

IFSBriefing

Taking control: which taxes could be devolved to English local government?

In recent years, there has been renewed interest in the question of tax devolution to local government:

- The past decade has seen a number of changes to how local government is funded, including the introduction of business rates retention. Broadly, these changes have focused on giving councils more control over their funding and providing stronger financial incentives to councils to drive local growth and development. Devolution of additional tax revenues and powers could be seen as a natural extension of this agenda.
- After years of cuts, councils in England face serious short-term funding pressures. In the longer term the costs of funding social care are likely to increase faster than the revenues councils receive from council tax and business rates. While these issues could be addressed by using national taxation to increase the grant-funding given to councils, devolution of additional tax revenues and powers could also play a role.

This note summarises a new IFS report on the scope for tax devolution to English local government. It sets out criteria which can be used to assess whether different taxes and tax powers are suitable for devolution; applies these to a range of taxes; and looks at how much could be raised in different parts of England from different options.

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'Taking control: which taxes could be devolved to English local government?'

For further details, see the full report at www.ifs.org.uk/publications/13991

Key policy messages

- 1. Of the large taxes we look at, income tax seems the most promising candidate for partial devolution.** Concerns about tax competition between councils and about volatility and inequality in revenues could be mitigated by restricting councils' powers to a flat rate local income tax: a 3p tax on all income bands, for example, would raise £19bn. However, a local income tax would still involve some additional administration and compliance costs, and mean tackling a number of tricky technical issues.
- 2. Giving councils substantial new powers over council tax – such as the ability to revalue properties in their area – could pose problems for the redistribution of funding between councils.** In particular, it would make assessing the revenue-raising capacity of different councils – a vital step in this process – much more difficult. **It is likely to be better to revalue and reform council tax at a national level:** this is overdue and could make the tax fairer and, if desired, raise more revenues.
- 3.** There is currently significant interest in **tourist accommodation taxes**. While such taxes would be administratively feasible and would raise useful amounts in a few well-visited areas, **they would raise little money in many more places**. The economic case for such a new tax is also far from clear cut.
- 4.** While tax devolution could give councils more options and discretion over how to raise funding, it **is not a panacea for their funding issues**. Ultimately, what's needed is either tax increases (whether at a national or local level) or lower expectations of what councils can provide.

What tax revenues and powers are currently devolved to English councils?

Council tax	Business rates
£28bn in 2017–18.	£24bn in 2017–18, of which local government retained £15 billion.
Councils set their own tax rate but must hold a local referendum if they want to increase taxes by more than a certain percentage in any single year.	Central government sets the tax rate, which is uniform across councils. Councils can levy a 2p supplement on the national rate under certain circumstances.
Tax base (including tax bands and valuations) is centrally determined, as are key discounts/exemptions. Councils have some discretion over discounts and premiums for certain groups of taxpayers.	Tax base (including valuations) is centrally determined, as are a range of discounts/reliefs. Councils have broad powers to offer discretionary discounts, subject to state-aid rules.

A system of grants and transfers between councils is designed to account both for the fact that the amounts different councils are able to raise from council tax and business rates vary widely, as well as the fact that spending needs vary across councils.

How does this compare to other countries?

As in England, property taxes are typically devolved to local or regional governments in other countries. However, many countries employ a wider range of additional taxes at a local or regional level than we do. In some cases, taxes are devolved: local or regional governments have some power over tax rates and/or bases, as well as retaining revenues. In other cases, taxes are assigned, meaning that local or regional governments receive a share of the revenues raised in their areas but do not have control over rates or bases.

	Devolved	Assigned
Income tax	<ul style="list-style-type: none"> Flat-rate in Sweden, Finland, Denmark Progressive in Canada, US, Spain 	Germany
Sales tax/VAT	US (sales tax), Canada (VAT)	Italy, Portugal, Spain, Germany
Corporation tax	Germany (trade tax), Canada, Italy	Denmark, Finland, Portugal
Tourism tax	Italy, Germany, Netherlands	
Inheritance tax	Poland, Spain	Germany
Vehicle taxes	Belgium, Spain	Germany

Note: The table provides examples of countries where taxes are devolved or assigned only (it is not exhaustive).

What criteria do we use to assess options?

While a range of taxes are devolved in other countries, it is important to assess the suitability of different taxes for devolution or assignment on their own merits. We use a range of criteria to do this – although there can be trade-offs between them.

How administratively feasible would devolution be?

In order to devolve or assign a tax, one must be able to apportion taxes between different local areas. This can be difficult, especially when taxpayers have activities in multiple areas and it is unclear how much of their tax liabilities relate to each area.

What incentives would devolution create for local government?

Devolution or assignment of taxes can provide an incentive for councils to try to grow the relevant tax base in order to increase their revenues. Given this:

- The tax base should be one that councils are able to influence.
- Growth in the tax base should be associated with positive outcomes e.g. Economic growth, higher incomes, lower unemployment.

How mobile is the tax base?

- In general, a good tax system does not distort where activities take place or taxpayers locate. But devolution of taxes with mobile tax bases can distort taxpayer behaviour and location choices when there are differences in tax rates between areas.
- Furthermore, tax base mobility could result in ‘tax competition’ – councils competitively cutting rates to encourage taxpayers to relocate into their area. This means devolution could undermine the revenue-raising potential of a tax with a mobile tax base.

Would taxpayers be able to vote?

On the other hand, if a significant proportion of a local tax is paid by people who can’t vote in that area, voters may opt for higher taxes as they would only bear part of the additional cost. This could lead to excessively high levels of taxation.

How unevenly distributed are revenues across councils?

- Highly uneven distributions could mean big differences in the services different councils can afford to provide, or in the tax rates they have to charge to meet statutory duties.
- If this was seen as unfair, revenue equalisation arrangements could be put in place. But these could be complex, reducing transparency and accountability, and increasing the prevalence of lobbying. And such equalisation arrangements can also blunt the incentives for tax base growth that tax devolution is often aimed at creating.

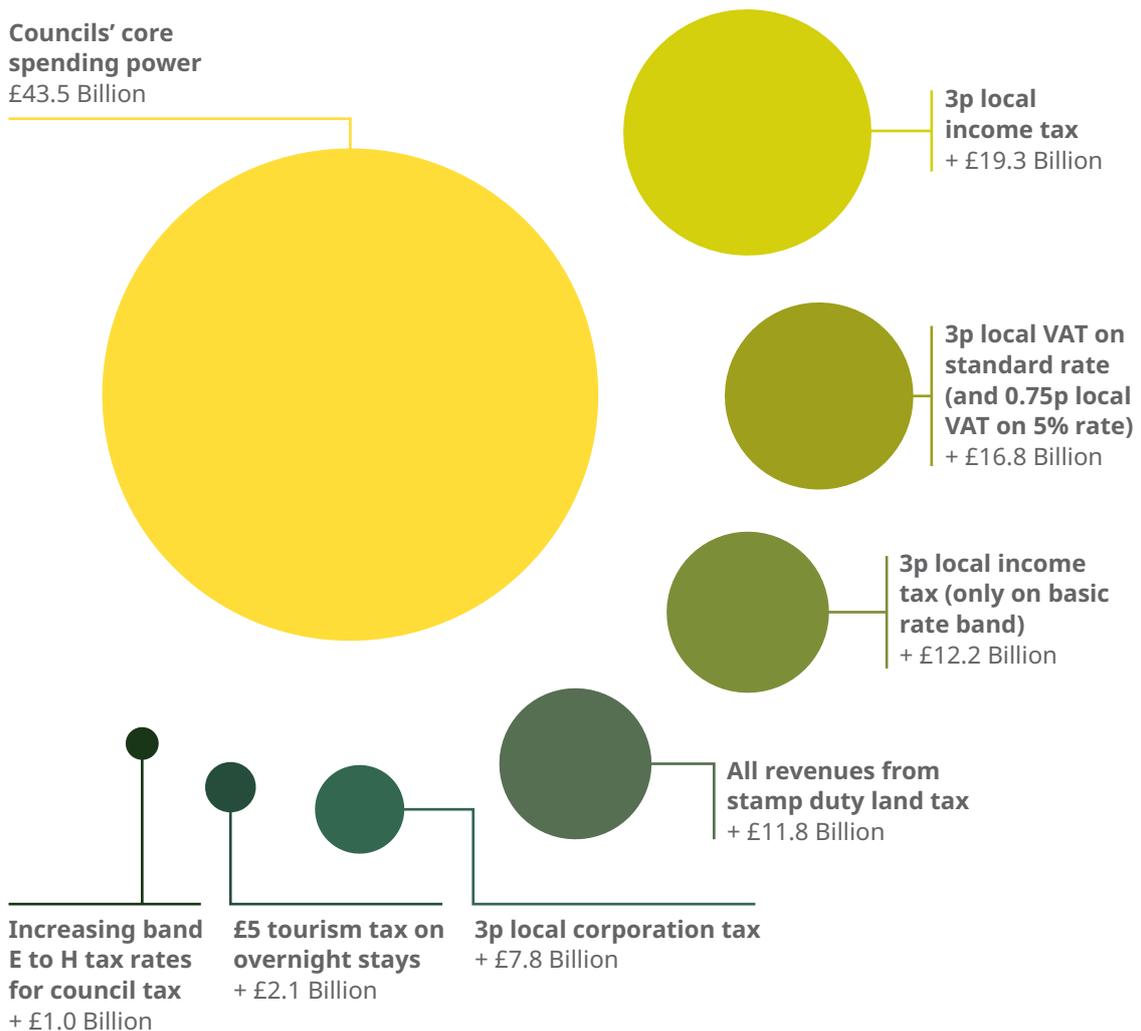
How buoyant and stable are revenues?

- A buoyant tax is one where the tax base and revenues grow automatically as the economy grows, without a need for increases in tax rates. Given that it can be difficult to increase tax rates, and that there are rising demand and costs for services (such as adult social care), councils could benefit from buoyant, growing revenue streams.
- But taxes that are very buoyant are also likely to be volatile. Devolving taxes with volatile revenues could create significant risk for councils’ funding, especially given current prohibitions on councils borrowing to cover day-to-day (as opposed to investment) spending.

How much could different taxes raise?

When thinking about options for tax devolution, it is also worth examining the potential revenues that could be raised. This will depend both on the size of different tax bases and the tax rates applied to them by local government if they were devolved.

To get a sense of the possibilities, the Figure below compares our estimates of the amount that councils would receive from various tax devolution options to councils' core spending power – the amount they currently receive from council tax, business rates and general grants.



The Figure makes clear that devolving part of major taxes like income tax or VAT could substantially increase councils' revenue-raising powers. A tourism tax, however, would raise much less, even if set at a relatively high level of £5 per person per night.

Of course, devolving taxes that can raise more is not a free lunch: it either means a bigger reduction in the revenues flowing to central government if national taxes are cut to offset the additional local taxes; or it means a bigger tax rise, impacting on households' post-tax income.

What is our assessment of different options?

	Benefits	Drawbacks
Council tax and business rates – more powers	Administratively straight-forward to increase power over rates, discounts, reliefs and exemptions.	<ul style="list-style-type: none"> • Councils' incentives would remain focused on property development rather than wider economic growth. • Giving councils powers over tax bands and revaluation would pose problems for revenue equalisation.
Stamp Duty Land Tax	Apportionment to councils administratively straight-forward.	<ul style="list-style-type: none"> • Revenues highly unequally distributed and very volatile. • An economically damaging tax that should be abolished, which is less likely if devolved.
Corporation Tax	Broaden the financial incentive of councils to include boosting profitability of local businesses.	<ul style="list-style-type: none"> • Difficult to apportion tax base (profits) between areas. • Relatively mobile tax base. • Business owners may not be local voters – accountability problem. • Unequally distributed and highly volatile.
VAT or sales tax	Broaden the financial incentive of councils to include boosting value-added of local businesses.	<ul style="list-style-type: none"> • Difficult to apportion tax base (value-added) between areas. • Relatively mobile tax base. • Shoppers may not be local voters – accountability problem.
Income tax	<ul style="list-style-type: none"> • Should be possible to apportion tax base (incomes) between areas – although not without admin and compliance costs. • Broaden the financial incentive of councils to include boosting income and employment of local residents. • Income taxpayers are local voters – helps accountability. 	<ul style="list-style-type: none"> • High income taxpayers may be relatively mobile. • High income taxpayers are unevenly distributed and have volatile incomes. • But both of these issues could be mitigated by only allowing councils to levy a flat rate, especially if restricted to the basic rate band.
Tourist accommodation tax	<ul style="list-style-type: none"> • Should be possible to apportion tax base (accommodation stays) between areas. • A financial incentive to support tourism industry. 	<ul style="list-style-type: none"> • Tourists unlikely to be local voters – accountability problem. • Would not raise much, and what would be raised would be very unequally distributed.

So, a local income tax?

If we want to devolve substantial additional tax revenues and powers, income tax seems the most promising option. It would provide a clear financial incentive to councils to boost the incomes and employment of local residents – including via commuting to jobs in neighbouring areas – and would be more administratively feasible than options such as a local VAT/sales tax or local corporation tax. Income tax is also a buoyant source of revenues which grows as inflation and economic growth boosts incomes.

Restricting councils' powers to the ability to levy a flat income tax rate above the personal allowance would mitigate issues that could otherwise arise with income tax devolution:

- Revenues from a flat-rate tax would be less unequally distributed around the country than from the national income tax, which applies higher marginal tax rates as income increases. It would still be progressive because of the tax-free personal allowance.
- Revenues would be less volatile as a significant part of the volatility in total income tax revenues reflects changes in the numbers and incomes of rich people and such people would matter less for overall revenues from a flat-rate tax.
- It is less likely that councils would engage in tax competition to attract rich people, as they would have to cut the income tax rate for all rather than just the rich.

The map on the next page shows how much income tax could be raised per resident from a 3p local income tax on all bands. Quite clearly, there would still be substantial disparities in revenue, with councils in richer parts of London and the Home Counties able to raise more than urban councils in the North and West Midlands. As with business rates and council tax, a system to equalise revenue-raising capacity would be needed unless we were willing to tolerate substantially bigger differences in council funding for services across the country.

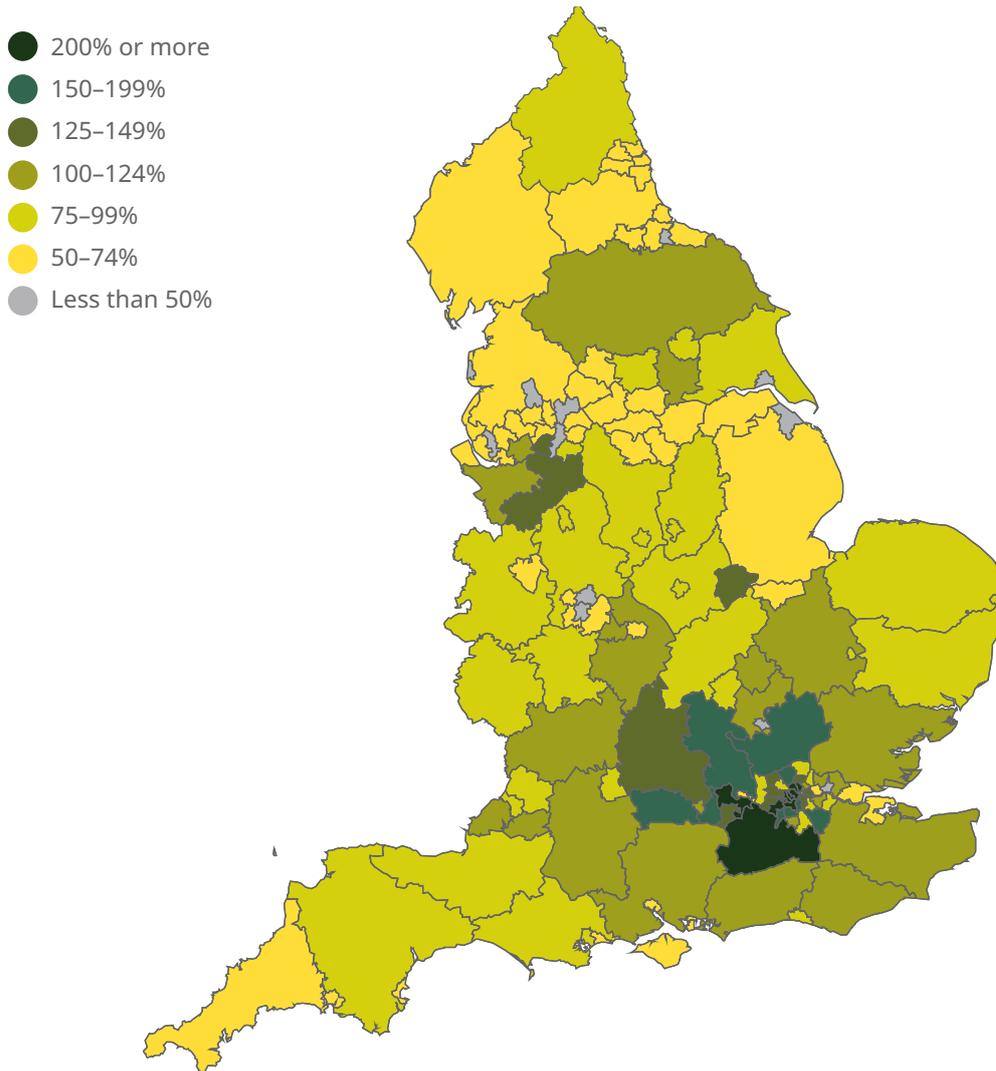
There would also be a choice, just as there is with business rates and council tax, about how much equalisation should be undertaken – with more equalisation implying more equal services but weaker financial incentives for revenue growth.

And while it should be possible to apportion tax bases and revenues between councils – income tax has already been partially devolved to Scotland and Wales and operates at a local level in much of Scandinavia and parts of the USA – there would still be administration and compliance costs and issues to contend with. Employers would potentially need to deduct and remit different amounts of income tax for people living in different areas. And HMRC would need up-to-date addresses for all taxpayers (which it does not currently have, perhaps reflecting the fact that it is not a legal requirement to inform HMRC when you move), as well as needing to make sure taxes are being paid to the right council if people own more than one property.

Decisions would also have to be taken regarding the level of local government to which the tax would be devolved - for example, lower or upper tier areas, combined authorities, regional areas etc.

Devolving income tax revenues and rate-setting powers to councils would therefore be a major undertaking. The question is whether providing additional financial incentives and increasing local control over revenues are seen as worth the costs involved in implementing and operating a local income tax.

Revenues per person from a flat-rate local income tax, share of national average (%)



Download our estimates of local tax revenues by council: www.ifs.org.uk/publications/13991.

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