3 Recent financial changes

Since 1987 the main change has been the abolition of domestic rates and their replacement by the community charge or poll tax, introduced in Scotland in 1989 and in England and Wales in 1990.[1] The new tax is part of a wholesale restructuring of local government finance.

The debate about the rates had earlier origins, gaining momentum in the 1960s and 1970s, as shown by the appointment of the Allen and Layfield committees.[2] The Conservatives included a commitment to abolishing the rates in their 1974 manifesto, repeated in a modified form in 1979. Governments were reluctant, however, to change the rating system because of its ease of collection and low cost. The alternatives seemed to throw up problems such as the local economic impact of sales taxes (for example, in cross-border shopping) and Inland Revenue opposition to a local income tax.

The unpopularity of the rates posed a particular problems for the Conservative party because many of its supporters thought that, as property owners, they were bearing too high a burden of local authority income. As local authority costs rose and central grant fell from 1976, the burden fell more heavily on ratepayers. Thus, from 1979 on the Conservatives' concern to control local government spending was combined with a search for a new system of local finance.

First, in 1981 a green paper reviewed the alternatives to the rates.[3] The government favoured a local sales tax, but feared the administrative complexities and economic costs of that and the other options. The options were rejected in the following white paper.[4]

Discussing a poll tax it said, 'The Government agree with the Environment Committee that this option should be rejected.'[5]

But rates continued to pose problems for the government. The ratecapping measure proposed in the 1983 white paper reflected its anxiety. The rate rises after the revaluation in Scotland in 1985 increased the political pressure to change the system, and the rates were replaced in Scotland before England and Wales. The proposal to reform local government finance radically – the community charge or poll tax, the changes in the grant system, the national non-domestic rate and the reform of capital and housing finance – was a reaction to the difficulties of trying to control local authority rating and spending during the 1980s.

The official aim is to promote the financial accountability of local authorities. In the government's view this should happen partly because more people have to pay the community charge than paid the rates, and partly because of the 'gearing effect' – community charge payers now have to meet the full cost of any increase in the council's expenditure (whereas, under the rates system, part of any such increase was met by business ratepayers). The idea is that both councils and electors will be more appraising and sensitive to proposals to increase expenditure.

On first inspection the community charge does not alter the powers and role of local authorities, for, like the domestic rates, it is set by the local authority. However, the interaction of the tax with the other aspects of the reform leads to a reduced discretionary role for local government. The Local Government Finance Act, 1988 removes local authorities' power to set the non-domestic rate and replaces it with the national non-domestic rate (uniform business rate). Local authorities are entitled to a level of income from non-domestic rates based on their population size. The Secretary of State has the power to set the rate, though it is pegged to the retail price index. The new system reduces by about half the amount of revenue subject to local decision.

The other main change is the reform of the grant system. The aim is to stabilise the distribution of grant in order to improve the connection between spending and local tax rates. The resources equalisation part of the grant is no longer needed. The grant compensates merely for the differences that authorities face (because of variations in population structure) in the cost of providing a standard level of service, with an additional element based on estimated

community charge income. The government hoped that the simplified grant would encourage local authorities to budget near the government's assessment of expenditure needs and, if they did, to set the same level of community charge as other authorities spending at that level.

An effect of the new grant system is to redistribute resources between authorities. This effect is compounded by a simultaneous reform of the method of calculating expenditure need – the new standard spending assessments. Though the pattern is by no means uniform, the authorities that tend to be worse off are the higher spending inner city areas, particularly in London and the north of England, while the gaining areas are in the south east. Inner city areas, which are generally Labour controlled, not only have the difficulty that their spending patterns are translated into higher levels of community charge than under the rates, but the loss of grant (though eased by transitional arrangements) also increases the level of community charge. Like ratecapping the new system is designed to modify the behaviour of certain Labour controlled councils, but the unintended consequence may be to stimulate the spending plans of other areas which are traditionally 'low' spending.

The regressive nature of the tax may cause pressures to reduce spending if councils are sensitive to the impact of the community charge on low income groups. The gearing effect will intensify these pressures, particularly if the increase in local authority costs, such as wages and salaries, rise more than the retail price index. On the other hand there are factors encouraging at least some authorities to spend more under the new system. The most important is the differential effect of the new grant system on individual authorities. In addition, as in Scotland, there has been little incentive for some councils to reduce expenditure in the first year. The unpopularity of the tax (which meant that community charge levels could be blamed on the government), the absence of a 'base year', the ending of grant penalty, the discrediting of central government's estimates of community charges and the level and distribution of central grant meant that many Scottish authorities included growth of services in their budgets in 1989/90.[6]

The attempt to rethink the relationship between the domestic taxpayer and local councils may have an adverse effect on the relationship between non-domestic taxpayers and local authorities.

The non-domestic rate is set by central government and this removes an element of accountability between local business and councils, because there may be little incentive for the representation of business interests in the consultation process and little responsiveness in the level of services provided to business.

The 1988 Act replicates some of the central controls which had been developed in the previous financial system. These include the powers for community charge limitation already mentioned, but there are new powers, including a power to set the level of the national non-domestic rate. One of the features of the community charge legislation is the extent of the powers to make regulations, which cover every aspect of the legislation.[7] The Act also removes the guarantee that central grant is distributed according to 'principles applicable to all authorities', a feature of the block grant system. Since 1989/90 central grant has been cut if councils overspend.

In summary the financial reforms decrease the discretionary powers of local authorities, reducing by about half the proportion of income they are able to set themselves and possibly, in the long run, introducing a constraint on spending. Even the new grant system, which appears as a technical reform, may when taken in combination with the other reforms have a centralising effect. This is because the indicators of need – the new standard spending assessments – encourage local authorities to spend near these levels. In the long run, the new system may increase the influence of central government over local authority expenditure levels.

Capital finance

Capital controls over local government have also been reformed in England and Wales. In an earlier attempt at reform, the 1980 Local Government, Planning and Land Act had replaced the previous system of loan sanctions with a system of spending allocations by central government departments, limiting items of 'prescribed expenditure'. This was because local authorities had evaded the effect of loan sanctions through new forms of borrowing such as leasing and credit sales during the squeeze on capital spending in the 1970s.[8] The 1980 Act limited the use of capital receipts to 20 per cent for housing and 30 per cent for other activities. In the government's view, the 1980 system was not successful in controlling the level of capital receipts.[9] Control was evaded by the operation of the 'cascade' principle – the

ability of local authorities to use unused capital receipts from previous years to justify capital borrowing and expenditure in the current year.

In Scotland local authority capital expenditure is controlled directly by central government.[10] Control is exercised through 'consents' made by central government over broad programmes of local authority expenditure. The system was generally thought to have worked well, but it was tightened in 1988 to control all capital expenditure, however financed. Local councils lost an element of budget flexibility with this change.

In England and Wales the Local Government and Housing Act, 1989 contains provisions to shift control from spending to borrowing, in some senses returning to the pre-1980 system. The Act controls the amount of new credit that local authorities may obtain. The limits are called credit approvals. These are calculated according to the central government assessment of the expenditure needs of the authority. Government grants towards capital expenditure take the form of lump sums rather than contributions towards loan charges. Local authorities are free to use revenue contributions to finance additional capital expenditure. Local authorities are able to use for capital investment part of the cash proceeds of the disposal of fixed assets – 25 per cent from the sales of council houses and 50 per cent from other asset sales. The rest has to be used to repay capital loans. There are now four main sources of finance for capital spending: credit approvals, capital grants from central government, current spending and usable capital receipts.

The reform creates some unexpected controls over the provision of land for housing associations and the like in return for nomination rights; this is because the receipt from land sales is treated as capital. Local authorities are also limited in their power to invest externally; the Department of the Environment provides a list of approved investments. The Act defines capital expenditure precisely. The effect of the definition is felt in housing since expenditure on repairs and maintenance of property is not treated as capital expenditure. Repairs have to be paid for out of the housing revenue account.

The new system is more restrictive because of its control over borrowing and therefore over capital spending. There are also many detailed controls. It may limit local authorities' ability to carry out 'creative accountancy' exercises through the repeal of the power to set up special funds. Regulations under the Act tightly define the types of investment a local authority may enter into which now have to be

redeemable within one year. This may constrain local authorities' freedom of manoeuvre. On the other hand, the Act loosens control in the sense that current revenue can be used for capital purposes, but with the community charge and the gearing effect, this facility is available to only a few authorities.

References

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