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CABINET

STEERING COMMITTEE ON LOCAL GOVERNMENT FINANCE STUDIES

DRAFT GREEN PAPER: ANNEX J

Note by the Secretaries

Attached is Annex J of The Green Paper on Local Government Finance (formerly Annex H). It has not yet been seen by Environment Ministers.

This is intended for discussion at the Meeting on THURSDAY 19 DECEMBER.

Signed J E ROBERTS
J RUTTER
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Cabinet Office

18 December 1985

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ANNEX J: THE DISTRIBUTIONAL IMPACT OF CHANGES TO LOCAL TAXATION AND GRANT

J.1 This Annex supplements the description in Chapters 5, 8 and 9 of the distributional impact of the proposed reforms to local taxation and grant. Additional background material, for example on household numbers, relevant to the analyses in this Annex is included in Annex C.

Distortions in the present local government finance system

J.2 As the discussion in Chapters 1-4 showed, the present local government finance system distorts to a significant degree the link between what local electors pay for their services and the benefit they receive from them. This arises because the present arrangements entail cross-subsidies from non-domestic ratepayers, and direct subsidies from the Exchequer which are related to authorities' spending levels and to the overall rateable values of properties in their areas. This can lead to large differences in the amount, both on average and at the margin, which local domestic taxpayers have to contribute towards the expenditure needed to provide comparable levels of service. Figure J1 shows the size of the range of average domestic rate bills that would be paid in English local authorities for expenditure at the level of the authority's GRE. For the individual taxpayer within each local authority, the link between payment for and benefit from services is further distorted by the fact that his share of local taxes is determined by the rateable value of his house. This will have little or no relationship with his use of local authority services.

Figure J1: Distribution of average domestic rate bills for spending at GRE (England 1984/85)

J.3 Because neighbouring authorities tend on average to have similar rateable values and similar expenditure patterns, this variation also shows through as a broad geographical pattern of rate bills which are lower than might be expected in high spending areas. Figure J2 shows average rate bills and average spending in relation to GRE by English regions. Rate bills are often very high in areas with relatively low spending.

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Figure J2: Average domestic rate bills, and expenditure in relation to GRE (English regions: 1984/85)

J.4 To correct these distortions, this Green Paper proposes:

- the setting of a national non-domestic rate with the yield pooled and redistributed as a common amount per adult;

- replacement of domestic rates in each authority by a flat-rate community charge levied on all adults;

- a grant comprising a needs equalisation element and a standard element distributed on a per-adult basis.

J.5 These proposals will lead to substantial changes in the income of local authorities and will affect the contributions towards local expenditure paid by their residents. This Annex assesses the scale of these changes, taking account of the arrangements proposed to "safety net" changes in local authorities' external income and to moderate the transition from domestic rates to the community charge.

Assumptions

J.6 The method adopted for illustrating the extent of changes involves comparing the financial effects for local authorities and households of the existing financial regime with the effects of the proposals described in this Green Paper.

J.7 To ensure comparability the baseline and the illustrations of the effects of the new system use data for <u>the same</u> financial year - 1984/85. The choice of analysis year was made on technical grounds. Local authority income and expenditure data for 1985/86 are available, but to establish a consistent household data base for that year would not have been practicable. In particular, it is not possible to estimate reliably the effects on individual households of the revaluation of domestic rateable values in Scotland in 1985.

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J.8 The local authority income and expenditure data used incorporate estimates of expenditure and grant entitlements before holdback for 1984/85. The results shown are therefore purely illustrative. They cannot be extrapolated into the future since relative spending levels will change in response to grant pressures and the effects of rate limitation.

J.9 For illustrating household effects, data from the Family Expenditure Survey (FES) have been used. Data from 4 years of the survey (1980-83) have been combined and re-priced to 1984/85 levels. The sample size is not sufficient to allow analysis for individual local authorities.

J.10 The assessment of effects on households of changes in local tax bills and housing benefit entitlements is modelled on the assumption that the proposals contained in "Reform of Social Security" (Cmnd 9691) are already in effect, since these are to be implemented before the local government finance reforms. In particular, for illustrative purposes, the analyses incorporate the Cmnd 9691 proposals on housing benefit - including a 20% minimum contribution towards rates/local taxes - in both the base position and the new system. Thus the changes shown for households are those which arise solely from the new local government finance arrangements.

J.11 The illustrations are based on the 1984/85 balance of contributions to local expenditure from central taxpayers and local domestic and non-domestic taxpayers in England, Scotland and Wales.

Effects on local authorities' external income of changes in grant and non-domestic rates

J.12 Under the proposals for non-domestic taxation and grant described in Chapters 2 and 4, local authorities' income would change: first, as a result of the pooling and redistribution of receipts from non-domestic ratepayers on a common per adult basis; and second, as a result of the distribution of general grant to local authorities, over and above that required to equalise needs, entirely on a per adult basis with no resources equalisation through the grant system. The income of individual authorities would also be affected by changes in their needs assessments. The change in income in this case would depend on the detail of changes in the methodology and changes in local circumstances; no general conclusions can be drawn in advance. The effects of the proposals for local domestic taxation are discussed later. They would have no impact on the overall income of a local authority, but would redistribute the local tax burden between adult residents within each local authority.

J.13 The new arrangements for non-domestic rates and grant would lead, if implemented unmodified, to large and sudden changes in local domestic tax bills. Chapter 5 explained the Government's intention to prevent this through a "safety net" arrangement to preserve each local authority's external income on introduction of the new financial system at broadly its present level, with the amount of assistance frozen in cash terms thereafter. The safety net would take the form of self-financing adjustments to the standard grant and, if necessary, non-domestic rate allocations of individual authorities to eliminate gains or losses as a result of the introduction of the new system. Under this arrangement, the new financial system would have no impact on local authorities' income in the first year if they maintained their spending at previous levels.

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J.14 Authorities' external income (net of specific grants, fees etc.) would then comprise:

(i) national non-domestic rate revenue;

(ii) standard grant, paid at the same amount per adult to all authorities;

(iii) needs grant;

(iv) safety net receipts or contributions, fixed in cash terms.

In future years, changes in the first two components would affect all authorities in the same way. The effects of the third would depend on detailed changes in local authorities' assessed needs which vary as their circumstances change. The effects of the safety net would vary between authorities according to the size of their entitlement in relation to their overall expenditure. Authorities with a large safety net entitlement would have a stronger incentive to seek economies in order to offset its declining real value.

J.15 The size of an authority's safety net entitlement or contribution will depend on the extent of the change in income it would incur if the proposals in Chapters 2 and 4 were introduced without modification. Authorities that would otherwise face large losses will have a high safety net entitlement. Authorities that would otherwise enjoy large gains will be net contributors to the safety net.

J.16 Chapter 5 (paragraphs ■ to ■) sets out the characteristics of local authorities which would gain and lose if there were no safety net. The biggest reductions in income would arise in high poundage/high rateable value authorities: high rate poundages resulting from high levels of current spending in relation to GRE produce a very large yield from these authorities' large non-domestic rate base. They will stand to lose significantly from the reduction of their non-domestic rate income to the national per adult average, and so will have a large safety net entitlement. The biggest increases in income will arise in low spending, high domestic rateable value authorities which will benefit both from the increase of their non-domestic rate income to the national average per adult and from the change in the basis of grant from equalisation of domestic rate poundages to equalisation of rate bills. They will be contributors to the safety net arrangements.

J.17 The marked regional pattern of changes in local authorities' income in England illustrates the effects of these factors. Many authorities in the Northern region, Yorkshire and Humberside, and the North West have high spending levels and low rate bills and so would lose income. Many authorities in the South East, South West and East and West Midlands and East Anglia, where spending tends to be lower and domestic rate bills higher, would gain additional income. High spending authorities in Greater London and authorities which are large gainers under the existing arrangements which allow London's excess non-domestic rateable resources to be retained would tend on balance to lose, notwithstanding some gain from the ending of domestic resources equalisation.

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J.18 The implied pattern of changes in income for authorities in each of the English regions which would result from full implementation of the new financial system is set out in Figure J3. The first three columns show the existing pattern of general grant and non-domestic rate income, and the next three columns show what the equivalent figures would be if the proposed new system were implemented without modification. The final column shows the safety net entitlement (negative in contributing areas) which would be necessary to compensate for any overall shortfall or surplus.

Figure J3: Implied changes in general grant and non-domestic rate income, and safety net entitlements for local authorities (English regions: £m)

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J.19 Similar redistributive effects would apply in Scotland and in Wales, though because the range of rateable values in both countries varies less between areas, the scale of changes would be less.

Effects for local domestic taxpayers of the replacement of domestic rates by the community charge

J.20 Within each local authority the distribution of the local domestic tax burden between residents will be affected by the proposals set out in Chapter 3. The general pattern of change will be the same in all areas. The analysis in this section considers these effects separately for households and for "tax units" - couples or single people who may form part of a larger household.

J.21 The broad pattern of redistribution between households resulting from the replacement of rates with a community charge is described in paragraphs ■ to ■ of Chapter 5. The position of individual households will be affected by two main factors: the number of adults in the household; and the rateable value of the property relative to others in the area. Single adult households will pay less towards local services; large households with 3 or more adults will pay more; households with 2 adults will tend to pay about the same amount. This household composition effect will be overlaid by the rateable value effect. Households in high rateable value property will pay a reduced proportion of the total local domestic tax bill, while those in low rateable value property will pay more. For some households the rateable value effect could be larger than the household composition effect.

J.22 Among tax units, the main pattern of redistribution is from householder tax units to non-householder tax units, who at present do not pay any local taxes. The majority of the new local taxpayers would be young single adults aged 18-24.

J.23 These patterns of redistribution among households and tax units occur both within rating authorities in respect of the cost of district services, and within precepting authorities in respect of the cost of county services.

J.24 The distributional effects for households and tax units have been shown on two bases:

(i) the effects in the first year of transition to the new system with the community charge introduced at a standard £50 per adult and the balance of domestic tax revenue raised from rates (see Chapter 5, paragraph ■);

(ii) the effects if rates were completely replaced by a community charge.

The assumptions on which the calculations are based are set out in paragraphs J.6-J.11 above.

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(i) The effects in the first year of transition

J.25 As expected, with the modest shift from rates to the community charge envisaged, the effects for local domestic taxpayers in the first year are very small. This is a consequence both of the relatively small assumed level of the community charge in year 1 - £50 per head - and of the nature of the shift from domestic rates to the community charge which means that the typical two-adult household will tend on average neither to gain nor to lose.

J.26 Figure J4 sets out the pattern of gains and losses for households, in £ per week and as a percentage of net income.*

Figure J4: Households gaining and losing in the first year of transition from domestic rates to the community charge (Great Britain: thousand households)

*"Net income" includes income from employment, unearned income and state benefits (excluding the local tax element of housing benefit) net of income tax and national insurance contributions. Local tax payments are net of rebates. The new housing benefit system, with a 20% minimum payment, has been assumed to apply to the community charge as well as to rates.

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J.27 For the vast majority of households, the gains and losses are very small indeed. 82% of households would gain or lose less than £1 per week, and 97% would gain or lose less than £2 per week. Only 1% would lose more than £2 per week. For 94% of households the changes would represent less than 1% of net income. Only 2% of households would lose more than 1% of net income, and virtually all of them would lose less than 2% of net income.

J.28 Figure J5 analyses these effects by tax unit types. Again, the effects are very small. 89% of tax units would gain or lose less than £1 per week. 98% would gain or lose less than £2 per week. Virtually no tax units would lose more than £2 per week, and only 1% would lose more than 2% of net income. The largest proportions of gainers are in the "single pensioner" and "one parent family" categories.

Figure J5: Tax units gaining and losing in the first year of transition from domestic rates to the community charge (Great Britain: thousand tax units)

J.29 The largest proportion of losers is in the "other single adult" category. The losers are predominantly those that become liable for local tax for the first time as a result of the widening of the tax base to include non-householder resident adults. They are typically single adults aged 18 to 24. Figure J6 shows the extent to which losses are concentrated among non-householder tax units. Over half the losers in the "other single adult" category are non-householders.

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Figure. J6: Proportions of tax units losing in the first year of transition from domestic rates to the community charge who are not householders (Great Britain)

(ii) The effects with full replacement of rates by the community charge

J.30 By the end of the transition from rates to the community charge the shifts would have become more marked as an increased proportion of the local tax bill fell to be met by non-householders who are not currently liable for domestic rates. Even so, the effects would be small for most people, since the majority of households comprise two adults and would be little affected.

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J.31 Figure J7 shows, on the same basis as Figure J4, the pattern of gains and losses for households on the assumption that domestic rates had been completely replaced by the community charge.

Figure J7: Households gaining and losing with full replacement of rates by the community charge (Great Britain: thousand households)

J.32 The majority (51%) of households would be better off with the community charge. Three quarters of all households would either gain, or would lose less than £1 per week. 14% of households would lose more than £2 a week, and for 6% of households the losses would amount to more than 2% of net income.

J.33 Figure J8 shows how the gains and losses are distributed among tax unit types.

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Figure J8: Tax units gaining and losing with full replacement of domestic rates by the community charge (Great Britain: thousand tax units)

J.34 The patterns seen in the first year of transition are accentuated, with a wider spread of gains and losses. 48% of tax units gain, and 13% gain more than £2 a week; 52% of tax units lose, and 15% lose more than £2 a week. 69% of single pensioners and 85% of one-parent families gain, with 13% and 27% of these categories respectively gaining more than £2 a week. 62% of "other single adults" lose. Numbers of gainers and losers among couples with children broadly balance out. Losses which represent more than 2% of net income are heavily concentrated among the young single adults in the "other single adult" category who are paying no local tax now. Their contribution would be the same as that of single householders in the same authority.

J.35 The proportions of non-householders who would lose in the various tax-unit categories would be the same as in Figure J6. Non-householder tax units are worse off because they are making a contribution to local services where they were making none before. This is precisely the effect that the widening of the tax base is intended to achieve.

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The relationship between incomes and domestic rates or the community charge

J.36 The description so far of the types of household and tax unit which stand to gain and lose from the replacement of rates by a community charge has been mainly in terms of household composition and broad economic status. The other important dimension is income. What impact would the community charge have on the distribution of local tax payments across income groups?

J.37 **A priori** one would expect the introduction of a flat rate community charge to increase the overall regressivity of the local tax system. A flat rate charge necessarily represents a higher proportion of income for people with low incomes. However, any changes have to be assessed against the impact of the existing local tax system based on rates. The Allen Report of 1965 first drew attention to the regressive impact of domestic rates. In the absence of rebates, the lowest income households would now pay, on average, 10% of their income in rates, compared with less than 2% for the highest income households.

J.38 In fact a flat rate community charge would represent a smaller proportion of net income for the lowest income households than domestic rates. The chief reason for this is household composition: a disproportionate number of low income households have only one adult, and therefore benefit from the move from a tax on property to a per adult community charge. Higher income households also benefit from the introduction of a community charge, since the proportion of income paid in local taxes declines more rapidly than with domestic rates. Annex F contains further detailed analysis of these effects.

Effects on housing benefit

J.39 The local taxation proposals widen the tax base so that all adults over 18 become liable for local taxes. This results in a shift in the incidence of local taxes from householders to non-householders. Non-householders become liable for local tax for the first time.

J.40 The illustrations in this Annex assume that these new local taxpayers would become eligible for rebates in the same way as existing ratepayers. The new housing benefit system described in Cmnd 9691, with a minimum 20% payment towards local rates, has therefore been applied to the new local tax system. During the transition, it has been assumed that individual tax units would qualify for assistance with their combined local tax bill from rates and the community charge. In practice, the detailed operation of the housing benefit system in this transitional period might need to be reviewed.

J.41 The widening of the tax base will inevitably produce a significant increase in housing benefit caseload. Complete replacement of domestic rates by the community charge would produce an increase in caseload in Great Britain of approximately 17%, but an increase in housing benefit cost of only 4%. More people would be entitled to help with their local tax bill, but the scale of the support required by existing ratepayers would be reduced.

J.42 Figure J9 shows the estimated increases both in year 1 of the transition and with full replacement of domestic rates. These estimates are based on estimated entitlements. Actual increases would be less to the extent that

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take-up was lower. The estimates are sensitive to assumptions made about who is currently eligible for housing benefit in multi-tax unit households. In modelling the benefit results, it has been assumed that unrelated tax units in multi-tax unit households are separately eligible for housing benefit in respect of contributions towards rates. If it were assumed that only the first tax unit in such households currently pays rates, this would suggest a larger increase in caseload, but from a lower base. The final caseload would be almost unaffected.

Figure J9: Estimated increases in housing benefit cost and caseload, assuming prior implementation of the Cmnd 9691 proposals, resulting from the new local government finance system (Great Britain)

J.43 In the first years of the new system, application of the housing benefit formula to the new initial levels of community charge would produce large numbers of very small rebates. The implications of this for the detailed design of assistance schemes will require further consideration.

Interactions with proposed changes to the social security system

J.44 In general, the interactions between the proposed changes to the social security system set out in Cmnd 9691 and the proposals in this Green Paper are limited. The Cmnd 9691 proposals are directed specifically at low income households. The proposals for modifying the local taxation system involve a general switch in local tax burden from householders to non-householders which produces gains and losses across all income groups. The critical factors are household composition and rateable value.

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J.45 There are also differences in timing. The local finance proposals are likely to be implemented some years after the social scurity reforms, and the scale of gains and losses from the change in the local tax system will be damped down by the gradual transition towards the community charge.

J.46 Even if the proposals were to be implemented simultaneously there would be limited interactions. Young single adult non-householders who comprise the vast majority of tax units who would pay local taxes for the first time are little affected by the social security proposals. In some cases, however, the effects of the two sets of proposals will be offsetting. Single householders - both pensioners and non-pensioners - tend to lose income support under the social security proposals but gain from the introduction of the community charge. Only in a few cases will the effects be reinforcing; for example, working lone parents will tend to gain and some pensioner couples - householders with low rateable value property - to lose, from both sets of proposals. But in general the scale of the changes implied by the local taxation proposals, even with a full community charge, will be modest.

Effects on work incentives

J.47 As explained above, if the system of rebates for the community charge were to be similar to that proposed in "Reform of Social Security" (Cmnd 9691) there would be an appreciable increase in the number of people receiving benefit, and some reduction in the average benefit payment to those currently paying rates.

J.48 Changes which affect entitlement to means-tested benefits affect the incentives of those in low paid employment to take up work. They do this by changing the relative levels of disposable income in and out of work. The measure of this relativity is called the 'replacement ratio'. They also change the effective tax rates of those with low incomes who are in work because income-related benefits are withdrawn as income rises.

J.49 Bringing more people into local tax and consequently increasing the number entitled to rebates would be expected to worsen incentives. Modelling these effects has shown, however, that although there is some worsening of incentives the effect on average is very small, even for those who become liable for local tax for the first time. Replacement ratios are little affected because even a maximum rebate of the community charge will generally represent a small proportion of net income in work. Moreover, most single young adults who qualify for unemployment benefit would not qualify for rebates because their income would be above the income support threshold. Among householders currently paying rates, there will of offsetting reductions in tax payments, and consequently in rebate entitlements. Marginal tax rates would be virtually unaffected by the new local taxation system since, for the levels of community charge faced by most adults, there would be a very narrow range of income over which rebates would be withdrawn.

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Summary

J.50 The main conclusions reached in this Annex on the effects of the proposed reforms to the local government finance system are as follows.

(1) As a consequence of the setting of a national non-domestic rate and the ending of resource equalisation authorities with high rate poundages (which reflect high spending levels) or low domestic rateable values (which lead to lower rate bills for any given level of spending) would tend to lose. They will have large safety net entitlements. Conversely authorities with low poundages or high domestic rateable values will tend to gain, and so will be contributors to the safety net.

(2) Changes in the local tax burden of households and tax units in the first year of the new arrangements would be very small. Even after the community charge had completely replaced domestic rates, the gains and losses would be modest for the great majority of households and tax units. The losses would be largely concentrated among the young single-adult tax units that would become liable for local taxes for the first time.

(3) The community charge would be somewhat less regressive than domestic rates for those with low incomes. This arises because of the large proportion of those with low incomes who are single-adult households. They would gain from the widening of the local tax base (see Annex F).

(4) The replacement of domestic rates by the community charge would ultimately lead, other things being equal, to an increase of 17% in housing benefit caseload and an increase of 4% in the cost of housing benefit.

(5) There would be little interaction between the proposals for change in the social security system set out in Cmnd 9691 and the reforms of local government finance described in this Green Paper.

(6) Any worsening of work incentives arising from the widening of the local tax base and the consequent widening of eligibility for housing benefit would be minimal.