Economic Perspective 1

THE GREEN PAPER ON LOCAL GOVERNMENT FINANCE

Roger Sandilands
Departmentof Economics, University of Strathclyde

Mrs Thatcher first promised to scrap the domestic rating system in 1974 when she became leader of the Conservative Party. Since then the **Layfield Commission** in 1976, the Green Paper **Alternatives to Domestic Rates** in 1981 and a 1983 **White Paper** have all rejected any radical change to the domestic rating system. In particular, the local income tax, local sales tax and local poll tax alternatives were rejected as either unworkable, too costly, or too regressive.

Despite widespread scepticism in her own Cabinet and in the Treasury, Mrs Thatcher has insisted that a way had to be found to scrap the domestic rating system and to modify the business rating system. There were two main reasons. First, she believes that local authority spending has been excessive and that more effective methods for controlling this spending had to be found. Various measures have already been taken, such as rate-capping and grant penalties. However, it is held that the underlying reason for 'excessive' spending by local authorities is their lack of accountability to local electors. Most of these electors, it is claimed, do not pay local rates, and so do not perceive any direct link between local authority spending and their own contribution to the finance of this spending.

Secondly, local rates were said to be very unpopular, especially with Tory party supporters. This view was confirmed by the furore in Scotland over the rates revaluation of 1985. The revaluation exercise was delayed by two years beyond the normal statutory five year interval since the last one in 1978. A revaluation announced in the Spring of 1983 would not have helped Conservative party fortunes in the General Election of that year. However, the Secretary of State merely stored up more trouble because the delay simply made rateable values more out of line with changing amenities and developments in different areas. In England there has been no revaluation since 1973 and the Government naturally dreads the even greater adjustments that in fairness are required there.

The unpopularity of rates during revaluations has little to do with any intrinsic unfairness. It is less fair not to revalue, and people in Scotland would have been less aggrieved if revaluation had been undertaken simultaneously in England and Wales. However, Mrs Thatcher has also been much exercised over a different reason why rates are perceived as "unfair" by many. This is the view, expressed strongly in the Green Paper, that the single-person household pays the same rates as a family of four working persons occupying a similar house next door. Nor, says the Green Paper, is it fair that a similar family living in a similar four-bedroomed detached house should pay more in Luton (£970) than in Carlisle (£550), just because of different rateable values (£580 against £330). Presumably, the same logic would mean that it is unfair that the Duke of Westminster pays more rates for living in Belgravia than a person living in Drumchapel or in a croft on Skye.

The new proposals

The Green Paper summarily dismisses the local income tax and local sales tax alternatives. As I explained in an article in the last **Commentary** (November 1985) these are objectionable on grounds of practicality, cost, certainty, effects on incentives to work, wage demands and opportunities for cross-border shopping.

Two main proposals are contained in the Green Paper. The firt is to move towards the abolition of domestic rating in favour of a uniform "community charge" on all adults resident in a particular local authority. Secondly, local authorities would be deprived of the power to set local non-domestic (business) rates. At present the rate poundage varies widely throughout Britain (though less so in Scotland), reflecting differences in local authority spending per capita. Instead, central government would fix a uniform business rate poundage according to central government's view on national expenditure targets. Local authorities would collect business rates as at present, but transfer these to a central pool. These will then be redistributed to local authorities on a uniform per capita grant basis.

Because these changes have significant implications for the finances both of individual ratepayers and local authorities it is proposed to phase them in over a transitional period. In Scotland there has recently been a revaluation of all property and there are less significant variations in rate poundage than in the rest of Great Britain. Therefore, the Government intends introducing the changes here sooner than in England and with a shorter transition period.

Legislation will be time-tabled for Scotland in the 1986/7 parliamentary session with a view to implementing the first stages of change in April 1989. A uniform community charge of £50 per head will be levied initially, along with a corresponding reduction in domestic rates by about 40%. After three years the average community charge will be around £209 in Scotland (£229 in Strathclyde), based on current local spending levels, and domestic rates will be scrapped completely.

Business rate poundage will initially be frozen in real terms (that is, allowed to increase only in line with an inflation index). As in England and Wales, non-domestic rateable values in Scotland will be revalued in 1990. Eventually it is hoped to move towards a valuation procedure that is harmonised with the English system and then to move towards the uniform national poundage rate. All business rates would be pooled centrally and redistributed to local authorities on a standard per capita basis.

There would be few significant changes to the present system of allocating central government grants in aid of specific services such as the police or in the "needs grant" system that compensates authorities with, for example, a larger number of school-children than average, or above-average costs because of remoteness or sparsity of population. The Exchequer will also continue to provide 'standard' per capita grants to subsidise local authority spending from national tax revenues.

Gainers and losers

Who would be the gainers and losers from these changes? Let us first consider the effect on the overall revenues received by different local authorities because, as we shall see, this will affect the level of the community charge imposed in different areas. We can then discuss the distributive effects on households of the shift from domestic rates to the standard community charge.

The local authorities that would gain most would be those with relatively low per capita spending and those with relatively high **domestic** rateable values. Under the present system resource equalisation grants favour those authorities with low rateable values for domestic and business properties combined. It also favours those with high poundages. Under the new system there would be no resource equalisation grants except under the uniform business rate system. The new system would equalise business rate revenues per capita but would not equalise domestic revenues, which are to be scrapped. Nor would the Government pay a higher poundage to high-spending authorities. The community charge for areas where housing is cheap and/or of inferior quality would be higher unless these authorities cut their expenditure. Districts such as Glasgow, where there is a disporportionate amount of low value council housing, would have to obtain the average per capita domestic rate entirely from the community charge on its residents. Residents would, however, be eligible for rebates of up to 80% of the community charge, and central government would continue to meet this bill.

High spending authorities will not be allowed to increase business rates and so will be forced to increase the community charge. Residents, but not local businessmen, nor outsiders who come into a city to work, shop or do business, will bear the whole of the marginal cost of higher than average per capita expenditure by their district councils.

The new community charge, is of course, highly regressive except at the lowest income levels where progressive rebates have a significant offsetting effect. However, loss of rebates as incomes move from around £50 to £100 a week will tend to accentuate the poverty trap and discourage young people from seeking work. The biggest beneficiaries will be the very rich. The couple living in a Belgravia flat will perhaps pay £400 to their local authority instead of £4,000.

Equal benefits from local services

The Green Paper justifies this change on the grounds that the rich do not benefit much more from services provided by local authorities than do people living in council flats in Drumchapel. It also states that some single-person households on low incomes live in dwellings with high rateable values and so would pay less under the community charge.

There are, however, strong counter-arguments. First, "hard cases make bad laws". Hard-luck cases are best dealt with by specific provisions, and, indeed, the current rates rebate scheme does alleviate the position of poor widowed pensioners living alone. It should be remembered that most pensioners have already paid off their mortgages, and so may have higher disposable incomes than some working couples. This is not taken into account in the Green Paper's figures.

More fundamentally, however, the basic premises of the Green Paper that domestic rates should be paid only to finance the current cost of local authority services, and that these services tend to be enjoyed equally by all are open to question.

Amenities and land values

To understand this, consider two neighbourhoods in a city, one a fashionable middle-class area, the other a working class council estate on the edge of the city. Property values in both areas comprise two elements: one is the value of the bricks and mortar; the other is the site value of the ground on which the property stands. In the middle-class area the site value is often greater than the value of the bricks and mortar. In an area like Drumchapel land values are only a small fraction of the value of flats and houses. Some of these houses are not much different from a few council houses built in middle-class areas which would sell for perhaps four times the price they could fetch in Drumchapel. The difference is accounted for mainly by land values.

If a local authority wants to build a new school in the middle-class area it incurs substantial land acquisition costs - or would do if it did not already own the land, or if the land were not zoned for that specific purpose so that it had no alternative allowable use. Explicitly or implicitly, the land has a very high opportunity cost. It has a very high potential value because if it were offered for sale on the free market there would be a competitive clamour to buy. Valuable housing, shops or offices could have been erected on the site. They represent the substantial opportunity foregone by building the school. The local authority may or may not pay that opportunity cost explicitly, because it may already be owner of the land or because of zoning restrictions. It is, nevertheless, the true opportunity cost in the economic sense.

The opportunity cost of land in Drumchapel, however, is very low. Thus Drumchapel children are educated at lower cost than the children in Glasgow's fashionable Hyndland, or Edinburgh's Morningside.

The same principle also applies to a range of other amenities provided by local authorities. It may not cost much today to maintain a park or an existing museum or theatre. But these amenities did cost a great deal to create in the past and today they still have a very high opportunity cost if located in fashionable neighbourhoods (where parkland could realise millions if released for building) or in valuable down-town business areas. These are amenities which tend to be enjoyed disproportionately by the rich, who live in the valuable neighbourhoods. Low explicit financial costs incurred by local authorities should not be allowed to hide the high implicit opportunity cost of services.

The high rateable values assessed on properties where the rich tend to live or work are a reflection of the high amenity value of the areas where these properties are located. Many of these amenities are the result of expenditures incurred today or in the past, by local and central government. High site values also arise because of the amenity value and accessibility of private shops and offices in the area. Accessibility depends on public transport services and the road network. The greater the local population the greater the demand on space and the greater its opportunity cost. The richer is that population, the greater the business for shops and offices. This is all reflected in high land vlues and high land rents. These values are created by the whole community. The value of a particular site is not created by its industrial owner or occupier. Indeed, a site in a down-town area may lie empty for years yet be extremely valuable.

The two elements of assessed rateable values

If land values are created by the whole community, a strong case can be made for returning these values to the community. This principle is implicitly accepted in the present rating system. District valuers assess the annual rental value of all properties and owners pay rates accordingly. However, three major defects of the present system can be idetified.

First, all agricultural land and the urban land that is lying idle are exempted. This has the effect of increasing agricultural land prices and the rents that tenant farmers pay their landlords. Money that would be paid in rates to the local authority are paid instead to the landlord in higher rents. The exemption of vacant urban land encourages the speculative hoarding of land, which drives up the price of land generally, makes land more scarce, and forces a more disperse pattern of urban sprawl development at high social cost.

Secondly, the rateable value of property includes the value of man-made improvements. If a householder instals central heating, builds a garage or instals a new bathroom he is penalised by heavier taxation. If an industrialist instals new plant and equipment he too is penalised. In several parts of the United States land is assessed separately from improvements and taxed at a higher rate. Other countries, such as Australia and New Zealand exempt improvements and levy the local rate only on site values. This has the effect of reducing land prices - making it easier for small companies to start-up in business and for families to buy new housing - while stimulating improvements and the more intensive use of land, subject to the usual zoning regulations.

Thirdly, revaluation occurs far too infrequently. This allows rateable values to move far out of line with the current amenity value of land. Partly, the reason for the infrequency of revaluation is the very high cost of assessing every single property inclusive of its unique set of buildings and improvements. It is far easier and quicker to assess the value of sites alone, ignoring improvements, and to draw up land value maps available for general inspection.

An **additional** objection to the present rating system, that would apply equally to a system that rated site values only, is the poor-widow argument. However, we have noted already that special provisions can be made to deal with specific hard-luck cases, notably through a rebate system attached to the person rather than the property. It makes little sense to relieve everyone of rates in order to help a very small proportion of hard-luck cases. It may also be noted that if the community charge does replace domestic rates it may reduce the rates bill for many single persons but would at the same time provide a greater incentive for these persons to occupy large properties on valuable space. They will be less inclined to move to smaller dwellings or to take in lodgers. This will lessen the intensity of use of the existing housing stock and increase the need for new house-building and associated infrastructure.

Another perverse effect of the community charge upon occupancy rates would be that persons currently lodging in larger or more valuable houses may feel unable to pay such high rents as before and move down-market. The overall supply of rooms for rent to students and others would fall. It could increase homelessness, especialy when homelessness would be one way to avoid paying the community charge.

Voters and ratepayers

At this point we should highlight a pervasive fallacy that runs throughout the Green Paper: namely, by pointing out that only 29% of the Scottish electorate and only 34% of the English electorate pay full rates, plus another 9-10% of ratepayers who receive partial rebates, the Green Paper implies that two-thirds of voters make no contribution to local authority expenditure and are parasites. This implication is fallacious for a number of reasons.

First, everyone contributes to national taxation, which is the main source of local finance through rate support grants, either through sales taxes or incomes taxes, or both. Secondly, almost all adults make an indirect contribution to the rates because all household members contribute to general household expenses, including rates, directly in cash or indirectly in kind, as housewives or handyworkers. Likewise a portion of the rent that lodgers pay is used to pay the rates. Only a small proportion of households are eligible for full relief from their rates bills. It is frequently said that the household with four working adults should pay more because it is earning more than the two adult, two schoolchildren household next door and therefore has greater ability to pay. However, this family is contributing more through income and expenditure taxation. Also, the adult household is currently benefitting less from educational expenditures than is the family with schoolchildren and so, on the benefit principle emphasised in the Green Paper, there is a case for a somewhat lower rate per adult head in that household. Perhaps more important, however, is the fact that the larger household uses less space per person, which has a real opportunity cost measured by its rateable value.

The Government is evidently operating double standards in its approach to the domestic and non-domestic sectors, for there is no proposal to abolish business rates. Yet in the Government's argument rates do not reflect the benefits businesses receive from local authority expenditure. And they have no vote. Fortunately the Government has not followed the logic of these arguments for scrapping business rates along with domestic rates.

Nevertheless, there is here clear merit in again distinguishing the two components of rateable value for industrial and commercial premises. The site value element reflects the general community-created amenities. Some of these are provided through local or national Government out of current expenditures. Others - the railway and road system, airports and the public utility infrastructure - have been provided by Government in the past. Land values are further enhanced by the degree of proximity to suppliers of raw materials, components and the workforce. Closeness to distribution systems and customers also affects land values. Shops, factories and offices do not enjoy these elements equally. The differences are reflected in differential land values and rentals.

These rents are a fixed cost of production but are offset by the corresponding increase in productivity, or lower unit variable costs of production. Thus rents do not enter the product price. Rents are a surplus. The only question is: who is to capture this surplus? Private landowners or the community which created the surplus? The present rating system does return a portion of land values to the community, and thereby keeps land prices lower than they would otherwise be. Abolition of rates would provide a windfall gain to landowners, just as it will do in the case of domestic rates. (The Green Paper reluctantly admits this point on Annex E. Anthony Harris, in the Lombard Column of the **Financial Times**, 30 January 1986, also makes this point and favours the site value rating alternative considered below.)

The second element of rateable values, namely man-made improvements, is, however, much more difficult to justify as the basis for taxation. Land is in fixed supply and a charge for its use does not alter the supply, although it would increase its availability if the charge applied equally to land currently held idle for speculative purposes. Improvements - buildings, plant and equipment - are not, however, in fixed supply and a tax on this element of rateable values does discourage development.

The sitevalue rating alternative

A more sensible reform of the rating system would therefore involve a progressive move away from the composite rate on land and improvements towards a rate that fell only on regularly assessed land values. This system of site value rating could apply equally to domestic and non-domestic properties.

Site value rating commends itself on most of the criteria usually required of a good tax. First, it is difficult to avoid. Land, unlike man-made improvements or people themselves, cannot be hidden and cannot move.

Secondly, it is efficient. It encourages more intensive use of land, subject to planning restrictions. (Land values are assed at the maximum **permitted** use value as reflected by market demand.) It permits the progressive removal of discouraging taxes upon labour and capital, which are elastic in supply and which could therefore be expected to increase if taxed less severely.

Thirdly, it costs much less to administer than the composite rating system because valuers do not need to examine the state of buildings and other improvements. In Britain its practicability has been demonstrated in two pilot surveys carried out in Whitstable, Kent (Wilks, 1974).

Fourthly, its incidence is more certain. The burden of a land tax falls on the landowners and cannot normally be passed on to tenants or consumers. Tenants will normally be paying the full economic rent already and a tax on rent would mean they would pay less to the landlord, if the bill were presented to the tenant as occupier. If the rates bill were presented to the landowner he would simply pay the bill out of the rents received from tenants. Likewise a tax on rent cannot be passed on to consumers because *rents are not a variable cost of* production.

Fifthly, its yield is predictable. Rateable values are known at the start of the financial year and, depending on the poundage set, the yield is known in advance because it is such a difficult tax to avoid.

Sixthly, it accords with the benefit principle. Rateable values reflect the potential benefits, in money terms, that a site can be expected to yield if put to its optimum use. This value is determined by what people in the market place are actually prepared to pay for its services if given a chance to rent it. The unimproved site itself has zero costs of production.

Land is the 'free gift of nature'. (The same applies to all natural resources, including North Sea oil.) It does, however, have a monetary value, which is therefore a pure surplus or monopoly rent. This is created by the whole community and therefore properly belongs to the community. Improvements, however, do have a cost of production. There is no surplus there and if improvements were taxed the supply would fall.

On a related terminological issue, it is of interest to note that the Green Paper deliberately chooses the term "community charge" rather than community tax to describe the Government's proposal. This is because the Government insists that payment is for services rendered by the local authority, or benefits received, and so is a charge similar to the charge made by the baker for a loaf of bread. A tax, by contrast, is a compulsory payment with no direct link to personal benefits received. We have seen that the community charge is in fact partly a tax because local authority services are not provided equally, and certainly not at equal cost.

Insofar as the payment made for the right to use land or natural resources is a payment directly linked to benefits received - the value of the asset - site value rating is, properly speaking, not a tax but a charge or fee for use of benefits provided by the community. In this it differs fundamentally from taxes on improvements, which are provided by *individuals not the community as a whole.* It differs also from income taxes on labour or taxes on interest and profit income (where interest and profit are defined strictly as returns on capital exclusive of explicit or imputed land rent payments).

The final criterion or canon of a good tax is that it accords with ability to pay. In general, people - householders or businessman - who occupy the more valuable space - for dwellings, shops, offices, factories of farms - are the more wealthy or have highest gross value of turnover. Usually, therefore they have greatest ability to pay higher rents. If a business is unable to pay the market rent it must be a reflection of relative inefficiency and there is natural pressure either to improve efficiency or to vacate the land in favour of those who are able and willing to pay the market price. In the case of households there will be families who fall on hard times, or whose income falls because of retirement or because adult working family members move out into their own homes. If the remaining family wishes to stay rather than move into a smaller dwelling they must somehow find money for the rates. In some cases the community may choose to help this family with rebates. This is easily accomplished and is already practiced under the present rating system.

The community charge proposal faces the same problems with hard-luck cases, which can be alleviated through the rebate scheme. But in general the community charge is regressive and uncorrelated with ability to pay. On all the other criteria of a good tax the community charge fails the test: it is difficult to enforce, expensive to administer, unpredictable in yield, uncertain in its ultimate incidence, and only partly accords with the benefit principle. It does nothing to increase incentives to work or enterprise. On all these counts site value rating wins over the community charge and over the other main alternatives such as the local (or national) income tax, sales tax or the present composite rating system.

Accountability and perceptibility

Finally, however, we should examine how site value rating compares with the Government's proposals judged against the criteria of accountability and perceptibility that are so greatly stressed in the Green Paper. Under site value rating all voters except those in receipt of full rebates would contribute directly or indirectly to the rates because everyone occupying space has to pay rent.

It would remain true, as under the present system, that businessmen who pay rates on the land where their shops, offices and factories are located would not have a vote unless they also resided in the same local authority area. Absentee landlords would be in the same position. If the local authority increased its level of expenditure, it would need to increase the rate poundage on site values, and these nonresident ratepayers would have no vote on the matter. However, so long as rates are levied only on site values and the poundage never exceeds 100%, rates bills are only a fee for locational advantages that are "Godgiven" or communitycreated.

When the site value rate is less than 100% the landowner continues to expropriate part of the surplus value created by the community and there seems no basis in justice to complain that he has no vote, still less that his voting rights are not proportional to his rate payments. We are not entitled to vote at a supermarket shareholders' meeting just because we do our weekly shopping at that supermarket. Every landowner does, however, have his equal right to vote in local and national elections and in this way help influence the way that communitycreated site value rates revenues are spent by the community.

A natural limit on local authority expenditure would be imposed by the total rateable value of land. Assuming that revaluations are undertaken regularly there should be no need to impose a poundage greater than 100%. To go beyond this limit would involve not only charging a **fee** for site value benefits but charging also a **tax** on labour and manmade improvements (capital). This danger could be averted by legislation prohibiting rate poundages from rising beyond a certain point.

However, there remains the problem that rateable values are very unevenly distributed throughout Britain and, as done under the present system, there must be some mechanism for spreading these resources more evenly on a per capita basis. This permits every member of the community to share more equitably in the surplus that the whole community has created collectively. Arrangements very similar to those presently operated under the needs and resource equalisation grant systems can be continued. Authorities which choose to spend more than average per head of population (after taking account of differences in objective needs, such as number of schoolchildren) would need to levy a higher rate poundage than average and be answerable to their own electorates for that. But, so long as the poundage is not allowed to exceed 100% of uptodate rateable values, this involves no injustice or inefficiency. Business, along with households, would be encouraged to make improvements to their properties, using space more intensively, because they could not incur any additional rate penalty for this.

Local and central government finance

Ideally the basis for central government revenues could also shift progressively towards rates on land values. In fact it involves the same principle the Government already applies to North Sea oil revenues, the great bulk of which are in the nature of pure economic rents, or a surplus. Petroleum revenue taxes help alleviate the burden of taxation on labour and capital. So too would a national rate on site values. As taxes on wages, capital and expenditure (VAT) were reduced **gross** wage and interest payments would tend to fall, leaving real **net** wages and interest unchanged at their 'natural' level. The excess of the value of output over gross wage and interest payments is the economic surplus captured by land as rents. Thus we see that a fall in taxes on wages and interest increases aggregate land values. This increases rateable values subject to the site value rate, so that state revenues from this source would increase to compensate for the fall in conventional tax revenues.

As the 'community fund' increased in this way so local authorities could become increasingly selffinancing and reduce their dependence on central government grants. If the central government continued to reduce the burden of taxation on labour and capital land rents would eventually rise to a level at which local authorties would make net transfers to central government instead of being net recipients of grants from central government. Central government would always require adequate revenues to finance expenditures which are essentially national in character, such as defence and much of the national transport network. It would also be responsible for needs and resource reallocation grants, as explained above.

Under these conditions site value rating would ensure that a much larger fraction of local expenditure is raised locally. This accords with the perceptibility criterion stressed in the Green Paper. It is bound to increase the degree to which local authorities are perceived as accountable to local electorates and would surely increase the interest which local voters take in local government affairs.

In view of the fact that the site value rating option meets all the criteria the Government has itself laid down for responsible and democratic local government it is perhaps surprising that the 1986 Green Paper has failed to consider this alternative. There are, perhaps, two explanations. The first is that the landowning class would tend to lose from the move, particularly those who hold land purely for speculative purposes or who use it inefficiently. This class is influential. Landowners who also own building and other improvements would suffer a loss on the value of land but a gain in the value of improvements. Their net position would be little changed. This applies to homeowners as well as businessmen.

The second explanation may be connected with the fact that the 1976 Layfield Commission summarily rejected site value rating on the grounds that the newly introduced Community Land Act and Develoment Land Tax rendered that option irrelevant. However, the CLA and the DLT both involved the taxation of development rather than the 'taxation' of land values. People were liable to pay tax only if they developed their land. No tax was applied to land values if land use (or disuse) was unchanged. In any case both the CLA and DLT have since been repealed. There is therefore now less excuse than ever for a truly reformist government not to examine seriously the site value rating alternative.

Radicalism

The Green Paper describes its proposals as "the most radical restructuring of local government finance this century". Yet it is hardly radical in the common definition of that term to connote progressive, forwardlooking reforms. For basically it is proposing a regressive head tax unrelated to ability to pay or social benefits enjoyed, together with a uniform business tax scheme that involves a major loss of local autonomy. The head tax is normally associated with tribal village communities where populations are small and immobile. It is also associated with mediaeval England. It has never before been seriously advocated for modern industrial societies.

A truly radical approach to local government would revive the site value rating or land tax proposals of Lloyd George's 1906 Finance Bill that was twice vetoed by the landowning interests of the House of Lords. The Lords no longer possess this veto power. It is therefore a pity that the opportunity for the people to return to the community that which the community has created land values has been missed again with the sweeping, but nonradical Green Paper of 1986.

References

Green Paper, **Paying for Local Government, Cmnd 9714, HMSO, London, 1986.**

Layfied, F, Report of the Committee of Inquiry into Local Government Finance, **Cmnd 6453, HMSO, London, 1976.**

Sandilands, R J "A Review of Alternatives for Local Government Finance," Quarterly Economic Commentary, The **Fraser of Allander Institute, Vol 11, No 2, November 1985, pp7073.**

Wilks, H M Site Value Rating: Report on a Research Exercise Carried out in the Town of Whitstable, **The Land Institute, London, 1974.**