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Raising the capital: the report of the London Finance Commission

Report

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Contents

Chair’s foreword

The London Finance Commission provides an opportunity to improve the government of London. Initiated by the Mayor and supported by the boroughs, the Commission has been able to consider the weaknesses of the existing system and to propose improvements. This report makes proposals to build upon reform which has already taken place under successive governments. The Commission believes that there would be more jobs and growth in London if the government of London had greater financial autonomy.

Devolution and localism face little opposition apart from national politicians’ cautious approach to constitutional change in Britain. Although Scotland and Wales now enjoy substantial devolved power, England has not seen anything like the same degree of devolution. London has a relatively new system of city-wide government which, in the Commission’s view, could readily wield more power and fiscal autonomy.

London is a leading international city which has, somehow, become a model for free-wheeling, tolerant, metropolitan living. It has a fast-growing population and, along with its surrounding counties, one of the largest regional economies in the world. It cannot stand still. Other major cities are rapidly building metros, enhancing education facilities and developing new homes. Infrastructure is the key to continued economic success and a decent quality of life.

The Commission has sought evidence from a wide range of organisations and individuals. The message we received was clear and unanimous: London’s government needs to be given greater freedom to determine and use the resources raised from taxpayers. At present, London (and, indeed, England as a whole) is an extreme outlier compared with other cities and countries. Only a tiny proportion of the taxes raised in London are determined by the city’s government. Even after the reforms of April 2013, barely seven per cent of all the tax paid by London residents and businesses is retained by the Mayor and the boroughs. The equivalent figure in New York is over 50 per cent.

Commissioned research provided us with evidence about previous finance reviews, the potential economic impact of greater local autonomy, longer-term trends in taxation and public expenditure, the position of other global cities, and the situation in Scotland and Wales. While the impact of earlier national reviews was very limited, recent inquiries in Scotland and Wales are paving the way towards substantive fiscal devolution. Evidence about the impact of devolution on economic growth is ambiguous, though there is no suggestion that London would be likely to see slower growth if there were more local freedom over taxation and expenditure. Research commissioned by the City of London projects continuing relative growth in London’s tax yield and thus in its contribution to the rest of the UK.

It is easy to assume that England’s centralised democracy is the only possible arrangement. Compared with other major countries, sub-national government in London has been infantilised by a long-term move over many decades to centralise public finance and tax-raising. The Mayor and the boroughs must rely on the Exchequer to redistribute almost all of the taxation paid in the city and to determine spending priorities. As a result, co-ordination which can deliver real results at a local level is lost. This is not a good situation for a developed democracy.

London's population is equivalent to those of Scotland and Wales combined. Its economy is almost double the size of these nations together. Yet while the dynamic of devolution continues to offer new powers and financial freedoms to the governments in Edinburgh and Cardiff (and, indeed Belfast) there have been no proposals to increase the autonomy of London government. The Commission has received no evidence as to why London and other English city regions cannot be afforded the kind of decentralised power offered to Scotland, Wales and Northern Ireland.

Hitherto, there have been a number of barriers to significant further devolution to London. First, public expenditure reviews currently work in such a way as to inhibit any deviation from individual departmental priorities or, indeed, overall Treasury control. Second, any substantive removal of London from Whitehall control would weaken departments and ministers; London is a large and interesting part of any spending department's empire. Third, London and its region are so important to the UK economy that any threat to growth there would be seriously problematic for the British government.

Yet it is economic growth that the Commission sees as the potential prize of a further shift of financial and fiscal control to London. As the city population grows to nine and then ten million people by 2030, there will need to be massive investment in enabling infrastructure simply to accommodate these new residents and, indeed, commuters. Beyond this investment to keep pace with the population, the Commission is convinced that London would be better able to prioritise decisions about investment. Londoners know they need new railways, schools, homes, waste facilities and streets. Because of their day-to-day dependence on physical infrastructure, we believe London voters would be more likely than voters elsewhere in Britain to prioritise spending on longer-term investments.

If London had enhanced fiscal capacity to back such investment, there could be an enhanced level of capital spending which would, in turn, produce additional growth and tax yield. London government could then re-invest higher tax revenues in more infrastructure; a virtuous circle would be created. Of course, it is important to acknowledge that with greater autonomy there would be greater risk.

London is not a city state. But it could have a greater degree of self-government and thus, in our view, be better governed. The same is true for other city regions. No one can seriously any longer believe that Whitehall always knows best. This report makes the case for a further, logical step towards a stronger and more productive system of London government. If reform is successful, the results would be good for London but also good for the rest of the country. The time has come for a more autonomous and accountable model of funding for the city.

Any devolution to London of powers over taxation, financial management or expenditure would have implications for both the Mayor and the boroughs. It is difficult to imagine a change that did not affect both parts of the city's government, or which might not have implications for longer-term relationships between City Hall and the boroughs, collectively and individually. With this in mind, we envisage the Mayor and London Councils creating a more formal mechanism for handling any transfer of taxation powers and/or responsibilities for expenditure. In any such mechanism, both parts of London's government would have to be represented and have the ability to ensure that there was agreement about how new responsibilities were handled in the longer term. This is not to say that a particular tax could not be given wholly to the Mayor or wholly to the boroughs. But in making any such decision in response to devolution of taxation or other powers by central government, each part of London government would need to assent to the broad structure and its mode of operation.

The London Finance Commission has been a collaboration of its members and a number of officers at City Hall and London Councils. A number of individuals worked on research, data analysis and refining proposals. The Commission is thus indebted to John O'Brien, Hugh Grover, Jon Rowney, Nigel Minto and Dick Sorabji at London Councils and, at City Hall, Jeff Jacobs, Martin Clarke, Martin Mitchell, Matthew Waite, Gordon Douglass, Tom Middleton and Salima Khatun. The officials most closely involved in the day-to-day management and delivery of the report were Jeremy Skinner and Julia Harrowsmith, without whom nothing would have been possible.

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May 2013

Executive Summary

The Commission's report recommends that funding arrangements in London should allow London government to make additional self-determined investments in its own infrastructure both to cater for the growth already forecast for its population and economy, and to promote additional economic growth. Relaxing restrictions on borrowing for capital investment while retaining prudential rules and simultaneously devolving the full suite of property tax revenue streams would afford London government greater autonomy to invest in the capital. Such reforms would also increase London government's accountability to residents and businesses. Change would be achieved without affecting the financial settlements of other parts of the country.

PART 1: INTRODUCTION AND BACKGROUND

The Mayor of London, Boris Johnson, established the Commission in July 2012 to investigate funding arrangements in the capital. Members came from a wide a variety of backgrounds, including Parliament, the London Assembly, Whitehall, think tanks, the private sector, public finance bodies, London local authorities (both political and executive leaders), and from other major UK cities (Birmingham and Manchester). We were invited to examine the potential for greater devolution of both taxation and the control of resources in London, and to develop options to improve the city's tax and spending arrangements, in particular to promote jobs and growth.

We agreed to judge any options we were considering against five core principles: accountability, transparency, efficiency and effectiveness, autonomy and fairness. These principles underpin good government and, we believe, are prerequisites for promoting jobs and growth. We have been keen to base all our work on evidence and to develop recommendations with cross-party support.

PART 2: EVIDENCE

We invited oral and written evidence from a number of experts and stakeholders so as to gather views and insights into matters relating to fiscal devolution. Although opinions varied, most submissions acknowledged how centralised the current system had become and recognised the impediments it presents to local autonomy and, accordingly, to local growth.

Overall, the body of existing academic evidence was inconclusive about the impact of devolving fiscal powers. There is no consistent and certain evidence that either centralised or, on the other hand, devolved models of government have measurable effects on economic growth. However, the comparative research we commissioned from the University of Toronto helped us to understand how municipal governments function in a number of major international cities, demonstrating that London, and by implication other British cities, have very low levels of fiscal autonomy. The Toronto research suggested that although fiscal devolution can entail risks, London would benefit from having more revenue streams under its control.

This body of evidence formed the basis of our subsequent deliberations, placing our own work in the context of previous reviews of a similar nature, comparing London with international cities and the devolved nations of the UK. It offered us greater insights into the possible effects of fiscal devolution, as well as demonstrating a broad consensus about greater fiscal powers for London.

PART 3: SUPPORTING LONDON AND UK GROWTH

London's strong demographic and economic growth is forecast to continue. We argue that a failure to invest in the city would hamper this growth. Providing for London's forecast population and economic growth, as well as promoting additional economic growth beyond this baseline, will require above all else sustained investment in all kinds of infrastructure, not least in transport, schools, housing, energy supply and technology.

In order to understand London's infrastructure needs we recommend that the Government should require the Mayor, London Councils and the London Enterprise Panel to develop and maintain a long-term, high-level capital investment plan for the city, in association with the London boroughs. This plan should set out the costs of strategic investment options and match them to the resources available, both now and in a more devolved future. An investment plan would help show gaps in available funding, and, indirectly, help to clarify further roles and responsibilities. This work should be done with the support and involvement of Infrastructure UK at the national level and the boroughs at the local level, including the information prepared for Community Infrastructure Levies.

However, beyond assessing need, structural problems with financing infrastructure must also be addressed. Existing funding models for basic infrastructure such as schools and housing are inadequate to cope with predicted growth and, for larger items, they are complicated and protracted. For example, securing funding for Crossrail entailed two decades of complex negotiations before final decisions were made.

London government needs fewer borrowing constraints and greater devolved tax powers to enable it to invest more comprehensively without the need for ad hoc, project-by-project financing arrangements. Consequently, we propose that the Greater London Authority (GLA) Group borrowing ceilings be removed (while retaining prudential borrowing rules), and that no further constraints be imposed on local authorities.

A mechanism will be required to ensure that any reform made to London's fiscal and financing arrangements are not negated by central government periodically adjusting grant resources available to the city.

We further propose the Government relax Tax Increment Finance restrictions. Also, we suggest that borrowing which will be used to promote growth or reduce public expenditure and thus be repaid should be distinguished from other kinds of debt.

We make number of recommendations about the need to improve the supply of housing, including a proposal that local authority borrowing limits for housing purposes be relaxed or removed, within prudential borrowing rules.

PART 4: FISCAL POWERS

Fewer borrowing restrictions must be accompanied by devolved revenue streams under the control of London government. Not only would this increase its autonomy to invest, levelling the playing field with other international cities, it would make London government more accountable to its residents and businesses and in this way promote economic growth and provide other benefits.

Property taxes should be devolved first, as they have immobile bases and are therefore well suited to local control. We recommend that the full suite (council tax, business rates, stamp duty land tax, annual tax on enveloped dwellings and capital gains property disposal tax) should be devolved to London government, which should then have devolved responsibility for setting the tax rates and authority over all matters including revaluation, banding and discounts. The yields of these taxes should be offset through corresponding reductions in grant to ensure a fiscally neutral position for the Exchequer, at the outset. Not least because the yield from property taxes is already high in London, devolution will lead to much greater pressure on London government to account to residents and businesses alike for the activities the tax revenues fund.

In addition to these devolved taxes, London government should be able to introduce new smaller taxes. Although unlikely to increase revenue substantially, they could be used as useful policy levers to promote economic development or other aims.

Another priority is for local government to be able to recover full costs, even for charges set at the national level. In general it should be able to set fees and charges for all discretionary services if it so chooses, thus allowing it the flexibility to respond to local needs. Such changes have clear potential to promote growth, for example by encouraging development through improved planning applications services.

We acknowledge and support the merits of existing initiatives such as Community Budgets and City Deals, which increase local control of resources, and we welcome Lord Heseltine's proposals to increase the involvement of LEPs in spending decisions. We encourage further initiatives of this nature, and consider that there may be a greater role for London government in the design and decision making process.

PART 5: RELATIONSHIPS WITHIN AND OUTSIDE LONDON

The proposals we make seek to increase the fiscal powers of London government. Clearly, this will require robust governance mechanisms between London's different sections and tiers of government, which have a strong interest in working together. While it is beyond our remit as a Commission to say how our recommendations should be governed, we accept the governance principles agreed by GLA and London Councils, which state amongst other things that the interests of the Mayor cannot be overridden by the boroughs or vice versa, and that the system must enforce binding decisions which must reflect clear consensus.

The powers of the London Assembly must also be reconsidered and potentially augmented as and when the Mayor of London's powers grow.

The agreed governance principles are consistent with our own aim to ensure fair outcomes for all parts of the capital and the country. In accordance, we have designed all our recommendations such that when they are introduced, the rest of the UK will not be put at a disadvantage. The devolution of taxation will be met with a pound-for-pound reduction in grant and most of our recommendations or similar options could, and in our view should, operate well in England's other big cities.

Recommendations

London government should have the freedom to make appropriate investments in its own infrastructure both to cater for the growth already forecast for its population and economy, and to promote additional economic growth. Relaxing restrictions on borrowing for capital investment within prudential rules and devolving revenue streams, including from the full suite of property taxes, will afford London government the autonomy to invest in the capital and increase its accountability to London's residents and businesses, without affecting the financial settlements of other parts of the country *(Part 3, Chapter 1).*

PLANNING THE INFRASTRUCTURE NEEDED FOR A GROWING CITY

The Mayor of London should have a responsibility to be a champion of all infrastructure planning for the capital, but should also look wherever possible to delegate powers to London's boroughs to act as commissioners of local infrastructure projects, thereby increasing the overall infrastructure capacity across the capital *(Part 3, Chapter 1).*

The Government should require the Mayor, working with London Councils, the boroughs and the London Enterprise Panel, to develop and maintain a long-term, high level capital investment plan for the city. This should set out the costs of strategic investment options and match them to the resources available both now and in a more devolved future *(Part 3, Chapter 1).*

The Mayor should be required to report progress against this plan to increase accountability. This exercise would help bring out gaps in available funding and, indirectly, help to clarify further roles and responsibilities. Such work should be done with the support and involvement of Infrastructure UK at the national level and the boroughs at the local level *(Part 3, Chapter 1).*

The Government should require the utility regulators to have regard to the London Plan and the high level investment plan recommended here in consultation with business, *(Part 3, Chapter 1).*

ALLOWING INVESTMENT TO GENERATE ECONOMIC GROWTH

The Government and London should explore more radical approaches to building incentives for London government into the tax system (Part 3, Chapter 2).

The Government should distinguish between borrowing that will be used to promote growth or reduce public expenditure and thus be repaid, and other kinds of debt *(Part 3, Chapter 2).*

In light of the robust and effective prudential borrowing regime, GLA Group borrowing ceilings should be removed *(Part 3, Chapter 2).*

The Government should continue to allow London local authorities to take independent borrowing and investment decisions within the prudential code, imposing no further constraints *(Part 3, Chapter 2).*

The Mayor and London's local authorities should determine which Tax Increment Financing (TIF) projects to proceed with, within the prudential borrowing code. The potential for locally led TIFs would be increased through the devolved fiscal measures we propose in Part 4. Meanwhile, the Government should start with a presumption in favour of funding all TIF projects that can demonstrate net gains to the public finances as a whole (through, at the national and/or local level, increasing the tax yield or reducing public expenditure or both) after adjusting for risk *(Part 3, Chapter 2).*

HOUSING FINANCE

Borrowing limits for housing purposes for boroughs should be relaxed or removed. Prudential borrowing rules would still apply, as would the rigour of long-term Housing Revenue Account (HRA) business plans *(Part 3, Chapter 2).*

The devolution of housing benefit (or a related share of Universal Credit) to London should be considered, and necessary transitional arrangements explored *(Part 3, Chapter 2).*

Measures to shift public funding from personal subsidy to investment in built assets should be further explored. This will require an appropriate capital settlement for London from central government in future Spending Reviews and Budgets. It will also require appropriate revenue funding for the transition phase (*Part 3, Chapter 2).*

TAXATION

The full suite of property taxes (council tax, business rates, stamp duty land tax, annual tax on enveloped dwellings and capital gains property development tax) should be devolved to London government, which should have devolved responsibility for setting the tax rates and authority over all matters including revaluation, banding and discounts *(Part 4, Chapter 3).*

DOMESTIC PROPERTY TAXES

Council tax should be retained as a local tax but London government should be given the power and be required to hold periodic revaluations (undertaken by the Valuation Office, according to national practice), to determine the number of bands, to set the ratio of tax from band to band and to set the tax rate. A fully localised council tax of this kind would be part of a suite of local property taxes determined by London government *(Part 4, Chapter 3).*

NON-DOMESTIC PROPERTY TAXES

100 per cent of business rates should be devolved to London government, through an appropriate governance mechanism, including the responsibility for the timing of revaluations. London government should be free to determine such issues as discounts and tax breaks, and should have the freedom to use business rates to undertake ‘Enterprise Zone’-style interventions *(Part 4, Chapter 3).*

At such a time that business rates were wholly retained in London, alongside other property taxes (as we recommend), London government should set the business rate multiplier in London, again in consultation with appropriate stakeholders *(Part 4, Chapter 3).*

If business rates are localised in the way we propose then London government should put in place a scheme that would protect ratepayers from any perceived risk of unreasonably high rate increases, in consultation with business *(Part 4, Chapter 3).*

Further assessment should be undertaken of the potential benefits and costs of new taxes such as those on undeveloped land as part of the wider reforms of property taxation that we advocate *(Part 4, Chapter 3).*

INCOME TAX

If greater powers are devolved to London over time, the assignment of income tax should be considered and should be viewed alongside more effective Community Budget or 'single pot' arrangements *(Part 4, Chapter 4).*

SMALLER TAXES

London government should be able to introduce smaller new taxes. The government should pass permissive legislation that would make such changes straightforward to implement *(Part 4, Chapter 4).*

GRANT REDUCTIONS TO OFFSET NEW TAX POWERS

The yields of newly devolved taxes should be offset through corresponding reductions in grant to ensure a fiscally neutral position for the Exchequer (and the rest of the UK) at the outset *(Part 4, Chapter 3).*

PROTECTING LONDON'S POSITION IN THE LONGER TERM

A mechanism is required that will ensure that any reforms made to London's fiscal and financing arrangements are not negated by central government periodically adjusting grant resources available to the city beyond the reduction required at the point of reform to ensure there is no shift of resources between London and the rest of the UK *(Part 3, Chapter 2).*

FEES AND CHARGES

The number of nationally set charges should be kept to a minimum; locally determined charges should be the norm *(Part 4, Chapter 5).*

Local authorities should be able to recover full costs, even for charges set at the national level *(Part 4, Chapter 5).*

Central controls should be removed on planning application fees, building control charges, land searches and licencing fees *(Part 4, Chapter 5).*

In the longer term, London government should be responsible for administering any introduction of road charging that may replace vehicle excise duty, and yields should be retained locally *(Part 4, Chapter 5).*

COMMUNITY BUDGETS AND CITY DEALS

Central government should extend the remit and scale of Community Budget Pilots through 'single pots' devolved from existing Whitehall budgets *(Part 4, Chapter 2).*

In our recommended model of London government, the Mayor of London should work with boroughs and groups of boroughs to create 'City Deal'-type initiatives within London *(Part 4, Chapter 2).*

1 Introduction and Background

In Part 1 we explain the circumstances in which the Commission was established, detail its approach to its objectives and situate its work in the context of previous comparable reviews.

PART 1, CHAPTER 1

Introduction and background to the Commission

1. This chapter provides an account of how the London Finance Commission was set up and a description of its remit, and approach to its work.

ORIGIN OF THE COMMISSION

2. The London Finance Commission was established by the Mayor of London after his re-election in May 2012, in relation to manifesto commitments to ensure improved funding arrangements for London.

3. Professor Tony Travers of the London School of Economics and Political Science (LSE) was appointed chair of the Commission in June 2012 and its members were drawn from different political parties, the private sector and relevant professions from across and outside London[1]. The members were:

   - **John Biggs** (London Assembly Member for City & East)
   - **Roger Bright** (former Chief Executive, the Crown Estate)
   - **Chris Duffield** (former Town Clerk and Chief Executive, City of London)
   - **Mike Emmerich** (Chief Executive, New Economy Manchester)
   - **Steve Freer** (Chief Executive, CIPFA)
   - **Nick Holgate** (Town Clerk and Executive Director of Finance, Royal Borough of Kensington and Chelsea)
   - **Stephen Hughes** (Chief Executive, Birmingham City Council)
   - **Alexandra Jones** (Chief Executive, Centre for Cities)
   - **Gerald Jones** (former Chief Executive, Wandsworth Council)
   - **Sir Stuart Lipton** (Partner, Lipton Rogers)
   - **Teresa O'Neill** (Vice Chair, London Councils)
   - **Jules Pipe** (Chair, London Councils)
   - **Nick Raynsford** (MP for Greenwich and Woolwich)
   - **Ben Rogers** (Director, Centre for London)
   - **Bridget Rosewell** (Senior Partner, Volterra Partners)
   - **Martin Smith** (Chief Executive, London Borough of Ealing)

   Please see Annex 1 for biographies.

4. The Commission was set up to work independently of the Mayor and to report to him in spring 2013. It met for the first time in July 2012 and subsequently met monthly until April 2013.

1 Ex officio members were: Jeff Jacobs (Head of Paid Service and Executive Director, GLA), Ed Lister (GLA Chief of Staff and Deputy Mayor for Planning) and Dr Gerard Lyons (Chief Economic Advisor to the Mayor of London). Official observers were: Martin Clarke (Executive Director, Resources, GLA), Steve Allen (Managing Director, Finance, TfL), John O'Brien (Chief Executive, London Councils) and Jeremy Skinner (Senior Manager, Economic and Business Policy, GLA). Clerk to the Commission was: Julia Harrowsmith (Senior Policy Officer, Economic and Business Policy, GLA).

REMIT

5. The purpose of the Commission was to examine the potential for greater devolution of both taxation and the control of resources in London and to develop options to improve London's tax and spending arrangements, in particular to promote jobs and growth. The Terms of Reference set a number of objectives: to describe and assess current funding arrangements in London, to examine the scale and distribution of London's public expenditure, to examine options for change and to make recommendations to the Mayor. *Please see Annex 2 for Terms of Reference.*

6. In correspondence with the chair of the Commission, the Chancellor of the Exchequer, George Osborne, expressed support for the Commission and stated that *"under the right conditions, fiscal devolution has the potential to increase the financial accountability of local government and promote additional growth."* We accepted his suggestion that proposals should be judged against three tests: they should be based on evidence, they should have cross-party support and they should be without detriment to the rest of the UK.

7. While the purposes and objectives of the Commission include consideration of both capital and revenue, in the main our work, deliberation and recommendations have focused more on capital issues and the need for infrastructure investment to support London's economic growth. This priority should not give the impression that we undervalue the importance of revenue funding and spending for services such as social care and recycling and waste collection. It is a given that, in the context of the current and future economic climate, core services delivered by, in the main, London's boroughs must not be adversely affected by any of our proposals.

8. Any proposals of the type put forward by the Commission in this report require fair, robust and resilient governance structures and mechanisms that ensure that the distribution of tax burden and benefit falls equitably across London's residents and businesses. The principles that would underlie the new structures and mechanisms that would be needed are discussed in more detail in Part 5, Chapter 2.

9. We recognise this will involve agreement about what it would be appropriate for:

   - the Mayor/Greater London Authority (GLA) to determine alone
   - the Mayor/GLA and boroughs to determine collectively
   - the Mayor/GLA and groups of boroughs to determine collectively
   - groups of boroughs to determine collectively
   - individual boroughs to determine alone.

10. Such arrangements could be complex. While it is not for the Commission to determine the exact nature of the governance structures, we would strongly encourage simplicity as far as possible.

APPROACH OF THE COMMISSION

11. In order to meet our objectives, we collected evidence, carried out stakeholder engagement events and deliberated findings over a number of months as the basis for developing recommendations.

12. We commissioned a series of research papers, exploring issues related to devolution such as feasibility, political and financial context and international models. GLA officers carried out much of the work with support from London Councils. Experts from Oxford

Economics (commissioned by the City of London) and the University of Toronto's Institute on Municipal Finance and Governance were engaged for specialist subjects.

13. We made a call for written evidence in September 2012. The responses we received provided evidence from a range of stakeholders from institutions inside and outside London, including London boroughs, London Councils, business organisations and the voluntary sector.

14. We hosted three public oral evidence sessions from October to December 2012. These sessions allowed the Commission to hear the differing views of a number of experts from a range of backgrounds and to enter into dialogue with them.

15. The chair of the Commission addressed wider audiences about its work on a number of occasions. A focus group event was held at the London Chamber of Commerce and Industry (LCCI), a seminar for academics, students and the public was held at the LSE and Centre for Cities hosted an expert seminar attended by representatives from think tanks, business and government. The chair addressed the Chief Executives' London Committee (CELC), the London Councils Leaders' Committee, the London Assembly, the London Enterprise Panel (LEP) and other audiences.

PART 1, CHAPTER 2

UK devolution in context

1. This chapter describes current government arrangements in Scotland, Wales and Greater London and provides an account of devolutionary developments there. It makes brief reference to the Northern Ireland Assembly.
2. Clear differences in form, function and funding exist between the GLA and the devolved administrations in Scotland and Wales. The latter were built on the concept of nationhood and grew out of existing government infrastructure, with devolution bringing devolved democracy to arrangements that were mostly already in place. By contrast, Greater London had been without any metropolitan government for fourteen years when the office of the Mayor and the London Assembly came into being in 2000; the GLA did not recreate the Greater London Council, its institutional predecessor was abolished in 1986, but has become a unique institution in UK government.
3. Yet in spite of their obvious differences, the GLA and the devolved national administrations form part of the same devolutionary movement. Comparisons can be useful as they exemplify how different devolved government structures can function within the UK, and highlight the dynamic nature of these institutions and their incremental development over time. Reforms that have occurred since 1999 also demonstrate that radical change can and has occurred in the UK.

SCOTLAND

4. Until 1999 the Scottish Office (a part of the UK government and answering to the Secretary of State for Scotland) operated a degree of administrative devolution in Scotland that distinguished it from England and Wales. Following a referendum in 1997 in which 74 per cent of the population voted in favour of further devolution, the Scotland Act 1998 established the Scottish Parliament, which was officially convened in July 1999. The Parliament comprises 129 directly elected Members and provided for a First Minister to be nominated by the Scottish Parliament to lead the Scottish Executive (officially referred to as the Scottish Government since August 2007), supported by a number of ministers and accountable to the Scottish Parliament. Devolved responsibilities include health, education, justice and policing, rural affairs, economic development and transport, and control over local government (including council tax and non-domestic rates, henceforth referred to as 'business rates'). The administration was funded through a block grant from central government, based on the Barnett Formula, and it had the option to raise additional revenue through the Scottish Variable Rate of income tax. This power allowed the Scottish Government to vary the basic rate of income tax on earned income in Scotland by up to 3 pence in the pound in either direction.
5. The Commission on Scottish Devolution ('the Calman Commission') deliberated in 2008-09. Accountable to both the Scottish and Westminster Parliaments, it produced two reports, concluding that while Scotland had wide spending powers, it should have substantially greater control over raising the revenues that make up the Scottish Budget. The Scotland Act 2012 (henceforth referred to as 'the Scotland Act') implemented many of the Calman Commission's proposals, including making substantial changes to the

Scottish Government's funding arrangements, such that Scotland will move to raising approximately 35 per cent of its income when the reforms have been phased in.

6. Changes to funding in Scotland are significant. From 2016, a new Scottish rate of income tax will be calculated by reducing the basic, higher and additional rates of income tax levied by central government by 10 pence in the pound and adding a new equivalent Scottish rate to be set by the Scottish Parliament. A new Scottish tax on land transactions to replace UK stamp duty land tax (henceforth referred to as 'stamp duty') will be introduced in 2015, as well as a new Scottish landfill tax to replace the UK equivalent. The Act also allows for new taxes to be created in Scotland and for additional taxes to be devolved in future. The block grant, still calculated according to the Barnett formula, will be reduced by an amount equivalent to the revenues from devolved taxes.
7. The Act also enhances the borrowing powers of Scottish ministers in relation to capital expenditure, subject to HM Treasury controls and limits. A Scottish cash reserve will be introduced alongside these powers, which will manage fluctuations caused by the devolution of tax receipts. HM Treasury ran a consultation in autumn 2012 about Scotland being given powers to issue its own bonds.
8. A referendum about Scottish independence has been confirmed for September 2014, in which a simple 'yes/no' question as to whether or not Scotland should be an independent country will be put to the Scottish electorate. Confirmation of the terms of the referendum put an end to speculation that a third option for full fiscal autonomy (commonly referred to as 'devo max') would be offered as an option, but it does not preclude further devolution, short of full independence, in the future.

WALES

9. The National Assembly for Wales was given broadly the same powers as those previously held by the Secretary of State for Wales in agriculture, culture, media and sport, economic development, education, environment, health, local government, housing, social services, trade and industry, training and transport. The Assembly was also given the power to pass secondary legislation, such that it could only vary existing laws in its areas of competence, and then only within the scope of the legislation authorised by the UK Parliament.
10. The structure of the Welsh Assembly was changed in 2006 to make separate the legislative and executive functions. It was also granted limited primary legislative powers, 'Assembly Measures', in areas within the legislative competency of the Assembly, which were further strengthened after a referendum, provided for in the Wales Act 2006, was held in 2011 about whether or not Wales should have full primary legislative powers. In the referendum, the Welsh electorate voted in favour of further powers being devolved to allow the Welsh Assembly to pass primary legislation in devolved areas of competence.
11. Despite incremental changes to the powers and structure of the Welsh Assembly, the Welsh Government has no tax raising powers and changes in its budget are set by the application of the Barnett Formula. However, it does have responsibility for local government's business rates and council tax. It sets the business rate relief rate and the rate of increase in business rates each year (the multiplier), and has the ability to conduct council tax revaluations in Wales and to cap local authority council tax increases if it deems necessary. The Independent Commission on Funding and Finance for Wales ('the Holtham Commission') was established by the Welsh Government in 2008 to investigate options for change. The Commission on Devolution in Wales ('the Silk Commission'),

which was set up by the Welsh and UK governments in 2011 with the support of the Welsh Government and Welsh political parties in the Assembly, further considered tax devolution and borrowing drawing on the Holtham Report. Silk's 2012 report looked into ways to improve the financial accountability of the Assembly. In broad agreement with Holtham, Silk's first report recommended that stamp duty, landfill duty, aggregates duty and potentially air passenger duty for long haul flights should be devolved to Wales. Silk also proposed that responsibility for income tax should be shared between the Welsh and UK governments, that the Welsh Government should have sole responsibility for business rates and also that the Welsh Government should have the capacity to borrow for capital investment on a prudent basis and to an extent for current spending (subject to limits agreed with HM Treasury.) It also recommended other matters such as improved financial information and a Welsh Treasury function.

12. The Government will respond to Silk's first report in spring 2013 and at time of printing it remains unclear if, when and how implementation will take place. The Silk Commission will produce a second report reviewing the powers of the National Assembly for Wales and recommending modifications to the present constitutional arrangements. The operation of the Barnett Formula in Wales is being reviewed through a separate bilateral process between central government and the Welsh Government and progress was announced in October 2012.

NORTHERN IRELAND

13. The Northern Ireland Assembly reflects a unique political reality that distinguishes it from other devolved administrations in the UK, such that its organisational structure places great emphasis on power sharing and consensus. The institution has legislative powers in a number of areas, including education, health, environment, trade and investment and justice. It has no significant tax-raising powers and its block grant is determined through the Barnett Formula, though it has lobbied the Government to be able to adjust corporation tax rates in Northern Ireland in order to compete with lower rates in the Republic of Ireland. Uniquely in the UK, the poll tax and council tax were never introduced in Northern Ireland, which operates a rating system of domestic properties based on a full range of capital values (but subject to an upper cap).

LONDON

14. London's city-wide government was established by the GLA Act 1999. It comprises a directly elected Mayor and an elected Assembly of 25 members with scrutiny powers. It was created as a unique structure, a strategic authority with few direct service delivery powers but responsibility for transport, policing, fire and rescue, development and strategic planning. The GLA's services are mostly delivered by functional bodies, not directly by City Hall. The Mayor was given powers of appointment and/or direction over these functional bodies, chairing Transport for London (TfL) and the Metropolitan Police Authority, since reformed to become the Mayor's Office for Policing and Crime, and the ability to set their budgets.

15. The GLA was originally prohibited from spending on education, health, social services or housing, though it had limited influence over the way national housing programmes directed spending. Its powers have since changed. The GLA Act 2007 increased the number of statutory strategies in new policy areas and introduced additional supervisory roles for the Mayor. The Localism Act 2011 conferred additional expenditure powers on

the GLA in relation to housing and regeneration, removing previous restrictions. However, spending restrictions on education (with the exception of academies), health and social services remain.

16. The powers and remit of the GLA are less than those of the Scottish and Welsh administrations, and the way it is funded is also very different. Unlike in Scotland and Wales, the Barnett Formula is not applied in London. Rather, the GLA Group budget is funded by a mixture of central government grant (34 per cent of its overall income in 2013-14), fares and other charges (50 per cent, of which the majority comes from transport fares), the council tax precept (7 per cent), retained business rates (8 per cent) and the use of reserves (1 per cent).

17. Grant is subject to change on a periodic basis and often involves protracted negotiations with government. The Barnett Formula, by contrast, automatically adjusts the resources available to Scotland, Wales and Northern Ireland in relation to change in the UK total.

18. From 2013-14 the existing GLA grant for the GLA's own activities is being reformed in such a way as to give the Mayor greater autonomy over the use of GLA Group funding. However the dynamics of the new arrangements will still be controlled by ministers so the dependence on government decision-making will remain. In addition, government departments, notably the Department for Transport in relation to TfL, expect the GLA to 'passport' on income which was previously paid as a specific grant, further limiting the flexibilities available.

LOCAL AUTHORITIES

19. The structure, functions and funding arrangements of local authorities in England have been restructured frequently since the 1960s. Outside London, a mixture of single and two-tier arrangements exists. London's 32 boroughs are unitary authorities that have broadly the same powers and responsibilities as councils elsewhere, with some strategic oversight by the GLA. The City of London has exceptional arrangements.

20. Local authorities were for many years funded mainly through central government grant. The rest of their income was made up of revenues from council tax, business rates and fees and charges. Recent changes to the financing of local authorities include those made in the Local Government Finance Act 2012, which introduced the local retention of business rates. As a result of this reform, from April 2013 councils will retain 50 per cent of their business rate yield. The Localism Act 2011 gives local authorities some discretion to offer business rate discounts while also introducing the requirement for a referendum to be held if council tax rises above centrally set limits.

21. The Act also made provision for the brokering of City Deals, which allow bespoke governance and finance arrangements to be agreed between central government and individual cities. The Manchester City Deal's 'Earn Back' model demonstrates the most radical example of financial freedom, allowing the ten Greater Manchester authorities jointly to retain part of the uplift in the local tax yield in addition to the business rate if such an uplift can be shown to be additional and as a result of local investment in infrastructure. The 'Earn Back' deal is the first example of its kind in England.

PART 1, CHAPTER 3

Summary of previous reviews

1. This chapter provides a description of previous reviews of local government finance and a summary of key recommendations and reforms.
2. The London Finance Commission is by no means the first review of its kind. Since the 1970s several major inquiries into funding for local and regional government have been undertaken. Overall these reviews have not led to substantive reform, but have contributed to modest changes such as the 2013 business rate reforms and City Deals.
3. We considered it important to situate our Commission within the context of evolving UK devolution and a long history of similar reviews. We are aware of the centralising tendency that was prevalent during the period that these reviews took place. However, with more recent steps towards devolution in Wales and Scotland, and 'pro-local' sentiments in England, we believe there is another and perhaps more promising opportunity this time for London to lead the way.

THE KILBRANDON COMMISSION 1969 – 1973

4. The Royal Commission on the Constitution (the 'Kilbrandon Commission') was set up by Government to look into the UK's constitutional arrangements, including local government. Its primary focus was Scotland and Wales, and though it considered the constitutional status of Cornwall, London was not examined separately from the rest of English local government.
5. The most tangible effects of this review were felt in terms of the debate about the governance of Scotland and Wales rather than the governance of regional or local authorities in England[2]. The Commission rejected the idea of England being considered an equivalent 'region' to Scotland and Wales but a minority of members favoured the idea of regional assemblies. London, it was proposed, would be part of a 'South East' region. This proposal was not acted upon at the time; it was resurrected in a different form during a later Government's period of devolutionary fervour in the late 1990s. However, the impetus for devolution in England lost vigour when the North East rejected regional government in a referendum in 2004.

2 In 1977, the Government published a white paper ('Devolution: Financing the Devolved Services White Paper', July 1977, Cmnd 6890) about its proposals for funding the devolved administrations in Scotland and Wales, which it proposed to create as a result of the Kilbrandon Report. Although devolution did not occur on this occasion, the White Paper remains interesting as a way of understanding the deep conservatism of Governments over many years. Having made proposals for devolution to Scotland and Wales, this official document made only limited proposals for the devolution of financial powers. The White Paper explained the Government's reasons *"for preferring a system based on expenditure needs rather than revenue-raising capacity".* It discussed *"the scope for conferring some limited tax powers on the devolved administrations to enable them to supplement the block funds" before going on to explain why "none of the possible devolved powers is considered suitable for inclusion in the forthcoming legislation"*. As a consolation prize, it added *"the Government are prepared to discuss with the devolved administrations, if they so wish, whether it is possible to find acceptable supplementary tax powers"*. The Government of the day wanted devolution of powers but not resources. Of course, no reform actually took place. Moreover, at about the same time, it was decided to lock in funding for Scotland by the application of the so-called Barnett Formula, which simply rolled forward Scotland's then existing share of UK spending without regard to changing expenditure needs. Thus, Scotland and Wales came to be funded within a system without reference to variations in expenditure needs. This latter arrangement remains in place today.

THE LAYFIELD COMMITTEE 1974 – 1976

6. To a backdrop of public discontent about domestic property tax rates, the Wilson government commissioned the Committee of Inquiry into Local Government Finance in 1974 (the 'Layfield Report'), as a comprehensive review of local government finance.

7. The report situated the debate about local government finance in terms of local-central relations and set out two possible options for reform. The first was to give central government more control over local expenditure and greater responsibility for local matters, and the second, favoured by the majority of the Committee, was to give local authorities more control over expenditure with the balance of funding moving in favour of locally-raised revenues, in part through devolving taxation powers.

8. Despite the report's enduring influence on contemporary discourse about the subject, none of its recommendations were implemented. On the contrary, changes to local government finance in the years after Layfield have rendered local authorities more reliant on grant.

LOCAL GOVERNMENT FINANCE REFORM 1986-93

9. In 1986, the Government published a Green Paper[3] proposing the replacement of domestic rates by a community charge, commonly referred to as the poll tax. The document suggested its proposals were *"the most radical reform of local government finance in Great Britain this century"*, which proved to be an understatement. In 1990 (1989 in Scotland), domestic rates were indeed replaced by the community charge, a flat-rate tax paid by every adult, at a locally set rate. This tax proved fatally unpopular. The community charge was, in turn, replaced in 1993 by council tax. However, as part of the community charge reform, business rates had been transferred to central government control in 1990. Council tax, like the community charge, was the only tax under local government control and has remained so since.

BALANCE OF FUNDING REVIEW 2003 – 2004

10. Following the introduction of council tax, concerns remained about the shortcomings of local government finance, and in particular the gearing effect of the council tax (where, for a 1 per cent increase in expenditure, council tax had to be increased by 4 per cent) and in 2003 the Government appointed Local Government Minister Nick Raynsford MP (a member of the London Finance Commission) to undertake the Balance of Funding Review, which considered the balance of local government funding sources and set out options for reform. Its remit did not include increasing local revenue, only rebalancing existing sources of funding. Its conclusions mainly set out areas for further investigation, including reform of council tax and business rates and the consideration of devolving existing taxes or introducing additional new revenues. Many of Raynsford's proposals were subsequently considered by the successor Lyons Inquiry.

LYONS INQUIRY 2004 – 2007

11. In 2004 the Government commissioned Sir Michael Lyons (who gave oral evidence to our Commission) to investigate ways to improve the form, function and funding of English local government. The Lyons Inquiry team published prolifically during its lifespan and identified many structural flaws in the local government finance system. The review argued that reform should render the system more flexible, offer clearer accountability and have built-in incentives. Lyons delivered pragmatic recommendations, some of which

3 Department of the Environment, Green Paper 'Paying for Local Government', Cmnd 9714

are set out below, based largely around improving the current system rather than radically reforming it.

12. The Lyons Inquiry recommended that council tax should be retained as a source of local government revenue, but suggested various options for improvement including five-yearly revaluations and new property bands at the top and bottom of the current structure. In reflection of the unique characteristics of London's property market, Lyons also argued that separate council tax bands should be considered for inner London. As a way to relieve pressure on council tax, the report recommended that greater discretion in relation to service charging should be extended to all local authorities.
13. Lyons did not propose that business rates should be re-localised, but advocated a power for local authorities to levy a local supplement in order to increase local flexibility and invest in infrastructure. In London this supplement should, it was argued, be collected at GLA level in agreement with the boroughs and be hypothecated for purposes agreed in consultation with businesses. The report suggested that incentives for the efficient use of land could be provided through reforms to the empty property relief and by the possible taxation of derelict and previously developed land. Lyons also recommended that the government should consider introducing a tourist tax.
14. Other recommendations were intended to increase transparency and accountability, through providing better information on how nationally collected taxes are spent locally, and in the longer term through assigning part of the income tax to support local services. Accepting that equity and stability should remain the key objectives of the grant system, the report argued that it should incentivise growth 'at the margins'.
15. The legacy of Lyons' comprehensive and pragmatic review of local government has been modest, though a number of his proposals have been implemented slowly at different stages since its publication. Lyons-initiated reforms have included the business rates supplement scheme[4], increased business rates on empty properties (though these are determined at the national not the local level), greater flexibility on the amount of council tax local authorities can charge on empty properties and a limited introduction of TIF to incentivise local growth.

CITY FINANCE COMMISSION 2011

16. The City Finance Commission, chaired by Sir Stuart Lipton (a member of the London Finance Commission), was promoted by Birmingham, Manchester and Westminster City Councils. It proposed ways to promote growth in UK cities, in the context of continuing recession.
17. Recommendations, centred around growth, included proposals for pooled budgets to deliver integrated local services, further financial and regulatory freedoms for cities, a business rate retention scheme and TIF powers. Many of its proposals have been implemented, at least in part. Business rate retention and TIF feature in the Local Government Finance Act 2012, and the Localism Act 2011 created the opportunity for local authorities to make the case for being given new powers to promote economic growth and to set their own distinct policies, embodied in the brokering of several City Deals.

4 In practice, however, it is worth noting that only one business rate supplement levy has been implemented, in London, for Crossrail. We are not aware of any other attempts or plans to set supplementary levies elsewhere in the country.

MIRRLEES REVIEW 2011

18. The Mirrlees Review, conducted by the Institute for Fiscal Studies (IFS), is of partial relevance to local government finance, in that it describes how a modern tax system should look and makes recommendations for the reform and simplification of the UK system without arguing for devolution.

19. Levelling strong criticism at inefficiencies in the housing tax system, it argued that council tax is regressive with respect to property values, that it gives an unfair discount for sole occupancy, and that the valuations that form its basis are out of date. Stamp duty is considered inefficient as a transactions tax because it discourages mobility and offers perverse incentives because of cliff-edge thresholds. The report states these taxes should be replaced with a simple tax similar to VAT on the consumption of housing, though none of its recommendations for fundamental change to the UK tax system have been implemented.

PART 1, CHAPTER 4

Principles adopted in making recommendations

1. Our recommendations aim to improve governance in London, and we consider the duty to promote growth an integral part of good governance. While economic development is not an inevitable consequence of constitutional change, the system operated by sub-national governments should be such that the tax-setting authority can use it to encourage economic growth. We believe that financial arrangements in place at present constrain economic growth, and our recommendations seek to redress such constraints. We found no compelling evidence that the devolution of financial powers would risk reducing economic growth or success.

2. We also believe there are powerful democratic arguments for plurality of power within a modern democracy. At present, virtually all taxation in the UK is determined by central government. Only council tax (and, in England from April 2013, a proportion of business rates) can be seen as local taxation and even this tax is subject to cumbersome controls including referendum procedures if local authorities are to change the tax rate upwards. A democratic system where the centre determines virtually 100 per cent of taxation surely fails by the standards of best practice in most OECD countries. We have approached our work mindful of this weakness in British democratic practice.

Table 1: Taxation revenue attributable to sub-national and central/federal government as a percentage of GDP, 2010

	Local government	State/regional government	Local + state/ regional	Central government	Social security	Total
Canada	3.1	12.2	15.3	12.8	2.8	31.0
France	4.6	0	4.6	14.9	23.2	42.8
Germany	2.8	7.6	10.4	11.3	14.0	36.0
Italy	6.5	0	6.5	22.7	13.4	42.9
Spain	3.0	5.8	8.8	11.2	11.9	32.2
Sweden	16.1	0	16.1	23.7	5.5	45.5
United Kingdom	1.7	0	1.7	26.2	6.6	34.8
United States	3.9	5.0	9.1	9.2	6.3	24.8
OECD total (2010)	3.8	5.0	8.8	20.1	8.2	33.7

Source: OECD Stats Index

3. In the spirit of good governance, we have based our recommendations on an objective appraisal of evidence, both academic and that submitted by stakeholders, as appropriate.

4. The London Finance Commission is independent of the Mayor and, while we have cross-party political representation, our recommendations are not party-politically oriented

and, more importantly, are designed to encourage cross-party appeal as options to improve the way London government[5] is funded.

5. We have adopted five principles to aid thinking and assess options systematically. We share most of the principles used by Calman, Holtham and Silk, many of which can be applied generally to assess good governance and are not specific to London or sub-national government.

Principle 1: Accountability
There should be a link between spending decisions and taxes raised. The impact of spending decisions by government should be clear to taxpayers and should be clearly linked to local well-being, for example in the promotion of local jobs and growth.
Principle 2: Transparency
The financing system should be as simple as possible and it should not be so complex as to be incomprehensible.
Principle 3: Efficiency and effectiveness
Decision-making by sub-national government should be such as to ensure the preferences of citizens are better met than if the same decisions were made by national government. The use of public money should avoid waste, in the sense that inputs should be minimised in relation to outputs and outcomes. Arrangements should minimise administration costs, economic distortions and tax avoidance.
Principle 4: Autonomy
Sub-national government should have choice about how much to spend and on what, such that it is not blocked from promoting local interests such as jobs and growth. A higher percentage of funding raised locally would be more likely to deliver autonomous sub-national government than a lower one. The capacity to raise resources in this way is an important element in the constitutional balance between different spheres of government within a country.
Principle 5: Fairness
The overall funding system should operate in a way that ensures all parts of a country or city receive acceptably fair service provision and face acceptably fair tax burdens. Matters of fairness are also relevant between individual taxpayers in different parts of a country or city, as well as matters of inter-generational equity. The assumption has been made that any proposed reform should not lead to a redistribution of resources to or from London at the point the reform occurred; that is, in the year change took effect London would neither be better nor worse off, a principle that also applies to individual boroughs.

5 The term London government is used in a general sense in this report to mean the GLA and/or London Councils and/or London boroughs. Please see Part 5, Chapter 2 for more detailed discussion of the topic.

2 Evidence

In Part 2 we briefly summarise the evidence we received from stakeholders, and set out the findings of our academic literature review and the research we commissioned.

PART 2, CHAPTER 1

Summary of evidence received

1. We collected both written and oral evidence from a range of experts and interested parties. All evidence submissions are available on the London Finance Commission website here: www.london.gov.uk/london-finance-commission/evidence
2. Our call for written evidence was open from September to November 2012. We asked respondents to consider the current system for capital investment, to appraise local government finance arrangements and to propose improvements. It received a good response from a range of stakeholders[6], including London boroughs, London Councils, business organisations and the voluntary sector.
3. We hosted three oral evidence sessions from October to December 2012, allowing us to hear the differing views of a number of experts from a range of backgrounds and to enter into dialogue with them. The following witnesses addressed the Commission:
   - **Greg Clark** (independent expert on city government)
   - **Sir Merrick Cockell** (Chair of the Local Government Association) accompanied by Paul Raynes
   - **John Dickie** (Director of Strategy and Policy, London First)
   - **Professor Jim Gallagher** (Secretary to the Calman Commission)
   - **Lord Heseltine** (former Deputy Prime Minister, author of 'No Stone Unturned')
   - **Gerald Holtham** (chair of the Independent Commission on Funding and Finance for Wales)
   - **Paul Johnson** (Director of the Institute for Fiscal Studies)
   - **Ken Livingstone** (former Mayor of London)
   - **Sir Michael Lyons** (chairman of the Lyons Inquiry into Local Goverment)

ORAL EVIDENCE

4. Reflecting the diverse backgrounds of the witnesses, the nature and content of the evidence they presented differed, as did the opinions they expressed, in some cases greatly. For example Sir Michael Lyons was keen that further devolution should lead to more comprehensive stewardship of place, while Paul Johnson believed the case for national reform of a deeply flawed tax system should be prioritised before devolving any tax powers.
5. Witnesses agreed that arrangements in the UK are very centralised and acknowledged the fact that different models of government, some of which allow local government to operate in more fiscally independent ways (as highlighted by Greg Clark and Sir Merrick Cockell), function successfully in international cities.
6. Jim Gallagher and Gerald Holtham discussed the underlying principles behind localised and centralised models; the former is more likely to be based on need, the latter on the principle of the origination, ie revenues raised in a certain area are also spent

6 The City of London, the City of Westminster, the Core Cities Group, Greg Clark (cities expert), the Institute of Public Policy Research, the Local Government Association, the London Chamber of Commerce and Industry, the London Borough of Camden, the London Borough of Ealing, the London Borough of Islington, the London Borough of Newham, the London Borough of Redbridge, the London Borough of Sutton, the London Borough of Waltham Forest, London Councils, London First, Manchester City Council, the Royal Borough of Kingston Upon Thames, Transport for London and Tomorrow's People.

there (as is the case with taxes raised in the UK being spent in the UK). Both systems have inherent advantages and disadvantages. However, the current system in the UK's devolved administrations is somewhat more blurred, in that the Barnett Formula is not based on need per se, rather it is based on population size (and even that is inaccurate as calculations are 30 years out of date). Yet population size cannot be said to accurately relate to the origination of revenue either.

7. Full consensus did not exist as to why the current system of governance is sub-optimal, how it should be improved, or whether the best route to improvement would be through devolving funding or powers or through other means, such as improving the national tax system.

8. Witnesses also disagreed about the extent to which fiscal devolution can lead to growth. However, beyond arguments about the interpretation of academic research, Greg Clark referred to evidence presented by market sentiment surveys, which demonstrate market dissatisfaction with public sector infrastructure investment in London, for example in housing and airports. Although London has clear strengths that do attract business, its weak points could deter international investment, particularly from Asian markets. This problem seldom presents itself in UK discourse because infrastructure has been improving in London, but by international standards the progress made is insufficient.

9. John Dickie explained that from a business perspective, the belief prevails that local authorities are not only insufficiently incentivised to promote growth, they are actually deterred from it. When granting planning permission for large developments, residents, who are also local voters, often oppose changes because they can cause disruptions and eventually increase service costs. Moreover, the local authority in which a development is situated has traditionally received none of the financial benefits of local growth.

10. Greg Clark, John Dickie, Ken Livingstone and Sir Merrick Cockell emphasised London's need for infrastructure, which will become increasingly acute as the population grows faster than in other parts of the country. This challenge is difficult to address because of uncertainty about future revenue flows. There is also an unhelpful tendency of bidding for 'trophy projects', which is often inefficient and/or leads to prominence being given to major developments over smaller ones. However, although the extent of the Mayor's control over infrastructure projects is considered too limited, Paul Johnson acknowledged that central government's agenda to restrict borrowing in the national interest was reasonable. He highlighted the merits of the prudential borrowing regime.

11. A broad consensus existed amongst witnesses about the feasibility of further devolution or greater local autonomy. A number of practical suggestions were put forward. Lord Heseltine took the pragmatic view that 'radical' devolution is unlikely to take place in the UK context. He advocated an improved version of the development corporation model, with streamlined governance and finance arrangements, strong leadership and sufficient private sector representation, planning powers and resources. John Dickie stated that the business rate system should be improved because at present it is too complicated and uncertain.

12. Regarding council tax, Sir Michael Lyons suggested that at the very least, revaluations should be conducted on a regular basis, Gerald Holtham considered it should be a local tax retained in London (based as it is on a London tax base), while Paul Johnson stated that the tax should be replaced completely by a more rational and progressive form of domestic property taxation. Sir Michael Lyons and Gerald Holtham stated that assignment of taxation is less preferable than full devolution, as it does not increase autonomy. Though witnesses

were cautious to recommend radical devolution because of the scope for distortions at London's porous border, Jim Gallagher stated that if tax devolution were pursued, stamp duty would be a good candidate because of its immobile base.

WRITTEN EVIDENCE

13. The majority of respondents to our call for written evidence expressed support for the London Finance Commission and criticised current local government finance arrangements for being too centralised *"largely through history not design"* (London Borough of Ealing). The Local Government Association (LGA) stated that *"the local tax system in this country is very centralised by international standards, and breaches the European Charter on Local Self-Government"*. In general, respondents supported our principles of increasing accountability, autonomy and efficiency, transparent and fairness in local government finance.

14. Respondents recognised London's increasing need for infrastructure investment; the London Borough of Redbridge warning that *"failure to invest in [infrastructure] will mean London's offering is much less attractive for investors and thus a drawback to expansion plans."* The current system was generally regarded as inflexible, as it fails to allow local government to respond adequately to local circumstances and this inflexibility was considered to constrain growth. Greg Clark pointed out that London's low level of fiscal autonomy means that it cannot *"promote its own growth […] as effectively as it should. [Its limited tax raising ability] leads to a lower incentive structure for London governments to encourage business investment, and fewer tools to do it with."*

15. Business groups criticised the lack of engagement with the private sector that the current system engenders. This lack of engagement was seen to impede local growth because insufficient incentives are built into the system. As relatively little income is raised locally, councils are less likely to take seriously the concerns of businesses and are not compelled to incentivise growth. Indeed, London First stated that, *"[the current situation] disincentivises London's government from taking decisions that are economically positive (such as many relating to development) but may be politically unpopular."* Consequently business groups called for greater accountability towards businesses, with more effective business engagement as a pre-requisite for any reforms proposed.

16. The call made by business groups for greater growth incentives through greater accountability implied a need for local autonomy and an ability to respond to local circumstances. Respondents highlighted London-specific needs for capital investment, including for transport infrastructure, schools and housing. Greg Clark considered that at present, much infrastructure planning relies on *"bidding and trophy projects"*. Ealing agreed that local authorities are not incentivised to use time and resources efficiently in the current system of bidding rounds for investment; bidding for any funds that happen to be available replaces evidenced cost-benefit analyses and *"weakens the rigour which should be applied for the development of cases for investment in the capital".*

17. A number of suggestions were made to encourage capital investment. At the heart of these proposals was the need for certainty; London First cited *"volatile government grant"* as one of the main problems blocking investment and planning, and criticised *"the absurd situation in which the Mayor has to press central government to give him the resources to make vital investment in London's infrastructure."*

18. The London Borough of Newham placed importance on local authorities being provided with additional capacity to borrow against their assets and rental income to deliver local priorities, echoing general enthusiasm for borrowing restrictions to be removed or relaxed. The LGA used the strong credit ratings of certain local authorities such as Kensington and Chelsea to argue for greater freedom from central government to borrow, though TfL stated that it can borrow at favourable rates at present because of its perceived proximity to central government, an arrangement it would like to see sustained in order to retain its good credit rating.
19. Greg Clark explained that borrowing powers are spread asymmetrically between London governance organisations. *"Most of London's financing power is at TfL and this probably means that London's investment progress recently has been skewed more towards transport than in other areas such as housing, energy, waste and water."*
20. A number of London boroughs and London Councils criticised the design of the Housing Revenue Account (HRA). Ealing explained that *"the HRA borrowing caps […] bear no relationship to the actual value of assets in London and act to limit access to private finance."* The London Borough of Sutton argued that *"this is 'good borrowing', investing in local housing, in capital assets for the future and against a proven rent stream; this is not borrowing that is just offsetting a shortfall in annual tax revenues."*
21. The principle of TIF was welcomed, but more schemes, with an extended reset timeframe of 25 years, were called for. The LGA stated that: *"to place an arbitrary limit on the number of TIF schemes means potentially missing out on the upside gains of developments […], this quota is a negligible amount compared to the potential TIF has to unlock new investment at no cost to the Exchequer."*
22. Overall, respondents specifically emphasised the need for a larger number of funding streams to be available to allow London government to finance infrastructure development successfully. This objective could be achieved through tax devolution or assignment.
23. An appetite for further fiscal freedoms was clear amongst respondents, though there is a spectrum of ambition. Sutton called for more powers and corresponding funding to be devolved to local authorities *"not by total place or community budgets but by structural and legislative changes."* Yet there was also an acknowledgment that fiscal devolution is not a panacea; as expressed by the City of Westminster in reference to the way grants are allocated, *"a more equitable allocation [of local government funding] could be achieved without the granting of any additional powers."*
24. Greg Clark stated that if London had more control over tax revenues and investment tools it would be able to *"capture the value of growth (taxes, land values, levies, charges) to support borrowing and investment and to recycle value to accelerate growth."* The Greater Manchester 'Earn Back' scheme is based on a similar premise, taking the idea of incentivising growth beyond existing business rate schemes, and allowing additional revenues to be retained locally in relation to additional GVA created. Manchester City Council explained in its evidence that *"if Greater Manchester is successful in driving economic growth, [it] will receive a larger proportion of resultant tax take generated from this growth than would otherwise be the case under business rate retention."*
25. Frustration was apparent from local government respondents about council tax restrictions and the inadequacy of business rate reforms, both of which are considered too modest and too centralised.

26. The business rates system which has been in place since April 2013 is less devolutionary than the government's original proposals and, in its current form, can be argued to be insufficient, over complex and too centralised. An increase in the locally retained share of business rates, some suggested up to 100 per cent, would be welcome, though opinion varied about where overall control over setting the business rate level should sit. Some evidence favoured central government, others local.
27. A broader definition of growth in the business rate retention scheme was also called for, in order to encompass revaluation or 'real-terms' growth rather than just year-on-year growth resulting from development on new sites. LCCI pointed out that *"for many councils [...] permitting new development may not be the main economic priority for the area and instead focus should be on delivering for existing business premises."* The London Borough of Camden suggested that local authorities should be able to benefit from revaluation gains resulting from public realm investments in 'Local Action Zones'.
28. Referenda on council tax rises, which are regarded as prohibitively expensive, and central government 'council tax freeze grant' represent an unwelcome move towards central control of a local tax source. As Camden put it, *"central government does not have a referendum when it raises VAT or income tax and neither should local government face a referendum when it raises council tax"*. The LGA stated that council tax should be 'uncapped and locally decided'.
29. The City of Westminster called for relaxed central control over council tax, but accepted that if the referendum requirement is to stay in place *"at the very least it should be expressed as an increase in absolute terms [...] rather than a percentage increase"*, because the effects of the current arrangements have the greatest impacts on local authorities with historically low council tax rates.
30. In order to reflect local circumstances, Camden stated that the ceiling on council tax bands should be removed. The current system *"solely benefits owners of multi-million pound properties of which the overwhelming majority are in London. Many of these properties are owned by foreign companies or non doms and their band H council tax (£2,657 p.a. in Camden) is minute in comparison to the value of a multi-million pound home."*
31. Beyond modest improvements to council tax and business rates, a number of proposals were made for taxes including assigned property taxation and the introduction of new taxes. In order to avoid volatility, London Councils recommended that any tax devolution should be made up of a mixed portfolio of revenues. However, London First struck a note of caution that the businesses they represent may oppose devolution of taxes unless they experience tangible benefits as a result of any changes made.
32. Greater local discretion over fees and charges was recommended. London Councils stated that the result of centrally set fees *"has always been perverse, militating against councils' ability to work effectively with businesses and help drive growth and it also has other significant financial consequences for local taxpayers."* It therefore recommended that fees for planning applications, building control, land searches and licensing should be at the discretion of boroughs, which should be able to achieve full cost recovery and in some cases set market rates for these services. Westminster also called for the ability to offer price-differentiated levels of service in order to recoup costs and to offer innovative services, as well as the ability to extend the Night Time Levy in order to reflect particular local circumstances.

33. Many respondents criticised the 'siloed' nature of central government grants and called for greater co-ordination between Whitehall departments. A number of London boroughs and the charity Tomorrow's People recommended a devolved budget for employment and skills programmes and recommended that there should be some local influence over the design of related programmes. London Councils concluded that *"the devolution of national services, currently delivered through Whitehall silos, is key to both better tailored and integrated local services."*

PART 2, CHAPTER 2

Academic and international evidence

1. Most academic authors point to the difficulties in measuring and comparing both the extent of fiscal devolution and its effects. With these inherent difficulties in mind, we have considered existing academic evidence available on the topic of fiscal devolution and where possible we have drawn general conclusions. We also commissioned our own research looking into the existing London arrangements in relation to comparable international cities in order to better understand the specifics of the situation.

EXISTING ACADEMIC EVIDENCE

2. Broader academic evidence is inconclusive regarding the impact of devolution on economic growth or, indeed, on other possible effects. Studies variously show negative, positive and neutral relationships between devolution and growth, as outlined below.

3. A number of academics have explored the positive effects of devolution. Research by Professor Paul Cheshire and colleagues[7] demonstrates some positive effects on economic outcomes when economic development powers are held at the appropriate level and when local authorities are incentivised to create pro-growth planning regimes[8]. Research from the Centre for Cities[9] demonstrating incentive effects, along with other research done by the Department for Communities and Local Government (DCLG) which had been endorsed by Professor Henry Overman, formed the academic backbone of the Government's recent business rate reforms.

4. Other positive effects include those discussed by Professor Kevin Morgan, who argues that devolved arrangements empower citizens and make governments more accountable[10], and a paper by Professor Andres Rodriguez-Pose and colleagues, which suggests that general satisfaction with government can increase as a result of devolution, if the actual capacity of local government to deliver is augmented. Such findings bolster the idea that although devolution alone may not lead inevitably to economic development, allowing local leaders the autonomy to innovate and respond to local affairs may promote economic development.

5. Yet other studies by Rodriguez-Pose and colleagues considering decentralisation in OECD countries show robust and significant negative relationships between economic development and decentralisation[11]. However, these authors state that the only exception to this trend occurs in areas with relatively low levels of fiscal decentralization; in such cases, moderate increases in fiscal decentralisation may have a positive impact on growth by allowing governments margin for manouvre[12]. Overall they conclude that the

7 Cheshire, P. and Magrini, S. (2009) 'Urban growth drivers in a Europe of sticky people and implicit boundaries'

8 Cheshire, P. and Hilber, A. (2008) 'Office space supply restrictions in Britain: the political economy of market revenge'

9 Centre for Cities (2011), 'Room for Improvement: creating the financial incentives needed for local growth'

10 Morgan, K., 'The English Question: Regional Perspectives on a Fractured Nation', in Regional studies, VOL 36; PART 7, 2002, 797-810 p798 and Morgan, K., 'The Polycentric State: New Spaces of Empowerment and Engagement' in Regional Studies. VOL 41; NUMBER 9, 2007, 1237-125 p1240

11 Ezcurra, R. and Rodriguez-Pose, A. (2010) 'Is Fiscal Decentralization Harmful for Economic Growth? Evidence from the OECD Countries', p9

12 Ezcurra, R. and Rodriguez-Pose, A. (2010) 'Is Fiscal Decentralization Harmful for Economic Growth? Evidence from the OECD Countries', p24-25

overall body of evidence about devolution is too contradictory to offer any meaningful conclusions[13].

6. This diversity of findings is understandable given that measuring the degree of fiscal devolution in a region is very difficult and that outcomes for regions are influenced by many factors (such as existing regional disparities, regional policy and national economic performance) outside of fiscal devolution. We have therefore been cautious about using any single academic study to justify our recommendations, focusing instead on principles of good governance, including the premise that no compelling evidence should be disregarded.

7. However, we find the inconclusive nature of the body of evidence significant, in that it cannot be used to justify current arrangements either. In other words, no evidence conclusively shows that England's highly centralised arrangements as they stand at present promote growth or are in any way objectively better than a localised solution.

INTERNATIONAL COMPARISONS

8. In order to better understand international models of city governance, we commissioned research from the University of Toronto to describe and assess arrangements in comparable international cities (Paris, Berlin, Frankfurt, Madrid, Tokyo and New York) and to draw lessons from the wider literature on fiscal devolution to cities in the international context. Although the researchers encountered difficulties in making precise comparisons, the report we received gave us a useful insight into feasible solutions for metropolitan governance and placed London's situation in context. The clear and important lessons which emerged are summarised below.

9. In terms of fiscal autonomy, London is an outlier compared to the cities studied. By comparison, it relies heavily on transfers from central government, with 73.9 per cent of its income received through grant, compared to 37 per cent in Madrid, 30.9 per cent in New York, 25.5 per cent in Berlin, 17.5 per cent in Paris and only 7.7 per cent in Tokyo[14]. Moreover, London does not have comparable access to the diverse tax bases enjoyed in other cities:

   "The council tax in London does not meet all of the criteria for local fiscal autonomy because the GLA and boroughs do not determine the base of the tax and tax rate setting is restricted by national government. Non-domestic rates are not included as a local tax because these rates are a national tax in which the central government determines the tax base, sets the tax rate, collects the revenues, and distributes the funds to local government."[15]

10. The Toronto paper makes a balanced appraisal of the benefits and disadvantages of fiscal autonomy using international examples, reflecting primary research and the body of academic evidence described above. The research suggests inconclusive outcomes, and includes the usual caveats that comparison is made difficult by many factors. It shows that tax competition can render a city more attractive to businesses and residents, particularly if revenues are used to improve local services. However, the report cites the cautionary examples of increases in local income tax levels in New York City and Philadelphia resulting in out-migration of business and significant estimated job losses.

13 Ezcurra, R. and Rodriguez-Pose, A. (2010) 'Is Fiscal Decentralization Harmful for Economic Growth? Evidence from the OECD Countries', p10

14 Slack, E. University of Toronto (2012), 'International Comparison of Global City Financing', p12

15 Slack, E. University of Toronto (2012), 'International Comparison of Global City Financing', p13

11. Yet although the paper highlights problems associated with some forms of fiscal autonomy, overall the report concludes that London would benefit from greater fiscal autonomy through a portfolio of devolved taxes:

    "A mix of taxes would give London more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, and other factors […] Local fiscal autonomy and, in particular the ability to set tax rates, is also important for accountability: governments that raise their own revenues and set their own taxes to meet local expenditure needs tend to be more responsible and more accountable to taxpayers." [16]

12. We also received written evidence detailing arrangements in a number of international cities, including New York, Tokyo, Paris, Hong Kong and Singapore, from a highly respected independent advisor on global cities, Greg Clark, who observed lessons for London both as a capital and as a global city.

13. He identified two main challenges facing London, which in his view cannot be overcome without greater fiscal and financial autonomy. First it needs to have the ability to better integrate different approaches, reconciling different infrastructure and utilities regimes in 'smart' ways. Greater control over investment would also allow it to anticipate growth better and to invest to manage growth more effectively. It would allow the city to capture the value of growth (taxes, land values, levies and charges) to support borrowing and investment and to recycle value to accelerate growth further. It may also allow it to set taxes in such a way as to incentivise enterprise and private investment. Second, London needs to act as a supportive capital city, providing opportunities and resources for the growth of other cities in the UK without having to compete with them for public funds.

16 Slack, E. University of Toronto (2012), 'International Comparison of Global City Financing', p25 - 26

3 Supporting London and UK growth

Part 3 of the report considers London's infrastructure needs; with an economy larger than Sweden's, London has become one of the world's pre-eminent city economies, and the strong demographic and economic growth it has seen in recent years is forecast to continue. In this part of the report we argue that it would be detrimental for London and the UK if the capital's growth were to be hampered by a failure to invest. We demonstrate that the current model for providing capital investment is likely to be insufficient both for London's needs and its economic growth potential. We argue that the Mayor and the boroughs working in partnership with business and others should have much greater independence to provide infrastructure and to incentivise growth, and we recommend that a range of borrowing constraints on productive investments should be removed. Our argument that cities are engines of economic growth, and that civic leaders are the best custodians of their future, applies to the UK's other major cities just as well as to London.

PART 3, CHAPTER 1

London and UK Cities

INTRODUCTION

1. Our overarching recommendation is that funding arrangements in London should allow London government to make additional self-determined investments in its own infrastructure both to cater for the growth already forecast for its population and economy, and to promote additional economic growth. Relaxing restrictions on borrowing for capital investment while retaining prudential rules and simultaneously devolving the full suite of property tax revenue streams will afford London government greater autonomy to invest in the capital. Such reforms would also increase London government's accountability to residents and businesses. Such change would be achieved in such a way as to avoid affecting the financial settlements of other parts of the country.
2. Indeed, London's growth is important for the economic health of the whole country, and it is therefore vital that it is not impeded by a failure to meet its demand for infrastructure. As London's population and economy grows, substantial investment in it's infrastructure will be required. In this chapter we briefly set out its projected infrastructure needs and explain the shortcomings of current funding methods. We propose as a starting point a high-level assessment of London's growing needs, matched to potential sources of funding in a way that does not burden the UK Exchequer.

CITIES AS DRIVERS OF GROWTH

3. Cities are the economic motors of the country. In the UK, they cover just 9 per cent of its landmass but contain 54 per cent of the population and generate 60 per cent of its GVA with 53 per cent of all businesses and 72 per cent of all highly skilled workers[17]. Sustaining cities requires a combination of investments to meet their social needs, help grow their economies and make them better places to live and work. We consider that civic leaders, working with local stakeholders, are much better positioned to get this right than Whitehall officials and ministers working in a number of separate and insufficiently coordinated departments. Better governance would be possible through deciding locally about priorities and helping to integrate investments. In the UK, cities need greater freedoms and tools to do this work; we consider these prerequisites for stronger economic growth.

LONDON AND THE REST OF THE UK

4. The recent performance of London's economy is a success story. However, its economic prosperity has not always been considered a priority. Managed decline of the UK capital was the overarching post-war policy until the early 1980s and it has only been since the renaissance of London from the early 1990s to the present day that the UK has once again been home to one of the world's premier cities. London is one of the greatest business centres in the global economy and one of the strongest performing regions in the UK. ONS data shows that between 2007 and 2011:

17 Centre for Cities website, 'City by City', http://www.centreforcities.org/cities/

"London's nominal output has risen faster than other regions; its employment and unemployment rates have fared better than other regions; it has seen a larger growth in its active business stock; it has seen an increase of over 250,000 jobs whilst most other regions have seen a decline; and the average incomes of its residents have increased when compared to residents elsewhere in the UK… From 2007 to 2011 London's economy (GVA) grew by a nominal 12.4% compared to between 2.3% and 6.8% across other UK regions…"[18]

5. It is clearly not ideal for the overall performance and balance of the UK economy and the rest of the country to be so reliant on the capital, and also for there to be a growing disparity between the capital's economy and that of the rest of the UK. Interventions to support growth in the rest of the UK are therefore to be welcomed. We support the efforts of the Core Cities[19] to exploit the economic potential of England's regional cities and gratefully received their support for the London Finance Commission in their written evidence submission. We agree with their statement there that:

   "We all need London to continue to succeed, but it is unhelpful and incorrect to see growth elsewhere in the country simply as displacement from the South East. This severely limiting concept stymies the national ability to recover and grow."

6. No one would sensibly argue that London should be less able to invest in itself than at present or receive less investment than it needs. It is difficult to envisage a scenario in which London's economic decline would be favourable for the rest of the UK and we reject the notion which is occasionally articulated that London should be constrained in order to 'balance' UK economic growth. In most markets, London is competing as much, if not more so, internationally than against other UK cities[20]. Many foreign direct investment projects that London wins in competition with other international cities provide benefits for other regions[21], and many tourists who visit London go on to other parts of the UK[22]. Other international cities vie for investment, visitors, students and talent, and in the global competition, London risks falling behind and, in respect of infrastructure, further behind.

7. However, we argue that the freedoms the capital should enjoy should also apply to other cities, which are drivers of growth in the rest of the UK. As Greg Clark stated in his evidence to the Commission:

   "London needs to be an effective and generous capital city for the UK, supporting other cities, regions, and nations within the country, and providing opportunities and resources for their development, whilst not competing with them for public funds and transfers."

18 ONS, 'London's economy has outperformed other regions since 2007' (http://www.ons.gov.uk/ons/dcp171780_302543.pdf)

19 The Core Cities represents the following major English cities: Birmingham, Bristol, Leeds, Liverpool, Manchester, Newcastle, Nottingham and Sheffield.

20 The Mayor's promotional agency, London and Partners, has an explicit remit to attract international (and only international) FDI projects, students and tourists. It does not promote London for an increasing share of the UK market.

21 A survey by Think London found that "more than half (55%) of the companies (surveyed) said they had used London as a "springboard" for expansion into other parts of the UK and Europe." Source: Think London, '52 Billion: the Value of Foreign Direct Investment to London', p7, http://d2mns3z2df8ldk.cloudfront.net/l-and-p/assets/media/london_focus_52billion.pdf

22 The capital is one of the most visited cities in terms of international visitor numbers, comparable to some Far Eastern cities such as Singapore and Hong Kong, outperforming other European cities such as Paris. Total annual visitor numbers to London were greater than 15 million in 2011 (around half of the UK total) and visitor spend increased by 7.7 per cent to over £9.4 billion (over half of the UK total) with London receiving around 91 and a half million visitor nights with the rest of the UK regions receiving just over 143 and half million visitor nights.

LONDON'S GROWTH

8. London's population grew from 6.7 million to 8.4 million between 1986 and 2013. It is projected to surpass its previous peak (8.6 million in 1939) as early as 2016, and to reach 9 million by 2020 and nearly 10 million in 2030. This rise will be driven by London's natural growth rate, itself driven by London's relatively youthful population[23].

9. Accommodating London's growth in ways that are benign for society and good for the economy will present many challenges. Financing the investment required will be a major challenge, whether as a direct consequence of population growth (housing, schools, primary healthcare and so on), to assist sustained economic growth (for example through transport, skills, higher education, innovation, research and development, ICT, electricity supply and the green economy) or to benefit society more broadly (through investments in the public realm, culture, crime prevention and so on). In practice, many investments will meet more than one of these objectives simultaneously.

10. Based on historic trends, London's employment is likely to reach almost 5.8 million jobs by 2036, an increase of 860,000 from 2011. Jobs are highly concentrated, with 34 per cent of London's employment located in just two per cent of its land mass. GLA projections show that jobs could grow by some 280,000 between 2011 and 2036 within the Central Activities Zone, creating the additional agglomeration benefits associated with dense clusters of employment.

11. Such agglomeration benefits support the development of economic activity by providing firms with access to a deep and highly skilled labour force, a range of complementary input and output markets and the benefits of spillover effects such as the rapid transfer of innovation and knowledge. It is just such agglomeration benefits which mean that many specialist economic activities take place solely in London, for example in the creative and high-tech industries. Maintaining and enhancing these agglomeration benefits will require increased spending on infrastructure such as transport, electricity supply and internet access into the future, enabling London's increasing population the opportunity to access London's jobs and simultaneously giving London's businesses access to a large pool of well qualified labour.

INFRASTRUCTURE NEEDS IN A GROWING CITY

12. Clearly, cities and the economic clusters they accommodate rely on a combination of infrastructure investments, which are not independent of one another. If London government had the autonomy to invest in its own priorities, it is likely it would be able to assess and deliver the correct balance.

Transport

13. For transport, London's overall growth is expected to mean that the additional public transport capacity created by Crossrail, Tube and national rail upgrades will be fully utilised by the early 2020s, so more capacity will be needed. London's overall growth is projected to translate into a rise of 30 per cent in passenger numbers on the tube and rail between 2011/12 and 2020[24]. The pressures on London's roads are also growing and there is a need for a major investment programme to improve the reliability of the

23 Rounded, London's average annual natural growth (births minus deaths) is expected to be 87,000 (2012-2021) and 84,000 (2022 – 2030); average annual net migration, by contrast, is forecast to be 2,000 and -27,000 respectively over the same periods. Source: London Data Store (http://data.london.gov.uk/datastore/package/gla-demographic-projections).

24 TfL, 'The Mayor's Rail Vision for London - Investing in Rail Services in London', p7 (http://www.london.gov.uk/sites/default/files/mayors-rail-vision-2012-final.pdf)

road network and tackle congestion. Investment will also encourage walking and cycling, improve air quality and deliver a better public realm.

14. In its written evidence London Councils cited not just the need for greater investment, but also the need for more commissioning capacity across the capital. In particular London Councils suggested that powers be devolved to boroughs to initiate and act as a client for local infrastructure and to increase the commissioning capacity to meet the demands of new investment. This relates to transport in particular. London Councils believes that the capital cannot develop at the pace it needs to meet present demand plus the future requirements of over a million new residents unless more responsibility is devolved. London's boroughs need to be given greater power to help develop the shared vision for infrastructure and growth, particularly in relation to transport.

Housing

15. For housing, three key considerations must be addressed as part of an effective policy. First the supply of homes must be adequate to meet current and projected future needs. Second the pricing and tenure of the housing stock must ensure that homes are accessible and affordable to the full range of needs that must be met. Third the size, condition and energy efficiency of homes must be appropriate to meet these needs without creating unreasonable problems of overcrowding, squalor or fuel poverty. New housing must also contribute to meeting carbon reduction commitments. Each of these requirements overlaps to some extent with the others. For example, as can be seen from current experience in London, a shortage of supply exerts upwards pressure on rent levels particularly in the private-rented sector, which in turn has impacts on access and affordability. These requirements also raise interesting questions of definition. In our view it is clear that housing need has long since exceeded supply. The emphasis on supply being sufficient to meet needs rather than demand is deliberate and necessary in a city which has seen a rapid growth in population over the past 20 years (caused both by natural expansion and immigration). London is a magnet to incomers from all over the UK and worldwide. Many of these incomers bring skills and entrepreneurial aptitudes that will contribute very substantially to London's future economic success, but the capacity of the capital city to accommodate potential demand is limited.

16. Over the past decade, London's population has grown to 8.4 million people, but housing supply has failed to keep pace with this growth. London needs to build about 40,000 new homes a year, which is double the number that has been built over the last two decades. This mismatch between supply and need results in rising homelessness in the capital, a high proportion of households in temporary accommodation, the highest levels of overcrowding and the greatest disparity between average incomes and house prices. The cost of buying a home has risen to an average of £392,000, 60 per cent higher than in the rest of the UK, and home ownership in the capital has fallen below 50 per cent for the first time in generations. With buyers unable to access mortgages, more and more young people are in the private-rented sector, which now houses a quarter of all Londoners, double the proportion of 20 years ago and the only growing housing tenure. These tenants are paying more than ever, with rents having risen by one third since 2009. More than 360,000 households are on borough waiting lists and over 38,000 are housed in temporary accommodation. Even with optimistic assumptions about new house building in London it is estimated that the current housing shortage will have increased by around 249,000 homes by 2020[25].

25 London Councils, 'Meeting Londoners' housing needs: investing in housing infrastructure' p2 (http://www.londoncouncils.gov.uk/policylobbying/housing/supply/MeetingLondonershousingneeds.htm)

17. As well as helping to house London's increasing population, building new homes makes a significant contribution to job creation and stimulates economic growth. Housing helps the economy in two ways. First, through construction and subsequent furnishing it creates jobs and supports a wide range of suppliers in both London and the rest of the UK. Second, through the mix of housing provided, it can ensure a balance of supply to support the range of workforce that is essential to the economic and social wellbeing of the capital. London is distinguished from many other international cities by successfully housing a diverse range of people, with widely different incomes, all across the city. If there are not enough homes to accommodate the projected increase in London's professional and technical sector, London's economy could lose out. Analysis suggests that the greatest deficit in supply is in the mid and lower mainstream markets, homes at prices people working in newly created jobs can afford[26]. Over seventy per cent of London's businesses say that the lack of housing that is affordable is one of the most important constraints on London's economy[27]. The Confederation of British Industry has, for the first time, cited housing as a bigger barrier to growth in the capital than transport[28]. Failing to invest in London's housing will run the danger of choking off London's economic growth, and with it the growth of the UK.

Schools

18. In relation to schools, research by the National Audit Office shows[29] there will also be continued and substantial demand for investment, as London's school population increases from just under 1.1 million pupils in the system in 2011/12 to approximately 1.25 million by 2016/17. London Councils estimates that, based on current projections, London boroughs are facing a shortage of 118,000 primary and secondary school places up until 2016/17. The pressure on school places is at its most acute in London, where 42 per cent of all shortages in school places nationally will be found (although other areas also face shortages), yet London will only receive 36 per cent of the recent basic need capital allocation for 2013 to 2015[30]. The pressure that is currently felt most in primary schools will inevitably extend to secondary schools over time, with the result that both primary and secondary schools need to be expanded and new schools built to respond to growing demands.

Other infrastructure

19. Amongst others, investment in healthcare, energy, waste, and water supply infrastructure will also be needed. It is estimated that by 2015 demand for water will outstrip supply by over 20 million litres per day. In its written evidence submission, the City of London raised housing, schools, transport and sewerage as infrastructure priorities but also stated that:

"London needs to be forward looking in embracing [infrastructure for] new technology sectors and innovation, in particular in areas that would help to address pollution and energy concerns, for example sustainability and energy efficiency."

26 Savills, 'Spotlight on London's housing supply', 2012, p3

27 LSE, 'The case for investing in London's affordable housing', 2011, p3

28 CBI, 'London Business Survey', 2012, p14.

29 The NAO research concludes that "there are indications of real strain on school places". The number of infant classes with more than 31 children has doubled since 2007; that 240,000 of the new places required by 2014/15 are primary school places, of which 37 per cent are in London. Source: National Audit Office 'Capital funding for new school places'. See Figure 5, p20

30 London Councils, 'Do the maths: tackling the shortage of schools places in London', p3

FUNDING FOR INVESTMENT

20. The different sectors in which capital investment will be required have a variety of governance and funding mechanisms, but broadly can be divided into the regulated utilities, the private sector and the public sector[31].

21. The regulated utilities, water, gas, electricity, and telecommunications, are all able to borrow relatively cheaply on capital markets and repay borrowings from user charges. These markets do not always provide sufficient goods and services to meet demand, but at least the model of having a regulated asset base enables borrowing against clearly identified future revenue streams. Furthermore, because the regulatory system guarantees a return on efficient investment, regulated utilities are able to finance their activities at a relatively small margin above the cost of government borrowing.

22. The private sector model of investment (to make returns for those providing capital) is also straightforward, although in some instances suffers from market failures, including public goods that the private sector cannot provide, and social inequities that require state intervention.

23. Public sector sources of investment are less straightforward and have in the past comprised a mixture of central government grants, Public Works Loans Board (PWLB) borrowing, the private finance initiative (PFI), and individually negotiated funding packages for specific projects. Investment sources are very heavily departmental in nature; new schools, hospitals, homes and major transport schemes are all nationally funded by separate central government departments through ring-fenced grants. This fragmentation makes co-ordination of investment decisions across sectors difficult, which can increase inefficiency and reduce effectiveness. Furthermore, while public sector bodies have the lowest cost of finance, additional investment leads to pressures on the overall public finances, tending to discourage sufficient investment. At present, there are examples of joined-up investments at the local level, though this is generally because of local ingenuity rather than central government consistency. This no more than ‘satisfactory’ outcome, however, has derived from the delivery of schemes conceived and funded in rosier times for the UK’s public finances.

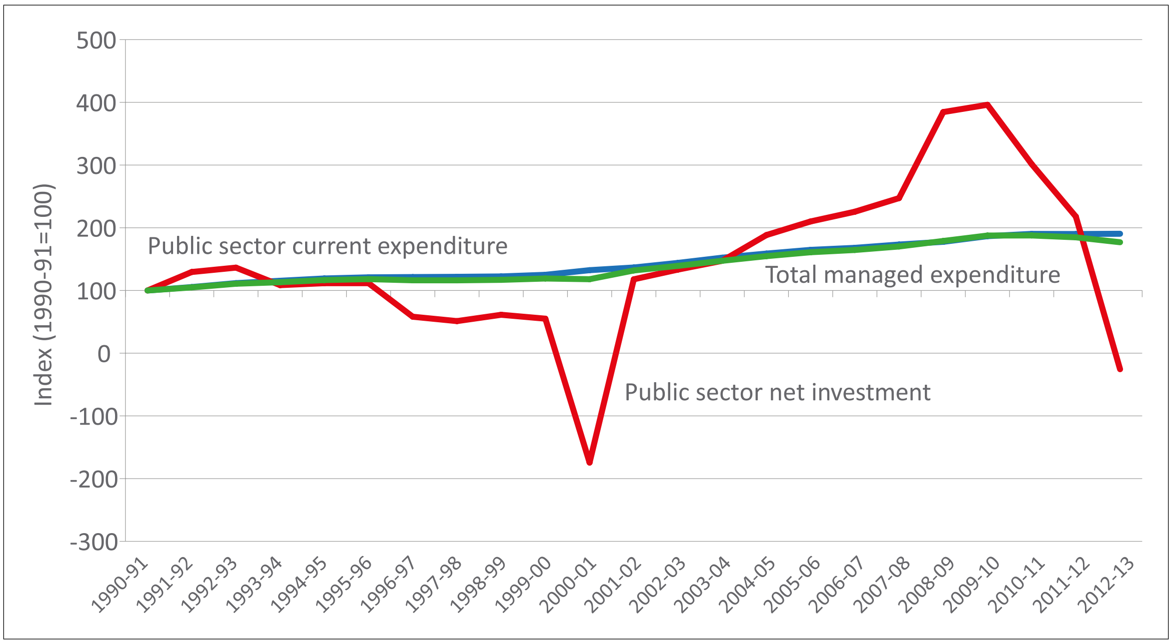
24. Ensuring the prioritisation of long-term investment can be difficult within a political process that is often more short-term in perspective. Successive governments have favoured consumption over investment, a problem that has been exaggerated by increasing pressures on revenue budgets in recent years; as the effects of cutting capital expenditure are not immediately visible, capital budgets can be more vulnerable than others. Although we welcome the Government’s explicit decision to increase capital investment[32], we note still that overall capital investment has declined[33]. While investment in transport has improved in recent years (though remains sub-optimal, please see the case study of Crossrail below), pressures on the system will intensify in line with population and economic growth. As discussed above, investment in many kinds of infrastructure has been insufficient.

31 See Figure 2 on p24 of the London First Infrastructure Commission report (http://londonfirst.co.uk/wp-content/uploads/2012/09/London_First_Infrastructure_Commission_report_-_EMBARGOED.pdf)

32 With the March 2013 Budget announcing that the Government will “increase capital spending plans by £3 billion a year from 2015-16, to lock in recent increases in capital spending over the Spending Review 2010 period, funded through reductions in current spending.” Source: Budget 2013, Executive Summary, p4, (http://cdn.hm-treasury.gov.uk/budget2013_executive_summary.pdf)

33 Public Sector Net Investment expressed in 2011/12 prices declined from £51.2 billion in 2009/10 to £28.7 billion in 2011/12. Source: Public finances databank March 2013.

Figure 1: Government capital investment over time



Source: Office for National Statistics (Public Expenditure Statistical Analyses, 2012)[34]

25. Furthermore, funding bigger and one-off capital projects has rarely been considered effective or satisfactory. Putting together the funding for Crossrail was a difficult and protracted process, and other transport schemes are still experiencing difficulties, although the Mayor has recently devoted a £300m fund from TfL's overall budget to assist transport schemes that are necessary for housing and business growth. Other major schemes, though, such as Crossrail 2, will still require equally innovative funding methods.

34 With permission, taken from the report: Travers, T. (2012), 'Local government's role in promoting economic growth, Removing unnecessary barriers to success' (an independent report commissioned by the LGA), p11

Crossrail: a case study

A version of Crossrail was first put forward in the 1940s and proposed formally in 1974 following a joint Government and Greater London Council inquiry. However, after many years of development, a Government backed private bill fell at the Committee stage in 1994, ostensibly on the grounds that an insufficiently strong business case had been made. Crossrail was revived in the early 2000s and both Mayors Livingstone and Johnson led sustained lobbying campaigns over the following years. Numerous reports were written and inquiries held and the Government only finally decided to fund Crossrail in October 2007[35].

The green light was given two years after the Crossrail Bill had started its long passage through Parliament. Purportedly it had the longest run of any Bill in Parliamentary history, from 2005 – 2008. The Business Rates Supplement Act 2010 enabled a core part of Crossrail's funding, empowering the Mayor to establish a special hypothecated tax, the business rate supplement[36]. A further campaign was led by the current Mayor in 2010 in order to reconfirm the decision of the previous Government. Thirty-five years after it was formally proposed, Crossrail's construction finally began in 2009, but services are not due to start until 2018, nearly 80 years after the scheme was first suggested.

It is almost certain that such projects would be delivered more quickly were there to be greater local autonomy both to decide and finance them. It is hard to imagine the process being any slower[37].

CONCLUSION

26. In our view, London government would consider investment in infrastructure more of a priority than central government does, for reasons of accountability; the electorate in London has a more acute appreciation of infrastructure because of its centrality to their lives and London politicians are therefore more likely to address infrastructural problems.

27. Data on the investment needs for the city are still contained in a number of different documents, and no comprehensive assessment exists, which partly reflects the variety of organisations and investment regimes described above. The GLA's *London Plan Implementation Plan* attempts to bring together many of the different regimes that operate in London. However, a more comprehensive funding and financing plan is needed, with requirements for key stakeholders to pay regard to the capital's needs and report progress. London government should take greater responsibility for infrastructure in the capital, potentially through commissioning powers being delegated to borough level.

35 Depending on various assumptions, the range for Crossrail's transport benefits (net of costs) has most recently estimated to be between £5-10 billion with wider economic benefits between £4-8 billion. Its benefit cost ratio is appraised at between 2-3:1 (see the Department for Transport's 'Crossrail business case update: summary report 2011'). This strong business case has not altered significantly since work done from the early part of the last decade.

36 In 2010, the Mayor of London used the power granted under the Business Rate Supplement Act to establish a 2p in the pound business rate supplement for Crossrail for premises over £55,000 in rateable value. This supplement is projected to provide £4.1 billion, or over one third, of Crossrail's total funding requirement of £12.3 billion (TfL 2013/14 Business Plan).

37 Although beyond our remit as a Commission, we consider that the wider system for delivery of large infrastructure projects may also require reform.

RECOMMENDATIONS

R1: Our overarching recommendation is that funding arrangements in London should allow London government to make additional self-determined investments in its own infrastructure both to cater for the growth already forecast for its population and economy, and to promote additional economic growth. Relaxing restrictions on borrowing for capital investment while retaining prudential rules and simultaneously devolving the full suite of property tax revenue streams will afford London government greater autonomy to invest in the capital. Such reforms would also increase London government's accountability to residents and businesses. Change would be achieved without affecting the financial settlements of other parts of the country.

R2: We recommend that the Government should require the Mayor, working with London Councils, the boroughs and the London Enterprise Panel, to develop and maintain a long-term, high level capital investment plan for the city. This should set out the costs of strategic investment options and match them to the resources available both now and in a more devolved future. The Mayor should be required to report progress against this plan to increase accountability. This exercise would help bring out gaps in available funding, and, indirectly, help to clarify further roles and responsibilities. Such work should be done with the support and involvement of Infrastructure UK at the national level and the boroughs at the local level, including the information prepared for Community Infrastructure Levies.

R3: The Government should require the utility regulators to have regard to the London Plan and the high level investment plan recommended here, in consultation with businesses.

R4: We further propose that the Mayor of London should have a wider responsibility as a champion of all infrastructure planning for the capital, but should also look wherever possible to delegate powers to London's boroughs to act as commissioners of local infrastructure projects thereby increasing the overall infrastructure capacity across the capital.

PART 3, CHAPTER 2

Funding and incentivising growth

1. In order to provide the infrastructure necessary for London's growth, it is clear that London government as a whole must have greater access to finance to enable it to invest for the growing city, as well as ways to incentivise additional growth in ways that can fund further projects. In this chapter, we discuss the delivery and financing mechanisms that could be applied to the identified investment priorities.

FISCAL DEVOLUTION

2. Fiscal devolution should act as a powerful incentive to promote, sustain, accommodate and speed up London's projected rate of growth. The Government's own independent appraisal of the 2013 business rate reforms indicates that, on average, there would be a beneficial GDP impact across England of between £2 billion and £20 billion over seven years[38]. Such an increase in GDP is significant given the limited nature of the incentives introduced. Following the logic of business rate retention, if even greater fiscal authority were devolved to London, the city's government would be given a still more powerful incentive to develop the economy.
3. Such fiscal devolution would enable London government to borrow more within its own prudential borrowing framework and thus to deliver additional and more appropriate projects. It would also allow London to set more of its own priorities, with due regard to central government policy and best practice, but without slavishly bidding for central government funds. With even a limited form of fiscal devolution, there would be greater ability to allocate resource funding to capital investments both directly and by building up reserves.

'EARN BACK'

4. Though the logic of the April 2013 business rate reform represents a starting point, there is clearly scope for London to retain more of the resources it raises in order to usefully reinvest them, building on the initiative of the Manchester 'Earn Back' scheme.

38 DCLG, 'Business rates retention scheme: The economic benefits of local business rates retention', p4, (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/11472/2146726.pdf)

Greater Manchester 'Earn Back'

Greater Manchester received agreement in principle for its 'Earn Back' Model as part of its City Deal in 2012. It uses a formula, linked to changes in rateable values over time at the Greater Manchester level, to provide a revenue stream to Greater Manchester over 30 years if additional GVA is created relative to a baseline. It provides an additional incentive for Greater Manchester to prioritise local government spending to maximise GVA growth. If successful in driving economic growth, Greater Manchester will receive a larger proportion of resultant tax take generated from this growth than would otherwise be the case under business rate retention.

The 'earned back' resources are the to be used for further investment, similarly prioritised on net GVA impact at Greater Manchester level. This will create a revolving fund which rewards Greater Manchester for delivering growth. Investment will be funded up-front by Greater Manchester, and Government will only surrender revenues once Greater Manchester's investment has generated value above an agreed baseline from 2015-16.

The model is expected to have a substantial impact on Greater Manchester. The locally funded element of the programme will deliver a short-term boost to demand in excess of £2bn by 2016 and in the longer term the forecast economic impact of the local contributions exceeds £1bn per annum by 2025. At least 25 per cent of the impact comes through productivity gains and given that these benefits are net at the Greater Manchester level, a significant proportion of the remainder will also be net at the national level. In addition, operating at Greater Manchester level will eliminate displacement from elsewhere in the city.

5. Following the logic of the Greater Manchester agreement, it should be possible to develop a pan-London (and/or a series of sub-London proposals) such that, if agreed employment forecasts were exceeded, London would benefit from a proportion of the resulting additional tax revenue and foregone public sector costs such as welfare payments. The ability to make such agreements would create the opportunity and incentive for London government to develop policies, programmes and projects intended to produce a higher level of tax and lower public spending than would otherwise have been the case. Both London and national government would benefit from this increased revenue and reduce expenditure. Clearly, there could also be risks with such an approach if targets were not met, for example the London economy might underperform as compared to the UK as a whole or the devolved tax base might shrink for some reason. But, notwithstanding such risks, we consider that the Government and London should explore more radical approaches to building incentives for London government into the tax system, similar to those proposed for Greater Manchester. At the very least, the logic of Greater Manchester's 'Earn Back' scheme provides a framework to consider more radical tax retention policies for London and other cities or city regions.

TAX INCREMENT FINANCING

6. Another model that can be used to unlock growth is TIF. This mechanism is well established in the United States for promoting growth in regeneration areas. It has recently been endorsed by the Government in the UK, although its use is heavily regulated. There is a limit on borrowing against future business rate yield outside the new local government finance system of levies and resets (so-called 'TIF 2', which has now been re-styled as New Development Deals), and central government is placing a

nationwide limit of £150m over a three-year period, which is funded through a top-slice from the national pot of local government formula-based grant funding.

7. The principle of TIF is central to our vision for London, as the capital has clear potential for growth if it can finance the infrastructure it requires. The Government's support for the Northern Line Extension to Battersea, which will be funded by additional business rates as well as developer contributions, is a welcome endorsement of the TIF principle in practice. However, the evidence we received is strongly in favour of removing centrally imposed constraints on TIF; for example, the LGA stated in its evidence to us:

   'Tax increment financing offers considerable scope for generating growth that would not otherwise happen by expediting development where the main obstacle is the high upfront cost of enabling infrastructure.'

8. In our view, the Mayor and London's local authorities should determine which TIF projects to proceed with, within the prudential borrowing code. The potential for locally led TIFs would be increased through the devolved fiscal measures we propose in Part 4. Meanwhile, the Government should start with a presumption in favour of funding all TIF projects that can demonstrate net gains to the public finances as a whole (through, at the national and/or local level, increasing the tax yield or reducing public expenditure or both) after adjusting for risk. The high level of regulation in the UK has been justified in part because of practice in the United States, where some implausible projects have been endorsed. However, the situation in the US is very different; the TIF market there is far more mature, initial schemes having started in the 1950s and thousands more having been given the go ahead since the rapid expansion of the policy instrument in the 1970s, whereas in the UK it is not even in its infancy. There should still be a role for central government to oversee the overall portfolio of such projects and assess any systemic problems, but by far the biggest problem at present is the dearth of TIF projects that are currently underway.

IMPACT ON BORROWING

9. The Prudential Code is a well-developed framework for capital investment which has operated successfully for a decade and which applies to the GLA, TfL and local authorities. As the Chartered Institute of Public Finance and Accountancy (CIPFA) has stated in correspondence with the Commission:

   "the Prudential Code provides a framework to ensure that borrowing of local authorities for capital investment is affordable, deliverable and in line with local authorities' service plans."

The Prudential Code

The Prudential Code was developed by CIPFA as a professional code of practice to support local authorities in taking their decisions. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that Treasury management decisions are taken in accordance with good professional practice.

Local authorities need to demonstrate that their capital investment plans are affordable, prudential and sustainable. This performance is reported in a range of prudential financial indicators. The Prudential Code sets out the indicators to be used and the factors to be taken into account in making treasury management decisions. Authorities need to give consideration to the following when setting or revising prudential indicators:

- service objectives, eg strategic planning for the authority
- stewardship of assets, eg asset management planning
- value for money, eg option appraisal
- prudence and sustainability, eg implications for external debt and whole life costing
- affordability, eg implications for council tax
- practicality, eg achievability of the forward plan.

In order to carry out their duties under legislation in respect of affordability, local authorities are required to have regard to all those aspects of the Prudential Code that relate to affordability, sustainability and prudence. In particular the following prudential indicators are key indicators of affordability.

Looking ahead for a three-year period:
- estimates of the ratio of financing costs to net revenue stream
- estimates of the incremental impact of capital investment decisions on the council tax

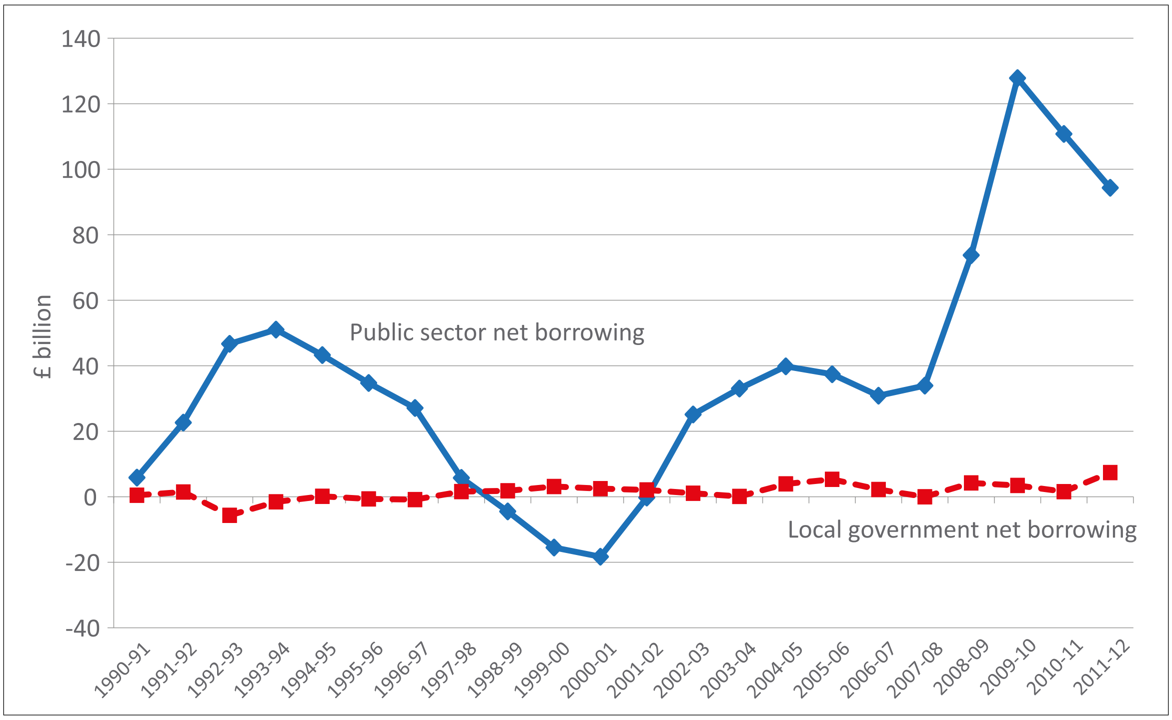
After the year end:
- actual ratio of financing costs to net revenue stream.

The prudential indicators required by the code are designed to support and record local decision making. They are not designed to be comparative performance indicators because local authorities had widely different debt positions at the time of introduction of the current system of self-regulation and differences may have increased over time as a result of local choices.

10. It is also widely recognised that borrowing by local government is always on the basis of affordability and always for investment generating social or economic returns, whereas borrowing by central government is often for current consumption.

11. Local government's finances must be seen in a wider context. UK sub-national government enjoys financial management of a high standard. It is governed by clear statutory duties on designated officers and a strong professional code of practice, its accounts are rarely qualified and its overall financial position is strong. Local authorities, unlike central government, cannot borrow to fund revenue spending. Local authority net debt was £45.3bn as at March 2012, or £53.7bn including long-term liabilities (eg PFI and finance leases). London accounts for about 10 per cent of these totals. Local government in Britain represents only a small fraction of the UK's total public sector net debt. Local authorities have to maintain appropriate levels of reserves. They have done so in the past and by international standards, therefore, have proved themselves to be consistent over time and also prudent.

Figure 2: Public sector and local authority borrowing



Source: Office for National Statistics[39]

12. Despite this prudence, local government saw some of the sharpest budget cuts in the 2010 spending review[40] and the sector has raised concerns over its continuing ability to resource its statutory services in the light of expected future spending reductions. The LGA's Funding Outlook for 2010/11 to 2019/20 explains:

    "…our model shows a likely funding gap of £16.5 billion a year by 2019/20, or a 29 per cent shortfall between revenue and spending pressures… On the assumption that demand in social care and waste are fully funded, other services face cash cuts of more than 66 per cent by the end of the decade. Assuming that capital financing and concessionary fares are also funded in full, the modelled cash cut for remaining services rises to over 90 per cent… which, in real terms, leaves practically no funding for them at all. Reductions on this scale would be highly likely to leave councils vulnerable to legal challenge. Many of these service blocks have statutory elements."[41]

13. These future budget uncertainties and its single, capped source of tax revenue mean that local government as a whole is unable to make significant investments of its own. Revenue constraints inhibit capital spending.

14. We consider that in London (and elsewhere), there is significant scope for delivering more consistent and cost-effective services at the local level. Further financial devolution would encourage this improvement to happen and, most importantly, would enable greater borrowing for investment that should catalyse growth.

39 With permission, taken from the report: Travers, T. (2012), 'Local government's role in promoting economic growth, Removing unnecessary barriers to success' (an independent report commissioned by the LGA), p13

40 The Spending Review 2010 forecast a -27 per cent cumulative real growth for the departmental budget of DCLG Local Government between 2010/11 and 2014/15, with funding for police and fire authorities excluded the Local Government DEL was forecast to fall by -28 per cent. Source: HM Treasury Spending Review 2010, http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf

41 LGA, 'Funding outlook for councils from 2010/11 to 2019/20: Preliminary modelling', p1 and p10 (http://www.local.gov.uk/c/document_library/get_file?uuid=c98405b7-b4a6-4b25-aebf-a63b5bcfa5c1&groupId=10171)

15. Furthermore, at least for the GLA Group, HM Treasury has sought to impose additional controls over and above the prudential borrowing regime. It has provided a schedule in the London Settlement letter which sets and limits GLA's non-Crossrail borrowing; and it sets explicit annual borrowing ceilings for TfL[42]. We believe these should be removed (see below for housing finance).
16. Fiscal devolution would enable somewhat more local authority borrowing within the prudential regime. But it would also increase the temptation on the part of central government to introduce new controls to ensure that its borrowing targets are met. On an important point of national policy, we argue that London and other cities should not be further constrained in this way and that the Government should differentiate between debts that are incurred for the purpose of delivering economic growth that will, over time, enable them to be repaid and, on the other hand, borrowing to fund general government debt. Local government cannot currently differentiate in this way between borrowing for different kinds of expenditure.
17. Capital investment is a priority in London, a large and growing city. If London became more capable of fiscal self-determination it could have the freedom to decide the proportion of its resources to devote to investment. A city which depends heavily on physical infrastructure will be more likely than the country as a whole to spend on investment rather than consumption. The capital should therefore be able to borrow as much as it can prudently afford, without any further intervention**,** an approach that could also be adopted for other cities. The Government could, of course, oversee these kinds of growth-promoting local investments but it should not constrain them.
18. It would be important to ensure that if London were given greater freedom to invest in infrastructure which was intended to generate increased economic output that it would not be subject to pound-for-pound reductions in its spending power. In its written evidence submission, the London Borough of Islington stated:

    "There may even be a case for a separate revenue funding settlement for London […] which more closely reflects London's needs and contribution to the national economy although this would need detailed discussion to ensure an appropriate balance between the interests of London and the rest of the country – work on this could be aligned on any review of Barnett funding affecting the devolved administrations."
19. Central government's existing mechanisms to control public expenditure operate in such a way that no area of the country can spend in excess of HM Treasury-imposed limits. There is modest freedom within 'local self-financed expenditure', but only at the margins of overall spending. The proposals we make here can only be effective if any additional growth generated as the result of reform can be held locally and re-invested. The recent report from the House of Commons Political and Constitutional Reform Committee proposed a constitutional codification of relations between central and local government[43]. Such a move, if it occurred might allow London (and other) areas greater autonomy to hold resources generated. Alternatively, it might be possible to ring-fence London's grant support using a Barnett Formula-type mechanism. It would be essential that if greater autonomy were granted there should be no clawback of resources if there were additional growth and expenditure above what would otherwise have been the case.

42 London Settlement letter, http://www.london.gov.uk/mayor-assembly/gla/spending-money-wisely/budget-expenditure-charges/the-mayors-budget-for-2013-14

43 Political and Constitutional Reform Committee, 'Prospects for codifying the relationship between central and local government', Third Report, Session 2012-13 42

HOUSING FINANCE

20. As discussed in Part 3, Chapter 1, capital investment in housing is failing to meet need. Responsibility for overseeing, planning and delivering housing in London is shared between the Mayor and the boroughs. There have been welcome moves towards greater devolution of housing and regeneration responsibilities through the GLA Act 2007 and the Localism Act 2011, both to the Mayor and to local government. However, these reforms do not go far enough and both tiers of London government will find it increasingly difficult to meet their strategic priorities and to maximise opportunities to increase supply because of the constraints that remain. We consider different solutions below that would help to increase housing provision.

Stable investment in housing

21. Only stability of funding can deliver stability of housing supply. The GLA is now able to invest directly in housing for the first time in its history, complementing its existing powers on planning and infrastructure. However, funding for many housing programmes continues to be allocated on a piecemeal, short-term basis by central government. London's ability to increase the supply of new homes of all tenures will only be optimised with long-term and stable financial resources such as through devolved property taxes.

22. London's boroughs could also become important players in the delivery of new homes following the 2012 reform of the HRA system. The settlement left London boroughs with significant borrowing headroom of £1.4 billion but the government has imposed a fixed cash limit on HRA debt which prevents sustainable borrowing for investment, including for new housing development.

23. We recommend the removal or revision of boroughs' debt caps, which could generate a significant increase in council house building and deliver complex estate regeneration projects. This does not open the door to unrestricted or unaffordable borrowing as the boroughs would remain subject to both prudential borrowing limits and the rigour of the long-term HRA business plans, which were a further feature of the 2012 reforms. Indeed it is estimated that the increased borrowing would be modest compared with government borrowing overall[44]. It would, however, allow for a significant and affordable investment in new housing schemes, which would both help meet needs and contribute to economic growth.

The longer-term: shifting from personal to building subsidy in housing

24. Direct subsidy for development has been a feature of British housing policy since 1919. From the 1970s onwards, the nature of housing subsidy has been characterised by a steep decline in 'bricks and mortar' subsidy, and increasing personal subsidies, of which housing benefit has been the dominant form for a number of years. Over the last ten years, London has received just over £17 billion of capital investment to build new or improve existing homes; this compares with a total housing benefit bill of £50 billion for the same period. It is, therefore, right to explore if housing benefit could work more strategically and be better aligned with the policy objectives of investment in affordable housing.

25. In response to our call for written evidence, we received a submission from IPPR which proposed that all capital and revenue housing expenditure allocated for London should

44 Heriot-Watt University and University of York, 'UK Housing Review 2013', March 2013

be devolved to London. This would move away from national rates and entitlements for housing benefit, in order to shift the balance in favour of house building. To afford London the power to invest in and shape the capital's housing market, it is proposed that devolved housing expenditure should be combined with greater borrowing powers against housing assets and future rental income. We encourage further assessment of the IPPR's proposals of this time, taking into account the considerations we make below.

26. While there is a case for devolving housing benefit to London, in view of wider welfare reforms, in particular the introduction of Universal Credit, devolving housing benefit in isolation would be problematic. There would also be transitional challenges in terms of how existing low-income households in the private rented sector would continue to pay their rent. Given that there is unlikely to be additional funding in the short term to mitigate the transitional costs, the relaxation of borrowing controls is the only obvious solution to enable the delivery of greater supply. This, over time, would allow reduced dependence on high-cost privately rented housing for low-income households. The broader devolution and assignment of property and other taxes is necessary as a long-term funding stream to repay debt and to enable London government as a whole to shift more of its resources into housing capital investment.

27. An additional challenge in any attempt to shift away from revenue to capital subsidy through control of benefit are the transitional consequences for low income households in receipt of benefit that continue to pay high rents while funds flow out of benefits and into home building. Additional funding would be required to mitigate these transitional costs.

CONCLUSION

28. We consider that London government should become, as far as possible, self-funding by retaining more of the resources it raises. At the same time we accept that, at least at the outset, this would lead to a proportionately lower grant from central government. Such a reform would give it greater incentives to create additional growth, with the autonomy to reinvest additional tax yields as it sees appropriate. This move would create the opportunity for London government to invest in projects that produce a higher level of tax, from which both London and national government would benefit. Moreover, the increased responsibility for spending more resources would likely lead to more scrutiny of spending decisions at the London level, arguably resulting in more considered and effective spending decisions over time. A more devolved system of this kind implies both a need to remove government borrowing limits on London government (while retaining the prudential borrowing code) and need to devolve revenue streams in the form of taxation to London government. The latter point is explored further in Part 4.

RECOMMENDATIONS

R5: The Government and London should explore more radical approaches to building incentives for London government into the tax system, similar to those proposed for Greater Manchester.

R6: The Mayor and London's local authorities should determine which TIF projects to proceed with, within the prudential borrowing code. The potential for locally led TIFs would be increased through the devolved fiscal measures we propose in Part 4. Meanwhile, the Government should start with a presumption in favour of funding all TIF projects that can demonstrate net gains to public finances as a whole (through, at the national and/or local level, increasing the tax yield or reducing public expenditure or both) after adjusting for risk.

R7: The Government should distinguish between borrowing that will be used to promote growth or reduce public expenditure and thus be repaid, and other kinds of debt.

R8: In light of the robust and effective prudential borrowing regime, GLA Group borrowing ceilings should be removed.

R9: Alongside the recommendations for fiscal devolution we make in Part 4, the Government should continue to allow local authorities to take independent borrowing and investment decisions within the prudential code, imposing no further constraints.

R10: A mechanism is required which will ensure that any reform made to London's fiscal and financing arrangements are not negated by government periodically adjusting grant resources available to the city beyond the reduction required at the point of reform to ensure there is no shift of resources between London and the rest of the UK.

R11: The borrowing limits for housing purposes for boroughs should be relaxed or removed. Prudential borrowing rules would still apply, as would the rigour of long-term HRA business plans.

R12: The devolution of housing benefit, or a related share of Universal Credit, to London should be considered, and the necessary transitional arrangements explored.

R13: We recommend that measures to shift public funding from personal subsidy to investment in built assets should be further explored. This will require an appropriate capital settlement for London from central government in future Spending Reviews and Budgets. It will also require appropriate revenue funding for the transition phase.

4 Fiscal powers

The previous section of this report sets out the increasing demands for capital investment in London and explains the shortcomings of the current system, which, in our view, is unlikely to provide the necessary infrastructure for London's economic and population growth. Part 4 considers in detail a number of options that would diversify London's revenue streams and afford it the autonomy to cater for its own spending needs in future. It makes a number of recommendations to improve London's financing system including through devolving taxes.

PART 4, CHAPTER 1

Introduction to fiscal devolution

1. Virtually all the evidence we have reviewed argues that London government could and should have greater financial autonomy, through tax devolution and assignment.

Tax devolution and assignment

At present almost all most taxes collected in the UK are paid to central government and spent and/or redistributed according to its priorities. Tax devolution allows sub-national government to raise some (or all) of its own tax revenues, delivering accountability and removing dependence on grant. But in some cases such reform has the potential to introduce distortions.

Local tax assignment is where a proportion of a national tax collected in a local area is assigned to the relevant tier of sub-national government, in place of some (or all) of its grant.

Benefits of assignment are that it is more transparent than a grant settlement, meaning central government can have less influence over spending decisions, and that it can generally provide a buoyant form of revenue. If growth in the yield of any assigned revenues can be held locally they can have an incentive effect because of the link between the taxes raised and the revenues available to the area concerned. Assignment does not introduce economic distortions because central government still controls tax rates.

However, assigning taxes does not increase the fiscal accountability of sub-national government, as the tax rates from which it is assigned a share are not determined locally. The system can be inflexible as sub-national government has to accept falls in tax receipts but has no power to adjust tax levels. Even in the event of windfalls, sub-national government may not have the power to pass benefits on to local taxpayers by lowering tax rates.

2. Any devolved or assigned taxes should be met with an equal and opposite reduction in central government grants at the point of reform, insofar as would be necessary to ensure fiscal neutrality at the outset, but with mechanisms in place to allow London government to retain any additional growth which may arise to re-invest over time.
3. Moreover, the international evidence we commissioned suggests London is a significant outlier as compared to other major cities. It is rare, if not unique, for city government to have as little fiscal freedom as London. There is also a powerful democratic argument for allowing sub-national governments a reasonable degree of autonomy. Unless sub-national governments have both an electoral mandate and the power to raise resources, there is a risk that over-centralised national government will operate in a way that precludes pluralism and innovation. London and other cities in England fall well short of respectable international standards in terms of their freedom to direct their own finances. We therefore believe there is an unanswerable case for additional fiscal autonomy in London, in ways set out in this section.

4. Substantial devolution would certainly improve the current situation against the principles we have adopted. In particular, it would:
   - improve accountability by linking more closely locally raised revenues to decisions on the use of those revenues
   - better align policy towards the needs of local areas, reducing for instance the number of grants with inappropriate strings attached
   - be more efficient and effective, reducing local government's need to bid to central government for funding
   - provide London government with greater autonomy
   - offer the scope for London government to simplify the system in the interests of transparency
   - rebalance the power dynamic between central government and the democratically elected leaders of the UK's largest and only global city.
5. It is evident that governance arrangements and mechanisms may need to be developed to accommodate our proposed changes in an appropriate way. We turn to the matter of governance arrangements in Part 5 of the report.

PART 4, CHAPTER 2

Emerging concepts of devolution to cities

INTRODUCTION

1. We have undertaken our work in full acknowledgement of the fact that devolution to English sub-national government has been modest at best, particularly in comparison to the increasing dynamic towards more significant devolution to Scotland and Wales. However, while Government responses and the concrete legacies of Layfield and Lyons were minimal, we welcome recent movements towards devolution to cities that have emerged in part from the government's business rate retention scheme and Lord Heseltine's 2012 review of local growth. In this chapter we consider the implications for London of these developments, and look to the further potential they present.

COMMUNITY BUDGETS

2. Community Budget Pilots, exemplified by the tri-borough project in London, are an excellent example of local leaders taking on the stewardship of place advocated by Sir Michael Lyons in his evidence to us and in his comprehensive review of local government finance. The principle of local autonomy to direct budgets and transcend Whitehall departmental rigidities is welcome and should be extended. Progressing from the experimental nature of the Community Budget Pilots towards 'single pots' drawn from existing Whitehall budgets is the logical next step in liberating sub-national government from unnecessary constraints, and we propose the further development of 'single pot' schemes in London.

   The London-wide level should not be discounted for some specific responsibilities, and we can see merit in exploring 'single pots' involving health, education, skills and welfare. But in the main it is important that 'single pot schemes' operate at the appropriate spatial level and it is likely they would generally be based on individual boroughs or groups of boroughs, such as the existing tri-borough arrangement in inner-west London. The West End Commission, set up by Westminster City Council and chaired by Sir Howard Bernstein, has proposed more effective joint working within central London, involving boroughs, the GLA, TfL and the Metropolitan Police. It states that: "a new leadership and governance model is required, but getting this right extends beyond the West End" [45]. We endorse this idea.

3. The evidence we received from local authorities and London Councils demonstrated particular interest in the further devolution of budgets for skills and employment programmes. The voluntary sector delivery organisation Tomorrow's People supported this approach in its evidence to the Commission, explaining:

   "The GLA has responsibility for discrete areas of public service such as transport and police, however, it doesn't have responsibility for unemployment and related benefits, for education or the criminal justice system, as these are managed nationally. This means that some savings gained by effective preventative work in London are enjoyed by national government, rather than at borough level. Any changes to financial arrangements must recognise that responsibilities will always be distributed across different layers of

45 West End Commission, Final Report, April 2013, p4, (also pages 27-34)

government. Should greater devolution of financial powers to London deliver savings, the GLA and boroughs should take advantage of that freedom to seek out preventative and innovative work. London-based spending offers more opportunity for innovative ideas and improved support through a flexible pot of money. […] Funding needs to allow third sector organisations, in particular, to work more responsively to local conditions and client situations and for this to happen, more financial power must be devolved from central to London's government."

CITY DEALS

4. City Deals are another welcome development. Concepts of recognising local differences, incentivising growth, ensuring robust governance arrangements and making confident offers back to central government are all prudent steps in building stronger sub-national tiers of government. The Manchester 'Earn Back' scheme is a particularly significant development, as it recognises the ability of local government to incentivise additional growth and allows the city region to retain additional tax yields created, beyond the business rate base (please see Part 3, Chapter 2).

5. London's scale, both economically and spatially, means a London City Deal would probably be inappropriate. However, our recommendations pay due regard to the principles of other City Deals, and the spirit of mature dialogue with central government about the capital's clear potential for growth underpins our recommendations. Moreover, the potential exists for City Deal-type approaches to be agreed between City Hall and groups of boroughs should greater devolution for London be secured from the centre. We believe there is a strong argument for the Mayor to develop a London version of City Deals, potentially brokering bespoke arrangements in specific zones of the capital**,** including some of the elements included in those agreed by DCLG for places outside the capital, such as transport or skills. The West End Commission's proposals could, for example, be met by a 'City Deal' type arrangement for central London. Other parts of the city would also be able to bid for equivalent status.

LORD HESELTINE: *NO STONE UNTURNED*

6. We support Lord Heseltine's approach to incentivising local growth in cities by dismantling central silos and transferring the power to determine growth-related spending to cities through a 'Central Growth Fund'. This proposal is consistent with our view and links to existing agendas around City Deals and Community Budget Pilots. His focus on transferring powers to use skills funding locally is supported by much of the evidence we received, and we would support a greater ability at the local level to incentivise better outcomes from skills funding.

7. However, while we acknowledge the sense of this pragmatic approach and are encouraged by the Government's acceptance of many of Lord Heseltine's recommendations, we believe that greater potential exists to move away from the top-down system of bidding for funding and approval from central government, towards more mature arrangements in line with those soon to be enjoyed in Scotland and which are already present in many comparable international cities. Our recommendations are ambitious but in line with London's economic potential.

CONCLUSION

8. Recent initiatives, as detailed above, are a prelude to more significant fiscal devolution, and as such they are welcome steps in right direction. The following chapters set out our ambitious recommendations for the next stage in the empowerment of London and potentially other cities and city regions.

RECOMMENDATIONS

R14: We recommend that central government should extend the remit and scale of Community Budget Pilots through 'single pots' devolved from existing Whitehall budgets.

R15: In our recommended model of London government, the Mayor of London should work with boroughs and groups of boroughs to create 'City Deal'-type initiatives within London.

PART 4, CHAPTER 3

Property taxes

1. The evidence we received and reviewed showed merit in and an appetite for greater local fiscal powers. In our view, the starting point for delivering such autonomy should be property taxes (business rates, council tax, stamp duty land tax and the new annual tax on enveloped dwellings and capital gains property disposal tax), which are to some extent under the aegis of local government already (including in their widest sense through existing Section 106 powers and the recent introduction of the Community Infrastructure Levy). Property taxes are suitable for local control because of their immobile bases, the fact they are easy to collect and enforce, and insofar as they relate to land, they are economically efficient. In the international cities we have reviewed, property taxes are largely devolved to sub-national government[46].
2. Evidence we received suggested that both the design and operation of property taxes in Britain are inefficient, regressive and subject to ad hoc reform. In addition, they work particularly awkwardly in London's property market. Stamp duty, for example, has a disproportionate impact in London, where the brunt of its burden is borne as the result of there being a large number of high-value properties in the capital. If wrongly handled Stamp duty could act as a block to economic growth and detrimentally distort the housing market. Many argue that reform of these taxes in the capital is required and, indeed, overdue. We believe that introducing the possibility of London-focused changes to these centrally-designed taxes could make London's property market work more effectively and, in so doing, promote additional growth.
3. In this chapter we include detailed proposals about how London government could take control of property taxes. We recommend that the full suite of property taxes (council tax, business rates, stamp duty, annual tax on enveloped dwellings and capital gains property development tax) should be devolved to London government which should have devolved responsibility for setting the tax rates and authority over all matters including revaluation, banding and discounts. The yields of these newly devolved taxes should be offset through corresponding reductions in grant to ensure a fiscally neutral position for the Exchequer, at the outset. If all property taxes were transferred to London government in this way, their yield would represent at least 50 per cent of the income required to fund all existing GLA and borough services apart from schools, which are now almost entirely financed by central grants.

BUSINESS PROPERTY TAXES

4. We consider business rates a good starting point for reform not least because, with their direct links to business activity, a well-designed system under local control would introduce potential incentive effects and could promote growth.

46 The research we commissioned from the University of Toronto demonstrated that Frankfurt sets a property tax; Madrid determines a property tax, a tax on construction and a tax on land value increase; Paris sets a property tax on developed land, a property tax on undeveloped land, a residence tax, a local economic contribution tax on business premises and real estate taxes on land transfers; Tokyo determines an inhabitant tax, a real property acquisition tax, a special tax on land holding, an urban planning tax and an accommodation tax; Berlin has a land tax (at city level) and a real estate transfer tax (at state level); New York determines real estate taxes, a hotel room occupancy tax, a commercial rent tax and a tax on the conveyance of real property.

Full retention

5. Apart from minor changes, the way the business rate system affects ratepayers has not changed significantly in recent years. However, a major reform to the system came into force in April 2013[47]. A dual system of redistributing business rates now operates, first through local authority retention of 50 per cent of their rates yield and, second, through a system of' top up' and 'tariff' payments against a fixed baseline. This latter arrangement was designed to stop a redistribution of resources at the point the new system was introduced. In addition, central government revenue support grants continue to be paid. While local authorities have welcomed the movement towards fiscal devolution that the new system involves, most have criticised it for being complex and bureaucratic. Incentives to promote economic growth are weak and no incentives are built in to develop and capture land values. Rather, incentives serve mainly to increase the amount of property stock, which puts highly developed urban areas such as central London at a disadvantage. Camden expressed the following view in its evidence to us:

   "The new business rates retention system offers the prospect of growth in business rates providing some additional funds for local government but again central government determines what is growth (physical growth) and what isn't (revaluation growth) and leaves local government with half of the former and none of the latter."

6. In London, we believe a number of steps need to be taken to improve the operation of retained business rates. We agree with the many local authorities and London First who argued that all of London's business rates should be retained in London, in line with the Government's original reform proposals which were subsequently watered down. We recommend that 100 per cent of business rates should be devolved to London government, through an appropriate governance mechanism, including the responsibility for the timing of revaluations. London government should be free to determine such issues as discounts and tax breaks, and should have the freedom to use business rates to undertake 'Enterprise Zone'-style interventions.

7. The London-retained share should commensurately increase and central government grants, at the outset, should reduce by an equal amount to ensure fiscal neutrality for the Exchequer. For 2013/14 this share is estimated to be £3.2bn.

8. Which grants, or mix of grants, would reduce and how the newly retained business rates would be split between the GLA and the boroughs would, of course, be decided through the proposed new governance arrangements and discussion with the Government. Such a reform could, for instance, dispense with the complex dual system of funding, involving retained business rates and grant, which the Government is currently operating. It would also double the incentive to support business growth and would result in London businesses funding more of London's expenditure directly. We agree with John Dickie of London First, who presented oral evidence to us, on the need for a combination of intelligibility and certainty in an improved business rates system.

47 From 1 April 2013 business rates in London are distributed as follows: 30 per cent to the boroughs, 20 per cent to the GLA Group and 50 per cent to DCLG. A system of 'tariffs' and 'top-ups' was introduced to equalise and protect authorities which might otherwise gain or lose from the 2013 reform. DCLG also continues to pay revenue support grant to local authorities from its 50 per cent share – another form of equalisation and protection which has evolved from the previous system, under which DCLG received 100 per cent of business rates and redistributed them. There are also protections for those authorities witnessing large declines in their business rate base (over 7.5 per cent per annum) and a levy on tariff authorities experiencing significant absolute growth compared to their funding baseline. Overall the system introduces an incentive for the GLA and local authorities to maintain and grow the business rate base.

Business engagement

9. Business voices have made it clear that they would prefer more of the business rates they generate to be used to fund services related to the successful functioning of the economy, such as transport, skills, housing, and other economic development activities. According to LCCI's report Driving Local Growth: the Business Case :

   "The success of Business Improvement Districts (BIDs) is proof that businesses are prepared to pay more in business rates, but only because firms know those taxes will go towards investment in their locality. If councils are permitted to keep a proportion of increases in rateable values, it is vital that they commit to developing a new relationship with their business community."[48]

10. In its written evidence submissions, the London Borough of Kingston Upon Thames also highlighted the success of the BID model in its local area.

11. We agree that businesses voices should have a place in sub-national governance and could productively offer advice to aid economic development. However, core local authority services will continue to be funded through business rates and local government will remain accountable for meeting residents' needs and fulfilling statutory responsibilities. In full recognition of the core role of local government, if London government were to take full control of business rates, it could provide local businesses with a greater opportunity to be involved in decision making about the use of the resources raised through their operations, potentially through the LEP but also directly with the boroughs.

12. Businesses and residents have demonstrated willingness to pay additional taxes and charges in recent years when properly consulted. The Crossrail business rate supplement, the congestion charge and the council tax precept for the 2012 Games, have mainly proved acceptable because they were ring-fenced for a particular purpose and because of the benefits they have delivered.

13. In order to ensure business buy-in, it would be possible to develop a mechanism for business ratepayers to trigger a referendum if they believed any annual increase in the multiplier was excessive, especially as we propose the local determination of the multiplier (please see below). We recommend that if business rates are localised in the way we propose then London government should put in place a scheme that would protect ratepayers from any perceived risk of unreasonably high rate increases, in consultation with business.

14. It is impossible to specify precisely which grants should be reduced if business rates were localised, given that they tend to change each year and, as stated above, such decisions should be made jointly by London government. However, we do recommend that any adjustments that are made should be such that, at the point of reform, the GLA and London boroughs would be no better or worse off than hitherto.

15. While specifying the use of devolved funds is beyond our remit as a Commission (this would be a political decision, subject to governance mechanisms agreed by the GLA and London Councils at the point of devolution) we have paid some thought, for illustrative purposes, to potential uses of a devolved business rate in order to demonstrate some possible effects and benefits. In our view, and only as an example, it is possible that as well as replacing revenue support grant in London, the GLA share of the additional business rate yield retained could substitute (in whole or in part) existing grants for

48 LCCI (2012), 'Driving local growth: the business case', p2

housing, transport or other of the Group's activities. Business rates are generally a buoyant tax whose yield would provide the GLA or TfL with a stable financial platform on which to plan over the long term, avoiding the vagaries of government Spending Reviews. Other devolved taxes discussed below could be used in a similar way as London government becomes increasingly self-funded.

16. It is important to emphasise, however, that funding TfL or other GLA activities through business rates would not detract from the funding of local authorities. London's boroughs deliver vital services, many of which are underpinned by statutory obligations, and these have always been, and continue to be in the new system of rates retention from April 2013, funded to a significant extent by the proceeds of business rates. The example above refers only to the GLA's share of the business rate and any future decisions on how business rates yield should be apportioned must recognise the on-going need for borough services to be funded appropriately. The decision about how to determine the reduction in grant support that would be required as and when local fiscal power was increased would have, in the last resort, to be made by London government jointly and by agreement.

Setting or varying powers

17. We have also considered whether or not London government should be able to set or vary the main business rate. Evidence was mixed on this matter; some supported the full localisation of the business rate, others have been adamantly opposed. On balance, we support London government having the ability to vary the main rate across Greater London, with robust governance arrangements in place and in consultation with local authorities, the LEP and businesses directly, as this would substantially improve the autonomy and accountability of London government.

18. At such a time that business rates were wholly retained in London, alongside other property taxes (as we recommend), London government should set the business rate multiplier in London, again in consultation with appropriate stakeholders[49]**.** The business rate multiplier would be linked to the rate of council tax. There would also need to be arrangements to ensure that all boroughs were treated equitably by the locally determined business rate.

19. Other parts of the UK currently receive income from London's business rates via the tariffs and top up system and levies on central London authorities. In light of our principle of fairness, we have therefore considered whether or not this proposal would be detrimental to the rest of the country; overall, we have concluded it would not be so long as grants were adjusted appropriately. At the point that the reform came into force, we propose that changes should be fiscally neutral for the Exchequer by balancing any gains from additional business rates retained with reductions in grant that would otherwise be allocated to London. In any case, central government would still be responsible for the overwhelming majority of all tax revenues. A business rate pool or additional tariffs and top ups would ensure that London dealt with its own equalisation. Separating London's business rate from the rest of England would bring potential longer-term risks and opportunities both for London and the rest of England. Therefore, we consider that our proposal would increase the momentum for further devolution of powers and responsibilities, which would be a welcome development.

49 The City of London can set its own business rate because of its unique circumstances, being a major financial and business district with a small number of residents. We recognize that any reforms would need to take into account its particular requirements.

National reforms

20. We also received evidence that the business rate retention system does not incentivise action by local government to improve property values through, for instance, public realm improvements, only the amount of stock. Major increases in business rate values can indicate wider economic regeneration, often on a very local scale, and local authorities should have incentives to carry out this work. We agree with those who have suggested that, in the short term at least, the system could be modified to enable local authorities to specify and benefit from valuation rises in 'investment zones' within their overall areas. The London Borough of Camden put forward a proposal in its evidence submission that should be considered further:

    "Measures to revitalise high streets for example can include environmental and public realm improvements and crime reduction initiatives. If successful these measures will result in greater footfall, more trade and higher profits for the businesses in the area which in turn will result in time in an upward revaluation in rateable values. It is perverse that the local authority investing in these improvements will receive no benefit from this revaluation gain. We would suggest that authorities should be able to apply for streets to be designated as Local Action Zones in which they will invest in the public realm and that the local authority should benefit from any above average revaluation gain that results."

21. Over time, we also consider that there is the potential to reform business rates along the lines of the Mirrlees Review so that it becomes a genuine business land tax based on real-time valuations (rather than periodic revaluations)[50].

Taxation of derelict and undeveloped land and property

22. In his review of local government finance, Sir Michael Lyons recommended that *"the Government should develop proposals for the taxation of derelict property and brownfield land and consult on those with stakeholders."*[51] We consider that his overall objective to bring underutilised land and property into more economic uses was right. However, we believe it would be more appropriate for the Mayor and London's boroughs to develop proposals, rather than central government. We recommend that further assessment be undertaken of the potential benefits and costs of new taxes such as these as part of the wider reforms of property taxation that we advocate.

DOMESTIC PROPERTY TAXES

Council tax

23. The taxation of domestic property in England is in a state of complex evolution. Council tax, which was introduced in 1993, is regarded by national politicians as awkward and unpopular, mainly because of its visibility in comparison to many other taxes. Even though it represents less than five per cent of UK tax revenues, it has become heavily politically contested, in the sense that ministers, shadow ministers and think tanks comment on local tax levels and the behaviour of councils in a way that does not occur for other, often larger yielding taxes.

24. Since 2011-12, council tax in London and elsewhere has been operated in such a way that councils set their annual tax increases at or below a central government-determined level. If they wish to increase council tax above this level, a referendum is triggered, with

50 IFS, 'Mirrlees Review', Chapter 16.1.3 'Replacing Business Rates' p376 - 379

51 Lyons Inquiry into Local Government, Final Report, Chapter 8 'Business Taxation', p309

costs to be borne locally. The same Government that introduced the referendum has also brought in a paternalistic 'freeze grant' to reward councils for retaining previous levels.

25. In spite of irregularities in its design and operation, successive Governments have left it unchanged. For example, no Government has been willing to trigger a revaluation of the council tax base, with the consequence that the tax is now operating on the basis of valuations undertaken in 1991. Given how dramatically the property market has changed since the point of last revaluation, particularly in London, it would be surprising if, overall, a revaluation did not lead to a substantial number of London properties having higher relative values now (compared to the rest of England).

26. Unlike the domestic rates system that was abolished in 1990, council tax does not operate on the basis of a full range of values. Rather, all properties are attributed to one of eight bands of value, based on capital values in 1991. The ratio of tax paid from Band A (the lowest) to Band H (the highest) is 1:3. Thus, a home in a London borough with a 2013 value of £25 million is likely to pay just three times the council tax of one with a value of £250,000. The Lyons Inquiry suggested that council tax as a proportion of new household income fell sharply for those in the top income groups[52]. Again, this seems like an irrational way to operate a tax that in other ways receives so much 'corrective' attention from the Secretary of State for Communities and Local Government.

27. We accept that council tax is highly visible and politically-salient. But we also believe that domestic property tax has a continuing part to play in the system of public finance in London and that it must function efficiently and effectively. We recommend that council tax be retained as a local tax but that London government should be given the power and be required to hold periodic revaluations (undertaken by the Valuation Office, according to national practice), to determine the number of bands, to set the ratio of tax from band to band and to set the tax rate. A fully localised council tax of this kind would be part of a suite of local property taxes determined by London government.

Stamp duty land tax

28. Council tax is not the only tax on domestic property in use in the UK. Introduced in 2003, stamp duty is an Exchequer tax on property transactions levied on the buyer. Since its introduction, tax rates have increased (without the requirement for any referenda), in large part as a way of raising revenues (and, in our view, at least in part to make up for stagnating council tax yields in a less visible way). For properties worth in excess of £2m, the current rate of stamp duty is seven per cent. Because so many of the UK's most expensive homes are in London, the yield of stamp duty is disproportionately derived from the capital (33.3 per cent of the overall yield 2010/11, in a city that makes up only 13 per cent of the UK population), and 79 per cent of the yield from the seven per cent band.

Annual tax on enveloped dwellings, capital gains property disposal tax

29. From April 2013, a new annual tax on enveloped dwellings will be levied on company-owned homes worth over £2 million. There will be four bands, with the top band (for properties valued at more than £20 million) paying £140,000 per annum. Also from April 2013, capital gains tax will be chargeable on the disposal of high-value UK residential property. The charge will apply to companies registered both in the UK and abroad. In addition, UK companies will be liable for corporation tax on capital gains realised before April 2013[53]. The 2012 Budget explained that these changes were introduced to deliver fairness and to stop tax avoidance.

52 Lyons Inquiry into Local Government, Final Report, Chapter 7 'Household taxation and local charges', Chart 7.3 p 228

53 HM Treasury, 'Budget 2012', HC 1853, paragraph 1.195

30. London properties will produce the bulk of the yield from the annual tax on enveloped dwellings and the extended capital gains tax and from the higher rates of stamp duty. The estimated yield of each of these taxes and of council tax for London and the UK is shown in Table 2 below.

Table 2: Selected forecast tax yields in London and the UK for 2013/14 (£ million)[54]

	London	UK	London %
Council tax	3390	27400	12%
Business rates	6245	26700	23%
Stamp duty land tax	2567	7700	33%
Annual tax on enveloped dwellings	36	45	80%
Capital gains property disposal tax	20	25	80%

Sources: HM Treasury & Office for Budget Responsibility[55], Oxford Economics and GLA Economics calculations[56].

31. While it is evident that London, because of the number of high-value properties in the city, has become the target of new taxation, it is not clear what the overall purpose of the system of four taxes is supposed to achieve, nor are we convinced that these taxes work effectively for London. Council tax appears to be in decline, while the other three taxes have recently been introduced.

32. In our view, these four domestic property taxes would be appropriate for transfer to London government. The fact that a high proportion of the yield of the taxes aimed at high-value properties is raised in London suggests there would be a role for London government in managing the wider challenges that these new taxes appear to be attempting to tackle, such as fairness. As a Commission, it is beyond our remit to recommend how the domestic property systems should function. However, we do emphasise the important fact that if property taxes were transferred, London government would inherit the responsibility to decide how the system should work. If it chose to do so, it could rebalance the burden between domestic and non-domestic property taxation and offer exemptions or discounts where it saw fit, in a way that could promote growth.

33. Moreover, it would be possible for London government, with appropriate decision making structures in place, to manage the suite of domestic property taxes in a way that made it possible to decide on appropriate responses to matters such as revaluations and banding. As discussed above, we suspect that the failure to hold revaluations and to reset the ratio of council tax paid from band to band has produced a situation where the government has felt the need to add entirely new property taxes aimed at top-value homes. Had domestic rates continued to exist in their pre-1990 form, and had there been regular revaluations under that system, very high-value homes might well be paying council tax bills several times existing top council tax levels. The political reticence of national politicians to administer council tax properly should not be allowed to impede growth and distort the London property market in this way.

54 UK data is forecast by the Office for Budget Responsibility and taken from the March 2013 Budget. For London no such published forecast numbers exist for 2013/14 and assumptions have been made to forecast these numbers. For council tax, business rates and stamp duty it was assumed that the ratio of London's taxes to UK taxes would not change between 2010/11 and 2013/14 (which was seen as the most conservative realistic assumption to make), this ratio was then calculated from the published numbers for 2010/11 in the Oxford Economics report and applied to the UK numbers for 2013/14 to calculate London's values. For annual tax on enveloped dwellings and capital gains property disposal tax it is know that previously around 80 per cent of the yield from the top stamp duty tax band came from London and this ratio was therefore applied to the UK yield for these taxes to calculate London's values.

55 HM Treasury, 'Budget 2013', March 2013

56 Oxford Economics, 'London's Finances and Revenues'

34. In our proposed system London government would, therefore, be fully responsible for the operation and impact of council tax, stamp duty and other domestic property tax other than inheritance tax. It would be open to London government to make no reform at all, or, alternatively, to reform the operation and impact of the system. Such decisions would be made after the transfer of fiscal responsibility had occurred. Growth or contraction in the council tax base would be contained within London.

RECOMMENDATIONS

R16: We recommend that the full suite of property taxes (council tax, business rates, stamp duty, annual tax on enveloped dwellings and capital gains property development tax) should be devolved to London government which should have devolved responsibility for setting the tax rates and authority over all matters including revaluation, banding and discounts.

R17: The yields of these newly devolved taxes should be offset through corresponding reductions in grant to ensure a fiscally neutral position for the Exchequer, at the outset.

R18: Specifically, we recommend that 100 per cent of business rates should be devolved to London government, through an appropriate governance mechanism, including the responsibility for the timing of revaluations. London government should be free to determine such issues as discounts and tax breaks, and should have the freedom to use business rates to undertake 'Enterprise Zone'-style interventions.

R19: If business rates are localised in the way we propose then London government should put in place a scheme that would protect ratepayers from any perceived risk of unreasonably high rate increases, in consultation with business.

R20: At such a time that business rates were wholly retained in London, alongside other property taxes (as we recommend), London government should set the business rate multiplier in London, again in consultation with appropriate stakeholders.

R21: Further assessment should be undertaken of the potential benefits and costs of new taxes such as those on undeveloped land as part of the wider reforms of property taxation that we advocate.

R22: Council tax should be retained as a local tax but London government should be given the power and be required to hold periodic revaluations (undertaken by the Valuation Office, according to national practice), to determine the number of bands, to set the ratio of tax from band to band and to set the tax rate. A fully localised council tax of this kind would be part of a suite of local property taxes determined by London government.

PART 4, CHAPTER 4

Radical tax reforms?

1. This chapter considers options for the devolution or assignment of existing taxes currently set and collected at the national level, and explores options for new local revenues. It locates the debate about these taxes in the context of arrangements in other devolved administrations within the UK and international cities.
2. Devolving or assigning any taxes currently administered nationally would constitute relatively radical change from the current system but would be beneficial for London, according to research by the University of Toronto, which points to the benefits of cities having a portfolio of taxes at their disposal:

   "a mix of taxes would give London more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, and other factors. A portfolio of taxes also would allow London to achieve revenue growth, revenue stability, and equity."[57]

INCOME TAX

3. Income tax is levied on an individual's income above a threshold. It raises large revenues in London (£32.6bn in 2010/11 on a residence basis) and of all the higher-yielding taxes, it is the most obvious candidate for devolution. Many international cities derive income from a local income tax, including New York, Berlin, Madrid and Singapore. In the UK a precedent has been set in the Scotland Act, which introduced the Scottish rate of income tax[58].
4. However, potential problems are associated with the devolution of income tax[59]. Some international evidence suggests that higher rates of local income tax can have a detrimental effect on employment[60], and London's porous border may present scope for distortions[61]. The written and oral evidence received by the Commission did not demonstrate explicit support for a local income tax.
5. We consider that income tax is therefore not a priority for devolution; rather, the impetus should be for property taxes, which have a strong immobile base, to be devolved first (please see Part 4, Chapter 2). But at such a time, in future, that property taxes have been devolved to London, the option of devolving or assigning income tax to London should be revisited particularly as greater powers, for example in welfare, health or education, were in time devolved to London.

57 Slack, E. University of Toronto, 'International Comparison of Global City Financing', p25

58 From 2016, the Scottish rate of income tax will be calculated by reducing the basic, higher and additional rates of income tax levied by the UK government by 10 pence in the pound and adding a new equivalent Scottish rate set by the Scottish Parliament.

59 We accept the premise that the council tax will remain in place. Therefore, our deliberations about a local income tax do not follow the logic of the Lyons report, which considers a local income tax as a replacement of council tax and therefore concludes that it would unfairly shift the tax burden from the non-working to the working population.

60 Slack, E. University of Toronto, 'International Comparison of Global City Financing', p21

61 However, we considered that within the overall context of many other 'distortions' and geographical differences in the economy, eg created by the impact of school results, train fares and other factors on house prices, an ability to vary income tax at the margin may have a negligible impact on activity and not a harmful one at that.

NATIONAL INSURANCE, VAT, CORPORATION TAX

6. Although National Insurance Contributions (NICs), VAT and corporation tax are high yielding taxes (raising on a 'residence' basis £14.8bn, £12.8bn and £8.85bn respectively in London in 2010/11), we considered them unsuitable for devolution or assignment. VAT cannot be devolved because EU law prohibits varied rates within a member state, and its volatility anyway renders it unsuitable for assignment. NICs are not suitable because they are (theoretically, at least) hypothecated for nationally administered services such as pensions, which will remain at the national level. Corporation tax appears to be a potent lever for economic development and raises significant revenues in London, but there are a number of problems are associated with its devolution, including volatility, scope for distortions or a competitive 'race to the bottom', the challenge of state aid law and the difficulty of specifying geographical provenance.
7. Smaller yielding taxes may not significantly increase financial autonomy but could be used as policy levers, as suggested by the London Borough of Waltham Forest in its written evidence submission (new taxes could also function as policy levers, please see below). The Scotland Act devolved landfill duty to Scotland, and allowed for the option for further taxes to be devolved without the need for additional legislation, and aggregates duty and air passenger duty are being considered. Yet in spite of this precedent, we did not identify any compelling arguments to devolve smaller taxes to London at present. At such a time, in future, that London had greater financial autonomy, there may be a case to be made for devolving smaller taxes, such as air passenger duty and betting or gaming duties.

SMALLER NEW TAXES

8. The power to create smaller new taxes could modestly diversify London's revenue base, but new taxes are unlikely to yield large revenues. Rather they would be of greater application as policy levers, enhancing the achievement of objectives in service areas for which London government has some responsibility, either as an incentive or a deterrent, or through hypothecation for specific purposes.
9. We received evidence about a number of smaller new taxes, notably a tourist tax and environmental taxation. The international evidence we received suggested that all the other cities reviewed had one or more tax of this kind, including levies on sales, betting and alcohol. A tourism tax would seem to have particular potential in London because of the size and particular needs of the leisure and tourism industry. If the city's cultural, tourist and entertainment industry are to flourish, there is a powerful argument for a levy that could then be reinvested in marketing and urban realm improvements. Similarly, allowing London government to introduce levies on, say, environmentally detrimental or unhealthy activity could assist in delivering wider public good objectives. We support the maximum discretion for the GLA and London boroughs in the use of such levies.
10. The Scotland Act introduces permissive legislation to allow new taxes to be created in Scotland, when agreed by the devolved and Westminster parliaments, and similar powers have been proposed for Wales. We see no reason why new taxes should not be created at the London level and we recommend that permissive legislation should be introduced to allow each new tax to be considered on a case-by-case basis.

RECOMMENDATIONS

R23: London government should be able to introduce smaller new taxes, with the agreement of the Westminster Parliament. The Government should pass permissive legislation that would make such changes easy to implement.

R24: If greater powers are devolved to London over time, the assignment of income tax should be considered and should be viewed alongside more effective Community Budget or 'single pot' arrangements.

PART 4, CHAPTER 5

Fees and charges

1. This chapter assesses existing and new opportunities for fees and service charging. It summarises our discussions about these topics and sets out our recommendations.
2. At present local authorities are able to levy charges on discretionary services if no profit is made and providing they are not prohibited by other legislation. This logic is sound but ignores the fact that in many important cases legislation states that fees and charges will be capped, set centrally or prohibited. Evidence we received showed strong support for discretion around service charges. According to London Councils:

   "There are many services that local government has a statutory duty to deliver, but is required to charge for at a level determined by central government rather than local councillors. The result is that there are a number of services which leave councils with an overall net loss each year. This has always been perverse, militating against councils' ability to work effectively with businesses, help drive growth and it also often has other significant financial consequences for local taxpayers."

PLANNING APPLICATIONS FEES

3. Evidence we received highlighted centrally imposed caps on planning application fees as particularly problematic for local authorities and for some businesses. London Councils and the City of Westminster called for deregulation and the freedom for local authorities to be able to set fees that allow full cost recovery. In his oral evidence to the Commission, John Dickie of London First explained that the large businesses his organisation represents would be willing to pay the additional cost of swift, clear and high-quality advice from experts, as the cost of advice being given slowly and ineffectively is detrimental to business.
4. DCLG maintains that its 2011 Localism Act represents a dramatic shift of power to local areas, yet in our view, localism will underachieve if Whitehall can still exercise the power to set single national levels of charges for services delivered by local authorities, in the face of clear demand from local businesses and locally elected leaders. The Mayor of London has the power to set transport fares, despite their salience and scale of yield. Local authorities should have the same ability to control the fees they charge for discretionary services and recover full costs, and should be able to offer differentiated services where appropriate, for example if consultations show that small and large businesses wish to make different choices about planning applications. Though local authorities should be able to recover full costs, due regard must be given to the impact of increased fees on economic activity and especially the impact on small and medium sized businesses. We recommend that a flexible approach should be taken to ensure that cost recovery is implemented in a rational and appropriate manner reflecting local circumstances and service user profiles.
5. London Councils also highlighted charges for building control, land searches and licencing as other priorities for deregulation. We support such liberalisation and localism.

CONGESTION CHARGING AND ROAD PRICING

6. The Mirrlees Review considers current arrangements for motoring taxation, through fuel duty and vehicle excise duty, as badly targeted policy levers, which fail to adequately address the problem of congestion, and as ultimately unsustainable sources of revenue if petrol and diesel use is to reduce in line with greenhouse gas targets.

7. The Mayor already levies a congestion charge, primarily as a policy lever to reduce traffic, but Mirrlees recommends that this tool should be extended to replace other motoring taxes, even in spite of the clear difficulties associated with a task of this scale. As the report explains:

   "Introducing national road pricing would be a huge and complex undertaking. It would involve significant political risks. But the scale of gains available is enough to persuade us that further steps towards road pricing must be a priority. With the congestion costs of driving an extra mile varying dramatically according to when and where people travel, the current range of taxes is nowhere close to being able to reflect the costs that different motorists impose on others. Moving to a system of charges would also open up the possibility of changing quite radically how the highway network is owned and financed. Proposals to switch to a system of user charges for a road system owned, regulated, and charged for in much the way we currently charge for other utilities deserve to be taken seriously."[62]

8. We do not consider a major extension of congestion charging or road pricing a feasible option for the short term. However, we recognise the likelihood that in such an extended system London would generate high yields, as traffic volumes are relatively high in London (Glaister[63]) but could find that most of the revenue produced was absorbed by the Exchequer[64]. London government already has the power to use and extend road pricing and it would be a pity if, at some future point, central government imposed a national charging system which absorbed revenues into the Exchequer. We acknowledge the inevitable imperative to reform the taxation of vehicles and fuel, possibly leading to a national road pricing scheme. We believe such charges should be set and administered locally, with yields retained at the London level for use on roads and transport.

RECOMMENDATIONS

R25: The number of nationally set charges should be kept to a minimum; locally determined charges should be the norm.

R26: Local authorities should be able to recover full costs, even for charges set at the national level.

R27: In particular, central controls should be removed on planning applications fees, building control charges, land searches and licencing fees.

R28: In the longer term, London government should be responsible for administering any introduction of road charging that may replace vehicle excise duty, and yields should be retained locally.

62 IFS, 'Mirrlees Review', Chapter 10.2 'Taxes and Trading' p273-274

63 Glaister, S. Governing and Paying for England's Roads, p26

64 Glaister's report 'Governing and Paying for England's Roads' states on p56: *"the revenue neutral policy would generate somewhat less overall net benefit, but it would make road users as a whole better off because the revenues would be returned to them and the road network is more efficiently used. A major feature of the revenue neutral policy is that it would transfer considerable sums of money from urban areas to rural areas, particularly from London. Unless compensation was made, such as a change in the local government finance regime, the residents of the urban areas would, as a group, be made worse off. Since a majority of the population lives in or near the urban areas a consequence could be that a large number of people would be made worse off and a small number would be made better off."*

5 Relationships within and outside London

In this part of the report we consider the practical implications of the recommendations we have made. The measures we propose in Part 4 would constitute significant change and would therefore require fair, robust and resilient governance structures and mechanisms to ensure that the distribution of tax burden and benefit falls equitably across London's residents and businesses. Given London's place in England and as capital of the UK, we have also considered how our changes would affect the rest of the country.

PART 5, CHAPTER 1

Distributional and equalisation mechanisms

1. As stated in a number of places in this report, any proposals to reform the financing of London government create the inevitability of distributional consequences. If one or more taxes were transferred from central government to the GLA and/or the London boroughs, London government would have more income than before. Such a transfer would be made with the object of increased accountability and transparency. If the transfer of taxation to London were substantial, it is possible the total level of tax income available to the capital's authorities would exceed the existing total of tax-borne public expenditure. However, our proposals to transfer the control of property taxes to London would not amount to a sum greater than the total of existing GLA and borough expenditure.
2. In order to ensure that the Exchequer, and thus other parts of the UK, did not lose out as the result of any transfer of taxes to London there would need to be an equivalent off setting reduction in the grants received by London. With a reform of taxation which led to a position where London's local tax income exceeded existing tax-borne spending, it would be necessary for central government to transfer the responsibility for some services from the centre to London. On the basis of our proposals in this report it would not be necessary to make such transfers.
3. This report is making more modest proposals than a transfer of income tax, at least in the short term. But we accept that at the point of making the transfer of, say, property taxes from the Exchequer to London government there would need to be a reduction in grant paid to the capital's authorities. This off-set could be achieved either by reductions in the residual Revenue Support Grant or by changes to transport funding. A change of this kind has been made for all local authorities in 2013-14 to take account of the partial retention of business rates from April 2013. It would be easy enough for the DCLG to adopt a similar approach to London finance reform.
4. Equalisation between local authorities in different parts of England, though not between England, Scotland and Wales, has long been a feature of grant mechanisms. Differences in assessed expenditure needs and also in taxable capacity have been moderated by differential grant payments. From 2013-14 onwards, equalisation will have a much-reduced importance within the local government funding system. Authorities will generate additional resources by increasing their residential and business tax base, but not as the result of changes in needs or resources.
5. As stated above, the 2013-14 business rate reform provides a means for shifting taxes from central to local government without inter-area disruption. This is a means that could be adopted for any other transfer of taxes from the Exchequer to London. However, once a transfer had been made, there should be a Barnett Formula-style ring-fence around any further growth or contraction of the tax base within London. If the UK government periodically made adjustments to adjust for any 'gains or 'losses' that occurred over time, the incentives provided by the reforms we suggest would be reduced or lost.
6. The balance of funding between England, Scotland, Wales and Northern Ireland is not currently subject to any needs and resources equalisation. The Barnett Formula merely

adjusts the resources available to Scotland, Wales and Northern Ireland so as to reflect changes to the funding of England, taking account of changes in population. There have been no official estimates of changes in the expenditure needs or local taxable capacity of, say, Scotland in relation to England at any point since the Barnett Formula was created in the late 1970s. If London were similarly (to some extent) removed from England an analogous mechanism could easily, if desired, be put in place, such that London government can retain all the growth from its property tax base.

7. It is interesting to note that HM Treasury's figures, published in the annual publication Public Expenditure Statistical Analyses (PESA) show extraordinary stability in each nation and region's share of UK public expenditure. Despite the enormous energy expended on local government, NHS and other funding mechanisms each year, there is little variation in the indexed share of public expenditure over time. This stability of resource distribution suggests it would be possible to create a longer-term settlement between Whitehall and London within which the GLA and the boroughs could have greater freedom.

8. If there were a transfer of one or more taxes from the Exchequer to London, particularly if the boroughs took responsibility for a new revenue source, there would almost certainly need to be measures in place to secure a degree of fairness from authority to authority within London. Some taxes are very unequally distributed from place to place. The GLA and the boroughs would have to put in place a robust and formal institution for handling any distributional issues that resulted from reforms to the tax system. In the past there was a London Rate Equalisation Scheme which was put in place to bring about redistribution from central boroughs to the rest.

9. One of the advantages of England's complex and much-reformed local government system is that civil servants have always found it possible to invent mechanisms to allow any degree of redistribution deemed necessary. Unfortunately the nature of such mechanisms tends to inhibit both accountability and transparency.

PART 5, CHAPTER 2

Implications for wider London government reform

1. We have made a number of proposals to devolve taxes and other financial functions to London. If this were to occur, it would be necessary to make decisions about the allocation of new financial powers between the two parts of London government.
2. Such an allocation would involve an agreement about what it would be appropriate for:
   - the Mayor/GLA to determine alone
   - the Mayor/GLA and boroughs to determine collectively
   - the Mayor/GLA and groups of boroughs to determine collectively
   - groups of boroughs to determine collectively
   - individual boroughs to determine alone.
3. To secure formal and long-term agreement on such matters would require the development of new governance systems and structures that are sufficiently robust to cope with the variety of possible situations, but sufficiently simple to be efficient and without the need to invent additional structures as new and unforeseen situations arise. The purpose of such new governance arrangements is to provide assurance to all parts of London government and to increase effectiveness. It is possible to imagine some principles that should guide the creation of a system that meets these needs:
   1. Elected Leaders of all London local authorities and the London Mayor must have a stake in the success of London as a whole and all of London.
   2. The system must ensure that no one borough or groups of boroughs can be excluded from the benefits of London's success, or become powerless to address local needs.
   3. The interests of the Mayor cannot be over ridden by the boroughs, or vice versa.
   4. The system must enforce binding decisions and these decisions must reflect a clear consensus. This is likely to require less than unanimity, but significantly more than 50 per cent +1.
   5. The system must be broadly consistent with the sort of requirements central government might have in order to trigger such devolution.

   The result of these principles is likely to be complexity and so a further principle will be needed in order to meet central government's likely tests for good governance:

   vi. Arrangements must either prevent or break gridlock in decision making in order that all London leaders are pre-disposed to find agreement.
4. Governance systems are a means to an end and their value must be tested against that criterion. Local government has long experience of the challenges created by formula funding systems and the differing interests that they expose. With financial devolution these challenges are likely to re-emerge at the London level. The reason to consider governance now is to close off the risk that conflicting perspectives within London will undermine the additional value that can be created by financial devolution to London. The Mayor and London boroughs will have to determine how new arrangements work and which level of government is responsible for the new, devolved taxes. It is likely the Mayor would have significant responsibility for stamp duty and any related new revenues relating

to high-value domestic taxation. The operation and retention of council tax and business rates would have to be operated in a way agreed between the Mayor and the boroughs. In the longer term, similar agreement would be necessary if larger revenues such as income tax were assigned or transferred to London.

THE ROLE OF THE LONDON ASSEMBLY

5. As and when there is a significant reform of London's funding, for example the transfer of one or more revenues from central to London government, it is possible there will need to be a review of the Assembly's powers of scrutiny. If the Mayor assumed substantial additional taxation responsibilities it would be necessary to review the Assembly's powers with a view to enhancing them.

PART 5, CHAPTER 3

London within England

1. Our Commission, as its name suggests, was given a remit to consider the future of public finance in relation to London. But London plays such a significant role in any debate about the governance and funding of England, it is impossible to discuss it without taking note of the implications for the rest of the country. Indeed, changes to London's partly-devolved position could affect the whole of the United Kingdom.
2. We have been conscious in our debates that the kind of proposals we make in our report could equally apply to other major cities. Greater Manchester has evolved an impressive city regional government model from which London can derive lessons. In particular, the Greater Manchester 'Earn Back' arrangement, determined as part of the Government's City Deal policy has provided a precedent for London and other cities to make the case for a capacity to invest in order to generate additional tax revenues that can be held and re-invested locally.
3. Thus, proposals made in this report to give London access to a larger share of national revenues could also be applied to Birmingham, Greater Manchester, the Leeds City Region or other areas. Lord Heseltine's report 'No Stone Unturned' made the case for a form of devolution to city regions. We very much agree with his views.
4. We are conscious of the need to present the case for strengthened financial autonomy for London as one which other cities, towns and counties can support. The proposals in this report would not take resources away from anywhere else in England. What is proposed is that some taxes should be transferred to London and that others should be made available should London authorities decide to introduce them. Those that are transferred would trigger a pound-for-pound reduction in central government grant, though new taxes introduced by London alone, as is the case with the congestion charge and the business rate supplement, would not lead to any adjustment.

PART 5, CHAPTER 4

Conclusion

1. This report is not suggesting London should become a 'city state'. The capital's residents and businesses would continue to pay most of their taxes to the Exchequer. But, where a tax is transferred to London, we believe that any future growth or contraction in the tax base would be a matter for the capital. If the tax base grew faster than in the rest of the UK, London would be marginally better off than would otherwise have been the case. If the tax base grew more slowly than the UK average, the relative loss would be borne in London. Such is the risk involved in local autonomy.
2. Giving London, or any other city, a larger local tax base would provide an incentive for the city to build up its tax base. This is the logic that lies behind the Government's business rate reform, which took effect in April 2013. We believe that London authorities should also have greater freedom to determine tax rates, as is common in major cities internationally. The existing arrangements, where the GLA and the boroughs can only change local tax rates (beyond central government-imposed limits) by holding a referendum are not consistent with proper localism. In an era of tax competition, tax rates might go down or up. London's elected politicians should have discretion to set the level of the taxes for which they are responsible.
3. London will remain part of England and of the UK. But this continuing role within the country cannot mean there is no fiscal devolution. If London were given a bigger tax base and thus a greater incentive to drive economic growth, national tax revenues would also be higher. This is the prize for the country as a whole.

Annexes

ANNEX 1

Biographies

TONY TRAVERS

Professor, Department of Government, LSE

Tony is an academic specialising in city and local government. He has been an advisor to a number of Parliamentary committees and was a member of the Audit Commission. He has also held advisory posts at the Arts Council, the King's Fund and on the finance working group of the Urban Task Force. He is an honorary member of CIPFA and of the IRRV.

JOHN BIGGS

London Assembly Member for City & East

John is in his fourth term as Assembly Member for City and East London. He is a former leader of Tower Hamlets and has recently been selected as Labour's candidate for the Tower Hamlets Mayoral election in 2014. He chairs the Assembly Budget and Audit Committees. He has a keen interest in regeneration and his priorities this term include maximising the post-Olympic benefits for East London.

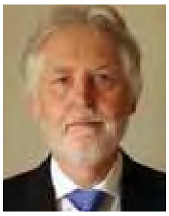
ROGER BRIGHT

Former Chief Executive, the Crown Estate

Roger Bright is currently Deputy Pro-Chancellor of City University, London, a Board member of London First, a trustee of The Heritage of London Trust and Chairman of the Advisory Board of the public affairs company Curtin & Co. From 1973 he occupied a variety of posts in the Department of the Environment, leaving the civil service in 1991 to become Deputy Chief Executive of the Housing Corporation, and subsequently working at the Personal Investment Authority and its successor the Financial Services Authority. He joined The Crown Estate as Director of Finance and Administration in 1999, becoming Chief Executive in 2001, a post he held for 10 years until he retired in 2011.

CHRIS DUFFIELD

Former Town Clerk and Chief Executive of the City of London



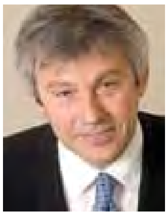
Chris Duffield has worked in London government for over thirty-five years. He was Chief Executive of the City of London for nine years. Prior to that, he worked for authorities including the Greater London Council and two London boroughs, where he undertook the roles of both Chief Executive and Director of Finance.

MIKE EMMERICH

Chief Executive, New Economy Manchester

Prior to joining New Economy, Mike was Director of the Institute for Political and Economic Governance at the University of Manchester and Dean of External Relations in the Faculty of Humanities. Before this, he pursued a career in the political and economic strategy sectors, at the Centre for Local Economic Strategies where he served as Principal Consultant and then Deputy Director from 1991 to 1996. After a period as a management consultant at Ernst & Young in 1997, he became a Policy Adviser with HM Treasury before becoming Senior Policy Adviser in the Prime Minister's Policy Unit.

STEVE FREER
Chief Executive, CIPFA



Steve Freer has been CIPFA's Chief Executive since 2000. Previously he had worked for three large local authorities – Birmingham, Nottinghamshire and Warwickshire – and in management consultancy. He has been involved in several prior reviews of local government finance. He was a member of the Balance of Funding Review chaired by Nick Raynsford (2003/04), an adviser to Sir Michael Lyons' Inquiry (2004/07) and a member of the City Finance Commission chaired by Sir Stuart Lipton (2011).

NICK HOLGATE
Town Clerk and Executive Director of Finance, Royal Borough of Kensington and Chelsea

Nicholas Holgate has worked at the Royal Borough since 2008. Before that he worked in HM Treasury, mainly on public spending, and in the Department for Culture, Media and Sport.

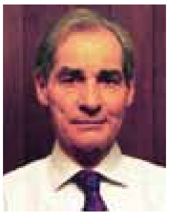
STEPHEN HUGHES
Chief Executive, Birmingham City Council

Stephen Hughes became Chief Executive of Birmingham City Council in May 2006. He has seen local government finance from all sides as policy advisor to local government organisations, running finance in Islington, Brent and Birmingham and seconded to the Department for the Environment, Transport and the Regions managing Council Tax Business Rates policy.

ALEXANDRA JONES
Chief Executive, Centre for Cities

Alexandra Jones has been Chief Executive of the Centre for Cities since summer 2010. Prior to this, she led Ideopolis, the Cities team at The Work Foundation. She has over ten years of experience working with national and local policymakers and with business to develop economic strategies. She has managed projects with a range of public and private sector clients on issues including the knowledge economy, public service reform, management and human capital. Previously, Alexandra worked as a private secretary for the Permanent Secretary at the former Department for Education and Skills and as a researcher at the IPPR.

GERALD JONES
Former Chief Executive, Wandsworth Council



Gerald retired at the end of 2010 after 24 years as Chief Executive of Wandsworth Council. After an early career of some seven years in the City and then the mining industry he moved to Haringey Council in 1972 and then on to Wandsworth in 1974 as an Assistant Director. He became Director of Policy Analysis and Administration in 1981 and Deputy Chief Executive in 1983, before moving onto the role of Chief Executive.

SIR STUART LIPTON
Partner, Lipton Rogers

Sir Stuart Lipton has been a commercial developer since the late 1960s and has been responsible for a number of large regeneration projects. He was the founding Chairman of the Commission for Architecture and the Built Environment and has been a board member of the National Theatre and the Royal Opera House. He chaired the City Finance Commission and more recently the independent review of Tottenham after the riots.

TERESA O'NEILL

Vice Chair of London Councils

Councillor Teresa O'Neill has been the Leader of the London Borough of Bexley since May 2008. In addition she is also Vice Chair (and Lead Member for Health) at London Councils, a member of the LGA Improvement & Innovation Board and Mayoral Advisor for Outer Borough Relations.

JULES PIPE

Chair of London Councils

Mayor Jules Pipe has been Chair of London Councils since June 2010, and Mayor of Hackney since 2002. He has overseen the transformation of council finances and the delivery of council services in Hackney over this time, reflected in rising resident satisfaction with the council, and the area as a place to live.

NICK RAYNSFORD

MP for Greenwich and Woolwich

Nick Raynsford is MP for Greenwich and Woolwich. As Minister for London (1997-1999) he was responsible for the Greater London Authority Act, establishing the Mayoralty and London Assembly. His subsequent Ministerial responsibilities included Housing and Planning (1999-2001), Local and Regional Government and the Fire Service and London Resilience (2001-2005). He chaired the Balance of Funding Review in 2003-04 and he now chairs the Centre for Public Scrutiny.

BEN ROGERS

Director, Centre for London

Ben Rogers is a writer, policy analyst and Director of Centre for London, which he founded in 2011. He was previously Associate Director of IPPR and has led strategy teams at Haringey Council, DCLG and the Prime Minister's Strategy Unit. He is a visiting research fellow at the Royal Society of Arts.

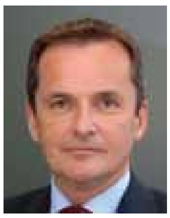
BRIDGET ROSEWELL

Senior Partner, Volterra Partners

Bridget Rosewell is an economist who has advised on the prospects for the London economy over many years and was Chief Economic Adviser to the GLA from 2002 to 2012. She is a founder and Senior Partner of Volterra Partners and a non-executive director of Network Rail and of Ulster Bank.

MARTIN SMITH

Chief Executive, Ealing Council



Martin Smith is Chief Executive of Ealing Council. Ealing serves a rapidly growing population of over 300,000 people – one of the largest in London and one of the most diverse in the country. Martin leads on the efficiency agenda on behalf of the Chief Executives of London's Boroughs. He is an unashamedly proud Londoner.

ANNEX 2

Terms of Reference

PURPOSES

The Mayor of London established the Commission to help him improve the tax and public spending arrangements for London in order to promote jobs and growth.

The Mayor wants the Commission to examine the potential for greater devolution of both taxation and the control of resources (capital and revenue) to achieve this goal.

OVERALL APPROACH

The Commission will hold an initial inquiry and report its findings by Spring 2013. Subsequent work by the Commission or others may then be requested by the Mayor depending on its findings.

OBJECTIVES

The objectives of the initial inquiry of the London Finance Commission are to:

- Describe and assess existing arrangements for government funding for London, including capital and revenue (and the relationships between the two, e.g. in PFI and borrowing powers available to local authorities). This exercise should assess how they compare to other countries, regions and cities internationally and in the UK and how revenues raised are distributed locally, regionally and nationally.
- Examine the relative scale and distribution of London's public expenditure, within the context of the wider South East region, with a view to considering the plausibility of a 'Barnett Formula' style settlement for the capital.
- Examine options for change, including the potential to devolve to London's elected leaders both more of the taxes Londoners and London businesses pay and greater control over public expenditure decisions. Appropriate checks, balances and accountabilities will apply and the roles of the different tiers of local government will be considered.
- Set out the benefits (with particular regard to promoting jobs and growth) and costs, and advantages and disadvantages, of lead options and make recommendations.

SCOPE

The scope of the review will not be limited other than by the purposes set out above. The Commission may consider all taxes raised and government expenditure incurred within London and make recommendations as it sees fit for improvements in accountability and local control.

MEMBERSHIP

Membership of the Commission is:

Chair:	
Professor Tony Travers	London School of Economics
Members:	
John Biggs	London Assembly Member for City & East
Roger Bright	Former Chief Executive, the Crown Estate
Chris Duffield	Former Town Clerk and Chief Executive, City of London
Mike Emmerich	Chief Executive, New Economy Manchester
Steve Freer	Chief Executive, CIPFA
Nick Holgate	Town Clerk and Executive Director of Finance, Royal Borough of Kensington and Chelsea
Steven Hughes	Chief Executive, Birmingham City Council
Alexandra Jones	Chief Executive, Centre for Cities
Gerald Jones	Former Chief Executive, Wandsworth Council
Sir Stuart Lipton	Partner, Lipton Rogers
Teresa O'Neill	Vice Chair of London Councils
Jules Pipe	Chair of London Councils
Nick Raynsford	MP for Greenwich and Woolwich
Bridget Rosewell	Senior Partner, Volterra Partners
Ben Rogers	Director, Centre for London
Martin Smith	Chief Executive, Ealing Council
Ex officio members:	
Jeff Jacobs	Head of Paid Service and Executive Director, GLA
Ed Lister	GLA Chief of Staff and Deputy Mayor for Planning
Dr Gerard Lyons	Chief Economic Advisor to the Mayor of London
Observers:	
Steve Allen	Managing Director, Finance, TfL
Martin Clarke	Executive Director, Resources, GLA
John O'Brien	Chief Executive, London Councils, London Councils
Jeremy Skinner	Senior Manager, Economic and Business Policy, GLA
Clerk to the Commission:	
Julia Harrowsmith	Senior Policy Officer, Economic and Business Policy, GLA

SECRETARIAT AND RESOURCES

The GLA will provide the secretariat to the LFC and will convene working and stakeholder groups as appropriate. GLA resources (and external support where necessary) will be made available to help the Commission to carry out necessary research. London Councils' research base will, by agreement, be accessed.

REPORTING AND TIMETABLE

The key milestones of the initial inquiry are expected to be as follows:

- July 2012: Commission meets for the first time to agree its Terms of Reference and commission its initial inquiry work
- December 2012: draft interim report
- Spring 2013: final published report

Thereafter, depending on conclusions and recommendations, an implementation timetable may then be set.

APPENDIX: RELEVANT MAYORAL MANIFESTO COMMITMENTS

The Mayor's manifesto committed to the establishment of a London Finance Commission to:

- *"examine existing and propose revised funding arrangements for the capital to put funding sources on a secure long-term footing; examine whether it is time we should keep more of the taxes Londoners pay in London (a 'devo max' solution similar to that being considered for Scotland)"*

And to:

- *"monitor revenues raised from people and businesses in Greater London and review their distribution, use and the comparative financial outcomes for Londoners compared to others in the UK, and providing the data needed to ensure that Greater London gets a fair deal."*

ANNEX 3

London's tax and spending

This annex summarises London's recent and projected financial contribution to the UK, the make-up of its expenditure and taxes and the uses and sources of public sector funding in the capital.

London has been a substantial net contributor to public finances. Oxford Economics have for many years researched the capital's contribution for the City of London demonstrating that:

"From the turn of the millennium up to the start of the economic crisis, London contributed a surplus of between £10 billion and £20 billion towards the UK budget balance. During the crisis of 2008/09 this narrowed substantially, although on our estimates even during the worst financial year of the current economic downturn, London's fiscal account only just went into deficit…before rebounding to around £5 billion the following year (2010/11). Only the South East of England and the East of England have matched London in delivering a consistent fiscal surplus."[65]

EXPENDITURE

On the expenditure side, London's share of public expenditure has remained remarkably stable over time as the chart below shows. Total expenditure increased (as a share of UK public expenditure) from 13.7 per cent in 2001/02 to 14.5 per cent in 2003/04 but has remained virtually flat over the last ten years. This masks some variations, but major areas of expenditure, health, education and public order and safety have remained very stable over the last decade.

Overall expenditure per head in London is higher than the UK average (see Table 3) and is higher than other statistical regions in transport, public order and safety, and health and education, but just below the average for enterprise, employment and social protection.

Table 3: Identifiable expenditure by function (2010/11) in London, the UK and the Rest of the UK (£ per capita)

	Public order & safety	Enterprise & employment policies	Transport	Health	Education & training	Social protection	Total identifiable expenditure on services
Greater London	843	136	774	2210	1730	3567	10198
UK	542	131	368	1948	1458	3717	9199
Rest of the UK	498	130	309	1911	1419	3739	9055

Sources: PESA 2012, ONS and GLA Economics calculations

However, London is the only region that mostly comprises a metropolitan area; this represents a significant difference from all other regions in UK statistics, which contain a mixture of urban, suburban and rural areas. The average expenditure per head across the Greater South East

65 Oxford Economics, 'London's Finances and Revenues', (http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Pages/Londons-finances-and-revenues.aspx)

(the closest approximation to London's functional economic region) is £8550, which is below the UK average of £9199[66]. Therefore comparing expenditure per head in London with other regions is misleading; using a more consistent comparison (ie public expenditure on the Greater South East as a whole), expenditure per head would actually appear to be below the average for the UK as a whole.

PUBLIC EXPENDITURE AS A PROPORTION OF LONDON'S ECONOMY

Research also shows that public expenditure in London as a proportion of its GVA is low compared to other regions as shown in Table 4. In particular, capital investment as a proportion of GVA is very low, as shown in Table 5.

Table 4: Public spending as a per cent of London or UK GVA

	Greater London	UK		Greater London	UK
1999/00	30.5%	41.8%	2005/06	32.6%	46.7%
2000/01	30.7%	42.9%	2006/07	31.9%	46.3%
2001/02	31.3%	43.9%	2007/08	31.2%	46.1%
2002/03	32.6%	44.7%	2008/09	32.5%	48.8%
2003/04	32.6%	45.3%	2009/10	35.3%	52.7%
2004/05	32.8%	46.2%	2010/11	35.0%	52.3%

Source: Oxford Economics (December 2012), London's Finances and Revenues, City of London Corporation

66 PESA 2012 and GLA Economics calculation.

Table 5: Expenditure on selected services in London, the Greater South East and the UK in 2010 /11: total, current and capital in levels (£ million) and as a per cent of regional or national GVA

		Greater London		Greater South East		UK	
		Level	% of GVA	Level	% of GVA	Level	% of GVA
Public order & safety	Total	6593	2.4%	12186	2.1%	33724	2.6%
	Current	6204	2.2%	11490	2.0%	31415	2.4%
	Capital	389	0.1%	697	0.1%	2309	0.2%
Enterprise & employment policies	Total	1064	0.4%	2301	0.4%	8131	0.6%
	Current	952	0.3%	2041	0.4%	6464	0.5%
	Capital	112	0.0%	260	0.0%	1668	0.1%
Transport	Total	6059	2.2%	10005	1.7%	22901	1.7%
	Current	2411	0.9%	3578	0.6%	9462	0.7%
	Capital	3648	1.3%	6427	1.1%	13440	1.0%
Health	Total	17290	6.2%	41884	7.2%	121305	9.2%
	Current	16556	5.9%	40147	6.9%	115855	8.8%
	Capital	733	0.3%	1736	0.3%	5450	0.4%
Education & training	Total	13539	4.9%	32212	5.6%	90761	6.9%
	Current	1690	0.6%	18123	3.1%	10325	0.8%
	Capital	11849	4.3%	14089	2.4%	80436	6.1%
Social protection	Total	27913	10.0%	74639	12.9%	231431	17.6%
	Current	27744	10.0%	74208	12.8%	230106	17.5%
	Capital	170	0.1%	432	0.1%	1110	0.1%

Sources: PESA 2012, ONS and GLA Economics calculations

TAX

On the tax side, London makes a greater contribution to the national finances largely because of its sectoral make up. It specialises in more highly paid and more profitable sectors, especially financial and business services, reflected in higher income tax (London contributed 23.2 per cent of the UK total in 2010/11), business rates (23.4 per cent) and corporation tax (25.4 per cent).

FUTURE PROJECTIONS

London is projected to remain a net contributor to public finances under current assumptions. Its proportion of UK tax and public expenditure is anticipated to grow and its surplus likewise.

SOURCES OF FUNDING

Despite London's tax surplus, it receives most of its income from central government, as shown in Table 6. In 2011/12, government grants accounted for 73 per cent of local government expenditure in the capital (the GLA and boroughs), while council tax provided only 12 per cent of local resources. The majority of public service expenditure is managed by central government (58 per cent).

Table 6: Sources and uses of funding in London local government

Capital and Net Current (Revenue) Expenditure	Central Government	GLA	London Boroughs	London local government	Total Public Sector Expenditure
	£ million	£ million	£ million	£ million	£ million
Defence	13	–	–	–	–
Economic Affairs	490	5,106	963	6,069	6,559
Education	5,242	0	8,263	8,264	13,506
Environment protection	185	36	1,004	1,040	1,226
General public services	141	54	910	965	824
Health	17,247	–	–	–	17,247
Housing and community amenities	613	9	1,458	1,467	2,079
Public order and safety	2,254	3,833	81	3,914	6,168
Recreation, culture and religion	697	107	651	758	1,455
Social protection	19,486	–	10,305	10,305	29,790
Grand Total	**46,087**	**9,145**	**23,635**	**32,780**	**78,867**
Funded by:					
Council Tax	–	935	3,019	3,954	3,954
Grants (inc government and other contributions)	–	4,954	18,869	23,822	23,822
Capital Receipts	–	48	489	537	537
Revenue Contributions	–	1,941	583	2,524	2,524
Borrowing: Supported	–	–	118	118	118
Borrowing: Unsupported	–	1,267	557	1,825	1,825
General Taxation	46,087	–	–	–	46,087
Total	44,509	5,715	20,428	32,780	78,867

Source: London Councils[67]

67 This table was based on the Government's Public Spending Statistics for 2011-12. This included the Country and Regional Analysis 2012, which provides a further level of public spending analysis by country, region, and function. The regional analyses presented in the Government release show where the individuals and enterprises that benefited from public spending were located; it does not mean that all such spending was planned to benefit a particular region. The analysis is limited to identifiable expenditure for London, which accounts for 86 per cent of total expenditure on services. The expenditure has been classified in ten broad categories, as defined by HM Treasury in its public spending statistics. Using the HM Treasury figures as a baseline for London, the data was cross referenced against information from DCLG's Revenue Outturn (RO) and Capital Outturn Report (COR) data for 2011-12. This provided further information on the level of expenditure incurred by the GLA and the London boroughs and the City of London. Where the amount of total expenditure was higher than that recorded by London local government it was assumed that the remaining spend should be attributed to central government. A full reconciliation between these individual returns and HM Treasury statistics has not been possible. However, it is felt that these figures do serve to illustrate, in broad terms, the level of expenditure across the various tiers of government in London and where it is spent.

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