriate assessment would then be applied to the property.

Both these approaches would simplify valuation for many properties, but would involve difficult decisions at the margin of each category, made worse than in conventional ‘continuous’ valuation by the substantial tax penalty or gain that would be associated with assignment to one band or beacon rather than another. We think it an open question whether these approaches would reduce the overall costs of valuation; the greater simplicity for some valuations could be outweighed by the costs of appeals and arguments at the margin.

The second purpose for which banding or beaconing might be used, however, is to update the register of property values, so as to avoid the sudden jumps and adjustments in values which arise when valuations are conducted only periodically. Property values might be adjusted on an annual basis, each in line with estimates of the value for the appropriate band or beacon property, allowing for approximate adjustments to take place smoothly in between main revaluations. We think there is a lot to be said for doing this, to minimise the political costs associated with periodical revaluations.

## *Site Value Rating*

Unlike the schemes of rating so far considered, which would tax both land and buildings, site value rating seeks to tax only land values, and not the value of buildings. The value on which land would be assessed is not its value in its current application, but its value under the most profitable permitted development of the property. The principle behind site value rating is thus that taxes should be levied on the *potential* income which would arise if the land was most profitably utilised (Prest, 1981).

The main benefit from this approach would be that the tax would not discourage the development of buildings on any site, since the buildings themselves would not be taxed. Site value rating, where the valuation is based, not on the current use, but on the most profitable permitted use, would also not provide any disincentive to improve land. In fact the converse would apply and there would be an incentive to develop land so that it reached its maximum potential income. There are, however, important practical difficulties with site value rating. As with rental valuation, there may be little market evidence on site values in some areas, and public understanding of the system is likely to be poor.

Valuations could also change sharply for reasons 'external' to the taxpayer's own circumstances. For example, neighbouring developments or re-zoning for planning site purposes could sharply increase the site value of domestic properties, although they might have little or no effect on their value as housing. The economic arguments for allowing the values for taxation purposes to reflect these changes in site values, when the capital value of the property remains unchanged, are certainly debatable, and the public acceptance of shifts in valuation from this source may well be poor.

## *Alternative Methods of Property Tax Assessment*

More recently, alternative methods of calculating the tax base for a property tax have been suggested, including rebuild value, number of rooms, or the square footage of a dwelling. There seem to be three possible justifications for considering the use of such indicators to calculate the tax base.

One, which we believe to be incorrect, is that a calculation based

on square footage or the number of rooms would constitute a cheap and quick approximation to the value of different properties, enabling the tax to be introduced quickly, without the need for a lengthy and costly revaluation. Using rebuild costs and/or square footage as indicators of value would leave out a host of economic, demographic and locational factors which ultimately determine the value of a dwelling.

A second justification would be that a calculation based simply on indicators of rebuild costs and physical attributes of the property would provide a measure of housing value that varied less between different parts of the country than any measure of rental or capital value. Complex equalisation arrangements within the central government grant would then not be necessary to ensure that the tax burden for similar spending did not vary across the country. This argument is probably true although not compelling. It will be noted that it derives much of its effect from the omission of the site value from the calculation.

A third justification would be that such physical attributes might be desirable as a supplement to an assessment based on values, to adjust values to reflect other aspects of the ability to pay of the residents or their consumption of local services. Whilst we can see many circumstances in which property taxes based on property values would not reflect either ability to pay or service use, this is not necessarily a reason for wishing to tinker with the tax base, using various *ad hoc* adjustment factors which could cause as many anomalies as they resolve. The arguments set out above for a property tax are arguments for a tax on property *values*, to reflect, in particular, the absence of taxation elsewhere on the value of housing consumption. Where the use of such a tax conflicts with other objectives, such as those regarding income distribution, the rebate system provides a more appropriate vehicle for adjustments to the tax burden, targeted to the precise circumstances of individual households.

## **Conclusion**

A local property tax would be relatively easy to administer. Unlike people, properties are, at least in the short run, immovable. Capital value rating is probably the best valuation method when compared with the alternatives. The benefits from capital value rating, such as the availability of market evidence and clearer understanding by

the public, make capital values a better option than either rental value or site value rating. Simpler methods have been suggested, but there is some concern that the lack of relationship between market valuations and valuation for rating purposes will undermine the economic arguments for property taxation.

One of the disadvantages of using a property tax as a source of local finance is that varying local tax rates weakens to some extent the economic arguments for a property tax. However, this criticism is mitigated substantially if an equalisation system is introduced which attempts to equalise capital value. Under this system tax rates — rate poundages — will be clustered far more tightly around the average than if there is no equalisation. Other concerns about local property taxation relate to its high degree of regressivity, which will be a particular problem where the system of local government finance requires large amounts of revenue to be raised from the tax, at widely-differing rates. High burdens of local property tax on low-income households will involve the need for an extensive rebate system.

#### NOTES TO CHAPTER 7

1. Raised to 17.5 per cent in the 1991 Budget.
2. Referred to sometimes as the 'new' view and put forward by Harberger (1962) and Mieszkowski (1972).



## CHAPTER 8 LOCAL INCOME TAX

### Equity

A local income tax would involve a very different pattern of tax payments by households from either the rating system or the Community Charge. As Figure 8.1 shows, the patterns of domestic rates and Community Charge payments across households, after rebates, were very close; the main difference was that slightly less tax, as a proportion of household income, was levied from the richest households under the Community Charge than under rates. The differences are, however, slight when compared with the pattern of payments of a local income tax. With a local income tax, lower-income households would pay much less than with either of the other two taxes, even taking into account their entitlements to rate rebates and Community Charge rebates, and better-off households would pay much more.

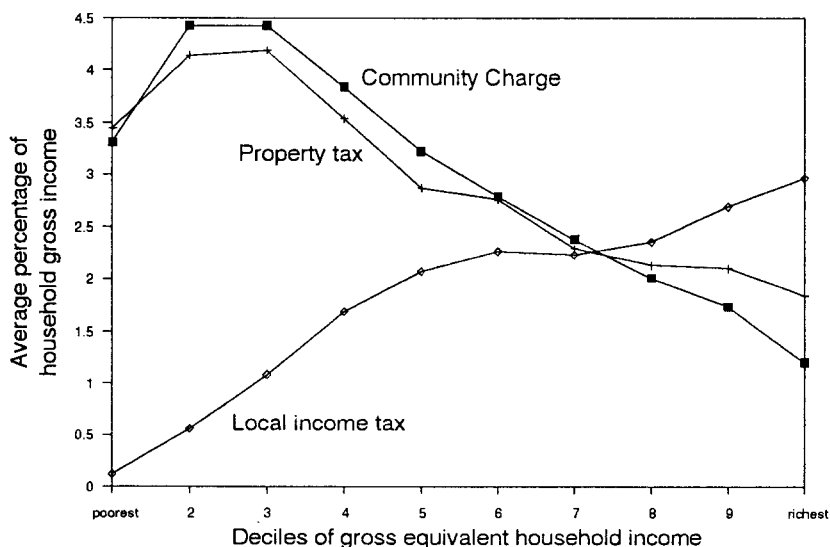


FIGURE 8.1  
Local Income Tax, Property Tax and Community Charge after Rebates

Moving from the Community Charge to a local income tax would involve substantial gains and losses across households. In Table 8.1 we show the pattern of household gains and losses according to household type, region and income range, based on calculations

using the same sample of households from the UK Family Expenditure Survey studied in earlier chapters, and estimates of the local income tax rates they would pay. It is assumed that the local income tax would raise the same total revenue as the Community Charge does at present, *net* of rebates (since rebates would be unnecessary with a tax with such a highly progressive incidence).

Table 8.1 shows that the distributional effects of moving to a local income tax are far more substantial than any of the property tax scenarios discussed in Chapter 7. It can be seen that about half of all households will gain from a local income tax compared with significant losses confined to about one-fifth. Across household type there are substantial losers and gainers in all types of households, although single-adult households have in percentage terms the most large gainers and losers. There is a slightly more systematic pattern when we consider regions. Households in the North and North-West will gain proportionately more than households elsewhere. There are more losers amongst households in the South, with particularly large losses in London, where 25 per cent of households would lose more than 2 per cent of their gross income by a move from Community Charge to local income tax.

However, the most dramatic gains and losses are across the income range. Poorer households would gain substantially from a local income tax. Table 8.1 indicates that 90 per cent of poorer households would gain from a move to local income tax. As we move up the income range household gains diminish and losses increase. This is in contrast to a move to a local property tax which indicated that it was households in the middle income ranges that would benefit most. Many of the top 20 per cent of households would face, however, substantial losses from a move to a local income tax. Over 30 per cent of these households would find their gross incomes declining by more than 2 per cent.

### **Economic Efficiency**

In terms of equity, a local income tax would relate local taxation more closely to the most obvious indicator of local residents' ability to pay — their income. This, however, brings with it a new range of problems to do with economic efficiency, especially to do with the incentives for individual migration. High-income households, in particular, may be able to reduce their tax payments substantially

TABLE 8.1

## Households Gaining and Losing from Revenue-Neutral Replacement of Community Charge by a Local Income Tax

*Percentages of households, England, 1991/92 basis*

Percentages of:	Gain more than 2% of gross income	Gain between 1% and 2% of gross income	Gain or loss under 1% of gross income	Loss between 1% and 2% of gross income	Loss more than 2% of gross income
All households	32	18	32	9	8
One-adult households	42	14	20	10	14
Two-adult households	31	19	33	9	7
Three+ adult households	21	22	44	9	4
<i>Households in:</i>					
Northern and North-West regions	42	19	26	6	7
Greater London	31	10	22	11	25
South-East	22	19	41	12	6
Rest of England	34	20	32	8	5
<i>Households by quintile of gross equivalent income</i>					
Poorest quintile	72	17	10	0	0
2nd quintile	63	21	15	1	0
3rd quintile	19	25	48	6	2
4th quintile	5	22	44	19	8
Richest quintile	0	6	41	19	33

Note: Figures are net of rebates, assuming 100% take-up. Row totals may not sum exactly to 100 because of rounding.

by moving to areas where the tax rate is lower. This in turn will tend to accentuate the difference in tax rates, since the low-tax area will benefit from a higher tax base (although a system of full resource equalisation could offset this). Migration of this sort, purely for tax reasons, may be regarded as undesirable.

In practice, migration is unlikely to be a serious problem in most of the UK, since local authorities cover relatively large areas, and household decisions about where to live will be affected by many other factors besides fiscal considerations. However, in some urban areas a 'flight to the suburbs' by the rich may be a danger. It could probably be kept within reasonable bounds if the local income tax applied to incomes only up to a certain threshold, such as the higher rate threshold for the national income tax, and incomes above this were taxed at a single national rate.

There have also been suggestions that 'fiscal migration' would be substantially reduced if only the largest authorities — counties, or even new regional authorities — were allowed to implement the income tax. However, this solution would require either some form of revenue-sharing process among the lower tiers or alternatively it would require that lower-tier authorities raise revenues in an alternative way.

Because the local tax burden would be more closely related to local taxpayers' ability to pay, a system based on local income tax would permit a greater proportion of local spending to be financed from local taxes. This difference compared with the revenue-raising capacity of either rates or the Community Charge could have important implications for the way that local government functions. Reducing local government's dependence on financial transfers from central government would be likely to increase the autonomy of local government, and to reduce central government's ability to impose its objectives on lower levels through the grant distribution. The Layfield Committee's view was that, if a greater degree of autonomy was regarded as desirable, local authorities should rely substantially less on central government grants, and that in addition to the rates the local tax base should therefore be increased to include a local income tax. However, as the Layfield Committee recognised, it is clear that this is not an unconditional argument for a local income tax; the merits of a local income tax cannot be considered independently of considering the type of local government system that is sought and

the degree to which central control is regarded as desirable or destructive.

## **Administration**

Unlike a property tax or poll tax which would normally be administered and collected at the local level, a local income tax could be integrated entirely within the national tax system. Alternatively the administrative and collection responsibilities could be shared between the Inland Revenue and local authorities, or local authorities could even, conceivably, run a local income tax system independent of the national tax system. In this section we examine the administrative difficulties a local income tax might face and consider four alternative models of local income tax which could be considered in the UK.

### *Fully Integrated Local Income Tax*

A local income tax fully integrated into the national income tax system was put forward by the Layfield Committee. The fully-integrated system would allow local authorities to set their own local income tax rates. The Inland Revenue would be informed of each local authority's tax rate by a given date. The Inland Revenue would then pass on the information on local income tax rates to employers by applying a suffix to the PAYE code number of each employee in the firm. To be able to calculate the amount of tax to be paid by each of their employees, employers would receive sets of PAYE tax tables which would incorporate both local and national income tax rates. The suffix to the employee's code would inform the employer which PAYE table to use in each case.

The PAYE system, however, does not give the Inland Revenue all the information required to tax individuals' *total* incomes. Large numbers of employees will have earnings from investments and other sources, which are currently often taxed at source. To levy a local income tax at source on the income from investments would require identifying the place of residence of each building society investor, bank depositor and shareholder, which is likely to be impracticable; on the other hand to tax such income on the basis of individual tax returns would forgo the administrative simplicity of the present arrangements for investment income taxation. To overcome the difficulties of applying a local income tax to investment income it is suggested that investment income ought to

be taxed at a single rate, i.e. the average of all authorities' local income tax rates.

It was argued at the time of the Layfield Report that if all local authorities currently setting their own local taxes were to set local income tax rates then the amount of PAYE suffixes and the resulting complicated tax tables may be too severe a burden on employers. Suggested modifications to ameliorate this problem are to reduce the number of authorities that can set local income tax rates or to allow authorities to choose from only a limited 'menu' of tax rates. For example, one might allow only non-metropolitan counties, metropolitan districts, London boroughs and Scottish regional councils to set local income tax rates. This would reduce the number of suffixes by 75 per cent and in many cases outside the urban areas employers could be dealing with only one or two PAYE suffix codes. In practice, the automation of payroll procedures in the past decade has largely disposed of the need to limit the number of tax tables and codes.

Much of the complexity of the present system reflects the 'employer-based cumulative and self-adjusting system of deduction'. This means that the system attempts to match exactly the tax deducted from week to week or month to month with the actual amount the individual is liable for, without reference to the individual taxpayer. Even at the end of the financial year there is rarely any need to contact the taxpayer to make an adjustment, and in fact adjustments such as rebates can be made through the employer. This aspect of the present system means that it can operate with little contact with the majority of taxpayers; only a small minority, mainly those with complex tax affairs, are required to fill in a tax return in any given year. Whilst this allows some administrative saving compared with a system where taxation is based on universal tax returns, it also introduces complexity and cost for both employers and the tax authorities in handling job movers and other taxpayers whose circumstances change. It also severely constrains the degree of complexity in the income tax structure that can be accommodated; the complex progressive rate structure operated by most other countries would be difficult in the UK, and, similarly, introduction of a local income tax would — even with the recent advances in computerisation — add more to the administrative costs of the UK system than to those of systems which do not aim at exact cumulative deduction. Local income tax would look considerably more attractive if it were introduced at the

same time as a move to a system of assessment and deduction at source more like those operated in other countries. We discuss the implications for a local income tax of reforming the tax system in such a manner below.

### *Integrated Local Income Tax with Year-End Assessments*

A second approach to local income taxation would require the simultaneous introduction of major changes to other aspects of the UK tax system. A major reform to the tax system which would simplify the operation of a local income tax would be to introduce year-end assessments based on the issue of tax returns to all taxpayers. The main benefit of year-end assessments would be that the Inland Revenue would then receive annual information about taxpayers' total income, i.e. PAYE and income from investments, which would allow investment income to be taxed at the relevant local income tax rate as opposed to the average rate, and which could ease the complexity of PAYE with many local tax rates, by permitting end-year adjustments of tax paid.

The introduction of year-end assessments would allow the Inland Revenue to make approximate deductions through PAYE from employees' pay throughout the year. An approximate deduction rate might be set slightly above the average rate so that the majority of taxpayers would overpay during the year and would, therefore, have an incentive to promptly complete their annual income tax return. With a single tax rate set above the average the burden of complex tax tables and numerous suffixes will be removed from employers; adjustment reflecting the differences in local tax rates would be handled at the end of the year. It follows that year-end assessments with a single rate throughout the year would make it easier for lower-tier authorities to set local income tax rates.

### *Local Authority Local Income Tax with Year-End Assessments*

A third approach is to allow local authorities to use information on incomes provided by the Inland Revenue. This would only be really practicable if the Inland Revenue were to move from the present schedular income tax and cumulative PAYE to a system based on end-year assessment. The local authority would then set its own tax rate, bill on the basis of income information supplied by the Inland Revenue, and collect from local income taxpayers in much the same way as at present. The benefits of this approach are that

perceptibility would increase through separate billing, there would be no restriction on lower-tier authorities setting local income taxes, and there would be no involvement of employers at all.

A difficulty with this form of local income tax is that it could not easily be based on current incomes. Taxpayers would be liable to pay bills on assessments that could be out of date. For example, if a taxpayer's income were to fall substantially just after assessment as a result of illness or unemployment then hardships could ensue.

A further concern relates to the confidentiality of income information held by the Inland Revenue and whether it ought to be passed to local authority officials who work in the area that the taxpayer resides in. This is a particularly contentious issue. Nevertheless, it ought to be kept in mind that many local authority officials are currently required to deal with the information about incomes and individual personal circumstances that is required from benefit applicants.

#### *Local Authority Level Local Income Tax*

The fourth alternative is to allow local authorities to administer, bill and collect a local income tax independent of the national tax system. This system could be specified exactly to local authorities' needs, i.e. it would be independent of any national budgetary decisions on thresholds, allowances, etc. It is also likely to be the most perceptible type of local income tax. It would clearly be a costly option, however.

The present system of local tax rebates requires local authorities to make an assessment of income for each benefit claimant. Such an income assessment partly duplicates any income assessment made for national income tax by the Inland Revenue; it cannot draw on Inland Revenue data, and the local authorities making the assessment do not have the range of resources or legal powers at the disposal of the Inland Revenue. A completely locally-administered income-related local tax would, in effect, extend this operation all the way up the income scale. The costs of extending the number of assessments are likely to rise more than in proportion to the number of individuals covered, since the types of people who will be brought within the scope of the assessments will be those for whom assessment and administration are costly and complex. They will include a greater proportion of people with



earnings from employment or self-employment than existing claimants, adding to the duplication of operations already undertaken for the national income tax. On the other hand, it is unlikely that the cost of local assessment for all individuals would be as high as the costs of the Inland Revenue's own assessment and enforcement operations; Kay and Smith (1988) point to a number of costly enforcement activities of the Inland Revenue which would not need to be duplicated by a parallel system.

## **Conclusion**

A local income tax would mark a major departure from the local taxes so far employed in the UK. Tax levels would be much more closely related to household incomes, with the result that the overall distributional incidence of the tax would be progressive over the whole of the income scale. There would be a major redistribution of the local tax burden, with substantial gains and losses amongst different groups of households.

The closer relationship of tax payments to income brings with it both problems and opportunities. The main problem that might be encountered is the risk of a 'flight to the suburbs' by high-income taxpayers moving to authorities with low tax rates, although this could be kept within bounds by restricting the locally-variable tax rate to the basic income tax rate band only. One important opportunity that a local income tax would provide is that, unlike rates or the Community Charge, it could be used to raise a much larger proportion of local authorities' revenue needs, thus reducing the importance of central government grant. If greater local autonomy from central government is sought, a local income tax would seem to have major attractions.

However, it is clear that the administration of a local income tax could not be introduced quickly. Perhaps the best option — the second of those outlined above — would require major reforms to existing income tax administration, based on the introduction of universal end-year assessment, and this would require time. As far as administrative cost is concerned, the impact of a local income tax is difficult to assess. There would be important savings on rebate administration (since a local income tax would not require rebating), and there are reasons to believe that the identification of local taxpayers would be considerably cheaper than Community Charge registration.

## **CHAPTER 9**

### **CONCLUSIONS**

The current public debate about the replacement of the Community Charge has been dominated by considerations of short-term political advantage. In this report we have attempted to widen the discussion and assess the range of possible local taxes against a series of basic criteria — equity, efficiency, administrative feasibility and accountability. In our view, this perspective is important; what matters almost as much as the precise choice of the local tax is that the choice should be sustainable and, in particular, should be able to survive changes of national government.

Little of the experience to date with the Community Charge has given any indication of whether it would ultimately have functioned as the Government intended. The pattern of Community Charge bills across authorities in the first year was too heavily influenced by the transitional arrangements for the impact of an individually-billed tax on accountability to be assessed. Much of the hostile reception the new tax received has reflected problems of transition, especially the sharp rise in average tax levels in the first year of operation and the impact of the regional redistribution of the local tax burden. However, it is clear that even over the longer term, the tax would have faced major difficulties over administration: in a country without universal population registration, a tax on all individuals will inevitably be neither cheap nor easy to collect.

What, then, does our assessment of alternative local taxes conclude would be the best tax for UK local government? Perhaps the most important conclusion, which we wish to emphasise strongly, is that there is no ideal local tax — each of the various options has significant drawbacks and disadvantages. The choice of local tax must therefore seek the financing option with the fewest, or least costly, drawbacks, given the relative weight to be accorded to the various criteria set out above.

As far as a property tax is concerned, there are three main conclusions we wish to highlight.

The first is that the economic efficiency case for a property tax is strong; property enjoys substantial fiscal privilege in the UK, but

should ideally bear taxation in the same way as other things that households spend their money on. This argument would point to a national property tax, at a single rate throughout the country. If a local tax is to fulfil this role in the tax system, it is desirable that the local differences in tax rates should be kept to a minimum. This implies a need for resource equalisation, so that differences between localities in the property tax base do not cause large differences in local rates of property tax. Variations in the local property tax rate would also be less if it was introduced in conjunction with another local tax, such as a local income tax or locally-variable business taxes.

Second, if a property tax is introduced without provisions in the central government grant for resource equalisation, it can only be used to raise small amounts of local revenue. Without resource equalisation, significant and unacceptable differences could emerge in the level of taxation to be paid by similar individuals in different authorities, and the inequity of this will be magnified, the more revenue is raised from the local tax. Thus, if it is sought to raise significantly higher revenues from local taxation than at present, a property tax without appropriate resource equalisation grants would appear undesirable.

Third, as far as valuation is concerned, we see a strong case for using capital values rather than rental values, because of the lack of usable rental evidence for certain types of property. We see no great merit in rough-and-ready forms of valuation (numbers of rooms, etc.) nor in banding. Both are likely to lead to more perceived inequity in the treatment of similar properties than with a conventional capital valuation; banding in particular seems unlikely to promise much saving in valuation and administration costs, since the tax implications of being placed in one band rather than another are likely to provoke taxpayers to contest the valuation in borderline cases.

The amount of revenue that can be raised from any form of property tax, even with equalisation grants, is likely to be limited. Although the current level of Community Charge revenue could probably be raised from a property tax without the development of obvious inequity and public dissatisfaction, it would be unrealistic to expect a property tax to be able to raise a substantially higher proportion of the financial resources required by local government. In the discussion of accountability we have set out why

we think that raising a higher proportion of local revenues from local taxation may be important; funding too much of local government from central government grants has been a source of instability in local authority finances. This problem has of course been exacerbated by the recent increase in grant funding to finance the £140 per head reduction in the Community Charge announced in the 1991 Budget.

There is of course room for action on either of the 'non-tax' components of local authority revenues to ease this problem. Instability in the local household tax could be reduced by restoring in whole or in part each authority's ability to raise additional revenue from business ratepayers. Some of the causes of instability could also be eliminated by introducing a more objective mechanism for the distribution of government grants (such as the independent commission advocated by Coopers and Lybrand Deloitte (1990) and, in the Irish context, by Ridge and Smith (1991)), which might help to limit the year-to-year swings in the contribution of grant to local revenues. Alternatively, or in addition, an additional source of local revenue could be provided. The most obvious candidate, as the Layfield Report recognised a decade and a half ago, would be a local income tax.

A local income tax, in contrast to any of the various forms of property tax, could raise considerably more revenue than is currently raised from local taxation. It would also have a very different distributional incidence from either rates or the Community Charge; payments would be much more closely related to income. If what is understood by fairness in local taxation is how well payments of local tax are related to households' incomes, then a tax that related payments to income directly is preferable to one that tries to relate payments to income through some indirect relationship between property values or other possible tax bases and income. The need for rebates would be eliminated, which would provide an administrative saving and reduce the high marginal rates of deduction from additional income faced by poorer households (although at the cost of higher marginal rates elsewhere in the income range).

An earlier IFS report (Kay and Smith, 1988) studied various schemes for the administration of a local income tax in detail. The ideal system, however, would be one which required significant changes to the way that the national income tax operates, and these

would require time and careful planning.

The administrative requirements for a local income tax do not in our view pose an insuperable obstacle to introducing such a tax, but they do place restrictions on how rapidly it could be introduced. A property tax could probably be introduced quite easily and quickly, given the considerable experience that remains from domestic rates. In the longer term, however, if it is intended that local taxes should contribute more to the costs of local government, we see no alternative to the eventual introduction of a local income tax, either as a supplement to, or replacing, property taxation.

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