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Fiscal devolution: An era of opportunity

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In recent years, local government has emerged as a significant stakeholder in driving local growth. Whether it is the place element of the industrial strategy or the increased focus at the macro level due to Brexit, local governance is required to step up and deliver better growth outcomes for all. However, for far too long, the country has been fiscally centralised to a great extent. Now is the time to consider the decentralisation of powers and financial decisions. To do this, local authorities need to prove they can be prudent in their financial decision making and wise in the sustainable use of additional funding in order to deliver good growth for everyone.

How can we have more devolution?

- Local government should investigate the opportunities for greater fiscal freedoms as well as the threats, risks and impacts.
- Devolution should be a step by step approach in which local authorities prove they can be prudent and more efficient local decision makers.
- National government should support the process by diversifying the range of options/tools and pooling the risk for reasonable experimentation.

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Introduction

City-REDI has prepared this brief to inform the debate on fiscal devolution. The UK has traditionally been a fiscally centralised system with most of the local authority income coming from government transfers. The acknowledgment of the importance of place and local leadership in policies such as the industrial strategy, devo deals and the budget, together with the challenges of delivering Brexit provide an opportunity for local government to argue for more fiscal powers to generate local inclusive growth.

National Context

There is a historical pattern of fiscal centralisation in the UK. In 2014, UK local taxes were 1.6% of GDP (OECD, 2016), almost 20 times less than the taxes collected at the central government level and far below Sweden 15.8%, Denmark 12.5%, the US 3.59% and Turkey 2.72%.

Tax revenue as percentage of GDP				
Country	**Level/Year**	**1994**	**2004**	**2014**
Denmark	Central	31.82	31.59	38.31
	Local	14.72	14.83	12.58
	Local	3.61	3.90	4.16
Sweden	Central	29.52	30.68	26.89
	Local	15.07	14.97	15.81
Turkey	Central	15.04	22.38	26.00
	Local	1.51	1.69	2.72
United Kingdom	Central	29.46	31.79	30.98
	Local	1.15	1.60	1.60
United States	Central	17.29	15.92	17.39
	State	5.28	5.01	5.02
	Local	3.61	3.65	3.59
Source: OECD				

Similarly, the share of local taxes to the total tax revenue in the UK (4.9%) is substantially smaller than most OECD countries .

In addition, local taxes represent a very small proportion of the total revenue for local government in the UK. In 2012, 13% of total local revenue was raised by local taxes in the country, compared to 61% in Sweden, 45% in Italy, 48% in France, 39% in Germany and 52% in Spain (OECD, 2016).

At the same time, local government funding has been under severe pressure since 2010. The National Audit Office (2014) estimates a 37% decrease in funding from 2010-11 to 2015-16. The decrease is smaller once the council tax income is considered but is still 25%. It is worth mentioning that this decrease does not include the loss from year to year increases in local authority financing in the years before 2010. These drops translate in £10bn savings in the three years from 2011/12 and another £10bn for the two years after (Local Government Association, 2014).

The situation becomes bleaker when we consider projections for the future. The post-2015 welfare reform is expected by 2020-21 to cost each working adult in Sandwell £500 and in Birmingham £490 per year (Beatty & Fothergill, 2016).

At the same time, projections from the Local Government Association (2015) show that with the funding gap at 0 in 2014-15, there is an expected £9.5bn shortfall between income and expenditure for local authorities by 2019-20. Considering that waste collection and social care statutory services will continue to require an ever increasing share of the councils' revenues, money for other services are expected to be reduced by 35% in nominal terms from £26.6bn in 2010-11 to £17.2bn in 2019-20. A drop that is more than the £7.7bn expenditure on central services, 'other' services and capital financing combined for 2014-15.

The impact of these reductions is expected to particularly affect the city and combined authority level. According top City-REDI estimates, more than 73% in WMCA and almost 69% in London's revenues come from central government transfers. When these figures are compared to the relevant ones for Frankfurt (13%), Berlin (33%), New York City (26%) and Tokyo (13%) (London Finance Commission, 2017; Slack, 2016), it is evident that local government in the UK is fiscally more constrained compared to other global cities.

Whilst it is not clear whether fiscal devolution leads to greater productivity or growth, allowing local authorities greater flexibility to generate and manipulate their own finances is expected to deliver a number of benefits :

- **Accountability**. Bringing closer the taxpayers to the decision makers is expected to raise the degree of scrutiny on the latter and improve outcomes locally.

- **Ability to attract** businesses by manipulating taxes. Provided with devolved powers, local authorities could incentivise the colocation of specific firms within their territory in order to increase growth in their area. This is even more relevant in the case of a place based industrial strategy where the advantages of each locality are recognised and built on whilst guidance is provided to avoid a race to the bottom.

- **Optimisation and fiscal resilience**. A greater range of taxes devolved to local government could have at least two positive effects. Firstly, cities with more diverse revenue streams can generate more revenue (Chernick, Langley & Reschovsky, 2011; Kitchen & Slack, 2016; London Finance Commission, 2017; Slack, 2016).

Secondly, a greater range of fiscal powers could be regularly adjusted to fine tune the effect on local growth (Davey, 2011).

- **Efficiency**. Greater fiscal devolution could lead to efficiency gains by avoiding the distorting effects of taxes (Mirrlees et al., 2011), improving their collection and the decision making on public spending (Chernick, Langley & Reschovsky, 2011).

- **Equity**. Increasing capacity to raise tax revenue is associated with decreasing regional disparities through increasing competitiveness and activation of untapped resources (Bartolini, Stossberg & Blöchliger, 2016).

An era of opportunity

The current volatile politico-economic environment coupled with the increased recognition of the importance of place in the industrial strategy, of local leadership in Devo deals 1 and 2 and the latest budget announcements provide a unique opportunity for greater devolution which should not be missed. With the national government focusing on the macro task of delivering Brexit, now is the time for local and combined authorities to step up and argue for more powers to drive local growth.

To do this, the latter should prove they are worthy of further financial power and that they can responsibly manage and lead local areas to more sustained models of inclusive growth. To this direction the West Midlands Combined Authority's Funding for Growth Commission as well as the London Finance Commission are seen as significant assets.

Policy Recommendations

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Local and combined authorities should grasp the opportunity to ask for greater fiscal decentralisation. However, with great power comes great responsibility and the onus of proving worthy of more powers falls with them. It is suggested that:

- local and combined authorities investigate the opportunities, possibilities, threats and impacts of new or devolved funding mechanisms. In this respect, the model of commissions (i.e. WMCA's Funding for Growth and London Finance Commission) is considered worth supporting and replication to other places.
- local and combined authorities show evidence of prudent management of increased fiscal powers and responsibilities and earn more freedoms in a step by step process.
- the national government fosters this process of decentralisation, encourages diversification and supports rational experimentation by effectively pooling the risk of new ventures.

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