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Evidence Review – Systems of Local Government Finance, Local Taxation and Resource Allocation

Executive Summary

1. Introduction

1.1 This evidence review stems from the Welsh Government reform programme for Local Government in Wales. The programme follows from recommendations made by the Commission on Public Service Governance and Delivery (the “Williams Commission”) in January 2014, and subsequent consultation and policy development on reform through a series of Welsh Government White Papers that set out proposals for the reform of Welsh Local Government including the proposed restructuring into fewer, larger councils as well as other reforms in relation to culture, leadership, performance and corporate planning.

1.2 In the context of this ongoing reform programme for Welsh Local Government, this Review examines the existing base of knowledge and research to establish how far it might inform potential options for the future funding and finance of Welsh local government and local public services.

2. Approach

2.1 The Review examined a substantial UK and international literature covering official papers, academic studies, high level reviews and commissions and sources drawn from practice and experience. These sources were sifted by applying a set of broad criteria to judge potential relevance and applicability to the Welsh context. A small number of experts were interviewed to validate that the Review was exploring the most relevant lines of inquiry. Section 3 sets out the Review’s methodology in detail. Section 4 outlines the Welsh context and highlights some of the key factors applied to test the evidence for relevance and transferability.

3. Balance of Funding

3.1 Section 5 explores the issue of funding balance in local government. This is a long-standing issue for local government in Wales, in the rest of the UK as well as at an international level and has a significant accompanying body of research. This section reviews the theoretical and normative perspectives for and against greater autonomy and examines some of the trade-offs implied by the tension between local autonomy and social equity. This section also looks at how the funding balance works in practice and considers some possible options for change.

3.2 At an international level there are many and varied systems of local finance and funding and no consistent approach which is immediately transferable to Wales. The evidence shows major differences in systems of taxation, the amount of revenue raised as a proportion of total national tax, the proportion of self-financed revenue and the responsibilities that local authorities hold. Among and across these there are also complexities of status and powers, so simple comparisons should be treated with caution.

3.3 Local government in Wales is characterised by relatively high central control and influence (through a combination of UK as well as Welsh Government powers) and relatively low levels of fiscal autonomy. In addition, Welsh local government is highly reliant on a single source of local tax (the council tax) in a way which is relatively unusual by international comparison.

3.4 Any changes in the balance of funding need to be based on the form and functions defined for the relative roles of local and central government. Central and local governance in democracies are fundamentally interdependent so designing systems and accountabilities need to take this into account.

3.5 There are two particular dimensions that impact on decisions about the balance of funding. The first is the extent to which fiscal devolution is a causal factor in good and responsive local government. On this view, decentralisation to the lowest level is a necessary condition for strong local democracy. The counter holds that sub-national governments are subject to relatively ineffective democratic accountability and scrutiny and are prone to capture by elites or interest groups. These groups govern through the filter of their interests not the community's. The extent to which the latter exists or is a risk may condition a need for strong external challenge and regulation from the centre or independent sources, and for measures to improve local democracy.

3.6 The second issue that influences the transferability of experience is the extent to which equalisation is possible and necessary. Most of the evidence finds that equalisation is fundamental to fairness. However, there is a notable critique of equalisation suggesting that it leads to dependency rather than self-sufficiency.

3.7 The evidence also suggests that the challenge of equalisation is related to the scale of the local government unit. Where the governance footprint is larger, local governments tend to have greater capacity to redistribute internally. Nevertheless,

divergent social, economic and demographic conditions across Wales suggest that further work may be needed to establish how far this will be the case for a reformed Welsh local government.

3.8 One option to increase locally raised finance is to introduce or increase charges for services. There is a basis in economic theory for charging for services, and evidence that for at least some services, the public will accept charges as reasonable. However, the evidence also indicates conditions where charging may not be appropriate and where, for example, public good concerns, or those for equity and redistribution, make charging less effective.

3.9 It is a political judgement as to who ought to bear any new burdens implied by such changes, the extent to which there is a trade-off between charging and other taxation, and what constitutes the right balance between taxpayer funding and user-charge.

3.10 Also, whilst charging has been extended over time, where major savings are needed, local government has tended to outsource or ration service through eligibility criteria to reduce public sector support, rather than levying substantial additional charges so that support can continue to be provided directly by the public sector.

4. Local taxation and revenue raising

4.1 Section 6 explores potential options for local taxation reform. It examines the wide variety of practice from international evidence across OECD countries and identifies potential principles that might guide change. Specifically the Review considers the case for and against a local income tax and what the implications might be. This section also looks at options for change regarding non-domestic rates or business taxes, reviewing experience and evidence from across the UK. Property taxes are also examined from theoretical and practical perspectives including consideration of international property reform experience.

4.2 Property taxes are widely used in local governments internationally though they generally form a smaller part of local government revenues than in the UK. They are favoured for their clear tax base, because they are difficult to avoid and because they promote local autonomy. Arguments against property taxes focus on taxpayer resistance, the challenges of regular revaluation and the absence of a direct relationship between liability and ability to pay. There is a significant literature related to potential reform of the council tax. Proposals for potential reforms are relatively consistent in proposing more council tax bands and specific measures to address equity in relation to low incomes, coupled with regular and improved systems for revaluation.

4.2 Given that UK and Welsh local government is unusually reliant on a single form of local taxation (council tax), successive examinations have considered alternatives and additions since the Layfield Committee's review in 1976. Many conclude that there is a case for a local income tax and that it is a viable potential major new source of income

for local authorities.

4.3 Advocates argue that income taxes are 'fairer' than property taxes in that liability more closely reflects ability to pay. Others suggest that a significant shift from property-based tax to income tax means a rebalancing of the tax burden away from retired households with accumulated wealth and onto the working-age population. Also, income taxes can be more volatile than property taxes so local finance systems that rely on them may need capacity to adjust for fluctuations, for example through negotiations with central government over finance or substantial borrowing powers.

4.4 Local income tax is a potential means to diversify the local tax base and increase buoyancy, but evidence suggests it is unrealistic to expect it to support significant overall spending growth. Upward pressure on local income tax rates could be as controversial as increases in council tax bills.

4.5 Non-domestic rates reform is another key potential element for greater local fiscal autonomy. The Morgan Review in Wales (Morgan 2012), the Independent Review of Local Government Finance in England (ICLGF 2015) and very recently the current Chancellor of the Exchequer (Osborne 2015) have all argued for a re-localisation of income from the rates on the grounds that greater retention would focus local authorities on growth.

4.6 While equalisation would still be necessary, it is argued that greater local retention would foster higher self-sufficiency over time. Other experts take the diametrically opposite view believing that local authorities can have no or little impact on economic growth and that such a reform would simply lead to greater inequality.

4.7 Overall, the evidence suggests that no one tax can display all the ideal properties needed for an effective and efficient system of local taxation. Many local government systems rely on multiple sources. The reliance on a range of taxes with different bases has the potential advantages of improved local stability and buoyancy, and a greater likelihood of the burden falling more fairly.

4.8 If local autonomy means that local government seeks to act differentially between places, or seeks to raise significant additional funds locally to address local challenges or to fund services the evidence shows that effective dialogue with citizens is crucial.

5. Resource allocation

5.1 In Section 7 the Review examines approaches to resource allocation and distribution. This section considers the traditional approach in Wales and in other parts of the UK and then explores some arguments for and against different directions of possible reform. Specifically the Review looks at approaches, which have sought to incentivise performance through systems of finance and funding.

5.2 The allocation of central grants to local authorities in Wales is based on an approach driven largely by past expenditure balanced by formulae driven "standard spending assessments." Similar but separate systems operate in England and

Scotland.

5.3 The traditional approach has tended to provide predictability and stability. However, it is criticised for inadequately taking into account concepts of 'need,' and therefore of being unfair to places with more extreme circumstances such as highly deprived or sparsely populated areas. Others argue that the system is opaque and too complex and that it would be more efficient to aim for a simpler and more transparent system.

5.4 More recently there is a trend towards allocating resources on the basis of outcomes or results or on the basis of participatory and direct community choices. The National Audit Office has warned that payment by results is not applicable in all contexts and cannot be seen as a universal model. Also, effectiveness rests on the ability to set well described results capable of meaningful assessment in terms of outcomes achieved and being able to attribute causality, something that public services often struggle with, particularly when addressing complex challenges they face.

6. Principles of change

6.1 There is no ideal approach to systems of local finance and funding, rather there is a need for trade-offs between different possibilities. However the available choices need to be guided by a principled theory of change. Section 8 therefore examines what principles might inform those choices in Wales.

6.2 Culture and tradition, political expectations, and approaches to public services are among the factors that influence how far experience is potentially transferable between countries and explains the diversity of international local government finance. For example, some states regard more services as appropriately local and needing local delivery and responsibility, while others see a greater proportion of services as national, and see national consistency and therefore control as a greater priority.

6.3 Effective local government finance reform needs to be approached holistically to reflect and respond to a system characterised by interdependence and pluralism. Reform also needs to be suited to the adjustive capacity in the political and administrative context for which it is designed. This requires clarity of roles, responsibilities and functions for local government. It also requires a view about what level of government should deliver which services. Local finance and funding reform is a means to achieve more effective delivery of public policy and services but cannot be seen in isolation. The benefits will be limited in the absence of clear objectives, effective policy, strong service delivery and robust and regular evaluation.

7. Conclusions, judgements and dilemmas

7.1 In concluding the Review, section 9 summarises evidence around some of the key issues that relate to the Welsh context as emerge from the report of the Williams Commission:

- Complexity, governance and accountability - Public services in Wales are highly complex and in a small country such as Wales there are legitimate, shared interests in the achievement of outcomes across local and central government. Systems of finance and funding reflect this complexity and effective reform needs to respond to the interdependencies and relationships between form, function and finance, and therefore take a whole system approach. Governance and accountability are therefore best thought of as multidimensional and networked rather than binary and hierarchical. Equally, questions of local taxation cannot be answered in isolation from national taxation, not least because no single tax can embody all ideal properties or objectives. Similarly, approaches to the allocation or distribution of scarce resources depend in part on decisions about the scale of local authorities, the responsibilities they are to hold and the extent and desirability of central controls on local expenditure.
- Scale - The findings of this Review suggest that smaller sized authorities may provide greater local autonomy in the sense of distinctiveness, but may also require larger central intervention to achieve equitable distribution. There is, in other words, a fundamental interrelationship between central and local government. The issue of scale is interrelated to the other themes in this list which are key to a holistic approach to change. Effective reform demands more than redrawing boundaries or restructuring organisations.
- Leadership culture and values - The findings of this Review suggest that Welsh local finance and funding reforms need to support traditions and approaches (old and new) that strengthen efficient and effective service delivery and development, and challenge those that weaken or obstruct these goals. This will involve asking questions about whether and how far it is necessary to challenge and diverge from the tradition of collaboration and shift towards greater competition choice and/or willingness and ability on the part of citizens and businesses to pay for services.
- Performance - The evidence shows that a shift to achieve a more outcome-focused approach is achievable if, and only if, connected and interrelated policy, service design and delivery, and evaluation processes are also reformed. The Review finds that inputs and outputs are useful as part of a wider reformed system and help accountability and transparency. Finance reform cannot be addressed in isolation from wider clarity about the objectives set for local government. In particular, effective finance reform requires allied and effective performance and improvement frameworks.

7.2 Overall the evidence is complex and offers no single model for local government finance reform, but rather a need to establish acceptable trade-offs and policy choices about the relative weight that should be given to key considerations such as:

- How to recognise and take account of the vertical and horizontal interdependence of central and local government and other public services in the design and reform of local government, including in changes to finance

and funding.

- The need for equity between places against the desirability of local governments that reflect the needs and wants of their particular places;
- The desire to incentivise good performance, against the difficulties of penalising poor performance where such penalties may impact on service users;
- The balance of which services should be paid for by all taxpayers and which by users;
- The requirement that distributional formulae fully capture need against the desirability of a system that is simple and transparent;
- The need to gain and sustain popular and political support for finance and funding reform and implementation of a system.

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Full Research Report:

<http://gov.wales/statistics-and-research/evidence-review-systems-local-government-finance-local-taxation-resources-allocation/?lang=en>

Views expressed in this report are those of the researchers and not necessarily those of the Welsh Government

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