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**Working Paper**

## Slicing up the public sector: A radical proposal for devolution

IEA Discussion Paper, No. 59

**Provided in Cooperation with:**

Institute of Economic Affairs (IEA), London

*Suggested Citation:* Packer, Tom; Sinclair, Matthew (2015) : Slicing up the public sector: A radical proposal for devolution, IEA Discussion Paper, No. 59, Institute of Economic Affairs (IEA), London

This Version is available at:

<https://hdl.handle.net/10419/313960>

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IEA Discussion Paper No.59

# **SLICING UP THE PUBLIC SECTOR:**

A radical proposal for devolution

Tom Packer and Matthew Sinclair  
March 2015

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## Summary

- The recent Scottish independence referendum opened up an important debate about the appropriate level of governance for all regions of the United Kingdom. However, many of the current proposals, such as English votes on English matters, city deals, and an 'English Parliament', are flawed.
- The UK is highly centralised and devolution combined with fiscal decentralisation could bring significant economic benefits. This can happen through several mechanisms: decisions will be taken closer to those they affect; there will be more policy experimentation; and there will be horizontal competition between jurisdictions.
- Unlike the current situation where devolution is selective, devolution should be symmetrical: all authorities to which power is devolved should have the same responsibilities. This improves accountability for both national and local government. If devolution continues to be extended to areas where voters prefer a larger role for government, policy experimentation will be limited and the size of government will increase.
- Westminster should remain sovereign, and powers devolved to local authorities should be clearly enumerated. Central government should remain responsible for foreign affairs and defence, major infrastructure projects, competition policy and migration.

- The ideal should remain that services such as schools are accountable to those who use them, rather than to local or national politicians. Broadly conceived competition powers should ensure that consumers are able to transact freely across local authority boundaries and consumers are not confined to local monopolies.
- Devolution throughout the UK should be applied to the following areas of spending and regulation: welfare, environmental policy, health, housing and labour market policy. There is also scope to devolve significant other law-making powers relating to the control of purported localised externalities, particularly where local variation in preferences might be expected.
- To obtain the benefits of devolution, tax-raising powers must be devolved alongside spending powers. Central and sub-national government should have distinct sources of revenue. The evidence suggests that the decentralisation of spending alone reduces economic growth whereas the decentralisation of both spending and taxes increases economic growth.
- Consumption taxes are likely to have limits as a source of local revenue in a densely populated country with permeable boundaries. Local authorities should have the power to levy taxes on income and duties on natural resources, subject to approval by voters and with restrictions on the structure to prevent manipulation of the tax base.
- Westminster should remain responsible for the existing national debt and place restrictions on new borrowing by local authorities. The Bank of England should not accept sub-national government debt as collateral for lending operations. Borrowing by local authorities should be allowed but only to smooth spending over the cycle and to pay for large projects.
- Devolution should not create additional layers of government, as proposed with the new English Parliament or regional assemblies. Instead, powers should be devolved to existing county and unitary authorities.

# Introduction

The Scottish Parliament in Holyrood enjoyed considerable authority even before the recent referendum on Scottish Independence. In the course of the campaign, the leaders of the main political parties in Westminster pledged to devolve a range of new powers to the Scottish Parliament. The UK Parliament might in theory have minimal responsibilities in relation to Scotland.

This commitment to further devolution did raise the question: what about the rest of the UK, and particularly England without its own devolved institutions? The decision to devolve more power to Scotland had exposed the asymmetric nature of the UK's current constitutional settlement.

After the campaign, the Prime Minister argued that we 'have heard the voice of Scotland and now the millions of voices of England must be heard' (Wintour, Carrell and Mason 2014).

A number of potential reforms could correct that asymmetry in theory, including:

- Scottish MPs being blocked from voting on measures not reserved to Westminster (commonly described as 'English Votes for English Laws').
- The creation of an English Parliament.

- England being compensated with a greater number of seats per person in Westminster. With the Government of Ireland Act 1920, under which considerable powers were devolved to the Parliament in Stormont, Northern Ireland returned fewer MPs than its number of electors would have implied it should. The number of seats was increased in 1979 after the return of direct rule in 1972 (Bowers 2012: 5).
- Devolving powers to existing or potential sub-national authorities, new regions or – as we will propose in this paper – existing local authorities.

Devolution should mean that decisions are made closer to those who feel the consequences. The appropriate principle is that of subsidiarity: social issues are best addressed by those closest to the problem (Sirico 2007). This should include fiscal decentralisation too, with local services financed by local taxes. Yet the design of devolved institutions will be crucial to their success, particularly in terms of economic efficiency.

An optimist would argue fiscal decentralisation will make the relationship between a taxpayer and their government more like that of a shopper entering a market. They can choose the mix of public goods and level of taxes with which they are most comfortable. Any authority which does not offer reasonable value for money will see its tax base eroded as people vote with their feet. This horizontal competition is the well-established Tiebout (1956) model for local expenditures.

A pessimist would argue fiscal decentralisation will simply mean more governments and more taxes. The tax base would become a common pool with a chain of monopolies competing to serve special interests, by increasing taxes on the community as a whole. Sub-national governments become like a series of toll stations on a river: they enjoy the full benefits from charges imposed on the unlucky boats passing through but only face a share of the consequences in reduced traffic (their higher taxes have a vertical externality borne by other authorities, by reducing the size of the

base available for them to tax). Berry (2009: 1-2) describes the less attractive side of federalism in the United States:

‘A citizen of Cook County, Illinois, for instance, would have to go to the polls on six separate dates over the course of four years in order to vote for each of the 70 different local officials that represent her. It is little surprise, then, that voter turnout in local single-function elections is usually in the range of 2 to 10 per cent. [...] the benefits of single-function jurisdictions spending accrue disproportionately to a particular group but the costs of taxation are spread over all groups, a problem arises that is analytically similar to the overfishing problem seen in environmental economics. That is, just as each individual fisherman has an incentive to overexploit the shared resources of the sea because he receives all of the adverse consequences, so too, I contend, each government has an incentive to overexploit the shared tax base to provide benefits to its special interest constituency.’

On balance, we can probably be optimistic. The existing empirical literature tends to show that fiscal decentralisation is associated with more limited government, economic growth and public sector efficiency.<sup>1</sup> Also, greater tax decentralisation is generally associated with greater economic liberty, as measured by the Heritage Foundation Index of Economic Freedom. It should be noted that there are some countries that are highly centralised and exhibit a high degree of economic liberty but they tend to have smaller populations than the UK and thus their central governments show similar constraints to local governments in larger countries. Smaller countries tend to set lower corporate income tax rates, for example (Gravelle 2014: 3).

The pattern is not clear enough to justify complacency, however. The number of countries is small and there are a host of other differences between the US (or Switzerland) and France (or Greece). In the UK, we argue that we should aim to maximise the horizontal competition that promotes better government and minimise the vertical externalities that lead to an excessive burden on families and businesses.

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1 That literature is summarised in Sinclair (2014).

In this paper we aim to provide an outline of the principles under which devolution is most likely to promote prosperity and the fiscal responsibility and liberal economic policy most likely to support economic growth over time. We outline a broad framework that can be adapted in response to new evidence and changing circumstances. We set out five principles which we believe would be a sound basis for effective decentralisation:

1. Devolution should be symmetrical
2. Local powers should be clearly enumerated, with Westminster sovereign
3. Councils should have strong incentives to promote local prosperity
4. There should not be too many layers of government
5. Units need to be viable, but not so large that the potential benefits of decentralisation are lost.

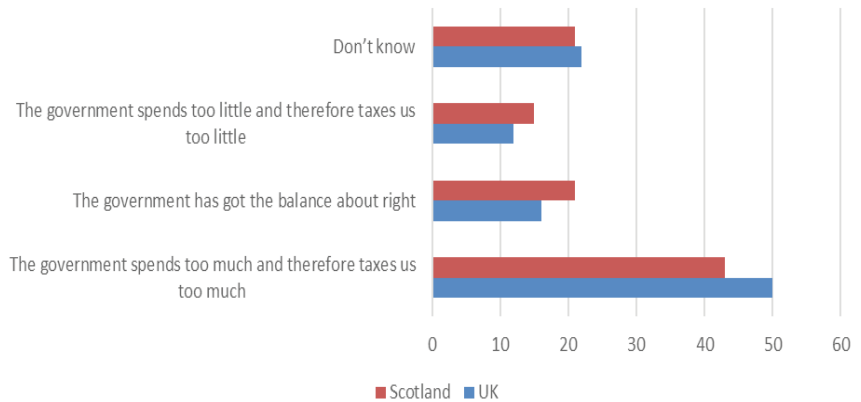
## Devolution should be symmetrical

Equal, or symmetrical, devolution enhances accountability. Unequal devolution – as in significant differences between the powers devolved to different geographical areas – weakens accountability, for both local and national government. If there is less variety in the deviation from national policy, then it will be harder for voters and the media to use other authorities as a benchmark in order to assess whether national or local policy is responsible for successes or failures. To give one concrete example of this process under the status quo, it is harder for local authorities to insist that above inflation rises in council tax are needed, when authorities from Trafford to Hammersmith and Fulham are delivering council tax cuts.

The greater the extent to which authorities are able to develop a diverse range of policies, and some thereby secure high performance, the harder it will be for local authorities performing poorly to evade accountability by blaming their problems on central government policy.

Unfortunately, at present devolution is highly asymmetrical and there are significant differences in the opinions of voters between those subject to devolution and those in England who are not. When asked for their view on whether the level of spending and taxes should be higher, lower or around the same, voters in Scotland were more likely than those in the UK as a whole to say they would prefer higher spending and taxes and less likely to prefer lower spending and taxes (see Figure 1).

**Figure 1: The money the government spends on public services and other things comes mainly from taxation. Do you think...<sup>2</sup>**



There is also a partisan divide. If we leave aside Northern Ireland, where the partisan divide is complicated by having a different set of parties from the mainland, the Labour vote is considerably higher in the areas subject to devolution, whereas the Liberal Democrat vote is somewhat lower and the Conservative vote is very considerably lower. That partisan divide may reflect differences in opinion on the issues, but it may also cause it, with parties more likely to prefer lower taxes and lower spending historically weak in those areas subject to devolution. Voters support policies favoured by their party, as well as supporting parties which favour their preferred policies.

If you assume that policy will – over time – tend to reflect the preferences and voting behaviour of the electorate, you would expect unequal devolution biased towards those voters who are more likely to prefer a larger government to result in a larger role for the government in aggregate. That could have economic implications for those areas not subject to devolution. If Scotland and Wales choose to increase government spending — then that may mean diminished trading opportunities for businesses in the

<sup>2</sup> Total sample size was 1,684 adults. Fieldwork was undertaken 10 - 11 March 2013 by YouGov for the TaxPayers' Alliance. The survey was carried out online. The figures were weighted and are representative of all GB adults (aged 18+).

rest of the UK, even if they pay for it themselves with higher taxes, due to a reduction in the devolved areas' rate of economic growth.<sup>3</sup>

There may also be political implications, which create second order economic effects. Devolution can allow sub-national governments to experiment with new policies and test their effectiveness. In the debate over the ban on smoking in public places, introduced in Scotland before the rest of the UK, Labour MSP Andy Kerr said that: 'The Executive and I are proud that we in Scotland are leading the rest of the United Kingdom in the smoking debate, which is a tribute to devolution.'<sup>4</sup> The Royal Borough of Windsor and Maidenhead allowed residents to see all items of expenditure over £500 from April 2009. That initiative was later taken up by other local authorities and central government.

If devolution is only extended to those parts of the country where voters tend to prefer a larger role for government, the range of experiments will be curtailed. The process of policy reform will be biased against pro-market approaches to social and economic issues.

For this reason, proposals to extend incomplete devolution to major cities should be seen as unwelcome. They would mean further unequal devolution, again towards voters who are less likely to favour smaller government and lower taxes. Devolution should not mean gerrymandering to grant more powers solely to areas likely to carry out a particular type of economic agenda.

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3 This result has been found by a number of authors including, but not limited to, Barro (1997), OECD (2003) and Afonso and Furceri (2008). Those studies and others are summarised in Heath et al. (2012: 132).

4 Scottish Parliament, debate on the Smoking, Health and Social Care (Scotland) Bill: Stage 1, 28 April 2005

## Local powers should be clearly enumerated, with Westminster sovereign

The Parliament in Westminster should remain the sovereign government. Whatever they are called, sub-national authorities should be assemblies with clearly defined powers and responsibilities, rather than broad authority to go empire building.

At the same time, localism should not become an excuse for unnecessary intervention in services which are better left to suppliers and consumers: that would be to centralise powers in local government that should be left with individuals, families and other organisations in society. It is important to aim for more power to be in the hands of individuals and communities than government – at any level. Schools, for example, should answer primarily to parents rather than politicians and officials, whether those authorities operate at a national or local level.

There are other political risks with not having a clear sovereign government. Multiple sovereigns can mean duplication, with regulations layered on top of regulations. That kind of duplication exists in many areas in the United States, where healthcare, for example, is regulated by both Federal and State regulations. Authorities may even regulate a certain area in order to assert their role and avoid pre-emption by some other would-be government, which they feel would do a worse job. This could lead to a set of regulations worse than either tier of government would produce alone, as the authorities attempt to game the system.

Our intention here is not to set out precise powers that should be devolved to local government, but just to consider some of the more important choices facing policymakers in maximising the scope for horizontal competition to deliver the best possible service and minimising vertical competition to profit at the expense of other jurisdictions.

### ***Foreign affairs, defence and other national public goods***

There are some areas of policy which will likely remain with national government, as they relate to public goods from which it would be difficult to exclude any sub-national authorities which did not contribute. Foreign affairs and defence, for example, are probably the least controversial areas of policy to leave with the national government in Westminster. The defence of the realm and the conduct of foreign policy are generally understood to be properly the responsibility of the sovereign state. Indeed, one beneficial implication of decentralisation in other areas might be that foreign affairs and defence policy become the subject of greater political scrutiny.

There will also be a role for national government in some major infrastructure projects. That will often mean economic regulation for natural monopolies responsible for major infrastructure projects, but, at times, it may also mean investment for which central government funding is appropriate. Given the tendency of these projects to overrun substantially (O'Connell 2009) and for demand to be overstated (Flyvbjerg, Skamris Holm and Buhl 2005), policymakers should – in practice – be sceptical of these projects in general, but there will still be projects where the benefits are too widely dispersed for it to make sense that a single local authority is responsible for them.

One way to reconcile localism with national priorities and funding might be to run reverse auctions for unpopular projects such as waste dumps and power plants (Direct Democracy 2007). Communities would bid amounts by which they would need to be compensated in order to accept development. Whichever community was willing to accept the development for the lowest amount would get the money and host the project. This allows essential infrastructure to be built in a way that internalises some of the positive externalities for wider communities and has infrastructure built in a location which is relatively supportive.

### ***Widening the scope of competition policy***

Central government will also have a crucial role in competition policy. This should have its traditional focus but should also be extended to include scrutiny of sub-national governments to ensure that they do not take actions, whether through fiscal or regulatory policy, which effectively discriminate between firms or prevent trading across authority boundaries. The rules would be similar in nature to, for example, the state aid rules currently in force at EU level. The competition authority would also ensure fair political competition. One example of that kind of intervention would be the government's ban on expensive council newspapers, which is a legitimate part of its role in ensuring that local parties play fair and do not exploit their authority to cement their place in power. Other examples include restrictions on political advertising; fair election rules; freedom of information requirements; and – as discussed elsewhere – insistence on referenda for certain decisions.

This could be similar to the current laws that regulate council budgets, their ability to raise taxes and place other limitations on their powers. It should be passed through primary legislation and therefore enforced legally rather than relying upon enforcement from the central executive (which might undermine such principles in order to achieve short-term policy goals).

In some areas, such principles should protect existing consumer choice. Education, for example, has traditionally been managed locally. However, devolution should not be an excuse to overrule the increasing freedoms enjoyed by schools and parents. In this area there should continue to be the broad principle, in line with the broader principle of subsidiarity, that subject to the proper constraints in law, parents and teachers are entitled to organise education without external interference. Existing freedoms for schools should be protected.

Central government should also remain responsible for migration policy. Free movement within national borders is essential to effective devolution, both in order to create a competitive pressure for efficiency and in order to manage asymmetric economic shocks. There may also need to be some restriction on the scale of policies which inhibit free movement, for example requirements for professional qualifications which might create a significant obstacle to those professionals moving.

### ***Localising environmental policy***

There are many other areas where considerable further devolution to local areas should be possible. For example, with respect to environmental policy, the Environment Agency should, at the very least be more subject to local democratic oversight. Local government leaders may be better placed to manage its work themselves, particularly now that the principle of co-operation across councils and sharing services has been well-established through organisations such as waste management partnerships. If people in – say – Somerset feel they have been let down with respect to flood defence there should be an avenue for democratic accountability. However responsibility may need to be organised in line with natural sources of risk, for example flood plains.

There are areas of environmental policy where there is already considerable decentralisation, but where fiscal decentralisation can improve incentives facing local decision makers. Local authorities

already have considerable discretion over approving new housing. Over time, the objective should be that a combination of improved fiscal incentives for local authorities and communities – as new housing would increase the size of the local tax base (Marc Hartwich and Evans 2005) – and building homes with which communities are more comfortable (Morton and Boys Smith 2013) would mean house building no longer depends on central government's intervention.

### ***Health and welfare***

Welfare as it exists today developed from a set of local institutions.<sup>5</sup> While some central funding may be needed, and this is discussed later, the flexibility of sub-national government could, over time, make it easier to avoid the safety net creating welfare dependency. US welfare reform illustrates the potential here. Pensions may need to remain the responsibility of national government, at least while there remains a considerable unfinanced liability for existing commitments.

Healthcare is a difficult area in that local administration can ensure much greater freedom to innovate and flexibility to respond to local circumstances.<sup>6</sup> Unfortunately it also means a smaller market. That might mean that it is hard to establish a competitive market. The problem should not be over-stated relative to the status quo. Labour costs are the largest component of healthcare expenditure and a single employer is not the best basis for a healthy labour market. Equally a single monopsony purchaser attempting to bully suppliers has not been the most productive relationship in the drugs market, often strangling innovation (Huber 2013).

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5 In many ways, the 'creation' of the welfare state after 1945 consisted in part of centralising existing local institutions (Wrigley 1988).

6 Indeed, at the formation of the NHS, Herbert Morrison preferred a locally run health system while Aneurin Bevan pushed for full nationalisation of the hospital service. Political compromise saw community and social services left with local authorities (Greener 2005).

Switzerland has a highly localised healthcare system, with basic requirements set down in Federal law, but most responsibility for administering healthcare is left to cantons, which essentially operate 'twenty-six semi-autonomous health systems'. While there are concerns that makes it difficult to develop 'competitive markets for health-care insurance' (OECD 2006), the 'Swiss healthcare system is high performing and responsive, reflected in high levels of patient satisfaction and one of the longest life expectancies in the world' (OECD 2011).

The simplest reform in the short run might simply be greater local authority over existing local NHS organisations, the various trusts and groups that make up the NHS as it exists today. Over time it should be possible to learn from other successful healthcare systems in Europe and elsewhere, and build a system that is more responsive to patients. The general principle should be to ensure that people are able to trade across jurisdictional lines and authorities are able to coordinate in order to attain the scale necessary for reforms.

Aspects of public health regulation could also be localised with authorities given the discretion to either extend or roll back rules such as the smoking ban where preferences for the balance between safety and lifestyle freedoms might vary. Local authorities already handle the administrative effort of enforcing most of these regulations, so this is not beyond their means. Voters should be able to find an authority that better matches their preferences for lifestyle regulation and this approach will also provide opportunities for experimentation and the copying of successful experiments.

## Councils should have strong incentives to promote local prosperity

### ***Councils should generally raise the taxes to finance their spending***

It is reasonable to believe that local governments will be more responsible when they are required to raise taxes to fund their spending, rather than appealing to national government. People are generally more likely to spend their own money carefully than someone else's and, while local government is not spending its own money, voters are aware that the money for projects that local government finances is coming from them and their neighbours, rather than a remote central treasury.

The mechanism by which this is achieved may be that the logic of collective action is less compelling in local government. The logic of collective action (Olson 1971) is that a small special interest group (for example, investors in solar energy or creditors to banks) will generally be better able to coordinate their efforts to extract resources (generous subsidies or bailouts) from a majority (electricity consumers or taxpayers). Each individual in the majority does not pay enough for it to be worth their while to engage in the political process and resist, but smaller interest groups can co-ordinate their campaign efforts and limit free-riding.

There is empirical evidence that when sub-national government is responsible for financing its own spending it promotes economic growth. Gemmell, Kneller and Sanz (2013) find that among developed economies 'spending decentralization has tended to be associated with lower economic growth while revenue decentralization has been associated with higher growth.' They report that, since in most developed economies spending is less centralised than taxation, their findings are consistent with the hypothesis that 'maximum efficiency gains require a close match between spending and revenue decentralization.'

To achieve this and to achieve effective devolution, central and sub-national government should have distinct sources of revenue. To the extent there is a common pool of resources, it is very important to ensure complete transparency over the amounts being paid to different authorities, for example through separate tax bills.

### ***Should consumption taxes be decentralised?***

In earlier plans for fiscal decentralisation, the focus was often on decentralising consumption taxes (Carswell 2004). That is difficult in a densely populated country such as the UK where consumers could easily cross boundaries to find cheaper products. That is far from a fatal flaw. People are often willing to pay more to shop in a more pleasant environment and even with a high degree of horizontal competition the resulting tax rate may not be zero (for example, Vermont has a sales tax while New Hampshire does not). But it does suggest that there are limits to the extent that consumption taxes can pay for local services. Sales taxes are, in general, hard to operate while raising anything like the amount of revenue currently generated by VAT (Heath et al. 2012).

### ***Decentralising taxes on incomes, capital and natural resources***

The objective for local taxes should be that they align the incentives of sub-national government with the economic interests of the wider community. Taxes on income and duties on natural resources might achieve this best.

If taxes are levied on income, commercial and residential growth increase the local tax base. This may mean that new residents represent not just more demand for services, but also the basis of an increased supply of public services. It may thereby diminish some of the stress associated with internal migration or immigration at present as well as making debates about house building more balanced.

Taxes on capital income are more difficult to manage as they have the potential to create opportunities for firms to game the system between authorities. Furthermore, the complexities of capital taxation may not be realistic for even larger local authorities to manage. Local authorities might enact rules which define more capital income as being earned in their area, either competing over a common pool or colluding to maximise overall revenue, rather than genuinely competing to attract investment. Manipulation of the capital tax base is a considerable problem in the US (Greve 2012).

Assuming a move over time from the taxation of capital gains and corporate profits to the taxation of capital income – as set out in the 2020 Tax Commission, to which both authors of the present paper contributed (Heath et al. 2012) – the best solution might be for taxes on income from capital to continue to have their base set in Westminster and their rate set nationally, but then allow local taxpayers to claim back any taxes on income from capital paid to the UK government in excess of the labour income tax rate set by their local authority. If the present system of corporation tax, capital gains tax and income tax on capital income continues, then the best solution might be to leave corporation tax and capital gains tax with national government but allow income tax on income from capital to be charged locally. Either way the decentralisation of

capital tax revenues would be another way to encourage local government to support business investment in their area and can be achieved without allowing authorities to game the tax base.<sup>7</sup>

If duties on natural resources were levied locally, that would give sub-national authorities a stronger incentive to encourage their development. The current centralisation of the direct revenue from shale gas production dilutes the incentive for local communities to support its development.<sup>8</sup> Given that both national and local government will often be involved in the political decisions, which could encourage or discourage development, and there may be concerns that it is unfair to apportion all the revenue to those areas fortunate enough to enjoy valuable mineral resources, some form of revenue sharing might be best. The enormous difference in the local political appetite for the development of shale gas and tight oil resources in the US – where taxes are much more decentralised – and the UK – where development has so far been slow, shows the potential for some decentralisation to improve incentives for local authorities in this area.

### ***Restraints on tax increases***

There is a danger, particularly in the short run, that local governments would increase taxes in order to avoid having to restrain local spending, hoping that low turnout and a tradition of using local elections to pass a verdict on national politics insulate them against electoral consequences.

Central government has a legitimate role in ensuring fair play in local democracy and part of that could include ensuring that local

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7 All this assumes that taxes continue to be levied on capital income, either directly or in the form of profits or capital gains. However, there is a case that the most appropriate tax rate on capital income is zero (Sumner 2012).

8 It is important to note, however, that oil and gas exploration and production produces corporate, income and other tax revenues as well – the total tax contribution has been estimated in an industry study at over £30 billion, or around 5.5 per cent of government revenues (PwC 2012), so any fiscal decentralisation will again better align the incentives of local government with development.

authorities secure the support of local voters before raising taxes. This is done at the moment using the referendum cap for council tax. Any tax rise above a certain percentage has to be approved in a local referendum. That principle could be extended to new local taxes, with a requirement that any increase in taxes, or increase in thresholds by less than inflation, be approved in a referendum subject to rules ensuring electoral fair play (for example, preventing councils distributing propaganda).

### ***When should central government help finance local government?***

In theory, special interests could still lobby central government to fund their priorities and, if necessary, require local governments to do their bidding. To some extent that is likely to happen even with robust rules to the contrary. Clear boundaries would make it harder though, as local governments could resist central government infringing on their areas of responsibility and national government straying outside its areas of responsibility would necessarily raise alarm bells and would probably require primary legislation. There has been little infringement thus far by Westminster on the powers allocated to the Scottish Parliament in Holyrood.

Greve (2012) has argued that we cannot rely on devolved authorities to defend their local jurisdiction, because they tend to support laws and subsidies that promote their interests or policy agenda, for example subsidies for welfare programmes. It is argued that this explains the lack of support for Ronald Reagan's New Federalism agenda among other things. Therefore if local government leaders accept additional funding from central government, they should also have to accept new limitations on their actions. This provides an incentive for them to defend the exclusive prerogatives of local government that does not exist in many current federal systems.

The crucial principle with devolution should be that fiscal equalisation between the regions is not intended to represent a relationship of permanent fiscal dependence, but instead support economic revival for individuals or communities in specific and exceptional

circumstances. Any central government subsidy to local authorities should entail new restrictions on policy. For example, central government could insist on proper testing and evaluation, through rigorous, controlled experiments where possible. There is a precedent for that approach: Manzi (2012) describes how a combination of flexibility to experiment and insistence on robust testing was the core of the successful welfare reform process in the US. As ‘the federal government began to grant waivers that permitted states to experiment more radically...the federal government made randomized experiments to evaluate these changes something like a de facto condition for granting the waivers.’

That meant states could try different reforms, or combinations of reforms, and had to provide robust evidence as to which of them worked. RAND found ‘mandatory work-related activities generally reduce welfare use’ and ‘it is possible to require work and raise income (and more substantially reduce poverty) at the same time. The key is to combine the work requirement with a strong financial incentive, so that earnings rise more rapidly than benefits fall’ (Grogger, Karoly and Alex Klerman 2002). If central government transfers money from more fortunate to less fortunate regions, that support should be based on a plan for recovery, not to underwrite dependency.

Local governments may well resent these restrictions. However it is important to note that they would only apply to recipients of central government transfers. To the extent that authorities are able to reduce their reliance on equalisation funding, or become contributors, they will enjoy greater freedom to determine their own policy. This provides a significant incentive for leaders in devolved authorities to avoid lasting dependence.

After all, there is no reason that we should accept that poorer regions have to remain poor. The north-south divide has flipped more than once before (Hunt 1986). The south was generally the richer half of the country before the Industrial Revolution, closer to the Continent and profiting from the wool trade and high agricultural productivity. Afterwards the north and the midlands were richer, as the workshops of the world. Finally the decline of the staple industries in the early

20<sup>th</sup> century saw another reversal of fortunes, as the new industries and then later the growing service economy were concentrated in the south. There have been similar reversals in other countries: Virginia has become one of the highest-income US States; Bavaria has become one of the highest-income German Länder; and Flanders has become more prosperous than Wallonia in Belgium.

Unfortunately regional transfers and common labour market regulations could be locking regional inequalities in place. Regulations that increase the cost of employing people can diminish private sector employment particularly severely in those areas where average labour productivity is low. Smith (2006: 131) argues that, with a series of distinct regional labour markets, with imperfect mobility between them, the effects of regulation could be particularly pronounced in areas receiving fiscal transfers:

‘Because welfare benefits (and the minimum wage) are the same in cash terms throughout the UK, they have greater adverse effects on employment in the low-productivity areas as measured in current prices. The ‘free money’ that finances welfare benefits in Northern Ireland, Wales, Scotland and northern England through taxes collected in London and the south-east actually diminishes employment in the former regions due to its microeconomic effects.

This effect seems to be what has happened in the UK, and was also the situation in East Germany, where West German employment costs were imposed on an economy where output per head was only around one third of that in the west. A transatlantic example of the same adverse processes at work can be found in Puerto Rico, where the availability of US levels of social support seems to have destroyed what at one point looked like a prospective economic miracle.’

There have been similar problems observed in the Mezzogiorno in southern Italy (Boltho, Carlin and Scaramozzino 1997), where there has been a failure to converge on incomes in the north since the 1960s, despite (and perhaps as a result of) ‘massive regional policy efforts’, ‘with reduced wage sensitivity to regional labor market conditions and with increases in rent-seeking opportunities and corruption.’

### ***Local government borrowing powers***

Finally there is the question of the extent to which sub-national authorities should be free to borrow.

It seems important that Westminster remains responsible for the existing national debt and places reasonable restrictions on any new borrowing. Sub-national authorities are seen as too systemically important for politicians to allow them to fail in practice. The resulting moral hazard this creates means that fiscal reins need to remain with central government.

The euro zone crisis illustrates the risks that can result from fudging the question of sovereignty in an area with a common currency. If there is a single, sovereign government it can internalise the negative externalities of imprudent national fiscal policies for other members of the currency union and insist on more responsible policy; it can police moral hazard; and, when things do go wrong, it can share fiscal risks and accommodate any shifts in competitiveness between members of the currency union with transfers to diminish political pressure on the stability of the currency union.

While federations such as the US, Canada and Germany smooth around 80 per cent of local shocks, the euro zone only insulates half that amount, or 'in other words, when GDP contracts by 1 per cent in one of the euro area countries, households' consumption in that country is depressed by as much as 0.6 per cent (as opposed to 0.2 per cent in the US, Canada or Germany)' (Allard et al. 2013). Federal policy may also be needed in order to limit obstacles to people relocating (such as different requirements for professional qualifications), as free movement can also accommodate asymmetric shocks.

Armstrong and Ebell (2014) argue that, so long as borrowing powers are devolved to a broad spectrum of sub-national authorities, lenders 'would have an incentive to monitor and discipline excessive borrowing; and more successful and prudent authorities would be unsympathetic to the idea of bailing out failure.' They give examples

including Detroit in the United States, where bailouts from central government have been refused or limited in scope, but their analysis of the historical evidence is limited and does not capture less explicit bailouts. Those bailouts undermine the incentive for lenders to police sub-national fiscal policy. Greve (2011) calls such interventions 'bailouts under a different name' and gives examples including the American Recovery and Reinvestment Act (the stimulus bill) which, through a temporary increase in the Medicaid reimbursement formula put enough money in state budgets to 'close the predicted budget gaps at the time of passage'. The same act's 'Build America Bonds', which provided a 35 per cent interest subsidy for state and local bonds, supported the issuance of well over \$115 billion in state and municipal bonds. In addition, part of the Affordable Healthcare Act, allowed 'a transfer of hundreds of thousands of state and local employees and their health care expenses from state-funded programs into federally subsidized health care exchanges'. Greve argues that those implicit bailouts reflect the fact that many states are in a dire fiscal position and a state bankruptcy option is needed, in part, to 'help restore the federal government's precommitment against bailing out states'.

There have been serious sub-national fiscal crises and bailouts in other countries too. In Brazil, Rodden (2003) notes that there have been 'three major state-level debt crises between the late 1980s and the present, and unresolved debt problems threaten to precipitate further crises. In each of the crisis episodes thus far, the state states – already facing precarious fiscal situations with high levels of spending on personnel and dangerous levels of borrowing – were pushed into debt servicing crises by unexpected exogenous shocks. In each case their first reaction was to demand bailouts from the central government, and in each case the federal government responded by taking measures to federalize state debts.' In Germany, there has been an explicit bailout of Bremen and Saarland since the early 1990s, aiming to reduce per capita state debts (Seitz 1999).

Just as the need for greater coordination is being accepted in the euro area, it would probably be a mistake to abandon central restraint in UK fiscal policy.

One part of that control should be an insistence that the Bank of England will not accept sub-national government debt as collateral for lending operations, which undermined no-bailout rules in the euro zone. However, no-bailout rules are inherently weak as it will always be possible for central government to – overtly or otherwise – find a way around them. The incentive to lobby for a bailout is generally much more concentrated and urgent than the incentive for the many other areas that will pick up the bill to resist.

We conclude by suggesting that borrowing to finance local spending could be allowed under three circumstances:

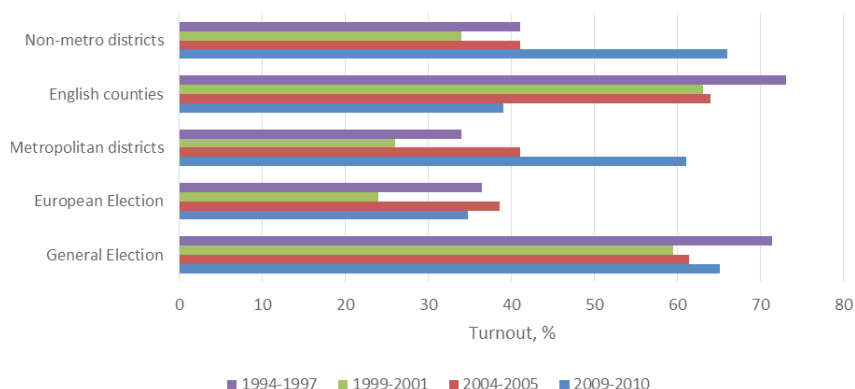
- To smooth spending on public services, such as health, over the economic cycle. This should be restricted in its scale, perhaps to within a plausible typical rate of economic growth, around 2-3 per cent, and any fiscal plans which involve borrowing should be subject to approval in Westminster, but it should not be disallowed entirely. Debt might also be limited, perhaps to a certain share of gross value added in the area.
- To pay for large-scale capital projects. This should be subject to approval by referendum, in order to ensure that voters are sufficiently committed to pay for the borrowing undertaken in their name.
- Borrowing by central government, to support individuals and communities in times of economic stress. This should be subject to a requirement for quality evidence – particularly experiments – to test effectiveness, as set out above.

## There should not be too many layers of government

If proposals for an English Parliament or a similar measure were to go ahead, many voters would be left with six tiers of government:

- The European Union
- Westminster
- English Parliament
- County Council
- District Council
- Parish, town or city council

Five tiers of government are already too many. Turnouts at elections for many tiers of government are low when they do not coincide with a general election, generally around 30 to 40 per cent. That may underestimate the scale of the problem, as many people use European and local elections as a means of expressing their opinion on national politics.

**Figure 2: Election turnout, selected types**

Source: UKPolitical.Info and House of Commons Library Research Note SN/SG/1467. Where multiple elections took place within the period, the median was chosen.

This should not be surprising as it reflects the general paradox of voting: a single voter's check on the ballot is almost certain to have no effect on the outcome. Why then does anyone make the effort and turn out to vote when they undoubtedly have more immediately rewarding things they could be doing? (Posner 2012)

The answer may be simple social conformism (Gerber and Rogers 2009), or a sense of responsibility: a sense that it is hypocritical to hope others will vote the way you prefer but not do so yourself. However, the same paradox may also mean that there is little incentive for people to inform themselves about the issues at stake in an election.<sup>9</sup> We can hope that the efforts of the parties and the media to engage with voters can overcome that to some extent, but requiring people to inform themselves about more elections, of less individual significance, will necessarily diminish the quality of electoral accountability. It is not a matter of laziness that most people do not know much about the debates of the day in the European Parliament.

<sup>9</sup> This is one reason why compulsory voting is a bad idea. You can force people to cast a vote, but you cannot force them to cast a well-informed vote, and the removal of the need to drive turnout undermines the adversarial incentive for parties to inform voters.

The UK's future relationship with the European Union is beyond the remit of this paper, except to the extent that it might prohibit certain reforms, and there has been extensive debate elsewhere about the merits of the division between unitary and county and district authorities (Gaskarth and Palmer 2006). Given that most of the budget and authority already lies with the counties, we expect that all or most of the additional responsibilities which we envisage being devolved from national government would fall to them rather than the districts.

Given the number of tiers of government at the current time, we should be sceptical of calls for an English Parliament or regional assemblies. Even if turnout at elections for such bodies could be sustained at a level higher than for European Parliament or local elections, voters are likely to vote in line with a single set of preferences instead of informing themselves for another regular vote. Proposals for regional assemblies compound this problem as their boundaries do not match well-established communities of voters.

'English votes for English Measures' within the House of Commons would worsen another existing problem. MPs are already torn between two jobs. Unlike in the US, where a congressman in the House of Representatives is solely dedicated to holding the executive to account, in the UK an MP has two career paths: one in which they hold the executive to account either in the chamber itself or through committee rules and parliamentary questions; and a second in which they hope to stand out and be promoted to and within that executive, with as much as half of the governing parliamentary party on the payroll vote at any one time (Goodman 2013).

If English MPs were supplying the members of two executives and the remaining MPs were holding two executives to account, then accountability would undoubtedly suffer. Devolution would allow MPs to better focus on the essentials of national government, such as national security. English votes for English Measures within the House of Commons would just widen further the enormous variety of MPs' responsibilities.

Overall, the best tier of government to which powers should be devolved seems to us to be the existing county and unitary authorities.

## Units must be viable, but not too large

If sub-national authorities are too large then many of the benefits of fiscal decentralisation may be lost. If they are too small then it may be difficult to establish a competitive market, in services managed by the private sector, or fixed costs may be spread over too small a population for those services directly managed by local government.

Sub-national governments vary enormously in size even within the most prosperous decentralised democracies:

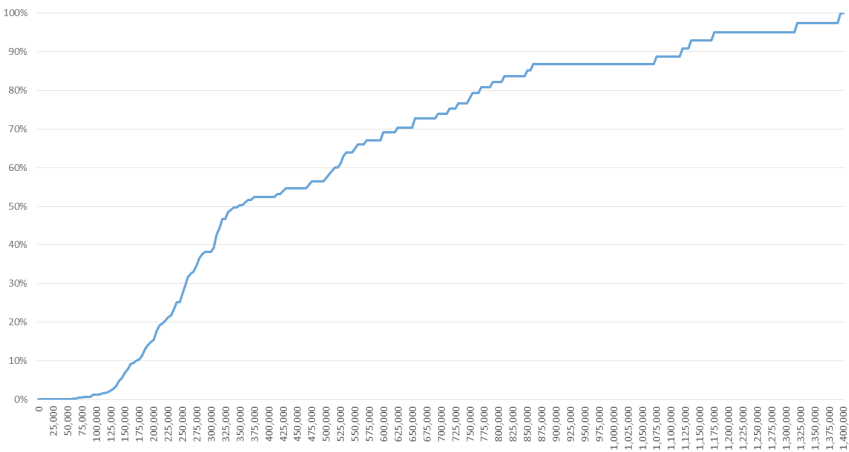
- In Switzerland, there are five out of twenty six cantons with populations lower than 50,000 and two with populations over a million. The median population of a canton is around 0.2 million and the mean population is around 0.3 million.
- In Canada, there are three out of thirteen provinces with populations lower than 50,000 and four with populations over 3 million. The median population of a province is around 0.9 million and the mean population is around 2.6 million.
- In the US, leaving aside territories, there are 7 out of fifty states with populations lower than 1 million and seven with populations over 10 million. The median population is around 4.2 million and the mean population is around 6.1 million.

The median population of a top-level (unitary or county) local authority in the UK is around 249,000 and the mean population is around 322,000. The cumulative distribution is given in Figure 3. There are 62 countries in the world with smaller populations than the mean population for UK local authorities (CIA 2014).

Those top-level local authorities seem like the most plausible units of sub-national government. New organisations would not be created, restraining any transition costs, and – as institutions – they are well understood by voters and politicians. They would be on the small side but that might be managed in a number of ways:

- Smaller local authorities could merge electorally, when there are appropriate partners for them to merge with. There could be a provision for referenda on mergers with or secessions from existing local authority areas.
- Central government could use broadly-conceived competition powers to ensure that businesses in sectors such as healthcare based in one local authority area were able to compete in others. Essentially the competition authority would police for non-tariff barriers to competition and ensure that markets that were created were large enough to sustain competition.
- Many local authorities already share services in order to spread fixed costs across a broader revenue base. An ambitious shared services programme between Westminster, Hammersmith and Fulham, and Kensington and Chelsea councils, launched in 2011, was initially expected to save £33 million a year between the three authorities by 2015-16, but that target was later raised to £40 million a year (LBHF 2012). At some point, competition rules may be necessary to prevent cartelisation among local authorities, but shared services should not be precluded as a means to achieve administrative efficiencies.

**Figure 3: Cumulative percentage of population in local authorities above a certain size, England and Wales**



Source: 2012-based sub-national Population Projections, 2014. Local authority refers to London or metropolitan borough, unitary authority or county.

## Conclusions

In this paper, we have attempted to set out five principles for effective devolution:

1. Devolution should be symmetrical in terms of the powers granted to regional authorities. It should not be skewed towards those more likely to vote for a greater role for government in economic life.
2. Local powers should be clearly enumerated, with sovereignty remaining in Westminster. While central government has a role in providing national public goods (such as defence) and ensuring fair competition and free movement within the UK, there is considerable scope for further decentralisation of public services.
3. Councils should have strong incentives to promote local prosperity. They should face a strong incentive to finance their own spending, on the basis of robust economic performance, rather than clamouring for subsidies from central governments. As such, as well as spending responsibilities being devolved, aspects of taxation should be devolved too.
4. There should not be too many layers of government. The attention of voters is already divided between too many tiers of government, reducing accountability.

5. Units need to be large enough to be viable, but not so large that the potential benefits of decentralisation are lost. While UK sub-national authorities are small, most people already live in local authority areas of a size comparable with successful units in other advanced economies. There should be scope for local people to set their own boundaries over time.

Effective devolution could produce more responsive institutions and improve the UK's economic performance. It might also have broader political implications, such as increasing the stability of the Union. Relative economic decline or ruinous debts would only strengthen the temptation for parts of the UK to jump ship and leave the rest to their fate.

Careless devolution could be very dangerous. It is easy to look at the successes, such as Switzerland or the US as a whole, and forget the failures, even within those countries (for example, the economic meltdown that recently afflicted Detroit). There are only so many developed economies comparable with the UK and there are enough other differences between them that any conclusions about the best approach are necessarily tentative.

However, the principles we have set out would encourage fiscal responsibility; align the incentives of local government with the broader public interest in development and prosperity; and encourage experimentation with reforms that could deliver better governance. Economic circumstances will change over time and we will learn more about what works. The framework we propose can evolve as circumstances change.

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