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Research Report

Reforming local government funding in England: The issues and options

IFS Report, No. R341

Provided in Cooperation with:

Institute for Fiscal Studies (IFS), London

Suggested Citation: Phillips, David (2024) : Reforming local government funding in England: The issues and options, IFS Report, No. R341, ISBN 978-1-80103-210-0, Institute for Fiscal Studies (IFS), London,
<https://doi.org/10.1920/re.ifs.2024.0948>

This Version is available at:

<https://hdl.handle.net/10419/309980>

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Institute for Fiscal Studies

IFS Report R341

David Phillips

Reforming local government funding in England: the issues and options



**Economic
and Social
Research Council**



Reforming local government funding in England: the issues and options

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Published by **The Institute for Fiscal Studies**

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ISBN 978-1-80103-210-0

Preface

The author gratefully acknowledges funding from the Health Foundation as part of their work on understanding the broader determinants of health and the role of the state in addressing these. He also acknowledges the support of the ESRC Centre for the Microeconomic Analysis of Public Policy (ES/T014334/1).

In addition, the author would like to thank members of a project advisory group, as well as Katherine Merrifield and Gwen Nightingale from the Health Foundation, and Carl Emmerson and Kate Ogden from the Institute for Fiscal Studies, for helpful comments and suggestions. However, all opinions and any errors or omissions are the responsibility of the author only.

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Executive summary

Despite real-terms increases in funding since 2019–20, English local government funding per resident remains on average 19% below 2010 levels and councils are under evident financial pressure. But as well as funding levels, there are also concerns about *how* councils and local public services more generally are funded. This includes the sources of funding available to councils, the range of services and activities that are devolved to them, and the way funding is allocated to and between councils.

This report, the third in a series on funding for local public services in England, looks at these local government finance *system* issues, and the options for reform. It is written in the context of large and entrenched geographical inequalities in health, well-being, and economic performance, which a more effective system could help to address. The report highlights a clear need to reform the process for allocating funding between English councils. But rather than chart a single path forward for reform, it instead highlights how different approaches would align with different objectives that the new government needs to decide how to prioritise – and ideally forge a consensus about.

What are the issues with how English council and local services are funded?

The clearest shortcoming with the English local government finance system is the arbitrary nature with which most funding is allocated between councils. It is therefore welcome that the government proposes to introduce an updated funding system from 2026–27 onwards, although the details of what is proposed will matter, and the government needs to be clear about what it is trying to achieve with its new system.

Historically, there was a complex but broadly sensible approach to assessing councils' spending needs (based on various local area characteristics) and own revenue-raising capacities (via local taxes, for example) and then using these to allocate central government funding to offset differences. Ill-advised reforms in the mid-2000s saw this system become unnecessarily opaque and subject to manipulation, before the abandonment of efforts to comprehensively assess spending needs and revenue-raising capacities in 2013–14. Previous reports in this series (Ogden et al., 2022; Ogden, Phillips and Warner, 2023) have shown how, since then, ad hoc changes in funding that redistributed away from more-deprived areas, and a failure to account for differential population growth, let alone other changes in local characteristics, mean that councils' funding allocations have become essentially arbitrary with respect to their current

circumstances. This means that current funding allocations are likely both unfair and inefficient, with negative consequences for both geographical inequalities and overall value for money. Inappropriate funding allocations have also been highlighted by combined authorities as adversely affecting collaboration with councils, undermining the potential benefits of their devolved powers.

In addition to the lack of a proper system for allocating funding between places, a range of recent policy reports have suggested several other concerns with the local government finance system.

First is a lack of clarity on future funding availability. Recent years have seen central government give councils a series of one-year financial settlements, making it difficult to plan spending, investment and service delivery over a longer horizon. This risks harming efficiency and service quality.

Second is a limited degree of revenue-raising power compared with local governments in other countries. Councils can vary the headline council tax rate charged, but increases above a certain percentage or amount have first to be passed by a local referendum. There is significant discretion to reduce but very limited discretion to increase business rates. And the wider array of revenue-raising options available in many other high-income countries (from specific levies, such as tourism taxes, to broader-based taxes, such as local income taxes) are lacking.

Third, and related to this, some commentators have suggested that English local government has a too limited financial incentive to improve local socio-economic outcomes. Those incentives that are present (via business rates retention, for example) relate mainly to the development of new property. However, there is little financial incentive to support residents to increase earnings, especially if that involves remote work or commuting to other areas.

Fourth, it has been argued that local government should have greater involvement in a wider range of local services and public spending, particularly in relation to local economic development. Related to this, a plethora of specific and ring-fenced grants, and accompanying reporting requirements, can both create administrative burden for councils and limit their scope to respond to local priorities and circumstances.

Fifth, financial and political accountability may be confused, with the remits and responsibilities of local and central government overlapping and little understood by voters and other stakeholders. This is particularly true given the complex structure of governance in England, with different tiers of local government and combined authorities, some with and some without mayors. It is not possible to demarcate responsibilities fully, but frequent changes in the duties or restrictions placed on local government, ‘unfunded burdens’, and a plethora of ad hoc deal-based arrangements make such problems worse.

Sixth, the institutional status of local government is relatively weak compared with many other countries. The lack of an overarching constitutional framework for assigning responsibilities and powers between tiers of government in England means that, in effect, central government can relatively easily and unilaterally add or remove them. Alongside accountability concerns, it has also been argued that councils' weak institutional status leads to the systematic underfunding of local services. And while central government has engaged with local government on the design of the finance system, there is no statutory basis for co-designing the system as in many other countries.

As a result of these issues, multiple reports from multiple organisations and authors have called for significant reforms to how councils and local services are funded – including changes to the revenue and spending powers devolved to councils, the re-introduction of a proper system to allocate funding between councils, and reforms to institutional arrangements to raise the status of local government.

What are the options for reforming council and local services funding?

Reforms to funding arrangements should be guided by a clear set of principles and objectives and aligned with an overall vision for the role of local government in service provision, economic development and democratic accountability.

An updated approach to funding allocation is needed, but there are trade-offs over how redistributive it should be

At a minimum, there is a need to put in place a local government funding system that can properly account for variations in local spending needs and revenue-raising capacity, and allocate funding accordingly. This is what the government has said it will do, which as far as it goes is welcome. But it is not without its technical challenges, and it is important to realise that no approach is fully objective – subjective, political judgements on the level and quality of services expected, and what 'need' is, cannot be avoided. In particular:

- The level and quality of services expected, and so the absolute levels of funding provided, will affect the relative spending needs of different councils. With an expectation of more universal services, and higher funding, needs may not be so concentrated in the most-deprived areas, for example. This means that a clear view of the range and quality of services expected from councils is needed, as are realistic assessments of how much it would cost to fund these.
- Does 'need' mean only accounting for differences in demands for and costs of services between areas, or is additional support to disadvantaged areas in an effort to reduce underlying inequalities also deemed desirable? The latter approach is used to allocate NHS

funding and is worthy of consideration for local government if a high priority is placed on tackling geographical socio-economic (including health) inequalities.

Putting in place a proper funding allocation system also does not necessarily mean that funding should fully adjust for differences in assessed spending needs and revenue-raising capacity. There is a trade-off between redistribution and the provision of financial incentives, and while evidence on how financial incentives affect council behaviour and socio-economic outcomes is limited, this does not mean that such incentives do not matter. The important thing is that the system should make clear how much priority is being placed on redistribution versus incentives, and ideally allow the balance to be shifted at least somewhat relatively straightforwardly, if the priority placed on these objectives changes. In other words, a reformed system of redistribution should be both transparent and have a degree of flexibility, so that governments do not feel the need to tear up the system and start again if their priorities are not being met. In our view, this reduces the attractiveness of some of the most radical suggestions to fund local government almost entirely through devolved and locally assigned tax revenues.

Too much flexibility can be counterproductive though, and the government should try to build consensus for the broad objectives of the local government finance system, and particularly the balance between England-wide consistency and local discretion over both revenue and spending policy. Its forthcoming consultation on reform is the place to start this process.

How to make decisions over revenue and spending devolution

The choice of devolved revenue-raising powers and service areas also involves trade-offs. However, sets of principles can help guide decisions about the scale and scope of revenue and spending devolution.

In general, revenue and spending devolution is more attractive when one prioritises: (a) financial incentives to improve local socio-economic circumstances; (b) discretion to reflect variation in local preferences and needs, especially where such variation is believed to be significant, and local policymakers have substantially better information available to them on such variation; and (c) the opportunity to learn from different policies being adopted in different jurisdictions. Conversely, a greater focus on redistribution and consistency reduces the attractiveness of devolution, especially of revenues.

How to increase councils' limited revenue-raising powers

With this in mind, the empirical evidence for a positive impact on growth of the incentives, discretion and learning opportunities provided by devolution is weaker than would be suggested by the apparent consensus that this is true. However, on the revenue side of their budget, English councils' powers are highly constrained compared with many comparator countries, so there is probably a case for providing some further revenue-raising options.

When deciding what these should be, the following considerations are key.

- **Administrative feasibility.** Tax bases need to be apportioned between local areas, creating costs for the tax authorities and taxpayers, but the scale of these varies significantly by tax.
- **Incentives and risks for councils.** Exposure to changes in tax bases can incentivise councils to try to boost them, but if tax base performance is outside their control, this exposure is just a source of financial risk.
- **Tax base and payer mobility.** If taxpayers can easily move or change behaviour in response to differences in taxes across councils, devolution may significantly distort taxpayer behaviour and encourage harmful ‘tax competition’ between councils, driving down tax rates and revenues.
- **Accountability effects.** If taxes are paid largely by non-residents, and therefore non-voters, the lack of democratic accountability may inappropriately push up taxes. Conversely, if non-residents pay tax, councils may have a stronger incentive to provide services they value.
- **Revenue distribution.** Devolving tax bases that are highly unequally distributed may increase funding inequalities between councils, and while redistribution arrangements can offset this, these can undermine councils’ incentives and reduce transparency.
- **Revenue volatility and predictability.** More volatile and unpredictable revenues can increase the financial risks facing councils, especially given their limited borrowing powers.

Based on these considerations, property taxes (particularly on residential property) are typically good candidates for devolution, followed by personal income taxes – although the specifics of the revenues and powers over these taxes that are devolved need to be carefully considered. VAT/sales tax and corporate income taxes are generally less good, being subject to bigger administrative challenges, more tax base mobility and weaker political accountability.

Stamp duty land tax (SDLT), while a property tax, is very unequally distributed and delivers volatile and hard-to-predict revenues. It is also a particularly economically damaging tax that should be abolished, rather than further entrenched via devolution. Tourism taxes have pros (administratively feasible, incentives to boost tourism) and cons (unequally distributed, taxpayers are non-voters). Given strong backing from local government for this (and a number of other local tax options), they could be devolved at a combined authority level rather than to individual councils, to reduce the scale of inequalities in tax bases, and be subjected to caps, to prevent excessive taxation.

On the spending side of the budget, it is important to distinguish between discretion over provision and discretion over funding

Decisions about devolution on the spending side of the local government budget should also be informed by clear principles and evidence. In addition to the aforementioned considerations, it is also important to take into account the alignment with other responsibilities of different government tiers, in order to maximise co-ordination benefits and economies of scope, and to

consider whether a particular spending responsibility has significant spillover effects on other jurisdictions, or important economies of scale.

Overall, there is a reasonable case that some functions – such as transport, housing, skills and employment support – are most appropriately delivered at a regional level. This would suggest devolving a package of related funding, responsibilities and powers to combined/mayoral authority areas or large country or unitary councils on a more consistent basis across England. However, the economy-related spending areas currently being considered for devolution are relatively small in comparison to even small fractions (e.g. 10%) of major taxes, such as income tax. This means that significant fiscal devolution would likely require councils to have more discretion over much larger areas of spending, such as schools, social care provision and potentially even health care. In contrast, the trend over the last two decades has been for increasing centralisation of decisions over these areas of core public service provision, with ring-fenced grants, a national schools funding formula, plans for a national care service, and the amalgamation of NHS organisations into bigger units, with the aim of more consistent and efficient service provision. Reversing course would be a big change and therefore should only be done after much consideration.

It is not necessarily the case that centralisation of funding does lead to more consistent standards of service provision though – because the spending needs assessments used to determine funding allocations can be wrong. In such circumstances, the ability of councils with revenue-raising powers and multiple services to spend more or less than these spending needs assessment to offset such errors can, in principle, improve consistency in provision – provided there are clear national standards of provision, and sufficient funding available to meet these standards. Thus, while placing a high priority on local discretion over service provision does require local discretion over funding levels, a high priority on consistency of service provision does not necessarily require centralised funding – it depends on factors such as the quality of spending needs assessments, and the enforceability of both national standards of provision and the provision of sufficient funding.

Institutional and other arrangements

We are less well placed to discuss institutional arrangements. However, aforementioned technical and economic considerations do have a bearing on these issues.

For example, because of the inherently subjective issues at the heart of spending needs assessment and funding allocation processes, any independent body set up to work on these issues should be subject to clear mandates and be advisory only. Any new legal mandates for engagement with local government in the design of these processes should also recognise that reaching a consensus on specific proposals is likely to be difficult (within a fixed envelope, more funding for some councils means less for others). Again, final decision-making will have to lie

with central government or parliament, where democratic accountability for national distributional issues lies.

Some have suggested legally guaranteeing local government as a whole a proportion of certain national tax revenues in order to raise its bargaining power relative to central government. But the revenues from a given basket of taxes and the spending needs of councils and other parts of the public sector can evolve differently over time. If these taxes are raised to fund other services (such as the NHS), such a rule allocating a share to councils too could mean a squeeze on other spending. Any such national hypothecation of revenues would need to be carefully designed and only adopted if other arrangements – such as enforceable funding sufficiency requirements based on assessments of absolute as well as relative spending needs – fail to improve councils' bargaining power over funding.

Ring-fencing or requiring competitive bids for too many small pots of funding does impose costs and reduces the ability of councils to respond to local knowledge. It can make sense though to ring-fence larger pots of funding for services where the aim is for more consistent provision in services across the country, in the context of a system that otherwise has a significant focus on discretion and incentives. An alternative to this approach is to avoid ring-fencing, but to hold local government more accountable for outcomes for such services. Other countries with greater devolution and financial flexibility for local government often accompany it with more formalised oversight and scrutiny of financial and service outcomes.

There is merit in providing councils with multi-year funding settlements to aid longer-term financial and service planning. These settlements should not be completely fixed and trying to provide complete certainty over cash-terms budgets is probably counterproductive – not least because inflation and demand pressures may turn out considerably higher or lower than expected. But they can provide a baseline, and information about how funding will be updated to reflect changes in circumstances.

Finally, the government is also planning to merge councils in areas with two-tier (district and county) governance structures into a single (unitary) tier. It will be important to align reforms to the finance system and financial powers of local government with any structural changes made. Unitary authorities can, in principle, help reap economies of scale and scope, and in turn improve accountability for outcomes determined by multiple services currently split between two tiers of local government. But the wider areas they cover can also mean a reduction in accountability for decisions affecting residents of only small parts of new larger council areas.

Final remarks

Some changes are therefore clearly needed – most notably, a proper system for assessing spending needs and allocating funding between councils on agreed principles. It would also be

wise to ensure that funding arrangements provide longer-term clarity to councils, are transparent to various stakeholders, and are sufficiently flexible to adapt to the priorities of different governments.

However, there is no one ‘right answer’ on how councils and local services should be funded. What matters is that the funding system should be aligned with the policy objectives being pursued. For example, a finance system that strongly emphasises local responsibility for revenue-raising via devolved taxes and financial incentives for growth is unlikely to be suitable if one is also aiming to have a wide range of services provided to a consistently high standard across the country for similar tax rates. Conversely, a system of grants fully and frequently updated for changes in spending needs, significant ring-fencing, and with a continued shortage of revenue-raising options, will not pass muster, if the aim is for local government to take the lead in promoting growth and shaping services to meet local preferences.

As the government – in conjunction with councils and other stakeholders – progresses plans for local government funding and devolution, it therefore must first be clear on objectives; then, the details of the system can be decided in line with these objectives.

Key conclusions for a reformed system

1. Updated assessments of councils’ spending needs and revenue-raising capacities, and a transparent and flexible system to account for them when allocating funding are vital. Once in place, these assessments should be kept up to date.
2. The design of such assessments and such a system is technically challenging but not a purely technocratic exercise, so any independent institution tasked with making recommendations needs a clear mandate and should be advisory only.
3. The relative spending needs of different councils depend on the range and quality of services expected of them, and so the government needs to begin assessing absolute as well as relative spending needs.
4. The government should consider whether funding allocations should include a specific component designed to channel funding to disadvantaged areas not only to account for socio-economic inequalities, but also to reduce them, as with NHS funding.
5. Assessments of revenue-raising capacity should be based on notional rather than actual tax rates and bases to avoid distorting councils’ decisions. Councils’ abilities to raise revenues through sales, fees and charges (SFCs) can continue to be assessed

implicitly through spending needs assessments based on net expenditure, although separate assessments would allow for more bespoke formulas based on drivers of ability to raise revenue from SFCs, particularly from parking. Whether it is appropriate to assess abilities to raise revenues through fully commercial activities is less clear-cut, and doing this would be more difficult in practice.

6. The extent to and frequency with which changes in assessed spending needs and revenue-raising capacities should be accounted for depend on the priority placed on redistribution to account for differences in socio-economic circumstances versus the importance of local financial incentives for improving those circumstances. Decisions on this should be guided by the government's Missions and its theories of change for delivering them (which may also be resource- or empowerment/incentive-based).
7. In general, a greater degree of devolution is desirable when more priority is placed on local discretion over national consistency, which in turn should partly depend on the scale of variation in preferences between areas, and the type and extent of any asymmetries in information between central and local policymakers.
8. Decisions over which revenue streams and spending powers to devolve should be taken on a case-by-case basis, as the benefits and costs of devolving them are likely to vary. On the tax side, recurrent property taxes and personal income taxes are better candidates for devolution than VAT/sales taxes and corporate income taxes. On the spending side, a distinction should be drawn between discretion over the range and quality of services to provide, and the amount to spend on those services.
9. Centralising decisions on spending levels may not lead to more consistent service provision if assessments of spending needs are inaccurate. In this instance, devolving spending decisions, but having clear and enforceable national standards, can be a better option if there are mechanisms to ensure sufficient funding is available to meet those standards.
10. A legal requirement for central government to ensure sufficient funding and revenue-raising powers to deliver these standards would be the best way to achieve this. Guaranteeing a share of national tax revenues for local government, which has been suggested as a way to give effect to such a requirement, has potential costs, and would be very much a second-best approach.
11. The government should provide longer-term clarity to councils on their budgets via baseline multi-year settlements and clear information on how they would be adjusted in different circumstances (such as significantly higher- or lower-than-expected inflation).

1. Introduction

Councils are at the heart of British democracy, local public service delivery and local economic development and placemaking, and play a key role in the delivery of new government's five Missions and associated milestones under its Plan for Change¹ – including to improve the nation's health. English councils, the subject of this report, have responsibility for adult and children's social care services, public health, local roads and support for bus services, planning and economic development, housing advice and support, libraries and leisure centres, and refuse collection and disposal – among other things. They are funded by a combination of grant funding from central government, a share of business rates revenues, and council tax, as well as a range of sales, fees and charges (SFCs) for certain services, and commercial and investment income. In 2023–24, the financial year just ended, spending on non-education services was around £62 billion, or roughly £1,080 per English resident. This is roughly in line with the amount spent on schools, and around 40% of the amount spent on the NHS.

Despite real-terms increases in funding since 2019–20, local government funding per resident remains 19% below 2010 levels and councils are under evident financial pressure.² But as well as funding levels, there are also concerns about how councils and local public services more generally are funded. This includes the sources of funding available to councils, the range of services and activities that are devolved to local government, and the way funding is allocated between councils.

This report looks at these local government finance system issues, and the options for reform. The Labour government has committed to begin implementing an updated and reformed finance system from April 2026, with an emphasis on reflecting up-to-date assessments of needs and local revenues, and accounting for differences in levels of deprivation between local areas.³ This is welcome, but the details of reform will matter, and the government must be clear about how it proposes to trade off the different objectives that local government finance systems try to

¹ See Prime Minister's Office, 10 Downing Street Press Release from 30 November 2024, <https://www.gov.uk/government/news/next-phase-of-mission-led-government-will-put-working-peoples-priorities-first-with-pm-set-to-unveil-plan-for-change>. The full Plan for Change was due to be published on 5 December 2024, after this report was finalised.

² Ogden and Phillips (2024) report an 18% reduction. Updates to inflation outturns and forecasts since this report was published have increased the reduction to 19%.

³ See Ministry of Housing, Communities and Local Government (2024) and the Hansard report on the parliamentary debate 'Local Authority Funding' on 28 October 2024, <https://hansard.parliament.uk/Commons/2024-10-28/debates/5FA19AB9-EBEE-4CFC-BFEE-283D04D76288/LocalAuthorityFunding>.

accommodate – such as redistribution, financial incentives, local discretion, and nationally consistent service standards – and why.

However, this report goes beyond the issue of funding allocation to consider other issues and options for the local government finance system. This includes the extent of revenue and spending powers available to local government, and institutional aspects of the system. The government is also set to undertake a structural reorganisation of local government with the aim of reducing costs by ‘simplifying structures’, which is code for merging councils in areas with two-tier (district and county) governance structures into a single (unitary) tier (Ministry of Housing, Communities and Local Government, 2024). A full discussion of this issue is beyond the scope of this (finance-focused) report. However, it will be important to align reforms to the finance system and financial powers of local government with any structural changes made. Unitary authorities can, in principle, help reap economies of scale and scope, and in turn improve accountability for outcomes determined by multiple services currently split between two tiers of local government. But the wider areas they cover can also mean a reduction in accountability for decisions affecting residents of only small parts of new larger council areas.

A number of reports have also made recommendations in relation to reforming the local government financial audit system.⁴ While this is clearly a finance-related issue, it is somewhat separate from the issues related to funding allocation, revenue-raising and spending that are our focus and is therefore also not discussed in this report.

The rest of the report proceeds as follows. Chapter 2 looks at concerns raised in policy reports and debates about how councils and local services are currently funded. In line with the new government’s focus, the clearest-cut issue is the lack of an effective system for assessing the spending needs and revenue-raising capacity of different areas. Other issues that have been highlighted include: a lack of certainty or clarity over future funding levels; a limited range of revenue-raising options; weak financial incentives to improve local socio-economic circumstances; a lack of meaningful control over a range of important local services and functions; and confused accountability and weak institutional status relative to central government. Chapter 3 looks at the scope for reform, and the potential to address these issues. It argues that there is a clear need to put in place a system that properly assesses spending needs and revenue-raising capacity, but that there is a choice about the extent to which funding is allocated in line with these assessments, reflecting trade-offs between redistribution and financial incentives. It also argues that choices about the funding sources and service responsibilities devolved to local government should be guided by a set of principles and the wider policy objectives that are being pursued. Chapter 4 concludes.

⁴ See, for example, Eke and Kaye (2024).

2. What are the issues with the way councils and local services are funded?

Before identifying and appraising options for reform, it is important to understand the way councils and local services are currently funded, and the issues with these current systems.

2.1 How are council and local services currently funded?

English councils have responsibility for a wide range of local services, which include the following.

- **Education.** While an increasing number of schools are directly funded by central government, and councils' control over funding for other state schools in their areas is relatively limited, education remains the single largest area of local government spending.
- **Adult social care.** Means-tested support for adults with significant personal care needs due to disability or illness, both in their own home or in a residential care home.
- **Children's social care.** Community-based support services (such as Sure Start and youth services), as well as safeguarding and residential care (including with foster families) for children at risk of harm, and support for children with significant personal care needs due to disability.
- **Public health.** Services to improve public health, including sexual health services, alcohol, drugs, obesity, physical activity and smoking strategies, health checks for the over-40s, and children's preventative health-care services (excluding vaccinations).
- **Housing services.** Housing advice and regulation, grants for urgent improvements and renovations, and homelessness prevention services (including temporary accommodation).
- **Highways and transport.** Local road maintenance, parking provision and enforcement, street lighting, transport strategy and support for bus services (including concessionary bus passes).
- **Environmental and regulatory services.** Waste collection and disposal, street cleaning, trading standards and food safety, noise and pest control, licensing, community safety, and drainage and flood prevention.

- **Culture and recreation.** Community centres, cultural and heritage facilities, leisure centres, libraries, open spaces and parks, and promotion of the arts and tourism.
- **Planning and economic development.** Building and development control, planning policy, and local economic development and business support.
- **Central and other services.** Support services for other functions, local and national elections, local tax collection, registration of births, deaths and marriages, coroners' courts, emergency planning, and local welfare schemes (such as the Household Support Fund).

In urban areas, and an increasing number of more suburban and rural areas, a single tier of government is responsible for most of these services. This includes areas governed by so-called 'unitary authorities', as well as boroughs in London and metropolitan districts in the largest urban areas in the Midlands and North (Greater Manchester, Merseyside, South Yorkshire, Tyneside, West Midlands and West Yorkshire). In most rural areas, especially in the south and midlands of England, responsibilities are instead split between two tiers of local government: shire districts and shire counties. Here, the counties are responsible for the costliest services, where it may be more efficient to deliver provision over a wider area, including education, highways and transport, public health, social care, as well as libraries and waste disposal. The districts are responsible for housing, parks and recreation, local environmental regulation, local planning and development, and waste collection. This may change in the coming years, with the new government aiming to increase the number of unitary authorities (Ministry of Housing, Communities and Local Government, 2024).

In addition, recent years have seen an additional tier of local government emerge in many major urban areas, and some more rural areas – the combined or mayoral authority. These authorities cover a number of individual council areas and typically have responsibility for further education and skills, as well as regional economic development and transport planning. However, the responsibilities of each authority differ because until recently arrangements were negotiated on a case-by-case basis between local leaders and the national government.⁵

To fund these services, councils rely on several income sources, as follows.

- **Council tax.** The single largest source of council funding, this is a tax levied on the occupiers of residential properties, with bills based on the relative value of properties as of April 1991. A range of exemptions, discounts and premiums apply to certain kinds of properties – most notably, properties with one adult (a 25% discount) – and means-tested

⁵ Powers will continue to vary between areas in future but will be guided by a four-level framework, depending on whether an area has an elected mayor, and its institutional capacity. For further details, see the Department for Levelling Up, Housing and Communities, Technical paper on Level 4 devolution framework, Annex: Devolution framework, <https://www.gov.uk/government/publications/technical-paper-on-level-4-devolution-framework/technical-paper-on-level-4-devolution-framework#annex-devolution-framework>.

reductions are available for households with low incomes and savings. Central government determines the structure of the tax, while councils set the level of tax for their area, subject to a requirement of a referendum of local voters for increases above certain fixed percentages or amounts.

- **Business rates.** A tax levied on the occupiers of non-residential properties, with bills based on the relative rental value of properties as of April 2021. A range of discounts apply, including for small businesses, charities, and the retail, hospitality and leisure sectors. Prior to 2013, revenue from this tax was collected by councils but transferred to central government, which used it to fund grants to councils. Since 2013, councils retain a proportion of business rates revenues directly through the business rates retention scheme (BRRS), with this proportion varying locally – although most areas retain 50% of any *change* in revenues. Councils have significant discretion to offer discounts but not to change the headline tax rates.
- **Grant funding.** Central government provides a range of direct grants to councils, some of which councils are free to spend as they choose (such as the revenue support grant), and others of which are ring-fenced for particular purposes (such as schools, social care or public health).
- **Transfers from other organisations.** Local NHS bodies provide funding for social care services via pooled ‘Better Care Fund’ budgets and other arrangements, and other organisations (including charities) sometimes contribute to the cost of local government service provision.
- **Sales, fees and charges (SFCs).** Income received from the users of local government services and facilities provided on a non-commercial basis.
- **Commercial and investment income.** Income received from the users of services and facilities provided on a commercial basis, as well as income received from financial and property investments.

A range of local services operate and are funded entirely separately from councils. As already highlighted, this includes an increasing number of schools funded directly by central government as academies or free schools. It also includes most further education provision for 16–18 year olds. Most notably, it includes most health-care services, which are organised via NHS integrated care boards for much larger geographical areas than councils. These services are funded overwhelmingly via central government grants, although SFCs play some role (for example, for school trips, or prescription medication).

2.2 What are the problems with current funding allocations for different councils?

Given differences in the demographic and socio-economic characteristics of the areas they cover, both the spending needs and revenue-raising capacity of councils differ substantially across England. Historically, the grant funding for councils was allocated to councils using a complex set of formulas that tried to fully account for these differences, with the aim of enabling each council to provide the same range and quality of services if each set the same headline council tax rate. From 2006–07, a series of reforms changed this, with the end result that England lacks a proper system for allocating funding for council services across the country. Detailed information on the changes that led to this situation can be found in Amin-Smith et al. (2016) and Ogden et al. (2022), but a summary is useful to understand both the problems with current arrangements and, in the next section, potential ways to address them.

- The first major change took place in 2006–07, when the so-called ‘four-block model’ was introduced. This allocated funding via four mechanisms: a simple per-person allocation; a mechanism to account for spending needs above the minimum level of any council; a mechanism to account for revenue-raising capacity above the minimum level of any council; and a ‘damping’ mechanism to smooth any changes in funding. This allowed the government to vary the weight placed on different objectives (such as accounting for variation in needs and revenue-raising capacity) when determining councils’ funding. However, the specific way this model operated led to perverse outcomes: for example, allocations to each council were highly dependent on the characteristics of the council with the minimum need and revenue-raising capacity (Gibson and Asthana, 2011). Moreover, the model was so complicated that it allowed the coalition government to claim it was actively protecting councils serving deprived areas from cuts to funding, when it was in fact doing precisely the opposite (Amin-Smith et al., 2016). This contributed to councils serving more-deprived areas seeing substantially larger cuts to funding than those serving richer areas during the 2010s (Ogden and Phillips, 2024).
- The second set of major changes took effect from 2013–14.
 - Grant funding was cut substantially, and instead councils were able to retain a proportion of business rates revenues raised in their area under the BRRS.⁶ The proportion varies because a system of ‘tariffs’ and ‘top-ups’ redistributes these retained revenues between councils that had relatively high revenues or low assessed spending needs as of 2013, to those with relatively low revenues or high assessed spending needs.

⁶ See Harris, Hodge and Phillips (2019) for a fuller discussion of the operation of the BRRS.

At the margin though, most councils bear 50% of any real-terms change in business rates revenues due to the construction, demolition or change of use of non-residential property in their areas. The aim of this reform was to strengthen the financial incentives that councils have to promote local economic development, especially through the provision of non-residential property.

- Previously annually updated assessments of spending needs and revenue-raising capacities used in the allocation of grant funding (even under the flawed four-block model) were no longer updated or used systematically. Instead, changes in grant funding have been made on an ad hoc basis each year. In some years, all councils have seen effectively the same percentage change in their general-purpose revenue support grant funding (2014–15, 2015–16 and 2020–21, and later), taking no account of how much they rely on their own revenue-raising capacity (or, conversely, their grant reliance). In other years, changes in this revenue support grant funding have accounted for how much councils raised in council tax in 2015–16 (2016–17 to 2019–20), but not changes in revenue-raising capacity (or grant reliance) subsequently.

The problem with these changes is not that they reduced the priority placed on distributing grant funding in accordance with assessed spending needs and revenue-raising capacity: that is a legitimate objective, especially if one wants to provide councils with stronger financial incentives to tackle the drivers of spending needs and boost local economic performance. The problems instead are twofold. First, England has been left without up-to-date official assessments of the spending needs and revenue-raising capacities of different councils, making it very difficult to see the extent to which funding deviates from such assessments. Second, funding levels for different councils depend in a complex and completely untransparent way on a combination of assessed spending needs as of the early 2000s, the operation of the flawed four-block model in the late 2000s and early 2010s, and various ad hoc arrangements over the last decade – in other words, they are essentially arbitrary.

Recent IFS research, which has attempted to update official assessments of spending needs, finds big differences between the relative levels of funding of different councils and their relative levels of spending needs (Ogden et al., 2023). For example, as of 2022–23, councils in the most-deprived fifth of areas are estimated to receive a share of funding that is 10% below their share of assessed spending needs, after adjusting for differences in the council tax levels they set compared to the average council tax rate. Conversely, councils in the least-deprived fifth of areas are estimated to receive a share of funding that is 13% above their share of assessed spending needs on the same basis.⁷ There are also large and systematic differences between assessed spending needs and funding for public health services and police services. But gaps for

⁷ Based on the actual council tax rates they set, the differences are –9% and +15%, respectively. These estimates also reflect differences in local tax choices as well as decisions taken by central government though.

NHS spending are relatively smaller and not strongly related to local demographic or socio-economic characteristics, reflecting the fact that the NHS funding allocation system has been kept up to date (Ogden et al., 2022, 2023).

These issues mean that current funding allocations are likely both unfair and inefficient, with potentially negative consequences for both geographical inequalities and overall value for money. Inappropriate funding allocations have also been highlighted by combined authorities as adversely affecting collaboration with councils, undermining the potential benefits of their devolved powers (Goodwin et al., 2024). More generally, funding misallocations risk devolution increasing inequalities rather than helping to tackle them and improve services (Phillips, 2024).

2.3 What are the other potential issues with funding arrangements for local services?

In addition to the lack of a rational, up-to-date system for allocating funding between councils, several further issues have been identified by researchers and organisations making recommendations in relation to how councils and local services are funded. Some relate to funding specifically, while others are wider in scope, and relate to councils' responsibilities and powers, or the relationship between central and local government.

A lack of certainty or clarity on future funding

In recent years, councils' have typically been provided with single-year financial settlements covering only the upcoming financial year. Both councils themselves and systematic reviews of the local government finance system have highlighted how the unpredictability of funding beyond a year ahead can hamper medium-term financial planning and changes to service provision models, particularly for initiatives having an impact over multiple years (such as 'invest-to-save' type initiatives).⁸ This may reduce both the efficiency and quality of service delivery, and may be a contributory factor to the relatively high reserves many council now deem it prudent to hold.

⁸ See, for example, Independent Commission on Local Government Finance (2015), Local Government Association (2024), Central London Forward (2021) and Weinberg et al. (2024).

Limited revenue-raising powers

Another issue highlighted by local government and a number of reviews of the local government finance system is the limited range of revenue-raising options available to councils compared with local governments in other high-income countries.⁹

As highlighted above, the two main taxes collected are council tax (fully retained) and business rates (partially retained and partially remitted to central government). The issue is not the scale of these revenues relative to councils' spending, as is sometimes implied: together they account for approximately 85% of 'core spending power', an official measure of the funding that councils have significant flexibility in how to spend (with the remaining 15% being grant funding from central government).¹⁰ Instead, it is the narrowness of the tax base subject to local taxation (residential and non-residential property), and the limited ability of councils to (upwardly) vary how much they raise from these taxes. For example, council tax is subject to limits in the scale of increases councils can make each year without calling and winning a local referendum on larger increases. And councils have very limited powers to increase business rates at all – although they do have wide discretion to offer reductions in bills to certain kinds of property or business, subject to state aid rules.

In contrast, local governments in other high-income countries often have a wider range of tax options available to them, generally with fewer restrictions on the rates of tax system. Table 2.1, reproduced from Amin-Smith, Harris and Phillips (2019a), shows for a range of tax types whether local or regional governments have devolved powers – in which case they have at least some powers over tax rates and base – or assigned revenues – in which case they cannot vary the rate but gain or lose as revenues rise or fall. In some countries, councils have access to a wide range of taxes – 24 in the case of Japan, including local consumption taxes and duties, levies on golf courses, hot spring facilities and hunting, and the Japanese equivalents of vehicle excise duty and SDLT (Muldoon-Smith et al., 2023d).

⁹ See, for example, Local Government Association and Localis (2020), Local Government Information Unit (2024), Raikes (2023) and Studdert (2023).

¹⁰ Most other grants are ring-fenced for specific purposes, such as schools or public health services. Some grants included in core spending power are officially ring-fenced for social care services, but because they cover only a small part of funding for social care services, the size of these grants is not a binding upper or lower bound on how much is spent on these services.

Table 2.1. Examples of subnational taxation in other countries

	Devolved	Assigned
Income tax	Sweden (regional and local), Finland (local), Denmark (local) Progressive taxes levied in Canada (regional), United States (regional and local), Spain (regional)	Germany (regional and local)
Sales tax/VAT	United States (regional and local – sales taxes), Canada (regional – VAT)	Belgium (regional), Italy (regional), Portugal (regional), Spain (regional), Germany (regional and local)
Corporation tax	Germany (local – ‘trade tax’), Canada (regional), Italy (regions)	Denmark (local), Finland (local), Portugal (local)
Tourism tax	Italy (local), Germany (local), Netherlands (local)	
Inheritance tax	Poland (local), Spain (regional)	Germany (regional)
Vehicle taxes	Belgium (regional), Spain (regional)	Germany (regional)

In addition to local taxes, councils also raise significant sums from SFCs associated with the services they provide, as well as commercial activities and investments. There are restrictions on the SFCs that councils can set though – with a general limit of ‘cost recovery’, and specific caps for a number of services (such as planning application fees). Some have suggested giving councils greater flexibility to set SFCs to enable them to make a profit from the delivery of chargeable services if they so wish.¹¹

Weak financial incentives

A number of reports have suggested that despite reforms undertaken in the 2010s, such as the BRRS and ending of annual updates to spending needs assessments, English councils still do not have strong enough financial incentives to improve local socio-economic incentives (Breach, Bridgett and Vera, 2023; Studdert, 2023). In particular, while the BRRS provides a financial incentive for authorising and facilitating the development and retention of non-residential property, councils do not have direct financial incentives to increase the incomes of local residents and profits of local businesses in ways that do not involve the use of more local non-residential property. These could include residents improving their skills in order to access higher-paid jobs in neighbouring areas or via remote work, for instance, or businesses developing new higher-value services or products. Because the BRRS offsets changes in

¹¹ See Independent Commission on Local Government Finance (2015) and Central London Forward (2021).

revenues due to changes in assessed property rental values when revaluations take place, councils gain (or lose) little indirectly due to the effects of business performance on property rents.

It is worth noting that the lack of updates to spending needs assessments does mean councils have relatively strong financial incentives to address the drivers of spending needs for the services for which they are responsible – their funding is not reduced as it would be (at least to some extent) if a system of needs assessment and redistribution were put back in place. However, others have noted that councils' activities could have significant impacts on the demand for and cost of other areas of public spending, such as health care and disability benefits, and that there is currently no financial incentive to take account of such impacts (Independent Commission on Local Government Finance, 2015).

A lack of discretion or influence over key spending areas

As well as complaints that too few revenue sources are devolved to local government, several reviews have argued that too few spending and policy responsibilities are devolved. The concern is that this limits the ability to tailor investment and service provision to local preferences and needs if central government has less information, less incentive or less ability to respond to geographical variation in needs and incentives.

A common concern is that local government has too little control over funding and decisions related to 'economic development' broadly defined (including transport, further education and adult skills, employment support, housing, digital infrastructure, and potentially innovation/research and development).¹² It is therefore suggested that councils or groups of councils covering 'functional economic areas' could be provided with 'single pot' grants for investment and services related to these areas, which would remove existing ring-fences tying specific grants to particular services.¹³

Views over responsibilities for traditional areas of public service provision – such as social care and housing support – are mixed. Some reports have called for increased funding but continued local control of these areas, potentially with an enhanced role for local government in related areas such as health-care planning, to better link up services and account for local needs (Independent Commission on Local Government Finance, 2015; Beacon, 2024). Others have

¹² See, for example, Raikes (2023), Pope, Dalton and Coggins (2023), Royal Society of Arts (2023) and Weinberg et al. (2024).

¹³ There is no single definition of a functional economic area (FEA). However, factors such as labour market and commuting flows, goods and service markets and consumer flows, transport networks and usage of social and cultural facilities are used to define groups of councils that can be considered strongly economically linked. FEAs may be based around a major city or conurbation, or instead be anchored by several smaller urban centres (such as in more rural parts of the country).

suggested that such public services, where central government has played an increasing role in mandating national eligibility standards and minimum service standards, should be removed from local government, and funded centrally (see Phillips and O’Brien, 2024). It is argued this would enable local government to focus instead on services where there is greater acceptance of local variation to reflect local needs and preferences, and remove the main drivers of recent spending pressures.

Confused accountability

Several reports highlight confused financial and political accountability, with the remits and responsibilities of local and central government overlapping and little understood by voters and other stakeholders.¹⁴ This could potentially lead to lower performance if different tiers of government are able to shift blame on to others for their failures, or conversely miss out on credit for their successes: the disciplining device of the ballot box is likely to be less effective. Such accountability problems could be exacerbated by the increasingly complex governance arrangements in England – with areas seeing up to four tiers of government (district, county, combined authority and central), and the new middle tier of combined authorities having different responsibilities and governance arrangements (e.g. mayoral or non-mayoral) in different parts of the country.

In any system where central government plays a role in funding local government services and sets out some expectations of the range and quality of services to be provided, fully demarcating responsibilities is infeasible. Moreover, the performance of local government services is likely to depend to some extent on the performance of other public services, such as the NHS, and the social security system: tackling homelessness among those with mental health issues is likely to be harder for councils if there are problems with health-care services or inflexibility in benefit payment arrangements. Responsibility for outcomes is therefore always to some extent shared. However, certain actions (or inactions) by central government can make it more difficult than necessary for voters and other stakeholders to understand who is likely *primarily* responsible for a particular issue. This includes placing duties on local government for which funding is not available (‘unfunded burdens’), where formal accountability (which in this case would lie with the council) would not align with where real responsibility for failure to deliver would lie (with central government). It also includes frequent changes in duties placed on local government, and changes in responsibilities of central versus local government, which voters and other stakeholders can find difficult to keep track of. In addition, a deal-based approach to devolution, while flexible, may lead to (subtly or significantly) different arrangements in different places, which again may be difficult.

¹⁴ See, for example, Lyons (2007) and Muldoon-Smith, Forbes and Pearson (2023a).

Institutional status of local government

While the Localism Act (2011) provides local government with an expansive power of general competency, in contrast to many other countries, the division of powers between central and local government, and the relationship between central and local government is not set out in law, in contrast to many other countries (where, indeed, it is often set out in written constitutions). This means that it is relatively easy for central government to add or remove responsibilities or powers, or to intervene in areas traditionally under the purview of local government. Related, both funding levels and distribution are fully at the discretion of central government, whereas in other countries, such as Germany, there are legal requirements to assess and ensure funding adequacy, which can be enforced in constitutional courts, and/or formalised joint arrangements for determining funding allocation methodologies, such as in Italy (Muldoon-Smith et al., 2023b, 2023c). While the UK government has previously set up joint working groups with local government on funding system design, and consults on both principles and technical details, it is argued the lack of legal requirement and formalised arrangements reduces the bargaining power of local government relative to central government.

3. What are the options for reforming council and local services funding?

After identifying a set of issues with the way councils and other local services are currently funded, the next questions are: what can change, and what should change? In this chapter of the report, we first present a set of potential objectives and principles with which to assess both the current funding system and future options for reform. We then identify one issue that needs to be addressed – the lack of an effective system for allocating funding between councils. However, beyond this, rather than a single clear path forward, there are different options available, depending on the priorities placed on the different objectives that funding systems try to achieve.

3.1 Potential objectives and principles for local government funding systems

Local government finance systems must balance a range of potentially competing objectives and be aligned with the role envisaged for councils in delivering objectives for political accountability, public service provision and economic development. Ogden et al. (2022) discuss the main objectives and trade-offs between them in detail, but these are summarised here.

- **Redistribution versus incentives.** Local areas differ in their geographical and socio-economic characteristics, which may affect both the demand for and the cost of providing public services. In addition, areas differ in their capacity to raise revenues from local residents and businesses, affecting the range and quality of services that could be funded from local sources alone. One common objective of funding systems is to equalise for differences in the spending needs and/or the revenue-raising capacity of different local areas in order to achieve more similar levels of overall funding or service provision across places. One may also want to go further by providing more or higher-quality services in areas with high assessed needs, hoping to help reduce inequalities, as with NHS funding.

This can conflict with another objective though: providing councils with financial incentives to improve local socio-economic circumstances, in turn reducing spending needs and boosting revenue-raising capacity. This is because an ongoing process of redistribution

would reduce the funding provided to areas that see reductions in their assessed spending need or increases in their own revenue-raising capacity.

The priority placed on needs versus incentives should be guided by several factors. A belief that people should have access to a similar range and quality of services irrespective of where they live would lead one to place a greater emphasis on needs. The ability of councils to meaningfully act upon incentives, and the scale of the impacts of their actions on needs and revenue-raising capacity relative to the impacts of factors outside their control, also matter. If it is felt that actions taken by councils have relatively little effect compared with factors outside their control, then this should also lead one to place a greater emphasis on needs – because the ‘incentives’ are instead largely additional risks.

Funding systems can strike a balance between these competing objectives by only partially accounting for changes in assessed spending needs and revenue-raising capacity and/or applying changes with a lag. This would allow councils to benefit financially on a partial and/or time-limited basis from improvements in local circumstances, while still partially and/or eventually compensating them if local circumstances worsen. Alternatively (or in addition), spending needs assessments may purposefully account for only some of the assumed drivers of spending needs – often those that local policymakers are least able to manipulate – so that there are still financial incentives to tackle other drivers. Similarly, funding systems may be hybridised and include both needs-based and outcomes-based (or competition-based) elements, potentially for different service areas – with the former used where ensuring services can be provided to at least a minimum standard nationwide is a priority, and the latter where incentives are deemed relatively more important.

- **Stability versus responsiveness.** Significant year-to-year changes in funding can be difficult from both a practical and political perspective by making budgeting difficult and, in turn, reducing the effectiveness of spending. Therefore, on the one hand, finance systems often aim to minimise large sudden changes in funding, particularly downwards. On the other hand, one may want funding allocations to respond to changes in local circumstances, ensuring that councils seeing a particular surge in demand for services or a reduction in local revenue-raising power can still meet minimum service standards. Fully fixing or setting out in advance funding allocations precludes this.

Updating funding allocations with a lag, provided information is provided in advance about the changes to be expected, can help ameliorate this trade-off. Another option is to use damping or pace-of-change rules, which use needs assessments as ‘target’ funding allocations, but which cap the increase or decrease in funding in a given year, to prevent changes deemed overly large.

More generally, the priority placed on stability relative to responsiveness should depend on how able councils are able to cope with changes in funding. In turn, this will depend upon their financial reserves, and their flexibility to adjust both service provision and levels of location taxation and other revenues.

- **Discretion versus consistency.** Discretion over spending, policy design and implementation can allow councils to take account of local preferences and local knowledge, and offers the opportunity for learning between councils trying different approaches. However, this can conflict with the desire for services to be delivered in a consistent way and to a consistent standard as ‘citizens’ rights’ across the country.

Decisions over whether to prioritise discretion or consistency should not just be principles-based. Instead, they should be informed by evidence on the extent to which preferences and needs vary between places, as well as the extent to which variation in policy (such as tax rate structures and levels of service provision) can distort the location decisions of both people and businesses.

One approach to balancing these competing aims is to distinguish between services where discretion is allowed, and others where national standards are in force. Another is to specify *minimum* standards nationally, which councils can choose to exceed if they wish.

Systems may also differentiate between discretion over spending and discretion over policy. In the absence of discretion over spending, the amount available for a particular service in a particular area depends upon centralised assessments of needs and funding allocations. If these are sufficiently accurate, this can support consistent service delivery. But if they are not, then enabling councils to vary the amount spent (by varying local taxes or reallocating funding between services) can offset inaccuracies. In this context, discretion over spending can actually better enable greater consistency of service delivery, provided it is paired with clear and enforceable national (minimum) standards of service provision.

In addition to having to decide how and in what way to balance these competing objectives, several other principles are important for local government finance systems.

First is **transparency**. The objectives and practical effects of a local government finance system should be clear to stakeholders so that they can understand the implications of actual and counter-factual policies, and so make relevant suggestions on the design and operation of the system. The English local government finance system has not always been transparent: the aforementioned four-block model was sufficiently complex that it enabled the then-government

to claim it was protecting councils serving deprived areas from cuts in the early 2010s,¹⁵ while cutting their overall funding by more than average.

Second is **accountability**. The way local services are funded should help ensure the organisations making decisions on revenue-raising, spending and service design and delivery can be held to account for their decisions. This could include via political means (such as local or national elections), bureaucratic means (such as targets or service standards) or legal means (such as through legal challenge or judicial review) or through financial gains or losses when performance is good or bad (highlighting the link between financial accountability and financial incentives). As discussed in Chapter 2, it is not possible to fully demarcate the responsibilities of central and (different tiers of) local government, given the role of central government in determining funding levels and allocation and the interactions between services delivered by different tiers of government. But a transparent finance system, a common understanding of areas with national standards and local discretion, and coherence between these two elements can all help.

Third is **flexibility**. The extent to which different governments (and indeed wider society) prioritise different objectives, and how these objectives are interpreted, is likely to vary somewhat over time. Ensuring a system has a degree of flexibility, especially in relation to the measurement of spending needs and the degree of redistribution can allow such changes in prioritisation to be accommodated without a fundamental redesign of the system – which could prove costly and disruptive.

However, as with automatic responsiveness, policy flexibility can also conflict with the aim of providing a stable and predictable system for councils. There is therefore a benefit in forging a consensus on the broad objectives of the local government finance systems that can survive changes in government. This is particularly true in relation to the balance between national consistency and local discretion, over both revenue and spending policy: regular changes in the powers and/or duties of local government are likely to be both costlier and more confusing to stakeholders (potentially affecting accountability), than modest changes in the degree of redistribution being undertaken by the funding system.

Several other principles particularly relevant for decisions over revenue and spending devolution are discussed later.

¹⁵ The then Under Secretary of State, Bob Neill, said: ‘The Coalition Government has taken unprecedented steps to protect councils most reliant on central government funding’. See <https://webarchive.nationalarchives.gov.uk/ukgwa/20120919132719/http://www.local.communities.gov.uk/finance/1112/setwms.pdf>.

3.2 Needs assessment and funding allocation

Based on the above considerations, it is vital to have a proper system to assess the spending needs and revenue-raising capacity of councils and, in turn, allocate funding. This is not because the government need necessarily fully account for differences in assessed spending needs and revenue-raising capacity when allocating funding between areas. Indeed, it would be a legitimate decision to take no account of variation in these variables at all, provided one was also willing for the range and quality of services to be higher in the typically more-affluent areas with lower needs and/or higher revenue-raising capacity. However, even in such circumstances, information on the extent to which the resulting funding available to each council differs from its assessed spending needs would be important to enable stakeholders to hold national and local government to account for the design of the funding system and outcomes. And, given that the starting point is funding allocations that depend arbitrarily on past patterns of assessed spending needs and various ad hoc funding decisions, there would be a case for an initial redistribution of funding to align new distributions with one's objectives.

As highlighted earlier, statements on funding reform suggest that the current government is likely to place a relatively high weight on accounting for differences in needs and revenue-raising capacity. But there are still important decisions to be made: on how to assess spending needs and revenue-raising capacity; how fully and how frequently to update funding allocations to account for changes in these assessments; and how to transition to updated funding allocations.

The conceptual definition of spending needs

Fortunately, we do need to start from scratch in making these decisions: consultations held by previous Conservative administrations (Ministry of Housing, Communities and Local Government, 2016, 2018a, 2018b), and responses to these by IFS researchers (Harris and Phillips, 2018; Amin-Smith and Phillips, 2018, 2019; Amin-Smith, Harris and Phillips, 2019b) among others provide detailed analysis and discussion and recommendations in relation to these choices. These emphasise that the technical details matter for both the assessment of spending needs and revenue-raising capacity and the design of funding allocation systems, but that decisions on these issues are not purely technocratic: subjective, political judgements must be made.

One key conclusion is that councils' spending needs are subjective and depend on what one is trying to achieve with local public services. There are two key aspects of this.

- **First, while historically the English local government finance system attempted to measure the relative spending needs of different councils independently of the absolute amount of funding provided, this is not fully possible.** This is because the absolute level

of funding, and hence the range and quality of services that are expected to be delivered, will affect the relative needs of different parts of the country. For instance, with an expectation of more universal services, and higher funding, needs may not be so concentrated in the most-deprived areas. Conversely, an increase in expectations around safeguarding children and supporting transitions from care, combined with an acceptance of more stringent care needs assessments for adult social care, may mean higher relative levels of needs in more-urban areas with younger populations compared with more-rural areas with older populations. This means a clear view of the range and quality of services expected from councils, as well as realistic estimates of how much it would cost to fund these, are needed: it is not possible to separate assessments of relative spending needs from the absolute funding requirement for local government.

- **Second, is the question of whether ‘need’ means only accounting for differences in the demands for and costs of services, or also provision of services explicitly aimed at reducing geographical inequalities.** Historically, the English local government finance system aimed at only the former with ‘standard spending assessments’ designed to capture variation in how much it would cost councils to deliver the same set of services if they charged the same council tax rate. However, the approach used to assess spending needs in the NHS includes top-ups (in total, accounting for between 5% and 15% of funding, depending on subservice) to those areas with high levels of avoidable mortality (i.e. deaths that could have been avoided through health care or public health interventions), with the aim of increasing access to services and reducing geographical inequalities in health. A decision is needed on whether such an approach should be adopted in the local government finance system and, if it is, what measures of inequality to base funding top-ups on.

Assessing spending needs and revenue-raising capacity in practice

Empirically estimating spending needs (however defined) and revenue-raising capacity is difficult because neither can be directly observed – they must instead be inferred from proxies.

For spending needs, these proxies have traditionally been local area characteristics – including the demographic and socio-economic indicators (such as age structure, housing tenure and benefit claimant rates), physical and human geography (such as coastline length, road length and commuter flows) and factors affecting the cost of service provision (such as labour and property costs). These are then weighted using either judgement or by estimating the relationship between these characteristics and spending on different services.

Judgement-based weights are clearly subjective and so may not reflect any objective measure of ‘need’. But estimated relationships too may not necessarily pick up variation in spending needs and also rely on subjective decisions.

To see this, consider estimates based on the relationship between council-level spending on services and council-level local area characteristics. Suppose, for example, that the government previously chose to allocate funding to council areas with high levels of deprivation and high levels of ill-health. If the resulting pattern of spending across council areas was used to estimate a spending needs formula, this would show a positive relationship between deprivation and ill-health and spending levels. But this formula would largely reflect these past funding allocations, and reveal little about the relative spending needs of different areas. Similar issues may arise when looking at service utilisation rather than spending – patterns of service usage may pick up where past funding has created the capacity to provide services, rather than the need (and unmet need) for the services.

Estimating the relationships using individual- or neighbourhood-level spending or utilisation patterns and individual or neighbourhood characteristics can help ameliorate this problem and should be used where possible. This is because it allows one to strip out the effect of other factors (such as availability of funding, local preferences or efficiency) that can affect the average level of spending by different councils, and estimate spending needs formulas using *within*-council relationships between spending/utilisation and characteristics. If councils allocate their spending between residents and neighbourhoods on the basis of needs, the within-council relationships between spending and individual/neighbourhood characteristics would provide useful information on spending needs. Adult and children's social care formulas commissioned by previous Conservative administrations as part of their aborted attempts to reform the local government finance system use such an approach (based on neighbourhood and individual-level data, respectively). With some updates, they could form part of the government's reforms to the local government finance system.

But such approaches do not overcome estimation problems entirely. First, as discussed above, the relative spending needs estimated for a given level of absolute funding may not be a good guide to relative spending needs for the higher or lower levels of funding pertaining in future. Related to this, sub-council relationships between spending/utilisation and characteristics can still be affected by council-level funding allocations. For example, suppose that some councils receive more funding relative to their 'true' needs than others. Including and stripping out council 'fixed effects' in the statistical analysis used to estimate spending needs formulas can control for the impact of this on the average spending of these councils. But a higher level of spending may be associated with a different distribution of spending across individuals or neighbourhoods with different characteristics – perhaps allowing spending on better-off less-needy groups than in councils with less-constrained budgets than in councils with more-constrained budgets. In such circumstances, the estimated formulas can still be distorted by the availability of funding in different types of councils.

For many other services, sub-council level data are not readily available, meaning that formulas used for spending needs assessments will need to be based on council-level correlations between spending or utilisation and local area characteristics. In such circumstances, it is particularly important to not just use the latest available data – as the patterns in those data will, to a large extent, reflect how funding is allocated in the latest year. Instead, one needs to use a combination of judgement and analysis of the variation in service access and quality across places to identify a year in which one thinks funding most closely aligns with one's conception of need. Harris and Phillips (2018) show that, given big changes in how funding was distributed across councils during the 2010s, the year chosen to estimate spending needs formulas could make a big difference to the resulting spending needs formulas and, in particular, to the weight placed on factors such as deprivation. Choosing a year after the big cuts to funding for councils in more-deprived areas in effect bakes in those cuts to future spending needs assessments. Choosing an earlier year would, over time, act to undo the cuts, but would lead to a bigger redistribution of funding and therefore have to be phased in more slowly.

Another subjective decision – again linked to the range and quality of services expected – relates to the weight allocated to each service area when assessing overall spending needs. Given differences in local area characteristics and the different drivers of spending needs for different services, this choice can significantly affect how assessed needs are distributed across councils. One option would be to use the current average spending share across councils for each service area, and then update the shares over time in line with expectations of how these spending shares would need to change to meet expectations on the range and quality of services to be provided.

Assessing revenue-raising capacity is now more challenging

Assessing councils' own revenue-raising capacity was historically easier than assessing their spending needs, but the localisation of means-tested support for households with low income to pay their council tax has made things more challenging.

Assessments of councils' ability to raise revenues through SFCs have historically been done as part of spending needs assessments, by using the relationships between spending net of contributions from SFCs and local area characteristics to construct spending needs formulas. Previous Conservative administrations proposed to stick with this approach, although it would be possible to estimate separate formulas using different characteristics for gross expenditure and SFC income if one thought different factors drove these.

Commercial and investment income – which has grown significantly over the last decade – was not historically accounted for when assessing revenue-raising capacity. To the extent that differences in commercial and investment income reflect differences in how proactive, entrepreneurial or risk-taking different councils have been, this may be appropriate: it may be deemed unfair to redistribute these revenues. But differences may also reflect the differing

opportunities available to different councils: for example, areas with larger or richer populations may allow for more profitable commercial operations. Consideration should therefore be given as to whether it is possible to assess ‘commercial opportunities’ in a meaningful way.

When assessing councils’ ability to raise revenue through local taxation, the key thing is to do this using a benchmark tax system – a common set of tax rules such as rates, exemptions and reliefs – applied to all areas. This avoids incentivising local policymakers with tax-setting powers to cut taxes in order to appear to have a lower revenue-raising capacity.

Estimating revenues under a benchmark tax system has become harder for English local government over the last decade. In particular, since April 2013, councils must design and fund their own systems of means-tested council tax reduction schemes (CTRS) to help low-income households pay their council tax bills. These schemes differ across councils and there is no easy way, given available data, to calculate exactly how much a common benchmark scheme would cost to operate in each council area.

The options to address this are discussed in Amin-Smith, Harris and Phillips (2019a). The most feasible option would likely be to undertake statistical analysis of the factors driving the cost of council tax support schemes, including the characteristics of the schemes (such as minimum payments). The estimates of the impact of CTRS characteristics on costs could then be stripped out of each council’s CTRS cost to approximate costs under a chosen benchmark system.

Striking the balance between redistribution and incentives

Given assessments of spending needs and revenue-raising capacity, a decision then needs to be taken on how fully and how rapidly funding can be adjusted to account for these factors. This decision should depend on the priority placed on redistribution, responsiveness and consistency relative to incentives, stability and discretion. A greater priority on the former considerations would imply fuller and more rapid updates to funding, to help ensure different councils can deliver an equivalent set of services. Conversely, a greater focus on the latter considerations would imply partial and slower updates, so that councils are financially incentivised to improve local socio-economic outcomes.

Amin-Smith and Phillips (2018) discuss in detail the design of potential systems to account for needs and revenue-raising capacity when allocating funding. Key conclusions were the following.

- Because what matters for incentives is whether *future* funding is adjusted to offset falls in assessed needs or increases in revenue-raising capacity, it would be possible to undertake a full initial redistribution of funding in line with needs and revenue-raising capacity without disincentivising action by councils to improve local socio-economic conditions. This means

that even if one strongly prioritises incentives, one can align overall funding with needs initially without compromising this objective.

- If, subsequently, funding is not immediately updated on an annual basis to account for changes in assessed spending needs or revenue-raising capacity, in order to provide financial incentives, it would be better to make changes on a rolling basis rather than a periodic basis. For example, updating on a five-year rolling basis would update assessments for changes in assessed needs and revenue-raising capacity for year t in year $t + 5$, for year $t + 1$ in year $t + 6$, and so on. This would mean councils always benefit from any reduction in needs or increase in revenue for five years. In contrast, a periodic redistribution every 10 years would mean that councils would benefit from reductions in needs or increases in revenue for 10 years if they took place immediately following a redistributive ‘reset’, but less than one year if they took place immediately before one. This could distort behaviour in bad ways – potentially incentivising councils to try to delay activities (such as the development of new property) that could lead to a reduction in funding at an imminent reset until after it.
- As well as updating funding only after several years and on a rolling basis, the updates made need not account for 100% of the change in assessed spending needs or revenue-raising capacity. Different percentage updates could be applied to different elements of spending needs and revenues, depending on the extent to which one believes councils can influence these factors, and in turn the extent to which incentives matter.
- If the government looks to historic systems for guidance on the design of a new grant allocation process, then it should adapt the broad approach used in ‘standard spending assessments’ (SSA) prior to 2002–03 rather than the most recent four-block model utilised between 2006–07 and 2013–14. The former set out clearly assessed spending needs and revenue-raising capacity, with redistributive grant funding calculated as the difference between the two. This relatively transparent approach contrasts with the complex and opaque four-block model, which did not feature any summary assessments of spending need and revenue-raising capacity. An adapted SSA approach could also accommodate rolling and partial updates to funding if an element of financial incentivisation is deemed desirable.

Building on the ‘standard spending assessment’ approach, and publishing detailed information about assessed spending needs, revenue-raising capacity and actual funding, would help ensure that any reformed system is transparent. Allowing variation in elements such as the length and extent of any rolling resets would also ensure a degree of flexibility, although forging a degree of cross-party consensus on these would still be wise, to avoid large changes when governments change. We will assess proposals for reform brought forward by the government against these principles when they are published. We will also assess how they propose to address the technical challenges (and how honest they are about them) in assessing spending needs and revenue-raising capacity, as discussed earlier. And if the government is not fully clear how its proposals prioritise different objectives (such as redistribution versus incentives), we will explain the implications of its proposals.

Most reports produced outside of government do not provide much information on how needs and revenue-raising capacity should be accounted for in practice. Implicitly, most appear to assume some combination of equalising grants from central government and equalising transfers between councils (such as the ‘tariffs’ and ‘top-ups’ used to redistribute business rates revenues as part of the BRRS). However, there are more radical proposals, such as equal per-person grant funding, and effecting redistribution via the assignment of different shares of national tax revenues (for example, from income tax) collected in an area to different councils, depending on their assessed spending needs (Breach, Bridgett and Vera, 2023). However, varying the share of taxes assigned in this way does not just vary the amount of funding provided to different councils, it can also lead to them facing very different financial incentives to grow the assigned tax bases. In our view, this approach is also less transparent than redistributing directly via grant funding or equalising transfers. It is also likely to be less easy to update in response to changes in different councils’ circumstances and governmental priorities.

3.3 Revenue and spending devolution

While an updated system of needs and revenue-raising capacity assessment and funding allocation is vital, whether there should be wider changes to the way local public services are funded and determined depends on what one is trying to achieve.

General considerations for revenue and spending devolution

Academic research highlights a range of practical and political-economy benefits and costs from devolving revenue-raising and spending responsibilities, which are strongly linked to the discretion–consistency and redistribution–incentives trade-offs discussed at the start of this discussion. On the benefits side of the ledger:

- Local government may have greater knowledge about local needs and preferences, and a greater ability to tailor service offerings and levels of taxation and spending accordingly, than central government. Individuals and businesses then have the option of locating in jurisdictions whose tax/spend and policy mix most closely matches their preferences (Tiebout, 1956; Oates, 1972).
- Some degree of devolution is necessary to allow local jurisdictions to reap the financial rewards of higher revenues, lower spending needs, and more efficient service delivery. This can provide stronger financial incentives to boost local economies, tackle needs-drivers and improve efficiency, both at a bureaucratic level and at a political level: local politicians can

capitalise on higher-quality services or lower tax rates/service charges or be punished for poor performance at the ballot box.¹⁶

- With policy being made in multiple jurisdictions, there can be opportunities for cross-jurisdictional learning both by policymakers and by voters. For instance, if voters can reliably compare policies and outcomes with those in other jurisdiction, this ‘yardstick’ can help them hold local politicians to account, incentivising better performance (Besley and Case, 1995).
- Some theoretical work also argues that devolution can overcome issues that can arise when decisions are taken centrally by politicians representing different geographical areas.¹⁷

However, these potential benefits are not a free lunch, with the potential costs being:

- While some suggest that complex issues involving collaboration between multiple service areas and organisations can be better addressed at a local level (Cox, Henderson and Raikes, 2014), addressing other issues may be more difficult when multiple jurisdictions are involved. For instance, when infrastructure and services benefit residents of multiple jurisdictions, devolution may require costly coordination between jurisdictions and/or lead to under (or even no) provision of the item in question if such coordination is infeasible. It could also result in the loss of scale economies.
- Decisions by one local jurisdiction can impose damaging fiscal externalities on other jurisdictions.¹⁸ For instance, when setting its tax rate, a jurisdiction may not account for the fact that rate cuts could cannibalise the tax bases and revenues of other jurisdictions. Tax competition could then mean that rates and revenues, and hence public service provision, may end up suboptimally low. This may also reduce the scope for redistribution, as jurisdictions seek to boost tax revenues and reduce spending needs by enacting more regressive tax and spending policies than would be chosen by a centralised government.
- More generally, devolution might be expected to contribute to inequality between citizens of different jurisdictions. The spending needs and revenue-raising capacity of different

¹⁶ Seabright (1996) and Persson and Tabellini (2000) highlight how devolution to local politicians makes decision-makers more dependent on pleasing voters in their particular jurisdiction, and hence more accountable across jurisdictions. Besley and Smart (2007) emphasise how this accountability to the local electorate has both a ‘disciplining’ effect on local politicians and a ‘selection’ effect, allowing higher quality/more honest decision-makers to be chosen. Hindriks and Lockwood (2009) study the operation of such effects under the assumption that local voters are not aware of policies and outcomes in other jurisdictions (ruling out so-called yardstick effects). They show that compared with centralised tax and spending decision-making, devolved decision-making increases the strength of the disciplining effects of elections but increases the probability that, in at least some jurisdictions, this disciplining effect fails to work at all.

¹⁷ Lockwood (2002) suggests that devolution can reduce an over-focus on cost-minimisation when decisions are made centrally following bargaining between jurisdictions. In contrast, Besley and Coate (2003) highlight that when decision-making is centralised, voters have an incentive to elect representatives who favour high spending to obtain a larger share of overall expenditure, which can lead to overall expenditure being too high: devolution can avoid this excess expenditure.

¹⁸ Brennan and Buchanan (1980) argue that this competition for mobile tax bases is a benefit of devolution that can limit what they see as a bureaucratic tendency towards large and inefficient government (the ‘leviathan’).

jurisdictions can differ due to differences in their geographical (e.g. terrain, climate) and socio-economic (e.g. the density, age profile, health status and deprivation of local population) characteristics. Moreover, one might expect a negative correlation between local revenue-raising capacity and spending needs per capita. Those areas with the greatest needs could be left with the least to spend.

Empirical evidence on the impact of devolution on outcomes

Therefore, the key benefits of devolution are: an increased scope for policy to reflect local needs and preferences; greater political accountability to voters; and stronger fiscal incentives. The drawbacks are related to: spillovers – including fiscal externalities – between jurisdictions; the potential to exacerbate geographical inequalities; a reduced ability to redistribute both geographically and inter-personally; and a loss of economies of scale and scope.

There is therefore no clear-cut answer as to whether (more or less) devolution is a good thing: different people may trade off the issues (e.g. incentives versus redistribution; discretion versus consistency) in different ways; and both preferences and trade-offs may differ for different services (e.g. leisure and cultural facilities versus schools and social care). Empirical analysis can also help inform us about the nature of these trade-offs. So, what is the empirical evidence on the impact of devolution?

A wide range of studies investigate the impact of devolution on a range of outcomes, including health,¹⁹ education,²⁰ the efficiency of public services (Sow and Razafimahefa, 2015), geographical and inter-personal inequalities,²¹ and overall economic performance.²² These studies generally find that devolution is associated with improved public services, but evidence on growth and inequality is more mixed.

As highlighted by Pope, Dalton and Coggins (2023), despite using broadly similar methods, different studies have found positive, no or even negative effects of devolution on economic growth (Rodríguez-Pose and Bwire, 2004; Pike et al., 2010; Baskaran and Feld, 2013). Perhaps most influential in the debate has been research by the OECD, which typically finds that devolution has a small positive effect on the level and rate of growth in gross domestic product (GDP) per capita (Blöchliger, 2013; Gemmel, Kneller and Sanz, 2013; Blöchliger and Akgun, 2018). The effect is stronger for revenue devolution than expenditure devolution, although some studies suggest that there are benefits of ensuring ‘balanced’ devolution, as a reliance on

¹⁹ Cantarero and Pascual (2006, 2008) provide analysis for the European Union and literature reviews.

²⁰ Fredriksen (2013) and Blöchliger (2013) are typical examples.

²¹ See Sacchi and Salotti (2013), Cavusoglu and Dincer (2015), Bartolini, Stossberg and Blöchliger (2016), Blöchliger, Bartolini and Stossberg (2016) and Sibylle and Blöchliger (2017).

²² Blöchliger and Egert (2013) is a typical example.

transfers between central and local governments is sometimes associated with poorer performance. Evidence also suggests that institutional quality matters, with positive impacts more likely in areas with effective local government covering sizeable functional economic areas (Rodríguez-Pose and Ezcurra, 2010; Dougherty and Akgun, 2018; Jong et al., 2021).

Turning to inequality, cross-country studies suggest that greater expenditure and, especially, revenue devolution are associated with lower geographical inequalities in economic *output* but could increase inequalities in household *incomes* and public service provision. There is no consensus on the impact of devolution on inter-personal inequalities. Some studies suggest revenue devolution is associated with higher inequality (Sacchi and Salotti, 2013), while others suggest impacts differ according to which part of the income distribution one considers (Sibylle and Blöchliger, 2017).

In deciding how much weight to place on these findings, it is important to note the difficulties with inferring causal impacts from cross-country correlations. Many of the findings turn on the inclusion in the analyses of Scandinavian countries, which are rich, equal, and have good public services and high degrees of both expenditure and revenue devolution. The strength of the evidence in favour of devolution is therefore probably less than the broad consensus in the policy world would, at first glance, suggest.

It is also worth bearing in mind that significant devolution can be accompanied by a high degree of fiscal equalisation, and most studies do not control directly for equalisation arrangements. Indeed, there is relatively little evidence on the effects of fiscal equalisation on public service and economic outcomes.²³ Fiscal equalisation is shown to reduce disparities between jurisdictions' revenue-raising capacities, even in highly decentralised countries such as Finland and Sweden (Blöchliger et al., 2007). But arrangements are shown to be prone to both gaming by local jurisdictions and distortions due to political considerations.²⁴

Overall then, while there is suggestive evidence that expenditure and revenue devolution is associated with improved public service delivery and stronger economic performance (at least in areas with effective local government), the evidence is not that strong. Impacts on geographical and inter-personal inequalities seem to be complex, and fiscal equalisation is shown to be important in reducing disparities in jurisdictions' revenue-raising capacities – and hence in the services they can offer to citizens.

²³ A number of studies examine the impacts of fiscal equalisation on revenues and tax rates, including Barette, Huber and Lichtblau (2002), Buttner (2006) and Smart (2007).

²⁴ See, for instance, Johansson (2003) for a Swedish example and Hilber, Lyytikäinen and Vermeulen (2011) for an English example.

Factors for determining which revenue streams to devolve

As discussed in Chapter 2, English local government currently receives revenues from only two taxes – council tax and business rates – and has relatively limited powers over these. For example, tax bases are largely set by central government, and tax rates are subject to significant constraints: council tax increases above a fixed percentage are subject to local referenda, and business rates can be cut but not increased, with a few exceptions.

Whether these powers should be enhanced depends on how one trades off the benefits and costs of devolution in light of the empirical evidence just discussed. The greater the weight placed on discretion, incentives and learning, the more attractive revenue devolution is – although equalisation arrangements to redistribute between areas with higher revenues (or revenue growth) to those areas with lower revenues (or revenue growth) can be included if one prioritises redistribution over incentives, but still values the other aspects of devolution. However, if the provision of incentives is the prime reason one is considering revenue devolution, and one is concerned about potential costs of subnational variation in taxation, such as distortions to location decisions and tax competition, one can assign local revenues to local government, without devolving powers to change revenue policies.

Different taxes are more or less suitable for devolution to local government. Amin-Smith, Harris and Phillips (2019a) discuss in detail a set of criteria for assessing this, drawing on the broader principles for devolution discussed above. In summary, these criteria are:

- **Administrative feasibility.** Tax bases need to be apportioned between local areas, creating costs for the tax authorities and taxpayers, but the scale of these varies significantly by tax.
- **Incentives and risks for councils.** Exposure to changes in tax bases can incentivise councils to try to boost them, but if tax base performance is outside their control, this exposure is just a source of financial risk.
- **Tax base and taxpayer mobility.** If taxpayers can easily move or change behaviour in response to differences in taxes across councils, devolution may significantly distort taxpayer behaviour and encourage ‘tax competition’ between councils, driving down tax rates and revenues.
- **Accountability effects.** If taxes are paid largely by non-residents, and therefore non-voters, the lack of democratic accountability may push up taxes. Conversely, if non-residents pay tax, councils may have a stronger incentive to provide services they value.
- **Revenue distribution.** Devolving tax bases that are highly unequally distributed may increase funding inequalities between councils; while redistribution arrangements can offset this, these can undermine councils’ incentives and reduce transparency.
- **Revenue volatility.** More volatile revenues can increase the financial risks facing councils, especially given their limited borrowing powers. However, the requirement that local tax bases should be relatively stable may conflict with another potentially desirable feature –

that revenues respond to local economic conditions. If the revenues from a given tax do not respond to local conditions, then devolution of that tax will provide less strong incentives for councils to grow their local economies.

Devolving existing taxes to local government

Based on these criteria and an analysis of the distribution and volatility of revenues across councils, Amin-Smith, Harris and Phillips (2019a) assess the suitability of different tax types for devolution.

Property taxes

Property taxes are the most suitable for devolution overall, given ease of administration and limited scope for location decisions to be distorted (property and particularly land are immobile). Residential property taxes, such as council tax, also have the accountability advantage that local residents are local voters, and vice versa. And their current design means council tax and business rates are relatively stable sources of revenue.

- **Additional powers over tax rates.** There is a case for giving councils greater control over council tax rates, in particular by removing referenda requirements. Referenda mean that direct authorisation from local residents (most of whom will pay council tax) is required for large council tax increases, arguably increasing accountability. But this is unusual: accountability to residents normally operates through elections where candidates set out manifestos or plans, and voters decide how to vote on a range of issues including tax, allowing policies to be seen in the round. In the context of updates to assessments of revenue-raising capacity based on a notional tax rate rather than actual tax rates, referenda requirements may also make it difficult for councils to respond to changes in their funding.

Business rates are somewhat different. Unlike council tax, where those on whom the tax is formally incident can all vote in local elections, the owners or occupiers of properties subject to business rates often will not be able to vote, as they may live in a different area. This means reliance on regular local elections could be seen to provide insufficient accountability to taxpayers. Indeed, this was one of the arguments for moving to a system of centrally determined business rates in 1990:²⁵ a large majority of owners and occupiers would be living somewhere in the country (rather than overseas) and could vote in national elections.

- **Additional powers over premiums, reliefs, discounts and exemptions.** Giving councils more control over premiums, reliefs, discounts and exemptions would involve some additional administration and compliance costs, but would be administratively feasible, given that councils currently administer both council tax and business rates. It would allow

²⁵ See Ridge and Smith (1990) for a discussion of this rationale. The rationale for capping increases in the business rates tax rate (called the ‘multiplier’) at inflation is less clear.

for greater realisation of local preferences and also allow councils to use taxes to target specific policy goals more closely. However, if councils were given such powers, it would be important to ensure that the equalisation system was based on assessments of local tax bases under a benchmark system stripping out the effect of individual councils' decisions. One may want to update this benchmark system over time as 'average' policy changes. It would also be wise to cap premiums, particularly for properties owned or occupied by non-residents, such as second homes, to prevent excessive taxation of non-voters.

- **Power to change council tax relativities.** This would enable the council tax structures of councils to more closely reflect local preferences for redistribution, and would provide an additional way in which overall revenues could be increased or decreased other than by changing the headline tax rate. As with reliefs, discounts and exemptions, it would be important that the equalisation system was based on a fixed 'reference' set of relativities rather than each council's actual relativities.
- **Power to revalue properties in their area.** It has been suggested that devolving powers over revaluation could make it more likely to happen – which would mean council tax reflected up-to-date relative property values, rather than property values in 1991.²⁶ However, local revaluation would pose significant problems for equalisation arrangements between councils. Comparison of tax bases between councils that had and had not revalued (or had revalued at different times) would become a much more complex task. For this reason, devolving powers to revalue properties for the purpose of local taxation is undesirable unless one wants to move away from assessing councils' revenue-raising capacity directly.
- **Devolve stamp duty land tax.** While it is a property tax and is administratively feasible to devolve, SDLT has several features that make it less desirable for devolution than other property taxes. First, given current tax rates and bands, revenue-raising capacity is very highly unequally distributed across the country, with revenues per capita in London being approximately six times higher than in large cities in the Midlands and North as of 2017–18 (Amin-Smith, Harris and Phillips, 2019a). Second, revenues are highly volatile, especially at a local level, driven by variation in the construction of new homes and transactions of existing homes. Third, and more generally, SDLT is a highly economically distortive tax that significantly reduces property transactions and, in turn, residential and, to some extent, labour market mobility (Adam et al., 2011). It should be reduced and ideally abolished rather than entrenched by making some councils highly dependent on it for revenue.

²⁶ See, for example, Independent Commission on Local Government Finance (2015).

Personal income taxes

After property taxes, personal income taxes are the next-best main type of tax for devolution, and could be considered if substantial additional local revenue-raising powers are deemed desirable.

- **Accountability.** As with property taxes, local people who pay income tax are local voters, meaning that they can hold local politicians to account for their decisions on income tax at the ballot box. However, a higher share of the population does not pay income tax than council tax, and non-taxpayers may have an incentive to vote to increase spending and taxation, knowing that they would not bear the associated costs. However, this is a feature of income tax irrespective of whether it is devolved or not, and caps could be applied to prevent tax rates deemed ‘excessive’.
- **Administrative feasibility.** Those organisations responsible for the administration and remittance of income tax – such as HMRC, employers, pension providers, etc. – should have the residential addresses of taxpayers, meaning that it should be possible to allocate taxpayers to different council areas and to calculate, remit and allocate tax payments accordingly. This is not without its challenges though. First, addresses for some taxpayers may be missing or out of date – there is no statutory requirement on taxpayers (or their employers) to tell HMRC about any changes of address. Second, a number of taxpayers have multiple properties, and HMRC may find it difficult to determine which one is their main residence. And even if feasible, administration and compliance costs would increase at least to some extent. Tax administration and payroll systems would need to be adapted to allow for identification of where different people live and, potentially, application of different tax rates.
- **Financial incentives.** Subject to the equalisation arrangements put in place, local government would benefit from a share of increases in the local income tax base. This could include both increasing the incomes of existing residents and attracting new residents with high incomes to their areas. And because councils would gain wherever their residents worked, councils would have an incentive to facilitate residents’ access to (high-earning) jobs in neighbouring areas by, for example, investing in local transport infrastructure, as well as an incentive to increase the number and earnings of jobs in the local area. This would be a useful counterpart to the incentives provided by the BRRS, which relate to properties developed in their area alone.

However, income taxpayers are **more mobile** than the properties they live in, with this being particularly true for higher-income individuals. Councils could try to take advantage of that mobility by selectively reducing tax rates on those with high incomes, which could result in tax competition between councils. This could lead to an erosion of revenues from high-income taxpayers and a decline in the progressivity of the tax system.

Devolving powers for a small supplemental local income tax on top of national income tax rates would limit the extent of this mobility issue. This is because while a council would bear the full ‘mechanical’ effect on revenues of a lower tax rate, it would only gain part of the ‘behavioural’ effect on revenues of more high-income taxpayers moving to the area: the bulk of the revenues from these extra high-income taxpayers would flow to the national government via the national income tax rates. Indeed, such effects could provide an incentive to councils to increase tax rates on those with the highest incomes: they would gain the full mechanical revenue effect of the higher tax rate, but bear only part of the behavioural revenue effect of the smaller tax base.

However, both downwards and upwards pressure on tax rates for those with the highest incomes could be addressed by restricting the powers devolved to application of a flat-rate income tax rate, as in the Scandinavian examples in Table 2.1. Councils could then only cut or increase tax rates for those with the highest incomes if they cut or increased them for everyone. Revenues from a flat-rate local income tax would also generally be less volatile and less unequally distributed than revenues from a progressive income tax, given that it is the volatility and distribution of the highest incomes that is most extreme. A flat rate would also change the nature of incentives to boost the tax base, with a greater emphasis on employment and earnings increases for low- and middle-earnings residents than under a tax where rates increased with income as under the national income tax.

Overall though, devolving a flat rate of income tax could bring many of the benefits of tax devolution (including local discretion on funding levels and financial incentives to expand the local tax base), while limiting the degree of revenue volatility and inequality, and tackling concerns about downward or upward pressure on the tax rates applied to those with the highest incomes. In our view, a local component of income tax would be preferable than a local component of National Insurance contributions, as has also been discussed. This reflects the broader base of income tax, including income from dividends (and hence small incorporate businesses), property and pensions, as well as employment and self-employment.

Sales and value-added taxes

Devolving part of VAT or related sales taxes to local government would provide incentives to boost local consumption or value added (broadly speaking, profits plus wages), depending on the mechanics of how it was devolved. However, the costs of devolution are likely to be substantially higher than for property and personal income taxes.

- **Administrative issues.** Apportioning VAT revenues to different local areas is conceptually and administratively difficult. This partly relates to difficulties in apportioning value added between different stages of production and activities conducted by a single business, such as warehouse, store, website and support operations. However, it also reflects the way VAT works: it is charged on sales, but businesses can deduct the VAT they have paid on their

inputs. Devolved VAT could mean businesses not only having to charge different VAT rates in different areas, but also having to record where their input purchases came from, as different amounts of VAT would be deductible based on this. This would involve high administration and compliance costs. Alternatively, borders between local government areas could work like international borders for the purposes of VAT: businesses ‘exporting’ to another local government area would charge a 0% rate on their ‘exports’. But this would require businesses to record where their business customers were located and to charge VAT accordingly, which would again be a costly process.

Giving local government the power to set a local consumer sales tax, where no tax is charged on registered business-to-business transactions, instead of VAT would avoid these problems. But this requires businesses to distinguish whether a sale is to a registered business or not, and to charge tax accordingly. This opens up an opportunity to evade tax by misclassifying consumer sales as business sales (see Zodrow, 1999).

- **Tax base mobility.** Consumers are able to change where they buy goods and services in response to differences in VAT or sales taxes, and this in turn may affect where businesses choose to locate. This is particularly true when people live close to ‘borders’ between different tax rates, and when the transaction value is high, as the monetary and time costs involved in travelling to the low-tax area are then relatively low. Evidence for such cross-border shopping is found in numerous studies, covering numerous goods including tobacco, alcohol, petrol and food.²⁷ Impacts can also be significant: a study on petrol suggested Chicago’s tax base was 40% lower as a result of cross-border purchases from the neighbouring areas of Illinois and Indiana with lower taxes, for instance (Manuszak and Moul, 2009). The growth of Internet shopping is likely to have exacerbated this issue, except in the case where Internet retailers are required to charge taxes based on where people live rather than where the retailer or its warehouses were based.
- **Accountability.** In some areas, a large share of sales subject to tax will be made to non-residents. This would reduce the extent to which taxpayers can exercise political accountability via the ballot box.

Overall then, VAT or sales tax are less attractive options for devolution (and indeed assignment) than property and personal income taxes.

Corporate income taxes

Corporate income taxes are probably the major tax type least suitable for devolution to local government. While it would provide an incentive to increase corporate profitability and attract new incorporated businesses, there are several challenges.

²⁷ Leal, López-Laborda and Rodrigo (2010) provide an overview.

- **Administrative issues.** It is difficult to apportion the corporate income tax base between different areas. The profits of incorporated businesses typically result from multi-stage and multi-input processes. For example, the profits of a retailer will reflect the activities of its warehouses, stores, website and headquarters operations, which may take place in different locations. How can profits be split between these different activities and locations, given that there are no formal transactions (and prices) involved? Conceptually, is such a question even valid given that profits may be generated by such activities taking place in conjunction?²⁸

In practice, two broad approaches are used to apportion taxable profits between different areas.

- Internationally, the ‘arm’s-length’ principle is generally used. This means transactions between subsidiaries of corporations operating in different countries must be valued according to the prices that would be paid if the subsidiaries were in fact unrelated businesses. This requires lots of documentation and calculations, and a combination of limited resources by tax authorities and the difficulty in assessing market prices for highly specialised inputs (such as patents) opens up opportunities for tax avoidance and evasion – by assigning artificially high prices to inputs purchased from low-tax jurisdictions, for example. Countries employ various ‘transfer-pricing’ (and related) rules to guard against such risks. But these are both complex to design and implement, and lead to numerous legal disputes (Adam et al., 2011), resulting in high administration and compliance costs.
- A second approach is known as formula apportionment, which aims to proxy where profits are generated, and is used to apportion business income tax revenues between US states, Canadian provinces, Italian regions and German municipalities, among others. This involves apportioning taxable profits across areas according to a formula including factors such as the location of sales, property and wage bills. This is more administratively feasible, but still requires disaggregated information on the factors used to apportion revenues.
- **Tax base mobility.** Corporate profits and activity can be highly mobile with respect to tax rates. This is likely to be particularly true for the arm’s-length approach – where despite transfer-pricing and other rules, scope for profit-shifting can still be significant.²⁹ Corporations can also decide where to locate their investments and their employees to take advantage of lower tax rates, with such effects potentially stronger under formula apportionment, meaning there is a trade-off between distortions to the location of profits and the location of real activity.³⁰

²⁸ For example, without stores, the retailer’s marketing activities would not generate profits; while without marketing, the retailer’s stores could suffer from a lack of custom.

²⁹ See Heckemeyer and Overesch (2013) for an overview.

³⁰ See Reidel (2010) for a case study using Germany’s wage-bill-based apportionment formula.

- **Accountability.** Corporation tax is formally levied on business owners who may not be resident in a particular area and hence may be ineligible to vote in local elections.
- **Unequally distributed and volatile.** In part because a very high share of revenues comes from the largest, most profitable companies, corporate tax revenues per person are highly unequally distributed. They are also relatively volatile compared with other major taxes.

Overall then, corporate income taxes are towards the bottom of the list of taxes in terms of their suitability for devolution.

Devolving new taxes to local areas: the case of a tourism tax

As well as devolving parts of existing taxes to local government, it would also be possible to devolve powers to levy certain new taxes not currently levied in England. For such taxes, it is important to consider not only the benefits and costs of devolution, but also the benefits and costs of the taxes themselves.

One common suggestion is a tax on overnight accommodation for visitors (commonly known as a ‘tourist tax’). Such taxes apply in parts of many other countries, and the Scottish Parliament has recently granted councils powers to levy such a tax,³¹ with the Welsh Senedd soon to begin debating such powers.³² And in England, in the absence of specific powers to levy a tourist tax, accommodation providers in central Manchester voted to create a business improvement district levying a business rates supplement equivalent to £1 per room per night for tourist accommodation with a rateable value of over £75,000, to help fund events and tourism marketing. This excludes small hotels and holiday lets though, potentially distorting the accommodation market.

What is the case for granting local government the powers to set a wider tourism tax?

One argument in favour is that tourism may impose what economists call a negative externality – essentially a spillover cost – on local areas (and on other tourists) through the need for increased street cleaning and maintenance, the extra congestion created, and the regulation of entertainment venues and popular attractions, etc. This cost is one that is not priced into the cost to tourists of engaging in these activities. For example, tourists incur very little cost by littering. The most economically efficient solution to these problems would be to tax the costly activities directly, but this is clearly infeasible. Taxing overnight stays could thus be seen as an indirect way of doing so.

³¹ See ‘Visitor Levy (Scotland) Bill’, <https://www.parliament.scot/bills-and-laws/bills/s6/visitor-levy-scotland-bill>.

³² See ‘Written Statement: legislating to support tourism in Wales’, <https://www.gov.wales/written-statement-legislating-support-tourism-wales>.

Another argument is that because tourists can often not vote in relevant elections, services that they value may be under-provided, undermining the attractiveness of an area to tourists. The levying of a tax on tourism provides an enhanced financial incentive to policymakers to cater to the needs of tourists, offsetting their lack of political representation.

The main argument against a tourism tax is that it would raise the cost of tourist accommodation relative to other goods and services (including tourist accommodation elsewhere), distorting behaviour and reducing the number of visitors. Various studies have tried to estimate the elasticity, or responsiveness, of tourism to a country to the price of holidaying in that country, including as a result of tourism taxes, but this would clearly differ by area.³³ For example, areas with unique attractions might expect that the volume of tourism would be less sensitive to a small tourism tax than other areas, as tourists might see them as having fewer close substitutes. Other countries with tourism taxes often levy lower rates of VAT on visitor accommodation, often more than offsetting the additional tax raised by the specific tourist tax, but visitor accommodation is subject to the full rate of VAT in the UK.

The economic case for a tourism tax is therefore not clear but, if it was introduced, would it be suitable for devolution? Such taxes are often devolved in other countries, and several factors suggest this would likely make sense.

- **Administrative feasibility.** Tourism accommodation providers are likely to already hold information on overnight stays broken down by location. Platforms for booking holiday lets (such as Airbnb) could also be utilised to collect taxes, reducing the cost of collecting from many small accommodation providers – such an arrangement operates in many countries.³⁴
- **Economic considerations.** The externalities caused by tourism are likely to differ between areas. Furthermore, as mentioned above, the sensitivity of tourism demand to changes in price is likely to differ between areas. In this context, councils may have better information about the impact of tourism in their areas and it could be politically difficult for there to be substantial variation across areas if the tax were set centrally.

However, several factors reduce the attractiveness of devolution. First, distortions to where visitors travel to are likely to be larger if taxes vary across small geographical areas. Second, tourists are typically not voters in a local area, posing accountability concerns. Capping the taxes that can be set, as is proposed in Wales, could help address this. Third, revenues would be highly unequally distributed. If the revenues generated are used to support the tourism industry, this could further increase the advantage of already highly visited areas. If the revenues generated are

³³ For example, Blake and Cortes-Jiménez (2007) found a price elasticity of demand of -0.61 , implying that a 1% increase in the cost of holidaying in the UK results in a 0.61% fall in demand.

³⁴ See 'Areas where tax collection and remittance by Airbnb is available', <https://www.airbnb.co.uk/help/article/2509>.

used, in part, to subsidise other services, this could exacerbate more general geographical inequalities – many of the most-deprived areas of the North and Midlands have relatively low numbers of overnight visitors.

In the context of a redistributive local government finance system, taking some account of revenue-raising capacity from a tourism tax may therefore make sense. It may also make sense to assign powers to levy tourism taxes to combined/mayoral authority or county-level areas – the inequalities in revenue-raising capacity would be smaller at this level (although not insubstantial, as discussed in Amin-Smith, Harris and Phillips, 2019a) than at the single-tier/lower-tier level.

Greater powers to set sales, fees and charges

In addition to changes in their tax powers, it would also be possible to change the extent of control local government has to set SFCs. Currently, for most services, councils are unable to charge an amount higher than necessary for cost recovery, although this is broadly defined. Fees for certain services, such as planning and building control applications, are capped nationally. These rules could be relaxed to allow councils to set SFCs to generate a surplus.

Decisions on whether to do this should be made on a case-by-case basis, taking account of the features of the ‘market’ for specific services. On the one hand, where councils face competition for the provision of service from the private sector (such as for gym facilities or pest control services), such competition should constrain councils from setting excessive fee levels. On the other hand, where councils have a formal monopoly on the provision of services (such as licensing and planning fees), continued regulation makes sense to avoid excessive fees, especially given that a large part of such fees may fall on non-residents – and hence non-voters.

Factors for determining which spending areas to devolve

Turning to the spending side of the local government budget, decisions over the extent of devolution should be informed by many of the same principles as for revenue devolution. In particular, the greater the weight placed on discretion, incentives and learning, the more attractive revenue devolution is – although equalisation arrangements to redistribute between areas with lower spending needs (or needs growth) to those areas with higher spending needs (or needs growth) can be included if one prioritises redistribution over incentives, but still values the other aspects of devolution.

Decisions over what spending areas and powers to devolve should be guided by a number of principles:

- **Administrative feasibility and economies of scale.** Some areas of spending have important economies of scale in design or implementation, making devolution relatively costly.

- **Scale of preference variation.** All else equal, there is a greater benefit of local decision-making for services for which preferences vary more across places. The acceptability of variation in provision across places may also differ by service.
- **Information asymmetries.** The extent to which local government may have better information about not only preferences but also locally varying factors, driving the most appropriate policies conditional upon preferences, is likely to vary across services. Conversely, central government's greater knowledge about provision across the country may be of more value for certain services.
- **Coordination and economies of scope.** There is value in ensuring the responsibilities assigned to different tiers of government to account for interactions between different services. This can matter both for service design and delivery, and for financial incentives – for example, if greater spending on one service can reduce the demands on another service.
- **Accountability and spillover effects.** For some services and investments, the benefits of spending may be felt over a much wider area than a council or even a combined authority area. Devolution may lead to under-provision of such services as costs are fully borne locally but benefits spread more widely. In other cases, spending decisions may have negative spillover effects on other areas – for example, attracting their high-income low-needs residents, or displacing low-income high-needs residents on to them.

It is also important to distinguish between devolving powers to choose how much to spend on a particular service, and devolving powers to determine the type and quality of provision that should be made. If one favoured national consistency of a service, it would not make sense to devolve significant policymaking powers. But it may still make sense to provide discretion over how much to spend. This is because, as highlighted earlier, it is difficult to assess the spending needs of different councils, and the resulting assessments can thus be somewhat inaccurate. In such circumstances, the ability of councils with revenue-raising powers and responsibility for multiple services to spend more or less than these spending needs assessments to offset such errors can, in principle, improve consistency in provision – provided there are clear national standards of provision, and sufficient funding available to meet these standards. As discussed in Phillips (2023), centralising funding for services historically funded via local government also requires 'undoing' previous local decisions on tax and spending levels, which can be difficult to do in a fair way. Thus, while placing a high priority on local discretion over service provision does require local discretion over funding levels, a high priority on consistency of service provision does not necessarily require centralised funding – it depends on factors such as the quality of spending needs assessments, and the enforceability of both national standards of provision.

Assessing different spending areas

Economy-related functions

Recent years have seen governments of various stripes devolve a range of powers broadly related to the economy, typically to combined or mayoral authorities. This includes powers related to transport, housing, spatial planning, skills and employment support, although the precise package of powers granted varies across places. The new government has committed to rolling out such powers more widely, using a framework based on local accountability arrangements (such as the presence of a mayor) to determine more consistently what powers are devolved where.³⁵

A more consistent approach would have the benefit of being easier for both policymakers and stakeholders (including voters) to understand, helping improve accountability. Whether that should be brought about by devolution to more places or re-centralisation of certain powers depends on application of the aforementioned principles. Reviewing the evidence in detail Pope, Dalton and Coggins (2023) argue that the benefits of local knowledge and accountability, and the potential to better coordinate actions across services and investments linked to regional economic development, mean that further devolution to combined/mayoral authorities and county areas would make sense. As part of this, they also recommend allowing such authorities to overrule individual local authorities on cross-regional spatial planning issues. However, a combination of administrative challenges and potential negative spillovers and duplication means that they recommend that a range of areas, such as basic research and development funding, higher education, national rail routes and social security policy, as well as labour and product market regulation, should remain centralised.

Core public services

While there has been (patchy) devolution of economy-related functions from central government, there has been a process of centralisation of key elements of policy in relation to social care and schools, two areas of spending traditionally under the purview of local government.

Looking first at adult social care, the Care Act 2014 introduced a new national framework governing eligibility and assessment for publicly funded social care services. It also placed new statutory duties on councils to provide certain services.³⁶ Alongside this, a growing pot of

³⁵ See 'Letter from the Deputy Prime Minister to local leaders: the next steps to devolution', 16 July 2024, <https://www.gov.uk/government/publications/letter-from-the-deputy-prime-minister-to-local-leaders-the-next-steps-to-devolution/letter-from-the-deputy-prime-minister-to-local-leaders-the-next-steps-to-devolution>.

³⁶ These include: information and advice services available to all; support for those providing informal care to friends or relatives; clear personal budgets for those receiving care; independent advocates for those unable to engage with the assessment and care process themselves; and deferred payment schemes.

funding has been ring-fenced specifically for social care services. This includes transfers from the NHS via the Better Care Fund, grant funding from central government via the so-called Improved Better Care Fund and various social care grants, and part of the revenues from council tax increases (the social care precept). The new government's election manifesto called for a 'National Care Service', which would be 'underpinned by national standards, delivering consistency of care across the country' (Labour Party, 2024). The new government has also recently published a set of proposals aimed at improved provision and a more consistent approach to children's social care services (Department for Education, 2024), building on a 'national framework' published by the last government (Department for Education, 2023).

For schools, recent years have seen the centralisation of decisions over local spending levels, but devolution of additional responsibility and powers to individual schools over how they spend their own budgets. Since 2006–07, funding for schools has been ring-fenced as the Dedicated Schools Grant (DSG). The size of this grant therefore represents a hard floor below which school spending cannot fall, and while councils can top up the DSG from their own revenues, very few do this in practice (Sibieta, 2015). The Department for Education also plans to introduce a national funding formula for schools, whereby schools with the same characteristics would eventually receive the same level of funding wherever they are in the country. As part of transitional arrangements, councils are required to move their school-level formulas closer to the national formula used to allocate funding between councils.³⁷

Increasing central control over social care and schools policy in this way makes sense if consistency of provision is a key goal. Centralising decisions over spending levels is not necessarily required though and, as discussed above, can be counter-productive if centralised needs assessments suffer from inaccuracies. This needs to be borne in mind when considering proposals by Demos to transfer responsibility for services such as social care, homelessness prevention and special educational needs support from councils to new public services trusts, funded directly by central government (Phillips and O'Brien, 2024).

However, to the extent that local government retains some degree of responsibility for and discretion over spending levels, the main local government funding allocation system must place a significant priority on redistribution relative to incentives. If it does not, the ability of councils serving areas with high (or increasing) needs and/or low (or falling) revenue-raising capacity to meet the required national standards of provision would be jeopardised.

³⁷ See 'Pre-16 schools funding: local authority guidance for 2025 to 2026', Education and Skills Funding Agency, <https://www.gov.uk/government/publications/pre-16-schools-funding-local-authority-guidance-for-2025-to-2026/summary-policy-document-for-schools-national-funding-formula-2025-to-2026#local-authority-mainstream-schools-formulae-in-2025-to-2026>.

It is also worth noting that if substantial revenue devolution (or assignment) was deemed a priority, it would be easier to do this under a system with greater local control over spending on core public services. This is because the economy-related spending areas currently being considered for devolution to combined/mayoral authority areas are relatively small in comparison to even small fractions (e.g. 10%) of major taxes, such as income tax.

3.4 Institutional and other arrangements

As highlighted in Chapter 2, in addition to reforms to how funding is allocated between councils and the range of revenue and spending powers that are devolved, reforms could be made to institutional arrangements to improve the status of local government relative to central government.

An independent body to advise on funding levels and distribution?

Several reports have recommended the creation of an independent body to make recommendations on local government funding levels and allocations.³⁸ Others have suggested that funding allocation methods should be decided collectively by local government (see Raikes, 2023), potentially in formal conjunction with central government, as in Italy, for example (Muldoon-Smith et al., 2023c).

It is worth noting that both under previous Conservative administrations and the new Labour administration, central government has consulted extensively with English councils (and other stakeholders) on reform proposals, including the allocation (but not the level) of funding (see, e.g., Ministry of Housing, Communities and Local Government, 2016, 2018a, 2018b). Indeed, a range of joint working groups was in operation between 2016 and 2019 to inform the principles and detail of government reform proposals.³⁹ However, such arrangements do not have a statutory basis and the government could decide to elicit much less input from the sector on funding allocation decisions.

Given the importance of funding allocation to achieving wider objectives (for example, in relation to the degree of consistency in service provision, and the financial incentives that councils face), there is a case for reform. There is a significant body of research showing how governments use funding allocation systems to benefit areas that are politically important to them relative to other areas with similar socio-economic characteristics.⁴⁰ And as highlighted

³⁸ See, for example, Lyons (2007) and Independent Commission on Local Government Finance (2015).

³⁹ See 'Business rates retention', Local Government Association, <https://www.local.gov.uk/topics/finance-and-business-rates/business-rates-retention>.

⁴⁰ See, for example, Hilber, Lyytikäinen and Vermeulen (2011).

earlier, governments have sometimes misled stakeholders about the effects of their funding allocation decisions. An independent body could help address (or at least shine a light on) such issues.

However, because of the inherently subjective issues at the heart of spending needs assessment and funding allocation processes, any independent body set up to work on these issues should be subject to clear mandates on the objectives the government wishes to pursue and be advisory only. Similarly, any new legal mandates for engagement with local government in the design of these processes should also recognise that reaching a consensus on specific proposals is likely to be difficult: funding allocation is a zero-sum game, with more funding for some councils, meaning less for others. Again, final decision-making will have to lie with central government or parliament, where democratic accountability for national distributional issues lies.

In addition to allocation methodology, a new independent body could also usefully make recommendations on the overall level of funding required for local government as a whole to deliver the range and quality of services expected of it. This could aid voters and other stakeholders to hold both central and local government to account for performance; currently, it is not clear the extent to which shortcomings in service delivery are driven by central government decisions on grant funding and revenue-raising powers, or local government decisions and operational performance. And as discussed previously, it is not possible to estimate the relative spending needs of different councils without at least implicitly assuming the range and quality of services that they are expected to deliver. However, as with funding allocations, the role of any such body in assessing absolute funding requirements should be advisory only: judgements about how much priority to place on local government funding, as opposed to spending on other services, taxation and borrowing, are ultimately political.

Assignment of national revenues to local government as a whole?

Some have suggested guaranteeing local government as a whole a proportion of central national tax revenues.⁴¹ This differs from local assignment discussed earlier, in that the allocations for individual councils would be in the form of formula-based grants, rather than the revenue raised in their areas. It is hoped that doing this would raise local government's bargaining power relative to central government and provide greater long-term certainty on funding levels.

However, the revenues from a given basket of taxes and the spending needs of councils and other parts of the public sector can evolve differently over time. The assigned tax revenues could grow too slowly to meet increases in the spending needs of councils, meaning that there would

⁴¹ See Lyons (2007), Independent Commission on Local Government Finance (2015), Birmingham University (2024) and Muldoon-Smith, Walker and Stride (2024).

still be significant uncertainty at the margin over whether changes in spending needs would be met. If these taxes were raised to fund other services (such as the NHS), a rule allocating a share to councils too could mean a squeeze to spending on other (unprotected) spending.⁴²

If the concern is that current arrangements lead to the systematic under-funding of councils, then there may be scope to address this more directly. The ‘new burdens’ doctrine means that when central government decisions create new responsibilities for local government – for example, in relation to homelessness prevention or support for carers – the costs of these must be assessed and funding provided.⁴³ This policy is not backed by legislation, however, and does not apply to existing burdens, the costs of which will change over time as a result of changes in the demand for and cost of delivering particular services. The doctrine could be expanded to include existing burdens, and put on a statutory basis, perhaps with an independent body assessing whether funding is sufficient.

Germany’s principles of funding adequacy, set out in its financial constitution, are an example of such an approach – albeit without an independent body (Muldoon-Smith, Forbes and Pearson, 2023b). This states that centrally imposed tasks must be accompanied by a sufficient amount of central funding to deliver them, and allows municipalities to challenge the Länder or federal government in constitutional courts if they believe sufficient funding is not provided. In an English context, it is probably not feasible to require centrally imposed duties, without a sufficient reduction in the number of such duties or part-centralisation of existing local taxes such as council tax: a large part of spending on such duties is currently funded via local tax revenues. But central government could be required to ensure that funding available to local government, including from some notional level of council tax, is sufficient to deliver the range and quality of statutory duties expected of councils. If this were the case, the government would need to set out clearly the assumed level of council tax.

A move away from small ring-fenced and competitive pots?

Ring-fencing and competitive funding can serve a purpose. For example, ring-fencing funding for services where the aim is for more consistent provision in services across the country can make sense in the context of a system that otherwise has a significant focus on discretion and incentives for local government. In particular, it can provide a backstop to minimum or expected standards of service provision, limiting the extent to which councils can redistribute funding from such services to help offset increases in needs for other services or reductions in local

⁴² This was likely to have been a problem with proposals by the Scottish Conservatives, in advance of the 2021 Scottish Elections, both to guarantee Scottish councils a share of overall Scottish Government funding and to guarantee the Scottish NHS the full increase in Scottish Government funding following increases in English NHS funding. See Adam et al. (2021).

⁴³ See ‘New burdens doctrine: guidance for government departments’, <https://www.gov.uk/government/publications/new-burdens-doctrine-guidance-for-government-departments>.

revenue-raising capacity. Competitive bidding between councils could improve funding outcomes, if the appraisal process is able to identify high-quality bids, and bidders respond to the competition by crafting better projects, with some evidence of the latter effect from analyses of regeneration funding competitions in England (Taylor, Turok and Hastings, 2001).

However, ring-fencing or requiring competitive bids for too many small pots of funding does impose costs and reduces the ability of councils to respond to local knowledge: rather than spend in the way they deem most appropriate, they must do it in ways required by central government. Moreover, the evidence on the impacts of competitive bidding is decidedly mixed overall. Variables related to bid presentation (e.g. the inclusion of maps in bid documents) have been found to be stronger predictors of success than the extent to which bids met the strategic objectives of past regeneration programmes in England (see John, Ward and Dowding, 2004; John and Ward, 2005). And there may be particular concerns that areas with weaker governance and institutions – which might be in particular need of support – may be expected to particularly struggle to craft high-quality and competitive funding proposals. Therefore, likely it does make sense to simplify the funding landscape by reducing the number of small ring-fenced and competitive pots of funding.

Multi-year budgets for local government?

Finally, the phased introduction of a reformed funding allocation (and new needs and revenue-raising capacity assessments) provides an opportunity to provide councils with multi-year funding settlements that they have lacked in recent years. This should provide greater clarity over future funding levels, helping councils with their medium-term financial, service and investment planning, in turn improving value for money and delivery.

However, it is important to recognise that clarity does not mean certainty in funding. Settlements for later years should not be completely fixed, because it would be counterproductive to try to provide full certainty over cash-terms budgets – not least because inflation and demand pressures may turn out higher or lower than expected. Instead, the settlements could be used to provide a baseline cash-terms budget that would not be reduced except in exceptional circumstances (for example, a government debt crisis). The government could also provide information about how decisions on any subsequent increases in funding would be made – for example, due to changes in expected cost pressures (e.g., due to inflation and wage growth) and demand pressures. In setting out this information, the government should carefully choose indicators that reflect the pressures facing local government, but which are not easily manipulatable by local government. For example, economy-wide earnings growth and changes to the National Living Wage would be preferable to using increases in wages negotiated between councils and employees' unions.

4. Conclusion

Recent years have seen major concerns about the level of funding available to councils. The focus of this report though has been on the *system* by which councils are funded. After first reviewing the issues with the current ‘system’, which have been raised by councils, sectoral bodies and others, it has appraised the options for reform.

Some changes are clearly needed – most notably, a proper system for assessing spending needs and allocating funding between councils on agreed principles. It would also be wise to ensure that funding arrangements provide longer-term clarity to councils, are transparent and subject to appropriate scrutiny, and are sufficiently flexible to adapt to the priorities of different governments.

However, there is no one ‘right answer’ on how councils and local services should be funded. What matters is that the funding system should be aligned with the policy objectives being pursued. For example, a finance system that strongly emphasises local responsibility for revenue-raising via devolved taxes and financial incentives for growth is unlikely to be suitable if one is also aiming to have a wide range of services provided to a consistently high standard across the country for similar tax rates. Conversely, a system of grants fully and frequently updated for changes in spending needs, significant ring-fencing, and with a continued shortage of revenue-raising options will not pass muster, if the aim is for local government to take the lead in promoting growth and shaping services to meet local preferences.

It is not possible for any finance system to fully satisfy all the various objectives a government may have – because those objectives may conflict. In designing a new system, it is important that the government should be honest about which objectives it is prioritising. Ideally, it should attempt to forge a consensus with local government and other stakeholders about the broad parameters of the system, although this may be difficult on the issue of funding allocation in particular (which is something of a zero-sum game).

Our key guidelines for the reform of the local government finance system are the following.

1. Updated assessments of councils’ spending needs and revenue-raising capacities, and a transparent and flexible system to account for them when allocating funding are vital. This means using redistributive grants from central government or transfers between councils, and providing clear information on how those grants or transfers have been calculated. Once in place, assessments of spending needs and revenue-raising capacity should be kept up to

date. This means not only updating data on local area characteristics, but also updating on a periodic basis the formulas used to link these characteristics to needs and revenues: changes in service delivery models and tax systems mean such relationships can change over time.

2. The design of such assessments and such a system is technically challenging but not a purely technocratic exercise, so any independent institution tasked with making recommendations needs a clear mandate and should be advisory only.
3. The relative spending needs of different councils depend on the range and quality of services expected of them, and so the government should clarify its expectations. An independent institution could be tasked with assessing whether funding is sufficient to meet the governments' expectations of councils, which would require assessment of absolute as well as relative spending needs.
4. The government should consider whether funding allocations include a specific component designed to channel funding to disadvantaged areas not only to account for socio-economic inequalities, but also to reduce them, as with NHS funding. Such an approach would make sense if it were felt that additional funding and enhanced service provision was the most promising approach to reducing these inequalities. However, it would further weaken financial incentives for councils to reduce needs (because more funding would then be at risk of being lost). So, if it is felt that an incentivised and more-focused service delivery apparatus is the most promising approach to reduce inequalities, then over-weighting disadvantage in funding formulas could be counterproductive.
5. Assessments of revenue-raising capacity should be based on notional rather than actual tax rates and bases to avoid distorting councils' decisions. Councils' abilities to raise revenues through SFCs can continue to be assessed implicitly through spending needs assessments based on net expenditure, although separate assessments would allow for more bespoke formulas based on drivers of ability to raise revenue from SFCs, particularly from parking. Whether it is appropriate to assess abilities to raise revenues through fully commercial activities is less clear-cut, and more difficult in practice.
6. The extent to and frequency with which changes in assessed spending needs and revenue-raising capacities should be accounted for depend on the priority placed on redistribution to account for differences in socio-economic circumstances versus the importance of local financial incentives for improving those circumstances. Decisions on this should be guided by the government's wider Missions and its theories of change for delivering them (which, as highlighted above, may also be resource- or empowerment/incentive-based). And options such as delayed or rolling updates can ease the trade-off between redistribution and financial incentives.
7. In general, a greater degree of devolution is desirable when more priority is placed on local discretion over national consistency, which in turn should partly depend on the scale of variation in preferences between areas, and the type and extent of any asymmetries in information between central and local policymakers.

8. Decisions over which revenue streams and spending powers to devolve should be taken on a case-by-case basis, as the benefits and costs of devolving them are likely to vary.
 - a. On the tax side, recurrent property taxes and personal income taxes are better candidates for devolution than VAT/sales taxes and corporate income taxes. It does matter what powers are devolved though. For example, giving councils enhanced powers to set council tax rates (for example, by abolishing referendum requirements), discounts and premiums makes more sense than giving them powers to revalue properties (which would make assessing revenue-raising capacity consistently much harder). Restricting a devolved local share of income tax to a flat rate above the personal allowance would reduce the risk of potentially harmful tax competition and reduce the extent to which revenues vary across the country (helping reduce the scale of redistribution that may be deemed necessary).
 - b. On the spending side, there is a case for giving combined/mayoral or county councils additional economy-related powers on a more consistent basis across the country to improve understanding and hence support accountability. Recent years have seen increasing central government control and reduced local discretion over core public services such as schools and social care services, the aim of which has been more consistent national standards of provision.
9. It is important to draw a distinction between local discretion over the range and quality of services to provide, and the amount to spend on those services. Centralising decisions on spending levels may not lead to more consistent service provision if assessments of spending needs are inaccurate. In this instance, devolving spending decisions, but having clear and enforceable national standards, can be a better option if there are mechanisms to ensure sufficient funding is available to local government to meet those standards.
10. A legal requirement for central government to ensure sufficient funding and revenue-raising powers to deliver these standards would be the best way to achieve this. Guaranteeing a share of national tax revenues for local government, which has been suggested as a way to give effect to such a requirement, has potential costs, and would be very much a second-best approach. This is because such hypothecation can distort the allocation of funding across the public sector.
11. The government should provide longer-term clarity to councils on their budgets via baseline multi-year settlements and clear information on how they would be adjusted in different circumstances (such as significantly higher- or lower-than-expected inflation).

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