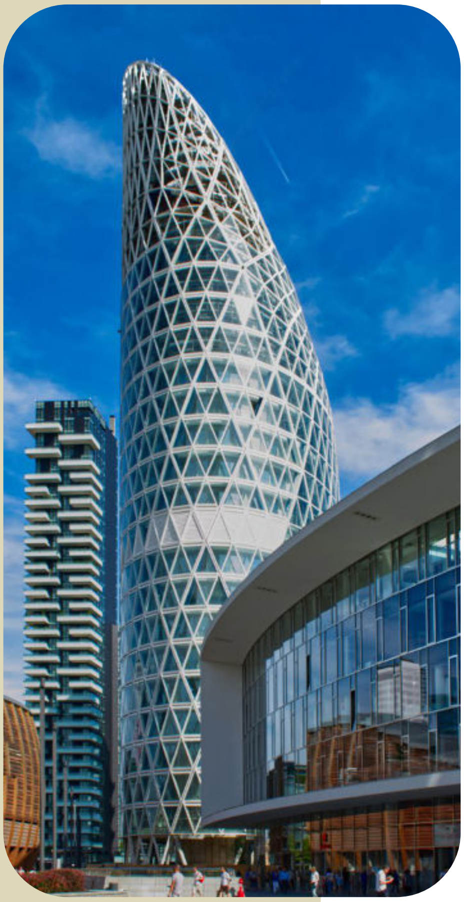
LGiU

Learning from local government finance across the world:

Proposals for improving the financial resilience of local government in England



LOCAL DEMOCRACY RESEARCH CENTRE

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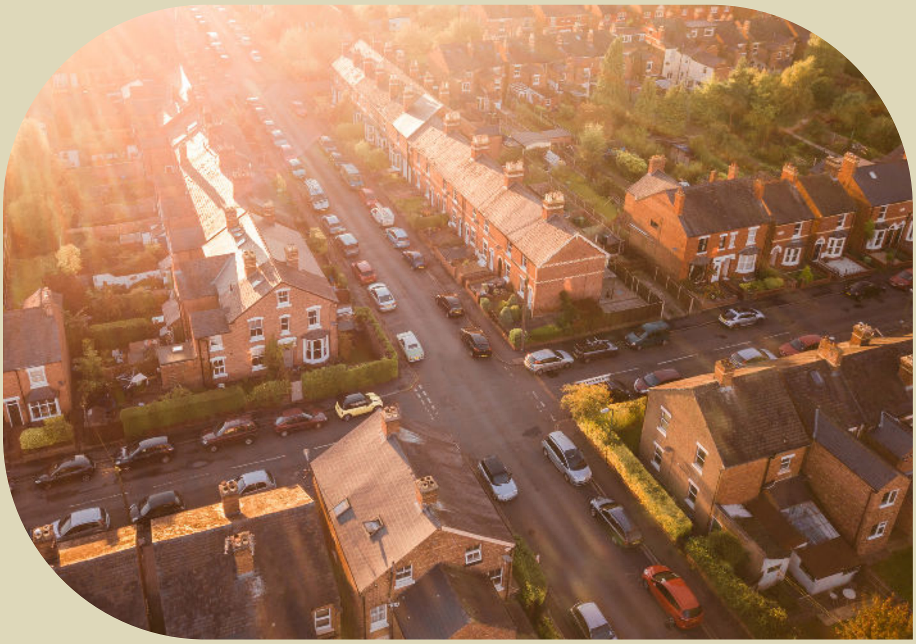
Foreword

Over the last ten years, the evidence that there has been a major sustained failure to properly fund local services in England has become undeniable. We know local government finance in England is broken, the next question is: how can we fix it? To answer this, the LGIU's Local Democracy Research Centre has worked together with a team of experts, led by Professor Kevin Muldoon-Smith at the University of Northumbria, to see how other countries have managed it.

The proposals in this paper, together with the LGIU@40 manifesto, are all important, practical steps that governments in countries like Japan, Germany and Italy have taken to make local government funding more sustainable and resilient. Other places have tackled sustained failures in local government finance with the imagination and seriousness that the delivery of essential services, and the health of democracy at the local level, warrant. It's time we did the same.

Jonathan Carr-West,
Chief Executive, LGIU (Local Government Information Unit)



Introduction

In England there has been continual discussion in recent years about how the financing of local government works. Particular attention has been devoted to options for fiscal devolution; funding shortages, originating in the UK Government's 'austerity' policy of the early 2010s; and controversies over large-scale borrowing, resulting in a small number of English local authorities experiencing severe financial difficulties. This situation has been brought into sharp relief in recent months as more local authorities issue Section 114 notices (bankruptcy in all but name). The Local Government Association (LGA) reported towards the end of 2023 that one in five local authorities are at risk of entering the same situation in the near future (LGA, 2023). However, the problems of local government finance are relatively well trodden (see the work of Gray and Barford 2021, IFS, 2023). What we are currently seeing is the reality of pressures on the local government finance system coming home to roost. What is less common are systematic accounts of how the local government finance system in England can be reformed – something that is acutely needed in the current local government climate.

It could be tempting to regard widespread financial failures in local authorities as a minor inconvenience in a large and complex system of national government. However, local authorities have broad responsibility for public services and for the wellbeing of their local populations. If they stop working, or lose capacity, at scale, the impact will be felt across the government policy and delivery – and from the electorate. This is an incentive for the government elected at the next General Election to have a plan in place to address this issue rapidly and effectively.

Existing analyses of these situations typically focus on a single element of the finance system, rather than a wider connected system approach to local government finance. For example, considerations of the local authority take place without consideration of its relationship with central government, or local government autonomy is sought without consideration of equalisation between location. The objective of this research is to counter this situation by placing local government finance in England in a wider perspective of international best practice.

The initial research focuses on Germany, Italy and Japan. It considers the functions of local authorities; capital finance and its regulation; audit and budgeting practice; funding redistribution and socioeconomic variations; and the often-uneven culture of central-local relations. The aim is to then use this valuable insight to consider how the local government finance system in England can be made more resilient and how turn around management can be delivered.

The main overriding finding from the international investigation is that the provision of public services, and their financing, is a partnership effort by central and local government based on proportionate financing, clearly funded mandates, supported by a meaningful system of equalisation between locations to account for uneven development.

Proposals for improving the financial resilience of local government in England

The following four proposals, based on interim findings from the first three study locations (Germany, Italy, and Japan), set out how these findings could be applied to England. These proposals are:

1. Rework the local government needs assessment [the Fair Funding Review].

2. Establish a systematic form of territorial equalisation between local authorities.

3. Establish a standing commission, akin to the 'English Devolution Council' proposed by the Institute for Government.

4. Develop a long-term programme exploring assigning national tax revenues to local authorities.

These proposals have been developed mindful of key characteristics of the UK's short- to medium-term political context. First, money is likely to be in short supply – and 'new taxes' are always unpopular – so the proposals provide for more effective use of existing funds. Second, moving from a top-down central-local relationship to a more partnership-based polity is a large and unfamiliar step for the British political system. New sources of funding will generate effects across the local government system: for this type of change to endure, those effects must be acknowledged. This calls for consensus and trust and cautions against wholesale change in the short term.

1. Rework the local government needs assessment [the Fair Funding Review]

Germany, Italy, and Japan all have a mature and detailed process of needs assessment. In England, needs assessment has been suspended since the introduction of business rate retention in 2013. This system was designed to include regular 'resets', where needs would be reassessed, but these have not taken place so far.

The Government launched a 'fair funding review' in 2016, but this has not progressed since a consultation in 2018. The fair funding review would have reassessed a range of indicators of local need and taken decisions about the relative weighting of those indicators.

If this process were completed, it would lay the ground for redistributing funds between local authorities more closely in line with an assessment of need. The dynamics of the business rate retention scheme would mean that funding would then diverge from the needs assessment over time, in line with local rate revenues, pending a further needs assessment in the future.

The reach of the Fair Funding Review could be extended to apply it to specific grants within the Local Government Finance Settlement (LGFS) as well as (Revenue Support Grant) RSG / (Settlement Funding Assessment (SFA). These totalled £7,855m in 2023/24: RSG is £1.905m. The general grants listed in DLUHC's local growth and place fund register could also be included. This would add some £3.5bn per year to the total funding available. Many of these funding sources are already distributed by reference to indicators that have formed part of the general needs assessment in the past. This could continue within the broader Fair Funding Review.

These changes would improve the current situation of unfunded mandates and bring England more closely into line with best practice overseas.

At the same time, it would be possible to simplify the range of indicators used substantially, and to simplify the needs assessment's 'four-block model'. Proposals for both these changes were set out in the paper Reforming local authority needs assessment, produced by LG Futures for the then HCLG Committee in the House of Commons in 2017. This would go a considerable way to simplifying the funding system, and making it more transparent and related to relative need between local authorities.

What would this achieve?

- This change would substantially reduce ring-fencing and 'bid culture' within the central-local relationship, consolidating all or most funding into a single amount.

- It would remove most of the bureaucratic overhead on local authorities required to account separately for spending funding sources.

- It would remove the incentive for cash-poor authorities to apply for funding for projects that do not reflect their requirements, as they would have greater latitude over the use of funds.

- This would ensure that funding reflected changes in population and need between authorities since 2013. Including additional funds in the scope of the needs assessment would enable the smoothing of the impact of these changes on individual authorities.

2. Establish a systematic form of territorial equalisation between local authorities.

England is an outlier in not having a systematic form of territorial equalisation, that ensures solidarity and parity in needs-based revenue between location. Germany, Italy, and Japan all utilise forms of vertical (central to local) and horizontal (between location) redistributions of major income streams (including elements of personal, company, consumption, and asset taxes) that ensure that all location have access to resources.

What would this achieve?

- A system of equalisation based on sound needs assessment would help remove the risk of increased Section 114 notices. In particular it would help to give local authorities more certainty in their budget position which will give more room for manoeuvre and allow for future planning.

- It is important that the system of equalisation is not ring-fenced – the funding within the equalisation systems in the international locations is not ring-fenced and this results in individual local authorities having significant discretion over large quantities of income.

- Such a system of equalisation recognises that all locations do not have access to buoyant local income streams and opens the door to all locations being able to take part in devolution and some form of local decision-making and accountability. This is the essence of embedded resilience – fiscal autonomy is not a panacea for resilient local government finance, although it is often taken as an article of faith in the England debate. Without equalisation, autonomy only benefits those locations with buoyant income streams and relatively low demands upon service. In order for all locations to have a stake in fiscal resilience, local powers of action and decision-making need to be embedded within and supported by structures of active intergovernmental cooperation and interstate relations.

3. Establish a standing commission, akin to the 'English Devolution Council' proposed by the Institute for Government and a light touch assessment of performance.

A proposed one-stop, regular discussion forum for local authority representatives and the Government. It would be a pro-active vehicle for consultation on government proposals, raising of emerging issues, negotiation of financial agreements and mediation of conflict. This would form an essential pillar of a more developed settlement, or concordat between local and national government. As well as the situations in the countries within the current study, Scotland's recent Verity House agreement provides an interesting example close to home, while Australia and New Zealand are going through similar processes of review and settlement at the time of writing.

Delivery and purpose

- Germany, Italy, and Japan all have comparable institutions that are well-resourced, embedded, and respected. Such institutions practise intergovernmental co-ordination and strengthen relationships between the tiers.

- As with the UK's intergovernmental relations machinery, a possible structure would be a main forum complemented by a series of subject committees, which would include attendance from a broad range of government departments.

- There is significant demand throughout the sector for a formalised approach to the representation of local government in national policy and structured dialogue between local and national policy makers.

- The commission would provide a one-stop shop for central departments and public bodies looking to engage with localities and/or with the sector in order to design and implement policy.

- The commission would provide a forum to discuss matters such as local taxation, grants and needs assessment, and financial management. It could debate and formally or informally sign off a new needs assessment approach.

- The commission would be likely to save resources by applying expertise to emerging (and emergency) policy. Subjects covered need not be restricted to local government responsibilities: they might include, for instance, matters such as water, immigration pressures, health services.

- In tandem with the commission, move towards a light-touch system of assessing local government performance against outcomes, to complement entirely un-ringfenced funding for local authorities. This system would consist of a small number of sophisticated and clearly thought-out outcome metrics and could be operated by an independent iteration of the new Office for Local Government (OFLOG). It would function as an early warning system for financial or delivery failure. This change would serve as a rebooting of the central-local relationship, which has been dogged by conflict in recent decades. The Italian local government finance system operates a similar system which is, in part, based on the Comprehensive Performance Assessment deployed in England in the early 000s. In response to local authority insolvency, enhanced financial reporting, early warning signals and improvement plans are also now a proactive part of the local government finance system in Japan, targeting even the smallest signs of distress via a yellow (approaching distress) and red card (in distress) procedure.

- Consider an approach to confirming that local authority budgets comply with legal requirements. In Japan, Germany and Italy, extensive income from shared and local taxes is complemented by regulation of local budgets and voluntary restrictions on borrowing. This would provide reassurance to the Treasury that a more flexible system of finance could be scrutinised. Internationally, this type of assessment is managed by an independent body (typically a 'court of accounts' or constitutional court), not by the central government. OFLOG could be well placed to undertake this role. In the vast majority of cases the assessment is a formality. This type of process could be expected to pick up, for instance, the mis-allocation of minimum revenue provision within local authority budgets, which has featured in a number of the recent decisions to issue a section 114 notice.

4. Develop a long-term programme exploring assigning national tax revenues to local authorities.

- This would acknowledge that the demands for 'more taxes for local government' often focus on options (for example Tourism Tax) that attract minor amounts of extra revenue;

- It would also acknowledge that the basket of local revenue sources is limited compared with other countries, with comparative over-reliance on property taxes that have long operated at the boundary of legitimacy (due to high rates and increasingly complex methods of valuation);

- Assigning national tax revenues has the benefit of not comprising 'new taxes' or 'increasing taxes' at the local level. For example, in Germany, localities receive shares of national income tax and VAT revenues but they do not have powers to raise an additional rate;

- Assigning national taxes to the local authorities also removes the over-reliance on local sources of revenue, which can be cyclical and uneven between location;

- Establishing and agreeing any system would take the bulk of a parliamentary term (in Scotland, shared VAT receipts took four years from conception to implementation). A first parliamentary term would be used to advocate and bed in the concept.

- It is crucial that the process is developed in partnership with representatives from various tiers in local government.

The taxes involved:

- A fixed percentage of the revenue from one or more national taxes would be assigned to local government as a whole. Revenue could be assigned from one or more of income tax, VAT, employers' National Insurance, corporation tax, vehicle excise duty, apprenticeship levy, and stamp duty. The revenue would then be distributed according to the needs assessment developed at stage 1 of these proposals. (The needs assessment could be adjusted if further powers were devolved to local authorities, and commensurate extra tax revenue were made available.)

- Areas could be permitted to keep a proportion of increased revenue against a baseline, in the manner of business rate retention. However, the role of revenue incentives should not be overplayed: there is little evidence that it plays much role in our international case studies while it tends to reward buoyant economies in England;

- A selection of current grants would be discontinued, to offset the additional income available. Examples might include the range of smaller grants from the LGFS (noted above), and allied funds such as the Public Health Grant and Better Care Fund.

What would this achieve?

- Access to substantial and sustained sums of money would increase local government resilience. Predictable revenue levels would enable local authorities to plan long-term with greater confidence. This will be a substantial gain in an environment where financial strain has been the norm for many years, and it would address long-term demands for multi-year financial settlements for local authorities. Sustainable finance is a necessary condition for confident and resilient local public service provision;

- Access to a broader basket of taxes would open up the potential for more discretion at the local level, and a parallel reduction in centrally determined ring fencing;

- The system can be future-proofed to allow for some degree of incentivisation for local authorities to improve economic conditions and benefit from increased revenues; and/or for additional local tax rates to be charged. Establishing the joint principles that local government is a part of the national delivery of public services, but that it also has an independent democratic mandate.

Inevitably, all of these proposals cannot be delivered at once. As well as presenting these proposals within the recognised context of a broadly constrained local government finance system – these proposals are also presented in pragmatic order. The reworking of the needs assessment logically comes first, to acknowledge changes in local demands upon finance and available resource. Not having this in place in England makes it a significant outlier in the international community. This is then followed by an efficient means of territorial equalisation and the development of a standing commission to manage, in collaborative fashion, the relationship between scales of government and related interests – all three locations have a meaningful forum for proactively working through inevitable financial challenges in tandem with assessment of performance and scrutiny of financial returns to ensure overall financial certainty in government system. This stands next to a longer-term programme of exploring the assignment of national tax revenues to local authorities – inspiration can be taken from the Trinity Reform in Japan during the early 2000s that laid out the legislative framework for reworking the Japanese local government finance system around principles of sub-national financing. Taken together, these principles indicate how financial resilience and meaningful discretion and autonomy can be embedded in local government working.

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About the Local Democracy Research Centre and LGIU

The **LDRC** was set up by LGIU (Local Government Informaiton Unit) to investigate the things that matter to our members and to local government around the world. We bring together experts, policy makers and academics to do practical research on some of the biggest challenges for the sector and to shape the future of local democracy.

The **LGIU** – Local Government Information Unit – is a not-for-profit, non-partisan membership organisation. We are for local government and anyone with an interest in local democracy and finding local solutions to the challenges that we all face. Councils from across the UK, Ireland and Australia are supported by our full member benefits, including in-depth policy analysis and other resources, innovative research and local government training. Our new Global Local subscription service now brings colleagues from other countries into the LGIU community.

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