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The Local Government Finance Studies

Introductory Report

An appraisal of current local government finance policies and the relationship between those who finance, use and vote for local services.

**Presented to
the Ministerial Steering Committee
on Economic Strategy
Sub-committee on Local Government Finance
by the Minister for Local Government
and the Parliamentary Under Secretary of State,
Department of the Environment**

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Introduction

1 In October 1984 Cabinet agreed that a series of studies of the local government finance system should be set in hand as a matter of urgency. They did so because they considered that the existing system was under severe strain; and that present policies — notwithstanding some success in reining back local authority spending — could not hold the position far into the next Parliament.

2 The Secretary of State for the Environment announced the studies at the Conservative Party Conference later that month. They were to be conducted by the Minister for Local Government and Mr Waldegrave. They would be looking at the entire system of local government finance, focussing in particular on the distribution of rate support grant, the balance between exchequer and local funding of council spending, measures for improving local authority accountability to their electorates and how local revenues might best be raised, whether from domestic or business ratepayers.

3 In November, Ministers discussed at E(LF) the arrangements for conducting the studies. They agreed that the first phase should be conducted within the Department of the Environment, supported by a number of outside advisers, with informal consultation with other departments as necessary. The first phase was to be concluded with a report to E(LF) at Easter, exposing issues and presenting initial proposals for Ministerial consideration. The Committee would then give guidance on further work to develop detailed proposals with a view to their eventual publication for consultation. These detailed proposals were to be presented for consideration by E(LF) in November 1985, in order to keep open the possibility of legislation in the present Parliament.

4 Department of the Environment ministers gave an informal presentation to the Prime Minister on the studies' progress shortly before Easter. This report provides a formal presentation of the studies' initial findings and conclusions at the end of the first phase; and sets out the principal components of the proposals for reforming the local government finance system.

Chapter 1: The Background: Local Authorities and Government Policy Since 1979

1.1 Since its election in 1979 two of the Government's principal objectives have dominated its relations with local government. The first was the Government's desire to lift the burden of detailed central control off local government and to encourage where possible local government to lift unnecessary controls off the backs of citizens and business. As Michael Heseltine promised in 1978:

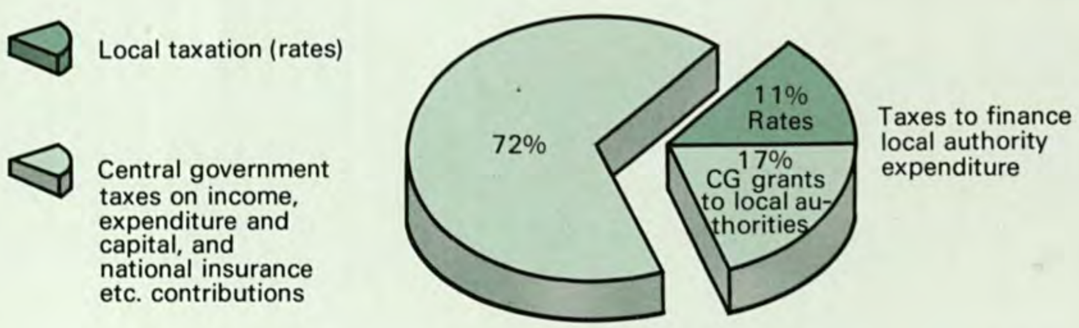
> "We are committed to a root and branch appraisal of the powers of Whitehall over local government. We shall . . . reduce and eliminate many of the controls that currently tie Britain's cities to the Whitehall departments. I believe that that will speed decisions, save money and restore a sense of competitive independence to local democracy"

The second, central to the Government's economic policy, has been the attempt to secure a sustained reduction in the size of the public sector and in the level of public expenditure. Both were seen as part of a co-ordinated policy of increasing national efficiency and of creating the financial and social background for sustained economic recovery.

1.2 The Government's initial legislative and administrative effort gave equal weight to the two aspects of the policy. A large number of unnecessary detailed controls over local government which sought to establish Whitehall's responsibility for matters which lay properly within the ambit of local decision were abolished. Unified block grant, introduced in the Local Government Planning and Land Act of 1980, sought to increase the costs for authorities spending far above average, while leaving them free to determine their spending levels on the basis that they would answer to their electorates for the costs involved.

1.3 Inevitably, however, central government's priorities have shifted to dealing with the problem of the level of local government spending. This was understandable. Local government in the United Kingdom is a major part of the public sector. It employs over one and a half million full-time and nearly a million part-time employees. Its current and capital expenditure account for a quarter of all public expenditure and 10½% of the Gross Domestic Product. It is therefore responsible for a significant proportion of the tax burden borne by individuals, industry, business and commerce, either nationally through government grants or locally through rates, as figure 1 shows.

Figure 1 : LOCAL AUTHORITIES' CLAIM ON THE TOTAL TAX BURDEN — UNITED KINGDOM



1.4 The Government had taken the view from the outset that its objective of reducing public expenditure and taxation should apply as much to local authorities as to central government. In doing so, however, it was seeking to reverse a trend of growth and expansion which had continued virtually uninterrupted since the end of the last war. In the 1960's and 1970's the volume of local government current expenditure and its manpower each grew by about 3½% a year in England. In the 1970's the growth was about 3% and 1¾% respectively, as figures 2 and 3 illustrate.

Figure 2 :
AVERAGE ANNUAL GROWTH IN LOCAL AUTHORITY CURRENT EXPENDITURE

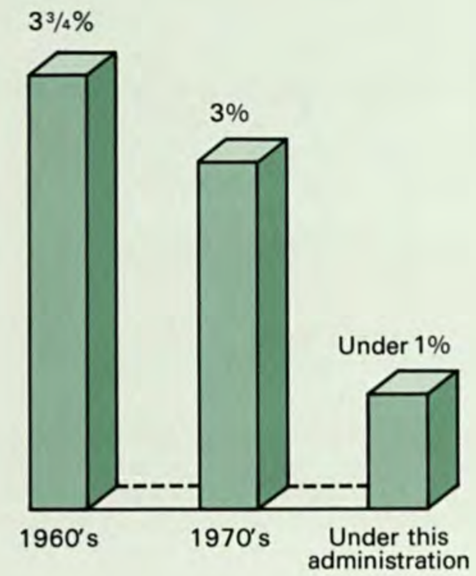
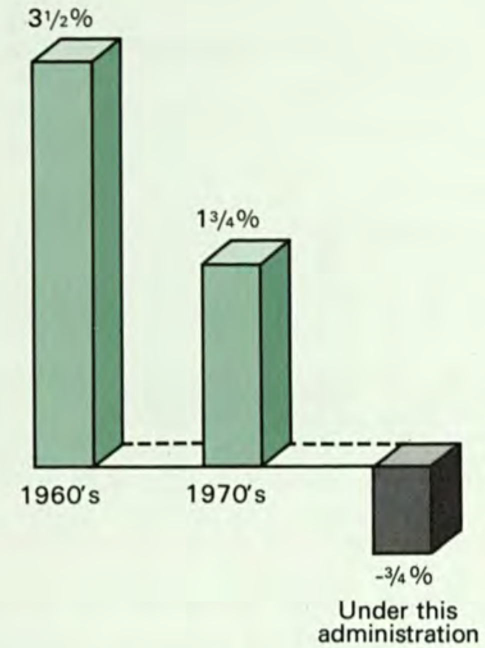


Figure 3 :
AVERAGE ANNUAL CHANGE IN LOCAL AUTHORITY MANPOWER — ENGLAND



1.5 It became increasingly clear that none of the mechanisms available in the past nor even the new block grant pressures would easily slow down this growth. The Government therefore found it necessary to impose a series of external pressures of ever-increasing toughness on local government. The measures adopted in England were:

(i) reductions in the total amount of grant distributed to local authorities; since 1978/79, the percentage of planned expenditure met by grant has been reduced from 61% to 49%;

(ii) the block grant system altered the basis of distributing rate support grant, so as to reduce the proportion of an authority's expenditure met by grant if it spent significantly above its grant-related expenditure (GRE) — the level of spending assessed by the Government to provide an average standard of service.

(iii) the block grant system was further supplemented by a system of expenditure targets designed to secure year-on-year reductions; authorities which spent above their targets suffered grant penalties;

(iv) The new Audit Commission was established to encourage a keener search for improved value for money by local government;

(v) from 1981/82 the Government for the first time sought to control the local authorities' net capital expenditure;

(vi) rate limitation.

1.6 The implicit assumption of the first three of these measures was that authorities, when faced with reductions in grant, would make corresponding reductions in their expenditure rather than risk courting electoral unpopularity by covering the grant losses with corresponding rate increases. This basic assumption has turned out to be flawed, however; and particularly so in a minority of councils, which have not only failed to reduce their expenditure but have increased it substantially in real terms, with correspondingly high rate increases.

1.7 In 1983/84 local government's budgeted expenditure exceeded the Government's targets by £770 million, 75% of which was accounted for by the expenditure of the top 16 overspending local authorities. A similar pattern occurred in 1984/85 when 75% of a planned overspend of £850 million was attributable to 12 authorities. Though some of the total overspend may derive from optimistic figures in the public expenditure White Papers, it is clear that at least for an important minority of authorities accountability was simply not operating in the way Government had hoped and so the grant pressures were proving ineffective.

1.8 The Government's response was to introduce statutory powers to enable it to limit directly the rates of selected local authorities, backed up by a reserve power to limit the rates of all authorities. The powers have been applied for the first time in 1985/86 and affect 18 local authorities.

1.9 The financial pressures have had some success over the period since 1979 in slowing down expenditure growth:

(i) the annual rate of growth in the volume of local authority current expenditure has fallen from 3% in the 1970's to under 1%, as figure 2 shows;

(ii) local authority manpower has fallen by ¾% a year, a cumulative reduction of 5% since 1979, as figure 3 shows;

(iii) average rate increases have fallen substantially from a peak of 22.7% in 1980/81 to 5.5% in 1984/85,(although this is principally a reflection of the fall in overall inflation, and the 1985/86 reduction in aggregate exchequer grant will reverse that trend).

(iv) gross capital expenditure has fallen by about 20% in cost terms between 1979/80 and 1984/85. In addition, some £10 billion of local authority assets have been sold.

1.10 Compared with the trends of the 1960's and 1970's these results represent an achievement. But it is a relatively modest achievement. The fact remains that local authority current expenditure is still growing, albeit at a slower rate than before, and as a proportion of GDP it is now higher than it was in 1979/80. The Government has had to revise its public expenditure plans upwards every year to take account of existing spending levels. Local government in England is in 1985/86 planning to spend about £1.8 billion more than was originally planned for that year in the Government's public expenditure plans published in 1983. The reductions in local authority manpower are very modest compared with what has been achieved elsewhere in the public sector (15% since 1979 in the Civil Service, for example) and the total has been more or less static over the past eighteen months. On capital expenditure, big underspends in 1981/82 and 1982/83 were followed by large overspends on the cash limit in 1983/84 and 1984/85, despite a request for restraint in July 1984.

1.11 Meanwhile, by imposing increasing external pressures on institutions jealous of their democratically-elected status (institutions with in many cases a natural propensity to expand) the Government has faced conflict with local authorities. That was inevitable. It has meant, however, the near abandonment of the other leg of the original policy — the restoration of independence to local government in its own proper sphere. That was perhaps a necessary price to pay in pursuit of the overriding aim of expenditure restraint. What is becoming clearer now is that the policy of expenditure restraint is itself in increasing danger as the financial weapons so far employed become increasingly blunted by use. In particular:

(i) the rate support grant distribution system with targets and holdback has become increasingly complex, both for central government to operate and for local authorities in terms of managing their finances effectively, while the grant paid to individual authorities has fluctuated considerably from year to year. Authorities have in response to targets and holdback adopted creative accounting techniques in order to maximise their eligibility for grant. At the same time the policy of cuts in the overall percentage in aggregate exchequer grant aimed at advancing both the original policies of expenditure restraint and restoration of local responsibility has shifted more of the burden of paying for local services from the national to the local tax payer. As a result of all these factors the ratepayer has little idea of how his rate bill relates to the spending decisions of his council, and it is becoming ever easier for councils to persuade their voters that central government carries the blame for increased local rates.

(ii) the system of expenditure targets and grant holdback has alienated most of central government's lower-spending allies in local government, who accept neither the need for central government to set their targets nor the basis on which they are set — a basis which they believe treats them arbitrarily and unfairly in comparison with high spenders, since it is based on past spending patterns.

(iii) the measures taken to reduce overspending on capital have aroused strong opposition from the Government's own supporters in local government, which has not been offset by any marked success in controlling the overspending.

(iv) rate limitation has necessitated detailed central government involvement in the affairs of a number of individual authorities, which is administratively difficult and makes heavy demands on resources; it has also led to direct confrontation with certain authorities involving political and legal brinkmanship.

(v) both grant pressures and rate limitation may have helped foster political extremism in certain inner city local authorities; such authorities are using the present local government finance policies as a pretext for promoting the ideologies of class conflict.

These problems point to an increasingly heavy price in the future for relatively modest gains.

Chapter 2: The case for reform

2.1 In political terms, if we continue to try to apply existing policies within the present financial framework we will, in effect, be declaring the modern equivalent of a hundred years war on local government. But in any event, those policies have in practical terms only a limited life expectancy. Of the external pressure mechanisms, targets are proving so difficult to justify and to operate in any sensible or equitable way that their demise is only a matter of time. In the short term the pressure for restraint imposed by targets and holdback can be replaced by grant pressure using grant mechanisms under existing powers. But such mechanisms can only be used for a few years before they become ineffective or their effects become politically unacceptable. Rate limitation is working reasonably well in the first year of its operation. But it cannot be expected to serve as a permanent, long-term mechanism for constraining the generality of local authority expenditure.

2.2 The key point is that experience has shown that with the present rating system we cannot rely on the accountability of authorities to their ratepayers to secure expenditure restraint. And those parts of our present mechanisms (ie block grant reductions, targets and penalties) which rely for their effectiveness on voter reaction to increased rates have brought into even starker focus the inadequacies of rates as a source of local accountability.

2.3 On the capital side the present control system has fallen into disarray, largely because of the success of the policy of sales of local authority assets. Local authorities have accumulated £5 billion of capital receipts from those sales, which they would like to use to supplement capital spending allocations to meet what they see as urgent needs. But in the interests of macro-economic management we have had to ration the rate at which they can spend these receipts by reducing the "prescribed proportion" of receipts which they may spend in one year to 20% for housing receipts and 30% for other receipts. This has proved highly unpopular with authorities of all political persuasions, and avoidance devices are multiplying.

(i) The Grant System.

(a) Targets and holdback.

2.4 E(LA) have agreed that it would be highly desirable to abandon targets and holdback for 1986/87 for a number of reasons. In particular targets have caused considerable resentment and a sense of grievance among relatively low spending authorities which would otherwise be allies of the Government. These are authorities which have been set targets, related to their past spending, below the level of their GRE. Thirty eight of the thirty nine non-metropolitan counties are in this position. They cannot understand why they are being obliged, under pain of severe grant penalties, to spend below a level of expenditure assessed by Government as constituting a standard level of service, while other high-spending authorities are set targets well above their GRE. Figures 4 and 5 give an indication of the problem.

2.5 Other objections to targets are that they are inflexible, being based on general principles, which makes it increasingly difficult to devise equitable spending figures for over 400 individual authorities; that they override and undermine the basic block grant system; that they interact with rate limitation in a way which requires rate limits to be higher than they otherwise need be in order to finance grant penalties levied by the Exchequer; that they will become very difficult to operate in the wake of the abolition of GLC and the metropolitan counties, most of whose service responsibilities are to be divided up between the London boroughs and metropolitan districts; and that targets are only effective if holdback is made more severe each year, yet holdback cannot reasonably be made even harsher than the 1985/86 scheme, particularly given the inevitably rough justice underlying the targets.

2.6 The political and practical pressures to abandon such a system are strong indeed.

Figure 4 :

TARGETS AS A PROPORTION OF GRE

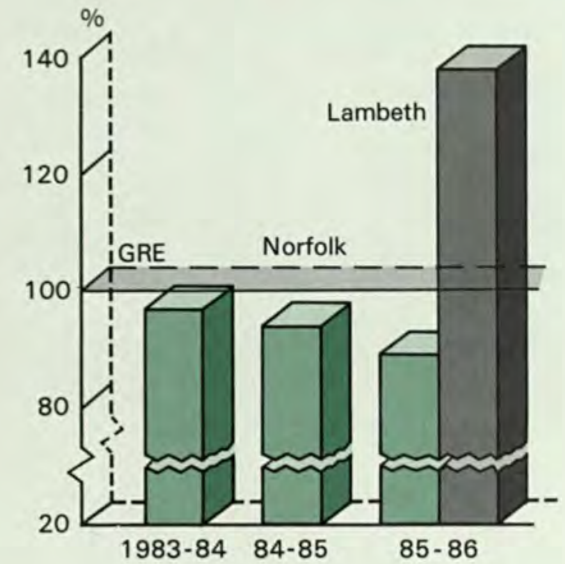
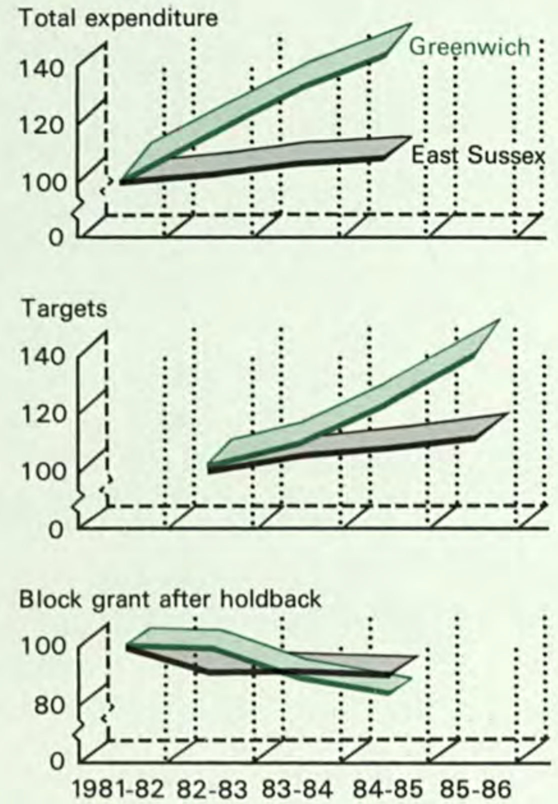


Figure 5 :



(b) Grant pressures

2.7 The abandonment of targets will require other measures to sustain pressure for spending restraint. Reductions in aggregate exchequer grant and a stiffening of the disincentives to increased spending incorporated in the block grant system are the main options. Grant pressure should be effective in the short term — perhaps the next two to three years — but thereafter becomes self-defeating. For both reductions in the level of aggregate exchequer grant and steepening of the block grant taper (to make the cost of marginal increases in spending higher to local ratepayers) have the effect of driving an increasing number of authorities out of grant altogether. They are then immune from the pressures of the grant system and the cost of marginal increases in expenditure actually diminishes for their rate payers. Figure 6 shows the number of authorities which are driven out of grant if the level of aggregate exchequer grant continues to be reduced on present trends from its 1984/85 level of 52% to 38% by 1990/91. If, in addition to reductions in aggregate exchequer grant, the slope of the block grant schedule is doubled,the group of authorities driven out of grant changes to include a number of high spending local authorities, such as Tower Hamlets, Newcastle, Lambeth, Basildon, Thamesdown and Southwark. It might be possible to rate limit all the high spenders pushed out of grant to maintain pressure on them; but it would not be possible to select the low spenders in the same position.

(ii) Rate limitation

2.8 Rate limitation has so far worked well in the first year of operation. But the Department of the Environment has been fully stretched in handling the 18 authorities selected. If further expenditure reductions are required more authorities would need to be selected; and for significant reductions to be achieved a very large number of authorities would need to be selected, as figure 7 indicates. These are much larger numbers than the Department could realistically cope with and would expand the selective scheme beyond what it was designed to achieve.

Figure 6 :
AUTHORITIES WHICH GO OUT OF GRANT AS THE AEG PERCENTAGE IS REDUCED

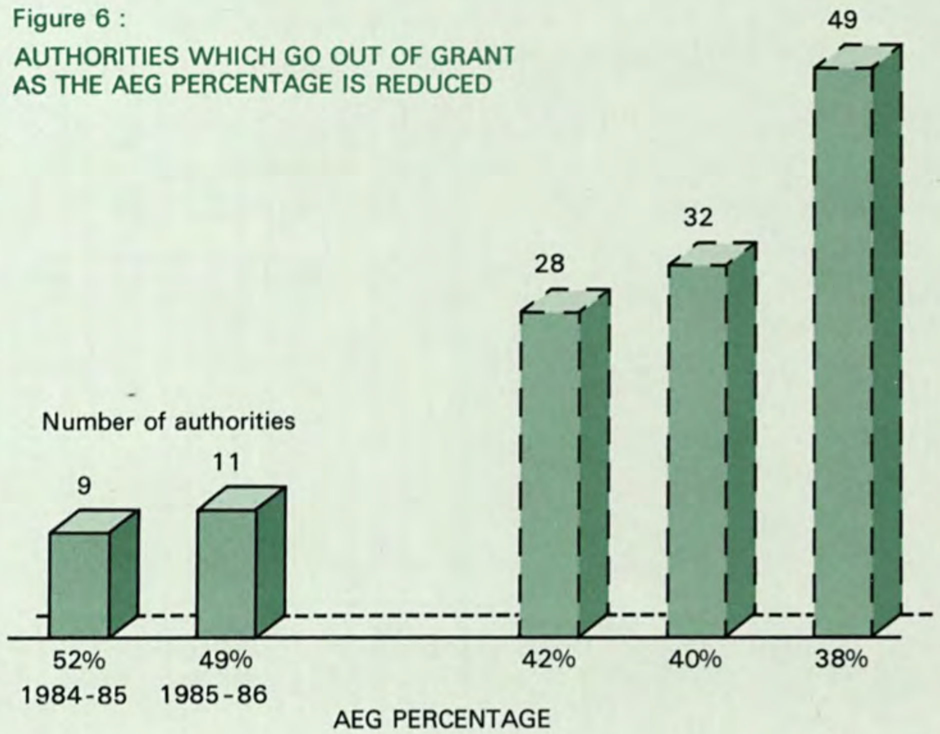
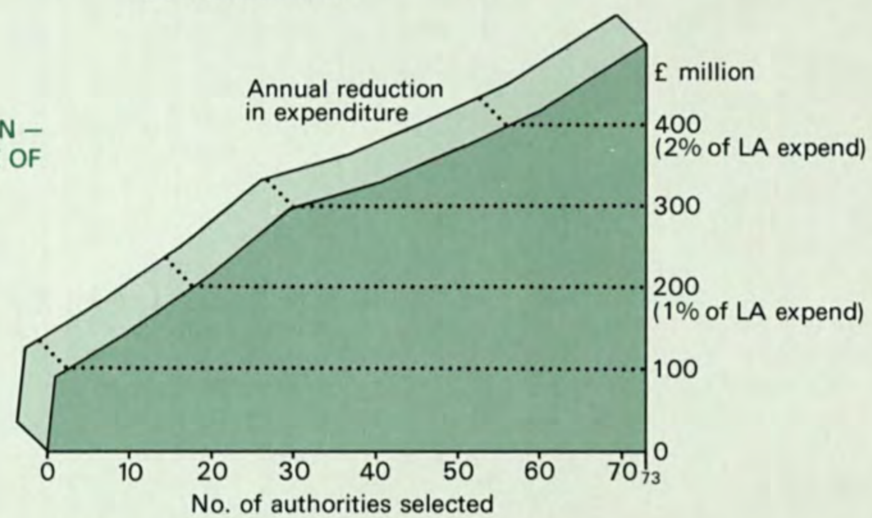


Figure 7:
RATE LIMITATION — THE HIGH PRICE OF SIGNIFICANT REDUCTIONS



The chart assumes that each authority selected reduces its expenditure by 5% per annum in real terms

(iii) Rates

(a) Not enough voters pay

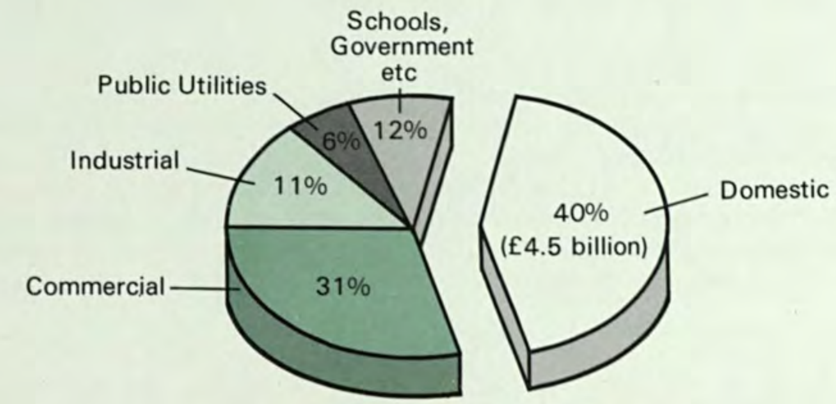
2.9 The attempt to rely on the accountability of councils to their ratepayers as a means of securing expenditure constraint has shown clearly the weak linkages between those who pay for, vote for and use local authority services. In particular it has highlighted two major flaws in rates as a tax on which to rely exclusively for the stimulation of voter reaction:

(i) local authorities derive more than half their rate income from the non-domestic sector which has no vote;

(ii) of those who do have the vote, only about a third directly pay full rates.

2.10 As figure 8 shows, 60% of the rate income of local authorities in England comes from the non-domestic sector, which includes commerce, industry, public utilities and other public buildings. In 1984/85 this sector yielded £6.5 billion in rate income. The remaining 40% — £4.5 billion (after rate rebates) — came from domestic ratepayers.

Figure 8 : RATE INCOME IN ENGLAND 1984–85



Rate income (net of domestic rate relief grant and rate rebates) £11 billion

2.11 Local Authorities are thus able to tap more or less at will the unrepresented non-domestic ratepayer, who has no effective sanction over the level of expenditure to which he is required to make a hefty contribution. And his contribution in turn substantially reduces the cost both of average levels of expenditure and marginal increases in expenditure to the *domestic* ratepayer.

2.12 The effects of such a situation can be seen at their most extreme in authorities such as Camden, where the non-domestic sector provides 75% of the authority's total rate income. Figure 9 shows how the Kodak company, which has premises in Camden, has suffered as a result: over the last five years its rate bill has gone up twice as fast as inflation.

Figure 9 :
RATE BILL OF KODAK PREMISES IN CAMDEN (RV £445,000)

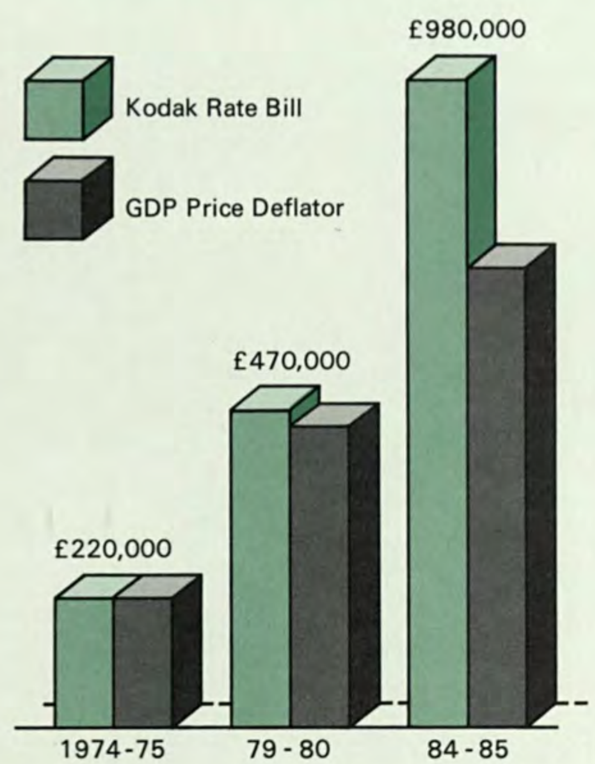
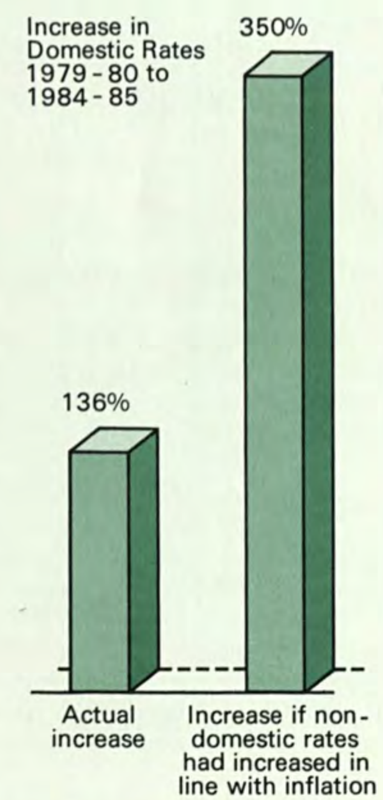


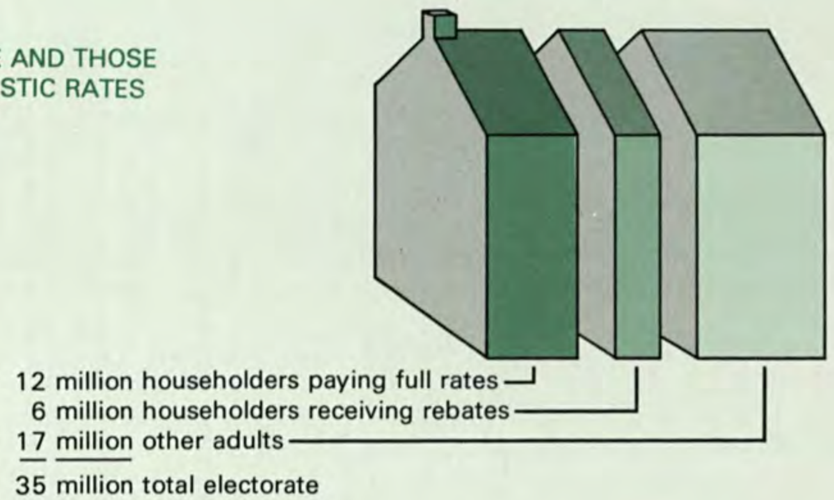
Figure 10 :
EFFECT OF INDEX LINKING NON–DOMESTIC POUNDAGE FROM 1979–80:CAMDEN



2.13 If, however, Camden's non-domestic rate poundage had been tied to the rate of inflation over the last five years, the domestic rate poundage would have had to increase by 350% to finance the authority's expenditure, as compared with the actual increase of 136%, as figure 10 shows.

2.14 The accountability of authorities for their expenditure and taxation decisions is further eroded by the weak links between the electorate and those who pay domestic rates. Of the total electorate in England of 35 million, some 18 million are liable to pay rates. A large proportion of the remaining 17 million will of course, be spouses or co-habitees of ratepayers. But of the 18 million liable to pay rates, only about two thirds — some 12 million — actually pay their rates in full; 3 million receive partial assistance with their rates through rate rebates and the remaining 3 million receive full relief from their rates bill.

Figure 11:
THE ELECTORATE AND THOSE WHO PAY DOMESTIC RATES



2.15 These figures are national averages. They disguise some significant variations between individual authorities. In Hackney, for example, the position is more marked: only about half of ratepayers — a quarter of the electorate — are paying full rates, as figures 12 and 13 show.

Figure 12 :
HACKNEY – PERCENTAGE OF DOMESTIC RATEPAYERS PAYING FULL RATES

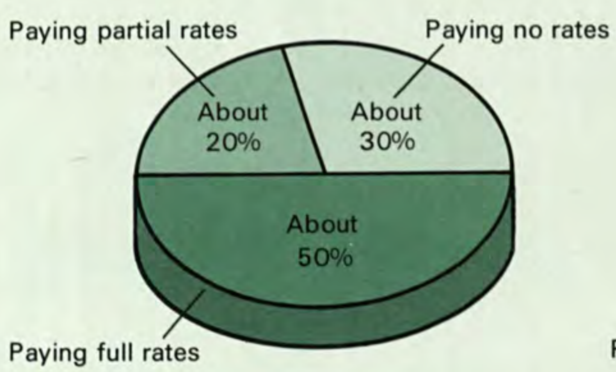
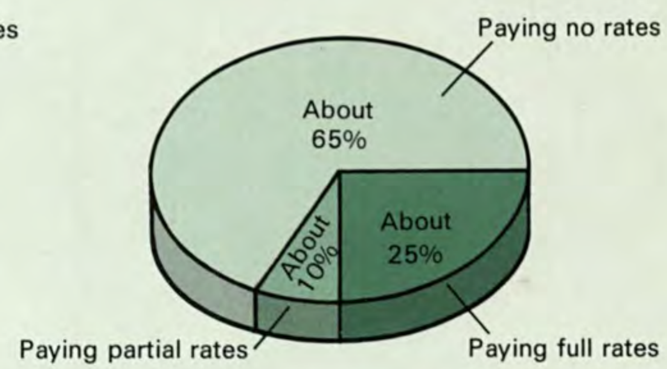
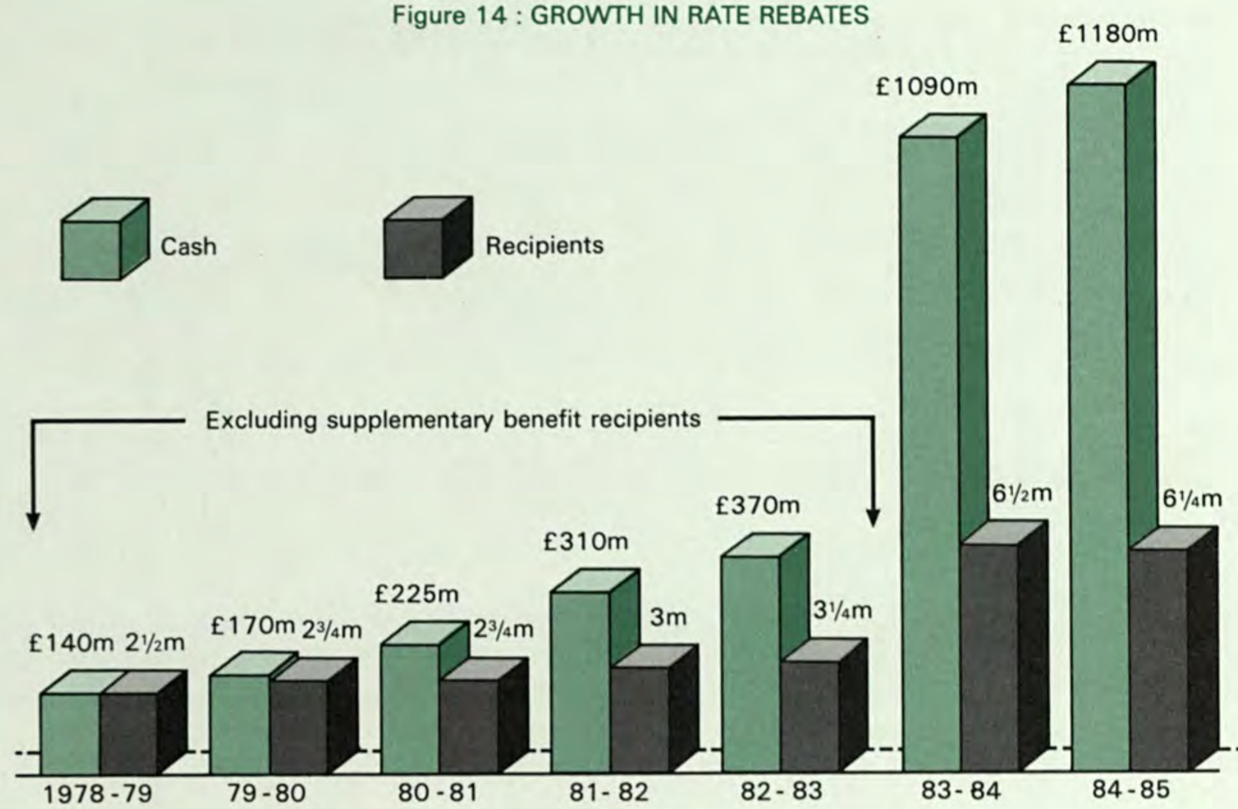


Figure 13 :
HACKNEY – PERCENTAGE OF ELECTORATE PAYING FULL RATES



2.16 The growth in rate rebates has therefore been a significant factor in weakening the link between voters and ratepayers. Figure 14 shows the pattern over the last five years. The dramatic leap in 1983/84 is explained by the introduction of the housing benefit scheme, which for the first time brought together those receiving assistance under the rate rebate scheme (the first five columns on the chart) and those receiving help with their rates through supplementary benefit, where separate data relating to assistance with rate bills had previously been unavailable.

Figure 14 : GROWTH IN RATE REBATES



(b) Confusing signals to those who do pay

2.17 There is nothing intrinsically wrong with taxing property, any more than any other commodity. And rates have many virtues and advantages which have long been recognised, a fact which was acknowledged by the Government in its 1983 White Paper "Rates"(Cmnd 9008). But if our main and overriding concern is with what a local tax tells those who pay it about the cost and level of the services they consume, then changes in rates are not a good guide for the taxpayer.

2.18 First, a tax on property cannot take account of the composition of households and thus of households' consumption of services. This may have been less of a problem in the past, when the bulk of local spending went on property-related services. Before the war a much larger proportion of municipal activity related, for example, to the provision of utilities, such as gas, electricity and water. But nowadays the bulk of local spending is on services to people, such as education and personal social services; see figures 15 and 16.

2.19 Second, rateable values for similar properties vary substantially from one part of the country to another, because they are based (in theory) on market rental values. As a quite explicit

Figure 15 : HOUSEHOLD COMPOSITION – SOME EXAMPLES

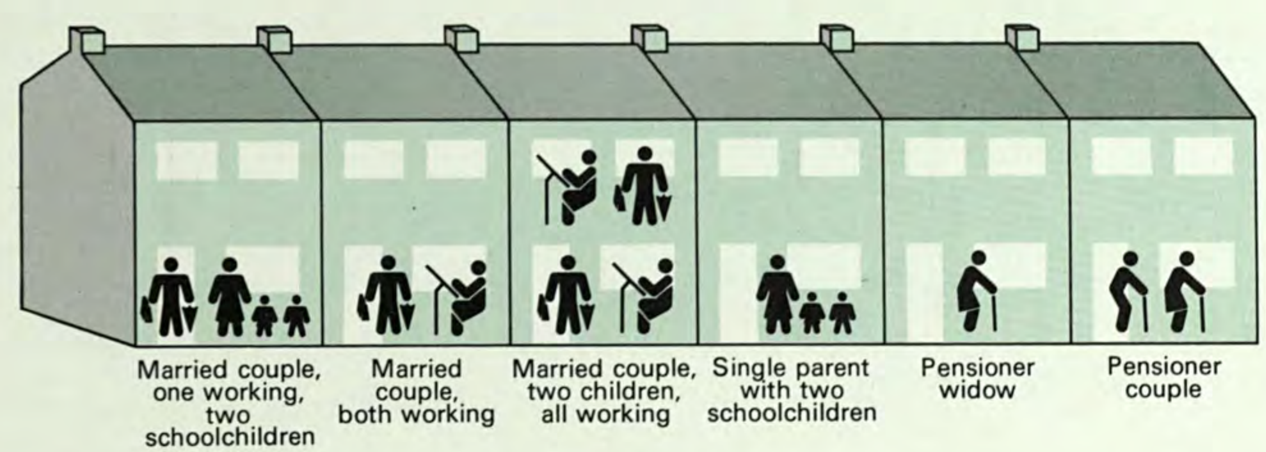
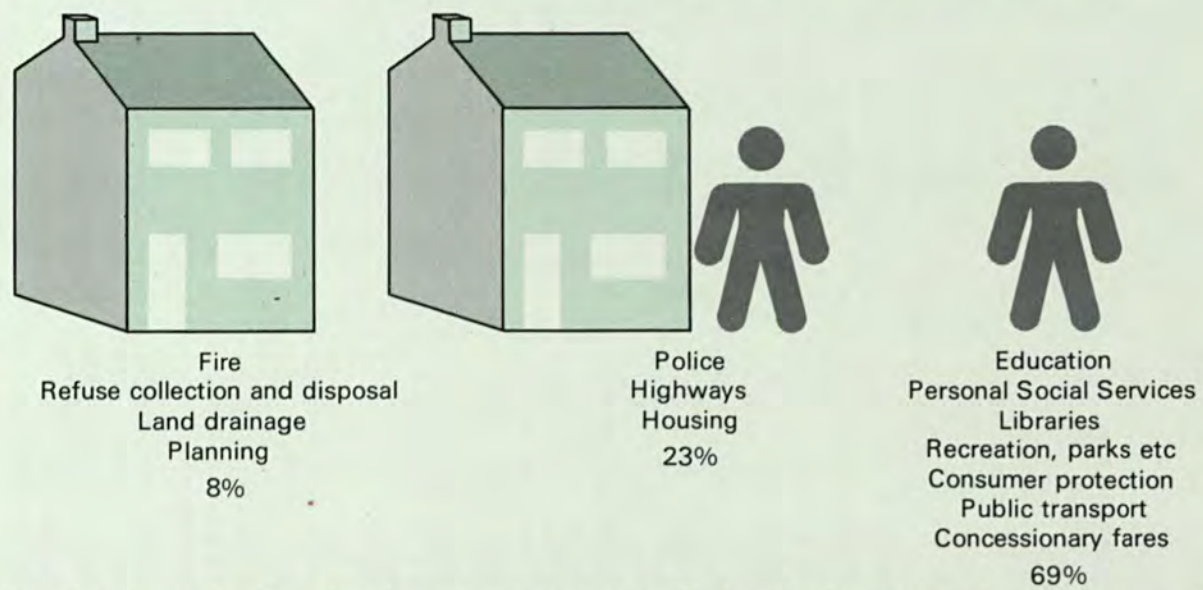
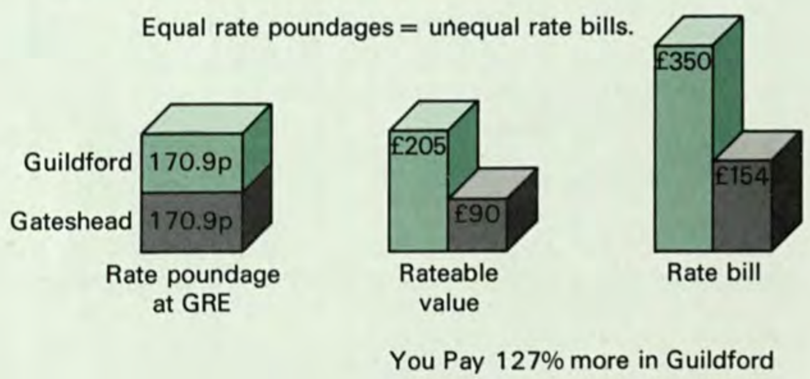


Figure 16: PROPERTY-RELATED AND PEOPLE-RELATED SERVICES
AS A PERCENTAGE OF LOCAL AUTHORITY EXPENDITURE



political and social policy aimed at ensuring comparable levels of service nationwide, successive Governments have distributed grant between authorities to compensate them for variations in rateable value so that local authorities can finance comparable levels of spending with a common rate in the £. In effect, the Government subsidises local expenditure by standing in as an additional ratepayer in each area. The consequences for individual ratepayers, however, are extremely varied. Someone living in a 3-bed terraced house in the home counties where rateable values are high not only pays a greater proportion of his income in housing costs, but also pays a much higher rate bill for the same level of service than his colleague in a similar house in the North East, where prices for equivalent houses are cheaper and hence assessed rental values are likely to be lower; see figure 17.

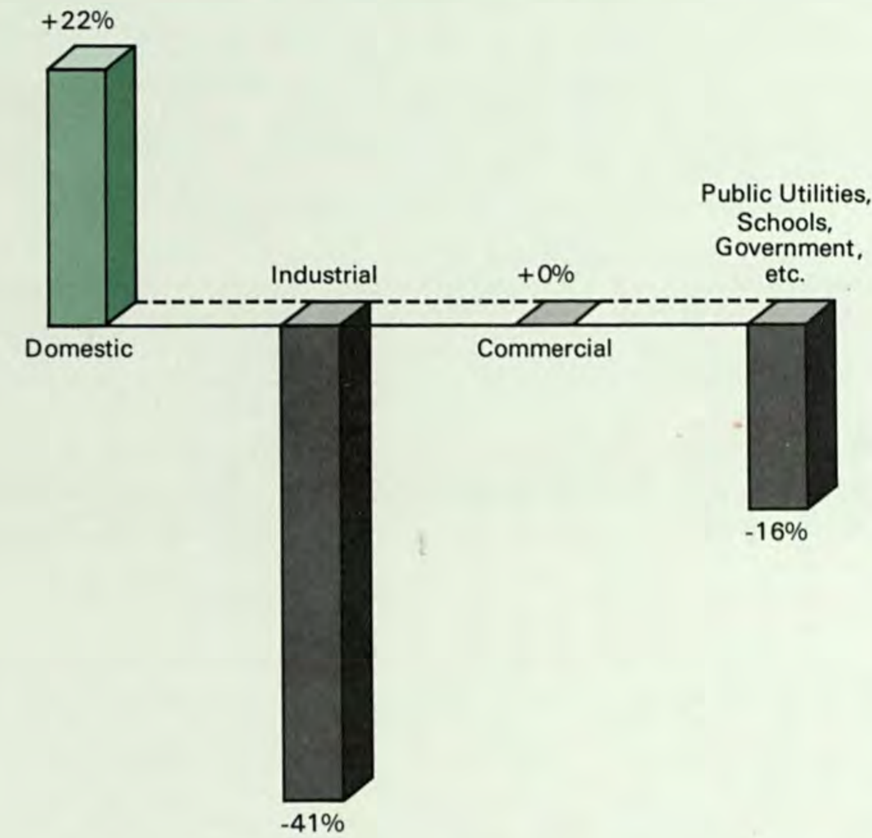
Figure 17: ILLUSTRATIVE RATE BILLS FOR A THREE BEDROOM TERRACED HOUSE
FOR AN EQUIVALENT LEVEL OF SERVICE



2.20 Third, a tax on property, if it is to be equitable within its own terms, must take account of relative changes in the value of different properties (however that might be measured). Yet revaluations taken at intervals can and do produce dramatic changes in the tax liability on individual properties, with consequential disruption to the finances of the individual taxpayer. Such effects are highly unpopular; and it is no surprise that the last two domestic revaluations in England were followed by enquiries into the Rating System, that the two after that have been postponed, or that the recent revaluation in Scotland has been so controversial; see figure 18.

2.21 These are not criticisms of the rating system for failing to do things it was never intended to do. The characteristics of the system described above have their own internal logic and consistency as a tax on property. As far as our studies are concerned, it is outside our remit to judge whether central government might want to keep domestic rates as one of its own capital taxes. But what we conclude is that rates, both domestic and non-domestic, are a bad tax as the sole basis for local authority income,since they do little to transmit explicable signals of sufficient strength to voters about the spending behaviour of local authorities.

Figure 18 :
CHANGES IN AVERAGE RATE BILLS IN GLASGOW CITY
AS A RESULT OF THE 1985/86 REVALUATION (ALONE)



The effect of the revaluation (alone) on the average domestic property in Glasgow City is to increase the rate bill from £340 p.a. to £415 p.a. – over £1 per week

(iv) Capital control system

2.22 The present capital control system is intended to enable Government to control the total level of net capital expenditure each year by local authorities (ie their gross capital expenditure less their capital receipts from sales of assets in the year). The system is however flawed because the allocations to individual authorities together with various freedoms and tolerances built into the system enable authorities' total spending to diverge substantially from national planning totals without any individual authority breaking its own limits. In particular, local authorities have freedom to supplement their capital allocations in any year with a proportion of their accumulated receipts or reserves built up in earlier years.

2.23 The logical thing to do to correct this might be to restrict or remove the right of authorities to spend the proceeds of asset sales, particularly those accumulated from earlier years. But this would destroy the incentive for authorities to sell further assets, which is an important political objective; and the controversy over the restrictions that have already been imposed indicate that it would be politically very difficult to reduce any further the right of authorities to spend their "own money" at any rate within the context of the present control system and present levels of planned capital expenditure.

Chapter 3: Reforming The Local Government Finance System

(i) Macro-economic Considerations

3.1 Our pursuit of policies to restrain local authority expenditure and taxation has sharpened perceptions of latent but fundamental flaws in the local government financial framework, and the mechanisms of restraint themselves have a limited life expectancy. But that does not, in itself, suggest that the government should abandon its objective of seeking to constrain the level of local authority expenditure, in order to achieve its main objectives of reducing the overall burden of taxation and limiting the extent of local authority borrowing.

3.2 Government has to be concerned about the overall size of the public sector. High tax rates, necessitated by high public expenditure, impair the efficient working of the economy. They act as disincentives to activity in the private sector, as the rewards of enterprise are diminished. The levels of taxation required to finance a large public sector absorb resources which could be put to more efficient use by the private sector; and a large public sector is likely to be undertaking activities which could be undertaken more efficiently by the private sector, operating under market pressures.

3.3 These arguments apply to taxes raised to finance central and local expenditure alike. But only a limited proportion of local expenditure is financed by local people. Grants from central Government — ie the national taxpayer — finance about 50 per cent of local spending and for some authorities more spending attracts more grant. Almost another 30% is financed by non-domestic ratepayers. Local domestic rates bear on average, only about 20% of the tax-borne costs of local authority services and that burden is concentrated on the 1 in 3 voters who directly perceive that they pay rates.

3.4 In these circumstances the government has been unable to rely on local pressure to deliver restraint in local expenditure and taxation. The Government has sought the delivery of specific local authority expenditure levels derived from its own public expenditure plans. The wrangling between central and local government has therefore been over the delivery of those expenditure levels. Yet delivery of specific expenditure levels for local authorities is not, in itself, essential to the successful management of the economy; it is a means towards achieving the real end of reducing the burden local authorities impose on all taxpayers, which under the current system electoral pressures are failing to achieve.

3.5 On the capital side Government is concerned about the broad level and composition of gross expenditure since capital projects represent the growth point of the local authority sector in response to new needs and pressures. The size and balance of capital expenditure must therefore be brought into reasonable relationship with the Government's perception of overall service needs, and the extent to which local authorities should be meeting them. Government must also be concerned with the general level of local authority borrowing. Curbing the rate of monetary expansion is central to the Government's policies for reducing inflation and laying the basis for sustained economic growth. That in turn requires a downward trend in public sector borrowing if interest rates are to be held to acceptable levels. Higher local authority borrowing makes it harder for the Government to achieve these objectives.

3.6 Under the present system Government seeks, ineffectively, to control net capital expenditure. It exercises no direct control over local authority borrowing, except insofar as the control over net capital expenditure and the prohibition on anything other than temporary borrowing for revenue purposes exercise an indirect influence. As a result total local authority borrowing is higher than it need have been for the given level of expenditure because the interaction of RSG pressures and the capital control system discourage the financing of capital by revenue contributions, ie from the rates. It has also always fluctuated rapidly and unpredictably by up to several billion pounds from year to year.

3.7 For the future it would be desirable in principle to establish a system that enabled a more stable and predictable level of local authority borrowing to be delivered. If this could be established without a direct control over capital expenditure we might reasonably allow capital expenditure greater freedom to find its own level within the constraint implied by the control on borrowing.

(ii) What kind of local government system do we want?

3.8 If the present grant and rating systems cannot meet for much longer the Government's legitimate concern about the level of the local authority tax burden a new framework must be devised. But what that framework should be raises the fundamental question of what kind of local government system we should have in this country.

3.9 There are essentially two choices facing the Government:

either (i) new mechanisms to achieve direct central control over local authorities' spending and/or rate levels, so as to ensure that they conform with Government's policies and priorities;

or (ii) a new "self-regulating" grant and local tax regime in which authorities are made fully and properly accountable to local people , so that the electorate can understand and influence the spending and taxation decisions of their local authority.

3.10 The choice between the two is not influenced by considerations of practicality or efficacy alone. The fundamental issue at stake is whether or not government believes in a reasonably pluralist and decentralised society in which local political choice and self-determination has a part to play within a clearly defined statutory framework, alongside the decentralised economic decision-taking in which we so fundamentally believe as supporters of market choice. Traditionally, the Conservative Party has held to that belief : as we have stressed, that was the other leg of our policy towards local government in 1979. Mechanisms for increased central government control over local authority spending and rates might perhaps ensure delivery of lower spending and taxation levels than would otherwise apply with our present financial system but they run counter to that tradition. Measures to improve the accountability of authorities to their electorates do not; but while we might expect enhanced accountability to lead to local victories for those who wish to reduce expenditure and taxation in many authorities, we must be prepared to accept that in some it may not. What a proper local government financial system should do is to minimise the effect on national economic and fiscal management of the fact that allies of the central government's low spending policy will not hold power in every local authority at all times; and it should ensure that higher local expenditure and taxation are only accepted as local policy when they are chosen by the majority of local taxpayers.

3.11 Improved accountability in respect of current expenditure and its consequences for local taxation does not, however, preclude effective means of influencing local authority borrowing or capital expenditure; indeed we would argue that the two approaches must go hand in hand.

(iii) Increased Central Control

3.12 Leaving aside the issue of principle, mechanisms for increasing central control all have major practical drawbacks. We have considered three such mechanisms.

3.13 First, *a general limit on rates*. This would limit the local tax burden and, together with the control which central government has over grant, it would provide an effective brake on local authority spending. But it would be administratively extremely difficult to operate: central government would either get drawn into the detailed financial affairs of a large number of authorities if tough limits were applied; or it would have to set generous limits to take account of the different circumstances of local authorities which would achieve little in the way of restraint in expenditure or taxation. It would be overtly very centralist and as such would be deeply unpopular for very little gain. Moreover, we do not have such a power on the statute book; in order to secure the passage of the 1984 Rates Act, considerable categories of authority had to be exempted from its reserve 'general' powers.

3.14 Second, *100% central funding of the main local government services* (education, personal social services, police, fire and highway maintenance), with the remainder of services financed entirely locally. This would provide control, at least as effective as that of Whitehall in respect of other centralised services, over about three quarters of local authority expenditure; it would establish a clear division of responsibility between central and local government for services with national characteristics as against purely local services; and it would enable uniform standards to be applied to services financed by central government. However, it would involve a very substantial increase in central government bureaucracy in order to assess accurately the need for services in each local authority and to monitor and supervise their delivery by local authorities. Central government and Ministers would become answerable for every detail of service provision in every local authority and would face pressure to level up standards of service provision in areas where it was alleged to be below average. Local authorities would simply become agents of central government and would lose their incentive to manage services efficently and they would blame central government for all shortcomings. In short, the system would be cumbersome, inefficient and expensive to run and savings in expenditure would not be certain. Meanwhile, sharpened controls would still be needed for locally financed services to prevent an increase in spending on such services as the burden of local tax fell. The outcome would be unpredictable and the game would not be worth the candle.

3.15 Third, *central funding of teachers' salaries.* This would provide direct central control of over half of education spending and one fifth of all local authority spending. It would enable the Government to take over responsibility for the attempt to influence standards of provision in education through the number and grading of teachers. Like central funding of the whole education service, however, central funding of teachers' salaries would require a substantial increase in central government bureaucracy to determine the number and grading of teachers required in each authority (quite possibly in each school) for which central government would become answerable. Like 100% funding of main services, it would only be a means of reducing the levels of rates if mechanisms were put in place to stop other local spending increasing. It would add 4p to the standard rate of income tax or increase VAT by 5%. We believe this option has little to commend it; and if the overriding concern is to secure greater central government influence over the education service we believe this could be more effectively achieved through further development of educational specific grants.

(iv) A self-regulating system

3.16 Both practical and philosophical objections therefore appear to rule out centralist solutions. But we do not advocate a new self-regulating system of local authority finance by default. Given that Government will retain its concern with the burden of local taxation, such a regime is the best choice if it still believes in the principles of pluralism and local choice and accepts that central Government cannot always know best; and if it recognises that in the end spending can only be restrained locally or centrally if enough people are persuaded to vote for such a policy.

Chapter 4: The Elements of a Self-Regulating System

4.1 The key to a new self-regulating local government finance system is greatly improved accountability on the part of local authorities to their electorates and taxpayers. The above analysis suggests that under the present system four principal factors weaken accountability:

- the non-domestic ratepayer represents a non-voting revenue source which local authorities can tap at will
- domestic rates are too narrowly-based a tax: not enough voters pay
- for those who do pay, domestic rates give confusing signals about the level and consumption of local authority services
- the rate support grant system distorts accountability through a resource equalising grant.

These are the problems which have to be addressed if accountability is to be improved.

(i) The non-domestic ratepayer

4.2 In principle, one answer to the lack of representation for the non-domestic ratepayer would be to give him the vote. This was discussed in the 1981 Green Paper "Alternatives to Domestic Rates" (Cmnd 8449). However, it was concluded that the practical problems of trying to devise a workable scheme in a way which would produce a real degree of accountability were overwhelming.

4.3 The decision not to reintroduce the "business vote" was confirmed in the 1983 Rates White Paper. We see no reason to differ. But from that we conclude that it cannot be right for local government to continue to have uncontrolled access to such a large taxpayer to which it is unaccountable. The non-domestic rate is not an appropriate tax to be left to local determination. It does, however, raise a very large sum of money — £6.5 billion in the current financial year, substantially more than the £4.5 billion paid by domestic ratepayers. If non-domestic rates were abolished the income they yield would have to be found from other sources: either from national taxation via Government grants or from domestic ratepayers; or some combination of the two. But whatever alternatives were found, the consequences for individual taxpayers, whether locally or nationally, would be very severe.

4.4 We therefore suggest that non-domestic rates be retained, and the proceeds made available to local authorities, but that control of the level of the rate be transferred to central government. Central government would then be accountable to Parliament for the level of the non-domestic rate (which might be set after consultation with representatives of the non-domestic sector) in the same way as it is for other taxes which bear on businesses. (An essential preliminary would be to have a non-domestic revaluation to put rateable values on an up-to-date comparable basis). Local authorities would then have to finance the full cost of marginal increases in expenditure from those to whom they are accountable, namely local voting taxpayers.

4.5 The second report discusses how non-domestic rate levels might be determined under the new arrangements and how the yield might be assigned to local authorities.

(ii) Domestic rates: a confusing tax which not enough people pay

4.6 If we accept that a property tax no longer serves the interests of local accountability and that enhancing accountability is our prime objective, then we should be thinking in terms of equipping local government with a new tax altogether.

4.7 Our criteria for assessing a new local tax have been based on the need to improve the accountability of local authorities to their electors. On that basis, any new tax needs to satisfy the following criteria:

(i) it should be perceptible

(ii) it should be non-buoyant

(iii) it should be as widely-based as possible

(iv) it should be clearly related to the consumption of local services

(v) it should reflect in an accurate and predictable manner marginal changes in expenditure.

Any new tax should also be compatible with the government's overall taxation policy.

4.8 We have examined again the major alternatives considered in the "Alternatives to Domestic Rates" against these criteria. They are:

(a) reformed domestic rates

(b) local income tax

(c) local sales tax

(d) a charge on all residents (residents' charge).

4.9 Domestic rates meet some of the criteria of accountability, in that they are highly perceptible to those who pay them and non-buoyant. But as we have seen, they fail in other crucial respects. Domestic rates might be brought more closely into line with consumption of services by making some adjustments to reflect the composition of households. But this would create a confusing hybrid tax and continue to give misleading signals to ratepayers. It would be an unsatisfactory half-way house between a straight property tax and a community charge, and would create yet more anomalies.

4.10 A local income tax on the PAYE basis would widen the tax base from the 15 million who currently pay full or partial rates to 20 million income taxpayers. It *could* be made to be perceptible, although at greater administrative cost, if collected by local authorities rather than the Inland Revenue. But it would be administratively complex; it would still leave 15 million electors with no direct financial stake in local spending decisions. The better off would pay more, irrespective of their consumption of local services and it would add to the burden of taxation on incomes;and it would conflict with the steps the government has taken to reduce the burden of direct taxation. It would also, or course, be buoyant, which is why it is the popular choice of most local authority officers.

4.11 A local sales tax would be paid by all consumers in the locality. It would widen the tax base to all residents — and also to a substantial number of non-residents. But it fails the accountability criteria for a number of reasons:

(i) it would be hard to perceive

(ii) it would give local authorities a buoyant source of income, allowing them to fund increasing spending without increasing the rate of tax

(iii) there would be no direct link between paying for local services and voting in local elections, since many non-residents would pay the local sales tax and residents in one authority could shop elsewhere

(iv) the yield is lumpy and not susceptible to fine-tuning to reflect marginal changes in spending

There are further problems given the present structure of local government. The proceeds of a local sales tax would benefit disproportionately regional shopping centres. This effect is particularly stark in conurbations (eg Newcastle would benefit from attracting shoppers from the rest of Tyneside and from Northumberland). So a Local Sales Tax would necessitate equalisation *between* neighbouring authorities.

4.12 The final option is a simple flat-rate charge on all adult residents. This produces the closest fit with local electors. It would widen the tax base from 15 million people to 35 million. It would be clearly related to the level of local authority services, since there would be no need for complex equalisation mechanisms to distort the link between service and cost. It would be perceptible and its yield should both be predictable and easy to fine-tune, so should not distort incentives. For all these reasons, we believe that a form of residents' charge would be preferable to domestic rates as the principal source of locally-raised revenue for local authorities.

4.13 The objections to the residents' charge were well rehearsed in "Alternatives to Domestic Rates." They include concern about the implications of registration of voters; administrative complexity; and the fact that it takes no account of ability to pay. The last is arguably the most important. The level and impact of any community charge would have to be assessed in the context of its effect on the range of household incomes and colleagues will want to see the result of this before reaching a final view. But it would be unrealistic to expect people on low incomes to be able to bear the full cost of the residents' charge, even if benefits were raised to take account of the average level of the charge. The residents' charge would either have to operate with a rebate system or be reflected in supplementary benefit levels. But, unlike the present position with housing benefit, we believe every adult should have to meet some proportion of the residents' charge from their own pocket even if for the poorest the welfare system put the money there in the first place. Automatic 100% rebates for any member of the community undermines the accountability gains from the introduction of a residents' charge.

(iii) The rate support grant system distorts accountability

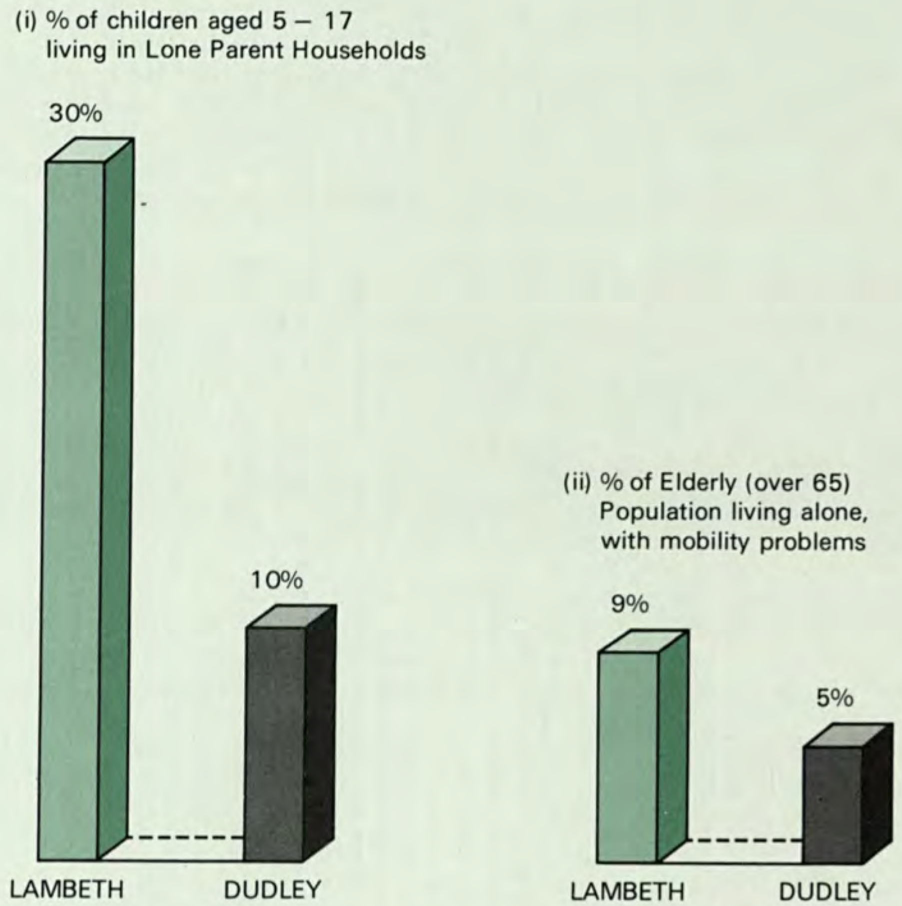
4.14 If the residents' charge is to reflect accurately the relative level of local services and to promote accountability, we need to ensure that differences in the needs and circumstances of local authorities which might otherwise distort those bills are properly compensated for.

4.15 The principle of compensating for such differences already underpins the existing rate support grant system. But as we saw in paragraph 2.19 the effect of also compensating for differences in authorities' rateable resources introduces major variations between different parts of the country in the rate bills levied on comparable properties for comparable standards of service. This is one of the confusing signals which the present grant and rating systems send to domestic ratepayers. However, the switch from domestic rates to a residents' charge deals with this problem, since the taxable capacity per adult does not vary from area to area. There is therefore no need for domestic resource equalisation, once it is accepted that all adults should be liable for the charge.

4.16 Non-domestic rates will be retained under our proposals and the amount of non-domestic rateable resources varies widely between authorities. However, we can compensate for these differences if we pool and redistribute the yield from non-domestic rates on a national basis (following a non-domestic revaluation) as a standard amount per adult. The need for non-domestic resource equalisation through the grant system therefore also disappears.

4.17 There is, however, still a need to compensate authorities for differences in their assessed spending needs, for the kind of reasons illustrated by figure 19. However, because inequalities in resources have already been taken care of, the complex machinery of the present block grant is not required: the only grant we need is a lump sum allocation to each authority calculated according to their needs as assessed by central government formula, and not related to how much they spend.

Figure 19 : WHY NEEDS FOR L.A. SERVICES VARY



4.18 The effect would be that, whatever their varying needs, authorities providing a standard level of service will be able to levy a similar level of residents' charge. If they spend more than this, the whole of the excess will have to be met from a higher residents' charge.

4.19 This makes it all the more important that the needs assessment formula should be perceived to reflect differences in spending needs fairly: there is in particular doubt as to whether the inner urban areas' special requirements are adequately dealt with at present. But we aim, too, to make the formula simpler and more intelligible.

4.20 We should beware, however, of assuming that this proposal should lead to a lower overall level of grant than at present; if we were to constrain the grant to the minimum amount needed to equalise differences in authorities' expenditure needs, the overall level of local taxation would have to increase very substantially indeed.

(iv) Other measures

4.21 We also see merit in pursuing certain other measures which should either promote local authority accountability or redefine the framework within which local government operates so as to strike a sensible balance between the legitimate interests of central government and allowing local government freedom of manoeuvre. These measures are as follows:

— A new framework for the control of capital expenditure or of borrowing which delivers total figures closer to national plans, and which gives individual authorities greater certainty about the available level of resources within which they can plan capital programmes over several years. Following the analysis in paragraphs 3.6 and 3.7 above, there would be attractions in principle in operating the new control on net external borrowing by local authorities, and giving them the freedom to spend in addition on capital in any year any amount which they choose to raise locally either by asset sales within the year or by contributions from revenue. There are, however, considerable practical problems in devising any such system and it would be premature to decide in favour of a borrowing control at this stage before these have been explored further. It may turn out that in the event some form of capital expenditure control (perhaps based on gross expenditure) remains more practicable and could indirectly give a better degree of influence over borrowing as well. A separate paper will be circulated on a range of options shortly.

— a new framework governing the budgetary procedures of local authorities, so that the possibility of deficit financing can be pre-empted and the relationship between local tax levels and local spending levels preserved;

— the possibility of annual elections for all authorities (as happens at present in metropolitan districts and some shire districts) in order to improve accountability and electoral influence over council affairs;

— measures to encourage an increase in the amount authorities raise through fees and charges for their services.

4.22 Finally, we must recognise that, other things being equal, the new financial framework we have recommended will increase the burden of local taxation on the residents of the worst areas of inner city dereliction. This is primarily because the authorities concerned are spending considerably more than their assessed needs now, and in future the entire burden of such excess expenditure will fall on the residents' charge. It may be that the current needs assessment formula fails to reflect the full intensity of the problems of these areas, and we shall be considering this in our revision of the needs assessment arrangements. In addition, extra resources could be allocated to specific activities in these areas by the authorities and central government acting in partnership: this should help to ensure that the resources are put to best effect.

Chapter 5: Conclusion

5.1 Our objective has been to find a new system of local government finance which strikes a balance between on the one hand central government's desire to encourage authorities to operate more economically and efficiently and to constrain the burden they impose on local taxpayers; and on the other hand the need to restore proper local accountability and avoid detailed central government involvement in the affairs of local authorities, which we do not believe to be in central government's best interests.

5.2 We have accordingly focussed on means to improve the accountability of local authorities to local people, so that their electorates may better understand the actions and affairs of their councils, and have both the incentive and the ability to influence effectively those actions and affairs. We believe that in general this will encourage local authorities to behave in a way which is more compatible with the policy objectives on which we fought and won the last two elections. We must accept that in some authorities the electorate may choose differently; but under our proposals such a choice would at least more genuinely reflect the wishes of the majority of local taxpayers than at present. Above all, we believe our proposals offer the best chance of providing a durable, self-regulating system of local government finance from which central government can stand back.

5.3 To local authorities we would be offering a new deal — the most fundamental since the 1830's — whereby we would scrap targets, penalties, block grant taper, the complexity of GRE's, rate capping and perhaps capital allocations, for freedom to set a painful local tax within tighter legal constraints on borrowing and the manipulation of accounts. To local voters we would be offering real power over their councils — with the risk that if they did not vote they might get sharply higher bills — and a shift in local payments towards those who use local services most. The upheaval of domestic revaluations would disappear once and for all. Business would be protected. Central government would be free of its increasing entanglement with local decisions and domestic rates would have been abolished.

5.4 This report has described how we arrived at our recommendations. Our second report provides a detailed specification of these recommendations and a preliminary analysis of their likely effects on the finances of authorities, households and individuals.