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Beyond business rates

Incentivising cities to grow

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Executive Summary

UK cities currently lack the ability and incentives to prioritise spending and overcome barriers to local economic growth. Compared to their international counterparts, they have too few financial incentives to take the often difficult decisions required to boost growth, or innovate to deliver more effective and efficient public services.

But the funding landscape is changing. The move away from centrally redistributed grants to local government, towards places being more dependent for funding on the business rate revenues they collect locally, provides an opportunity to improve how the system works.

Often referred to as 'fiscal devolution', this process of giving places more responsibility to raise and retain their own funding will provide UK cities with sharper incentives to back investment in the things that can really make a difference to their local economy - building new homes, investing in the local skills base, or delivering new infrastructure to better connect people to jobs, and businesses to customers.

The devolution of business rates is a step in the right direction, giving cities more control over a growing tax base and more incentives to support and attract new businesses to the area, as well as the expansion of existing firms. But there remains a risk that the devolution of business rates alone – particularly in its current form – will not provide a strong enough growth incentive to generate significant additional funding for UK cities. To provide the financial incentives that cities need, policymakers should:

1. **Address weaknesses within the current business rates system, and ensure growth incentives are prioritised when devolution takes place in 2020.** Reforms should include: extending reset periods, encouraging pooling between authorities in city-regions, conducting more frequent valuations and replacing the fixed yield with a fixed rate. This would reduce volatility in the system and improve responsiveness to local economic conditions.
2. **Devolve control over the £10 billion generated in stamp duty in England alongside the full £23 billion in business rates to provide far stronger incentives for places to grow.** Doing so would mitigate the risk of cities being dependent upon just one devolved tax stream, by giving them control over the equivalent of 37 per cent of local spend, compared to just 19 per cent in the current system of funding (2014-15 figures). While this would still represent a relatively small proportion of local government revenue being drawn from local taxes compared to other countries – the figure is 48 per cent across municipalities in France, and 64 per cent in New York – it could make a

big difference locally by incentivising authorities to permit more development. If the authorities of the Oxfordshire LEP, for example, delivered on existing housebuilding targets between now and 2031, between £707 million and £805 million would be generated in stamp duty on local new build sales alone, or between £44 million and £50 million per year. This would work out at between £66 and £75 per resident – much more than the current £14 equivalent in New Homes Bonus.

3. **Provide more freedoms regarding the setting of council tax to encourage revenue pooling between authorities.** Around half of all workers in Britain live in one local authority but work in another, meaning that these workers generate tax in one authority, but consume public services in another. This means that within a city-region the tax base of more residential authorities is reliant on council tax, while in the core urban authority business rates make up a larger share of the tax take. Authorities across city-regions should not be encouraged to compete on these tax revenues. For example, in the context of Greater Manchester, Stockport should not be penalised for being a largely residential area (which therefore generates less in business rates), nor should it be incentivised to try and attract jobs away from Manchester city centre (in order to generate more business tax). This example also illustrates the need for authorities like Stockport to have more freedom and flexibility over council tax revenues, including the ability to raise rates without requiring a referendum, to spend the revenue generated as they see fit, and to introduce extra bands as appropriate.
4. **Ensure that the additional responsibilities passed down to cities alongside new tax streams are ones that local government can have a positive impact upon.** Devolving control over the right taxes together with responsibility for the right lines of expenditure can create 'virtuous cycles' and incentivise behaviour that can both reduce expenditure and increase tax revenues. For example, if both stamp duty and the housing benefit bill were devolved together, there would be both a greater incentive for supporting the delivery of new homes – due to increased stamp duty and council tax revenues, and the prospect of driving reductions in local expenditure on housing benefit.

Greater fiscal devolution will also bring big benefits for the national finances. Incentivising places to generate more tax revenue generated by business rates and stamp duty by allowing them to keep a larger share will also generate more in other taxes that go direct to the Exchequer, such as income and corporation tax. **If land and property taxes were devolved, resulting in behaviours by local government that increased revenues by 1 per cent above trend, this would generate an associated net additional £1.05 billion in income tax** (or 1 per cent of the total income tax bill based on 2014-15 figures).

Finally, there are concerns that giving places more responsibility to raise and retain their own funding could mean that disparities between cities grow. But if we want to support struggling places in the new system of local government funding, then we need to incentivise growing places to generate more revenues than they do now and redistribute some of the additional funds generated.

Introduction

Devolution has risen up the agenda in recent years. City deals, local growth deals and more recently, devolution deals with city-regions in England, have gradually decentralised some powers over housing, planning and skills. These are welcome reforms and give cities much needed additional control and flexibility over the policy levers that can support local economic growth. But there is a need to go further and to give more control to cities over their finances, in order to better support economic growth and local public services.

Multiple reviews have called for local government in Britain to have more control over some of the taxes raised locally and for existing taxes such as council tax and business rates to be reformed in order to help localities prioritise spending and support growth. This is backed up by international evidence and practice which suggests that in the current centralised system, giving more control over their funding and local taxes to local government would improve economic growth.

So why, despite the broad consensus that some fiscal devolution would be a good thing, is there a reluctance to devolve more fiscal freedoms to local government? The answer mainly lies in the desire for equalisation between local authorities, with two specific arguments set out against fiscal devolution:

- **Concerns about the ability of less economically successful areas to raise revenues.** Places with less successful economies have less ability to raise revenues from taxation, and these are often the places that also have high levels of need and require public funding. In a more devolved system, the fear is that these places will be unable to cope.
- **Fear of postcode lotteries in public service delivery.** This is based on the principle that the quality and access to services should not be determined by where you are born or happen to live; the belief being that if services are funded and controlled centrally they will be equal.

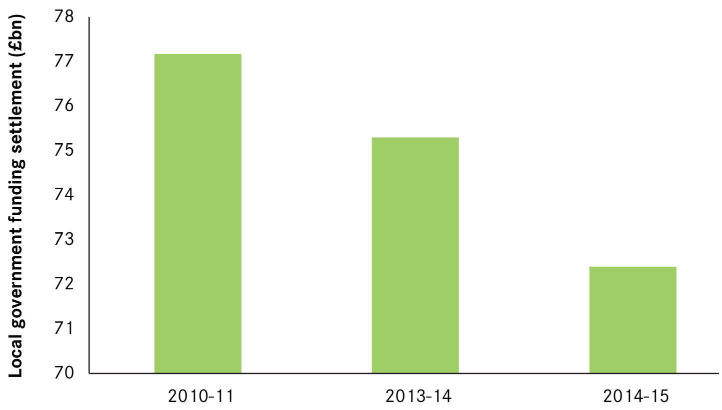
Both of these arguments tend to ignore the reality. There is already divergence in the quality of services delivered and local outcomes, as well as in the ability to pay, under the current highly centralised and grant-based system.

In addition, the recent central funding cuts for local government have reduced the resources available to them – with estimates that the total cuts, based on the latest Spending Review, will have been 56 per cent between 2010 and 2020.[1] Many local authorities have warned that by 2016 they will no longer be able to cover basic

1 Calkin S, (2 December 2015), *Analysis: Just how big is the cut to local government's funding?*, Local Government Chronicle. Accessed: 12/2/2015.

services.[2] The increasing cost of social care, driven by an ageing population and population growth, is of particular concern. It is estimated that by 2020 councils will need to find an additional £4.3 billion, or 2.5 per cent, increase in current local government spend, just to manage care at current levels.[3] Given the cuts that have already been made and the commitment from the Government to continue to reduce public spending and reduce the deficit, this shortfall (and others) is unlikely to be plugged by central government grants.

Figure 1: Local government funding settlement, 2010-2015



Source: DCLG (2015), Local Government Financial Statistics England

The only way for local government to meet the funding challenge is to reform the way in which it delivers public services and supports economic growth. Under the current system, local government has too few incentives and resources at its disposal to significantly shape and stimulate the local economy, or to deliver more effective and more efficient public services.

By giving local government more control, along with responsibilities, over local taxes (how money is raised) and public service funding and delivery (how money is spent), fiscal devolution provides an incentive for local government to prioritise public spending to deliver efficient and effective public services and to support local economic growth.

Incentivising successful places to grow their economies, which in turn will increase tax revenues, is likely to increase spatial disparities between them and other places that are not able to grow their economies as fast. But this is not a negative outcome in and of itself. And in the current context it provides the only way to increase the absolute amount of funding available to local government as a whole, given the reduction in grant funding.[4]

Much attention is given to the fear that fiscal devolution would create a system of winners and losers – that it is about creating 'city-states' with total local self-sufficiency. But none of these are inevitable outcomes, nor the primary purpose of fiscal devolution.

2 Grant Thornton (2013), *2016 tipping point? Challenging the current* London: Grant Thronton LLP
3 Independent Commission on Local Government Finance, (2015), *Financing English Devolution*
4 Blochinger and Petzold (2009), Taxes or Grants: What Revenue Source for Sub-Central Governments? *OECD Economic Department Working Papers 706*, OECD Publishing

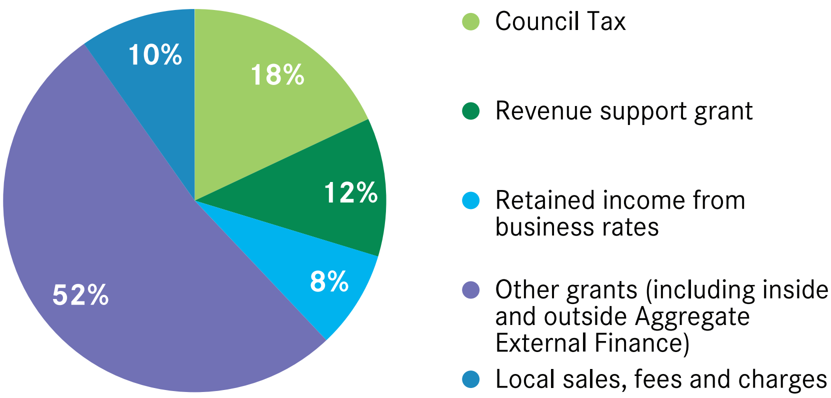
This report explores the impact of the business rate devolution proposals and argues for the need to go further, by diversifying the local tax base and creating sharper incentives for economic growth, in order to build a more sustainable system of local government funding, for *all* localities.

The first section examines the proposed devolution of business rates and what this will look like for local government. The second section then makes the case for devolution to go further and include land and property tax devolution to city-regions, while thinking carefully about how additional responsibilities passed down to local government can improve their ability to support growth.

Evidence for fiscal devolution

Britain is highly centralised. Cities in England are funded through a combination of local taxes, grants from central government and local sales, fees and charges. The only localised tax stream is council tax which accounts for 18 per cent of local revenue funding – with restrictions on the ability of cities to set rates. Grants from central government, including ringfenced grants for education, non-ringfenced grants, and the Revenue Support Grant which funds local government activities, make up 67 per cent of local government revenues. Business rates are collected locally and redistributed by central government.

Figure 2: Primary source of local government funding in England



Source: DCLG 2015: Local Government Financial Statistics England

Compared to their OECD counterparts, UK cities are more reliant on government transfers. For example, London receives 74 per cent of its revenues through transfers, in New York it is 31 per cent, in Paris 18 per cent and in Tokyo 8 per cent,[5] but this does not mean that other countries abandon principles of redistribution between places in order to support those less able to generate tax revenues. Even within more fiscally decentralised countries, there are models of sub-national funding and local tax raising powers. These include some form of redistributive mechanism between localities, funded through a combination of central government funding and 'horizontal' transfers between authorities. See Box 1 for more detail.

Finland provides an example of how a more devolved system does not necessarily lead to worse or more diversified outcomes in public services. Here local government is primarily funded through a local income tax which represents 39 per cent of total local revenues.[6] Local government also accounts for a higher share of total public

5 London Finance Commission (2013), *International Comparison of Global City Financing*

6 Loughlin J & Martin S (2005), *Options for reforming local government funding to increase local streams of funding: interational comparisons*, Cardiff University

spending than in Britain; 40 per cent of total public expenditure compared to 25 per cent. The Finnish education system, the second largest expenditure by local government, performs very well by international standards and and students achieve good outcomes, regardless of social background.[7] School age education in Finland is financed and delivered by local authorities – including funding, curriculum and hiring teachers – according to priorities set out by the Finnish Government every four years.

Calls for local government in Britain to have more flexibility and control over its funding, including over tax streams, are not new. The Layfield Committee (1974-76), Lyons Enquiry (2004-2007), Mirlees Review (2011), London Finance Commission (2013) and Independent Commission on Local Government Finance (2015) all called for one or more of the following: reform of existing local council tax , re-localisation of business rates, devolution of other property taxes and access to new forms of taxation for local government.[8]

This is based on the broad consensus that giving cities and localities some control over tax raising powers and expenditure, where cities bear the responsibility for implementing policy,[9] can improve both public services and economic growth.

- **Supporting economic growth**. Giving cities more control over tax revenues and tax raising powers creates sharper **incentives** for them to support economic growth which in turn boosts revenues. There is evidence that in countries with low levels of fiscal decentralization, moderate devolution can have positive effects on economic development.[10] Meanwhile, the reduction in the rate of floorspace growth in UK cities after nationalisation of business rates in 1990, suggests that centralisation acted as a disincentive for local authorities to permit more development and encourage business growth.[11]
- **Improving public services.** There is evidence from across OECD countries that local government efficiency is improved through decentralisation.[12] This is because decentralisation overcomes some of the dis-economies of scale that can occur in large administrations, as well as the improving the willingness and capacity of local government to innovate – the risks of innovating at large scale are bigger. Decentralisation coupled with greater funding certainty and control can also make it easier to deliver more integrated services across and within local authorities.[13] Finally, greater responsibility over budgets tends to increase the efficient use of public funding.

The next section examines the recent proposal to fully devolve business rates to local government and its impact on the ability to support growth and deliver more effective services.

7 OECD (2013), *Education policy outlook - Finland* http://www.oecd.org/edu/EDUCATION%20POLICY%20OUTLOOK%20FINLAND_EN.pdf
8 Scott A and Pitt J, (2015), *Need to Know Review Number 6: Local Government Funding*, Local Government Knowledge Navigator
9 Porcelli F, (2009), *Fiscal Decentralisation and efficiency of government. A brief literature review*, University of Warwick
10 Review of the London Finance Commission, (May 2013), *Raising the Capital*
11 Larkin K, Wilcox, Z & Gailey C, (2011), *Room for Improvement: Creating the financial incentives needed for economic growth*, London: Centre for Cities
12 Porcelli F, (2009), *Fiscal Decentralisation and efficiency of government. A brief literature review*, University of Warwick
13 Independent Commission on Local Government Finance, (2015), *Financing English Devolution*

Box 1: International comparisons

There is significant variation between countries as to how local government is organised, funded and what services it delivers.

France: Local government funded through local property tax

Like Britain, France is a relatively centralised country – despite successive waves of decentralisation over the past 30 years. Local government accounts for 20 per cent of local expenditure, compared to 25 per cent in the UK.[14] However it has much more fiscal autonomy: local taxes make up 48 per cent of local revenues. Local revenues come from local property taxes (with rates set locally) and include a residential property tax (based on the rental value of the property), a separate tax on buildings and on land (paid by owners and based on the rental value of property) and a business property tax (based on commercial property rental values and on business value added).

Transfers from central government account for 22 per cent of local government revenues.[15] Flat-rate grants are allocated to every local authority to fund public service delivery, while equalisation grants are used to support disadvantaged authorities.[16] Most redistribution is from central to local government (88 per cent of equalisation funds) but there has been a recent shift to increase redistribution between local authorities, with several 'horizontal' redistribution funds created between 2010 and 2013.

Local government in France has similar functions than in Britain, with responsibilities for social action, economic development, transport, housing, education and environment shared between the three tiers of local government. Public transport funding is particularly interesting. In the Paris city region, 39 per cent of transport companies' revenues come from a local transport tax. This is matched with the revenues raised through tickets (39 per cent) and is significantly higher than public subsidies (19 per cent) that also fund transport in the capital.

Finland: Local government funded through a local income tax

In Finland, local government is primarily funded through a local income tax (with rates set by municipalities) which contributes up to 95 per cent of local tax revenues, which in turn account for 45 per cent of local revenues.[17] Other taxes include a corporate and property tax, both of which can be set by local authorities, within limits. Local taxes account for 23 per cent of total tax revenues in Finland – the figure is 5 per cent in Britain.

Grant funding makes up 18 per cent of municipal revenues. Part of this is funded directly by central government, with allocations made on the basis of population and need (for instance, the number of students in a municipality partly

14 OECD (2013), Fiscal Decentralisation Database
15 Bergès, P. et al. (2013), *Enjeux et réformes de la péréquation financière des collectivités territoriales*, Ministère de l'économie et des finances.
16 French Government, *Les principes régissant les dotations*, Available from: http://www.collectivites-locales.gouv.fr/principes-regissant-dotations
17 Loughlin, J., Martin, S. (2005), *Options for reforming local government funding to increase local streams of funding: interational comparisons*, Cardiff University

determines the allocation for education). The rest is a compensation scheme based on municipal tax income, redistributing some revenues between municipalities.[18]

Finnish municipalities are in charge of broadly similar public services as in Britain – including planning and real estate, environment, culture and education – as well as social care and health. But municipalities provide most social services and directly fund primary health care, together they account for almost half of local spend. Hospitals are also decentralised and are run by groups of municipalities combined into joint authorities.[19] Education, which makes up the second largest element of local spend, is funded by a combination of municipalities' own revenues and a central government grant.[20]

USA: Local government funded through a highly diversified portfolio of taxes

Government in the United States is significantly more decentralised than in Britain, split between Federal, State and local levels. Federal government accounts for just half of total public expenditures but federal taxes account for 65 per cent of tax revenues. Combined, state and local taxes represent 34 per cent of government revenues. Local taxes include real estate taxes, sales taxes, income taxes (on personal income and corporations) and other taxes, such as hotel room occupancy, commercial rent, beer and liquor excise, etc.

Federal grants are allocated to both states and local governments on a need or population basis (for education, for example) and on a competitive basis. [21] Apart from a few programmes, there is little redistribution at the federal level between states. One such programme is Medicaid, where federal government transfers to states vary according to state income per capita – they cover between 50 and 77 per cent of the total state-level Medicaid bill.[22] There is more significant redistribution *within* states.

New York City's government is one of the largest city governments in the country and spends more than than most individual states.[23] The city has significant political and fiscal autonomy, with local taxes accounting for 64 per cent of the city revenue.[24] The New York City Department for Education funds principals, teachers, school buses, the cost of standardized tests and after-school programmes, as well as school facilities.[25] The city also delivers a large number of social services, including child care, employment and training, food assistance, senior benefits and rent assistance programmes.[26]

18 The Association of Finnish Local and Regional Authorities (2012), letter to the European Commission: http://ec.europa.eu/economy_finance/articles/governance/pdf/finnish_regional_authorities.pdf
19 The Association of Finnish Local and Regional Authorities: http://www.localfinland.fi/en/Pages/default.aspx
20 The Association of Finnish Local and Regional Authorities: http://www.localfinland.fi/en/Pages/default.aspx
21 Congressional Budget Office (2013), *Federal Grants to State and Local Governments*
22 Laubach T, Fiscal Relations Across Levels of Government in the United States. OECD Economics Department Working Paper No. 462.
23 Independent Budget Office (2013), *Understanding New York City's Budget: A guide*
24 City of New York Adopted budget 2016 http://www.nyc.gov/html/omb/downloads/pdf/erc6_15.pdf
25 New York City Department of Education: http://schools.nyc.gov/AboutUs/funding/overview/default.htm
26 New York City Access NYC: https://a069-access.nyc.gov/ACCESSNYC/application.do

Where we are now: business rates devolution

In 2020, business rates will be devolved to local government and will replace the current formula grant funding system. **This will give cities greater control over, and an increased reliance on, a growing tax base, which will significantly increase the financial rewards available from supporting economic growth.**

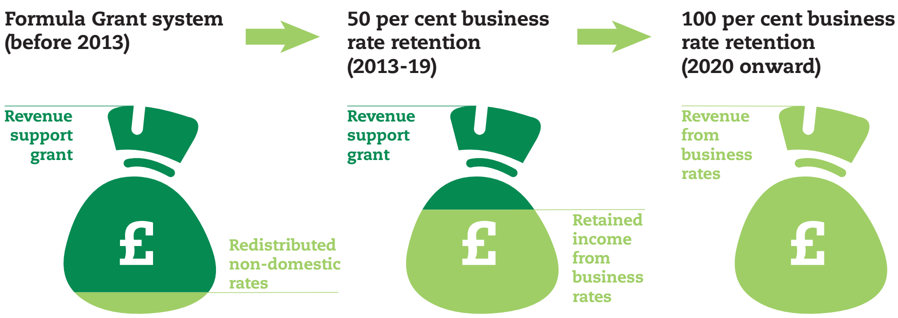
How is the system changing?

Business rates, officially known as Non-Domestic Rates, were worth £23 billion in revenues in 2014-15, the equivalent of 14 per cent of the total spent by local government in England.

Typically business rates have funded the formula grant element of the local government funding settlement. Prior to 2013, this was made up primarily of Revenue Support Grant and a small element of redistributed non-domestic rates. The current system, introduced in 2013-14, is made up of a smaller needs-based revenue support grant element and half of business rates revenues. These are are retained by local government and redistributed between local authorities subject to a complex system of top-ups, tariffs and levies.

In 2019-20, the current business rates funded portion of local government funding will be replaced entirely by the total revenue raised from business rates.[27] Under the new system, local authorities will be able to **reduce** the rate at which businesses are taxed and, conditional on having an elected metro mayor in place and subject to a local vote of the LEP, city-regions will be able to **raise** the rate up to 2 per cent in order to fund infrastructure improvements. **If the city-regions that recently agreed devolution deals ahead of the Spending Review had been able to adopt such a precept this year, they could have raised £76 million to spend on infrastructure investments that support local businesses and economic growth.[28]**

Figure 3: Change in the business rates funded element of the local government funding settlement

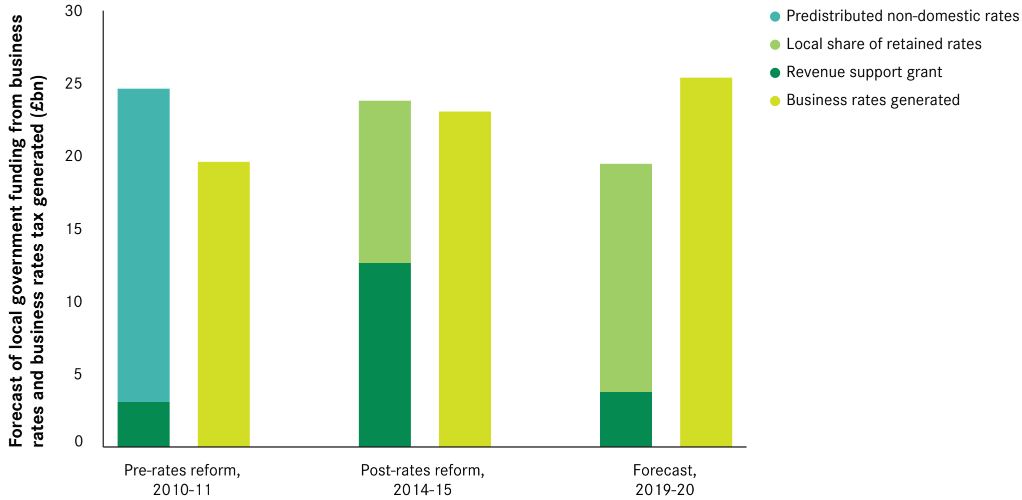


27 HM Treasury (October 2015), *Chancellor unveils 'devolution revolution' https://www.gov.uk/government/news/chancellor-unveils-devolution-revolution*

28 These city-regions include: Greater Manchester, Sheffield City Region, Liverpool City Region, North East, Tees Valley and West Midlands.

Business rates revenues have grown by 18 per cent since 2010-11, while the funding from formula grant has decreased by about 3 per cent over the period. In 2010-11, £5.1 billion more was allocated through formula grant funding than was raised in business rates. In 2014-15, the gap has shrunk to £753 million. Looking ahead to 2019-20, the year in which the new system will be implemented, revenues from business rates are estimated to exceed the combined funding from the local share of business rates and formula grant by £6 billion. **In aggregate terms, this means local government will benefit from the devolution of business rates compared to the current system.**

Figure 4: Local government funding from business rates and business rates tax generated



Source: DCLG, Revenue account budget; Collection rates for council tax and non-domestic rates in England.

What will this look like across local authorities?

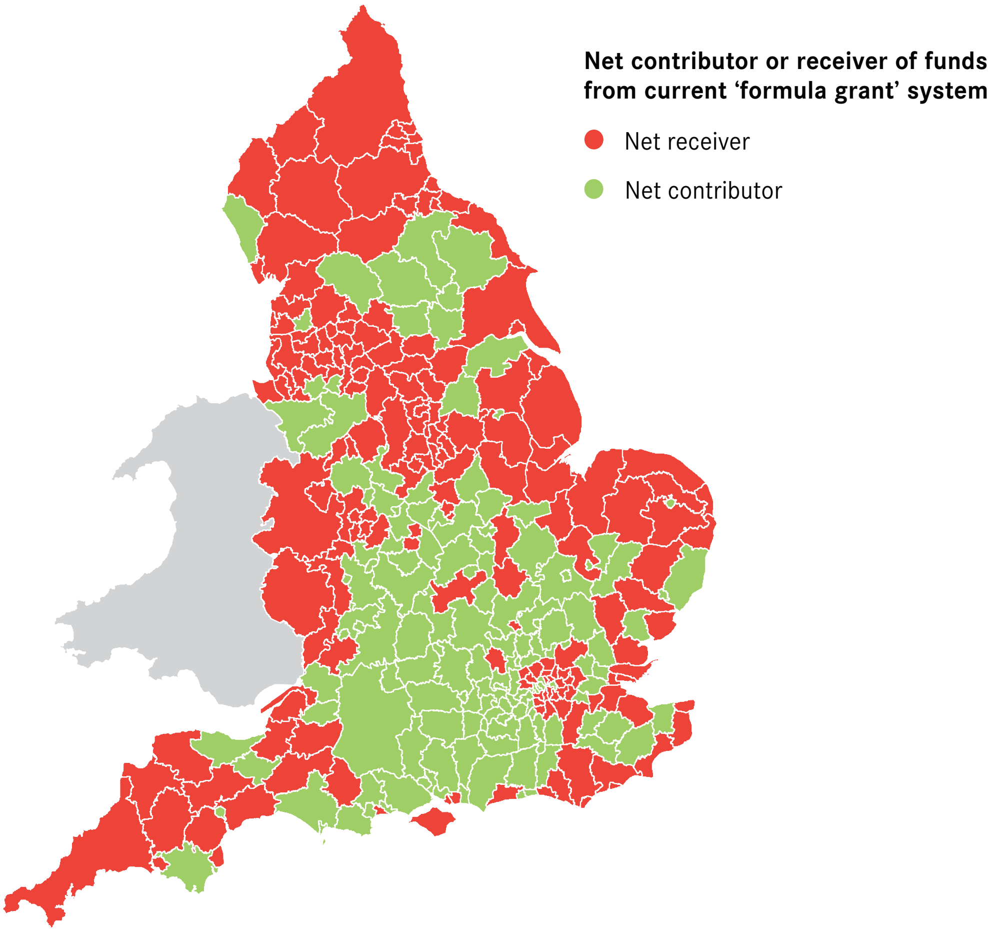
Since the Chancellor's announcement in October 2015 there has been considerable debate about the likely winners and losers once the amount local authorities have to spend is more closely connected with their ability to generate tax revenues.

Figure 5 shows in which authorities more or less was generated in business rates than was allocated through revenue support grant and redistributed retained rates in 2014-15. In 145 local authorities, more business rates revenue was generated than was received in funding, while the reverse is true in 181 local authorities where less is generated. However, it is important to note that the map of net recievers and contributors to the system does not, and will not, reflect the outcome of the shift to the new funding system.

The new system does not mean that each local authority will simply retain what it raises in business rates locally. Athough the detail of the new system has yet to be announced, the government has been clear that a system of top-ups, tariffs and safety nets will continue to redistribute revenues from those that generate the most to those authorities that generate the least from business rates.

In addition, the majority of local government funding will continue to come from other sources. Together, **Revenue Support Grant and the local share of business rates** account for **17 per cent of local government spending**, which in turn accounts for 20 per cent of total public expenditure in England.

Figure 5: **Net contributors and recievers in the 'formula grant' system**



Source: DCLG (2015) Revenue account budget, Collection rates for council tax and non-domestic rates in England. Note: The 'formula grant' system refers to local authorities where more (green), or less (red), was generated in business rates than received in the form of revenue support grant and the local share of business rates combined.

Improving the current business rates system

With or without greater devolution of business rates, there are long-standing concerns about the design of business rates as a tax and its effectiveness as an incentive for boosting business activity, that need to be addressed in order for the tax to be fit for purpose:

- **It is volatile.** Five yearly revaluations, or longer if they are delayed, create major shocks to the business rates system for both local government as a revenue stream, and for businesses as ratepayers.
- **It is not responsive to economic conditions.** The current five-year revaluation cycle also means that businesses are paying rates based on out of-date valuations, which penalises businesses in struggling economies and subsidises businesses in thriving economies. In areas where economic growth has been relatively strong since the recession (and rents have risen), businesses are paying less than they should, based on outdated valuations. By the same logic, in places that have seen rents decrease in the past five years, businesses are paying more than they should.
- **It is complex and poorly understood.** The mismatch between what the valuation is and businesses' current ability to pay has created greater need for a broad–and expanding–reliefs programme as evidenced by the new rates

reliefs offered in 2010 and extended since. This is both costly to government and a complicated and unpredictable system for businesses and local authorities.

- **It can reward perverse behaviour.** Because the tax is based on growth in commercial floor-space, the current system rewards space-hungry, often edge or out of town development which can be to the detriment of town and city centres. By the same logic, it does not reward behaviours that support business or economic growth which does not increase net rateable floor space.

To maximise the potential benefits from devolution of business rates the **following reforms to the system should be made:**

- **Replace the fixed yield with a fixed rate.** The requirement that business rates should generate a fixed yield in revenue from taxation each year creates distortions in the system which benefit relatively more successful economies. Removing the cap on business rates and moving to a fixed rate system would make business rates a more predictable and efficient tax.
- **Conduct more frequent valuations.** Properties should be valued every year or, at a minimum, every two years. More frequent valuations and a simpler valuation system would support a more accurate, timely and effective business rates tax system. Frequent valuations maintain the legitimacy of the tax and reduce the risk of sudden, dramatic shifts in tax burdens from large increases in assessed values.
- **Extend reset periods.** Under the current system baseline funding from the business rates system is set for a five year reset period. There is uncertainty for local authorities at the end of the period, as they do not know how much business rate income will be retained after resetting. Although extending the reset period to a minimum of 10 years would create similar risks towards the end of the longer period, this would provide authorities with longer-term certainty and stability.[29]

It is worth noting that some argue that the basic principle of a property based business tax is flawed[30] and that the current system should be replaced altogether, by a sales tax, for example. The changing business environment, away from floorspace-intensive industrial use, towards more dense land-use in city centres, adds weight to the arguments that a floor-space based property business tax is not fit for purpose.[31]

Reforming council tax

Alongside business rates reform, there are also changes to council tax that would improve the ability of local government to support growth. Cities need the freedom to raise council tax rates without referendum and to introduce extra council bands in order to better reflect the local economy and distribution of property prices. In the latest Spending Review, the Chancellor announced that local authorities will be able to raise council tax by 2 per cent, in order to help fund social care. The restriction on additional revenues should be lifted,

29 Wilcox Z (2012), *Urban outliers: will the local government finance bill incentivise growth in all England's cities?*, London: Centre for Cities
30 Diamond P and Mirlees J in Adam S and Miller H, (2014): http://www.ifs.org.uk/budgets/gb2014/gb2014_ch11.pdf
31 British Retail Consortium submission to business rates review, June 2015.

allowing local authorities to spend these funds in ways that best match local needs and priorities.

There are also broader risks and concerns if business rates and council tax are the only game in town when it comes to providing more incentives for cities to support economic growth. The next section looks at why and how we need to go further with fiscal devolution in order to provide stronger incentives for places to support growth and reform public services.

Creating a more effective local funding system

In order to provide cities with the resources and incentives to support economic growth and deliver the services people need more effectively and efficiently, we need to go further with fiscal devolution. In doing so the government should be thinking about how to:

1. Diversify the local tax base;
2. Encourage pooling between authorities at city-region level;
3. Devolve responsibilities (alongside taxes) where cities can make a difference.

1. Diversifying

Over reliance on a narrow tax base is risky. Developing a portfolio approach with more control over a broader range of tax revenues would give cities more funding certainty and incentives to support economic growth.

In addition to council tax and business rates, stamp duty and other property taxes should be devolved to local government. Stamp duty generated £10 billion in 2014-15, including the £3 billion from local sales, fees and charges. Devolving this would give local government control over 41 per cent of what was spent in 2014-15 (£140 billion).

Figure 6: Local revenues as a share of local spend, 2014-15

Source: DCLG (2015): Collection rates for council tax and non-domestic rates in England, Local authority revenue outturn; HMRC (2015): UK stamp duty statistics.

Land and property taxes are well suited to devolution as they are non-mobile and non-redistributive taxes, which means they are less likely to cause tax competition and tax distortions between places.[32] In a small country like England, it

32 Blochinger and Petzold (2009), Taxes or Grants: What Revenue Source for Sub-Central Governments? *OECD Economic Department Working Papers 706,* OECD Publishing

is not desirable to see individual local authorities competing on income tax rates, for example. Both the London Finance Commission and the Core Cities in Britain have called for the devolution of land and property taxes to cities.

Box 2: Land and property taxes

Council tax is levied on households by local authorities, based on the estimated value of a property (currently based on 1991 values) and the number of people living in it.

Business rates Business rates are levied on non-domestic properties based on their rateable value (currently based on 2010 values). 50 per cent of the revenue generated is retained by local government, which is redistributed by central government to local authorities according to a system of top-ups, tariffs and growth levies.

Stamp Duty Land Tax is levied on land transactions for both residential non-residential properties above a sale price of £125,000.

The Annual Tax on Enveloped Dwellings (ATED) is levied on companies that own residential property valued at more than £1 million.

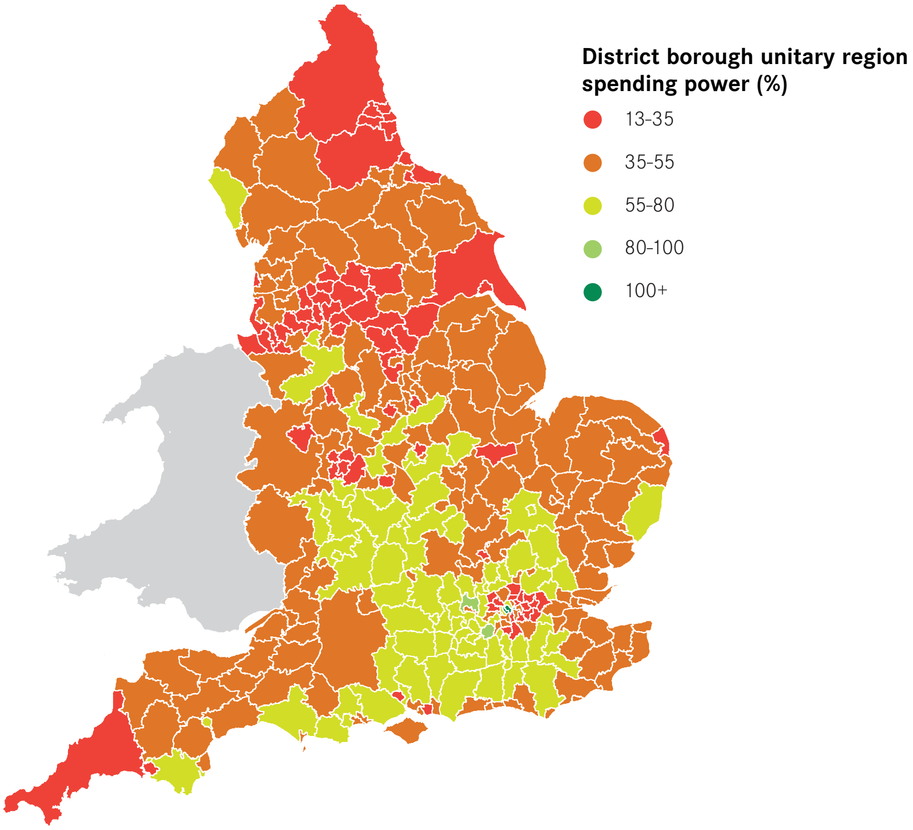
Land and property taxes	2014-15 revenue in England
Council tax	£24,052,365,000
Business rates	£23,066,362,000
Stamp duty	£10,027,000,000
Annual Tax on Enveloped Dwellings	£116,207,236

What would this look like across local authorities?

Because of the varying levels of taxes generated and local government spending in different localities, devolving land and property taxes will look different from place to place.

Devolving land and property taxes would give local authorities between 13 per cent and 90 per cent control over the equivalent public expenditure in that locality. City of London, Westminster and Kensington and Chelsea local authorities are outliers, where more land and property tax was generated than was spent by local government.

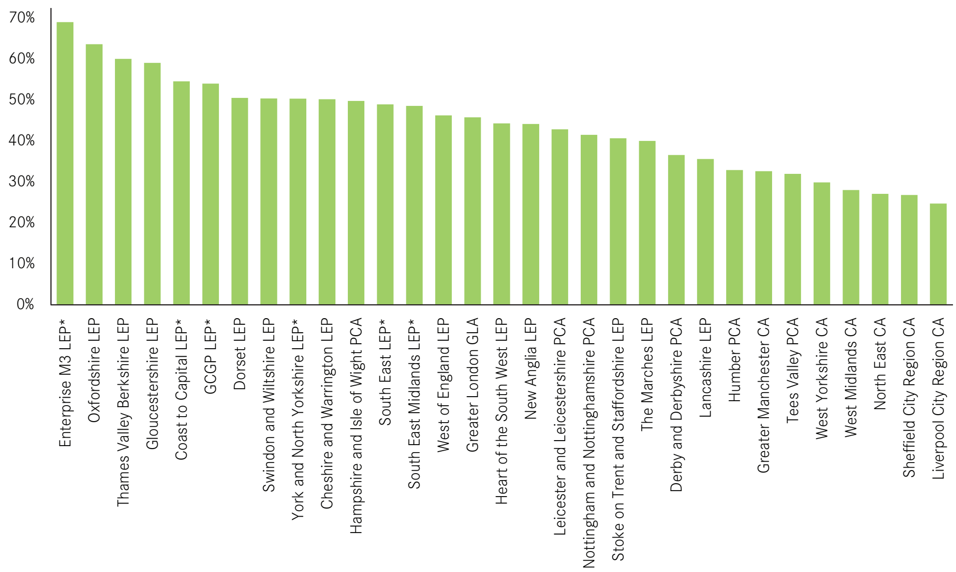
Figure 7: Land and property tax revenue as a share of local spend



Source: DCLG (2015) Collection rates for council tax and non-domestic rates in England, Local authority revenue outturn; HMRC (2015): UK stamp duty statistics.

Looking at city-regions, land and property taxes (including sales, fees and charges) would cover the equivalent of between 25 per cent (Liverpool City Region), and 69 per cent (Enterprise M3 LEP) of what is spent by local government.

Figure 8: Land and property tax revenue as a share of local spend by city-region, 2014-15



Source: DCLG (2015) Collection rates for council tax and non-domestic rates in England, Local authority revenue outturn; HMRC (2015): UK stamp duty statistics.
Note: To avoid double counting, the definitions of the starred LEPs include only some of their constituent local authorities. The full breakdown of the city-region definitions used in the report is available here:
http://www.centreforcities.org/reader/beyond-business-rates/appendix-political-geographies/

Devolving land and property taxes would provide an incentive for all localities to support local growth and housebuilding, but particularly in high growth and high demand cities. This is the case in Oxfordshire LEP, which the following example explores in more detail.

Stamp duty devolution in Oxfordshire: illustrating the 'size of the prize'

Oxford is the least affordable city in Britain. Average house prices are 14.9 times the average wage.[33] This affects both existing residents and potential new residents' ability to live in the area, which in turn poses a risk to economic growth in the long-term.

In recognition of this challenge, Oxfordshire LEP's programme for growth includes plans to build between 93,560 and 106,560 new homes by 2031 (between 5,848 and 6,660 per year).[34] By contrast, only 1,630 new dwellings were completed (across all tenures) in Oxfordshire LEP this year.[35]

Despite ambitious plans for growth, there are too few incentives for Oxfordshire local authorities to encourage and support housebuilding at the scale that is required to meet demand.

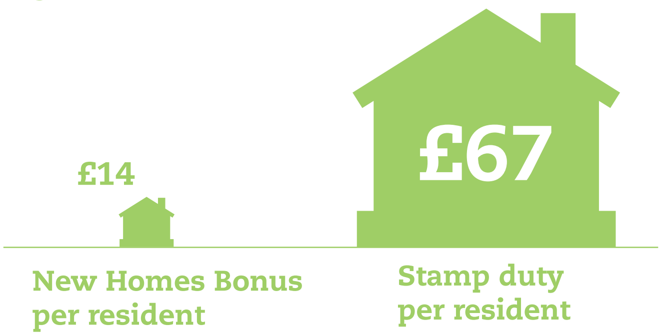
Under the current system, the primary incentive for local government to support the development of new homes is through the New Homes Bonus, which in 2014-15 totalled £9.5 million across the LEP area, equivalent to £14 per resident.[36]

Devolution of stamp duty revenues would significantly strengthen the financial incentive to permit more development in the area.

In 2014-15, the total revenue from stamp duty in Oxfordshire LEP was £187 million, £138 million of which came from residential property transactions. This is the equivalent of £278 per Oxfordshire resident.[37]

If Oxfordshire LEP delivers its housebuilding target between now and 2031, this will generate £707 million and £805 million in total, or between £44 million and £50 million per year, in stamp duty on new build sales alone.[38] This works out at between £66 and £75 per resident – much more than the current £14 equivalent per resident in New Homes Bonus.

Figure 9: **New build incentives in Oxfordshire**



Source: Land Registry Price Paid data (2014) HMRC (2015) Stamp Duty Statistics

33 Clarke E, Nohrova N & Thomas E (2014) *Building homes where we need them*, London: Centre for Cities
34 Oxfordshire LEP (2015), *Strategic Economic Plan: Executive Summary.*
35 DCLG, Housebuilding: permanent dwellings started and completed by tenure and LEP 2014-15
36 DCLG, New Homes Bonus allocations 2014-15
37 HMRC UK stamp duty Statistics 2014-15
38 Based on average stamp duty paid on new build sales in Oxfordshire in 2014. Calculated from Land Registry Price Paid Data (NB. Calculated by postcodes to best match LEP geography, includes all OX and RG9 and SN7 postcode areas)

50 per cent retention would see the area keeping an additional £353 to £403 million over the 16 year period – the equivalent of £33 to £37 per person per year, with another £365 to £415 million redistributed to other local authorities.

2. Encouraging pooling

The scale and geography to which taxes are devolved is also important. Around half of all workers in Britain live in one local authority but work in another, meaning that these workers generate tax in one authority, but consume public services in another.[39] This is reflected in the local tax base of different local authorities within city-regions, with residential areas more heavily reliant on council tax while business rates make up a higher share of the tax take in core urban areas.

Fiscal devolution in the form outlined in this report will enhance the ability of places to work together, rather than encourage localities in the same city-region to compete for the same tax revenues. Places need to be encouraged to increase the taxes they are 'good' at generating and should not be penalised by a system that only rewards business growth.

For example, it would not make sense for a predominantly residential local authority with a strong council tax base to chase the business rates revenues of the local authority in which most of its residents work, or to compete with the city centre of the city-region by building out of town shopping centres or business parks.

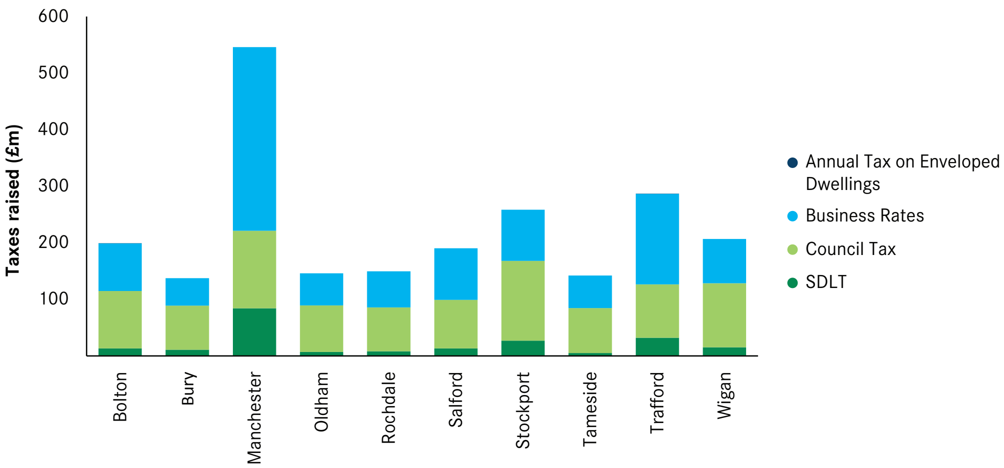
The following example of the distribution of land and property taxes in Greater Manchester illustrates why pooling tax revenues at the city-region level makes sense.

Land and property tax devolution in Greater Manchester: role and relationships within city-regions

A total of £2.3 billion in land and property tax revenues was generated in Greater Manchester in 2014-15. Manchester local authority accounted for the highest level of all land and property taxes (£546 million) as well as the highest levels of business rates generated (£325 million) and stamp duty (£84 million). Stockport accounted for the highest levels of council tax (£141 million). This reflects the high number of property transactions: 9,873 in Manchester compared to an average 4,402 in other Greater Manchester local authorities.[40]

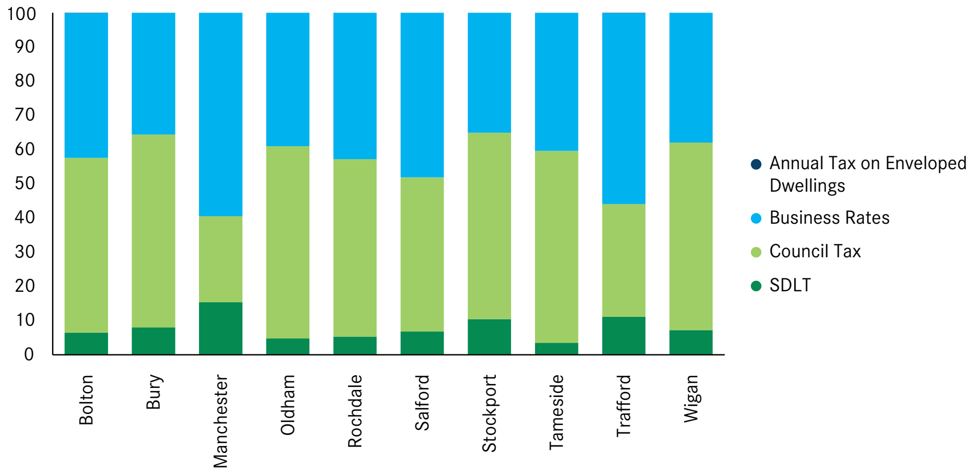
39 Wilcox Z, Nohrová N & Williams M (2014), *Breaking boundaries: empowering city growth through cross-border collaboration*, London: Centre for Cities
40 HMRC (2015) Stamp Duty Statistics

Figure 10: Land and property taxes raised in Greater Manchester, 2014-15



Source: DCLG (2015) Collection rates for council tax and non-domestic rates in England, Local authority revenue outturn; HMRC (2015) stamp duty and ATED statistics

Figure 11: Share of land and property tax revenue by local authority in Greater Manchester, 2014-15 (%)



Source: DCLG (2015) Collection rates for council tax and non-domestic rates in England, Local authority revenue outturn; HMRC (2015) stamp duty and ATED statistics

The pattern of tax revenue generation in Greater Manchester illustrates the need for devolved taxes to be pooled at the city-region scale. Business rates made up the biggest share of the total tax take in Manchester and Trafford local authorities, while council tax drove tax generation in the remaining authorities. This reflects the nature and role of Manchester local authority within the city-region, as a centre for jobs and economic activity. For example, Stockport should not be penalised for being a largely residential area (and therefore generating less in business rates), nor should it be incentivised to try and attract jobs away from Manchester city centre (in order to generate more business tax).

3. New responsibilities: improving incentives not just control

It is safe to assume that devolution of additional tax revenue streams will come with additional responsibilities for local government.

Any system needs to align taxes and expenditure with control over delivery in order to create 'virtuous cycles' and incentivise behaviour that can

both improve public services (and reduce inefficient spending) and boost economic growth (and in turn increase tax revenues).

Additional devolved responsibilities should consider how to create a link between the way local government is able to deliver any additional responsibilities, and the rewards on offer from achieving positive outcomes (such as increased revenues or savings from more efficient public spending).

Housing benefit bill devolution in London: aligning local tax and spend

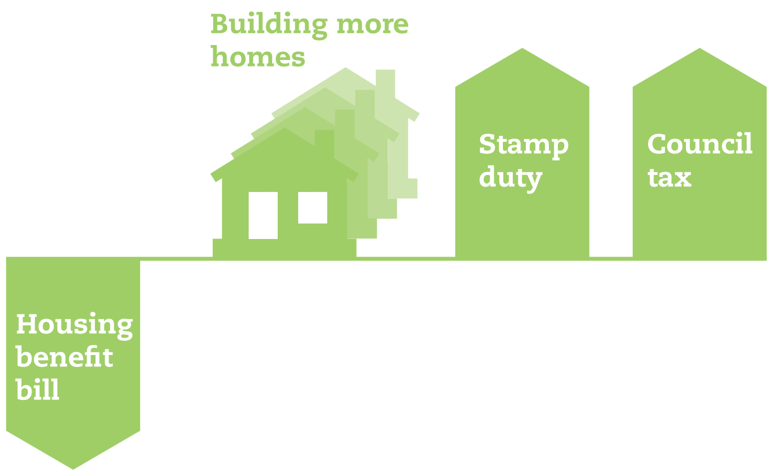
Residential development in and around London fails to meet high demand for housing from existing and potential residents who want to take advantage of the jobs and amenities the city has to offer.

The total housing benefit bill in England was £21.5 billion in 2014-15. It has risen in recent years, driven by a decrease in the provision of publicly built housing, along with an increase in the price of private sector rents and the number of renters. [41] Rising rents reflects rising property prices in high demand areas such as London and the South East. In London, the housing benefit bill was £6.2 billion in 2014-15, or an average of £732 per resident.[42] Meanwhile, £4.3 billion was generated in stamp duty, with £6.8 billion in business rates, £3.5 billion in council tax and £98 million in ATED in 2014-15, a total of £14.6 billion in land and property taxes overall.

In the current system, the increase in council tax and New Homes Bonus from building more homes provides a relatively weak incentive to build more homes when combined with the political disincentives for doing so.

Under the new system proposed in this report, devolving land and property taxes to Greater London would significantly improve the incentive to build more homes. London local authorities would gain more income through the tax revenues from council tax, stamp duty and the New Homes Bonus, and would reduce expenditures through a lower housing benefit bill.

Figure 12: Incentives and rewards: Local housing benefit bill driven by high housing costs and lack of supply



41 BBC News (21/09/2015), 'Why is the UK's housing benefit bill so high?', Available from: http://www.bbc.co.uk/news/business-34290727. Accessed (08/12/2015)
42 DWP benefit statistics 2014-15

Devolution is good for the national exchequer too

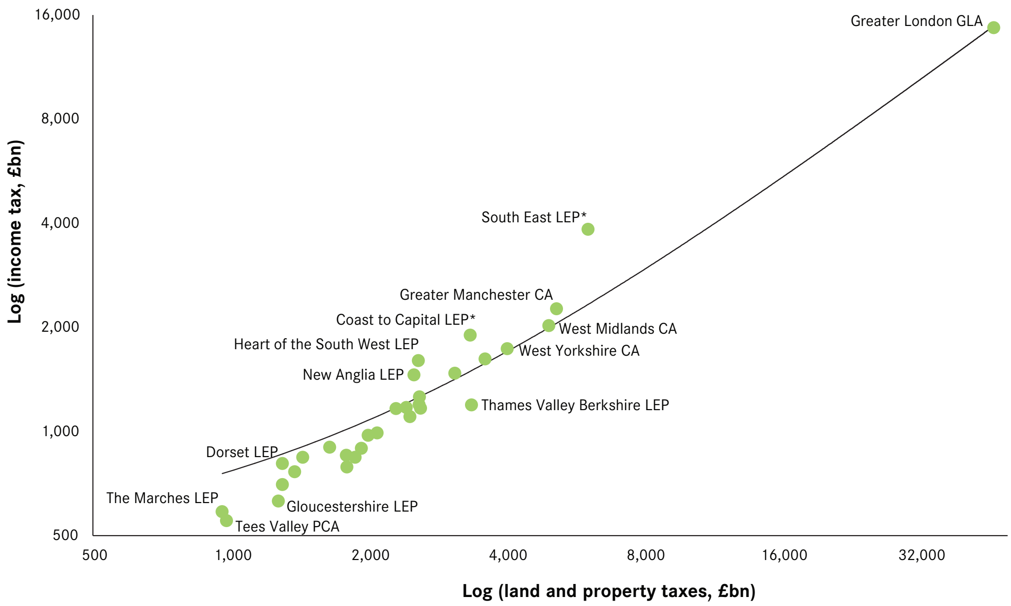
There is also good reason to believe that sharpening the incentives for places to grow through greater levels of local tax retention won't only bring financial benefits to local areas, but to the national exchequer too.

If cities successfully support business growth in their area and build more homes, it won't just be the levels of business rate or stamp duty revenues that increase, but also levels of income tax, or corporation tax too.

For example, if land and property taxes were devolved, resulting in behaviours by local government that increased stamp duty revenues by 1 per cent above trend, that could also generate in the region of an associated net additional £1.05 billion in income tax collected nationally (or 1 per cent of the total income tax bill based on 2014-15 figures).

This highlights that by shifting behaviours at a local level, national government could achieve a significant increase in national tax revenues, without needing to raise the level of taxes across the country.

Figure 13: Relationship between income tax and land and property taxes generaged by city-region, 2014-15



Source: DCLG (2015): Collection rates for council tax and non-domestic rates in England, Local authority revenue outturn; HMRC (2015): UK stamp duty statistics, Personal income by tax year; ONS (2015): Annual Survey of Hours and Earnings
Note: To avoid double counting, the definitions of the starred LEPs include only some of their constituent local authorities. These LEPs are: Coast to Capital LEP, Enterprise M3, Greater Cambridge and Greater Peterborough LEP, South East LEP, South East Midlands LEP, York and North Yorkshire LEP. The full breakdown of the city-region definitions used in the report is available here: http://www.centreforcities.org/reader/beyond-business-rates/appendix-political-geographies/

Conclusions and recommendations

The funding landscape for UK cities is changing, providing an opportunity to improve how the system works. The devolution of business rates is a step in the right direction, giving cities more control over a growing tax base and more incentives to support and attract new businesses to the area, as well as the expansion of existing firms. But there remains a risk that the devolution of business rates alone, particularly in its current form, will not provide **a strong enough growth incentive to generate significant additional funding for UK cities.**

Devolving additional control of land and property taxes, alongside new responsibilities, would create sharper incentives for cities to back investment in the things that can really make a difference to their local economy. This, in turn, will increase the size of the overall funding pot available to local government in the UK, meaning a proportion of those funds can be redistributed.

It would also bring big benefits for the national finances. If land and property taxes were devolved, resulting in behaviour by local government that increased revenues by 1 per cent above trend, this would generate an associated **net additional £1.05 billion in income tax** (or 1 per cent of the total income tax bill based on 2014-15 figures).

In order to provide the financial incentives that cities need, policymakers should:

- **Address weaknesses within the current business rates system, and ensure growth incentives are prioritised when devolution takes place in 2020.** Reforms should include: extending reset periods, encouraging pooling between authorities in city-regions, conducting more frequent valuations and replacing the fixed yield with a fixed rate. This would reduce volatility in the system and improve responsiveness to local economic conditions.
- **Devolve control over the £10 billion generated in stamp duty alongside the full £23 billion in business rates to provide far stronger incentives for places to grow.** Doing so would mitigate the risk of cities being dependent upon just one devolved tax stream and it could make a big difference locally by incentivising authorities to permit more development.
- **Provide more freedoms regarding the setting of council tax to encourage revenue pooling between authorities.** All local authorities need more freedom and flexibility over council tax revenues, including the ability to raise council tax without requiring a referendum, to spend the revenue generated as they see fit, and to introduce extra council tax bands as appropriate. This would encourage pooling within city-regions and reduce the need to compete on business rates.

- **Ensure that the additional responsibilities passed down to cities alongside new tax streams are ones that local government can have a positive impact upon.** For example, if both stamp duty and the housing benefit bill were devolved together, there would be both a greater incentive for supporting the delivery of new homes – due to increased stamp duty and council tax revenues, and the prospect of driving reductions in local expenditure on housing benefit.

The approach outlined in the report raise several issues that need futher consideration between now and 2019-20 when the new system of local government funding starts. **These focus on how best to design a system that balances the need to both provide strong incentives for cities to prioritise growth, as well as provide a means to redistribute funds to cities less able to grow their economies.**

1. Redistribution of business rates and stamp duty. The design and implementation of top-ups and tariffs under the new devolved business rates system will determine the extent to which local control over business rates operates as a growth incentive in different cities. In addition to the top-ups and tariffs which redistribute income from one local authority to another, the current growth levy penalises those local authorities that 'disproportionately' benefit from growth, thus acting as a disincentive for high growth areas to grow the business rates base further.

More work is required to compare the costs and benefits of a system that caps the proceeds of growth from successful cities for the purpose of equalisation with that of a system that redistributes a fixed share of a growing tax base from those areas to support struggling cities.

Given that London generated almost a third of all business rates in 2014-15, and 43 per cent of stamp duty – in comparison the combined revenues of the Northern Powerhouse city-regions accounted for 16 per cent of the national business rates tax take and 7 per cent of stamp duty revenues[43], there is an additional question of how to treat London within a national system.

2. Pooling. Devolving additional tax streams responsibilities should increase the benefits from pooling across city-regions.

Given these benefits, there is a question about whether a system of redistribution should be based on individual local authorities, or whether to organise the system based on city-regions and groupings of local authorities.

3. Marrying extra responsibilities with extra funding. The national housing benefit bill is £22 billion, more than double the amount raised by stamp duty (£10 billion).

If responsibility for the housing benefit bill was devolved to local government, the government would also need to devolve an additional £12 billion to cover the shortfall in the first instance. This raises the question of where this money would come from and whether it should be reduced over time to reflect the growing local tax base and the housing benefit bill, which is likely to fall as local authorities act accordingly by encouraging economic growth and building new homes.

43 The Northern Powerhouse is defined as: Greater Manchester, Liverpool City Region, South Yorkshire, Sheffield City Region, Hull and Humber and the North East Combined Authority

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