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The Reform of Local Authority Finance
in the United Kingdom: A Modern Poll Tax

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Abstract

In April 1990, the U.K. Government implemented the largest change to local authority finance in England and Wales since the postwar period. It involves the introduction of a poll tax on domestic residents, the centralization of local business taxes, and an overhaul of Central Government grants. This paper analyzes the effect of these reforms on local government and the wider economy.

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<u>Contents</u>	<u>Page</u>
I. Introduction	1
1. The size and scope of local authorities in the United Kingdom	1
2. The objectives of the Government and the reform proposals	4
II. Analysis of the new system	9
1. Accountability	9
2. Equity	14
3. Nondomestic taxation	19
4. The macroeconomic effects of the reforms	20
5. International and historical comparisons	22
III. Conclusions	23
Bibliography	25
<u>Tables</u>	
1. Current Account of Local Authorities, 1986	3
2. Relationship Between Rates and Community Charges to Net Household Income	16
3. Tax Units Gaining and Losing With Full Replacement of Domestic Rates by the Community Charge	17
4. Regional Impact of Reforms	18
5. Costs of Trading Up Property Value by £10,000	21
<u>Charts</u>	
1. The Two Systems of Local Finance	6a
2. The Relationship Between Domestic Rateable Value and Spending	12a

Summary

In April 1990, the U.K. Government implemented the most significant change to local authority finance in England and Wales in the postwar period. The change involved the introduction of a completely new tax on domestic householders (the community charge, a "poll tax"), the centralization of the current local taxation of business, and an overhaul of the method by which the Government allocates grants to local authorities.

The most controversial part of the reforms involves the replacement of the existing tax on property with the community charge. This tax is generally more regressive than its predecessor (although the very poor do gain slightly) and significantly more costly to administer. Although it might be expected that such a lump-sum tax would improve efficiency, its main effect is likely to further distort the housing market in the United Kingdom.

For local governments, the reforms raise the tax price of a £1 rise in local services from an average of 70 pence to £1. Estimates in the paper indicate that in the long run spending by local governments will decline by some 2 1/2 percent. The new way of allocating local grants on a lump-sum basis will avoid some of the confusion and complications of the past, but may not achieve the aim of simplifying the allocation of grants.

For business, the switch to a uniform national rate of property tax ends distortions caused by differential rates of tax. In general, the effect of this change on behavior is unlikely to be large, although it may be important locally.

Overall, the reforms simplify and improve relationships between central and local government. Despite this advantage, outside commentators have been almost uniformly critical of the reforms. A poll tax is seen to represent a backward step in the tax system. Overall, given the scope of the reforms and the inadequacies of the existing system, an opportunity for a radical improvement appears to have been lost to the pursuit of containing expenditure.

I. Introduction

In April 1990, the U.K. Government implemented the most significant change to local authority finance in England and Wales in the postwar period. It involved the introduction of a completely new tax on domestic householders (the community charge, a poll tax), the centralization of the current local taxation of business, and an overhaul of the method by which the Government allocates grants to local authorities. 1/

The most controversial of these proposals is the imposition of a poll tax. The most famous attempt to impose such a tax in England was in 1381, when it was withdrawn following the peasants' revolt. Earlier, the poll tax levied by Henry II in the twelfth century was steeply graduated: dukes paid 10 marks, earls 6 marks, barons and knights 3 marks, squires and attorneys 1/2 a mark, and others one groat (one fortieth of a mark), with the exception of those who were real beggars. Historically, poll taxes appear to have been highly unpopular, even by the standards of taxes in general, and the current proposal has proved to be no exception. The new tax has produced widespread opposition, the most dramatic manifestations being the largest riots in London this century, and the biggest swing since 1935 against a government in a parliamentary by-election.

The controversy on the poll tax has overshadowed other aspects of the reforms, which themselves represent significant changes in the relationship between central and local government. Both the change in the method by which central government allocates grants to local authorities and the centralization of local business taxation have important implications for economic behavior. In this paper the effects of all of the aspects of reforms are analyzed. This is of particular relevance since it now appears likely that the poll tax may be revised (Economist, April 28, 1990, p. 15); if this occurs, the question of whether to retain other aspects of the reforms is clearly important.

1. The size and scope of local authorities in the United Kingdom

Unlike many other countries, all powers of local authorities in the United Kingdom derive from parliamentary legislation. Their structure, services and revenues are defined by Parliament. These responsibilities have changed over the years; local authorities ceased to be responsible for prisons in the 1870s, gas, electricity and hospitals in the 1940s, and water and sewerage (in England and Wales) in 1974. At the same time, many other services provided by them have been expanded, notably on education (the largest single expenditure item). However, as the Central Government has taken more interest in domestic matters, it has

1/ While the transitional arrangements in moving from the old to the new system are discussed, the focus of the paper is on the effects of the new system when it is fully operational.

increasingly sought to define national standards toward which local government should aim.

From a base of 5 percent of GDP in 1900, local government expenditure increased to 9 percent of GDP in 1950 and 15 percent in 1975. 1/ This rise was not paralleled by an equal increase in local tax revenue, but rather by a secular increase in grants from the central government. By 1975, these represented two thirds of all local government revenue. Subsequently, the ratio of local authority spending to GDP has declined somewhat, particularly since 1979 when the Thatcher government made keeping local expenditure at affordable levels a key part of its agenda. This period has also seen a marked decline in the proportion of local revenue financed from central government grants.

Despite this, local authorities still represent a major sector of the U.K. economy. In 1988/89 (fiscal year April-March), local authority current and capital expenditures were almost £50 billion (10 percent of GDP), over a quarter of the total for general government; expenditure on goods and services alone represented over 8 percent of GDP. Local authorities employed over three million people, almost four times the size of the central government civil service. 2/

Table 1 shows a breakdown of local authority revenues and expenditures in 1986. 3/ About three quarters of spending was on goods and services, within which education absorbs almost half. The next most important items, in declining order of importance, were social services (chiefly services for families with social problems, children in need, the elderly and the handicapped), the police, local roads, garbage collection, and recreation and culture.

In financing expenditure, approximately equal amounts were derived from local government's own resources and from central government grants. Receipts from local resources include two minor sources, namely gross trading profits of trading enterprises and interest receipts, and one major source, a local property tax, known as the rates. The rates are levied on all buildings, domestic (residential) and nondomestic (business). Each building had a rateable value, assessed by a central government agency, which represented the rent it could command if

1/ Healey and Leach (1989).

2/ Financial Statistics, Tables 4.1 and 4.2 and Economic Trends Annual Supplement, Table 49.

3/ This table ignores expenditure on trading services unless they generated losses and had to be subsidized. However it does include two types of transfer payments, maintenance grants for students in higher education and cash payments to the poor to help them pay rent and local taxes.

Table 1. United Kingdom: Current Account of Local Authorities, 1986
(In billions of pounds sterling)

<u>Expenditure</u>		<u>Income</u>	
Goods and services	30.7	Own resources	20.9
Education	<u>14.5</u>	Profits	<u>4.8</u>
Social services	3.5	Interest	0.9
Police	3.2	Rates	15.1
Roads	1.5		
Refuse (garbage)	1.4	Government grants	<u>21.8</u>
Fire services	0.7	Specific grants	<u>7.4</u>
Other	4.5	General grants	14.4
Subsidies	1.0		
Housing	<u>0.5</u>		
Public transport	0.3		
Other	0.2		
Transfer payments	4.3		
Grants to students	<u>1.1</u>		
Rest and rate rebates	3.2		
Interest payments	4.2		
Current surplus	<u>2.3</u>		
Total	42.6	Total	42.6

Source: Hughes (1986b).

let. 1/ Local governments were broadly free to set whatever tax rates they wished on these values, although since 1985 some high spending authorities were constrained by rate-capping. Low income households receive transfers called rate rebates to help them pay these taxes. Altogether, about one third of all households received rebates, which cover up to 80 percent of their rate bills. 2/

Central government grants to local authorities can be divided into two components: specific grants which relate to specific services, such as the police, and general grants. The general grant had two functions: it aimed to equate tax levels across different authorities for a given level of services (negating the effects of differences in the local tax base), and to influence the level of expenditure through variations in grant amount. A more detailed description of the operation of the grant system is provided below.

2. The objectives of the Government and the reform proposals

The objectives of the Government, and the broad features of the reforms are contained in a consultative document (green paper) Paying for Local Government (HMSO (1986a)). The broad objectives of the Government since 1979 have been:

- to contain local expenditure at affordable levels;
- to encourage local authorities to carry out services more efficiently, and to introduce private sector competition where possible;
- to reduce detailed controls over local government.

In practice, there has been considerable conflict between these objectives. In particular, the desire to contain local expenditures led to a series of controls over local authorities, involving changes to the administration of central government grants aimed at imposing some discipline on authorities who spent more than the Government deemed appropriate. It culminated in rate-capping, a process by which the central government effectively set an upper limit on the local tax revenues of a small number of high spending councils. Hence it appears

1/ Revaluations are supposed to occur approximately every five years. However the last two revaluations in England were not carried out, so the last revaluation was in 1973. In Scotland however, rateable values were updated in 1985.

2/ The limit of 80 percent was introduced in 1988. Previously, many households had all of their rates rebated; in the fiscal year 1984/85 almost half of all recipients of rebates paid no rates at all (HMSO (1986a) p6, Figure 4).

that within the Government's objectives, the need to contain expenditure by local authorities has been paramount. 1/

The reforms are aimed at solving the problem of overspending by local authorities by strengthening local accountability. In the view of the Government, the principal reason for the excessive spending is a lack of accountability of local authorities to the local taxpayers. Local government has been able to raise the level of service provided to the electorate without charging electors the full cost of the increased services. This lack of accountability is endemic to the system of local authority finances, affecting all three principal forms of revenue. In particular:

- nondomestic rates (those rates paid by businesses), are paid by organizations to whom the local authority is not directly answerable.
- domestic rates, which do affect voters, are directly paid by only a minority of the local electorate. Furthermore, individual rate payments vary in a way that has little or no regard to the use made of local services.
- central government grants are calculated in a complex manner, which makes it difficult for the local electorate to be aware of the true cost of services being provided.

The reforms change the way in which all three sources of revenue operate. 2/ Domestic rates have been replaced by a new tax, called the community charge, a residence or poll tax, which is levied at an equal rate for each adult. 3/ There are, however, rebates for the poorer members of society. Like the rate rebates they replace, they will cover up to 80 percent of the cost of the charge. The green paper estimates

1/ In any case, the green paper makes it clear that the Government does not believe that local authorities should have too much autonomy over their revenue and expenditure decisions. Hence the third objective falls far short of a decentralized federal state, defined by Hughes (1987, p.2) as a high degree of local autonomy "even when this is at the expense of national economic or social objectives." The advantages and disadvantages of autonomy of different levels of government are discussed in the literature on fiscal federalism, surveyed in Hughes (1987) and Helm and Smith (1987).

2/ The discussion here focuses on the arrangements for England. Those for Scotland and Wales vary in some minor respects. The reforms were introduced in England and Wales in April 1990. In Scotland the most important reform, the community charge, was introduced in April 1989.

3/ For an extensive discussion of the effective incidence of head taxes and property taxes over a broad range of theoretical models, plus empirical results for the United States, see Miezowski and Zodrow (1989).

that these rebates will benefit around one fifth of those taxed. ^{1/} The Government retained the right to "charge-cap," or set an upper limit on the level of the community charge set by any given local authority, and in April 1990 announced that twenty councils would be capped in the fiscal year 1990-91.

Nondomestic rates continue to be levied, but the poundage (the term for the tax rate) is now set by the central government. Although the revenues will continue to be collected locally, they will be paid into a Central Government pool, from which they will be reallocated on a per adult basis. Hence, nondomestic rates have changed from being a local tax to being, effectively, a central government tax levied specifically to finance local authorities. The uniform business rate (UBR) in 1990/91 was set to equate revenues with those in 1989/90. Subsequently, it is expected that the tax rate will rise in line with the general price level. The ending of local control over nondomestic rates halves the tax base effectively under local government control, from half of all revenues to one quarter.

The system of government grants has been changed and simplified. ^{2/} The general grant now has two elements, a needs element and a standard grant. The needs element compensates different local authorities for differences in the tax base. It aims to ensure that a given level of services provided implies an equivalent community charge per capita in different local authorities. The standard grant provides general support for local expenditure from central government taxes. Like the nondomestic rates, it is distributed on a per capita basis. Unlike under the old system, the level of grants will be independent of the actual level of expenditure undertaken by each local authority. Hence local authorities must finance marginal expenditure increases from local revenues.

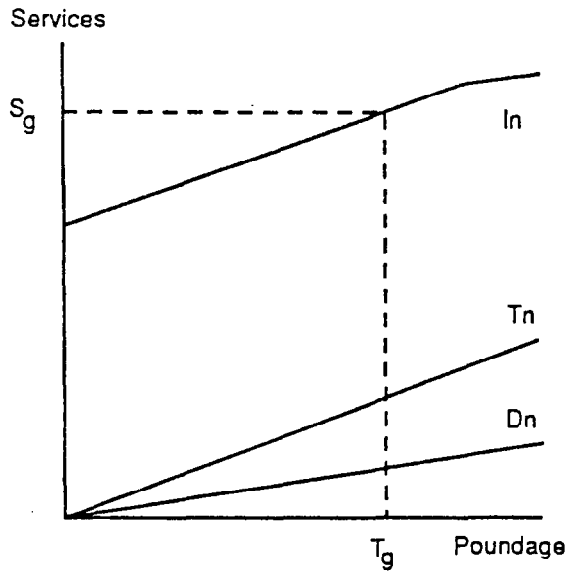
In order to understand the effects of these changes on the behavior of local authorities, it is helpful to consider the case of two authorities under both the old and new systems. In order to simplify the analysis, it is assumed that the only revenues available are from local taxes and general grants. One authority which will be labeled N (for needy), has a small tax base and high per capita service needs. The other, labeled P (for prosperous), has a large tax base and relatively low needs. The situation under the old system is shown in the upper panel of Chart 1. The vertical axis shows the level of services, while the horizontal axis represents the rate of tax (poundage). It is assumed that the adult population of the two authorities is the same.

^{1/} HMSO (1986a) Annex J gives the estimated recipients. The number of adults can be calculated from the tax unit data in Annex C.

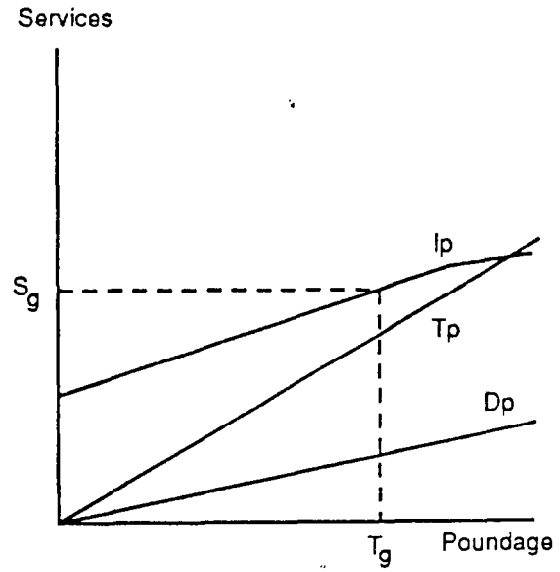
^{2/} This is the system envisaged in the Green paper. The scheme that has actually been put into effect has a single grant, but the effect is the same.

CHART 1.
THE TWO SYSTEMS OF LOCAL FINANCE

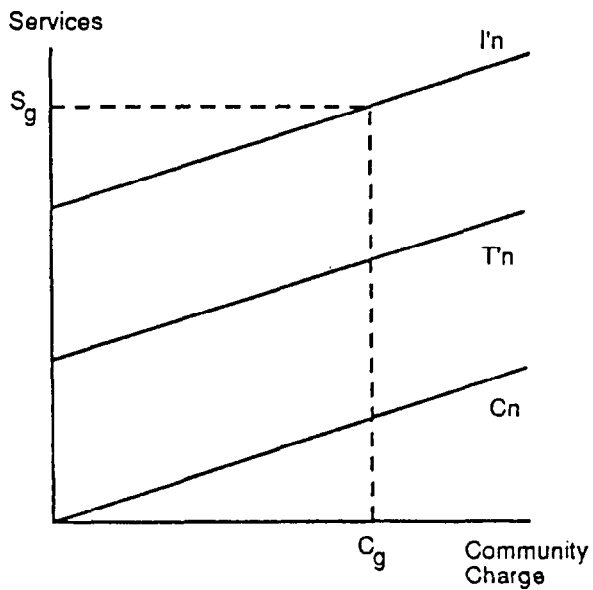
Old System, Authority N



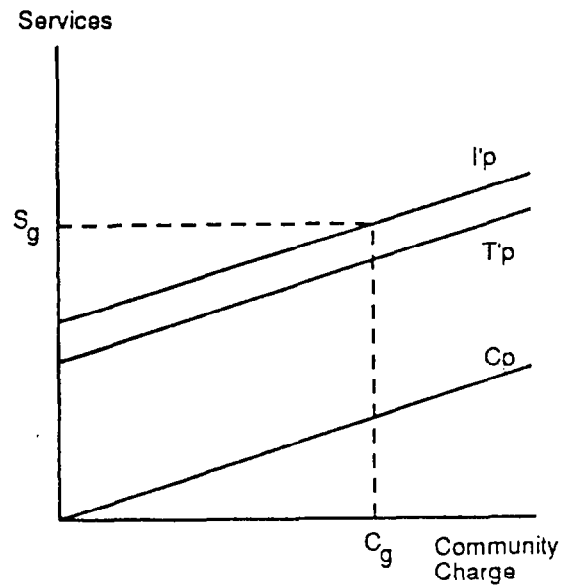
Old System, Authority P



New System, Authority N



New System, Authority P



In the case of authority N, the tax base is low, and hence the line T_n , which represents the total revenue from the rates, is less steep than the corresponding line T_p for the more prosperous authority. Similarly the line D_n , which represents revenues from domestic rates, is also below D_p . For every level of poundage revenues are lower for the low income authority, N. The lines I_n and I_p show income after the general grants. The difference between line T (total local tax revenue) and line I (total income) represents the level of government grants. At a given level of tax (T_g), which is the same for each authority, they pass through a level of services S_g , which is the level of services that Central Government considers to be reasonable. Since N requires more services, this level is higher for N than for P. This is the part of the grant which equates tax rates among different authorities for a defined level of services.

The two lines T and I are not parallel to each other. Instead the income lines (I_n and I_p) are less steep than the respective tax lines (T_n or T_p). This is because the Government seeks to equate the marginal increase in the tax rate for additional expenditure. Each extra pound of expenditure per capita involves a rise of 1.1 pence in the poundage of the local authority. Since a rise of 1.1 pence generally brings in over one pound in revenue per capita, this reduces the grant that the authority receives. Hence, at higher poundages, the tax and income lines move closer together as the grant from Central Government is reduced. The income lines, I_n and I_p , also have a kink in them at a level ten percent above the Government's defined level of services, S_g . At this point, the marginal tax rate faced by authorities rises from 1.1 pence per pound of extra expenditure per capita to 1.5 pence per pound. Hence the rate at which the central government grant is withdrawn rises at this point, and the income lines I_n and I_p become flatter. Notice also that the two income lines, I_p and I_n , are parallel. This is because the Government ensures that the same increase in the tax rate will provide for the same increase in expenditure per capita among authorities. It means that the withholding of grants is less for N than for P for the same increase in service levels, since line T_n is less steep than T_p . If the calculated grant becomes negative, the authority receives nothing from the Government.

Under this system, the marginal tax price (the amount of extra tax revenue required to finance a unit increase in spending) is above 1. Indeed, it is around 1.4 (see below for more details). However, recall that over half of domestic taxes were paid by business. The marginal tax price on the domestic sector, shown by the slope of line D, is still less than one. This is because there is a substantial marginal tax on business under the old scheme.

The lower panel of Chart 1 shows the arrangements under the new system for the same two authorities. The vertical axis still represents the level of expenditure, however the horizontal axis now represents the level of the community charge. The lines C_n and C_p represent the revenues from the community charge in the two local authorities. They

are parallel since the number of adults in the authorities are assumed to be the same. The lines T'n and T'p, as in the upper panel, reflect total tax receipts, the sum of the community charge and business rates. Since receipts from business rates are no longer under the control of local authorities and are distributed on a per capita basis, the line Tn is parallel to the line Cn. Lines I'n and I'p reflect total income including central government grants. These income lines pass through the projected expenditure points, Sg, at the same tax rate, Cg. Hence, the new system of grants implies an equal community charge, rather than an equal rate of property tax (poundage). Since neither nondomestic rates or government grants are related to actual expenditures, this line is also parallel to the community charge line, Cn, reflecting the fact that all marginal expenditures have to be financed by the community charge.

Comparing the top and bottom panels, two features emerge. The reforms imply large changes in the amounts raised by different local authorities under the two systems. Under the old system, grants were calculated to equate poundages, while under the new system grants will equate the level of the community charge. Hence a low resource authority, like N, will have to raise a larger amount of money from its tax base, while a high resource authority, like P, will face a lower requirement. Also, the marginal effective tax price of the community charge on the domestic sector (the slope of lines Cn and Cp) is between that of domestic and total rates (the slopes of the D and T lines respectively). The tax price faced by domestic rate payers rises, while that for nondomestic rate payers falls to zero. Indeed, from the point of view of the local authority under the new system, there is essentially no difference between the nondomestic rates and government grants. A reduction in one, complemented by an equal rise in the other, has no effect on the level of service. Also, the tax price of the community charge is the same for both authorities under the new system, while it was different under the old system. This reflects the fact that property values vary between the two authorities.

In addition to differences among local authorities, the reforms also change the tax paid by individuals within a given authority. The move from a property-based tax to a per capita charge involves a shift in the tax burden; those with high value properties will pay less, and those with low value properties more. Moreover, the base of taxation is shifted from the household (of widely differing sizes) to the individual. The view of the government is that this change will eliminate the ability of councils to levy high taxation on "prosperous" households in order to cross-subsidize households paying relatively small amounts of rates. Essentially, the issue comes down to whether the marginal tax rate of the median voter within the district is substantively affected by the change from the rates to the community charge, over and above the change in tax price faced by the authority itself. This issue will be discussed further below.

In order to ease the transition between the two systems, the Government has proposed safety nets for households, businesses, and regions. The household safety net will last for three years and involves reimbursing households where the tax liability of the first two charge payers, at the level of services deemed appropriate by the government, increases above a fixed threshold, set at £156 for the first year and rising after that. This provision will cost the Exchequer £449 million (over £10 per taxpayer) in 1989/90, and a slightly smaller amount in 1990/91. The area safety net will last for four years and will be self-financing in the first year. In the first year, local authorities which will be large gainers under the new system will only realize about half of their long run gains, the balance being used to subsidize authorities which will lose under the new arrangements. ^{1/} For the next three years there will be payments out (financed by the Exchequer) but no payments in. The business safety net is self-financing and phases in the changes over five years.

II. Analysis of the new system

The new regime has far-reaching consequences, both for local authority behavior, personal incomes and the economy in general. This section will focus on analyzing the most important of these, namely the implications for local accountability, equity, business taxation, and house prices.

1. Accountability

The Government argues that the new system will improve the accountability of local government in a number of ways. It will raise the number of taxpayers, broaden the tax base and reduce the number of people who receive services without paying for them. Furthermore, under the new system, all marginal increases in spending will have to be funded from increases in community charge revenue. It is expected that this marginal principle, which implies a rise in the effective tax price on the domestic sector, will make the electorate more aware of the real cost of local services. Finally, by making the new tax into a per capita charge, the Government believes that the connection between local tax bills and the provision of local services will be increased.

In terms of the number of taxpayers, there were over 35 million electors in England in 1985, while the number of householders was under 18 million. Since only one person per dwelling was formally a ratepayer, this implies that only half the electorate actually paid rates. ^{2/} However, the effective incidence was certainly much higher

^{1/} There are also some arrangements for low rate areas and inner London which are financed by the Central Government.

^{2/} Private tenants (who make up only 15 percent of households) usually do not pay rates directly. Similarly, local authority tenants have the rates factored into their rent.

than the number who directly paid rates. If spouses are added in to the total, then the number of effective rate payers would rise to 30 million people. The proportion would be increased even further by including other groups who probably share the rate burden to some extent. For example, if young adults sharing accommodation are included in the calculation, the total would rise to 31.5 million, around 90 percent of the electorate. Survey data give somewhat conflicting evidence on effective tax incidence. Results reported in HMSO (1986b) indicate that, when asked whether their household paid rates, 94 percent of electors said Yes, and only 4 percent No. ^{1/} On the other hand, King (1988b) reports results which indicate that wives and other non-rate paying adults are only a third as likely to know whether the rate bill has changed since the previous year as are adults who are directly liable. Overall, although it is clear that the community charge will have both a higher actual and effective incidence than the rates, the differences are probably not large, at least for sizable changes in the tax burden.

A second issue relates to the marginal tax rate faced by domestic tax payers. On average, the cost of an extra pound of expenditure in England (excluding London) under the old system was 69 pence if the authority is to the left of the kink in figure 1, ^{2/} rising to 95 pence in the pound if expenditure is over 10 percent above the central government's estimate of its normal spending level. However, as noted above, under the existing system of grants, a rise in spending across different local authorities means an equal increase in the tax rate. This implies that the marginal tax price faced by the domestic sector depends upon the rateable value per head in that particular local authority, with areas with high domestic property values facing a higher marginal tax rate than those with low property values. It is difficult to see an efficiency (as opposed to equity) argument for such variations in the local marginal tax price. Under the new system, the marginal tax price will be unified at 1, each £1 of extra expenditure will cost domestic tax payers £1 in tax.

For most authorities the new system implies a substantial rise in the marginal cost of extra spending falling on domestic taxpayers. The new proposals will have particularly large effects on authorities with low property values, where marginal tax rates will rise substantially. High spending authorities may face a smaller rise in marginal tax rates since these are to the right of the kink in the chart. However, if they have low property values, large nondomestic rate resources, or are out of grant, the rise may be larger than the calculations above imply. ^{3/}

^{1/} Quoted in Martlew and Bailey (1988).

^{2/} There is also a rise of 74 pence in revenues from business rates and a fall of 43 pence in grants (King (1988a) p. 142).

^{3/} This adverse selection problem does appear to be a feature of some of the very high spending councils. For example Camden in London, a persistent overspender, had a very large nondomestic rate sector.

There is also the issue of whether, by making the new tax into a per capita charge, the connection between taxation and services will be strengthened. In the words of the green paper "a Community Charge would provide a closer reflection of the benefit from a modern people-based service than a property tax" (HMSO (1986a) p. 25). While it is true that much spending of local authorities is oriented toward people, the largest components are education, where cost is not related to charge paying adults, and social services, directed towards the old, sick and disabled. By contrast, the new tax payers under the community charge (excepting spouses) are concentrated among single adults aged between 18 and 24, who are among the smallest users of local services. Recent evidence on the provision of benefits by Cheshire County Council, reported in Bramley, Le Grand, and Low (1989), indicates that benefits from local government services rise with both income and socioeconomic class. This is because expenditure on services that are primarily redistributive in nature is smaller than that on services primarily benefitting the better off. ^{1/} Hence, a poll tax is not a satisfactory charge for benefits received since the less well off receive lower services from local government than the prosperous. However, when rebates are taken into account, the poll tax is quite a good reflection of benefits across income bands; however, it is still regressive across socioeconomic classes (ibid. Figures 6 and 7). ^{2/}

The main effect from the new system will probably come through raising the marginal rate of tax on the domestic sector. The significance of this depends importantly on whether it will have a substantial effect on the spending behavior of local authorities. One approach to this question is to look at the correlation between spending in excess of the grant-related expenditure (GRE), the Central Government's calculation of the appropriate expenditure level for local government, and the tax price faced by the domestic sector in different areas. Under the old system, the domestic rateable value per head was proportional to the tax price faced by the domestic sector since rises in per capita expenditure across different authorities resulted in equal rises in tax rates. Hence, the degree of correlation between domestic rateable values per head and spending measures would reveal the extent of the connection between the domestic tax price and spending decisions. Chart 2 shows scatter plots for four types of English local

^{1/} This picture may not hold for some urban councils where social expenditures are considerably higher.

^{2/} The green paper (HMSO (1986a) Annex F) points out that rate bills are badly related to income, because of regional variations in the relationship of average housing costs to income and the fact that house values are related to past levels of income rather than current levels. In particular, single pensioners have low incomes compared with the rateable value of their homes. While this is correct, two caveats should be noted. Regional house prices reflect economic prospects and hence may be correlated with permanent income. In addition, the income calculations used ignored the implied income from owning property, which may be particularly important for pensioners.

authorities: inner London burroughs; outer London burroughs; metropolitan districts; and nonmetropolitan counties. 1/ The vertical axis shows budgeted spending in excess of GRE per head in 1989/90, while the horizontal axis shows the domestic rateable value per head. All four sets of authorities show a negative correlation between levels of expenditure and rateable value per head. These visual impressions are confirmed by formal statistical tests. Regressing excess spending against rateable values plus dummy variables representing the different types of local authorities yields the following results:

$$\begin{aligned} \text{Excess spending} = & 55.9 - 0.64 \text{ Rateable Value} \\ & (11.3) \quad (0.12) \\ & + 106.7 \text{ Inner L} + 53.0 \text{ Outer L} + 28.0 \text{ Metrop.} \\ & (15.2) \quad (11.1) \quad (8.7) \\ R^2 = & .36 \quad SE = 36.7 \quad \text{No. of obs} = 104 \end{aligned}$$

Where Excess Spending is spending over GRE per head in pounds sterling, Rateable Value is domestic rateable value per head, Inner L is a dummy variable which is one if the authority is in inner London and zero otherwise, Outer L is a dummy for outer London and Metrop is a dummy for metropolitan districts. Standard errors are reported in parentheses.

The results indicate that marginal domestic tax prices have a significant effect upon spending decisions. The coefficient on rateable value per head is negative, as expected, and is significantly different from zero. 2/ These results imply that by raising the tax price to unity, the local authority reforms will lower local spending in England by about £15 per capita in 1989/90 prices, 2 1/2 percent of total expenditure. 3/

Ideally, the analysis should use the tax price faced by the median voter, rather than the average tax price across the authority. However, there is unlikely to be large differences between these values. The results also show significant differences in spending per capita among the different types of authorities. This probably represents the congregation of individuals with particular preferences for levels of local government services in authorities providing such levels; "club"

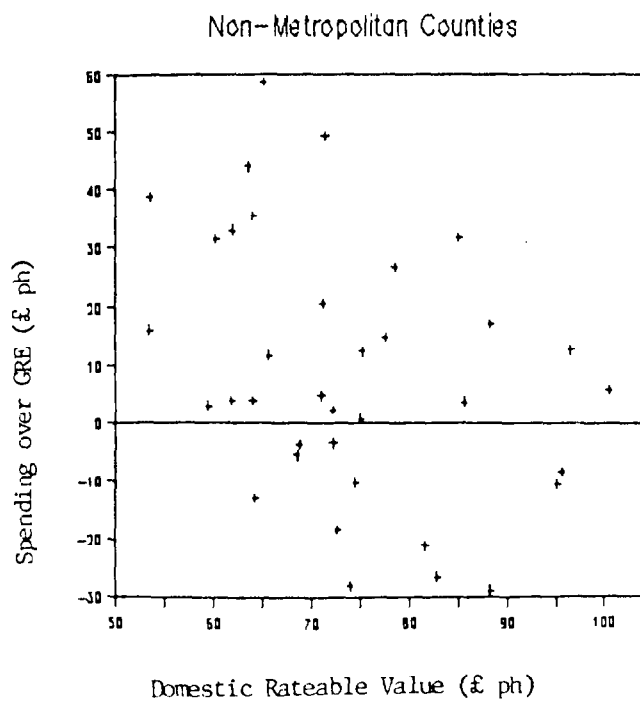
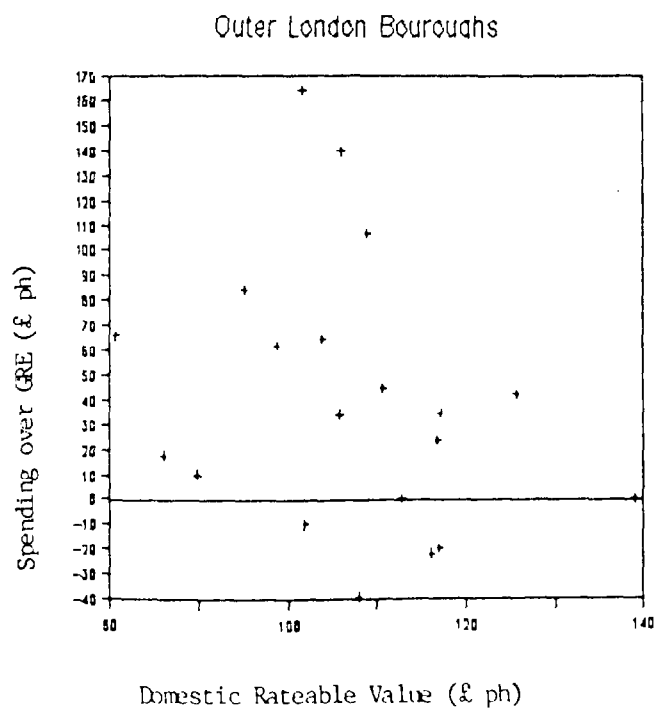
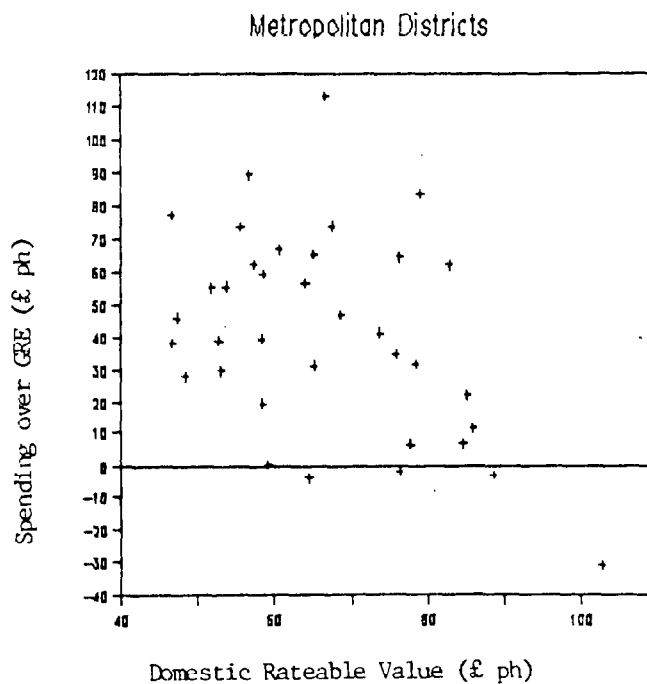
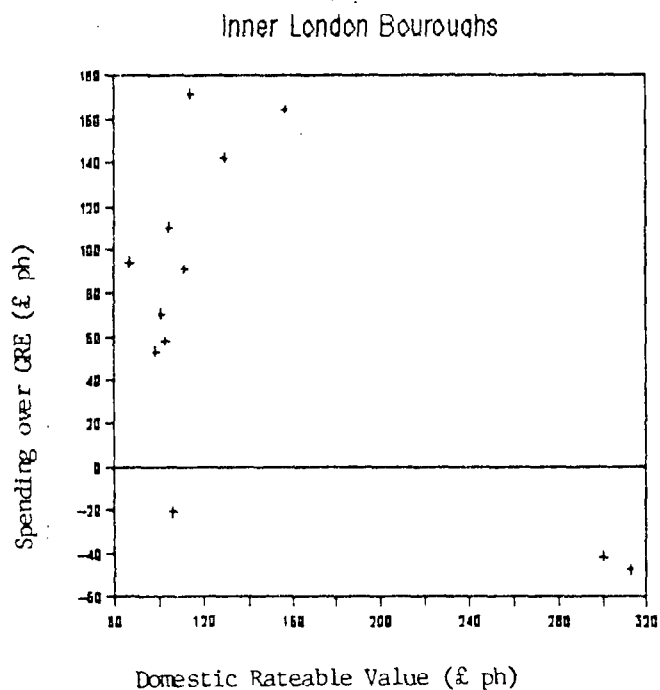
1/ The data comes from CIPRA (1989). The nonmetropolitan counties exclude three authorities which were out of grant.

2/ The restriction that the coefficient on Rateable Value is the same across different types of districts is easily accepted at conventional levels of significance.

3/ While the changes are likely to lower spending in the long run, the initial results from Scotland are that spending has generally increased (Midwinter and Moxen (1989)). Since the Scottish Office announced it would not charge cap, this probably reflects the impact effect of lifting the threat of direct central government sanctions on high spending authorities.

Chart 2.

The Relationship Between
Domestic Rateable Value and Spending



models of this type were first analyzed by Tiebout (1956) and are reviewed in Mieszkowski and Zodrow (1989). Alternatively, it could represent biases in calculated GREs.

One issue is whether this rise in the marginal tax price moves the provision of public services closer to the optimal level. Although a 100 percent tax price on the domestic sector might appear efficient, it may tend to produce an underprovision of services. First, not all local authority services are provided for the domestic sector. Jackman (1988) estimates that 17 percent of local government expenditures are on business-related items. Hence, on average for every £1 of extra spending, only 83 pence goes to the domestic sector. Since all of the increase in spending is financed from this sector, there will be a tendency to underprovide services. Second, social welfare theory implies that a flat rate per capita tax may tend to underprovide services if they are normal goods. ^{1/} In addition, the fact that the community charge only represents one quarter of revenues but absorbs all marginal costs may reinforce these effects. This gearing factor implies that every 1 percent rise in spending results in a 4 percent rise in tax rates. Against this, however, it must be borne in mind that most local authority services are provided free. This may tend to raise demand beyond the socially optimal level, and counteract the tendencies noted above. ^{2/}

One implication of the reduction in the local government tax base and increase in marginal taxation on domestic taxpayers is that the Central Government calculation of the Grant Related Level of Expenditure (GRE), ^{3/} Sg in Chart 1, becomes more important. For example, if the Government were to underestimate the needed level of expenditure by 1 percentage point, this would imply a 4 percent rise in local domestic taxation, as opposed to a rise of somewhat less than 3 percent under the old system. While this makes the objectives in the green paper of simplifying and stabilizing these calculations more important, it may also make these aims more difficult to achieve. The more important the calculation of the GRE in local finances, the more contentious and complex the system is likely to become.

^{1/} Consider the case where the marginal utility of local spending is proportional to income; since the income of the median voter is below the mean income, majority vote will produce lower local spending than that implied by a system which equates this marginal utility to local taxation for all voters.

^{2/} An easier way of ensuring more efficient levels of service would be to extend the number of services for which charges are made. However, much local authority spending cannot be financed in this way (Minford (1988) and King (1988c)).

^{3/} Under the reforms, the name is being changed to the Standard Spending Assessment (SSA). To avoid confusion, the old name will be used throughout.

One of the problems with the GRE is that often calculations have been based on actual expenditure, rather than on independent calculations of need. As a result, the system has often rewarded high spending authorities by raising their calculated GREs. Although the Government has tried to rectify these problems, there is evidence that a certain amount of dependence remains (Smith (1989)). The safety net transition arrangements could exacerbate these problems, since they are based on actual rate revenues; in Scotland, this has resulted in some apparently arbitrary allocations of the safety net (Midwinter and Moxen (1989)). However, while dependence on past expenditures has problems, so does any attempt to directly calculate needs. Derbyshire (1987) describes the method used to calculate the number of children under five at risk. The (subsequently discarded) system is interesting, but complex and open to suggestions for improvement. One problem is the paucity of data available on a local authority by local authority basis.

Cost and compliance represent another issue. Although the rates were an unsatisfactory tax in some respects, they were cheap and easy to collect. The community charge will probably double administration costs, due to its wide coverage and the need to keep up to date information on residences. ^{1/} Also, while nonregistration does not appear to have been as large a problem as was feared, the evidence from Scotland indicates that there may be a larger than usual problem with compliance; Strathclyde has initiated legal action against 350,000 people for nonpayment of the community charge (Guardian Weekly, March 11, 1990, page 6), over one in six taxpayers. This analysis is complicated, however, by the existence of political campaigns encouraging such noncompliance. Finally, there are legal questions involving the definition of residence (Sparkes (1989)).

The evidence from Scotland also indicates that local authorities may have used the confusion surrounding the introduction of the new system to raise revenues significantly more than expenditure (Hughes (1989)). The purpose of this is presumably to lower future increases in taxes for which the local authority will be more directly accountable. In England, the levels of community charge being announced for 1990/91 are on average 30 percent higher than those projected by the Central Government implying that a similar process may be occurring. It must be borne in mind, though, that the Central Government estimates were considered unrealistically low by most commentators.

2. Equity

Any poll tax, even one with rebates for the less well off, is likely to be regressive. The green paper accepts that, as well as a

^{1/} Strathclyde in Scotland, which covers almost half the Scottish population, estimates the running costs to be £33 million, compared with £17 million for the rates (November 1987 prices). The Government's assessment of the costs of running the new scheme in Scotland as a whole is £44 million, about 4 percent of revenue (John (1989) p. 36). This is probably an underestimate.

"beneficial principle," the ideal local tax would have a "redistributive principle." However, it concludes that "no tax could satisfy both aims simultaneously" (para 3.34, emphasis in original). The rates fail both tests; they are not well correlated with income, but are regressive.

Table 2 shows a comparison of payments of the rates and the community charge among different income bands. In comparison with the rates, which was itself a fairly regressive tax, the well-off (top three deciles) and very poor (bottom decile) gain at the expense of those in the middle. 1/ Even as a percentage of income, however, the gains to the well-off are larger than to the very poor. For example, the top income decile gain around 0.8 percent of income on average, the bottom decile 0.2 percent. 2/

The reason the very poor gain is that many of them are pensioners and single parent families, who are the group who gain most from the change. This is illustrated in Table 3, which shows the gainers and losers by type of tax unit from full implementation of the new system. Pensioners and single families generally gain, other single adults lose, while couples are broadly unaffected. 3/ In terms of household composition, single households gain at the expense of multiple adult dwellings. Since rates represent only 3 percent of net income on average, Table 3 indicates that the new system represents a radical change in taxation for many households. Part of the reason for this is that the reforms have large effects on the level of regional taxation. Table 4 shows the effect between the standard English regions. The reforms imply a change of over 1/2 percent of disposable income for seven of the nine regions. These effects are regionally regressive, in that the losing regions tend to be those with relatively low incomes per head.

1/ On balance, the change in the tax price faced by the median voter in any given authority is unlikely to deviate much from the change for the authority as a whole. As indicated in Table 2, those in the middle 40 percent of the income range pay a similar proportion of their income under both the rates and the community charge. Since the proportion of total tax paid by the median voter is similar under the two schemes the change in their tax price can be approximated using average values. One possible caveat to this analysis is that changes in individual taxation under the reforms varies widely with characteristics other than income, such as the number of adults living in the household. If one of these characteristics were particularly important for a median voter, tax prices could differ.

2/ Calculations from the actual experience in Scotland show a similar pattern (Hughes (1989)).

3/ The numbers of losers and gainers are very similar during the transition to the new system, although the amounts gained or lost are smaller (Department of Environment Press Release, December 15, 1988).

Table 2. United Kingdom: Relationship Between Rates
and Community Charges to Net Household Income

(Ranges of equivalent household income; pounds per week) 1/

Average Local Tax Bill	Under 50	50- 75	75- 100	100- 150	150- 200	200- 250	250- 300	300- 350	350- 400	400- 500	500 Plus	All House- holds
Rates	2.1	3.3	3.7	3.2	2.8	2.6	2.6	2.5	2.5	2.3	1.8	3.0
Community charge	1.9	3.3	3.9	3.3	2.8	2.4	2.1	1.9	1.6	1.4	1.0	3.0
Difference	0.2	0.0	-0.2	-0.1	0.0	0.2	0.5	0.6	0.9	0.9	0.8	—
Percentage of house- holds in income band	8.2	—23.9—		—39.9—		—20.0—		—7.9—				100.0

Source: HMSO (1986) Annex F.

1/ Equivalent household income measures relative standard of living by adjusting actual income for differences in household composition.

Table 3. United Kingdom: Tax Units Gaining and Losing
With Full Replacement of Domestic Rates by the Community Charge ^{1/}

(Percent of net income)

	Single Pensioner	One-Parent Family	Other Single Adult	Couples		All Tax Units
				No Children	Children	
Losers						
10+	0	...	25	0	0	25
5-10	25	0	700	25	0	750
2-5	150	25	2,100	550	275	3,100
1-2	250	25	800	1,100	775	2,900
0-1	775	100	1,075	2,650	2,275	6,900
Total Losers	<u>1,200</u>	<u>125</u>	<u>4,675</u>	<u>4,350</u>	<u>4,350</u>	<u>13,700</u>
Gainers						
0-1	1,425	375	1,500	1,925	2,350	7,592
1-2	575	175	500	650	850	2,750
2-5	500	200	625	350	350	2,000
5-10	150	25	150	50	50	400
10+	25	0	25	0	0	75
Total gainers ^{2/}	<u>2,675</u>	<u>750</u>	<u>2,800</u>	<u>2,975</u>	<u>3,575</u>	<u>12,800</u>
Total tax units	3,875	900	7,475	7,325	6,900	26,475

Source: HMSO (1986a) Annex I.

^{1/} Thousands of tax units, 0 = less than 12,500.

^{2/} Includes 900,000 tax units whose position is unchanged.

Table 4. United Kingdom: Regional Impact of Reforms

(Change in income from grants and nondomestic rates)

	Cash (£ millions)	Percentage of Disposable Income <u>1/</u>
North	-115	-1.0
Yorkshire and Humberside	-155	-0.9
North West	-57	-0.2
East Midlands	42	-0.2
West Midlands	152	0.8
East Anglia	54	0.7
Greater London	-475	-1.5
South East (excluding London)	470	1.1
South West	83	0.5

Sources: HMSO (1986a) Annex J and Regional Trends.

1/ The cash data are undated but assumed to be fiscal year 1984/85.
The disposable income data are for calendar year 1984.

Overall, the new system of paying for local government implies large changes in tax incidence. The largest changes are between different types of tax payers and different regions; the gainers being pensioners and those in high property value areas, while the losers will be young single adults and those in low property value regions. Compared with the old system, the reforms are basically regressive, with large gains for the well off; however, the very poor also gain.

3. Nondomestic taxation

As already discussed, business rates under the old system make up over half of rates received by local authorities. Each £1 of extra expenditure raises local business taxes by an average of 74 pence, while only providing an average of 17 pence worth of services. Differences in local rates of taxation imply differences in costs for similar business. In 1989/90 rateable poundages varied between 122.2 and 400.25 pence, with a distribution that was skewed to the right. The median poundage was 270 pence, with 80 percent of councils charging between 230 and 330 pence (CIPRA (1989)). The reforms will replace local nondomestic rates by a uniform business rate (UBR), which will be the same across the country. By equating local tax rates, these changes are intended to make business rates fairer and more predictable.

The importance of these differences in tax rates for companies depends upon two factors: the size of rates in total costs and the degree to which other costs vary among different areas. In general, rates are a relatively small part of aggregate costs, representing some 1.9 percent of net output in 1982. However they are considerably higher than this for commerce. While there is little evidence of widespread effects, studies of specific local environments in England indicate some impact on business behavior. Overall, Bennett (1988) concludes "rates do not have a general effect on business decisions, but can be of major significance in the case of a significant number of high tax locations" (p. 159, emphasis in original). Clearly, the uniform business rate will solve this problem, although at the cost of a considerable loss of local fiscal autonomy.

The UBR has two other implications. The first is that the local taxation of business is separated from the taxation of the domestic sector. Future governments will therefore be able to raise (or lower) local business taxation in relation to domestic taxation. In addition, along with the UBR has been a revision of rateable values. This had led to some dramatic changes in taxation, with manufacturing companies generally benefiting at the expense of commercial buildings, in particular shops. ^{1/} Since the rates are a particularly large part of costs for commercial concerns, these changes may effect the costs of distribution.

^{1/} In a particular well-reported example, Harrods Department Store in London saw its tax bill rise from £1 million to £8.4 million.

4. The macroeconomic effects of the reforms

The most significant general effect of the reforms on the macro-economy have to do with the housing market. The rates were the sole important tax on owner occupation, which is excluded from both value-added and capital gains tax, and the most important tax on other housing. The abolition of domestic rates will tend to raise consumption of housing, and further distort behavior in this market.

The community charge lowers the marginal cost of living in a more expensive house, since the local tax bill faced by a family will no longer be affected by the value of the property. There will also be income effects but, since the community charge is designed to raise the same amount of revenue as the rates, the income effect averages out to zero; hence the change can be analyzed purely in terms of its substitution effects. Table 5 shows some calculations of the cost of trading up by £10,000 on a house under the rates and the new community charge (these estimates are from Spencer (1988)). While rates are a small part of cash flow costs (around 10 percent on these calculations), they are a one quarter of costs when capital appreciation is taken into account. ^{1/} The latter calculation is the more relevant for the majority of households, who are not capital constrained. Hence, the move to a community charge brings a significant fall in the marginal cost of housing.

This fall in the price of housing will clearly boost demand, leading to higher prices and/or increased supply. Spencer (1988) calculates potential rises in house prices of 30 percent for capital unconstrained households, and 7 percent for constrained households, with an overall increase of around 20 percent. Using a similar approach, Hughes (1988a and b) comes out with an estimate of about 15 percent. ^{2/} These effects will be felt particularly at the top end of the housing market. On a regional level, the effects are somewhat stronger in the north, where prices are low relative to rate bills, than in the south. These changes in asset prices, which involve large gains for wealthy owner occupiers, are of such magnitude as to probably swamp the direct gains or losses from the introduction of the community charge analyzed above.

A second issue is the timing of the increase in house prices. Some commentators believe that the effect will be delayed, citing the fact that there are costs to moving house and hence demand will not rise immediately (Hughes 1988b). However, this ignores the fact that house prices are measured only on actual transactions. Once a household has

^{1/} Table 5 uses average values for the 1980s. These calculations are sensitive to the assumptions on interest rates and capital appreciation.

^{2/} This contrasts with the estimate in the green paper (Annex E) of 5 percent; the main reason for the difference appears to be that the green paper calculations take no account of capital appreciation.

Table 5. United Kingdom: Costs of Trading Up
Property Value by £10,000

(Pounds per week, after tax)

	System	
	Old	New
Running costs	7.0	4.5
Upkeep	3.5	3.5
Local authority rates	2.5	0 ^{1/}
Water rates and other charges	1.0	1.0
Extra mortgage interest	19.0	19.0
Cash flow cost	26.0	23.5
Less: capital appreciation	16.0	16.0
Net user cost ^{2/}	10.0	7.5

Source: Spencer (1988).

^{1/} Community charge does not depend on size of house.

^{2/} Excluding costs of moving.

decided to move, the costs of moving will not affect their marginal costs since they are the same under both regimes. So if a decision to move has been made, the benefits from the new regime are unchanged. Of course, some of the benefits from the new regime may be eroded by moving more often, thereby incurring higher average moving costs, but it is difficult to see this as an important factor in the price response. If moving costs are high, people will not move any more often; if they are low, this loss will be small. It seems probable that most of the effect of the reforms has already been anticipated in house prices. Indeed, this is believed to have been one element in the recent sharp increase in housing values in the United Kingdom; in the two years to the third quarter of 1989 real prices on new dwellings rose by almost a quarter.

Even if the price response is already largely capitalized in house prices, the supply response will be more delayed. This is both because of lags (purchasing suitable land, obtaining local authority approval, and construction), and because the costs of moving will mean that the actual demand (as opposed to the price) response to the reforms will indeed be gradual. At present, the stock of housing is rising by about 1 percent per annum. This rate could well double, although some of this may come through improvements to the current stock of housing rather than new houses. This implies that the construction industry (in its broadest sense) will experience a significant increase in demand over the medium term.

The increase in house prices also has implications for the macro-economy. Muellbauer (1989) summarizes these effects. Particularly important are the effect on consumption. Both the permanent income and life-cycle theories of consumption imply an important role for wealth in consumption decisions. There is considerable evidence that the boom in house prices has been a major factor in the fall in the United Kingdom household saving rate over the late 1980s, from 9.4 percent in 1985 to 4.4 percent in 1988. ^{1/}

5. International and historical comparisons

The most radical feature of the new reforms is the introduction of a poll tax as the sole form of taxation on domestic residents. There are few examples either of a poll tax in the modern world, or of local government having access to only one tax. In 1982 there was only one other OECD country in which local government had access to only one tax, Ireland, although in four other countries over 90 percent of revenues derived from one source. ^{2/} Examples of residence taxes are equally difficult to identify. ^{3/} Japan has a prefectural and municipal inhabitant tax, which forms an important part of the local taxation

^{1/} Muellbauer and Murphy (1989).

^{2/} HMSO (1986a) Annex K.

^{3/} Poll taxes are illegal in the United States under the 24th Amendment to the Constitution, because they were used as a method of disenfranchising blacks in the south.

system, raising 48 percent of income. However, the rate of tax is progressive with respect to income, and some groups, notably those receiving social security under the Social Aid Law, are exempted. Hence, the tax is in effect a form of income tax, very different from the British proposal even when rebates are included. Tanzania also attempted to introduce a poll tax in 1984/85, with a flat rate charge of 200 shillings per adult in Dar es Saalam. The following year this was changed to a progressive charge going a long way up the income scale. Overall, the international evidence does not provide other examples of an important residence tax which does not have considerable progressive elements.

The historical evidence of poll taxes in England is somewhat fuller. The most famous attempt to impose such a tax was in 1381, when it was withdrawn following the peasants' revolt. Earlier, the poll tax levied by Henry II in the twelfth century, which was an important source of revenue, was steeply graduated; dukes paid 10 marks, earls 6 marks, barons and knights 3 marks, esquires and attorneys 1/2 a mark, farmers 1/4 to 1/2 a mark, and others one groat (one fortieth of a mark), with the exception of those who were real beggars (Wilson (1988)). No poll tax has been levied since 1698. Poll taxes appear to have been unpopular (even by the standard of taxes in general) and were often progressive.

III. Conclusions

The reform of U.K. local authority finance is both far-reaching and radical. It involves the introduction of a completely new tax on domestic householders, the centralization of the current local taxation of business, and a change in the method of giving Central Government grants to local authorities. The reform will change the behavior of local governments and businesses, and has profound implications for the housing market.

For local governments, the reforms raise the marginal cost to electors of £1 of local services from an average of 70 pence to £1, which will probably lower spending by some 2 1/2 percent in the long run. The reforms may lead to a bias towards underprovision of local services, reversing the bias towards the overprovision which probably exists at present. ^{1/} Part of the reason for this change is the reduction of their tax base from half of all revenues to one quarter. The new way of allocating local grants on a lump sum basis will avoid much of the confusion and complications of the past, however the aim of simplifying the allocation of grants may be difficult to achieve.

^{1/} The Government retains the right to cap the level of the community charge in given areas. It has already made it clear it intends to use these powers.

The most controversial part of the reforms involves the replacement of the existing tax on property with the community charge, a poll tax. This tax is generally more regressive than its predecessor (although the very poor do gain slightly), and significantly more costly to administer. Although it might be expected that such a lump sum tax would improve efficiency, its main effect is to further distort the housing market in the United Kingdom.

For business, the switch to a uniform national rate of property tax ends distortions caused by large differences in the rate of tax. In general, the effect of this change on behavior is unlikely to be large, although it may be important in localized areas.

Overall, the reforms simplify and improve many areas of the relationship between central and local government. Despite this, outside commentators have been almost uniformly critical of the reforms. There appear to be four reasons for this, all of which are "political" in the broadest sense of the word. The first is that many people believe that the imposition of a poll tax represents a significant backward step in the tax system. Second, the reforms, by lowering the tax base, reduce local autonomy and limit choice. Third, attempts to avoid the tax will lead to disenfranchisement of voters. Finally, given the scope of the reforms and the unsatisfactory nature of the existing system, many believe an opportunity for a radical improvement of the system was lost to the pursuit of containing expenditure.

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