

# Response to the Independent Commission on Local Government Finance Wales call for evidence

David Phillips, Senior Research Economist, Institute for Fiscal Studies

## 1. Introduction

This is a response by David Phillips, a senior research economist at the Institute for Fiscal Studies (IFS). The views and opinions expressed here are those of the author only. The IFS has no corporate views.

The appropriate degree of redistribution and risk-sharing across local authority areas (and, on the flip-side, the appropriate degree of financial incentives) in the local government finance system is to a significant extent a *political* as opposed to economic one, and therefore lies outside the remit of the IFS. In the responses below, the focus is therefore on highlighting key considerations and trade-offs that need to be taken account of.

Note responses are not provided to all questions.

## Financial Overview questions

### 2. What should the objectives of central funding be? What kind of grant system should support those objectives?

A central funding system could have a number of objectives. Traditionally, the system of grants to local authorities in Wales has had two key objectives:

- a) To equalise the resources available to different local authorities across Wales. In particular, the idea is to distribute grant such that local authorities in Wales would be able to provide the same level of services if they set council tax at a common reference level. Authorities then can vary council tax to provide a higher or lower level of services (or to account for higher or lower levels of efficiency in delivering service).
- b) To target resources at particular areas deemed priorities by central government, whether through specifically earmarked grants, or 'labelled' grants (in a kind of 'nudge' approach).

A third objective of the funding system may be to provide financial incentives for particular local authority behaviours (e.g. to freeze council taxes, or encourage housing development, as in England) or for revenue growth (e.g. business rates retention in England and Scotland).

The appropriate set of objectives (and the weight placed on each) is ultimately a political choice. In many ways, there are trade-offs between different objectives.

There is a trade-off between autonomy for local authorities and the ability of central government to target resources at priority areas. One might expect that local authorities

know their areas better than central government so can make spending decisions more appropriate to local conditions. But there are interactions between local government spending and central government spending (e.g. between social care and health, say) and national politicians may be judged in part on the performance of local government services, giving them an interest in what local government spends its money on.

As discussed in more detail below, there is a trade-off between equalising the resources available to different local authorities, and the provision of financial incentives to increase revenues and reduce spending needs via economic growth or other beneficial socio-economic changes.

Given these tradeoffs, in developing its local government funding system going forward, the Welsh Government should take a first-principles approach to what it wants the system to achieve. There should be consultation with stakeholders (including, of course, local authorities), and a proper assessments of the costs and benefits of different options. Wales has the opportunity to do better than England in this regard, where there have been significant moves from equalisation to incentive provision with only limited consultation, seemingly little in the way of impact assessment, and provision of only limited information on just how large these changes have been.

### **3. Are grant distribution mechanisms fit for purpose and what changes would be desirable?**

It is widely perceived that grant mechanisms are complex and poorly understood, and some authorities complain that they are treated unfairly by the current system. It is therefore wise to review these mechanisms.

However, it is also worth bearing in mind what might be seen as relatively strengths of the Welsh system. For instance, recent years have shown the grant distribution mechanism in Wales to be better able to deliver equitable outcomes across local authorities in Wales than in England. Since devolution, the funding system in England has been reformed several times. The current “4-block” system in England has resulted in significantly larger cuts in spending power for more deprived, and for more grant-dependent local authorities, than for less-deprived, less grant-dependent authorities.<sup>1</sup> This is due to the way the system treats council’s own tax resources and interactions with the ‘grant damping protection’ arrangements that have operated in England.<sup>2</sup> Such a pattern has not been seen in Wales due to the different method for calculating revenue support grant. If the Welsh Government wishes the Welsh local government funding system to maintain an element of equalisation across local authorities, especially during periods of reductions in grants, it should ensure its system does not replicate these features of the English system.

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<sup>1</sup> See, for instance: <http://www.ifs.org.uk/publications/7617>.

<sup>2</sup> For instance, see evidence by Paul Woods to the Public Accounts Committee: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/financial-sustainability-of-local-authorities/written/15802.html>, and <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/financial-sustainability-of-local-authorities/written/16308.html>.

## **Council Tax, Business Rates and other forms of income**

### **4. Is council tax fit for purpose? What reforms might be made, if any?**

A recurrent tax on residential property is a sensible form of taxation for local government finance, and a key part of a well-functioning and efficient overall tax system. However, council tax would benefit from two significant reforms.

First, while council tax in Wales is based on property values that are substantially more up-to-date (2005) than in England and Scotland (1991), they are still more than 10 years old and there are no plans for further revaluation. It seems likely that the longer revaluation is delayed, the larger the changes in relative values will be (for instance, because of different economic and demographic trends in different parts of Wales). This makes any revaluation more painful to implement, further lessening the chance of one occurring. But clearly it would be nonsensical for council tax bills in 2105 to be based on relative property prices in 2005. It would therefore be sensible to move to a defined revaluation cycle (akin to that with NDR), with revaluation every 5 years or so. Even over 5 years, changes in relative values may be large so it might be worthwhile using local or regional price indices to index relative values in the intervening period. Linking council tax rates to local property prices directly may also reduce volatility and divergence in the property market (as higher prices would lead to higher council tax bills, which may reduce demand somewhat, lessening upward pressure on prices).

Second, a more rational system of local domestic property taxation would involve tax payments that are more proportional to property value than the existing council tax system, which is regressive with respect to property value. This could be achieved by moving to a system more akin to the old style system of domestic rates (still in use in Northern Ireland) or through the realignment of council tax band relativities, and the addition of additional higher rate bands. Such a move would likely reduce council tax payments for a large number of Welsh households, but lead to substantial increase in council tax payments for a small number of high value properties. Such a reform would also likely redistribute council tax base across local authorities, and if done on a revenue-neutral basis would lead to those with relatively many low band properties seeing a decline in their tax base, and thus becoming more grant dependent (and vice versa for areas with relatively many high band properties). Of course, such a reform need not be revenue neutral, and it would be possible for the reformed council tax to raise more (or less) revenues in total, allowing for reductions (or increases) in other taxes, reducing (increasing) the average degree of grant-dependence, all else equal.

### **5. Is the non-domestic rate working well? What reforms might be made, if any?**

The recent Business Rates Panel report assesses a number of options for NDR reforms in the context of the full devolution of business rates to Wales. A number of options for reform of the existing system can be found in that report.

More radical reform could also be considered, however. To see that, it is worth considering just what Business Rates are. Business Rates are a recurrent tax payable by the occupiers of non-domestic properties, with the amount payable linked to the rental value of the property at the time of valuation. As such, it combines what are economically speaking two distinct forms of tax:

- A tax on the value of land used for non-domestic purposes, and;
- A tax on the non-domestic property and plant located on that land.

Economic theory and analysis shows that a tax on land values has attractive features – land is not a “produced input” (it already exists), so taxing it causes fewer economic distortions than most other forms of taxation. In contrast, the buildings and plant located on that land are produced inputs. Taxing these therefore discourages investment in property and plant, distorting business production, and reducing economic efficiency. Business rates therefore combine an economically efficient form of taxation (land taxation), with an economically inefficient and potentially distortive form of tax (business property and plant taxation).

Many of the issues discussed in the Business Rates Panel report – such as the negative effects of business rates on incentives to invest in speculative new build properties, improvements to properties, and certain forms of plant and machinery – stem from this taxation of property and plant under business rates. Special schemes can and have been devised to deal with these problems. But such schemes can create other distortions; they make the system more complex; and there is the risk of a cascade of “special cases” undermining the coherency of the system, thus undermining a vital source of government revenue. In principle, a move from Business Rates to land value taxation – which does not distort property investment decisions in the same way – would solve these issues, without the need for complex special schemes. This led the Mirrlees Review of the UK tax system, led by Nobel laureate Sir James Mirrlees, to recommend working towards just such a reform of the Business Rates system as part of plans to improve the overall tax system.<sup>3</sup>

Implementing land value taxation in practice is not a simple task. It is often difficult to value land separately from the property that is built on it, for instance. And the owners of valuable but undeveloped land could be liable for significant amounts of tax, even though the land would not yet be generating an income (in principle, this could be dealt with via tax deferral, but this may itself act as a disincentive for sale and development). Further work by economists, tax practitioners and the property industry to overcome these issues is therefore needed. But local government and the Welsh Government (and the UK government) can drive forward such developments by engaging with these organisations to investigate and design a feasible system of land value taxation. This is a worthwhile goal because land value taxation has much to recommend it in terms of economic efficiency, and by design it would mean that the plethora of complex schemes that are being added to the existing system of business rates to address particular problems associated with taxing business property investment would not be needed.

**6. Would you favour local government in Wales taking control of additional taxes? If so, which ones?**

A number of options could be considered, each with advantages or disadvantages (*note: the following are options, not recommendations*). Any proposals for tax devolution (or new taxes) should have a clear rationale and be rigorously assessed to examine the impact on compliance and administration costs, local and Welsh government financial risk, and the potential for tax competition which may undermine revenues.

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<sup>3</sup> J. Mirrlees et al (2011), The Mirrlees Review: Tax by Design, available at: <http://www.ifs.org.uk/publications/mirrleesreview/>.

So what might the options be? Three stand out given recent policy discussions.

One would be to devolve the revenues from land transactions tax (the Welsh replaced for Stamp Duty Land Tax). This would give local authorities a stake in the health of the local property market (in terms of new build, turnover, and property values), and would mean that all property taxes were to some extent “local”. If full powers over rates as well as revenues were also devolved, it would also give Welsh local authorities the opportunity to abolish land transactions tax (which, as discussed in the IFS’s [Mirrlees Review](#), is a tax which violates fundamental tenets of the economics of taxation), and make up the revenues from council tax (and, potentially, NDR, if NDR rate-setting power is devolved).

A number of regions of England (most notably London) have called for devolution of this tax, citing its link to property development. However, it is a tax with highly volatile revenues, particularly at the local level, so would increase year-to-year budgetary risk for local government, likely necessitating some form of borrowing powers for current/resource spending. And because the tax will likely involve a threshold for payment that is high relative to house prices in parts of Wales (such as the Valleys) and a system of increasing marginal rates, the revenue growth and financial incentive provided by a given percentage increase in housing market activity or house prices could differ very substantially across Wales.

If income tax is partially devolved to Wales, there may also be the option to partially devolve the Welsh rate of income tax to local authorities to create a “local income tax” (in addition to, rather than instead of council/property tax). Local income taxes are a feature in a number of tax systems, such as Denmark, or Switzerland. The benefits of providing additional autonomy, accountability and financial incentives to local authorities would have to be traded off against the additional financial risk, and the additional administration and compliance costs.

Powers could be limited to setting a flat-rate local income tax assessed above the personal allowance. This may lessen concerns about tax competition that could arise if local authorities were able to vary the top rates of tax separately from the basic rate.

A third option would be a new tax – a planning gains tax. The granting of planning permission for development can lead to significant increases in land value, especially for Greenfield sites. At present, these gains are taxed via capital gains tax in the same way as other forms of capital gains, and can face tax rates as low as 10% (via entrepreneurs’ relief). Unlike other capital gains though, these planning gains exist purely because of the restrictions imposed on developable land by the planning system. A tax on these gains would therefore capture for the state some of the monopoly rents that are created via planning controls. The incidence of this tax would seem likely to be on landowners rather than on developers, meaning the impact on development activity should be modest.

If such a tax were introduced, and it were devolved to local authorities it could provide financial incentives to local authorities for development, and additional resources for the provision of infrastructure, services, social housing, etc. It could also replace, at least in part, negotiated funding provisions for Section 106 obligations. This might reduce delays in the planning system and mean less scope for ‘gaming’ the system by developers. On the other

hand, a defined tax may reduce the discretion of local authorities to strike deals for particular developments. Revenues may be volatile at the local level (meaning the risks of such a tax may be better managed at the national level). And there may be concerns that such a direct financial stake in (especially Greenfield) development may provide skewed incentives to local authorities to approve inappropriate developments. (But it may be said that allowing local authorities, and by implication “local people”, to capture a larger part of the gains from development, would correct existing biases against development whereby local authorities bear a large part of the costs – both financial and political – but benefit relatively little from the immediate financial gains, which accrue to landowners and developer).

## **7. Should incentives for growth play a greater role in the funding system?**

The degree to which the local government finance system provides financial incentives versus financial equalisation and risk insurance is to a large extent a political question.

For a long time, the local government finance system in Wales has effectively been one with full equalisation and risk insurance, and concomitantly, no financial incentives for economic growth.<sup>4</sup> This was also the case in Scotland and England until recently. However, since 2011, the English system (and to a lesser extent the Scottish system) has, in effect, moved significantly towards the provision of greater financial incentives for growth, at the cost of reduced equalisation and risk insurance. This is the result of three key policy changes:

- From 2011-12, the “New Homes Bonus” has taken a top-sliced percentage off revenue support grant to all local authorities to fund grants to local authorities based on new build homes, conversions, and the re-use of long-term empty properties.
- The business rates retention scheme introduced from 2013-14 means local authorities keep a fraction (25-50%) of their own business rates revenue growth (rather than this being redistributed across local authorities)<sup>5</sup>, providing a direct link between business property development and local authority spending power.
- Also from 2013–14 onwards, needs and own-resource assessment of local authorities will not take place annually. The next reassessment is due to take place in 2020, with further reassessments every 10 years. The UK Government has argued that this change was necessary to ensure that the business rates retention scheme delivered financial incentives to English local authorities.

Wales has the potential to learn from England’s experience and, if it so wished, adopt refined versions of these scheme. It could also choose a different point on the incentives versus insurance/equalisation trade-off.

For instance, if a scheme for residential development such as the New Homes Bonus was desired, rather than taking a percentage-based top slice off the grant to all local authorities (which would hit grant-dependent authorities hardest), a fixed cash-terms deduction (based

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<sup>4</sup> Although there have been incentives for improved revenue growth through increasing collection rates, and

<sup>5</sup> In a few city deals, particular authorities have negotiated 100% rates retention.

on population, or the number of dwellings at baseline, in an area) could be used. This would provide similar (marginal) incentives for house-building, and would be more equitable (in terms of the top-slice funding of the scheme) to authorities with different degrees of reliance on grant funding.

On business rates retention, one problem that arises under the English scheme is that the incentives for development vary significantly over the 10-year equalisation cycle proposed. In the first couple of years of a 10-year cycle there would be relatively strong financial incentives to facilitate business development as (part of) increases in business rates revenues would be retained for 9 or 10 years. In year nine or ten, however, any additional revenues would be retained for only 1 or 2 years, providing much weaker financial incentives. Indeed, there may be an incentive to delay development to the subsequent 10 year cycle so that revenues can be retained for the full 10 years.

The 10-year equalisation cycle is designed to prevent any divergences in funding due to differential business growth from growing and persisting indefinitely. But instead of a fixed 10-year cycle, it would be possible to move to a rolling cycle, whereby growth in revenues in a given year is retained for a period of 10 years (or 5 years or X years). This would stop differences in business rates growth from compounding indefinitely, would still provide medium term financial incentives for growth, and would avoid the problems that may be encountered with fixed equalisation cycles. Wales could also consider whether some pooling of business rates revenues at the regional level (e.g. City Region) is appropriate, especially if there is expected to be divergent trends between core cities (e.g. Cardiff and Swansea) and hinterland regions. This would weaken the financial incentives of individual local authorities to encourage growth, but would mean more risk-sharing and less funding divergence.

It would also be possible to provide financial incentives via retained business rate revenue growth (or retained council tax base growth) without completely dismantling the annual assessment of spending needs. This could be done by continuing to update the “needs” side of the revenue support grant calculation system, while using a common national index (set equal to forecast growth for Wales as a whole) to index the “own resources” contribution expected of local authorities. If spending needs changed (due to an ageing population, or an increase in looked-after children, etc), local authorities would be compensated via the spending side of the formula. But, the local authority would gain if increases in its own-resources (business rates and council tax) exceeded the national average, and lose if it were less than the national average. If changes in spending needs and economic growth are negatively correlated (and causally related), financial incentives would be somewhat weaker than under a system where annual needs updating is also suspended. But this illustrates that there are different choices available to Wales on where on the incentives–equalisation trade off its local government financial system is.