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I'm a Local Councillor, Get Me Out of Here!

England's System of Local Government Finance

by Tony Travers and Lorena Esposito

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Foreword

'I'm a local councillor, get me out of here!' is the second part of a major study into the reform of local government finance in England. Our aim is to provide a non-technical and accessible analysis of the current system and to suggest some key principles that should guide any reform of it.

The local government finance system is one of the things that we never seem to be able to get right. For most of the last century it has been trapped in an eternal cycle of political crisis, expert review and botched reform. As the Government's Balance of Funding Review draws to a conclusion, we hope that all political parties at Westminster will find the courage to break out of this cycle of failure.

The next phase of our study will examine the merits of the local government finance systems operating in other countries. We will conclude the study with detailed recommendations for reform of local government finance in England.

1. Introduction

This volume briefly reviews the revenue and capital finance system available to local government in England and examines the recent changes to the system under the Blair government. A detailed review of the local finance system and its constituent parts can be found in Appendix I, and a review of the structure of local government in England is set out in Appendix II.

An understanding of local government finance as it currently stands is crucial to any process of suggested reforms: it is imperative that the shortcomings of the current financial system are identified to ensure that any reforms suggested actually address the difficulties with the present regime.

Having completed a review of the capital and revenue finance systems, and examined the shortcomings and problems with both, we will seek to discover whether the local finance system is meeting the aims desired of it, as stated by the current Government, after which some guiding elements of a good finance system will be set out.

The system of local government finance in the UK has been endlessly reformed, both in structure and substance, in recent history. It has been the catalyst for much political debate and has even been the downfall of prominent politicians.

The local finance system has been criticised by politicians and the public alike and much of what follows in our own critique is not new, but it has informed our view that substantial and wide reaching reform of the system is long overdue if local democracy is to be revived.

2. The Local Government Finance System in England – In Brief

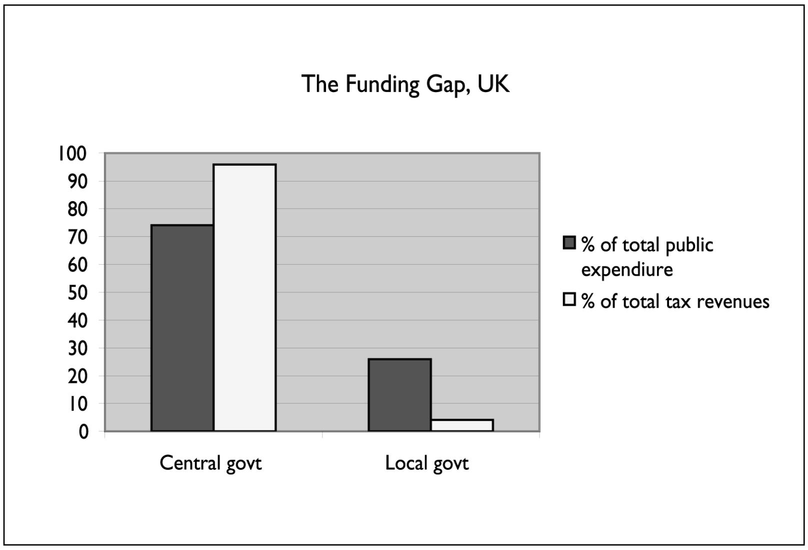
This section reviews the current system of local government finance in England, placing it in the context of national public expenditure. References in square brackets relate to the relevant section of Appendix I, which provides a detailed review of the workings of the finance system.

2.1 Local Government in the National Context [2]

Local government expenditure comprises approximately a quarter of all public spending in the UK and represents nearly 10% of UK GDP. Local taxes however (in the form of council tax) contribute only 4% of all taxes to the exchequer.

The gap between local government's share of public expenditure and the tax revenues it is able to raise itself (the funding gap) is shown in Fig 1 which clearly shows the extent to which local government is dependent on central funding in order to meet this discrepancy.

Fig I



Source: Joumard and Kongsrud, 'Fiscal Relations Across Government Levels', OECD Economics Dept Working Paper No 375, p11Data relates to the year 2001

2.2 What does local government do? [1]

Local government is responsible for providing those public services not provided by the centre. The main services provided locally are education, social services and housing, and local authorities are responsible not only for the day-to-day running of these services, but also in their long-term investment.

2.3 The Local Finance system – In Summary

Local government expenditure is split into two categories; revenue and capital. Each has its own prescribed method of funding under the current system [3]

Revenue expenditure is the spending required to finance the everyday running of council services, and is funded in four main ways:

- The Council Tax (a local property tax) [4.1]
- The National Non-Domestic Rate [4.2]
- Charges for services and fees [4.3]
- Central grants, both general and specific [4.4]

Capital expenditure is spending on long-term assets which provide benefits beyond the current year's spending activities (eg buildings, and fixed assets). Capital expenditure is financed in three main ways:

- Borrowing [4.5.2 and 4.5.3]
- Captial grants [4.5.5]
- Capital receipts [4.5.6]

3. Recent changes to the finance system – the late 1990s and a new Labour government

The Labour government that came to power in 1997 inherited a local government finance system which had proved itself to be a millstone around the neck of the previous Conservative administrations, whose reforms - from rates to poll tax to Council Tax – "lived on in the memories of politicians as a terrible warning about the dangers of over ambitious reforms of local taxation." [Travers, 2001, p126]

The system of funding in place in 1997 was more than three-quarters financed by national government (through central grants and national non-domestic rates) with only one income source- the Council Tax- directly under local control.

The new Labour government promised to review three main areas of local government finance:

- Budget capping
- The National Non-Domestic Rate (NNDR)

- The revenue grant distribution system

A White Paper published in 1998 was, however, cautious in its proposals. See Box 1.

Box 1 – The 1998 White Paper

In July 1998, a white paper was published setting out the Government's proposals with respect to local government finance. Its main proposals included:

- An end to 'crude and universal' capping but with the Secretary of State retaining the selective power to budget cap councils with excessive Council Tax increases
- A review of the revenue grant allocation system
- The introduction of a 'single pot' scheme for capital finance which would work alongside the requirement for local authorities to produce Asset Management Plans and Capital Strategies. Monies allocated from the single pot would then be non ringfenced and available to use on capital expenditure at the local authority's discretion.

The White Paper made it clear that the Government had no plans to change the existing Council Tax system, nor was there any intention to return the control of NNDR to local authorities

The Local Government (Best Value and Capping) Act 1999, was enacted to replace the old universal system of capping local authority budgets introduced by the previous Conservative government. Preannounced capping criteria were abolished and replaced with a system of reserve powers for selective capping of those councils deemed to have excessive Council Tax rises. So although the capping system was reformed, ultimate control over council budgets (and therefore Council Tax rates) remained in central hands.

With respect to NNDR, any hopes local authorities had of the business rate being returned to their control were disappointed, even though this single reform could have been an easy step to giving local authorities back control over approximately half of their income.

As promised, a review of the revenue grant system was undertaken in 1999-2000 with a wide ranging review of international finance systems. However, the 2001 White Paper (see box 2) confirmed that formula distribution would continue to be the basis on which central government grants were allocated to local authorities.

Box 2 - The 2001 White Paper

After the publication of a Green Paper in September 2000, in which the Government laid out aims for the local government finance system, a further White Paper was published in December 2001.

In the White Paper the Government noted what it believed to be a distinction between the 'balance of funding' and the 'balance of control' between local and central government. Despite conceding that the highly centrally funded nature of the local finance system created highly geared authorities, the government stated its belief that there was "…no hard evidence of the effects of the present funding balance on local authorities' autonomy." [CIPFA, 2002, p105] The establishment of the Balance of Funding Review was undertaken to investigate the issues of funding and local autonomy further. (see below for further discussion on gearing)

In relation to the Council Tax, no major proposals to fundamentally change the existing system were put forward. The Government did however state its intention to have regular (every ten years) revaluations of taxable properties for Council Tax, and to reserve power to alter Council Tax bandings at its own discretion.

With respect to grant finance, formulae would continue to be the basis on which Revenue Support Grant, RSG, is distributed to local authorities, although the formulae would be reviewed to make them 'fairer and more intelligible.' The increase in ringfenced grant finance since 1997 was acknowledged, but no proposals were put forward to address this trend (and its detrimental effect on local spending freedom). Instead, proposals for 'targeted grants' which would be given to selected authorities to be spent on a specific service area, eg, the Neighbourhood Renewal Fund, without being ringfenced within that area were introduced. [see Appendix 1, 4.4.4] As discussed elsewhere, despite not being thought of as 'specific' grants, targeted grants are in substance ringfenced to a service area and cannot be spent elsewhere. To all intents and purposes they are specific grants under another name.

With respect to capital finance, proposals to create a system of capital financing based on a system of prudential rules were cemented. Under this system, all capital controls would be abolished and local authorities would be free to borrow as they saw fit, subject to the prudential guidelines set by central government. This would have the effect of giving local authorities much greater control over capital expenditure, treating them more like commercial enterprises.

For the financial year 2003-04, a new formula grant distribution system was introduced which replaced the old Standard Spending Assessments (SSAs) with Formula Spending Shares (FSSs). "FSS is used to allocate grant according to the relative circumstances of different local authorities. It is the way the cake is divided." [LGIU, 2002, p62] However, the Government also introduced a requirement that any future increases in FSS to local authorities should be 'passported' into education funding for schools.

"…the Blair government has made no effort to reduce the centralised nature of taxation and public expenditure control." [Travers, 2001, p135]. In the financial year 2001-02, Council Tax made up only 4% of all tax revenues in the UK [ODPM, Local Govt Financial Statistics England, No13, p22]. Central government controls more than 95% of all tax revenues in the UK, and despite the publication of reviews and White Papers there are no significant plans to push any more revenue into the direct control of local authorities. No financial power or autonomy has been returned to local authorities.

4. Shortcomings of the current system of local finance

4.1 Council Tax

4.1.1 The Gearing Effect

As the main source of locally determined income (NNDR is allocated to councils on a per capita basis, and the RSG according to central formulae), the Council Tax is the only means open to local authorities to meet any shortfall in funding between their own budgetary requirements and central support allocations.

Councils which want to expand their budgets are therefore forced to raise Council Tax bills, and only those who cut spending or get more grant than they need can afford to cut Council Tax bills. The percentage impact on Council Tax bills of changes in local budgets is known as 'gearing'.

The greater the proportion of income a local authority raises from Council Tax, the smaller the knock-on effect any spending increases will have on its Council Tax bills. This creates confusion for taxpayers who receive higher Council Tax bills and wrongly infer that council spending has increased in the same proportion as their bills. Local authorities' dependence on central funding thus creates a further blurring of local accountability. 'Thus people cannot see any clear connection between local taxes and local decisions to spend.' [LGA, 2004, p2]

'In 2002-03, for English local authorities, a 1% change in spending (or budgets) results, on average, in a 4% change in the level of council tax.' [CIPFA, 2002, p139] This figure of course varies from authority to authority, but overall reflects the low level of Council Tax revenues in total local authority revenues. 'It is worth noting that, even if local authorities' budgets were to remain on the same level from one year to another, year on year changes to the amount of central government support would alter the level of Council Tax from one year to another.' [Ibid, p139]

4.1.2 Capping

In 1999 the Labour government enacted the Local Government (Best Value and Capping) Act 1999, which was intended to bring an end to 'crude and universal capping' of council budgets which had been taking place since the advent of rate capping in 1984.

Despite this abolition of universal capping, the Secretary of State retains the power to cap local authorities on a case by case basis. He is also able to directly regulate increases in local Council Tax bills.

Regardless of the public declaration to remove 'universal' capping, local authorities still find their budgets and the levels of their Council Tax bills ultimately presided over by the discretion of the Secretary of State. 'These powers have normally been described as powers to cap local authorities, but in reality they are powers to limit the choices open to local people. Local people cannot then decide through local elections that expenditure on local services should be increased, even if they are willing to pay the taxation involved...Capping distorts the electoral process, limiting choice on budgetary policy.' [Stewart, 2003, p 231 and 232]

For the 2004-05 financial year, central government has made it clear that it expects Council Tax rises to be below 5% and that they would consider using capping powers for Council Tax rises above this rate. 'Mr Raynsford [Local Government Minister] has written directly to the 56 councils he believes are considering high increases to warn them that they are in line for capping' [Local Government Chronicle, 6/2/2004, p1]

4.1.3 Regressiveness, lack of buoyancy, and unpopularity

(i) Council Tax is regressive in nature and does not take into account 'ability to pay'

Council Tax is a regressive rather than progressive form of taxation, with households in lower Council Tax bands tending to pay a much larger proportion of their income in Council Tax than those households in higher bands. Rises in Council Tax are therefore much more punitive for households on low/fixed incomes such as pensioners.

As well as being fundamentally regressive in nature, the Council Tax also takes no account of household 'ability to pay.' Except in the minority of cases (those on very low incomes who qualify for Council Tax benefit) no account is taken of household incomes when setting Council Tax levels.

This is the major failing of any tax based primarily on property values: most properties do not generate incomes for those individuals who live in them, particularly in the case of main residences. As such a property with a high valuation does not always reflect the incomes of its residents/owners.

As an example, two adjacent properties with the same valuation could be occupied by a couple with a dual annual income on one hand, and a pensioner couple with just a small pension income on the other. Despite the large discrepancy in household income (ie ability to pay), their Council Tax bills will be identical.

(ii) Council Tax is not buoyant, but is highly visible and distorts local accountability

Unlike national income taxes/corporate taxes, Council Tax is not a buoyant form of taxation, ie, its yield does not automatically rise in line with a growth in the tax base/economic growth. For Council Tax yields to rise, local authorities must publicly raise rates and adjust Council Tax bills. As a result, tax payers are much more aware of rises in Council Tax, than of rises in national taxes such as income tax. Each taxpayer receives an annual bill from their local authority which is directly comparable to previous annual bills.

This highly visible nature of Council Tax makes it difficult for local authorities to increase spending without receiving the direct (and often angry) attention of local taxpayers and, in most recent years, the national media.

The Council Tax's visibility and lack of buoyancy, many would argue, are only a shortcoming due to the gearing effect described above. If the gearing effect could be removed, it could be argued that visibility and non-buoyancy are positive attributes of the Council Tax. Highly visible taxes which must be directly altered annually to meet budgets, force tax-setters to be directly and clearly accountable for tax rises and avoid taxing by stealth. By distorting the link between spending and tax levels, high levels of central funding of local government undermines local accountability and reduces public trust on the tax system as a whole.

(iii) Council Tax has an inbuilt 'load-bearing' weakness

The nature of Council Tax as a tax on property values means that, to a degree, it has an inbuilt maximum yield. The property base in the UK because it is static, and not well related to income, will make Council Tax incapaple of yielding very much more tax revenue than it is at present. This is a particular disadvantage in a local finance system where it is the only tax under local control.

(iv) Is Council Tax really a local tax?

Council Tax is the only 'local' form of taxation in the UK, and is seen as a tax which is controlled, levied, collected and spent locally by local authorities, making local councils directly accountable for bill levels.

However much of the detail covered above suggests that Council Tax is actually more of a centrally controlled, albeit locally administered, tax, than a locally controlled adaptable one. The following features of Council Tax cannot easily be described as 'local';

- *Valuations are directly controlled by central government:* Property valuations for Council Tax purposes are NOT carried out by local authorities but by the Valuation Office. Moreover, the Valuation Office can only revalue properties when directed to do so by central government. Local authorities have no control over this aspect of the tax, and cannot benefit from rising property values, nor adjust valuations in times of property slumps. Also there is no fixed revaluation process or timeframe. Despite this, a national system of property valuations is necessary to ensure that all local authorities are given equal footing in terms of their tax base values when calculating annual Council Tax bills. This prevents local authorities distorting local valuations in order to manipulate their bills, and more importantly, equalisation grants. However, more frequent and regular timetabled valuations should be built into the system to allow changing property values to be properly reflected in local tax bases and bill levels.

- *Council Tax bandings are set by central government:* Council Tax bandings, and the ratio of bills from band to band, are set and fixed independently of local authorities. These restrictions mean, for example, that local authorities with high capital values cannot add additional bandings to top level valuations, nor can they change band to band ratios. Councils set the Band D tax levels and everything else is decided by statute.

- *Central government, rather than locally-elected officials and local taxpayers, has the final say over Council Tax levels:* Although universal capping has gone, the Secretary of State still has the discretionary power to cap local authority budgets and regulate Council Tax bills. If local authorities set Band D levels such that overall Council Tax income meets their budgetary needs for the year they can still be thwarted if the Secretary of State deems that the bills/budget is excessive. 'The fact that the capping threat remains….making our local financial system the most centrally dictated in Western Europe – speaks volumes for the fundamental lack of trust that successive governments have had even in councils of their own political complexion' [Wilson and Game, 2002, p199].

4.2 Shortcomings of NNDR

Despite being a locally collected tax on local business property, NNDR is in no way a local tax. There is no local autonomy in the setting of NNDR, either in its rate or in the valuation of property. The NNDR funds distributed to local authorities are akin to general grant financing – what economists call an assigned revenue. The method of distribution is heavily reliant on accurate survey information about population to ensure local authorities get their just share, however, as recent experience shows, councils such as Westminster, and Telford & Wrekin, may have been wrongly funded due to unreliable census data regarding population figures in their areas. [Local Government Chronicle, 31/10/2003, and Municipal Journal, 27/11/2003] 'Former local ratepayers have become national taxpayers, and there is no longer any direct tax link between local authorities and the businesses in their area. In 1989-90 non-domestic rates had provided over a quarter of local government current income: more than that from domestic rates. At a stroke, therefore, local councils saw the proportion of their income that they themselves controlled, fall from over a half to barely a quarter…' [Wilson and Game, 2002, p194-195]

Like the Council Tax, NNDR also falls down on the 'ability to pay' principle, as a property's rateable value does not necessarily bear relevance to the profitability of the business it houses.

The current system whereby NNDR is paid to, and collected by, local councils also distorts transparency and accountability between local businesses and local authorities, as the amount of NNDR distributed back to councils as part of the finance settlement is not the same as the amount of NNDR actually paid to them by local businesses.

There is an argument that NNDR should not be returned to local control as it is 'taxation without representation' ie, there is no link between a business tax and local voting power. However this argument could be just as easily applied to national corporation taxes and is not of itself a valid justification for not returning control of business rates to local authorities in the UK. Local businesses are as much consumers of local authority services as individuals and should arguably contribute to local authority tax revenues. Businesses also have a strong lobbying presence and can influence local authority decisions without actually needing a local vote. Allowing local authorities to vary and control local business taxes would also enable them to compete for business location on the basis of cross authority tax competition (though equalisation reduces this impact).

4.3 Issues with the current system of grant finance

4.3.1 Problems with grant calculation

The revenue grant system is based on distribution formulae which cover the main services and service sub-blocks. The development of the formulae is subjective and certainly under the direct control of government ministers. As such, the grant is partly objective and partly subject to change and modification at central discretion, and local authorities have no control over which variables are considered. "There is no scope for varying the grant to individual authorities to reflect local circumstances that are not picked up by the system." [ODPM, 2002, A guide to the Local Government

Finance Settlement, p4] Despite local authorities having complete discretion how they spend the Revenue Support Grant (apart from recent limitations arising from the 'passporting' of schools funding), its calculation and distribution are controlled centrally.

The rise of specific grants in the overall funding of local government in the last decade has severely restricted local freedoms as central government directly dictate how local authorities should spend a certain proportion of their income. This is a clear case of central government using the local finance system to pursue central ideals of uniform service provision. In addition to this, the introduction of 'targeted' grants (although currently only a small proportion of local financing) is effectively an increase in ringfenced funding. 'The distinction appears to be that while targeted grants remain specific grants having a defined purpose, they are not required to be spent in a specific way.' [Stewart, 2003, p237] Targeted grants are ringfenced to a specific service and the funds cannot be spent on other services. They are, to all intents and purposes, a form of ring-fencing.

4.3.2 Problems with reliance on central funding

The heavy reliance on central grant finance contributes to the gearing effect described above. Variations in annual grant financing (over which local authorities have no control) have a direct and immediate impact on Council Tax bills. The extent of this impact varies according to how highly geared a local authority is overall, but is a clear indication of the inadequacies of a system of local finance with only one directly controlled local revenue stream. Central decisions over grant distribution are also central decisions over Council Tax bills, as local authorities have no option but to vary their Council Tax bills in response to changes in grant finance in order to meet their budget requirement.

The gearing effect is further exacerbated by the current requirement for local authorities to 'passport' increases in FSS finance towards certain services. "…'passporting' actually works in such a way that local authorities are expected to pass on increases in specific areas, with little or no local discretion." [Fenney, 2002, p128] For example, currently increases in FSS for the schools subblock are to be passported into school funding. Increased use of 'passporting' criteria in 'general' grant finance thus not only undermines local discretion and reduces autonomy, but more importantly, contributes to the gearing effect by putting indirect pressure on Council Tax bills (in order to fund those services which the grant increases would have financed if they had not been used to fund passported FSS). Measures such as passporting could have a detrimental effect on service provision as councils struggle to finance all their requirements.

Heavy reliance on central funding also creates behavioural distortions at the local level by effectively promoting a subordinate upward-looking local government sector. Local authorities are consistently requesting more autonomy in their financial decision taking and revenue raising, whilst at the same time being constrained by the current system into arguing with central government for increased grant levels and central funding. Perhaps more importantly, from the perspective of diminishing local democracy, the grant system has led to local authorities seeking guidance, and taking their lead from central government when providing local services, rather than responding directly to local needs/wants.

4.4 Problems with the capital finance system

Notwithstanding the welcome introduction of the new 'Prudential System' for capital finance on 1 April 2004, the previous capital financing system in place was strictly controlled from the centre. Local authorities did have a fair degree of discretion in deciding which institutions they actually borrowed funds from, but the amounts that they were permitted to borrow were dictated centrally.

The issuing of Basic Credit Approvals just in advance of the financial year to which they were to be used prevented the forward planning of capital expenditure. Supplementary Credit Approvals and capital grants (central and otherwise) were in effect ringfenced capital financing, and only a very small amount of capital spending was financed from revenue funding each year.

'It is difficult to exaggerate how resented this form of 'control by approval' is. Responding to the Government's 2000 finance green paper, 285 our of 286 councils wanted the system abolished…' [Wilson and Game, 2002, p183]

The Prudential System of capital financing (which came into force on 1 April 2004) is a step in the right direction for restoring local freedoms and allowing local authorities to have control over both how they spend money on capital projects, and how they invest their funds overall. How the Prudential System actually operates in practice, and the realistic consequences of this for local autonomy, will have to be judged in the future.

5. What can be learnt from the shortcomings of the current local finance system?

This brief review of the local finance system in England has clearly exposed it to be complicated, opaque, rife with difficulties and heavily biased towards central funding.

Local government spending makes up approximately 25% of all public spending in the UK, but only collects just under 5% of total tax revenues (in the form of Council Taxes). This discrepancy raises obvious issues of transparency and blurred accountability, and also puts a great strain on the Council Tax as the only instrument under local control which can be varied to meet local requirements.

5.5.1 Aims of a local government finance system

Before going on to state those principles and features which we believe make up a good starting point for a system of local government finance, it is worth considering what the current government believes the aims of a local government finance system should be as stated in the Green Paper of September 2000. Those aims are:

- To 'fund all authorities adequately'
- To 'promote continuous improvement'
- To 'provide a reasonable degree of predictability and stability'
- To provide a balance for delivering national targets with 'real financial freedom and responsibility for local authorities'
- To 'be fair to those who use and pay for local authority services'
- To 'clarify accountability for financial decisions'
- To 'be intelligible and transparent'
- To 'make partnership working easier'
- To 'encourage consultation particularly with local taxpayers' [DETR, 2000, p5-6]

Unfortunately, we do not believe that the current system of local finance meets these objectives:

To 'fund all authorities adequately'

The current system uses central funding to meet the majority of local finance requirements. We believe the focus should be on local authorities having the power to adequately fund themselves via a variety of instruments/taxes without having to rely on the centre. This would avoid the annual wrangle between central and local government over grant allocations, and put the power to respond to local circumstances directly under the control of local authorities.

To 'promote continuous improvement'

The ideal of continuous improvement and Best Value practices for local authorities is admirable, and local authorities should be consistently aiming to improve the services they provide. However, the principles of 'Best Value' and the objectives that local authorities are required to meet are largely imposed and set centrally, rather than being determined locally, thus becoming just an additional facet of the centrally controlled nature of the local finance system. Local authority service levels should significantly focus on the wants and desires of local citizens and not be centrally determined.

To be 'predictable and stable'
Predictability and stability in a finance system are necessary to aid planning. At present local authorities are unable to calculate their Council Tax requirement until they are told their annual Formula Spending Share and other details by central government. They are ultimately reliant on central distribution decisions, and any impositions on their spending that come from these decisions (eg passporting for schools). Employing consistent grant allocation methods does aid stability in grant financing but this still does not necessarily enable local authorities to stabilise and plan Council Tax levels. Other factors such as sense-by-sense 'control totals' for spending, and many other complex internal details about grant distribution can effect an authority's financial position.

In addition, the stability of the finance system is not aided by constantly changing rules and regulations. For example, the capital finance system has been through multiple changes recently, from credit approvals to single capital pots to the prudential framework. Local finance officers are continually required to keep abreast of these changes and implement them when planning spending, both current and future.

To provide a balance for delivering national targets with 'real financial freedom and responsibility for local authorities'

The requirement for local authorities to meet national targets is another symptom of the increasing restrictions placed on much of the central funding they receive (ie, the rise in specific grants, the introduction of targeted grants and the requirement to passport increases in certain parts of annual expenditure increases). These impositions are not balanced with any real financial freedom or responsibility. It can be argued that local authorities are free to spend general grant funding as they see fit, but this is not synonymous with financial freedom since ultimately the level of funding is controlled centrally, and as we have seen with the school passporting requirement, central government is even able to impose restrictions on general finance. Real financial freedom could come with controlling the majority of income sources and spending decisions at a local level, and this is clearly not the case with the current system. Local authorities have their hands tied financially and cannot respond to local variations and needs with any flexibility

To 'be fair to local taxpayers'

The 'fairness' of local financing is also in question, in particular with reference to local taxpayers. As we have seen, the Council Tax is likely to be regressive and punitive to those on lower fixed incomes, but at present local authorities have no other taxes under their control. A wider basket of local taxes and charges would give local authorities greater flexibility in setting taxes and reduce the pressure on Council Tax bills.

To promote accountability and to be well understood and transparent

The system of local funding currently in place is overly complicated and wholly incomprehensible to councillors, local officials and local tax payers. Most local taxpayers understand the Council Tax bills they receive but have little or no understanding of the myriad grants and other factors that make up the majority of the system's workings. 'Few people have any knowledge of what the balance of funding is between government grants and money raised locally through the Council Tax….most people say they think the majority of money used to fund local services comes from Council Tax…guesses fall into the following range: 20-30% from central government, and 70-80% from Council Tax.' [Palmer and Laursen, 2003, p12] This has obvious knock on effects on accountability.

More worryingly, local officers are also struggling to understand and keep pace with the system. Of the 1,850 local officers questioned in a recent survey, 40% (including 26% of finance directors) felt the need for a better understanding of the Revenue Grant distribution system [Davis, 2000, Table 4.1]

To 'encourage consultation with local taxpayers'

The current system does not have any formal arrangements for consultation with local taxpayers, either over spending decisions (which can be substantial especially on the capital projects) or over local tax bills.

The shortcomings of the local finance system, and the individual elements therein, mean that even the Government's own aims for a 'good' local finance system are not being met. The case for reform is clear, and can be based on a few guiding principles which we set out in the following section.

6. The principles of a good local finance system

This section sets out what we believe to be the ten guiding principles that should form the foundations of a good local finance system.

1. The local finance system should ensure that local authorities have the power and responsibility to raise locally most of the funding for the services which they provide.

- no less than 50% of local revenue should be raised through locally determined taxes and charges in all authorities, and most local authorities should be raising 75% of revenue from locally determined taxes and charges

2. Local government should have more than one tax at its disposal: "One club golf does not work"

- having just one local tax puts undue strain and pressure on that

tax and can undermine the stability of local government service provision
- it is also highly unusual by international standards

3. The basket of taxes available to local government should be no less buoyant than those available to national government
- Buoyant taxes rise automatically with national income and inflation. Council tax does not
- Buoyancy is crucial for stability and local finance systems should mirror the stability afforded to national systems which rely on buoyant taxes such as income tax and corporation tax

4. Fairness requires that the basket of taxes available to local government should be progressive wherever possible
- Council tax penalises the asset rich and the income poor (eg pensioners)
- Council tax is regressive

5. The collection of any new local taxes should 'piggy back' as much as possible on existing collection/administration systems
- Any new local taxes should avoid the cost of additional bureaucracy

6. The basket of local taxes should include a form of property tax: "Buildings don't move"
- Property provides a secure asset base
- Property taxes are easy to administer and collect

7. Local government should have greater freedom to introduce and vary charges for local services

8. Local government should have greater freedom to borrow on capital markets within minimal prudential restrictions that guard against over-indebtedness

- local authorities should have the freedom to use appropriate sources of finance to fund capital investment whether from central government, banks, bonds or leasing
- Local authorities should take the necessary measures to minimize their costs of borrowing, eg, through getting credit ratings, or offering security

9. Methods of equalisation should focus on tackling extreme differences in overall local spending needs, and the capacity to raise taxes locally, BUT should not seek a level of precision which implies Whitehall second-guessing each authority's response to local spending requirements.

10. The local government finance system should strive for maximum transparency in regular budgeting and involve local people in major financial decisions as much as possible.

7. Conclusion

This volume demonstrates the complexities and shortcomings of the local government finance system in England.

The English local finance system currently in place is heavily biased towards central funding (and therefore central control) and is not, in our opinion, meeting the basic requirements of a good local finance system.

We believe that the current system needs to be reformed in line with the ten basic principles (as set out in part 6) and hope to show, via international case studies, that other countries have local finance systems that are much more aligned with these principles, and that better foster local democracy and accountability whilst still providing local services. Recommendations for reform will be published later in 2004.

Appendix 1
The Local Finance System in England

1. What does local government do? – the functions of local government

To understand the local finance system, it is necessary to review the functions/responsibilities which it supports and funds at the local level. Local government forms part of the public sector in the UK, and is responsible for delivering those public services not directly provided by central government.

At the present time, the main services provided by local government are:

- Education (primary and secondary)
- Social services
- Housing

In 2000/01, these three services accounted for 63% of local government expenditure in England, [ODPM, Local Govt Financial Statistics England, No13, p 30]

Other services falling under the remit of local government include, but are not limited to, transport, the arts (libraries, museums etc), planning and environmental health.

In 2000/01 the breakdown of total local authority revenue and capital spending by services was as follows:

Service	Percentage of total expenditure
Education	31
Social services	16
Police	9
Fire	2
Transport	6
Housing	16
Libraries and Arts	2
Sports	1
Environmental Services	8
Other	7

Source: ODPM, Local Govt Financial Statistics England, No13, p30

2. Local Government Finance in the national context

Local government expenditure forms a significant part of total public spending in the UK. In 2001/02 local government expenditure was 25% of total UK public expenditure [ODPM, Local Govt Financial Statistics England, No13, pg 21]. The spending represents 10% of GDP and approx £1,680 per capita of the UK population [CIPFA, 2002, p 38]

Council Tax is currently the only direct method by which local government can raise revenue to fund their expenditure. In 2001/02

Council Tax was approx 4% of all UK government revenue [ODPM, Local Govt Financial Statistics England, No13, p22]. The 'funding gap' between the total of local government spending and the amount raised in Council Tax shows that local authorities are heavily dependent on central funding to meet the balance of their expenditure.

3. Local Government Finance – some definitions and classifications

Local government expenditure is split into two categories; revenue and capital, each with their own prescribed methods of funding.

- *Revenue Expenditure*, otherwise known as 'current' expenditure, is the spending needed to finance the 'day to day' running of council activities and services. Accountants often describe revenue spending as only having a short term benefit (ie within the same financial year that the expenditure is incurred). The main component of any council's revenue spending is their employee wage bill.
- *Capital Expenditure*, relates to spending on more long-term council assets, which will have benefits beyond the financial year in which the expenditure is incurred, for example the purchase of land/buildings and construction projects.

As a rule, money raised to finance capital projects cannot be used to fund revenue expenditure, however capital projects can be financed from revenue funds although this tends to be only in small amounts (23% of total capital expenditure was financed from revenue funds in 2000/1) [ODPM, Local Govt Financial Statistics England, No13, p 83, Table 4.2A])

4. The Revenue Finance System

Revenue expenditure is financed through four main sources:

- Council Tax
- The National Non Domestic Rate (NNDR)
- Central government grants, both general and specific
- Charges for sevices, including rents

4.1 Council Tax

Council Tax is the main source of directly raised local income available to local authorities, and the only form of local taxation in the UK. It was introduced in 1993 to replace the Poll Tax, and is essentially a 'hybrid' form of taxation which takes into account property values as well as the number/status of the occupants in an dwelling.

In 2000-01, Council Tax revenues formed 16% of local authority gross income in England [ODPM, Local Govt Financial Statistics England, No13, p33] The revenues raised by Council Tax are not ringfenced in any way and can be spent at the local authority's discretion.

4.1.1 The Operation of Council Tax

Council Tax is payable on residential dwellings only, and is based on an open market valuation (for current purposes, the valuation date for Council Tax purposes was set at 1 April 1991). Dwellings are placed into one of nine valuation bands (A-H), with A being the lowest and H the highest.

The local council sets the level of Council Tax for a band D property, with the bills for properties in the other eight bands then being determined by fixed ratios (set by central government) to the Band D bill.

The current valuation bandings (2003-4), and Council Tax band ratios in England are as follows:

Band	Property Values	Council Tax billing ratio
A	<£40,000	6/9
B	£40,001 - £52,000	7/9
C	£52,001 - £68,000	8/9
D	£68,001 - £88,000	1
E	£88,001 – £120,000	11/9
F	£120,001 - £160,000	13/9
G	£160,001 - £320,000	15/9
H	> £320,000	2

The property valuations themselves are not carried out by local councils but are the responsibility of the Valuation Office of the Inland Revenue. There is no set term for reassessing property values, or bandings, and any changes are purely at the discretion of central government. Neither bandings, nor property valuations themselves, have been reassessed or altered since the Council Tax was introduced in 1993.

Across England as a whole, 25.9% of properties fall into Band A, with only 9% falling in bands F-H. These figures vary widely between regions, with London having the highest concentration of properties in the top bandings. The average Band D Council Tax (based on two adults with no exemptions) in England has increased by 71.8% in money terms and 37.5% in real terms between 1993-4 and 2003-3 [ODPM, Local Govt Financial Statistics England, No13, p 35-37]

The Council Tax was '…conceived as having a 50% property element and a 50% personal element' [Fenney, 2002, p114], both elements of which attract a range of exemptions and discounts.

By far the most common discount is a 25% reduction for single person households. The personal element of the tax can also be completely disregarded in certain circumstances (such as for second homes, long term empty properties, or homes where all residents are not liable) thereby attracting a 50% discount.

Despite the 'personal' element of Council Tax, because the levy is effectively a tax on property values complete exemptions can only apply to the class of property rather than the residents themselves. There are 23 classes of exemptions, of which the most applied are 'Vacant and Unfurnished dwellings' and 'Student Halls of Residence'

'Of the 20.7m chargeable dwellings in England [as at November 2001], 0.6m (3%) are entitled to a 50% discount and 7.1m (34%) are entitled to a 25% discount' [ODPM, Local Govt Financial Statistics England, No13, p42] The number of exempt dwellings at this time was only 647,000.

4.2 The National Non Domestic Rate (NNDR)

Before 1990, and the introduction of the poll tax, business rates were set locally by local authorities. Since 1 April 1990, rates on non domestic property have been nationally set by central government, and are known as NNDR.

In 2000-01 in England, redistributed NNDR accounted for 17% of gross local authority income [ODPM, Local Govt Financial Statistics England, No13, p33]

4.2.1 Operation of NNDR

Properties liable to business rates are known as hereditaments and are given a rateable value by the Valuation Office of the Inland Revenue. The rateable value assigned to each property is an approximation of its annual open market rental value. All hereditaments are revalued on a five yearly basis.

The amount of NNDR due on each property is calculated by multiplying its rateable value by the NNDR multiplier, as set by central government. The NNDR multiplier for England for 2002-03 is 43.7p in the pound.

Local authorities are responsible for issuing NNDR bills and collecting the revenues in from local businesses. Once collected the funds are paid into a central pool, which central government redistributes back to local authorities as part of Aggregate External Finance (AEF). Redistribution takes place on a per capita basis. NNDR revenues redistributed back to local authorities are not ringfenced in any way.

Certain classes of property are exempt from NNDR, including places of religious worship, parks and agricultural property. Charitable buildings also receive a minimum 80% discount.

4.3 Charges for services

The services which councils charge fees for are varied in both type and level of charge, from school meals and sports facilities, to house rents and refuse collection. Councils are able to charge for any of the services they provide at their own discretion with the exception of education services, elections, police and fire services, and library book borrowing.

In 2000-01, charges for services (including rents) formed 12% of local authority gross revenues in England. This is almost as much as the revenues provided by Council Tax clearly showing the significance of fees and charges in local revenue raising.

In the realm of service charging, local authorities are truly autonomous and free to set whatever charge or fee they deem appropriate for a particular service, be it an open market charge or a subsidised rate. They are also free to apply exemptions and concessions to fees charged.

4.4 Revenue grants

The central support allocated to local authorities by central government are known collectively as Aggregate External Finance (AEF). AEF is comprised of; redistributed NNDR, Revenue Support Grant (RSG) and a number of specific grants. AEF is essentially that part of local authority spending that central government is prepared to finance from central taxation revenues.

In 2000-01, RSG amounted to 22% of gross local authority income in England, with other central grants (including specific grants) making up a further 22%. [ODPM, Local Govt Financial Statistics England, No13, p33]

'Within AEF, 15.9% of grants are specific and special grants, up from 5% in 1995-96' [Ibid, pg50]

4.4.1 Grant Allocation process from 2003/04

The grant allocation process begins with central government calculating how much it assumes local government will spend in total in the financial year, known as Total Assumed Spending (TAS).

Grants are allocated to local authorities within the overall level of TAS on the basis of complex formulae taking into account demographics, social structure, and other variables to calculate each local authority's notional share of TAS, known as the Formula Spending Share (FSS) (formerly the Standard Spending Assessment). FSSs are divided into major service areas (Education, Personal Social Services, Fire, Police, Highway Maintenance, Environmental Protective and Cultural Services, and Capital Financing) such that the allocation formulae reflect the different social and demographic factors which affect the cost of providing services within the main service blocks.

Once the overall FSS is known for an authority, that authority's share of NNDR and their Share of Assumed National Council Tax (SANCT) is deducted from the FSS to arrive at the amount of funding which will be met directly in grants from central government.

[SANCT is the level of Council Tax that central government determines for Band D equivalent properties in England]

'The amount of money the government allocates is based primarily on its view of national economic priorities and it does not reflect local needs' [LGIU, 2003, p39]

The government does guarantee a minimum and maximum level of year on year increase in grant allocation to each authority. These are known as 'floors' and 'ceilings' and are set centrally each year. Those authorities who, under the normal process of grant allocation, would find themselves with a below-floor grant increase will have their allocation increased up to the floor level. Conversely, those authorities who are given an above-ceiling rise in grant allocation, will have their allocation reduced to the ceiling level.

Each council is therefore allocated its share of central grant finance based entirely on central government estimates/assumptions with respect to TAS, NNDR, and SANCT. 'In this way the government controls both the size of the cake and how it is divided up' [LGIU, 2003, p36] Any difference between each authority's FSS and its actual spending requirement must be met by Council Tax revenues.

4.4.2 Revenue Support Grant (RSG)

RSG is the largest single grant paid from central government to individual councils. RSG is a general grant and can be spent in whatever manner the council chooses, including capital expenditure in some cases.

4.4.3 Specific grants

Central government also allocates a number of specific grants to local authorities each year. These grants are aimed at those services which central government deems local authorities should provide and the funds are ringfenced accordingly and cannot be spent on other services.

'Specific grants inside AEF went up from £1.7bn in 1995-96 to £7.6bn in 2002-03, an increase of over 330%' [ODPM, Local Govt Financial Statistics England, No13, p52] The percentage of specific grants within total grant finance has risen steadily from 5.0% in 1995–96 to 15.9% in 2002-03 [Ibid, p50]

Specific grants are allocated by category of spending, eg, education, personal social services, police etc, and within these categories is the specific service the grant is allocated to, eg, teachers' pay reform or children's services.

Some grants are for very tightly defined purposes such as 'Nursery Education for 4 year olds', which as an example, was allocated specific grants of £131m in 2000-01 [ODPM, Local Govt Financial Statistics England, No13, p137, Table C2B]

Education accounts for by far the largest share of specific grants in England, where the total allocation of specific grants in 2001-02 and 2002-03 was as follows:

	2001-02, £m	2002-03, £m
Education	2,793	3,236
Personal Social Services	1,299	2,347
Police	164	301
Highways	66	162
EPCS	1,079	1,477
Capital Financing	30	91
Total	**5,431**	**7,618**

EPCS includes libraries, arts sports and other items
Source: ODPM, Local Govt Financial Statistics England, No13, p52

The allocation of specific grant varies on a grant by grant basis; '…some schemes use formulae or other rules of entitlement; others allocate funds on the basis of appraising bids.' [ODPM, 2002, p1]

4.4.4 Targeted grants

This new category of grant was introduced into the local finance system in 2002-03. Targeted grants are payable to selected authorities to use on a specific area of services, eg the Neighbourhood

Renewal Fund, but within that service area the funds are not strictly restricted to a specific service. 'Less than 1% of the total central government support for local authorities for 2002-03 comes in the form of targeted grants' [CIPFA, 2002, pg106]

4.5 The Capital Finance System

Local authority capital expenditure is financed in four main ways:

- Borrowing
- Capital grants
- Capital receipts
- Using revenue income from Council Tax and sometimes RSG

The first three methods listed above were, prior to April 2004, directly controlled by central government.

4.5.1 Capital spending – some statistics

'[Capital] Expenditure increased more rapidly from 1999-00 and reached £9.7bn in 2001-02, 40% higher than in 1995-96. In real terms this is an increase of 20% over the six year period' [ODPM, Local Govt Financial Statistics England, No13, p76]

In terms of expenditure by service, there has been a shift away from housing's share of capital expenditure to education. 2001-02 provisional figures show education and transport making up 20% of all expenditure each, with housing equating to 31%, and other expenditure making up the balance [Ibid,p 78]

4.5.2 Local authority borrowing

Prior to 1 April 2004 and the introduction of the Prudential

System of capital funding, local authority borrowing to finance capital expenditure was controlled by central government in the form of credit approvals. From 1995-96 to 1999-00 credit approvals financed approximately one third of all capital expenditure in England. [ODPM, Local Govt Financial Statistics England, No13, p83]

Central government tightly controlled how much each council could borrow via two main forms of credit approval:

i Basic Credit Approval (BCA) – this is what central government thought each local authority should spend on capital expenditure in the financial year. The BCA was issued in advance and was used to borrow funds in the year in which it was granted. The funds generated via the BCA were not ringfenced in any way. However, if a BCA was not fully used in the year to which it related, it would lapse and the borrowing capacity was lost.

ii Supplementary Credit Approvals (SCA) – these were issued by central government to local authorities in addition to the BCA to raise specific funds for specific projects. The funds generated were ringfenced and could only be spent over two financial years from the granting of the SCA.

Once the credit approvals were in place, a local authority could borrow from a variety of sources/institutions (although not from institutions outside the EU) at normal market rates like any other business, and made repayments of capital and interest as normal.

One of the main lenders to local authorities is the Public Works Loans Board (PWLB), a central government agency that provides short and medium term loan finance for capital projects. Local authorities could also issue stocks/bonds/annuities to finance spending within approval limits.

Although local authorities were not particularly constricted in the sources from which they could borrow funds, the amounts which they could borrow were strictly controlled by central government.

As noted below, major changes to the Capital Finance system came into force on 1 April 2004, with the introduction of the Prudential System.

4.5.3 Single Capital Pot (SCP)

The idea of SCP as a method of allocating approvals for capital financing was first proposed in the 1998 White Paper, and introduced into the capital finance system in April 2002.

The SCP allocations are linked to the production of Asset Management Plans and Capital Strategies by local authorities, and are not targeted at specific services but are open for use on financing capital expenditure as local authorities deem fit. For 2002-03, 95% of allocations from the SCP were made on a needs basis (as judged by central government) with the remaining 5% being based on the asset management performance of local authorities. This 5% portion is designed to act as an incentive for local authorities to better their management performance.

In 2002-03 the SCP allocated £2.3bn of BCAs [LGIU, 2003, pg 102].

4.5.4 Prudential Rules

As noted previously, the 2001 White Paper published proposals for a new prudential system for local authority capital borrowing.

The Prudential System abolishes the current system of credit approvals and instead each local authority will decide its own afford-able borrowing limit. The overall prudential guidelines within which these limits will be set, will be controlled centrally.

The new system came into force on 1 April 2004, allowing local authorities to borrow funds to finance capital projects without direct approval from central government. How this new system actually works in practice remains to be seen.

4.5.5 Capital grants

Local authorities also receive capital grants, both from central government and other sources (including the National Lottery), which are used to finance capital expenditure.

In 2002-03 in England, local authorities received £2,773m in capital grants, of which £1,983m were from central government. [ODPM, Local Govt Financial Statistics England, No13, p 86]

Capital grants, whether centrally funded or from elsewhere, are generally for a specific purpose with the income ringfenced accordingly. 'Some grants are only available if the council contributes to the overall expenditure from its own capital resources (eg Disabled Facilities Grant and Transport Supplementary Grant)' [LGIU, 2002, p 104]

4.5.6 Capital receipts

The majority of capital receipts are the monies local authorities receive when they sell a capital asset that they own. A small part of local authority capital receipts are derived from loan repayments to the authority from money it has lent elsewhere.

Of the £3,473m total capital receipts of English local authorities in 2002-03, £3,343 is forecasted to come from asset sales [ODPM, Local Govt Financial Statistics England, No13, p87]

Any capital receipt received is split into two parts; the 'reserved' part which must be set aside for the repayment of debt, and the 'usable' part which local authorities can use to finance capital expenditure.

The degree to which a capital receipt is usable depends on the type of asset which was disposed of and is set by legislation. For example, capital receipts from the sale of educational assets between April 1996 and March 1998 were 75% usable. 'The standard usable proportions of capital receipts until September 1998 were 25% from the sale of council houses, police authority assets, and financial assets; and 50% from the sale of most other assets. Since then, receipts from the sale of most non-housing assets have been usable' [ODPM, Local Govt Financial Statistics England, No13, p86]

4.5.7 Other sources of capital financing

(a) EU funding

Since 1993 local authorities have been permitted to borrow funds from institutions within the EU. However all transactions must take place in sterling unless express permission is received from the Treasury to a foreign currency loan.

The EU itself also gives funds to local authorities from specific schemes such as the European Regional Development Fund, and the European Social Fund.

(b) Private Finance Initiatives (PFI)/Private Public Partnerships (PPP)

PFI is another means by which local authorities can, by working in conjunction with the private sector, obtain the use of capital assets without having to actually buy or finance the purchase of that asset themselves.

PFI is in effect a form of off balance sheet financing for the public sector; PFI expenditure is viewed as 'private' for national accounting purposes, and as the assets 'made' by PFI projects are not actually owned by local authorities, they do not appear on local authority balance sheets.

Appendix II
The structure of Local government in England

The structure of local government in England has been constantly changing over the last 100 or so years. The last major change took place in 1974 when, outside London, the six Metropolitan counties (and 36 metropolitan districts inside them) and the 39 shire counties (and the 296 shire districts inside them) were created. In 1986, the metropolitan counties were abolished in favour of the new metropolitan areas. In London the GLC was abolished in 1986, and the ILEA in 1990. In July 2000, an upper tier of local government comprising the GLA and an elected Mayor were added to the London structure.

Currently there are three main types of local government structures in England:

- London
- The six main metropolitan areas outside London
- The shire areas

The structure in London, the metropolitan areas, and that of the shire counties with unitary authorities is referred to as a single tier structure. Those shire areas served by both county and district councils are referred to as two-tier structures. The main features and functions of each area are as follows:

London

- London is comprised of 32 boroughs and the corporation of the City of London
- The individual boroughs and the City of London are responsible for all local government functions in London
- Above the boroughs sits the Greater London Authority (GLA) which has four functional bodies; the Metropolitan Police Authority (MPA), The London Fire and Emergency Planning Authority (LFEPA), Transport for London (TfL) and the London Development Agency (LDA)
- The LFEPA runs the fire service
- The MPA runs the metropolitan police

Metropolitan Areas

- There are six metropolitan areas, (Greater Manchester, Merseyside, South Yorkshire, Tyne and Wear, West Midlands and West Yorkshire)
- These are served by 36 metropolitan district councils responsible for all services except for the police and fire services, which are run by six separate police and fire authorities respectively.

Shire Areas

- Within the shire areas there are 238 District Councils, and 34 County Councils, which split local authority responsibilities between them
- There are also 46 Unitary Authorities in the shire areas which combine the duties of the district and county councils in their areas
- The district, county and unitary councils are not responsible for policing which is instead presided over by 31 individual police authorities

Parish and Town Councils

Some areas also have parish and town councils, of which there are 8,700 parish councils in England. 'Parishes are very much the grass roots of local government and as such can be important pressure groups.' [Fenney, 2002, p15]

The role played by parish councils, and the functions they carry out, varies widely from locality to locality. They finance themselves by levying a precept on their local authority council or district, which then passes on the necessary Council Tax funds. In 2002-03 parish and town council spending financed by Council Taxes in England amounted to £210m (a tiny proportion of the £16,647m raised in Council Taxes by principal local authorities in the same year) [ODPM, Local Govt Financial Statistics England, No13, p 109, Table A2b]

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