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A REVIEW OF ALTERNATIVES FOR LOCAL GOVERNMENT FINANCE

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Members of the present Government, including Mrs Thatcher, have in the past expressed their determination to scrap the present system of local rates. This determination appeared to be strengthened earlier in the year by the political storm that blew up over the rates revaluation in Scotland. Revaluation in Scotland had already been delayed two years beyond the normal statutory 5-year period and the delay only served to make an even larger jump in rateable values inevitable. The storm was the greater because the last revaluation in England and Wales was in 1973.

It is said that the present rating system depends on fairly frequent revaluation if distortions and inequities are to be minimised. To understand this contention, however, we need to note that under this system rateable values arise from two types of source. The first is site value and the other is the value of the man-made improvements placed on the site. Improvements such as new or converted buildings, central heating, additional bathrooms, and fixed office or factory equipment and machinery will increase the rateable value of properties and render the owners liable to increased rates. In this sense the present system is a tax on development and so discourages it. From the point of view of incentives it would be better if improvements were revalued very infrequently but in principle, and generally in fact, improvements are reported as they occur and new rates assessed accordingly.

Naturally these imposts are resented by ratepayers because, apart from the disincentive effects, many improvements, especially in domestic properties, do not increase the owner's ability to pay. Nor are they automatically accompanied by increased benefits provided by the local authorities: an extra bathroom or garage does not mean that the ratepayer has more children to be educated or that he requires extra police services.

The other major element of rateable value is the value of the bare site on which homes, shops, offices, factories or crops may lie. Illogically, sites which, no matter how valuable in the market place, are left vacant or which are put to agricultural use are exempt from rates under the present system. In many areas the unimproved site value is the most important element in total property values. The most dramatic examples are to be found in city centre properties where a building may be sold or let at many times the price obtainable for identical premises in the suburbs or in a small country town. For example, in Glasgow space in a newly-converted shop on the corner of Renfield Street and Gordon Street is being let at an annual rent of £25 a sq ft (August 1985) while shop rents in less desirable areas may be only £1 a sq ft. The difference is almost entirely accounted for by the site or location value rather than by difference in the furnishings, fittings or building materials.

Differential site rents (and hence differences in potential rateable values) can and do change enormously over time to reflect changes in the general environment and amenities of different localities in a city or between one city and other cities, towns and villages. The differentials will be affected by new motorway links, the price of petrol, demography, changing patterns of demand, international competition, the closure of a steel mill, the opening of an exhibition centre, the closure of a school. These are some of the variables which have exerted an influence, often great, upon relative site values between the valuation years 1978 and 1985 in Scotland, and even more since 1973 in England and Wales. In Scotland revaluation, together with some changes in rate poundages and reliefs for different types of property, has increased the average bill for domestic ratepayers by 21%, increased it by 9% for commercial ratepayers and reduced it by 11% for industry. Even greater variations exist within each of these categories.

In this case more frequent revaluations - say, every two years - would reduce anomalies and lessen the size of the average change in rateable values. Domestic, commercial and industrial ratepayers whose property values have been enhanced by better communications and amenities would be asked to pay more; those who have suffered a loss of amenity or are victims of general trade recession, such as the industrial sector in Britain, would pay less. Site values are created or destroyed by the community independently of the individual efforts of landowners. It is therefore natural for the community, through the state or local government, to seek to return these values to the community through the rating of site values. This form of rating commends itself in terms of the benefit principle or the ability-to-pay principle or both.

By itself the rating of site values encourages intensive development of sites. However, in Britain this effect is emasculated by two opposing influences. First, more intensive development renders the owners liable to a tax on development, since it raises rateable value under our composite rating system. Secondly, if the land is not used at all the owner is exempt from paying any rates, even though the unimproved site may have an enormous market value. Thus a clear incentive exists to avoid development and hold land merely for speculative gain. The effect of this is to create an artificial shortage of building land and to drive up the general level of rents at the expense of wages and interest, thus reducing the supply of labour and capital to the economy.

These two negative aspects of the present rating system could be mitigated or removed altogether by following the practice adopted in several countries, such as Australia, New Zealand, South Africa and parts of the United States. There the rating authorities set separate rates for land and improvements, with a higher rate for the former and a low or even zero rate on improvements. Idle land is also assessed at its maximum permitted use value; that is, after making allowance for any restrictions imposed on use by zoning or 'green belt' planning norms. The practical problems associated with assessing the value of sites have been shown to be much less than those associated with the valuation of man-made improvements, as exemplified in the research exercises carried out in Whitstable in 1963 and 1973 (Wilks, 1974).

The 1976 Layfield Committee Report on Local Government Finance gave only cursory attention to the site value rating alternative on the grounds that the new Development Land Tax would take care of the taxation of development values and that 'in these circumstances a local tax on site values loses its relevance'. As we have seen, however, the rating of site values is not a tax on development but, on the contrary, is an alternative to such taxes. And the Development Gains Tax, being a tax on development was found in practice to be discouraging development and so was abolished in the 1985 Budget. The logical next step would be to scrap its sister tax, the element of local rates associated with the value of improvements. This would leave only the value of the site as the proper base for rates, so stimulating instead of discouraging development.

Nevertheless, the distortions arising from the infrequency of revaluation, the public outcry at the sharp increases in valuations on many domestic and commercial properties which were caused by the delayed revaluation, and the way in which the present system deters or penalises improvements, have combined to create a determination in many political quarters, to scrap the present rating system in its entirety and to seek a completely new alternative.

Among the more prominent alternatives canvassed recently has been the poll tax or 'residents charge' as the Government prefer to label it. A poll tax could involve a tax on the right to vote in local and national elections because people would be encouraged not to register in order to avoid the tax. Alternatively it could encourage people to report addresses of convenience, declaring themselves residents in areas where the poll tax or residents charge is lowest.

The 1981 Green Paper **Alternatives to Domestic Rates**, noted that its 'administration could well cost at least as much as that of domestic rating, since mobile individuals are harder to trace than occupiers of fixed property'.

The main argument advanced in favour of the poll tax is that it is fairer than a property tax in that it is paid by all adults, not only householders. However, all residents make a contribution, in cash or kind, to household expenses and so are indirect contributors to the rates under the present system. If five people live in a house while only two people live in an identical house next door the former pay lower rates per person but also occupy less space. They may together be receiving more benefits such as education and health (though the latter is administered and funded by national not local government) but will be reducing the costs of housing and infrastructure that would otherwise be needed if two-person households were the norm. Thus it is not obviously inequitable or inefficient if rates bills are proportional to the value of land occupied rather than a fixed per capita charge. The latter is clearly regressive while the present rating system has been shown by the Layfield Committee to be progressive at least through the lower income ranges and so does take account of ability to pay as well as benefits received in the form of amenities of all kinds.

Another alternative, favoured by the Liberal-SDP Alliance, is the local income tax (LIT). Various advantages are claimed for LIT. It is a 'buoyant' tax in that its yield rises automatically with inflation. It would expand the tax base to include all income tax payers. It is related to ability to pay. Each local authority could set its own LIT rate and so promote local accountability.

However, formidable practical difficulties surround its operation, even if, as the Liberals have proposed, LIT were deducted at source at a standard national rate with adjustments made at the end of each year according to the different local rates set. If the national rate were set high most taxpayers would claim rebates from their local authority at the end of the year. This would save employers the chore of deducting PAYE at many different rates, and also deals with the problem of taxing investment income. But Town Halls would be deluged by claims for rebates in April and there would be great uncertainty about the yield of the tax.

Addresses-of-convenience would again be encouraged as people tried to lodge themselves in low-tax districts. Wide variations between income in different areas would call for an equalisation scheme on such a scale as to obscure the principle of accountability. Most damning of all in the eyes of the present Conservative Government is that it would on average add 7p in the £1 to income tax if LIT replaced domestic rates, and this goes contrary to the Government's search for 'incentive taxation' by switching from direct to indirect taxes. If the LIT were merely supplementing instead of replacing the present system there would be considerable extra costs (estimated at £220m in the 1981 Green Paper) of local government.

Furthermore an income tax is essentially a payroll tax. Employees will seek compensation from employers in the form of higher gross wages, or they will withdraw from the labour force. Thus the ultimate incidence of the LIT would fall on employers as higher wage costs and then on consumers in higher prices, and on the unemployed.

If with the introduction of LIT the present rates were scrapped rentals and capital values of land and buildings would everwhere rise. The major beneficiaries would be landlords and existing owner-occupiers who would enjoy windfall capital gains. This has been the experience in de-rated Enterprise Zones where, as leases came up for renewal, rents rose in line with the reduction in rates. Researchers at the University of Cambridge Department of Land Economy, in a report earlier this year on the effect of business rates on location of employment, concluded that different rates have little or no effect on location decisions. One reason they give is that rents vary in line with rates, thus equalising the **net** price of land of similar quality (in terms of accessibility, amenities, etc) throughout the country.

Many US states and Canadian provinces raise revenues from a local retail sales tax. The advantages claimed for this sytem are that it forces more local residents who consume public services to make a contribution; that it brings tourists and commuters into the net; and that as an ad valorem tax it is 'buoyant'. We have already noted that the present rating system has in fact a much wider tax base than is supposed, because all household members contribute, in cash or kind, to household expenses, including rates. Furthermore, we should remember that around 60% of local authority expenditure is financed from central government rate support grants which in turn are financed ultimately from national income taxes and VAT.

In a small, densely populated country if different local authorities impose local VAT rates there is likely to be a growth of cross-border and mail-order shopping which would tend to create a relatively uniform local VAT rate constantly forced to a low level. If rates remained unequal cross-border shopping could make the yield very unpredictable and variable. Administrative and enforcement costs could also be high. This proposal has found little support from the various public enquiries that have been set up to investigate UK local government finance in recent years.

Finally, we should mention proposals to shift the finance of local government even more to the centre than is the case already. This would be accomplished by increasing the rate support grant element and by removing certain functions such as education from local control. The proposal to establish a uniform national business rate would tend to have the same effect of increased central control because it would increase the need for rates equalisation grants. Alternatively it would mean that local authorities would adjust the domestic rate to compensate for a rise or fall in the local business rate toward the uniform national level. Domestic rate poundages would then tend to diverge even more widely between authorities and from the rate applied to commercial properties. This could have significant allocative and demographic implications. So the Government would be likely to intervene to equalise rates and revenues (through rate-capping and specific, ear-marked grants, for example), with a consequent loss of local autonomy and accountability.

It would appear, therefore, that all the major alternatives to the present rating system that have figured prominantly in recent green and white papers and cabinet and political party discussions suffer from major practical, theoretical or political drawbacks. The site value rating alternative has received relatively little attention apart from the superficial mention accorded it in the report of the Layfield Committee. Yet this alternative does have several clear merits. It would retain the existing administrative apparatus and dispense with the need for the additional army of bureaucrats that would be required to administer a local income tax, poll tax or VAT system. The work of valuers would be simplified if they only had to value sites and could ignore improvements. Site valuation is done routinely as part of the overall valuation exercise anyway.

Pilot surveys of its practicability in the UK have been successfully conducted by the Rating and Valuations Association for Whitstable in 1963 and 1973. The system has existed in several other countries for many years with apparent success in stimulating more intensive land development. The effect has been to bring rated vacant land on to the market with a consequent fall in rents that allows the level of wages and interest to rise, increasing the supply of labour and capital for production. It also permits the alleviation of taxes on labour, capital and consumers with further benign effects on incentives and costs. It preserves local autonomy and accountability, though a proportion of site values can easily be siphoned off by national government for the purpose of effecting some equalisation among local authorities with different needs and resources, as is done already under the existing rate support grant system. Finally, this reform commends itself on grounds of equity and justice in that its effect is to restore to the community the site values that are created by the community while restoring to individuals their rights to all the man-made improvements that are created by individuals.

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