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Research Note 59[1]

The fiscal and economic case for localism

As we face up to a decade of public spending cuts, our key challenge is to find ways of achieving those cuts without crippling our essential public services. Public sector efficiency - the ability to deliver more for less - has to be driven to a much higher level, and that will require fundamental reform.

One of the most compelling reforms would be a radical decentralisation of taxation and public spending. Research for the new book *How to Cut Public Spending and Win an Election* suggests decentralisation could deliver tens of billions in efficiency savings, with local authorities spurred to greater effort by the need to fund themselves from their own local taxpayers rather than relying on central government grants. This research note summarises a chapter on the issue in the book, which provides a more detailed analysis.

Key findings

- Britain has one of the most centralised systems of taxation and spending anywhere in the developed world. Well under 20 per cent of local authorities' revenue comes from taxes they raise for themselves locally. The average across Britain's G7 competitors is over 60 per cent.
- The countries with the most efficient public sectors are all much less centralised than the UK. The US, Australia, Japan and Switzerland enjoy an average efficiency lead over Britain – according to the European Central Bank – of 20 per cent. If Britain could match their efficiency levels, spending could be cut by £140 billion with no diminution in the standard of public services.
- An econometric study in Germany found that government efficiency increases with the degree of fiscal decentralization. The results from that study suggest that if the proportion of local authority revenue raised from local taxes were increased to 50 per cent, then public sector efficiency could improve 10 per cent, for an annual saving of £70 billion.
- Another study, from the Spanish Institute for Fiscal Studies, suggests that the same increase in fiscal decentralisation could boost economic growth by 0.5 per cent per annum.

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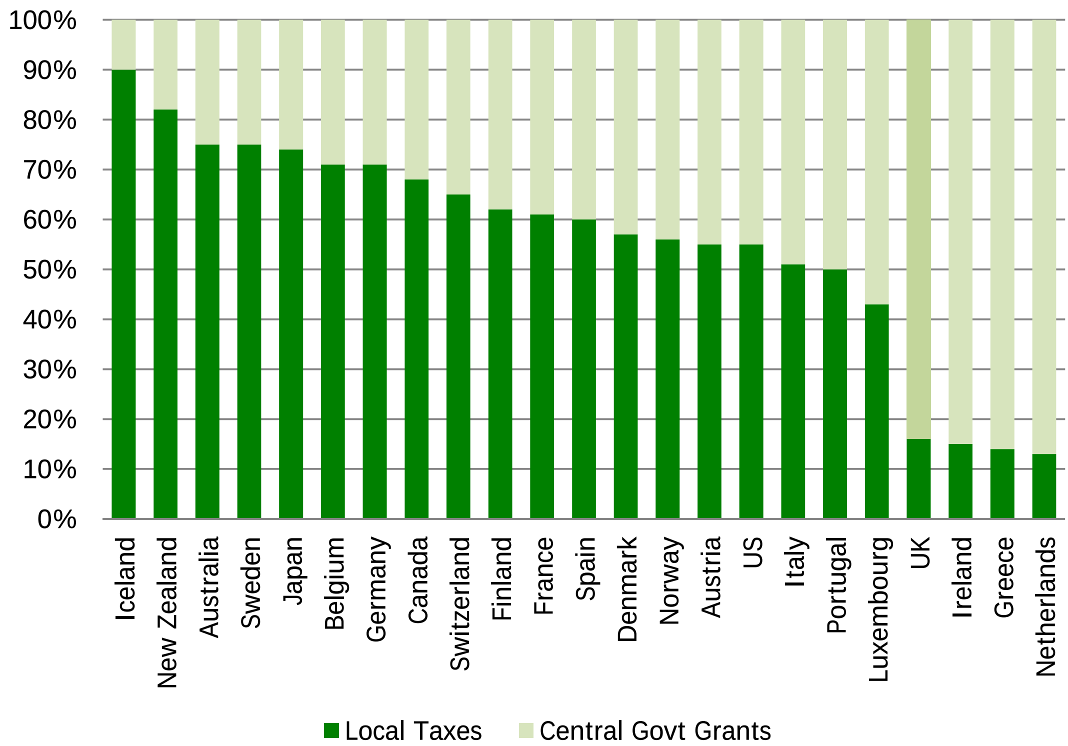
The status quo

As things stand, the UK has just about the most centralised system of taxation and spending anywhere in the developed world. Although local authorities account for nearly 30 per cent of public spending, much of it is directed by central government via a complex system of specific earmarked grants. And authorities are overwhelmingly dependent on grants, with well under 20 per cent of their revenue coming from taxes they raise for themselves locally. In sharp contrast, the corresponding average across our G7 competitors is over 60 per cent, giving their local and state authorities much greater independence (Figure 1; note that for federal countries the figures relate to state and local government combined)[2] .

Figure 1: Composition of Sub-Central Government revenue (ie state and local government combined, 2005, OECD



[2] *Taxes Or Grants: What Revenue Source For Sub-Central Governments?* by Hansjörg Blöchliger and Oliver Petzold, OECD Economics Department Working Papers No. 706, 2009

Public Sector Efficiency

In terms of public sector efficiency, it is clear that the best performers are all much less centralised than the UK. In particular, the US, Australia, Japan, and Switzerland enjoy a significant efficiency lead over us, estimated by the European Central Bank to average over 20 per cent.[3] In other words, if we could match their efficiency levels, we could cut public spending by 20 per cent with no diminution in the standard of public services. And that would save us a game-changing £140 billion next year alone.

There are a number of very good reasons for expecting decentralised systems to deliver superior performance,[4] including:

- **Responsiveness** - local government is more responsive to local choices and local needs: it can focus resources on the services that are most valued by the local community; top-down, one-size-fits-all, policies set by central government cannot do that.

- **Cost efficiency** - local government can organise its services to reflect local cost conditions; organisational structures and pay scales dictated from the centre cannot do that.

- **Incentives** - when local government raises its own revenue from local taxes, it has a strong incentive to encourage local economic growth.

- **Accountability** - when local government raises its own revenue, it ensures that service delivery on the ground can be closely scrutinised by those who actually have to pay for it.

Experimentation is also easier at the local level, allowing us to discover through diversity what works, much more quickly and cheaply than relying on top-down direction from Whitehall. And properly empowered local government is likely to attract better quality candidates into local politics, improving the overall direction and management of public services.

A number of recent international studies have examined the relationship between decentralisation and efficiency more closely. An econometric study by the German CESifo group[5] analysed 21 OECD economies over the period 1970-2000, and found that "*government efficiency increases with the degree of fiscal decentralization".*

[3] See for example, *Public Sector Efficiency: An International Comparison*, by Afonso, Schuknecht, and Tanzi, ECB Working Paper No 242, July 2003
[4] For further discussion, see Carswell and Hannan, *The Plan*, 2008
[5] *Fiscal Decentralization and Public Sector Efficiency: Evidence from OECD Countries*, by Adam, Delis and Kammas, CESifo Working Paper No. 2364, 2008

This study gives us some quantified estimates of the relationship. Applied to the UK, they suggest that increasing the proportion of local authority revenue raised from local taxes up to 50 per cent (from its present level of less than 20 per cent) could improve overall public sector efficiency by around 10 per cent.[6] In money terms, that would be an annual saving of £70 billion.

Economic Growth

Another recent study looked at the relationship between fiscal decentralisation and economic growth. The Spanish Institute for Fiscal Studies[7] analysed 23 OECD countries over the period 1972-2005, and confirmed that tax decentralisation is indeed associated with higher growth.

Specifically, they found that reducing the share of central government in total tax revenue by one percentage point boosts long-run GDP growth by about 0.06 per cent per annum. Applied to the UK, increasing the proportion of local authority revenue raised from local taxes up to 50 per cent could boost long-run GDP growth by about 0.5 per cent per annum - a huge uplift.

Conclusions

So to summarise, the international evidence suggests considerable scope to improve UK public sector efficiency - by around 20 per cent compared to our most efficient competitors, which would save us £140 billion pa. Fiscal decentralisation is emerging as a key driver of this greater efficiency, and the evidence suggests it would also boost long-term GDP growth.

Here in the UK, our current system of public finance seems designed for *in*efficiency. Rather than supporting local government with block grants, money is allocated by Whitehall across a complex array of spending silos, which then have to be adhered to locally, *whether or not* they reflect local preferences and cost conditions. There is also considerable duplication, as Whitehall's various programmes run into each other far down below at local level.

The potential for efficiency gains is widely acknowledged to be substantial. For example, a recent report from the Local Government Association[8] identified £4.5bn pa of specific

[6] The study estimates that a one percentage point increase in Sub-Central Government's own tax revenue as a share of General Government total tax revenue increases Public Sector Efficiency (PSE) by 0.005 - 0.007 (depending on which of two PSE measures is used). The scaling on the PSE measures is 0-1, with an average of 0.58 for PSE measure 1, and 0.61 for PSE measure 2. So a one percentage point increase in Sub-Central Government's own tax revenue share improves PSE by approximately 1 per cent. UK local authorities currently raise around 5 per cent of total tax revenue, so increasing it to 15 per cent – around half their total spending – would improve public sector efficiency by around 10%.

[7] *Fiscal Decentralization And Economic Growth In OECD Countries: Matching Spending With Revenue Decentralization*, by Gemmell, Kneller, and Sanz, Instituto de Estudios Fiscales 2009

[8] *Delivering more for less: maximising value in the public sector*, LGA, 2009.

savings that could flow from "reducing unnecessary Whitehall activity and the burdens it imposes on town halls". The London Borough of Hammersmith and Fulham has recently achieved £42m of savings from reducing waste and inefficiency,[9] and neighbouring Hounslow Council is aiming to save £53m over three years. All of which is being achieved with no diminution in service levels to the local community.

There are even bigger potential savings from rethinking the very role of local authorities. 70 per cent of public spending is currently in the hands of central government. Yet much of that actually goes on providing services at *local* level, with the money for such things as healthcare being funnelled down through a complex and poorly coordinated web of quangos and government agencies. Duplication is endemic, and since the system answers to Whitehall rather than local communities, it is woefully unresponsive to local preferences and cost conditions.

The waste is immense. According to Total Place - an initiative set up by the government and the LGA to study the problem[10] - in London alone the cost of duplication and inefficiency amounts to £11bn pa, an eye-watering 15 per cent of the total spend on public services[11].

But it's one thing to recognise waste, quite another to eliminate it. To achieve that, we must move beyond top-down managerial tinkering to a fundamental reform of the way local government is financed. And crucially, the reform must both empower authorities to realise efficiencies, *and* give them the financial incentive to do so. In summary:

a) Local authorities must raise a much greater share of their own revenue from local taxpayers – we should be aiming at least to match the OECD average of 60 per cent self-funding, and richer authorities should be entirely self-sufficient (at present even the richest authorities get 30-40 per cent of their spending funded by central government grants[12]).

b) To achieve this uplift, local authorities will need to be given tax powers over more than just domestic property; in other countries, authorities generally have power to impose a mix of taxes, covering incomes and retail sales, as well as property.[13]

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[9] See *Saving graces*, by Stephen Greenhalgh, Hammersmith and Fulham Council leader, Public Finance, December 2009.
[10] The *Total Place* programme describes itself as *"a new initiative that looks at how a 'whole area' approach to public services can lead to better services at less cost. It seeks to identify and avoid overlap and duplication between organisations – delivering a step change in both service improvement and efficiency at the local level, as well as across Whitehall".*
[11] *Public services could cut costs by 15%*, Guardian, 25 January 2010
[12] For example, the Parliamentary ODPM Committee found that the maximum share of any individual authority's budget funded by local taxes was just 69%, the remainder coming from central government grants - see *Local Government Revenue,* ODPM Committee, 2003-4, para 21.
[13] One interesting proposal already made for the UK is that VAT should be replaced by a sales tax which would be made the responsibility of local authorities, not least because current VAT revenue is very close to the current total for government grants. See Carswell and Hannan, *The Plan*, 2008

c) We should retain some element of grant support for poorer areas - almost all countries do this to some extent. But we also need to remember the inevitable trade-off between equalisation and efficiency: poor authorities supported by central government will inevitably have less incentive to develop their own local economies.

d) All grants should be combined into one block grant, with specific grants abolished - this would allow each authority maximum scope for tailoring its activities to reflect local choices and local cost conditions.

e) To avoid an overall tax increase, it is vital to ensure that central government taxes get cut by an amount corresponding to the cut in central government grant expenditure.

f) A key driver behind the efficiency gains would be the much closer link between those providing services and those called upon to pay for them; the tax gathering authorities would therefore need to be kept small enough to maintain that link; our major cities and existing counties are the obvious basis, whereas a shift to regional tax-gathering would almost certainly fail to deliver the improvement needed.