

# **Financing Regional Government in Britain**

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## **Preface**

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# 1 Introduction

Devolution and regional government are once again at the centre of policy debate in Britain. The Labour Party is committed to devolution in Scotland and Wales if it wins the next general election; regional assemblies could also be introduced in the English regions. The economic issues in designing a system of regional government, and its fiscal implications for the residents of the regions of Britain, are the subject of this study.

This report considers some key questions about the 'shape' of regional government and its fiscal consequences:

- What are the economic considerations in designing a system of regional government? What public expenditures and legislative functions might be better exercised at regional level rather than by Westminster and Whitehall, and what needs to be retained by central government?
- If some existing central government expenditure functions are decentralised to regional government, how uneven will be the pattern of regional spending per head that the regional governments will inherit? Are these differences desirable in a decentralised system, and are they sustainable?
- How should regional government be financed? Does it make any sense to consider regional government without tax-raising powers of its own?
- If the regions are to levy their own taxes, what taxes could they be given? What would be the administrative problems in decentralising income tax or VAT, for example?
- What would be the scale of the redistribution in the overall burden of taxation, if regions were wholly dependent on their own taxes to pay for their spending? What pattern of grants from central government to the regions would be needed in order to avoid massive regional gains and losses?

The report is in four main chapters. Following this introduction, Chapter 2 sets out basic data on the regional pattern of public sector activity in the UK. How are the various categories of public spending distributed across the UK regions, and how are tax revenues distributed? How far are these patterns the 'automatic' consequence of differences in the level of economic activity between regions, and how far do they reflect the discretionary decisions of central government about the regional allocation of spending?

Chapter 3 sketches out the economic criteria that could be employed to identify those functions of government that could be performed by regional government. It begins by noting that there are two fundamentally-different economic reasons for government decentralisation, having to do with the decentralisation, first, of 'choice', and, second, of the implementation of policies determined by central government, with regional government acting as the 'agent' of central government. These two different reasons for decentralisation would, in turn, imply regional governments of very different characters, involving a different pattern of devolved services and different needs for revenues.

Chapter 4 discusses the options for financing regional government under the various scenarios. It considers the extent to which there is a need for regions to have independent sources of tax revenue under their own control, and the implications of financing regions, instead, primarily through fiscal transfers from central government. Then it considers the further range of issues concerning the tax instruments that might be assigned to regional government. If regional government is to have its own taxes, what taxes should they be, and what would be the economic issues raised by decentralising the UK tax system in this way?

Chapter 5 draws some conclusions from the analysis.

## 2 The regional pattern of public sector activity in the UK

The existing pattern of taxes and revenues across regions in the UK forms the natural starting-point for considering the implications of regional government. A key issue in assessing the consequences of moving to a system of regional governments that would take over responsibility for certain areas of taxation and public spending is the sustainability of current standards of public spending and public services in the new system. Put simply, could each of the new regions 'afford' to provide the same services that are currently provided to their residents by the existing government institutions?

It may be, of course, that the new regions might want to choose different standards of public services from those currently provided, and - depending on the powers they were given - might change the taxes levied on their residents. But before we consider this possibility, and the possible powers that regional governments might be given to influence their spending and resources, we look in this chapter at the regional pattern of existing taxes and spending.

Of necessity, we concentrate on regions defined by the 'standard regions' of the UK, since it is only for these regions that any significant amount of data relating to UK public expenditure and taxation are available. The analysis thus comprises Scotland, Wales and Northern Ireland each as a single region, plus eight regions in England, making a total of 11 regions. The English regions comprise groupings of counties, as defined in Table 2.1. It may be worth making two observations about the choice of regions.

First, by having to use the 'ready-made' standard regions of the UK for the analysis, we avoid having to make difficult choices about how to design a coherent pattern of regional government units in England. England does not divide neatly into regions that command general consent and have a coherent identity, and the standard regions play little role of any significance in the existing organisation of government. Drawing regional boundaries in England thus probably has a considerable element of arbitrariness to it. Nevertheless, there are criteria that would obviously be of importance in defining the pattern of regions.<sup>1</sup> Moreover, once a system of regional government were in operation, it is likely that some degree of regional awareness and identity would attach to the new regions, merely by virtue of their role in government, no matter how arbitrary the initial regional boundaries.

Second, the standard regions do have one significant drawback, which is that they result in a very uneven allocation of population between regions (Figure 2.1). In particular, whilst most regions would have populations in a range between 3 and 6 million, one region - London and the South East - would have a population of nearly 18 million, almost three times as large as any other region and considerably more than a third of the total English population. Given the orientation of this enormous region towards London, it may be difficult to subdivide it further in a way that does not separate areas

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<sup>1</sup> Thus, for example, Chapter 3 will stress the importance of avoiding geographical 'spillovers' between different jurisdictions - in other words, situations where policies of one region have effects on the residents of neighbouring regions. These spillovers can be minimised by drawing the boundaries of regions appropriately. This might imply that regional boundaries should not cut across natural or economic areas.

**Table 2.1. The standard regions of England**

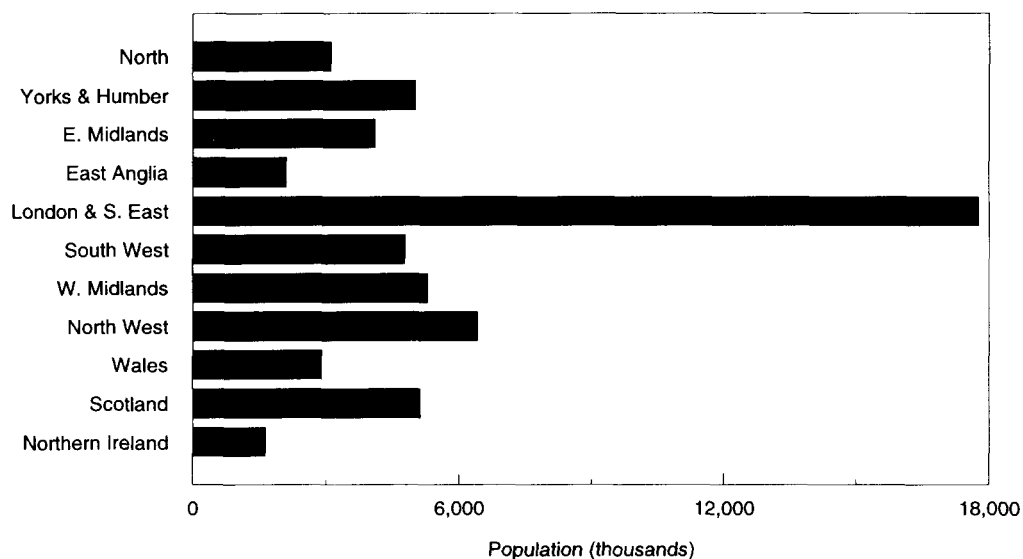
<i>Region</i>	<i>Counties</i>
North	Cleveland, Cumbria, Durham, Northumberland, Tyne & Wear
Yorkshire and Humberside	Humberside, North Yorkshire, South Yorkshire, West Yorkshire
East Midlands	Derbyshire, Leicestershire, Lincolnshire, Northamptonshire, Nottinghamshire
East Anglia	Cambridgeshire, Norfolk, Suffolk
London and the South East	Bedfordshire, Berkshire, Buckinghamshire, East Sussex, Essex, Greater London, Hampshire, Hertfordshire, Isle of Wight, Kent, Oxfordshire, Surrey, West Sussex
South West	Avon, Cornwall, Devon, Dorset, Gloucestershire, Somerset, Wiltshire
West Midlands	Hereford & Worcester, Shropshire, Staffordshire, Warwickshire, West Midlands (metropolitan county)
North West	Cheshire, Greater Manchester, Lancashire, Merseyside

with very clear interests in common. Unless this can be done, however, any system of regional government in England is likely to be very asymmetric, and the arrangements put in place would need to be able to accommodate this wide variation in size.

There is considerable variation between the standard regions and territories in economic performance and living standards. Per capita GDP in the richest region - London and the South East - is 16 per cent above the UK average, and in the poorest parts of the UK - Northern Ireland and Wales - it is, respectively, 18 per cent and 15 per cent below the UK average (Figure 2.2). There are also marked variations in unemployment rates. In 1994, the unemployment rate was nearly 13 per cent in Northern Ireland and over 11 per cent in the northern region of England, compared with only 7 per cent in East Anglia and 8.3 per cent in the South West (Figure 2.3).

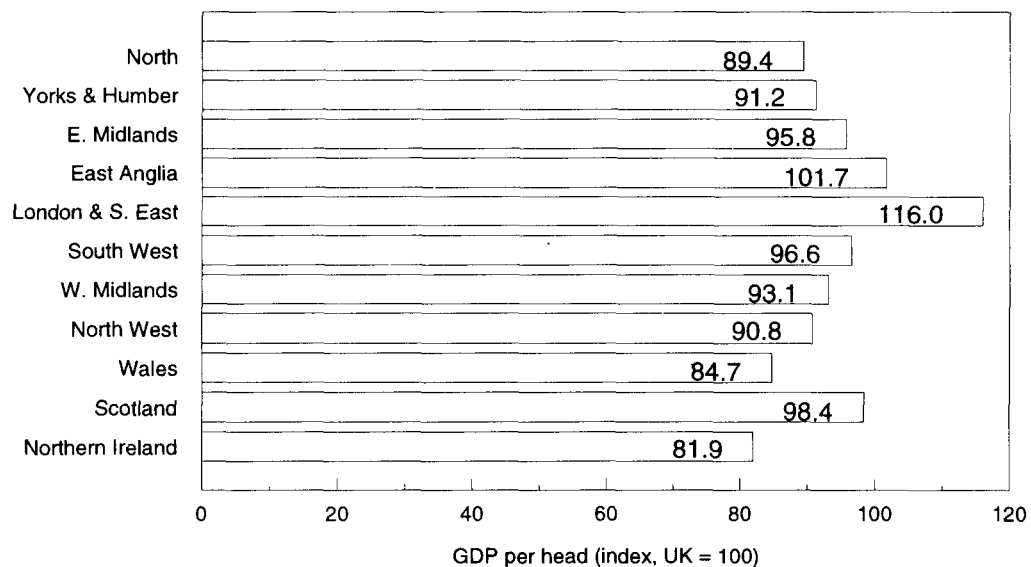


**Figure 2.1. Population of UK regions and territories, 1993**



Source: Table 3.1, Regional Trends, 1995 edition, HMSO, London.

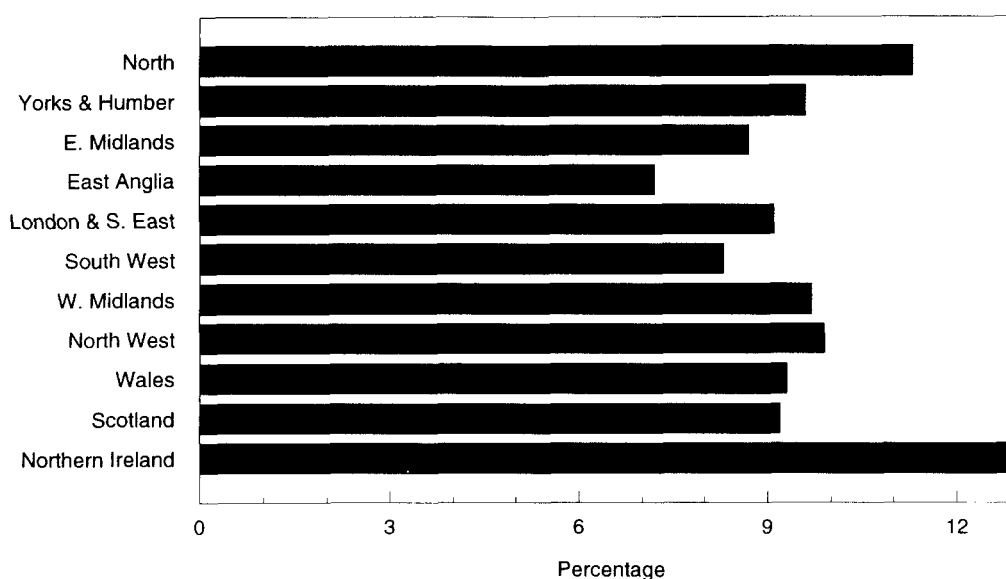
**Figure 2.2. GDP per capita in UK regions and territories, 1993**



Note: Index of GDP per head at factor cost, UK (excluding continental shelf and statistical discrepancy) = 100.

Source: Table 12.1, Regional Trends, 1995 edition, HMSO, London.

**Figure 2.3. Unemployment rates in UK regions and territories, 1994**



*Note: Figures are claimant unemployment rates, seasonally-adjusted annual averages.*

*Source: Table 5.21, Regional Trends, 1995 edition, HMSO, London.*

These variations in economic conditions and performance have implications for regional government, because they mean that the existing patterns of spending per head, and of tax revenue per head, vary considerably between areas. Spending on social security benefits, for example, will tend to be higher in poorer areas, whilst income tax revenues will tend to be higher in more prosperous areas. The rest of this chapter considers data on the extent to which there are regional differences in current patterns of spending and revenues per capita in the UK, and the implications of this for the pattern of spending and revenues that regional governments might inherit, if particular functions were devolved from central government.

## **2.1 Identifying the regional incidence of spending and taxes**

To what extent can we allocate the figures for UK public expenditures and revenues to different regions? The answer to this question is far from straightforward, both in principle and in practice.

It is worth beginning by noting the reason for our interest in the regional allocation of UK public expenditures and revenues. What concern us are the consequences of decentralisation to regional level of public expenditures and revenues currently supplied by central government. Ultimately, the question we wish to answer is 'how much would it cost for each region to provide, from its own tax revenues, the public services currently provided for it by central government?'

As far as the issues of principle in geographical allocation are concerned, we are clearly interested in the location of 'benefit' (or of the ultimate tax burden in the case of tax payments) rather than of 'supply' or 'payment'.<sup>2</sup> The issue is to identify the cost of providing to the residents of a region the public services they currently enjoy through central government provision; we are less concerned with where those services are purchased or where the payment takes place.

Sometimes, however, defining where the benefit from public expenditure falls is problematic. Straightforward answers can be given for some categories of spending, but not for others:

- Some public expenditures benefit an identifiable single recipient, and so long as the location of the recipient is known, it is possible to say to what region the benefits accrue. Examples of such public spending might include spending on unemployment benefit and on health care. Although publicly provided in the UK, these are what economists categorise as private goods, meaning, loosely, that more of them must be provided if more individuals are to benefit from them.
- Some public expenditures benefit a number of individuals collectively, but in a specific geographical area. Examples might be street lighting, the provision of local parks and playgrounds, and the services provided by local authority public health inspectors. These expenditures have the character of 'public goods', in the sense in which the term is used by economists; they are 'non-rival' in consumption, meaning that if one individual consumes the good, it does not diminish the amount of the good available for others to enjoy. They are, however, 'local' public goods which benefit only a particular geographical area, rather than the country as a whole. Whilst it may be impossible to divide up the public spending on such goods between individuals within the population (since, in some sense, all of the users each benefit from all of the spending), it may, none the less, be possible to attribute the spending to particular regions or local areas.
- There is, however, a third, and not insignificant, category of public expenditures, for which a regional attribution of expenditures is simply meaningless. The spending concerned is on 'public goods' of benefit to the nation as a whole. A major category of such spending is defence expenditure; whatever protection the UK's nuclear deterrent may or may not provide, it costs no more to extend the deterrent 'umbrella' to East Anglia or to Scotland, once a decision has been made to provide it to the rest of the UK. It therefore makes no sense to divide up defence spending on the nuclear deterrent between different geographical regions within the UK, because all regions benefit from all of the spending. In addition to defence, there are other public

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<sup>2</sup> It is astonishing how often this point is overlooked in debates over the geographical allocation of public spending. If we were trying to calculate the relative standard of living of households in central London and the London suburbs, we would not think of doing so on the basis of the total value of goods sold by shops in central London and in suburban shopping centres; we know that people can buy goods in central London even if they do not live there. On the other hand, when it comes to allocating the benefits of public spending between regions, all too often the location of supply and of benefit are confused in public debate. What matters, however, is where the benefits of public spending fall, not where the spending occurs; the public services provided by UK defence spending do not accrue to Aldershot to any greater extent than to other towns of similar size, even though spending on defence (in the form of the wages paid to soldiers stationed there) may be many times higher in Aldershot than in the other towns.

expenditures that have the character of public goods at the national level, including various aspects of governance and the legal system. These would include, for example, expenditures on defining and maintaining a basic framework of law, governing property rights, contracts and other aspects of trading activities; this benefits individuals and businesses in the country as a whole, and it does not make any sense to try to divide up the total UK spending in these areas into a part that benefits Wales, a part that benefits East Anglia, and so on.

Likewise, there are some taxes that cannot be allocated straightforwardly between areas. It is not, for example, possible to give a coherent answer in principle to the question of which region contributed corporation tax revenues for a business whose trading activity spans a number of different regions and whose shareholders are widely dispersed. Whilst the corporation tax bill may be paid by a head office located in a particular building in a particular city, it is far from clear that all of the revenue should flow to the region in which the head office is located; much of the profits may have been derived from production and trading activities in other regions, and the shareholders, whose entitlement to profits is being reduced by the tax, may also live in other regions. Moreover, even if we have information on the locations of production, sales and shareholders, we cannot give a clear answer about the geographical pattern of the corporate tax burden, because there is no clear answer, even in principle, to the question of the geographical pattern of profits on which the tax payments are based. A lot of the complexity of international corporate taxation arises because different countries seek to take a share of the profits of multinational companies, and because it is not possible to define objectively a single country that has the 'right' to such revenues.

These issues of principle place significant limits on the extent to which we can simply allocate the existing UK public spending total between regions. Where private goods and local public goods are concerned, a regional allocation is feasible. However, where public goods benefiting the whole of the UK are concerned, we cannot meaningfully divide the spending between regions; since the spending benefits all regions together, there is no sense in dividing the total, and, moreover, there can be no good basis to use in doing so.

## **2.2 The official figures on the regional pattern of spending**

Official figures on the regional and territorial pattern of spending are based on an annual exercise, co-ordinated by the Treasury, to break down the totals of government spending between different parts of the UK, as far as is reasonably practical. The figures have, for a number of years, been published as part of the background documentation provided along with the government's expenditure plans.

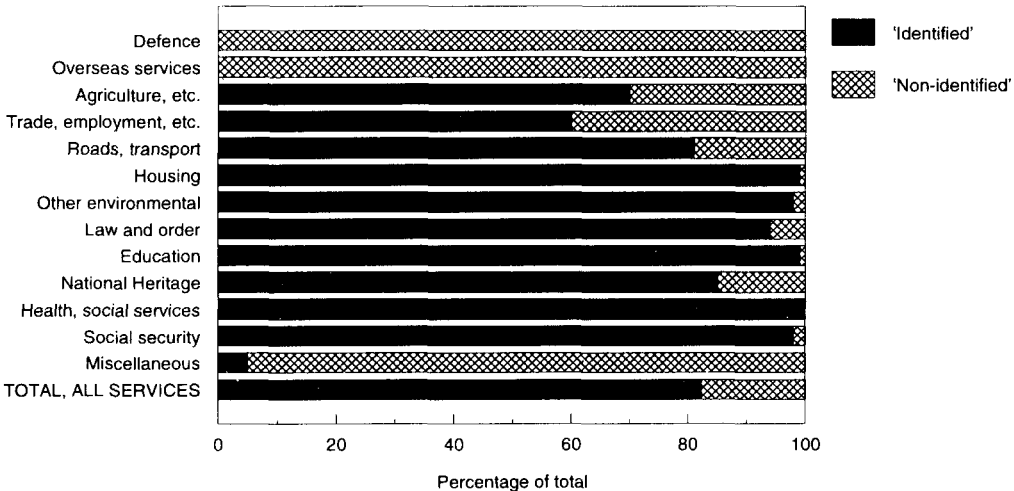
The Treasury exercise seeks to allocate 'general government expenditure' (GGE) between regions and territories. GGE comprises the combined spending of central and local government, excluding the payments between them; it thus consolidates the various existing layers of the public sector, by omitting the grants paid by central government to local authorities from the total spending of central government (and omitting the receipt of this grant from the revenues of local government). In 1993/94, total GGE for the UK amounted to £283.5 billion, (excluding privatisation proceeds).

The allocation to regions and territories is done on the basis of where the benefit of the expenditure falls, rather than where the money is spent. The initial stage of the analysis simply allocates spending between the four UK territories - England, Scotland, Wales and Northern Ireland. In 1993/94, £208.4 billion of the total GGE (i.e. some 74 per cent of GGE, or 82 per cent of expenditure on services) accrued to an identifiable territory. A further £44.8 billion of GGE consisted of UK-wide public goods, such as defence, for which the territory was 'non-identifiable'. The remaining £30.2 billion of GGE consisted of various items of 'other expenditure' not incurred in the provision of services - mainly debt interest and accounting adjustments.

Figure 2.4 shows the proportion of 'identified' and 'non-identified' spending under each main spending heading in the Treasury analysis. Defence spending and 'overseas services' (embassies, foreign aid, etc.) were both entirely classified to the 'non-identified' category, for which an allocation of the spending between the four UK territories could not be made. Significant proportions of spending on agriculture, on trade and employment policy, on roads and transport and on National Heritage were classified as 'non-identified'. However, all of the spending on health and social services, and nearly all of the spending on social security, education, housing, law and order, and other environmental policies, could be assigned to one of the four territories.

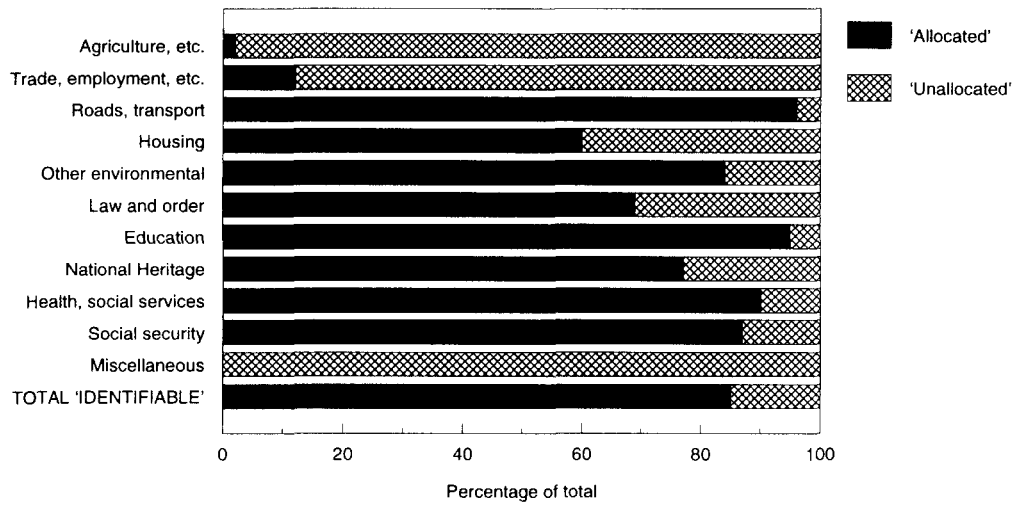
A subsequent exercise seeks to break down between the English regions the spending allocated to England. Since rather less extensive records are kept of the regional allocation of spending within England, not all of the spending that can be identified as occurring within England can be allocated to a specific English region. As Figure 2.5 shows, overall, some 85 per cent of 'identifiable' spending in England can be 'allocated' to a particular region.

**Figure 2.4. Proportions of 'identifiable' and 'non-identifiable' spending under each heading in Treasury analysis of territorial spending, 1993/94**



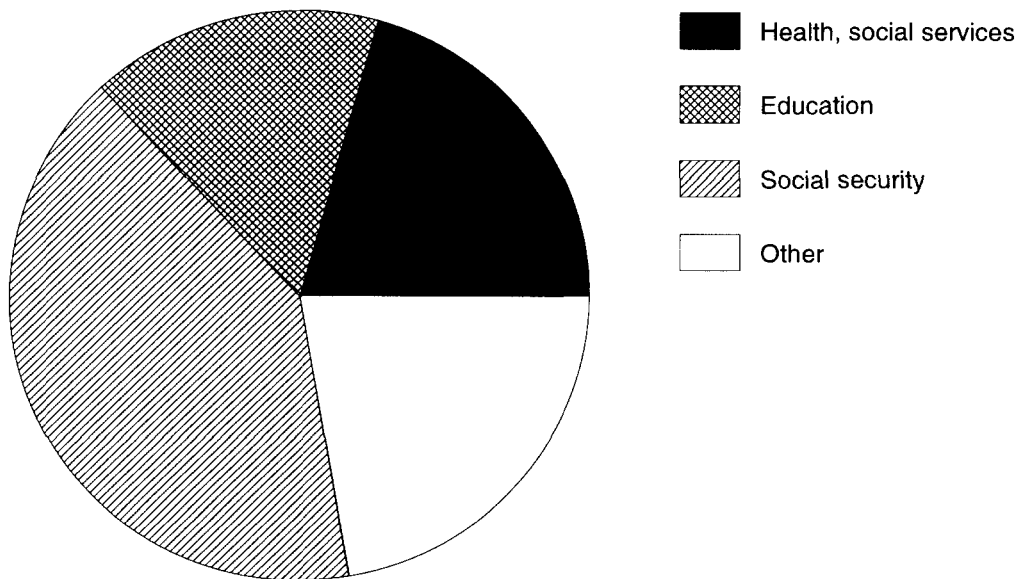
Source: Table 7.7, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995.

**Figure 2.5. Proportion of each spending heading allocated between English regions, 1992/93**



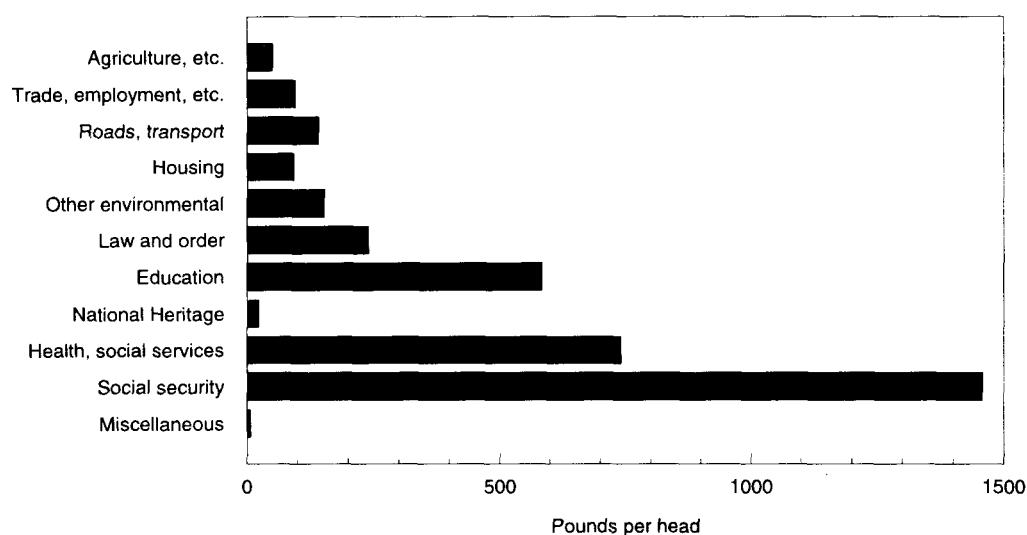
Source: Table 7.8, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995.

**Figure 2.6. The main items of government spending that can be allocated to the regions, 1992/93**



Source: Table 7.8, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995.

**Figure 2.7. Allocated expenditure per capita across different services in English regions, 1992/93**



*Source: Table 7.8, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995.*

Three service headings - social security, health and social services, and education - together account for more than three-quarters of all the spending allocated to the regions (Figure 2.6). Of these, social security is by far the largest single component, accounting for nearly £1,500 per head of population in 1992/93 (Figure 2.7). Health and social services spending accounts for some £750 per head and education for some £600 per head. A considerable proportion of the service expenditure in these two latter categories is, of course, currently spent below the level of central government, by local authorities. The amount of spending of central government that can be allocated between the English regions in these categories is therefore considerably smaller than the totals shown in Figure 2.7.

The fact that a greater proportion of total government spending can be allocated between the four territories of the UK than between the regions within England makes it difficult to compare precisely the levels of service spending in the English regions and in the other parts of the UK. In Section 2.4, where we compare the pattern of spending across regions with the pattern of tax receipts, we use rough-and-ready assumptions to allocate between regions the government spending in England that is not allocated in the Treasury analysis, so that comparisons can be made between the English regions and Wales and Scotland. Since there is no reason to suppose that allocated and unallocated spending is similarly distributed, we have not assumed that the unallocated expenditure on each service is distributed across regions in proportion to the allocated spending on that service. Instead, we have allocated the unallocated expenditures between English regions simply in proportion to population. This has the advantage that where we are looking at indicators of per capita spending, our allocation of unallocated spending does not give rise to differences between regions that are not present in reality. However, we

should warn that any basis for allocation of the unallocated component of spending is arbitrary, and there is no reason to be confident that the allocation basis we have employed gives an accurate picture of the distribution of the unallocated component.

### 2.3 The regional pattern of spending

Table 2.2 shows how 'allocated' government spending is distributed across English regions, per head of population. There are substantial variations in spending in per capita terms: spending per head in the northern region and the North West is some 7 per cent higher than in England on average, whilst in East Anglia total allocated spending is some 12 per cent below the average and in the East Midlands it is 10 per cent below the average.

These spending differences per head of population partly reflect quite large variation in social security spending per capita: this was 15 per cent higher than the average for England in the northern region and 12 per cent higher in the North West; on the other hand, it was 9 per cent lower than the average for England in East Anglia and 8 per cent lower in the East Midlands. However, there are also marked regional differences in per capita spending on other public services - health and personal social services spending, for example, was 10 per cent lower than the average for England in East Anglia, whilst education spending in the North West exceeded the UK average by some 7 per cent.

**Table 2.2. Per capita 'allocated' government spending in the English regions, 1992/93**

*Index, England (regionally-allocated total) = 100*

	<i>Total</i>	<i>Social security</i>	<i>Health and social services</i>	<i>Education</i>
North	107	115	101	101
Yorks & Humber	100	101	100	103
E. Midlands	90	92	91	97
East Anglia	88	91	90	95
London & S. East	103	96	105	100
South West	92	98	95	92
W. Midlands	97	99	93	100
North West	107	112	104	107

*Source: Table 7.9, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995.*



**Table 2.3. Per capita ‘identified’ government spending in England, Scotland and Wales, 1992/93**

*Index, England = 100*

	<i>Total</i>	<i>Social security</i>	<i>Health and social services</i>	<i>Education</i>
England	100	100	100	100
Wales	116	112	113	107
Scotland	122	108	126	134

*Source: Table 7.5B, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995.*

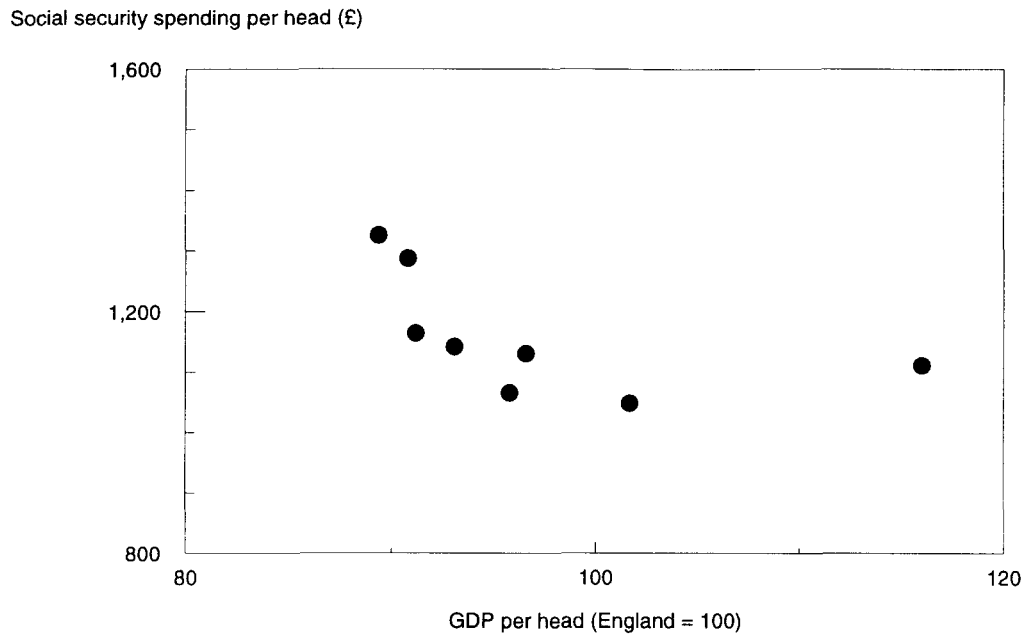
Considerably larger differences are, however, evident between per capita spending in England as a whole and in Wales and Scotland than amongst the English regions (Table 2.3). Although it should be borne in mind that the figures in Table 2.3 are not strictly comparable with those in Table 2.2, owing to the lower proportion of spending that is allocated between the English regions in the Treasury analysis than between England, Wales and Scotland, the differences between per capita spending in England and in Wales and Scotland are so marked that it seems unlikely that they can solely be attributed to variations in the 15 per cent of spending in England that could not be allocated between the English regions.

Aggregate spending per capita in Wales was some 16 per cent above the corresponding figure for England, and spending in Scotland was 22 per cent higher per capita than in England. These differences, unlike the variation between English regions, are actually less evident in social security spending than in other service areas. Social security spending per capita in Scotland exceeded the level in England by only 8 per cent, while spending on health and personal social services was 26 per cent higher and per capita spending on education 34 per cent higher. Spending in Wales significantly exceeded spending in England in each of these three areas, although in the cases of health and education the difference was less than that between England and Scotland.

There are likely to be five main factors underlying the observed variation in spending per capita across regions, and between England, Wales and Scotland.

- First, there is the ‘automatic’ effect of applying common policies across the UK. Regions will then differ in how much spending they receive, depending on the circumstances of the region’s population. Thus, for example, spending on unemployment benefit will depend on the number of unemployed people in a region;

**Figure 2.8. Per capita social security spending and per capita GDP in English regions, 1992/93**



*Source: Based on spending data in Table 7.8, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995, and per capita GDP from Table 12.1, Regional Trends, 1995 edition, HMSO, London.*

regions with an above-average rate of unemployment will thus tend to have an above-average level of spending on unemployment benefit, per head of total population.

This automatic relationship between regional spending and regional economic conditions can be seen in Figure 2.8, which plots the pattern of per capita social security spending against regional GDP.

- Second, there is the discretionary impact of policies, targeted to particular areas, or to areas with particular characteristics. Regional policies, for example, which include such measures as regional development grants payable to firms investing in a particular location, or spending on improvements to roads and other aspects of the regional infrastructure supported by the European Regional Development Fund, are deliberately targeted to particular areas, suffering from the impact of the decline of past industries or from particular locational disadvantages, for example.
- Third, the relative level of spending in Scotland, Wales and Northern Ireland compared with that in the English regions is affected by the operation of the so-called Barnett formula, which, when changes are being made in the level of public spending, determines the budget allocated to these three countries by applying a formula to the corresponding spending in England. Thus Scotland, for example, receives an extra financial allocation to the Scottish Office's budget equal to 10.66 per cent of the corresponding additional spending allocated to England (Heald, 1994). This

formula does not guarantee that Scotland receives the same allocation of funding as it would receive if instead the particular programme were operated on a UK-wide basis.

- Fourth, since the figures for general government expenditure include local authority spending, they will be affected by any decisions made by local authorities to spend above, or below, the average for the country as a whole. Whilst the scope for local authorities to increase expenditure much above the government's assessment of 'standard spending' (SSA) has been sharply curtailed in recent years by the use of widespread capping of local authority budgets, there is a tendency for local authorities spending below the average to be concentrated in the south of England, and for those spending above SSA to be urban authorities and predominantly outside the south-east of England. As a result, the regional pattern of GGE will show some variation due to differences in local authority spending choices.
- Fifth, since financial allocations made to Scotland, Wales and Northern Ireland are made as a block allocation, it is possible for spending on particular headings to vary from the corresponding figure in England, according to the spending priorities set by the territorial departments. Thus, for example, Wales has been able to use some of its block allocation to operate a more vigorous industrial policy than in England, by allocating some of its spending block for this purpose. Likewise, even though many local authorities have little control over their total spending level, they do have the power to allocate more or less to particular spending heads within the overall total.

## 2.4 Regional tax revenues

For the same reason that per capita social security spending varies across the regions of the UK, there are also large differences in the per capita tax burden in different regions. In both cases, the application of uniform national tax and benefit rates generates differences because of the differences in economic conditions - incomes, spending patterns, unemployment, etc.

Table 2.4 gives a regional breakdown of tax receipts per capita for eight of the most important sources of government tax revenue. The taxes are listed from left to right in descending order of total yield. The yields are expressed in index form: for each tax, per capita receipt for Great Britain as a whole is set at 100.

Per capita receipts of income tax vary quite substantially across the regions and are broadly what would be expected, given the regional distribution of income. In particular, the figure of 130 for London and the South East illustrates the disproportionately large number of high-income earners in this region. Indeed, income tax receipts in London and the South East take the average for Great Britain to a level where income tax receipts in all other regions are below this average. A similar pattern occurs in the distribution of business rates receipts. This reflects both the high concentration of business in London and the South East and its high property prices compared with those of the rest of the country.

National Insurance contributions are less variable across regions than the two taxes discussed above, but broadly reflect the distribution of income.

**Table 2.4. Regional per capita receipts from the main sources of tax revenue, 1992/93**

*Index, Great Britain = 100*

<i>Region</i>	<i>Income tax</i>	<i>VAT</i>	<i>National Insurance</i>	<i>Business rates</i>	<i>Petrol duty</i>	<i>Tobacco duty</i>	<i>Alcohol duty</i>
North	79	104	90	72	100	136	117
Yorks & Humber	86	104	101	72	98	124	115
E. Midlands	97	101	106	75	111	95	98
East Anglia	98	97	107	99	103	84	81
London & S. East	130	108	112	150	100	82	98
South West	94	101	96	80	112	91	96
W. Midlands	75	86	86	71	95	91	80
North West	85	92	91	69	95	102	105
Wales	74	89	80	71	101	102	86
Scotland	90	96	97	94	90	140	117
Coefficient of variation	0.17	0.07	0.10	0.28	0.07	0.19	0.14

*Sources:*

*Total receipts, by tax, for 1992/93: Financial Statistics, January 1995, HMSO, London.*

*Income tax, VAT, National Insurance contributions, and petrol, tobacco and alcohol duties have been allocated between the regions using the IFS Tax and Benefit Model (which is based on household income and spending data from the Family Expenditure Survey).*

*Business rates are allocated on the basis of total rateable values of business properties in the English regions and Wales, and the relative multipliers used in the two countries, given in Inland Revenue Statistics 1992, HMSO, London. Similar information for Scotland was supplied by the Convention of Scottish Local Authorities.*

VAT receipts show one of the lowest variations across regions. They are, again, highest in London and the South East, which, once more, probably reflects the high spending power of this region. However, VAT receipts are not as variable as income tax receipts, and do not have exactly the same ordering, which reflects different regional spending patterns over VATable and non-VATable goods, and the fact that spending does not vary as much as income, because high earners tend to save more.

Receipts from tobacco and alcohol duties do not seem to bear a positive relationship to wealth - smoking and drinking do not appear to be luxury goods. Indeed, some of the largest per capita receipts are to be found in relatively poor regions - for example, the northern region and Yorkshire and Humberside. This is not always the case: the West

Midlands, although a fairly poor region, has quite low per capita receipts of tobacco and alcohol duties. Tastes vary across regions - for example, regions where a high proportion of alcohol consumption is in the form of spirits will pay relatively more alcohol duty.

One issue that has attracted a considerable amount of attention in public debate over regional government and devolution has been the extent to which tax receipts in particular parts of Britain exceed or fall short of public spending. A number of studies have examined the relationship between tax receipts and spending in Scotland, for example (MacKay and Wood, 1992; Scottish Office, 1995; see also Welsh Office (1996) on Wales). The concern in some of these studies has been to assess the likely fiscal position of an independent Scotland; if Scotland were solely reliant on its own tax revenues to finance the current level of public spending in Scotland, how large would the Scottish budget deficit be?

This question is not the central concern of this study. It is, moreover, far from easy to answer it with a clear and unambiguous estimate. Both on the spending side and on the revenue side, there are significant items for which the territorial incidence cannot be identified, either in principle or in practice. Thus, for example, some major items of UK spending are, as we have already discussed, UK-wide public goods, the cost of which cannot simply be divided up between parts of the UK in any meaningful way. Likewise, in advance of any political decision, it is difficult to say how much of the burden of servicing the existing UK public debt would be allocated to an independent Scotland - quite apart from the difficulty of assessing what interest rate would apply. There are also taxes that are difficult to allocate between areas - corporation tax is perhaps the clearest example.

Here we restrict the analysis to those taxes and spending items for which a reasonably firmly-based regional allocation can be given, and compare the regional distribution of tax revenues from these taxes with the regional distribution of the spending for which the region benefiting can be identified. Table 2.5 shows total per capita tax receipts by region, based on the data in Table 2.4, and compares these with regional spending on items that could be identified to England, Scotland and Wales. As noted above, the component of identified GGE in England, which could not be allocated across the regions, was assigned to regions according to population; the arbitrary nature of this allocation should be borne in mind in interpreting the results.

The table shows that in Great Britain as a whole, identified regional spending in 1992/93 exceeded the revenues derived from taxes whose regional incidence could be clearly assessed by some £429 per capita. This deficit largely reflects the fact that a higher proportion of tax revenues than spending items have a regional incidence that is difficult to identify, either as a matter of principle or in practice. There is, however, considerable variation around this average. The highest shortfalls of identified revenues over spending are in Wales and in Scotland; the shortfall is less in each of the English regions, and, in London and the South East, identified receipts actually exceed spending, as a result of the much higher tax revenues per capita than the average. Because some proportion of spending, and a higher proportion of taxes, cannot be identified as relating to a particular region, the table does not present a complete picture of the overall balance between taxes and spending in each part of Britain; for the reasons we have already noted, this cannot really be done, since some spending and taxes cannot be split up in

**Table 2.5. Comparison of per capita regional receipts and spending, 1992/93**

*Index, Great Britain = 100  
(except final column)*

<i>Region</i>	<i>GDP per capita</i>	<i>Per capita tax receipts</i>	<i>Spending (including local authority and social security spending)</i>	<i>Per capita difference between receipts and spending (£)</i>
North	90	92	104	-810
Yorks & Humber	90	95	98	-496
E. Midlands	96	99	90	-112
East Anglia	101	99	89	-47
London & S. East	116	117	100	92
South West	95	96	92	-270
W. Midlands	93	82	96	-826
North West	90	90	104	-890
Wales	83	80	108	-1,312
Scotland	98	97	114	-1,003
Great Britain	100	100	100	-429

*Sources:**Tax receipts: as in Table 2.4.**Spending: based on data in Table 7.8, Public Expenditure: Statistical Supplement to the Financial Statement and Budget Report 1995-96, Cm 2821, HM Treasury, 1995, and per capita allocation between English regions of unallocated spending in England.*

the way that would be necessary. However, the relative pattern of tax/spending differences across regions probably presents a reasonable indication of the overall balance between taxes and spending in different parts of Britain.

Table 2.6 shows a comparison of regional spending and tax revenues, based on two narrower definitions of spending - first, regional spending excluding social security spending, and, second, regional spending excluding both social security spending and local authority spending. The exclusion of social security spending reflects the view that it is unlikely that this highly redistributive component of government spending would be devolved to a regional level. The exclusion of local authority spending focuses simply on those parts of public spending that could be devolved downwards from central government, leaving in place current local authority spending responsibilities.

**Table 2.6. Comparison of per capita regional tax receipts and three spending definitions, 1992/93**

*Index, Great Britain = 100*

<i>Region</i>	<i>GDP</i>	<i>Tax receipts</i>	<i>Spending, including social security</i>	<i>Spending, excluding social security spending</i>	<i>Spending, excluding social security spending and local authority spending</i>
North	90	92	104	99	95
Yorks & Humber	90	95	98	97	96
E. Midlands	96	99	90	89	88
East Anglia	101	99	89	87	91
London & S. East	116	117	100	103	100
South West	95	96	92	89	91
W. Midlands	93	82	96	94	88
North West	90	90	104	101	95
Wales	83	80	108	107	131
Scotland	98	97	114	118	130

*Sources: As for Table 2.5.*

The table shows that when local authority spending is excluded, total regional per capita spending is considerably more variable than when it is included. In particular, relative spending in Scotland and Wales becomes significantly higher than in the English regions. It would appear that a large part of the above-average spending in Wales and Scotland arises in areas that are the responsibility of central government rather than in local authority spending.





### 3 Some scenarios for decentralisation

In assessing the fiscal implications of the creation of regional governments in the UK, we first need to establish the scope and scale of the regional governments that we are considering. In principle, regional government could take various possible forms, differing in terms of the activities and responsibilities assigned to regional government, the geographical pattern of regions, and the relationship between regional government and the other, existing, government tiers in the UK - central and local government.

As far as scale is concerned, a number of possible scenarios might be envisaged. Regional government could take the form of:

- **limited regional government**, exercising a few functions, with little in the way of independent revenue-raising powers, and a substantial measure of central control restricting the scope for independent decisions by each regional government;
- **major regionalisation**, which could involve regional government units taking over a large number of functions (perhaps as many as are currently exercised in Scotland by the Scottish Office) and having significant own tax revenues; or
- **maximum devolution**, in which some parts of the UK assume responsibility for all of the major functions of government and become, to all intents and purposes, independent countries as far as the functions of government are concerned.

There are many aspects of the debate over regional government that do not concern issues of economics. Perceptions of national identity, for example, are an important element in the debate over Scottish or Welsh devolution. Political strategy and political calculation - the question of 'what the electorate will accept' - will obviously determine the proposals that are brought forward, and the shape of any system of regional government that thus emerges.

However, our point is that there are also issues of substance at stake, and not just of political strategy or attitude, and it is these that we can address in this study, using the concepts and analytical 'tools' that economics provides.

In this chapter, we consider the role that could be performed by regional government in relation to public expenditures and legislation. Our focus is on the issue of 'assignment', in the sense of the allocation of authority and responsibility over each of the functions of government between the different tiers of government - local, regional and national. We begin with a question that abstracts, as far as possible, from the political considerations that in practice may constrain the form of regional government that might be proposed, and ask 'given a clean sheet of paper and a brief to design an ideal division of responsibilities between different levels of government, what functions of government would be assigned to the central authority and existing local authorities, and what would be assigned to regional government?'

It will be noted that our question does not presuppose that regional government will necessarily involve decentralisation, compared with the present system. It is possible that the portfolio of responsibilities assigned to an efficiently-designed system of regional government could include both

- some functions currently performed by central government; and
- some functions currently performed by local authorities.

### **Box 3.1. Decentralisation and regional government in France**

France has three sub-national tiers of government. The first two levels date from the Revolution and consist of 34,600 *communes* and 92 *départements*. Regional government consists of 22 regions, which were established in 1972 by the Pompidou Government, although initially their powers were limited.

In 1982, a Bill proposing local government reform presented by the Minister for the Interior and Decentralisation, Gaston Defferre, was passed in Parliament. Over the next four years, further laws were passed, completing a programme aimed at decentralising government power.

#### ***Structure and responsibilities of regional government***

Before 1982, regions had a limited role and were not fully-independent tiers of government. They had two indirectly-elected regional assemblies and were run by the *Prefect* of the region's main *département*, an executive appointed by, and accountable to, the Minister for the Interior. Their primary function was to implement regional aspects of the central government's national plan, and they were also allowed to contribute to the financing of investment projects undertaken by the state or their constituent local authorities.

The Defferre reforms expanded the role and powers of the regions; for the first time, they were run by a directly-elected council. At all levels of local government, power was transferred to the directly-elected representatives, and there was a considerable reduction in the extent of prior administrative and financial control by the Prefect and central government.

All local authorities were given new powers to intervene in the local economy and assist local industries directly or indirectly via loans, grants or tax concessions. Each level of government was assigned specific responsibilities previously dealt with at national level:

- The regions' role in regional economic planning and development was strengthened. They were, in consultation with the *Commissaire* (the replacement for the old Prefect), to prepare a five-year regional plan for medium-term investment (covering mainly vocational training, research and technology, industrial aid, agricultural development, and communications). In addition, they were given specific responsibility for vocational and professional training.
- *Départements* were given responsibility for provision of most forms of public health care and welfare (social services, housing, etc.). The state retained responsibility for certain aspects of health care and for the main social security programmes.
- *Communes* received new powers in town planning and urban development.

#### ***Local government finance***

Under the French Constitution, the taxing powers of local government are determined by central government.

Before 1982, regions were given central government grants which they redistributed as specific grants and capital subsidies. Their budgetary powers were strictly limited by a centrally-set ceiling on regional fiscal resources.

Communes and départements shared various direct taxes. These were: a housing tax based on rental income; two property taxes (one on developed and one on non-developed land) based on the official market value of land and buildings; and a business tax, the *taxe professionnelle*, designed to be a tax on value added and based on the value of a business's assets and a fraction of its wage payments. The rates of these taxes were linked by a central formula.

All three sub-national levels were also allowed to borrow.

The 1982 reforms aimed to accompany any increased responsibility of local government with an increase in their fiscal resources, to enable them to finance these new activities.

Regions were given the same direct tax bases as the other tiers of local government, subject to a centrally-set ceiling on receipts. This ceiling was subsequently removed by two reforms in 1986 and 1988. In addition, the setting of the four tax rates was no longer linked. A vehicle registration tax, a vehicle licence tax and a tax on property sales and related registration fees (subject to a ceiling rate) were also transferred from the centre to the regions.

New block grants were created, which replaced the previous arrangement whereby local and regional authorities received central grants for specific investment projects.

### ***Evolution of spending and receipts***

In 1993, total local government spending was 47 per cent of central government spending, and about 10 per cent of GNP. The regions' share of total local spending was small, at around 4.7 per cent; however, this was 35 times higher than in 1974. Since the Defferre reforms, regional spending (in real terms) has grown at a rate of 45 per cent per annum compared with a figure of 5 per cent for the other tiers of local government. Per capita spending varies across regions from 688FF to 1,176FF, with an average of 960FF (in 1992).

The main sources of regional government revenue in 1993 were their own tax resources (which contributed 49 per cent of their total revenues), grants from central government (27 per cent), borrowing (13 per cent) and 'miscellaneous income' (11 per cent). The contribution of grant income has increased in recent years, to compensate the regions for the increases in expenditure required by their new responsibilities.

The tax revenues of the regions include both direct and indirect taxes. Direct taxes account for around 60 per cent of their tax revenue, of which about half comes from business tax, a quarter from housing tax and a quarter from the two land taxes. Indirect taxes (car registration fees, etc.) account for the remaining 40 per cent of regional tax revenue. Direct regional tax receipts per head rose from 34FF in 1984 to 360FF in 1989, mostly due to increases in tax rates and not in tax bases. Despite this increase, regional tax receipts are still significantly smaller than those of the other tiers of local government. Since the ceiling on their total allowable receipts was lifted, the variation in tax rates across regions has grown considerably.

### **Box 3.2. Regional government in Spain**

Democracy was restored to Spain in 1978. The new Constitution allowed regions that wanted to, to form a regional tier of government, called Autonomous Communities (ACs). By 1983, 17 ACs had formed (varying greatly in terms of population and per capita income) covering the entire country.

If their proposed Statute was put to a regional referendum, approved ACs could adopt a relatively 'high' level of responsibilities. If not, they were only allowed a 'low' level of responsibilities, at least for the first five years of their existence. Seven of the ACs have 'high' responsibilities, the other 10 'low'.

There are a further two levels of local government, which date much further back: the provinces, of which there are 50 (seven of which cover the same area as that of their AC and thus perform both the functions of AC and province), and the municipalities, of which there are about 8,000.

#### ***Powers of taxation***

Central government controls and collects all the main taxes such as personal and corporate income tax, customs duties, VAT, and excise duties on oil products, tobacco and alcohol. Under the Spanish Constitution, the power to tax is vested originally in central government, so any powers of taxation that lower government levels have must have been devolved to them by the state.

The new Constitution aimed to assign taxes using the following rules:

- Central government should be responsible for stabilisation and redistribution policies.
- Taxation should be uniform across the country. Thus taxes on mobile bases or those that may cause distortion or competition should be assigned to central government. Only benefit or earmarked taxes and user charges should be imposed at all levels. If this created vertical fiscal imbalance and potential horizontal inequity, they could be overcome by some kind of revenue-sharing grant distributed on a fiscal-equalisation basis.

Much of the ACs' revenue comes from central government grants. ACs with responsibility for health provision receive a block grant for financing this. All ACs can also receive other specific grants and project grants.

The other main grant is a tax-sharing grant. Two types of regime exist for tax-sharing: the common regime (in 15 ACs) and the special regime in the remaining two ACs (Navarra and the Basque country). Under the special regime, certain central taxes (income tax, VAT, etc.) are 'contracted' to the regions, which collect the full amount of the taxes and pay an annual quota to the central government.

Under the common regime, the tax-sharing rate for ACs is calculated taking into account an initial assignment of funds (calculated on a needs basis), the potential revenue from taxes, fees and charges, and a 'differential responsibility regulator' to adjust for additional or reduced services in the AC. The central government additionally imposed lower and upper bounds to the rate at which tax-sharing grants could grow.

As regards own taxing power, the ACs can levy surcharges on certain ceded taxes (stamp duty, property transfer tax, wealth tax, death and gift duties, gambling taxes) from which they collect the revenues which are regulated by central government; the ACs can levy a surcharge on personal income tax too. They may also impose taxes on bases that are not shared with the central government, but this is a negligible power as this residual tax base left to them is insignificant, and, in practice, few of the ACs have used these limited powers. They can also employ fees and user charges and borrow (as can all levels of government).

Some three-quarters of the ACs' revenue comes in the form of grants from central government; taxes and other sources of own revenues contribute the remainder. There is relatively little variation in the significance of grants in ACs with 'high' and 'low' expenditure responsibilities; on average, the former group receive only some 5 per cent more of total revenues in grant than the latter group.

Provinces have an almost negligible power to tax. Their only own tax is a limited surcharge on the municipal business tax. They used to have a share of the central government general sales tax, but lost this when, in 1986, it was replaced by VAT. Their main source of finance is unconditional grants from central government.

At municipal level, compulsory taxes consist of a property tax (on the ownership of cars and buildings), business and professional activities taxes and a vehicle tax. The municipalities may also levy a tax on urban land appreciation, a tax on buildings, plants and works, and surcharges on central government taxes. Fees and user charges (which are levied at all levels of government) are particularly important at municipal level. All these tax rates are controlled, to a certain extent, by central government.

Grants are an important source of revenue for the municipalities. They receive an unconditional grant from central government, partly calculated on a needs basis, the growth of which, as with the ACs, is subject to upper and lower bounds. Municipalities also receive project grants from regional or provincial governments.

### ***Structure of responsibilities***

- Defence, foreign affairs, economic stabilisation and distributional policies are carried out by the central government, as, mainly, is law and order.
- Education and health are mainly conducted at a regional level for those ACs with 'high' responsibilities, and by the centre for the 'low'-responsibility ACs (this is the main difference between the two types of AC).
- Housing, transport and roads, welfare services and economic development are shared between the centre, the ACs and sometimes the provinces.
- Community services, local transport, and sports and cultural facilities are provided at all three sub-national levels of government, with town planning, urban development, parks, water supply and sanitation being the main involvements of the municipal governments.

In 1989, the shares in public expenditure at different levels were as follows: central government 67 per cent, ACs 19.5 per cent and local government 13.5 per cent.

### **Box 3.3. The 1979 devolution proposals in the UK**

The 1974-79 Labour Government brought forward plans for devolution in Scotland and Wales, which were the subject of referendums in March 1979. A narrow majority of those voting in Scotland (51.6 per cent) supported the proposals, but this was only 33 per cent of those entitled to vote and thus fell short of the threshold required for the proposals to be approved, which had been set by the UK Parliament at 40 per cent of those entitled to vote. In Wales, a clear majority (79.7 per cent) voted against.

In both Scotland and Wales, the proposals would have introduced a directly-elected Assembly, but the powers of the Scottish Assembly would have been considerably wider than those of that proposed for Wales.

The Scottish Assembly would have been given *legislative* powers, and would have been able to pass primary legislation in the fields for which responsibility was devolved (see below). Where the Assembly's legislative decisions conflicted with UK legislation on non-devolved matters, or with the UK's international obligations, they could be overridden by the UK Parliament. Reflecting the role of the Scottish Assembly in legislation, control over the legal system and law and order policy would have been devolved in Scotland.

The Welsh Assembly would not have had the powers of primary legislation that were proposed for the Scottish Assembly. Unlike Scotland, where a separate legal system and legislation already existed, Wales was closely integrated into the legal system of England, and this would not have been altered by the devolution proposed. The Welsh Assembly would mainly have had *executive* powers, over regulatory and expenditure functions of government in Wales.

Apart from the basic difference in powers, and the additional control over the legal system that would have been exercised by the Scottish Assembly, broadly-similar functions of government were to have been devolved to the two Assemblies:

- health and social services;
- roads and transport;
- education (except university education);
- public sector housing and local government;
- land-use policy, economic development and tourism; and
- water supply and fire services.

Both the Scottish and Welsh Assemblies would have been financed through transfers from the United Kingdom Consolidated Fund - in other words, through a 'block grant' allocation by the Westminster government. Neither would have had any independent powers of taxation or any means (other than negotiation with the UK government) of controlling the level of financial resources at their disposal.

In other words, regional government might provide the opportunity for more centralisation than at present, where that would be desirable, without requiring centralisation to the level of the UK national government. It would also, of course, provide the opportunity for decentralisation of certain functions currently performed by the national government. Whilst much of the experience of the formation of regional governments elsewhere in Europe, such as in France (described in Box 3.1) and in Spain (described in Box 3.2), has in fact been a move towards government

decentralisation, it should by no means be taken for granted that in the UK case the greatest benefits from the creation of a regional tier of government would arise through similar decentralisation. As we will discuss in more detail later, the creation of regional governments would provide the opportunity to tackle certain deep-seated difficulties with the current system of decentralised local government in the UK.

### 3.1 Economics and the 'assignment' question

The assignment issue in the design of regional government can draw on an established theoretical literature on the economic criteria for the division of functions between different layers of government. This literature, which has become known as the analysis of 'fiscal federalism', has analysed the contribution that government structure can make to efficient public choices and the efficient delivery of public services. Much of the work on this topic has originated in North America, and reflects in its analytical structure and preoccupations the particular government structures of the US and Canada. However, the basic framework and concepts, and some of the key results, provide useful insights into the economic issues involved in designing a system of regional government for the UK.

Before deciding what functions might be better performed by regional government than by the other tiers of government currently in existence, we need to think about the purpose of having multiple levels of government at all. What opportunities arise from having a multi-tier system of government, compared with a single-tier system, and what role, within this structure, should be played by decentralised levels of government?

The economic literature on government decentralisation identifies two distinct functions that decentralised structures may perform:

- ***Decentralisation of choice.*** Government decentralisation allows communities to make different choices about the provision of public services and the consequent level of taxation. Assigning a particular area of policy to the regional level of government would enable regional differences in preferences to be reflected in different decisions about the level and pattern of service provision.
- ***Decentralisation of administration.*** On this view, lower tiers of government provide a way of decentralising the implementation of central government decisions. Administrative decentralisation to regional or local government units may mean that policy is implemented by a better-informed, and therefore more efficient, organisation than the central government itself. Regional government, on this view, is a vehicle for the administration of central policies, rather than a wholly-independent unit making decisions in its own right about the level and pattern of the public services under its control.

Inevitably, judgements about the optimal structure and size of regional government, and the assignment of policy functions and sources of revenue, will reflect a prior judgement about which of these very different models best represents both the context in which regional government operates and the purpose that decentralisation is intended to serve.

### ***Decentralisation of choice***

In 'choice' analyses of decentralised government, regional government would provide scope for regions to choose different levels of local services and taxes, matching their preferences more closely than if decisions had been made by the central government.<sup>3</sup> The principal focus of the theoretical literature has been on the provision of 'local public goods' - in other words, goods that display the 'public good' characteristics of non-rivalry in consumption and non-excludability, but that have benefits confined to only a limited geographical area (Cornes and Sandler, 1986). Nevertheless, the conclusions about assignment that result from the theory are, in the main, applicable to government policies more generally, including the large area of public spending where the government provides goods and services for reasons of distributional policy, such as education, health services, etc.

Where the function of regional government is to permit the decentralisation of choice, a key consideration in identifying the level of government to which particular functions should be assigned is the extent of interjurisdictional policy spillovers or externalities. These are cases where the policy adopted by one jurisdiction has implications - either positive or negative - for the residents of other jurisdictions, such as, for example, neighbouring areas. For example:

- public libraries or sports facilities may be patronised by residents from neighbouring areas;
- improving the quality of local roads may confer considerable benefits on travellers from other areas who are passing through;
- the burden of a tax on business levied by one region may be partly borne by customers, employees or shareholders who are resident in other regions.

Such policy spillovers or externalities constitute benefits or costs experienced by residents outside the region's area; since these people do not have a voice in the region's decisions, it is unlikely that their interests would be fully reflected in the decisions taken by the regional government. The willingness of the region's electorate to vote for local spending that benefits non-residents may be less than if the non-residents were included in the decision; likewise, the region may be prepared to adopt measures that impose costs or have other adverse effects on non-residents. In analysing the optimal assignment of policies in a multi-tier system of government, Oates (1968) has drawn attention to the problems that may arise where lower-tier levels of government are given responsibility for functions that have significant spillover effects affecting other areas. Assignment to a higher tier of government, embracing all of those affected by the policy, would 'internalise' the interjurisdictional externality.

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<sup>3</sup>A substantial part of the literature on 'fiscal federalism' considers systems where population mobility rather than voting allows individuals to obtain the level of public provision they prefer (the 'Tiebout model'). Faced with a range of local authorities offering the full spectrum of possible levels of provision, individuals choose a particular level of provision by moving to the area where it is on offer. The relevance of this literature to the design of regional governments in the UK is slight, although population and business mobility undoubtedly places certain constraints on the assignment of functions and taxes to regional government.



Olson (1969) has suggested that an appropriate assignment of policies would reflect 'equivalence' between the geographical scope of the decision-making unit and the geographical area within which effects of the policy are felt. Policies that affect only the residents of the relatively-small areas covered by district councils might, on this basis, be appropriate functions to be assigned to district councils; county councils should perform functions with costs and benefits covering a wider area; and the national government should be assigned policies that, if given to these lower levels of government, would have substantial spillover effects. Introducing a new tier of regional government into this framework would open up new possibilities for decentralising some central government functions that would have had excessive spillover effects if operated at county level; it would also provide a further sub-central tier that might be better placed to perform some of the functions currently performed by counties. Regional government would thus be assigned policies that concern wider areas than counties but where some regional differentiation of policies through different regional choices would be desirable.

This approach yields an assignment rule that would seek to assign functions to a sufficiently high level of government that interjurisdictional externalities are eliminated. A second consideration may be the effects of different assignments on the unit costs of service provision. If there are substantial economies of scale in providing certain public services, assigning these services to a small unit of government may involve higher unit costs of provision than where a higher-tier government, operating on a larger scale, has responsibility for the service. On the other hand, there may also be substantial diseconomies of scale in some public services, especially those that require the collection and processing of large amounts of information. In contrast to many 'production' activities, where economies of scale may arise through specialisation and a more efficient division of labour, the costs of communication and control in 'information-processing activities' rise more than proportionately with the size of the government unit, and these activities may suffer from appreciable diseconomies of scale (Helm and Smith, 1987).

As governments have moved away from direct involvement in the production of public services, towards a system where many services are provided by private sector contractors and suppliers, and where the role of government has become one of purchaser and regulator, the significance of scale economies in government production to the optimal design of a system of decentralised government may well have declined. The attainable economies of scale may no longer be determined by the size of government units, but by the scale of the private contractors who provide public services such as refuse collection or road maintenance. Small-scale government units may be less impracticable than when governments acted as producers of many services using directly-employed labour.

### ***Decentralisation of implementation***

A fundamentally-different perspective on the role of sub-central government is provided by 'agency' models of sub-central government, in which sub-central governments provide scope for administrative decentralisation of some of the policy functions of central government. Here, the objective of decentralisation is not to ensure that levels

of provision are responsive to the preferences and choices of an area's residents, but to exploit advantages of smaller-scale units in the administrative implementation of centrally-determined policies.

Administrative decentralisation can exploit the informational advantages of local government, which may be of two main forms.

First, local bureaucrats may have better information about local needs than central government bureaucrats, which may help them target the pattern and level of local provision more precisely to where it is needed. In principle, of course, information available at a decentralised level could be communicated to central decision-makers, but the costs of information-processing appear to rise sharply with the size of the organisational unit. For this reason, even where central government retains control over the implementation of its policies, it may choose to operate through administratively-decentralised central government agencies (e.g. the local and regional organisations of the National Health Service in the UK), which will tend to share, with local government, the informational advantages about local needs.

The change in the role of governments away from direct production of public services towards a purchasing and regulatory role may, as noted above, have reduced the importance of scale economies in the service 'production' activities of government. However, even where the role of governments is primarily regulatory in nature, the informational problems in targeting and delivering public services with a high information content probably still remain a strong argument in favour of some form of government decentralisation. Whilst 'production' can be contracted out, the assessment of need and the targeting of services will still require a substantial direct involvement of government, and decentralisation may still be needed to ensure efficient management use of the information needed for assessment, targeting and control.

Second, the informational advantages of local voters about the actual performance of the administrators of local services can be exploited to provide better control over administrative 'slack' and underperformance than central bureaucrats could achieve. Whilst central government may wish to delegate implementation of its policies to exploit information about local needs, this brings at the same time 'principal:agent' problems of control. Those charged with implementing central policies may choose to pursue their own objectives (comfortable conditions of service or 'empire-building', perhaps) at the expense of the objectives set by the central government. Given the comparatively poor informational position of central government, it is difficult for central government to observe and prevent this type of dysfunctional outcome. Decentralisation to local governments, rather than simply to administrative agencies of central government, allows the central government to make use of local voters as a control mechanism, to constrain bureaucratic underperformance.

In this model, therefore, the role of voting is not to express individual preferences, but to provide control in a situation of agreed preferences and priorities. Clearly, a key requirement for the control function to operate properly is that the interests and preferences of local voters should broadly coincide with the preferences and objectives of central government. Differences in the objectives of central government and local voters can undermine the value (from the point of view of central government) of elections as a control device to reduce bureaucratic slack, and, where differences in preferences

are likely to be substantial, may make this approach to decentralised operation less desirable from the point of view of central government than purely administrative forms of decentralisation. Whether this is likely, in any given situation, to be a serious limitation on the effective functioning of local governments as 'agents' for the centre will, at least in part, depend on the extent and pattern of preference differences between the population as a whole and the population of individual localities.

### **3.2 Assigning redistributive functions**

One implication frequently drawn from the 'fiscal federalism' literature is that redistributive policies should be assigned to the central level of government, rather than to sub-central governments. This is because population mobility between different areas may restrict the scope for sub-national governments to make independent choices about redistributive priorities.

A jurisdiction attempting to operate a more redistributive policy than its neighbours will tend to attract individuals who would benefit from more redistributive policies, and to be less attractive to those who would lose from greater redistribution. The ability of the area to sustain any degree of redistribution above its neighbours would then be reduced, or, where mobility was high, eliminated altogether. For example, an area that tried to provide services to 'poor' voters whilst taxing 'rich' voters would find that the poor would move in and the rich would move out; the need for expenditures would rise, while at the same time the financial resources to pay for them would fall. If it tried to maintain the level of services to 'poor' voters, the rates of tax on 'rich' voters would have to be increased still further, leading to more outward migration and a further loss of tax base.

This line of argument would confine the role of sub-central governments to those policies that do not have a significant redistributive impact.

In practice, however, there appears to be some scope for the assignment of redistributive policies and policy functions with some redistributive impact below the level of central government in the UK. Where mobility is low, the fiscal externalities from independent redistributive policies may be weak, and other considerations may be more relevant in determining assignment. In addition, it is possible - albeit at a cost - to devise financing arrangements for regional government (based on resources 'equalisation') that largely offset the budgetary consequences of fiscally-induced migration. Indeed, many of the policies currently operated by local government, including education and social services, involve a substantial redistributive element.

As Helm and Smith (1987) have argued, the appropriate assignment for the implementation of redistributive policies within an 'agency' model may contrast sharply with the conventional wisdom that redistribution should be left to higher tiers of government. The objectives of redistributive policies may require account to be taken of a number of aspects of individual circumstances, including both individual incomes and individual needs. A large amount of information may be needed if redistributive policies are to be targeted accurately towards individuals on the basis of their needs.<sup>4</sup>

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<sup>4</sup> The informational requirements of efficient distributional policy may be one reason why redistribution in kind may be more efficiently targeted than cash transfers; redistribution in kind encourages self-selection by those with higher needs (Blackorby and Donaldson, 1988).

This may be a reason for locating the implementation of these policies at the lowest levels of government, to economise on informational costs. On the other hand, there is perhaps more reason to expect that the redistributive preferences of central and regional governments may differ than that central and regional preferences for non-redistributive services differ, and the value of regional elections as a control mechanism may consequently be less.

### **3.3 Central influence and control**

The two different models of regional government outlined above have very different requirements for central government control and influence over the operations of subsidiary levels.

- In regional government systems that aim to provide scope for decentralisation of choice, the main function of central government may simply be to establish the framework within which regional voters can make efficient individual choices about regional service provision and taxation. The design of this framework will raise equity issues, which may require various forms of equalisation grant, as we discuss in Section 4.2. In addition, the financial framework will need to take appropriate account of the various spending and revenue spillovers from regional decisions. Beyond designing the system, however, the involvement of central government in regional decisions should be low in a regional government system of this sort - central government should sit back and let each region's voters choose what services should be provided and how they should be paid for.
- In contrast, where regional government performs an 'agency' function, providing a vehicle for more efficient implementation of central government policies, the scope for regional government decisions may be more tightly circumscribed, and the role of central government in controlling regional government may be much more extensive, possibly extending to detailed monitoring and control of individual decisions, as well as maintenance of the overall framework.

Where regional government is intended to provide arrangements for the implementation of centrally-determined policies, a much greater need arises for instruments of central control. Where the aim is efficient decentralised administration, it is necessary to allow regional units some discretion over the way that policies are implemented, reflecting the fact that they will be better informed about regional needs and circumstances. The principal:agent relationship that exists between the centre and regional units as a result of this information asymmetry creates, however, obvious difficulties for the centre in being able to monitor and control the performance of the regional units. If regional administrators choose to pursue their own private objectives rather than those set by the centre, the central authorities cannot always distinguish this from the justified exercise of regional discretion on the basis of the information available to regional decision-makers but not to the centre. As with similar problems of control in large business organisations, central government may develop various methods to limit bureaucratic slack at regional level - the development of comparative indicators of performance, targets, legal requirements for competitive tender, audit arrangements, etc.

In this model of regional government, regional elections function essentially as a control mechanism to ensure that regional bureaucrats and politicians are efficient in their implementation of the policies assigned to them, but differences in preferences between central and regional government can complicate this role. In the decentralised administration model, therefore, it may actually be appropriate for central government to devise mechanisms to *inhibit* the exercise of regional choice, at least in certain respects. The appropriate restrictions could be severe. Thus, for example, where the decentralised functions have a substantial redistributive component, it may be appropriate to constrain the aggregate level of expenditure on these functions (for example, by providing the regional units with little or no discretion over regional taxation), and to restrict the domain of regional choice to issues of targeting and production efficiency.

Where central government uses lower tiers of government as a means of decentralised administration, this may require substantial central control over certain aspects of local decisions, which can conflict with any role that the same lower-tier government units may have in decentralising choices. It is unlikely that central policy-makers could always resist the temptation to use the apparatus of control established for the 'administrative' functions of lower-tier governments to interfere with their choices in other areas. Attempting to combine the 'choice' and 'agency' functions of sub-central government in a single unit thus seems likely to lead to tension between the two functions.

This, in our view, is one of the underlying sources of conflict between central and local government in the UK system. As local governments have increasingly been required to take responsibility for the administration of major areas of public policy, involving substantial expenditures and, in many cases, public expectations of a uniform level of provision throughout the country, pressures for greater control over local expenditures have grown. The gap between the expectations of local authorities regarding their freedom of decision-making, and the constrained role that is in practice appropriate for the decentralised administration of major areas of centrally-determined national policy, has led to growing inter-institutional conflict between central and local government and serious ambiguities about the location of responsibility for local taxation and spending decisions and about the function of local democracy.

If this is indeed a problem, the remedies lie in the structure of sub-central government. Changing the pattern of financial resources, or the extent of central control through 'capping' and other measures, or the frequency of or voting rules for local elections, will not resolve the underlying tension between the two fundamentally-different purposes of decentralisation. Likewise, reorganisations of local government boundaries, or changes to the number of levels of local government, will not reduce the inefficiencies that are inherent in the present system, unless they achieve a much sharper separation between local government functions that are essentially a matter for unconstrained local choice and functions where local government is in effect operating on behalf of central government in implementing centrally-determined policies.

In systems of regional government with multiple tiers, the allocation of functions to different tiers could be used to achieve some degree of separation between the two roles, of 'choice' and 'implementation'. This has not been the case to any significant extent in the past two-tier system of local government in the UK; the allocation of functions between these two tiers reflected differences in the extent of scale economies in

production; those functions where scale mattered more tended to be allocated to the higher tier (counties) rather than to the smaller districts. This matters much less now than it used to. As we have argued, the change in the role of local governments from producers to purchasers of services means that it is no longer necessary for government boundaries to be drawn large enough to achieve economies of scale in service production.

Regional government would open the possibility of separating the 'choice' functions of decentralised government in the UK from those where lower tiers are implementing central policies as 'agents' of central government. It would, for example, be possible to assign the bulk of the agency functions currently performed by local authorities to new regional government units, leaving local authorities to provide services where local choice could be exercised freely. In these circumstances, clearly, regional governments would operate in a much more restrictive framework, regarding both decisions and financing, than would be appropriate for the lower-tier local authorities.

### **3.4 A sketch of some possibilities**

What, then, might regional governments be given to do? Which of the various functions of central and local government might operate better if performed at the regional level than by the level of government currently responsible?

The discussion in this chapter has suggested that assignment decisions could reflect two, somewhat different, basic objectives.

One would be for regional governments to take over functions of government that would have significant policy spillovers between areas if performed by smaller administrative units. Regional transport planning and co-ordination would be an obvious candidate for assignment to regional governments on this basis.

A second objective would be to use regional government to separate out 'choice' and 'agency' functions performed by sub-central government, so that local governments could, as far as possible, be left with a portfolio of responsibilities in which local choice was important and the need for central government control unimportant. This might point towards transferring social services, education and perhaps health service responsibilities to the regions (the first two transfers would, in the main, be 'upwards' and the third 'downwards').

## 4 Financing regional government

The appropriate basis for financing regional government will depend in part on the prior question of its role and functions.

- Where regional government is principally concerned with the efficient implementation and administration of policies determined by central government, it may be appropriate for regional government to be financed largely or entirely through financial transfers from centrally-collected tax revenues. There would be correspondingly little need for regional government to be assigned its own sources of tax revenue and to have the power to vary the rates of tax that are levied on its local population.
- In contrast, where regional government is intended to function as a more independent level of democratic decision-making, giving regional voters the power to make choices that differ from those in other regions or that differ from the choices that would be made by central government, there is a much greater case for assigning some taxation powers to regional government. Indeed, in this case, some independent power over revenue is essential if the opportunity for regional government to make independent choices is not to be a meaningless fiction. Moreover, to ensure 'accountability' when regional decision-makers choose to set higher levels of spending, it is essential that the additional revenues required to finance any extra spending chosen by independent regional governments should be raised from the regional population, through regional taxes; as little as possible of the tax burden should fall outside the region.

These requirements do, however, leave open a considerable range of possibilities. They could be met by a system of regional government finance in which all regional expenditure was financed by taxes under the control of regional governments. They could also be met if nearly all of the financial resources of regional government were provided in the form of transfers from the central government, so long as regional governments with control over spending levels also have some obligation to raise revenues from the region's population to finance their spending decisions.

This latter structure of financing, indeed, is what currently happens with local government in the UK. More than four-fifths of the spending of local councils is financed through transfers from central government, mainly in the form of a 'block grant' (the revenue support grant). Local taxes (the council tax) contribute only a small proportion of the total financial resources of local government. Local councils have the power to vary the level of local spending (except where they are subject to central government 'capping'), but when they choose to spend more, the full cost of that additional spending is borne by council tax payers. Thus, whilst the council tax contributes only some 20 per cent of total local authority revenues, it finances 100 per cent of the cost of marginal local spending. In the 1986 Green Paper *Paying for Local Government*, this pound-for-pound relationship at the margin, between a change in spending and in council tax revenues, was seen as the central requirement in ensuring local financial accountability - in other words, in linking those who vote for, those who benefit from and those who pay for local services (Department of the Environment *et al.*, 1986).

In the first section of this chapter, therefore, we consider the advantages and disadvantages of financing regional governments through own tax revenues, compared with transfers from central government in the form of a block grant. Section 4.2 then discusses issues concerning the allocation of transfers from central government. How far is it necessary and feasible for the allocation of any block grant to regional governments to take account of regional circumstances, both in terms of spending 'needs' and in terms of the 'resources' available from any taxes assigned to the regional level? If it is decided that there is a need for a regional tax, there is then the issue of choosing an appropriate tax to assign to regional government. Section 4.3 sets out some criteria for selecting a regional tax, and Sections 4.4 to 4.7 discuss three of the main candidates.

#### 4.1 Own taxes or block grants?

We have already argued that if regional governments are to have a genuine role in making decisions about the level of public spending in their area, rather than simply administering public spending decisions reached by central government, they would need to have control of some source of tax revenues under their own control. Regional taxes would promote both independence and accountability in regional government's spending decisions.

- **Independence** may be enhanced where regional governments derive a large amount of their *total* revenues from local taxes. If regional governments were to be largely dependent on a financial allocation from central government for the resources to finance their spending, central government would have considerable opportunity to influence the policy decisions of regional governments through the terms on which the financial allocation was paid.

This influence could be exerted explicitly, if, for example, central government made the payment of all or part of the grant conditional on certain actions of the regional government; thus, for example, a system of 'matching' grants, where central government offered to pay a given percentage of the cost of certain policy measures, might have a large influence over the behaviour of the regions.

More generally, even where the financial transfer was made, in principle, in the form of a block grant, without explicit conditions on how it could be used, the regions' dependence on the block grant might make it possible for central government to induce changes in regional government's behaviour, merely through the threat of changes in grant level or regional distribution.

- **Accountability** in regional government's decisions about the level of spending will require, at the minimum, that extra spending is paid for by extra taxes on the region's residents, and that national tax payers, or residents of other regions, are not asked to foot the bill for a region's decision to spend more.

On the other hand, financing lower-tier governments through financial transfers from the centre may have some considerable attractions.



Block grants have the merit of simplicity and low cost in administration; most arrangements for decentralisation of tax-raising powers carry with them additional economic costs, including both extra work in collection and enforcement, and additional economic 'distortions' of various sorts, when different jurisdictions choose to set different tax rates.

Block grants may also be used to achieve equity between lower-tier areas, to reflect differences in their expenditure needs (or differences in their tax-raising powers). This could, of course, be done without central-to-lower-tier transfers, by making lateral transfers of revenue between lower-tier governments, but in practice such arrangements seem rather less durable, perhaps because their transparency makes them a focus of resentment in the areas that are net contributors to the redistribution.

Of course, it may also be seen as a positive attraction of financing regional governments largely, or exclusively, from resources provided by central government that it may allow central government to keep full control of the aggregate level of regional spending. As with central government control over local authority expenditure aggregates, it is far from clear that there is any good reason, based either on macroeconomic or microeconomic considerations, for central government to need to do this. However, in practice, central government may not wish to establish a system of regional governments that cedes a considerable amount of control over aggregate public spending to the new governments, and grant finance may be the easiest way to keep the new tier of government on a tight leash, with minimal spending autonomy.

### ***How much regional taxation?***

If it is concluded that regional government should have access to some form of tax revenue under its own control, there are further questions of the form that this should take. How many regional government taxes are required, and how much revenue should they contribute?

- It may be possible to manage with a limited local tax, covering a relatively small proportion of local spending, so long as, at the margin, it provides local authorities with scope to change their level of revenue. As with local government, the notion of 'marginal accountability' is useful: if regions choose to spend more, this should result in an increase, pound for pound, in the level of local taxation. This criterion can be satisfied even where, on average, regional spending is financed almost entirely by grant; what matters is simply that *extra* spending should result in *extra* tax.
- However, where local taxes contribute a small proportion of regional revenues, the scope for central government to exercise influence over regional government decisions is correspondingly great, and there are potentially large problems of high 'gearing' of small percentage changes in regional spending (or in grant allocations) into much larger percentage changes in regional tax rates.

It will be observed that what is at issue here is providing regional governments with a source of tax revenues under their own control, and not simply providing regional

governments with an entitlement to particular tax revenues. The considerations of autonomy and independence would require that regional governments have the power to vary the revenues they derive from regional taxation, by varying the tax rate.

In some countries, regional governments are partly financed through assigned taxes, or shared taxes, which do not in practice offer them any significantly greater autonomy than direct transfers of financial resources from the centre.

- The revenues from certain existing taxes controlled by central government might, for example, be assigned in their entirety to regional government.<sup>5</sup>
- Alternatively, tax revenue-sharing might be established, under which regional governments would be given an entitlement to some proportion of the total revenues derived from a particular tax.

In both cases, no change would be made to the ultimate responsibility for setting the rates of tax; this would remain under the control of the centre. However, any revenues from the assigned tax, and a fixed proportion of revenues from the shared tax, would accrue to regional government as of right.

These arrangements may superficially appear different from regional government finance based solely on central transfers, but they offer little or no difference in economic substance. Where the region does not have power to control the tax rate, it does not gain the autonomy that would come from having a tax source under its own control. Moreover, assigned or shared taxes may provide regions with little protection from arbitrary, or politically-motivated, fluctuations in their financial entitlement. Although the pace of growth of revenue from the assigned tax would be governed by the growth of the assigned tax base, this will only guarantee a change in the revenues available to the regions if they were receiving no grants from central government. Where regions receive both assigned tax revenues and central grant, central government can offset changes in the revenues from the assigned tax through corresponding adjustments to any grant that it still pays to the regions, leaving the total revenue available to regions unaffected by the change in the assigned tax base.

It should be observed that similar objections apply to a system where regions might be provided with a tax base nominally under their full control, but where economic or practical pressures give them no power to increase the tax rate. This objection would, for example, apply strongly to giving regional governments the power also to levy taxes on the council tax base, through the kind of precepting that allows counties and districts both to share the same tax base.

### ***Financial friction between regional and local governments***

In many countries, one of the tasks that regional government is given is to provide financial transfers to support the expenditures of lower-tier governments.

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<sup>5</sup> Indeed, in the UK something very much like this currently happens with revenues from business rates; the tax rate is determined by central government, but all of the revenue collected from business rates is assigned to local governments.

The reasons for doing this are generally that regions may be better informed about the revenue needs of individual local governments than central government could be; when central government is responsible for allocating grant to a few hundred local authorities, the allocation can only be done on the basis of a centralised formula which cannot be adapted to reflect all of the individual circumstances of each local authority. Regional governments, which might have to deal with 20 or so lower-tier authorities, would be much better placed to allocate grant in a way that responded sensitively to the circumstances of individual authorities. (There may, of course, be strong countervailing arguments; in particular, decentralised grant allocations to local authorities at regional government level might be more exposed to lobbying pressure, and less effective at ensuring broad equity across the country as a whole, than a centralised procedure based on a broadly-objective country-wide statistical analysis of local authority circumstances.)

Where regional governments perform this role, giving them their own tax base to provide a significant source of revenue flexibility under their own direct control may help to avoid financial friction arising in the relationship between the regions and local governments. If regional governments have control of all aspects of the grant distribution to local authorities, but do not have any significant tax bases of their own, there is a risk that the regions may be tempted to obtain revenue flexibility by 'raiding' the tax base of local authorities, by cutting the level of grant they pay to local authorities. In some sense, regional governments would be levying taxes 'by proxy' through the council tax by cutting grant to the local authorities. Quite apart from the economic costs that may arise where an excessive level of revenues is extracted from a tax on a relatively narrow and unsophisticated tax base, levying taxes by proxy in this way may make unclear where the responsibility lies for the rise in the council tax burden, undermining local government accountability.

#### **4.2 Equalisation of 'needs' and 'resources'**

Financial transfers from central government to regional governments to finance all or part of the regions' spending could be paid on a straightforward per capita basis; each region would receive grant equal to its population multiplied by the grant amount per capita. Alternatively, the pattern of grant allocation could try to take account of differences between the regions, either in terms of own revenue-raising ability or in their 'need' to spend on the services assigned to the regional level. Regions with either a poor revenue-raising capacity or high spending needs would then receive a higher grant allocation, per head of population, than those with more scope for raising their own revenues or less need for spending.

'Equalisation' of this sort, to compensate for differences in regional government's spending needs or taxable resources, would be consistent with the way in which financial resources are allocated to local authorities in the UK. The allocation of the local authority block grant reflects an estimate by central government of the expenditure required to maintain a standard level of local services in each area (the 'standard spending assessment' or SSA). Grant is allocated to each local authority on a basis that aims to ensure that each could offer this standard level of service at the same level of council tax; the grant thus offsets both differences in tax base (the average council tax valuation) and differences in local service needs (due to differences in the structure of population, area, etc.).

### ***Reasons for equalisation***

A case could be made for similar equalisation in the allocation of resources to regional governments, on at least three grounds:

- First, some amount of equalisation may be seen as simply a matter of 'fairness' in the treatment of different regions. Equalisation could be used to achieve horizontal equity between similar individuals in different parts of the UK. Without equalisation, the living standards of an individual in a particular region will be affected by the demands on public spending and the tax-raising potential in that region. Residents of poor regions, with high spending needs and little scope for raising tax revenues, will be worse off than similar people living in richer areas, where there is less pressure on public services and more potential for raising tax revenues.
- Second, equalisation through the grant system may limit the fiscal pressures for businesses or individuals to migrate between regions. If regions were to be wholly dependent on their own taxable resources, and were wholly responsible for financing services to their population, significant differences could begin to emerge in either the tax rates or standards of services in different regions. 'Rich' regions, with a large tax base and/or little need for spending, could set lower tax rates and/or offer higher-standard services than 'poor' regions. These differences in the fiscal position of different regions would create incentives for relatively-footloose businesses or individuals to move out of the 'poor' regions into 'rich' regions, where they would either be taxed less or benefit from better public services. It is, of course, difficult to assess how large would be the migration flows that might be induced by the kind of differences in tax and spending that might arise between regions; a considerable proportion of businesses and individuals would, of course, have reasons not to move from a particular region, and the migration may involve only a relatively small proportion of particularly-mobile firms or individuals. However, fiscally-induced migration involves costs of inefficient location. Furthermore, it could lead to a growing fiscal divergence between regions, as those with the lowest tax rates attract more taxpayers, allowing them to reduce tax rates still further.
- Third, a commitment to equalisation may help in the process of defining regions and decentralising government functions. Where there is full equalisation of both needs and resources, all regions face the same fiscal 'opportunities'; the grant system ensures that no region is in a better or worse fiscal position than any other. From the point of view of a particular area, the 'wealth' of the other areas in the region does not affect the fiscal position of the region as a whole (although it could, of course, affect party political control and the policy choices the region would make). Choosing the boundaries of the regions does not, therefore, carry the same fiscal significance as when regions are dependent on their own resources. Without full equalisation, on the other hand, the definition of the regional boundaries would have clear fiscal implications; there would be a strong incentive for an area to try to escape from a poor region into a rich region through a redrawing of the regional boundary.

This argument for equalisation is probably of most significance where regions are arbitrarily defined, and may matter less where regional boundaries are based on historical or natural boundaries commanding general consent. It is therefore probably of more significance between the English regions, where the boundaries may not

command any great consensus, than between the territories of the UK. Even if there were a marked fiscal advantage or disadvantage from being included in Wales or Scotland, rather than in one of the neighbouring English regions, it is unlikely that there would be much pressure for the boundary to be changed. The same is unlikely to be true of the boundary between, say, the South East and the West Midlands if, for example, Oxfordshire were to be much better off by being placed in the former rather than the latter region.

### ***Forms of equalisation***

Equalisation could take a number of forms, differing, for example, in the extent of the equalisation of needs and resources that the system seeks to achieve.<sup>6</sup> Two possible equalisation schemes, one of which involves more comprehensive equalisation than the other, have been employed in the recent past in UK local government. Either might be considered as the basis for equalisation between regional governments:

- ***'Full' equalisation.*** This would ensure that each region faced exactly the same range of options, in choosing a fiscal 'package' of spending level and associated tax level, as any other region. The British local government system involved equalisation of this form until the start of the 1990s; grant was paid to ensure that each local authority faced the same schedule of tax increases for given levels of spending. The primary drawback of full equalisation is that the amount of grant paid will depend on the level of regional spending that is chosen; to ensure that resource-poor regions are able to increase spending without a larger increase in tax rates than resource-rich regions, it will be necessary either to pay extra grant to the former, to cover part of the cost of extra spending, or to reduce the grant of the latter, to increase the cost of additional spending. As a result, it is not possible for central government to cash-limit the grant total (at least, not without introducing instability in the financial regime facing all regions) or to predict its size in advance of knowing what levels of spending each region will choose.
- ***'Point' equalisation.*** This would only aim to put regions on a common footing in relation to one, particular, standard of public services. In the current system of local government finance, for example, grant is paid to ensure that all authorities could spend at the level of 'standard spending' whilst levying the same level of local taxation. If local authorities wish to spend above (or below) the standard level, the 'cost' to their local taxpayers will vary depending on their local tax base. The advantage of a grant of this sort is that it can be calculated, and cash-limited, in advance of spending decisions; its disadvantage is that it achieves equity across areas in a much more restricted sense than full equalisation.

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<sup>6</sup> A wide range of possibilities for equalisation schemes has been set out by Denny, Hall and Smith (1995).

### ***A practical difficulty***

Whilst comprehensive equalisation of the fiscal position of regional authorities in relation to both 'needs' and tax base (resources) might in principle be desirable, there may be practical difficulties, especially on the 'needs' side, that make equalisation more difficult to achieve between regions than between local authorities.

The current basis on which differences in spending needs between local authority areas are assessed is through regression analysis of local authority spending patterns. The assumption underlying this process is that local authority spending decisions will reflect differences in the underlying need for spending, as well as any differences in the 'quality' of the services provided. Regression analysis of the relationship between local spending and variables indicating local 'need' (such as the numbers of elderly people or children in the population) may then be able to capture the relationship between the indicators of need and the levels of spending. From this analysis, an estimate of 'standard' spending is then derived which reflects simply the differences between areas in the indicators of need; these 'standard spending assessments' (SSAs) are then used as the basis for grant distribution.

A difficulty in equalisation between regions is that it will not be possible to use the approach employed for local authority equalisation to estimate the spending needs of different regions. The use of regression analysis as the basis for calculating SSAs for local authority equalisation requires a large number of local authorities. With only a dozen or so regions, it would not be possible to include more than a handful of needs indicators in the analysis of regional spending patterns. It is therefore likely to be much harder to calculate needs differences between the relatively few regions than between the much larger number of local authorities.

### **4.3 Criteria for own taxes**

If regional governments are to be given their own sources of tax revenues, what taxes would it be most appropriate to assign to them? There are a range of possible candidates from within the existing tax system, but we believe that only three of them have any real potential as a significant source of tax revenues to finance regional government - a regional income tax, a regional sales tax and a regional assignment of the national non-domestic rate. We discuss the basis of this judgement in the remainder of this section and then consider each of the three main candidates in subsequent sections.

We do not devote much space in this discussion to the possibility of financing regional government from wholly-new taxes that do not currently figure in the UK fiscal system. Our judgement is that there are no major untapped sources of fiscal revenue that would have any significant merit as a source of revenues for regional government, and we see little value in a discussion of trivial taxes that, whilst they may have symbolic value, contribute little to the capacity of regions to raise a significant proportion of their own revenues and may, indeed, use up a large proportion of their revenues in administration costs.

Our assessment of the merits of possible regional taxes is based on seven principal criteria. Since we are considering the transfer of existing taxes to regional government, rather than the establishment of new taxes, the relevant questions concern the implications of transfer, such as the efficiency effects of permitting rates to vary and the administrative costs incurred in attributing yields to particular regions, rather than the overall merits of these three taxes. The question, in other words, is 'what does regionalisation add to the costs of raising tax revenues?'

- **Efficiency.** Would regionalising a particular tax, such that different rates of tax might be set by different regions, be liable to induce large effects on the allocation of private sector economic activity across regions? Such changes - or distortions - in private sector behaviour, if induced solely by the difference in tax rates, involve economic costs, adding to the existing deadweight burden of raising tax revenues. Thus, for example, regional differences in business tax rates might induce a business to move to a region with low tax rates; whilst it might reduce its tax burden, it might also incur other costs in relocating, such as perhaps increased transport costs, which would constitute an addition to the deadweight burden of raising revenues through the tax.
- **Administrative feasibility and cost.** How practicable is it to operate each candidate regional tax on a sub-national basis, with different regions setting different tax rates and with revenues being allocated to the region from which they are derived? Almost inevitably, operating a tax on a regional basis will increase the costs of administration - there are distinctions to be drawn between taxpayers and economic activity according to their location, which may require new information to be collected and processed. However, the additional administrative cost is likely to vary between taxes. For each possible regional tax, how much does regionalisation add to its costs of assessment and collection, and to the costs and effectiveness of enforcement activities?
- **Revenue stability and predictability.** If regional governments have a limited number of tax instruments and are not given powers to borrow freely to cover any shortfall of revenue compared with expenditure, it will be highly desirable that the tax instruments they do have generate revenues that can be predicted with reasonable accuracy and that are not highly cyclical or volatile in relation to other aspects of economic activity. Otherwise, the process of budget planning for regional authorities will involve considerable uncertainty and will require large contingency reserves to be held and other measures to be taken that may run counter to efficient planning and management of regional expenditures.
- **The need for equalisation.** The choice of tax base for regional government may have implications for the extent to which financial transfers from central to regional government, or between regions, are required to even out the financial resources available to different regions. Regions well-endowed with a particular tax base would otherwise be able to set a lower tax rate to finance a given level of spending; this might, in turn, attract more tax base, if the tax base is mobile, allowing a still-lower tax rate to be set and leading to a growing divergence in the tax rates between areas. The scale of equalisation payments required to avoid major differences in tax rates arising for the same level of spending will depend on how evenly the tax base is distributed across areas; with a more even distribution, correspondingly lower financial flows will be required to equalise the resources of different regions.

- **'Accountability' properties.** The incidence of the tax should be broadly distributed across taxpayers, and the amount of the tax and the government authority responsible for levying it should be clearly perceived by taxpayers.
- **Equity.** Aside from the accountability issues concerning the distribution of the tax burden, there are few issues of 'fairness' or equity that would be raised by the transfer of particular taxes to regional government. The taxes concerned may have either a progressive or a regressive distributional incidence, but if the average level of taxation were to remain unchanged as a result of the transfer then the average distribution of income would be unchanged. The only issue - and it is probably a relatively minor one - is that the distributional impact of significant changes from the average, or initial, tax level might be unduly borne by poorer households, where the regional tax is highly regressive. However, in the case of each of the three main candidates discussed in this report, this would not be a major issue.
- **Impact on the financial resources available to other levels of government.** Transferring an existing tax to regional governments would reduce the tax instruments available to the level of government currently employing the tax. This may not be a serious problem where the tax being transferred is currently a central government tax, although even in this case there may be issues about the possibility of competition between tiers of government over shared tax bases; transferring part of the income tax to regional governments could, for example, inefficiently erode the central government's income tax base. It is, however, a far more serious issue if what is contemplated is giving regional governments access to the existing local authority tax base. There are good grounds for believing that the current council tax base is too narrow to be compatible with efficiency in local authority finance; allowing regions to precept on the council tax base (as counties currently precept on the council tax collected by districts) would add to the pressure on the council tax.

Table 4.1 summarises the revenues derived from the main UK taxes. The three main candidates that we have identified as possible sources of own tax revenue for regional governments are income tax, VAT (or, more generally, a sales tax) and non-domestic rates ('business rates'). Of the other major taxes shown, we rule out the following as potential tax bases for regional government:

- **National Insurance contributions.** We have assumed, following the discussion in the previous chapter, that central government would continue to operate the social security system. Although the idea that National Insurance contributions (NICs) bear much relation to individual social security entitlements or aggregate social security expenditures is largely a fiction, and NICs really constitute a second income tax, there may be considerable resistance to explicitly breaking the link between NICs and benefits by assigning them to different levels of government. A regional payroll tax, levied on the National Insurance contributions base, would, however, be a possibility. It would raise many of the same issues as those discussed below with regard to a regional income tax.
- **Corporation tax.** The yields from corporation tax vary too much across areas, and fluctuate too much over time, for corporation tax to be a desirable tax for sub-central levels of government. Indeed, it is becoming clear that the scope for even national governments to exercise much discretion over corporation tax levels is increasingly



**Table 4.1. Breakdown of tax revenues, UK, 1995/96**

<i>Tax</i>	<i>Revenue (£ billion)</i>	<i>Percentage of total tax revenue</i>
Income tax	68.9	27%
National Insurance contributions	44.4	17%
VAT	44.0	17%
Excise duties	28.3	11%
Corporation tax	24.7	10%
Non-domestic rates	13.6	5%
Council tax	9.2	4%
Other taxes	21.2	8%
<b>TOTAL</b>	<b>254.2</b>	<b>100%</b>

Source: Table T4A.1, Financial Statement and Budget Report 1996-97, *HM Treasury, 1995*.

limited by international competitive pressures, and a persuasive case has been made for an increasing amount of international co-ordination of policy on corporation taxes, for example by the EU, and possibly also assignment of corporate tax revenues to the EU budget. Assigning power over corporate tax rates, or corporate tax revenues, to regional governments would run counter to the strong arguments for internationalisation of corporate tax policy.

- **Excise duties.** The incidence of excise duties is very unevenly distributed across groups in the population - between smokers and non-smokers, for example, or between car-owners and non-car-owners. Assigning control over excise duties to regional government would fail the 'accountability' test; for some voters, such as non-smoking non-car-owners, the tax implications of changes in regional spending would be negligible, whilst others, such as smoking motorists, would face a disproportionately-high 'tax price' for additional regional spending. There would also be difficulties in permitting regions to vary excise rates sufficiently to achieve much change in their revenues, since this would be liable to lead to large tax-induced price differences across regions for easily-transported, storable, commodities such as alcohol and tobacco. Significant variation in regional excise duty rates could easily lead to excessive cross-border shopping in dutiable goods.
- **Council tax.** The council tax currently constitutes the only source of tax revenues for local government. Whilst it would be administratively straightforward to allow regions to precept on the council tax base, adding their tax rate to that levied by existing levels of local government, it is difficult to see that there would be much scope for regions to raise any significant revenues from council tax without reducing the revenues that local government raises from this source. As it is, council tax

revenues contribute only a small proportion of the total spending of local government; this proportion is limited by the perception that much higher rates of council tax would provoke excessive taxpayer resistance and might raise significant problems of equity. Although it might be desirable for a higher proportion of local government spending to be financed by local taxes, there is little scope for this while the council tax remains the sole tax instrument available to local government, and the position would be exacerbated if the council tax had to be shared with regional government.

#### 4.4 Some illustrative calculations of tax rates and revenues

In this section, we look at the three serious candidates we have identified as possible tax bases for regional government, and provide some illustrative calculations of the patterns of tax rates and revenues that would result from using these taxes to support a major decentralisation of the UK public sector. In each case, we are assuming that regional government takes over all of the functions included in the Treasury's analysis of the regional pattern of public spending, with the exceptions, first, of social security, which we assume would continue to operate as a national system funded by central government, and, second, of local government expenditures, which we assume would continue to be performed by local government. We assume that the current block grant to local authorities would be made by central government. The scenario is, therefore, close to the maximum conceivable decentralisation of the central government component of the UK public sector. It probably goes well beyond the amount of decentralisation that might be implied by either of the theoretical arguments for regional government outlined in Chapter 3.

The tables in this section look at the implications of assigning this large body of public spending to the regions, and then financing it from two sources:

- **a regional tax:** the tables look, in turn, at the effect of transferring one of the major national taxes to regional government - a regional sales tax, a regional income tax or regional business rates;
- **a block grant,** paid by central government, to make up the difference between the revenues currently derived in Britain as a whole from the tax assigned to regional government, and the current aggregate expenditures assigned to the regions.

In each case, the regional tax would contribute a considerable proportion of the total revenues needed to finance the spending assigned to the regions. In the case of the regional income tax, this would almost exactly equal the regions' aggregate revenue needs; only a small central government grant, of £46 per capita (4 per cent of total revenue), would be needed to ensure that the average level of the regional income tax would be the same as the income tax burden at present. A rather larger grant, of £389 per capita, would be needed with a regional sales tax if the overall sales tax burden were to remain unchanged; the sales tax would, on average finance 63 per cent of the total regional government expenditure. With regional business rates, the tax contribution to regional revenues would be still lower (24 per cent), and the grant needed would be some £793 per capita.

**Table 4.2. Estimates of regional tax rates required to finance regional spending on all 'identifiable' regional expenditures excluding social security and local authority spending, for three regional taxes, with a uniform per capita grant**

**Regional sales tax**

<i>Region</i>	<i>Grant (£ per capita)</i>	<i>Revenue requirement (£ per capita)</i>	<i>Tax rate (%)</i>
North	389	603	15.7
Yorks & Humber	389	604	15.6
E. Midlands	389	525	14.0
East Anglia	389	557	15.4
London & S. East	389	648	16.2
South West	389	551	14.8
W. Midlands	389	527	16.6
North West	389	599	17.5
Wales	389	973	29.5
Scotland	389	964	27.0

**Regional income tax**

<i>Region</i>	<i>Grant (£ per capita)</i>	<i>Revenue requirement (£ per capita)</i>	<i>Basic rate (%)</i>	<i>Higher rate (%)</i>
North	46	946	30.0	48.1
Yorks & Humber	46	947	27.6	44.1
E. Midlands	46	868	22.6	36.1
East Anglia	46	901	23.0	36.9
London & S. East	46	991	19.2	30.6
South West	46	894	24.1	38.5
W. Midlands	46	870	29.3	46.9
North West	46	942	27.9	44.7
Wales	46	1317	45.1	72.1
Scotland	46	1307	36.6	58.5

**Regional business rates**

<i>Region</i>	<i>Grant (£ per capita)</i>	<i>Revenue requirement (£ per capita)</i>	<i>Poundage (tax rate) (%)</i>
North	793	200	45.1
Yorks & Humber	793	201	45.3
E. Midlands	793	121	26.6
East Anglia	793	154	25.5
London & S. East	793	245	26.5
South West	793	148	30.2
W. Midlands	793	124	28.5
North West	793	196	46.2
Wales	793	570	138.7
Scotland	793	561	119.9

Table 4.2 looks at the implications of making the regions wholly reliant on their own financial resources to cover any variations in the level of per capita spending; the grant is paid as a uniform per capita amount throughout the country, regardless of the pattern of local spending needs or taxable resources. In this case, in other words, the grant does not perform any function of 'equalisation' between regions.

There would be considerable variation between regions in the rates of each of the three taxes, reflecting both the wide variations in regional per capita spending noted in Chapter 2 and the variations in regional per capita tax base for each of the taxes. With a regional sales tax, based on a transfer of the existing VAT to regional government, tax rates in the regions in England would be lower than the current 17.5 per cent VAT rate (except for the North West where the rate would remain unchanged); in Scotland and Wales, by contrast, there would be large (and probably unsustainable) increases in the sales tax rate, to 29.5 per cent in Wales and 27 per cent in Scotland. Since the VAT base is one of the more evenly-spread tax bases across areas (as shown in Table 2.4), the higher tax rates in Wales and Scotland can be attributed to their higher-than-average per capita public spending.

With a regional income tax, tax rates would again rise sharply in Wales and Scotland (to a basic rate of 45 per cent in Wales and 37 per cent in Scotland), but there would also be increases in income tax rates in a number of English regions (to a basic rate of 30 per cent in the northern region, for example). There would, on the other hand, be a sharp fall in income tax in London and the South East, to a basic rate of 19 per cent. This greater range of outcomes reflects the greater variation in the income tax base between regions compared with VAT; other things being equal, tax rates would rise in regions with high public spending, but would also rise in regions where taxable incomes are low.

Business rates have the most variable tax base across regions - a very high proportion of business rateable value is concentrated in London and the South East - and consequently the widest range of tax rates without equalisation - the business rate poundage in Wales, for example, would be more than five times as high as that in London and the South East.

The results in Table 4.2 are clearly unsustainable, both politically and from an economic point of view. They emphasise the importance of equalisation in devising an efficient and equitable system of regional government for the UK.

Equalisation, as we have argued, could aim to offset both differences in tax base and differences in expenditure needs between regions. The results in Table 4.2 suggest that considerable equalisation in relation to both these dimensions might be called for. However, whilst the need for resources equalisation can be assessed quite straightforwardly from the regional distribution of tax base, it is more difficult to assess the regional pattern of relative expenditure needs.

**Table 4.3. Estimates of the pattern of fiscal transfers required from central government in order to finance regional spending on all 'identifiable' regional expenditures excluding social security and local authority spending, under three regional taxes, without any variation in tax rates**

**Regional sales tax**

<i>Region</i>	<i>Absolute grant (£ per capita)</i>	<i>Grant - Av. grant (%)</i>	<i>Spending - Av. spending (%)</i>	<i>Taxes - Av. taxes (%)</i>
North	319	-6.8	-4.5	2.3
Yorks & Humber	315	-7.1	-4.4	2.7
E. Midlands	260	-12.4	-12.0	0.4
East Anglia	313	-7.3	-8.9	-1.6
London & S. East	335	-5.2	-0.2	5.1
South West	287	-9.9	-9.5	0.4
W. Midlands	360	-2.8	-11.8	-9.0
North West	388	-0.2	-4.9	-4.7
Wales	785	38.1	31.1	-7.0
Scotland	728	32.6	30.3	-2.3

**Regional income tax**

<i>Region</i>	<i>Absolute grant (£ per capita)</i>	<i>Grant - Av. grant (%)</i>	<i>Spending - Av. spending (%)</i>	<i>Taxes - Av. taxes (%)</i>
North	205	15.3	-4.5	-19.8
Yorks & Humber	135	8.5	-4.4	-13.0
E. Midlands	-47	-9.0	-12.0	-3.1
East Anglia	-30	-7.3	-8.9	-1.5
London & S. East	-256	-29.1	-0.2	28.9
South West	11	-3.4	-9.5	-6.1
W. Midlands	175	12.4	-11.8	-24.2
North West	145	9.5	-4.9	-14.4
Wales	633	56.4	31.1	-25.3
Scotland	460	39.8	30.3	-9.5

**Regional business rates**

<i>Region</i>	<i>Absolute grant (£ per capita)</i>	<i>Grant - Av. grant (%)</i>	<i>Spending - Av. spending (%)</i>	<i>Taxes - Av. taxes (%)</i>
North	814	2.1	-4.5	-6.6
Yorks & Humber	815	2.2	-4.4	-6.6
E. Midlands	730	-6.0	-12.0	-6.0
East Anglia	704	-8.6	-8.9	-0.3
London & S. East	667	-12.1	-0.2	12.0
South West	744	-4.7	-9.5	-4.8
W. Midlands	742	-4.9	-11.8	-6.9
North West	818	2.5	-4.9	-7.3
Wales	1188	38.1	31.1	-6.9
Scotland	1122	31.7	30.3	-1.4

*Notes: Due to rounding, the figure in column 4 does not always equal the difference between the figures in columns 3 and 2.*

In the absence of a detailed assessment of regional spending needs, which would provide an assessment of the regional expenditures corresponding to a uniform standard of public services across the UK, we cannot assess the scale of transfers that would be required to equalise regional spending needs. Table 4.3, instead, provides a more straightforward calculation of the scale of grants that would be required by each region if regional governments are to be able to provide the same level of services as at present, without any increase in the rate of the regional tax. The three panels of Table 4.3 look at the grants required with, in turn, a regional sales tax, a regional income tax and regional business rates, if this condition is to be met.

In Table 4.3, therefore, the regions collect the receipts from each tax as they actually were in 1992/93 (that is, the rates of tax remain uniform). The shortfall between this and regional spending is covered by a central grant, the per capita level of which is given in the first column.

The next three columns seek to account for the regional variations in the amount of per capita grant needed. Throughout the table, the differences in grant, spending and taxes in these three columns are scaled in relation to the average per capita level of regional spending. (Using spending as the base allows the three cases, of regional sales tax, income tax and business rates, to be compared on a common basis.) The first of these columns shows the difference between the region's per capita grant and the average per capita grant (as a percentage of average per capita spending across the country as a whole). The next two columns break this down into that part of the difference that is due to higher-/lower-than-average per capita spending (common to all three panels of the table) and that part that is due to higher-/lower-than-average per capita tax receipts. That is, the third column minus the final column equals the second column.

With a regional sales tax, the equalising grant payments needed in order to maintain the same levels of spending with regionally-uniform tax rates would range from £260 per capita in the East Midlands (33 per cent below the average grant per capita of £389, as in Table 4.2) to £785 per capita in Wales (102 per cent above the average). The second column of Table 4.3 shows that, in relation to the average per capita spending across all regions, these grant differences from the average grant amount to 12 per cent of average spending and 38 per cent of average spending respectively. Most of the variation in per capita grant would arise from the regional variation in per capita spending; deviations in spending per capita would range from 12 per cent below the average in the East Midlands to 31 per cent above the average in Wales. By contrast, regional variation in the per capita tax base under a regional sales tax would be comparatively small; the tax base per capita would be at most 14 per cent below the average (in the West Midlands) and 8 per cent above (in London and the South East). In relation to average per capita spending, these correspond to differences in per capita tax base of 9 per cent and 5 per cent of average spending respectively, as in the fourth column.

With a regional income tax, some regions would have revenues in excess of their requirements to maintain current levels of spending; grant would thus be negative in London and the South East, the East Midlands and East Anglia. The largest positive grant amounts needed would again be in Wales - £633 per head. Both per capita

spending variation and tax base differences contribute to the regional variation in the amounts of grant required. Indeed, the contribution of tax base variation to the overall variation in grant payments is actually larger with a regional income tax than the contribution of spending variation.

With regional business rates, there is again considerable variation in tax base per capita; indeed, Table 4.2 showed that the distribution of tax base per capita is more uneven than with a regional income tax. However, in Table 4.3, the contribution of this tax base variation to grant differences is actually rather lower than with the regional income tax, because regional business rates would make a considerably lower total contribution to regional revenue than the regional income tax; as a result, variation in tax base has correspondingly less impact on the financial position of the regions, and therefore leads to correspondingly less variation in per capita grant (although the average level of grant is much higher).

#### 4.5 A regional income tax

The first possibility we consider for a source of tax revenues to be placed under regional government control - and, in many respects, the best available candidate - is income tax. Income tax raises substantial revenues - nearly £70 billion in 1995/96 - and even assignment of only part of income tax to regional government could provide regional authorities with considerable revenues and genuine scope to influence their level of resources through taxation.

How would a regional income tax measure up against the various criteria for regional taxation set out above?

- **Efficiency.** Introducing regional variation in income tax rates would give rise to incentives for individuals to seek to be taxed in areas with low rates of income tax; to the extent that individuals are able to move between areas and do not have overriding reasons to live in a particular area, a regional income tax might induce some population movements towards areas with low tax rates. These tax-induced migration flows would be likely to be limited, for two reasons. First, many people will have reasons to stay in a particular higher-tax region, despite the difference in taxation compared with other areas; these reasons may include employment opportunities, family ties, preferences for particular locations, etc. In the case of income tax differences between regions, these factors are likely to be of much greater importance than if there were differences in income tax rates between local government districts. A second factor limiting tax-induced migration is that, if significant numbers of individuals were to try to move, this would be likely to result in offsetting changes in house prices; since the stock of housing is largely fixed except in the very long term, a higher demand for housing in low-tax areas would bid up house prices in those areas; as a result, the gains from migration would be reduced. For both these reasons, migration in response to regional income tax differences might be expected to be relatively limited, although it might be rather greater amongst high-income individuals, who would stand to gain above-average amounts from moving.

The extent of migration could be further limited by appropriate design of the regional income tax system. First, the presence of arrangements for tax-base equalisation would prevent tax differences arising because of the divergence in per capita tax base between areas. Second, the tax saving that rich individuals could make by moving to low-tax regions could be 'capped' by confining the power of regions to set the level of taxation to the basic rate of income tax; the system would then have regionally-varying basic rates of income tax, but a single national higher rate. Third, it might be appropriate to limit the regions' choice of income tax rates within a defined range - such as, for example, plus or minus two percentage points around the existing national rate.

- ***Administrative feasibility and cost.*** Proposals for a local income tax in the UK have, in the past, had to confront a number of practical difficulties in devising arrangements by which the tax could be administered. Many of these difficulties arose from the particular features of the UK national income tax system, which makes extensive use of deduction-at-source arrangements to achieve an exact deduction of tax without the need for any contact between the tax authorities and the vast majority of taxpayers. It was not clear that tax rates varying according to a taxpayer's place of residence within the UK could be easily accommodated within this system, without substantial extra burdens on employers (who might have had to handle different rates of deduction for many different districts) and problems of administrative complexity in linking the deductions made on various forms of unearned income to individual taxpayers. Nevertheless, despite these problems, studies of the potential for a local income tax in the UK indicated a number of ways in which the tax could be administered, varying in the extent to which they made use of part or all of the existing apparatus of central income tax assessment and collection, and in the additional operations required (e.g. Layfield Committee, 1976; Kay and Smith, 1988; Isaac, 1992).

Many of the administrative problems that these studies had to tackle have been substantially eased by changes to the national income tax system, including the extensive computerisation of taxpayer records and the move to self-assessment. Some (including, perhaps, the burden on employers) would also be eased by the smaller number of different tax rates involved in a system of regional income tax, as opposed to local income tax.

It would still be necessary for a regional income tax to involve some form of taxpayer residence declaration, and for this to be processed and enforced; this would, however, be much easier than the analogous process of poll tax registration, since, as Kay and Smith (1988) note, many of the difficult cases for poll tax have negligible incomes, and the process of allocating a given list of national income tax payers between areas has a defined end-point, whilst poll tax registration involved looking for an unknown number of individuals in each area.

It would also be necessary to decide how far the existing deduction-at-source arrangements would reflect regional variations in tax rates. It would be possible to operate with a single rate of deduction at source from labour incomes, but at the price of introducing an end-year adjustment of underpaid or overpaid tax, reflecting the difference between the regional tax rate and the rate of source deduction; this would involve much more extensive contact between taxpayers and the Inland



Revenue than there is currently. It would also be possible to avoid introducing complexity into the arrangements for deduction at source on investment incomes, if the regionally-varying tax rate were only to apply to labour incomes; a system of this sort was, for example, advocated by Kay and Smith (1988).

- **Revenue stability and predictability.** Income tax revenues would have a considerable amount of stability, and would be broadly predictable over the annual budgetary cycle. Most revenues are collected by deduction at source from wages and salaries, and revenues thus follow trends in household incomes quite closely. The stability of revenues from a regional income tax would be increased still further if the tax were confined to basic rate incomes, since this would eliminate any effect from cyclical fluctuations in incomes subject to higher-rate tax. Comparing the forecast of income tax revenues for the year ahead made at the time of the Chancellor's Budget with the out-turn figures for the same period in three recent Budgets (1992/93 to 1994/95) shows an average absolute difference between forecast and outcome of less than 3 per cent.
- **Need for equalisation.** As the illustrative calculations in Section 4.4 have shown, a regional income tax would give rise to considerable need for equalisation due to regional differences in the per capita tax base.
- **Accountability.** A regional income tax could be made highly perceptible, for example by separately identifying the regional component in income tax assessments and requiring employers to identify the regional component in payroll deduction statements. Indeed, it would be possible for separate billing arrangements to be employed, although this would add to administrative costs and would not affect the majority of taxpayers, who pay income tax through PAYE and have no contact with the Inland Revenue.

The burden of income tax payments is spread reasonably widely through the population, whilst at the same time not so widely that some form of rebating would be required to avoid an excessive tax burden on poor households. Although there are some voters in regional elections who would not be income tax payers, and who would therefore not perceive any 'accountability' constraint on their voting behaviour through the regional income tax, these are, in the main, individuals whose payments of any regional tax would need to be low unless they were to experience undue hardship. In the case of the council tax, a considerable proportion of the electorate benefit from tax rebates, which are costly to operate, and for some voters these rebates reduce to zero their council tax payments.

- **Equity.** A simple transfer of all or part of income tax to regional government, with a corresponding reduction in the national income tax, would have equity implications (in the sense of effects on the distribution of household net-of-tax incomes) only in so far as regional governments chose to *change* the rate of tax. Then the burden of extra taxation, or the gains from reduced taxation, would be experienced by individuals according to the level of their taxable incomes. If income is taken as a reasonable yardstick of individual ability to pay for additional spending, there would be few distributional concerns raised by regional governments' decisions to vary their level of tax revenues. In comparison with other possible regional taxes with a

more regressive distributional incidence, there would be the advantage that a regional tax rebate system would not be needed to cover the costs for poor households of a regional government's decision to raise the regional tax rate.

More extensive distributional issues would arise if central government did not cut the national income tax to reflect the transfer of some income tax powers to regional level. If, instead, central government cut other taxes, the overall burden of income tax would rise, whilst the burden of other taxes would fall, and the distributional effects of assigning income tax to regional level would thus depend on the relative distributional effects of income tax and the taxes cut by central government. We do not consider this in any detail here.

- ***Impact on taxes of other levels of government.*** If only part of the current income tax were to be transferred to regional government, leaving the remainder as a national income tax, the income tax base would be shared between central and regional government. The policies of either level of government concerning income tax could, in principle, affect the other level, by affecting the size of the base available for it to tax. The regions, or central government, might be tempted to push the income tax rate beyond the point that would maximise their joint revenues, since their concern would be only with the extent to which they lost revenues through a reduction in the tax base, and not with the revenue loss experienced by the other tier of government.

It may, however, be doubted whether this should be seen as a major objection to a regional income tax. First, it is unlikely that there are major effects on the income tax base from changes in income tax rates; many taxpayers are not in a position to vary their working hours in response to a change in the income tax rate, although some groups (such as part-time workers, mainly women) may have greater scope to change their hours of work. Second, there are relatively straightforward things that could be done to limit destructive inter-tier interactions of this sort; for example, an upper limit to the income tax rate that the regional level could set would prevent it pursuing revenue maximisation to an extent that would severely damage the revenue interests of central government.

#### 4.6 A regional sales tax

- ***Efficiency.*** From the point of view of economic efficiency, the main issue that would arise if regional governments were to be given the power to levy a sales tax would be the effect of sales tax differentials in different areas on the geographical pattern of consumer spending and retail activity. Where people living in one region spend time and money travelling to a lower-tax region in order to benefit from the lower rate of tax on their spending, this has economic costs in terms of the opportunity cost of the resources used in making the 'cross-border' shopping trip. If, in addition, sales tax differentials induce some retail businesses to move to areas where tax rates are lower (but which would not be chosen if there were not the tax advantage), this may involve further tax-induced economic inefficiency.

The likely scale of such costs and inefficiencies arising from tax differentials between regions can be assessed, to some extent, from the range of evidence available on the implications of tax differentials between European countries, and between local governments and states in the US (Hall and Smith, 1995). Such cross-border

shopping undoubtedly takes place, but in the European context is largely driven by some very large differentials between countries in rates of excise duty on certain commodities such as alcoholic drinks and cigarettes, rather than by the much more modest differences in VAT rates between EU member states. Since the costs of cross-border shopping will tend to be a function of distance from the border, it is likely that routine cross-border shopping (except for high-value items or items with very large duty differentials) will tend to be greatest in border areas. Evidence from the Irish Republic on the pattern of cross-border shopping in the mid-1980s when there were large VAT and duty differences between Northern Ireland and the Republic indicates that cross-border shopping declined with distance from the border, and that the travel costs involved were of the order of some 40 pence per mile in 1987 (Fitzgerald *et al.*, 1988). This suggests that cross-border shopping would be unlikely to undermine the viability of sales taxes at sub-national level, so long as these were assigned to relatively large geographical units. Hall and Smith (1995), for example, suggest that with travel costs of £0.50 per mile a one percentage point sales tax differential between areas might divert about a quarter of sales worth £50 or more to neighbouring areas, if a sales tax were levied at the level of local authority districts, but that a similar differential with a tax levied at county level might divert only a tenth of such sales. With a regional sales tax, the proportion of cross-border shopping would be likely to be still lower, and the sustainability of interregional tax differentials correspondingly greater.

- **Administrative feasibility and cost.** As with regional income tax, a number of options for practical implementation might be considered. Hall and Smith (1995) discuss some possibilities, ranging from integrated administration of regionally-varying VAT rates through the national VAT system, to a supplementary regional retail sales tax, either integrated with national VAT or operated separately.

A fully-integrated system of regionally-varying VAT would raise issues concerning the operation of the VAT credit given to businesses for the VAT on their purchases of raw materials, components and other taxed inputs. Where a business purchases intermediate goods from a firm in another region, the rate of VAT credit appropriate for the purchased inputs would differ from the rate of tax to be applied to the firm's sales. This creates complications (concerning revenue allocation, enforcement and tax-setting incentives) that have also bedevilled the design of VAT arrangements for trade between firms located in different EU member states. At the very least, the multiplicity of VAT rates on intermediate transactions would be likely to increase administration costs for the VAT authorities and compliance costs for taxpayers, and could open new possibilities for evasion and fraud.

A supplementary retail sales tax would avoid the complexity of handling multiple rates of VAT on business inputs. The tax would apply only at the point of sale to final consumers. It would therefore be necessary for taxpayers to distinguish between sales to final consumers and to other businesses (and for the tax authorities to enforce this distinction); these would be new operations that would increase administration and compliance costs, and the creation of a new 'tax boundary' between untaxed sales to businesses and taxed sales to final consumers would create some new

possibilities for evasion. However, it is possible to see how such a supplementary tax might be integrated with VAT, in the sense that common definitions of taxpayers and tax base could be employed, and administration could be combined.

- **Revenue stability and predictability.** As with income tax, regional sales tax receipts would broadly track changes in economic activity, and would therefore be broadly predictable and quite stable from year to year.
- **Need for equalisation.** There would be considerably less need for equalisation to reflect regional differences in per capita tax base with a regional sales tax than with a regional income tax, as Table 4.3 in Section 4.4 shows.
- **Accountability.** A regional sales tax would probably be less perceptible than an income tax at regional level, if the tax burden were simply incorporated into product prices. On the other hand, the burden of a regional sales tax would be distributed more widely across the population than the burden of a regional income tax; individuals without any taxable income would none the less bear some burden of regional sales tax through their expenditures.
- **Equity.** The counterpart, however, to the wider distribution of the burden of the regional sales tax across the population is that a significant burden of sales tax may be borne by poor households. With the existing national VAT, the tax burden on poor households is presumably reflected in other elements of the tax/benefit system, especially in national social security rates. However, with regional or local sales taxes, equity issues arise concerning the burden of the tax in areas with above-average rates of taxation; this would not be fully compensated by the national social security scales, and may not be compensated either by service benefits (paid for by the higher taxes) of corresponding value to the households concerned. Regional sales tax rebates based on actual expenditures would be impracticable, but it is conceivable that regional differences in social security scales could be made to reflect the impact of regional sales taxes on the cost of living.
- **Impact on taxes of other levels of government.** If only part of VAT were transferred to the regions as a regional sales tax, the same issues of competition over the common base would arise as with income tax.

Further issues would arise concerning the compatibility of a regional sales tax with EU rules concerning VAT. The Sixth VAT Directive places considerable limits on the design and operation of VAT in member states, and other EU agreements place some limits on the rates that member states can levy. Certain aspects of a regional sales tax would therefore need to be negotiated with other EU member states, and whilst a regional sales tax along the lines we have suggested should not be a cause for EU concern, the need for EU agreement, and for some modification of existing EU rules, might be seen as obstacles to this option.

#### 4.7 A regional business rate

A third possibility for providing regional governments with a significant source of tax revenues would be to assign business rates to the regional level. Business rates are a

tax on the value of business premises ('rateable value'). They are a major source of tax revenues, raising some £13.6 billion in 1995/96, equivalent to some 5 per cent of total fiscal receipts.

Until the 1990 reforms to local government finance, business rate levels were under the control of local authorities. Since the 1990 reforms, a uniform business tax rate ('rate poundage') has been set nationally, and, although local authorities continue to administer business rates, the revenues are pooled and distributed to local authorities in proportion to their population. Business rates have become, in effect, a national tax, from which the revenues are earmarked to local government.

Business rates would have some important advantages as a regional tax. The tax base is immobile, evasion is relatively difficult and it would be very simple to allocate the tax base, and the revenues collected, to individual regional authorities. The additional administrative costs involved in operating business rates at regional level would thus be negligible. In addition to this, business rates would make a stable and predictable contribution to regional government budgets. The revenues raised from business rates can be predicted with considerable accuracy at the start of the financial year, because payments do not vary with the level of economic activity or business profits (except to the extent that partial or total business rates relief is given for empty properties).

Against these advantages there are also two major arguments against a regional business rate, concerning the possible impact of business rate differentials on business location decisions, and the effects of the lack of transparency of the tax burden on the accountability of regional government. These objections were also raised to local authority control over business rate poundages, and were the main reasons for the 1990 introduction of the uniform business rate.

- ***Efficiency (locational distortions)***. One objection to a system of finance that leads to differences in business rate levels between areas is that this could produce distortions in the geographical pattern of business activity and investment. Business activity might tend to gravitate towards low-rate areas, leading to inefficiency in business location and possibly to an increasing divergence between the tax base available to different areas.

The evidence from UK studies of the link between local business tax rates and investment, employment and profitability is somewhat mixed. Whilst the pre-1990 system led to considerable differences in the potential profitability of locating an investment in different areas, there was little systematic statistical evidence that business rates distorted the location of business investment and employment. Considerably greater evidence exists to show that such distortions have arisen from local and state taxes on business activity in the US. One reason, however, for locational effects being hard to identify is the very long time-frame within which they would take place. Recent research (Bond, Denny, Hall and McCluskey, 1995) shows that, in the short term, much of the effect of business rate differentials is absorbed in higher rents for business premises, and high business rates may thus not affect the profitability of the current occupant. Distortionary effects would then only arise in the long term, when new premises were being built. Even if the effects of tax differences were then large, they might be difficult to detect in relatively short-term data.

It is hard to assess what conclusions should be drawn from this evidence for the viability and desirability of a regional business rate. Since regional governments would cover larger areas than local authorities, there may be rather less scope for business relocation, and consequently relatively little risk of major locational distortion (except in the 'border' areas of regions and in the case of wholly-footloose businesses).

- **Accountability.** The 1986 Green Paper on local government finance argued that non-domestic rates were not an ideal local tax because they distorted the accountability of local authorities to their electorates. Giving local governments the power to levy taxes on business might reduce local accountability in a number of ways. First, business rates fall immediately on those who have no vote to influence local spending decisions. Second, business rates are ultimately borne by people who are unaware of how these costs arise and may not live in the area of the authority imposing the rate. This arises because businesses may be able to 'pass on' some of their local tax burden to workers in the form of lower wages, to customers in the form of higher prices and to landlords in the form of lower property rents. These individuals, whilst bearing some of the burden of the local tax, may have little or no connection with the local area. Third, business rates conceal the true costs of local services, and of marginal increases in spending, from domestic rate payers since businesses end up paying for over half of additional local expenditure which is primarily targeted towards services for the domestic sector. As a result, local electors do not face taxes reflecting the full costs of their voting decisions, and inefficient levels of local expenditure may result. Fourth, local variations in the non-domestic rate base require complicated grant arrangements.

All of these 'accountability' objections to local business rates would apply with similar force to regional business rates. As the sole source of tax revenues under regional authority control, these objections would count strongly against business rates. The defects of business rates in terms of accountability may, however, matter less if regional governments were to have control of other significant taxes, levied directly on households, in addition to business rates. Then the need for some measure of financial accountability to voters or taxpayers might be secured by the taxes levied directly on households.

The risk that regional governments might be tempted to load all of their revenue-raising onto the less-accountable tax might be avoided by, perhaps, requiring regional authorities to raise fixed proportions of their revenue from each of the taxes under their control, or to have some fixed relationship between the rates of tax applied to the different instruments (as used to be the case when local authorities controlled both business and domestic rates, but could not vary the balance between them).

## 5 Conclusions and further issues

In this chapter, we return to the 'key questions' that we set out at the start of the report, concerning the 'shape' of regional government and its fiscal consequences. We summarise our conclusions under each heading:

- *What are the economic considerations in designing a system of regional government? What public expenditures and legislative functions might be better exercised at regional level rather than by Westminster and Whitehall, and what needs to be retained by central government?*

We have argued that the assignment of functions to regional governments could be used to pursue two, somewhat different, basic objectives.

One would be for regional governments to take over functions of government that would have significant *policy spillovers* between areas if performed by smaller administrative units. Regional transport planning and co-ordination would be an obvious candidate for assignment to regional governments on this basis.

A second objective would be to use regional government to *separate out 'choice' and 'agency' functions performed by sub-central government*, so that local governments could, as far as possible, be left with a portfolio of responsibilities in which local choice was important and the need for central government control unimportant. This might point towards transferring social services and education upwards from local government to the regions, and perhaps health service responsibilities downwards from central government to the regions. Regions would then function as the central government's 'agents' in implementing nationally-determined policies; they would aim to exploit the informational advantages of decentralisation in the management of these large-scale services. However, in implementing central policies, it would be appropriate for the regions to be subject to considerable control and guidance from central government; they would operate in a much more restricted constitutional and fiscal environment than decentralised government units that were intended to provide regions with a genuine power to make independent decisions about service patterns and levels.

- *If some existing central government expenditure functions are decentralised to regional government, how uneven will be the pattern of regional spending per head that the regional governments will inherit? Are these differences desirable in a decentralised system, and are they sustainable?*

If all existing central government services that can be identified as benefiting a particular region are assigned to regional government, regional governments would take over responsibility for a very large proportion of total public spending. There would be considerable variation in public spending per head between different regions. The highest levels of per capita public spending are in Wales and Scotland, which currently benefit from higher public expenditure than English regions with comparable economic conditions.

Although the figures are not wholly comparable, per capita spending in Wales on public services (including social security) is some 16 per cent higher and spending in Scotland some 22 per cent higher than in England, whilst spending in the northern and north

western regions of England is only some 7 per cent higher than the average for England. Some, but by no means all, of these differences can be attributed to differences in social security expenditures.

For reasons we set out below, we suspect that these differences might not be wholly sustainable in a decentralised system, if this were to involve explicit financial transfers between regions that expose, more clearly than at present, the scale of the spending differences between regions.

- *How should regional government be financed? Does it make any sense to consider regional government without tax-raising powers of its own?*

If regional governments are to function as genuine democratic units, with the power to make free decisions concerning the level and pattern of public services, they will need to have access to some form of tax revenues under their own control. Reliance on fiscal transfers from central government will undermine the ability of regional governments to make their decisions free from central influence.

However, if the main purpose of regional governments is seen as decentralising some major services to a lower tier, charged with implementing centrally-determined policies, then a source of independent tax revenues for regions would be unnecessary, and could be positively undesirable.

- *If the regions are to levy their own taxes, what taxes could they be given? What would be the administrative problems in decentralising income tax or VAT, for example?*

We suggest that there are three principal candidates for regional taxes: a regional income tax, a regional sales tax and a regionally-varying business rate. We argue that the former is to be preferred, because it is least likely to lead to major locational distortions (especially if the regional power to vary tax rates is confined to the basic rate), and because it is more transparent in its burden and incidence than either a regional sales tax or regional business rate would be, and hence might better promote accountability. Whilst 20 years ago, at the time of the Layfield Report, administration of a local income tax would have involved considerable administrative complication, it is unlikely that there would be major administrative difficulties in operating a regionally-varying income tax now, although it would be necessary to incur the additional administrative cost of registering the place of residence of each income tax payer.

- *What would be the scale of the redistribution in the overall burden of taxation, if regions were wholly dependent on their own taxes to pay for their spending? What pattern of grants from central government to the regions would be needed in order to avoid massive regional gains and losses?*

It would be possible to sustain the higher levels of public spending in certain regions in one of two ways. One is that they could set higher tax rates than other regions. Our calculations show that if all of the cost of the additional public spending in Wales and Scotland were to be loaded onto a single regional tax, it would result in very large variations in tax rates. The resulting differences in tax levels might be uncomfortable, but might not be unsustainable from a purely economic perspective - we suspect that interregional mobility of the three tax bases we discuss (especially between England, Wales and Scotland) would not be high, even with quite large tax differentials. However,



loading the variation onto a single tax would be unwise; spreading the costs of spending differences across a number of large tax bases would reduce the extent of variation in tax rates between regions in any one of the taxes, and hence would be liable to limit the incentives for mobility compared with the single-tax case.

An alternative way of sustaining public spending differences with regional decentralisation would be for central government to provide equalising grants to finance the spending differences, without allowing tax differences to emerge. In effect, these grants would be the explicit counterpart of the implicit financial transfers within the present UK public expenditure and tax system. Our illustrative calculations show that the equalising grant flows needed to maintain constant tax rates across regions would be substantial. It is quite possible that when the scale of these flows is made explicit, they will not attract the same public consent as the implicit transfers currently have. This would imply that decentralisation could substantially worsen the position of areas that currently benefit from fiscal transfers through the UK tax and public expenditure system, by making the public unwilling to maintain these transfers at the present level.



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