Devolution: a capital idea

The report of the London Finance Commission
Executive Summary

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Executive summary

PART 1: INTRODUCTION AND BACKGROUND

The Mayor of London, Sadiq Khan, reconvened the LFC in July 2016 to further consider the tax and spending arrangements of the capital, particularly in the wake of the EU referendum result in June 2016 and of the evolving process of devolution in the UK since the first report of the LFC, *Raising the Capital*, in May 2013.

Commissioners were drawn from local government, Parliament, the London Assembly, the Mayor's Office, think tanks, the voluntary sector and business. We met approximately every fortnight over the latter half of 2016 to commission evidence and deliberate. An interim report was published on 11 October 2016.

The Commission learned there have been significant developments in Scotland and Wales with regard to devolution since 2013, when the LFC last reported. Some progress has also been made in English cities, although a number of other commissions and reports since the original LFC have recommended a more ambitious programme of fiscal devolution at the sub-national level. The most significant development is a major proposed reform to business rates, which from 2020 is expected to be fully retained by English local government, albeit subject to complex residual equalisation constraints.

As in the first report, *Raising the Capital*, we agreed to judge any options we were considering against five core principles: accountability, transparency, efficiency & effectiveness and autonomy & 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.

The main argument set out in our report is that a broader tax base with stronger fiscal controls at the local level will support the delivery of more integrated and efficient services and increased infrastructure investment, while allowing for the reform of individual taxes.

PART 2: EVIDENCE

We sought evidence in a variety of ways. A formal call for written evidence lasted from August until October and received a number of submissions. Four oral evidence sessions were held, two in London, one in Birmingham and one in Manchester. We updated the poll of adult Londoners originally conducted in 2012/13, as well as the international comparison study conducted by the University of Toronto for the first LFC. We also revisited and updated all the original charts and tables in *Raising the Capital* and carried out a further literature review.

Ten key findings arose from this extensive consideration of the available sources of evidence.

1. Londoners support fiscal devolution, irrespective of age, gender, race, location and wealth, both in general terms and with regard to specific tax devolution measures, which includes devolving stamp duty, allowing London's government to reform council tax, and assigning to London's government a small proportion of income tax and VAT.
2. Government in the UK is heavily centralised compared to its international peers. Most other cities have many more tax revenues available to them. The scope and potential for tax devolution to London is therefore significant.

3. Recent evidence from the OECD suggests that fiscal decentralisation can help reduce regional imbalances as it provides a strong incentive to use available economic resources more efficiently.
4. Other international evidence suggests that fiscal devolution also has positive impacts on accountability, business mobility, resilience, fairness and efficiency.
5. Within the UK, evidence from the oral sessions suggested that devolution (including devolution to London's government) commanded widespread support among civic leaders, think tanks and regional business groups. Common themes cited in favour of devolution included accountability, taking control, enabling innovation, focusing on distinct local challenges and incentivising growth, adaptability, governing capacity and fairness.
6. Community groups in London support devolution but warned against bad devolution deals (services devolved with insufficient funding) and the devolution of services to local government that may be regarded as secondary to its main purposes. They also seek devolution below the level of local government, directly to communities and individuals.
7. This chimed with the academic evidence we reviewed, which suggests that different decisions are best made at different spatial scales, from the national to the very local. The weight of evidence suggests that the UK has not yet achieved the most effective distribution of power.
8. The EU referendum result provides an opportunity not just to consider how powers are regained from the EU, but how all governmental powers may be better distributed.
9. Business wants specific protections to prevent unreasonable tax increases as a general condition for supporting devolution.
10. Devolution to London could lead the way for other cities and vice versa.

PART 3: LONDON AND UK GROWTH AFTER 2016

The UK's vote to leave the EU has created significant uncertainty in relation to the country's future economic path. It is our view that, given its combination of economic strengths, the capital is likely to be resilient in the face of the EU referendum result, but its long-term success cannot be taken for granted. Continued success will inevitably depend on good trading relationships and arrangements after the country exits the EU. We believe the post-referendum context strengthens the case for further fiscal devolution to London's government because it will enable the capital to make long-term commitments at a time of uncertainty. Such commitments might range from constructing infrastructure, building new homes and addressing the causes of long-term unemployment. While it focuses on negotiating the UK's exit from the EU developing new trading relationships, UK national government should afford London and other cities more freedom to manage their own affairs through fiscal devolution.

PART 4: FISCAL POWERS

As we outlined in our first report, any devolution of tax powers would be neutral from day one and would not result in tax increases at the point of devolution. Rather, the rationale for fiscal devolution is that it would incentivise London's government to grow its tax base, including by investing in infrastructure. This would diversify the range of taxes at its disposal, allowing it to manage its income and expenditure more fairly and securely – reducing its reliance on business rates. It would also enable London's government to reform the taxes under its control in favour of a more efficient system, for example to promote a better functioning housing market.

Property taxation

Building on the original LFC recommendations, we consider that the case for sub-national control over property taxes in England is even stronger following the successful devolution of tax-raising powers to Scotland and Wales. We continue to recommend the devolution of the full suite of property taxes, including council tax, business rates and stamp duty to the capital.

Potential for additional fiscal powers

The LFC recognises that devolution is a process and not a one-off event. London should benefit from substantial further devolution of services and we would encourage the Government to devolve powers over many areas of domestic policy to London's government, such as health, education, skills, transport and economic development. Other major cities including New York, Tokyo and Berlin are already responsible for a far wider range of services than London. In order to support the devolution of more services, London would need a broader revenue base. The LFC recommends the assignment of a proportion of income tax and VAT yields, increasing as and when services devolution occurs and when major capital projects are agreed. This further reform would have the advantage of incentivising growth in the tax base and it would provide a stable base against which London's government could prudently borrow for capital investment.

We recommend that the Government devolves the proposed apprenticeship levy, due to be implemented from 2017, to London's government, alongside other skills and employment budgets. This change would allow London's government to better design services in line with business needs, and in the longer run the purpose of the levy (and, indeed, whether or not it is needed) should be at the complete discretion of London's government.

Levies on property development

London's government has access to a range of property-related additional charges, including the business rate supplement for Crossrail 1, Section 106 payments and the mayoral and borough Community Infrastructure Levy. We are convinced that if London's government had the power to manage the full suite of property taxes and levies and had permissive powers to develop new mechanisms (subject to consultation with those who pay such revenues), it could develop more consistent, coherent and economically logical approaches, which would foster rather than hinder growth. We recommend full devolution to London's government of such additional charges.

Other minor taxes and levies

The Commission considers that London's government should have access to a range of locally specific taxes and levies designed to support culture and tourism, improve health outcomes, benefit local communities or create a better environment. The possibility of extending the congestion charge exists already, and it will probably be necessary to revisit the issue of a wider charging area in the near future.

Crossrail 2 and other major infrastructure projects

The LFC welcomes the commitment from the National Infrastructure Commission (NIC) and the Government to the Crossrail 2 project. The Government needs as a matter of priority to give consideration to helping London develop other funding sources for the major transport, housing and other capital investments that will be needed to maintain a successful and growing city. For Crossrail 2, the most plausible and acceptable of the many options we have seen to facilitate its funding and financing would appear to be the retention of at least some of the anticipated growth in London's business-rate yield revealed by future revaluations.

The full devolution of all property and minor taxes, as we recommend, combined with the assignment of modest proportions of income tax and VAT will enable greater borrowing for the investment needed to sustain London's growth (even taking into account the additional service responsibility that such a significant transfer of taxes would imply). The same principle could apply to the Greater South East and other areas that are growing economically. There may be scope to consider how a regional package of investment could be funded.

Land value uplift

Short of full property tax devolution, it may be possible and, indeed, necessary to develop mechanisms which tax some of the value uplift on property catalysed by public capital investments, such as in transport or regeneration schemes. As a first step, the Government should work together with the boroughs, the Greater London Authority (GLA) and TfL to develop a consultation paper on the objectives, principles and design options of a land value capture charge. Early analysis suggests such mechanisms could make a material difference to the funding of new transport infrastructure in London.

There is potential to combine property taxation measures with coordinated planning and development to both drive the delivery of transport and housing and to significantly improve the extraction of value from new development around transport hubs. The LFC considers that the GLA and TfL should work with the Government, local authorities and the development industry to improve the consolidation of public and private land for development around major transport investments such as Crossrail 2, including through innovative land pooling and auctioning arrangements, with an equitable sharing of risks and rewards between the private and public sectors.

PART 5: GOVERNANCE AND REFORM IN LONDON

The Commission is very conscious that our proposals, while neither radical by international standards nor in relation to devolution to Scotland and Wales, would represent a substantial break from recent practice and a step change in English devolution. As such, the implementation of these proposals would need an agreed timetable, with careful consideration given to the overall framework for devolution, the governance of decisions and the administrative resources and skills required to manage new powers.

Informal governance mechanisms involving the Mayor and the boroughs have built up over time and reflect a maturity in London's government that respects the two spheres of sub-national governance within the capital. The Commission recognises that more formal governance arrangements will be required to deliver more radical devolution and to facilitate shared decision making on certain issues. As such, we endorse the key principles that have previously been agreed and propose the development of governance mechanisms relating to particular taxes. We recognise the role of the London Assembly in scrutinising the Mayor's actions in relation to existing and any new functions.

If substantial devolution were to be granted, we recommend that London's government explicitly balance growth incentives with equity considerations as part of the governance arrangements. In Scotland, Wales and Northern Ireland, equalisation decisions are made within the nations themselves. We recognise that London would be different, in that there would need to be arrangements to allow both the Mayor and the boroughs jointly to administer matters relating to equalisation and redistribution. But the precedent for the sub-national operation of tax and equalisation has already been set.

PART 6: LONDON, ENGLAND, SCOTLAND, WALES AND NORTHERN IRELAND

The arrangements for devolution in Scotland and Wales have now largely matured, though additional steps are currently being taken to transfer further tax powers to both nations. The question of the English dimension to UK devolution has not been fully worked through. London is the obvious place to begin the process of more radical devolution within England – given that it is the UK's largest city, it was included in the original 1999 devolution settlement and its population is larger than those of Scotland and Wales taken together. The proposals within this report for London should be seen as making the case for a more devolved and better governed England.

Recommendations

DEVOLUTION

1. London's government should continue to work with national government to secure further fiscal and service devolution, including in transport, skills, employment, housing, planning, healthcare, criminal justice and economic development (*Part 4, Chapter 3*).

TAX AND REVENUES

Income tax

2. London should initially be assigned a modest percentage of its income tax yield to increase as and when service devolution occurs or to be hypothecated to fund major capital projects. Such a transfer would mean that grant support could be kept to a minimum or avoided altogether *(Part 4, Chapter 3).*

VAT

3. If a larger share of public expenditure were to be devolved to London, the possibility of assigning a proportion of VAT should also be considered *(Part 4, Chapter 3).*

Property taxes

4. We endorse the recommendations in *Raising the Capital* that the full suite of property taxes should be devolved to London's government – council tax, business rates, stamp duty, annual tax on enveloped dwellings and capital gains property disposal tax (Part 4, Chapter 1).

Council tax

5. The operation and setting of council tax should be devolved to London's government. Growth in the tax base should be retained locally as should the power to set rates. Council tax should be a local revenue which, in addition to delivering resources to fund local services, would provide an incentive for London's boroughs and the GLA to build up the tax base. The number of council tax bands and the amount charged from band to band could be reformed to reflect market conditions (*Part 4, Chapter 1*).

Stamp duty

6. Stamp duty on domestic and commercial properties – and related levies – should be devolved to London's government. The amount collected in council tax and stamp duty could be considered together, striking a balance between the annual taxation of property and the taxation of transactions. At the moment they are considered in isolation, in part because they are, to a significant degree, set nationally *(Part 4, Chapter 1).*

Business rates

7. The operation and setting of business rates (including setting the multiplier) should be devolved to London's government. To protect business rate payers, the multiplier should be linked to changes in council tax. London's government should also be granted full control of business rates reliefs, including the flexibility to introduce a more effective relief scheme for small businesses which reflects the capital's higher rental values *(Part 4, Chapter 1).*

A LONDON VALUATION OFFICE

8. A London Valuation Office should be set up that could consider improvements such as annual (or at least more frequent) revaluations to London's local taxes *(Part 4, Chapter 1).*

LAND VALUE CAPTURE

9. Short of full property tax devolution, the Government should work together with the boroughs, the GLA and TfL to develop a consultation paper on the objectives, principles and design options of a land value capture charge *(Part 4, Chapter 6).*

10. National government should work with London's government to trial the operation of a land value tax pilot on undeveloped land *(Part 4, Chapter 2).*

SMALLER REVENUES

11. The apprenticeship levy, due to be implemented from 2017, should be devolved to London's government in order to fund a wide range of skills and employment initiatives in the capital, as decided by London's government. In the longer term, it should be for London's government to decide whether or not to retain such a levy, at what rate and on what to spend it, in consultation with business *(Part 4, Chapter 3).*

12. We recommend the hypothecation of a share of London's contribution to VED (Vehicle Excise Duty) revenue for improvements of nationally strategic roads within the capital, accepting there may need to be other reasonable changes in the tax and revenues system to ensure that fiscal neutrality is achieved, and that there is benefit to London from national roads such as the M25. This would help to avoid unfair (and unfairly perceived) cross subsidisation, both from public transport fare payers to fund the London road network and from London car drivers to fund the road network elsewhere in the country *(Part 4, Chapter 4).*

13. UK government should consider devolving air passenger duty (APD) raised in London to London's government so that it has the flexibility and autonomy to consider making local adjustments to the tax and to provide more diverse sources of revenue. *(Part 4, Chapter 4).*

14. London's government should be able to introduce new smaller taxes and the government should pass permissive legislation that would make such changes straightforward to implement. In particular, we recommend the following smaller taxes for further exploration: a tourism levy, health-related taxes and a community levy *(Part 4, Chapter 3).*

15. National government should work with the GLA, London Councils and other local authorities to consult on the potential operation of a tourism levy and the devolution of the power to set such a tax in the city to London's government, subject to effective consultation and due process *(Part 4, Chapter 3).*

16. In the near term, London's share of the soft drinks industry levy should be retained within the capital, with a longer-term view to devolving it fully, including the ability to set the rate. In the longer term (post 2020), there is a case to devolve other health-related taxes, including a sugar sales tax and a saturate fat tax so that such levies were fully managed by London's government *(Part 4, Chapter 3).*

17. Other minor taxes could include the power to introduce a small community levy to fund discrete projects 'owned' by Londoners. This could approximate to existing models, such as Business Improvement Districts (BIDs), allowing the creation of 'Community Investment Districts'. Such levies would possibly be more modest in scale than BIDs but would be the

result of a democratic process in which London's diverse communities play an active role in initiating, endorsing and ensuring accountability. It could be used to leverage additional funding to increase the overall investment opportunity *(Part 4, Chapter 3).*

GRANT REDUCTIONS TO OFFSET NEW TAX POWERS

18. Any new tax powers for London should be neutral on 'day one' – with arrangements in place to guarantee this neutrality. Thereafter, London's newly-strengthened governance arrangements would have to assume responsibility for ensuring there was negotiated fairness between individual boroughs and the GLA *(Part 5, Chapter 3).*

FEES AND CHARGES

19. London's government should have permissive powers to develop new mechanisms for managing charges on property development *(Part 4, Chapter 2).*
20. Local authorities should be able to recover the full costs of services, even for charges currently set at the national level *(Part 4, Chapter 4).*
21. Central controls should be removed on planning application fees, building control charges, land searches and licencing fees. Such fees and charges should be audited locally to avoid cross-subsidisation of other functions *(Part 4, Chapter 4).*

INFRASTRUCTURE FUNDING

22. The GLA, TfL and London Councils with their counterparts in the rest of the South East, should consider developing a strategic transport and infrastructure funding proposal for submission to the Government by the time of the 2017 Autumn Budget. These organisations should also work with the National Infrastructure Commission to collect evidence for the National Infrastructure Assessment (NIC) *(Part 4, Chapter 6).*
23. As an interim measure, prior to full devolution, the Government should consider extending the principle of tax increment finance (TIF) to other taxes, including stamp duty *(Part 3, Chapter 2).*

GOVERNANCE AND EQUITY

24. If substantial devolution were to be granted, London's government should explicitly balance growth incentives with equity considerations as part of the governance arrangements *(Part 5, Chapter 1).*

LONG-TERM INCENTIVES

25. Any future reforms made to London's fiscal and financing arrangements should not be negated by central government periodically adjusting grant resources available to the city beyond the reduction required at the point of original tax reform. An agreed formula would need to make certain that there is no undue and unsustainable shift of resources between London and the rest of the UK in the longer term. Such arrangements would resemble those required for Scotland and Wales when income tax is partly devolved *(Part 5, Chapter 3).*

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