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Sub-national funding arrangements and fiscal equalisation in the United Kingdom

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Oxford University

@TheIFS

Welcome

- Institute for Fiscal Studies is the UK's leading microeconomic and public finance research institute

  - Tax, social protection, labour markets, consumption, saving health, education, development and more…

- I help lead to areas of work

  - Sub-national public finance in the UK

  - Taxation in low- and middle-income countries

- TaxDev programme partnering with 6 countries – including Nigeria's Federal Ministry of Finance

What we'll cover

- Funding arrangements for the nations of the UK

    - UK government is the English government

    - Asymmetric arrangements for different nations

    - Difficulty of reforming flawed systems

- Funding arrangements for English local government

    - Aim to account for variation if needs and own revenue capacity

    - System was allowed to atrophy leading to

    - Political will has enabled reform – but compromised it too

- Lessons from our (at best) mixed experience

Funding arrangements for the UK nations

Nations of the UK

Scotland

N Ireland

England
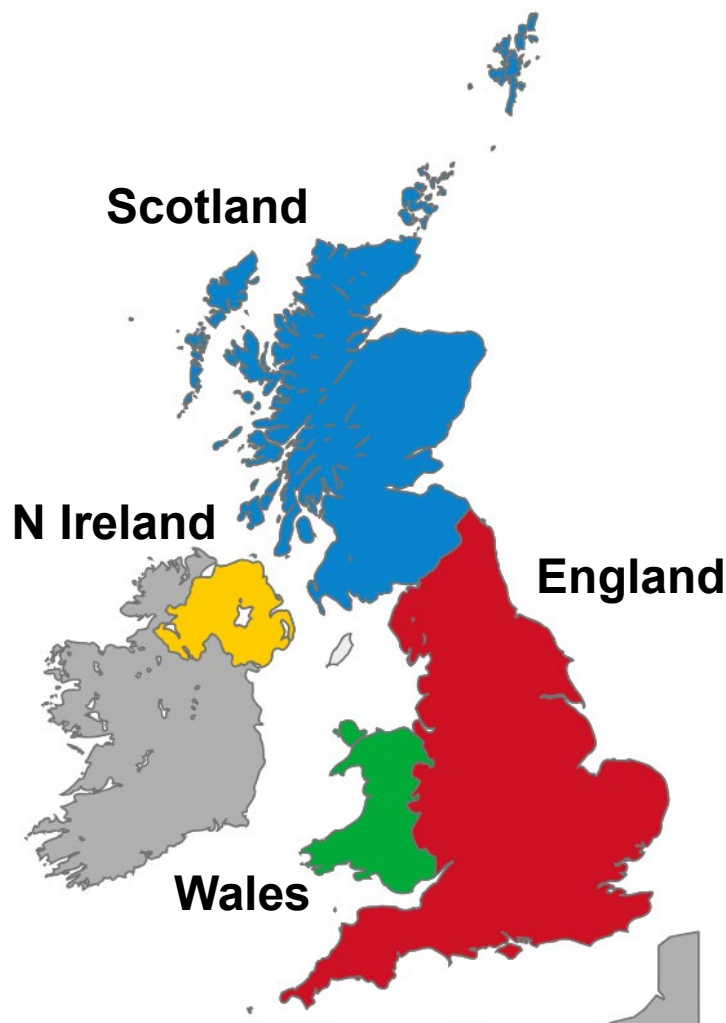
Wales

- The UK government IS the English government

- Scotland, Wales and Northern Ireland have own governments, responsible for some areas of public policy and spending

- Funded by transfers from the UK government and their own revenue sources

- Arrangements differ by nation – asymmetric devolution

- Reflects history and politics – and a little economics

Block grant funding from UK

- Largest single source of funding for each nation

    - Intimately tied to planned spending in England via Barnett formula

| Block grant in year (t) | = | Block grant in year (t-1) | + |

(Change in planned comparable English spending x Population share relative to England)

- Arguments about what counts as 'comparable' spending

- No account for differing funding needs or population growth

| Block grant in year (t) | = | Block grant in year (t-1) | + |

(Change in planned comparable English spending x Population share relative to England x 'Special factor' 1.24 (N Ireland) 1.05 (Wales))

Devolved revenues

- All nations determine and retain local government taxes

    - Largely property taxes, new 'tourism' taxes

- Powers over other taxes vary

    - Scotland has the most (inc. most of personal income tax)

    - N Ireland the least (long-distance airline tax)

        - Consideration given to corporate income tax to compete with the Republic of Ireland

- Unusual revenue equalization and insurance arrangements

    - Full equalization at the point these powers were devolved, and against UK-wide shocks

    - No equalization of subsequent changes in revenue capacity or nation-specific shocks

Borrowing

■ Borrowing powers are highly constrained – UK government does vast majority of borrowing on behalf of whole of the UK

■ Devolved nations can borrow (up to modest caps) for

- Forecast errors for their devolved taxes

- Capital investment

■ Why not grant them more borrowing powers?

- Fairness – there are no England-only borrowing powers, so unfair of other nations have unlimited extra borrowing on top of what UK government borrows on their behalf

- Politics – UK is worried devolved governments will borrow to influence elections, and Scottish independence debate

Key lessons

- UK set-up is very unusual – direct lessons for Nigeria are limited but there are some broader lessons

1. Hard to reform unfair or inappropriate arrangements once in place

   - Barnett formula was meant to be temporary but has been retained (with ad-hoc adjustments) due to Scotland

   ➜ Important to 'get it right' when reform opportunities do arise

2. Politics will inevitably play a role, esp. where different regions have differing bargaining power

   - e.g. Scottish independence

   ➜ Need a strategy to respond to that when designing system

3. Need clear sense of what differences and risks that regions will be equalized for and insured against

   - Spending & revenue? National shocks & idiosyncratic shocks?

   ➜ Agree a clear set of principles for the funding system

Funding arrangements for English councils

English local government

- Responsible for (some) schools, social care, public health, refuse services, housing support and advice, and other local services..

- Some areas have one council (unitary), others have two-tiers (county and district)

  - Unitary areas range in population from 30,000 to 1.2 million

  - Government thinks 0.5 million is ideal size (limited evidence)

  - New tier of "regional" mayors and authorities focused on economic development, adult skills & transport

- Funded through a combination of

  - Central government grants (vertical equalization)

  - Fees and charges for some services (vertical equalization)

  - Residential property taxes (vertical equalization)

  - Business property taxes (horizontal equalization)

Short history of council funding

- From mid 20th century, a complex system to assess councils' spending needs and revenue-raising capacities and allocate central government funding accordingly

- Reforms in the 2000s to make this system less transparent and more subject to ministerial discretion

  - Councils didn't like the spending needs assessments being seen as spending 'targets'

  - UK Ministers wanted more flexibility to allocate funding

- By early 2010s system had broken down

  - Much bigger cuts to funding in poor areas when funding cut

- Major reforms in 2013 ended needs and revenue assessments, with a greater focus on local business property tax retention

Balancing objectives

Redistribution

Insurance

Consistency

Incentives

Responsibility

Discretion

Problems and solutions?

- Funding levels increasingly arbitrary

- No account of differential population growth let alone other changes in local area characteristics

- Government recognized that a bigger focus on incentives did not mean abandoning assessing needs and revenue-raising capacity

- In 2016 brought together working groups of central and local government, and public sector accountants to discuss principles and design architecture of new system

  - Updated needs and revenue assessments

  - Fiscal incentivization schemes

  - Potential new responsibilities

  - A funding system to bring this all together

Challenge: assessing needs

- Spending needs cannot be observed – must be estimated/assessed

  - This process is inherently subjective

  - Estimates can be prone to circularity

Spending → *Geographic & demographic characteristics* → **Assessed spending needs** → **Funding** → **Spending**
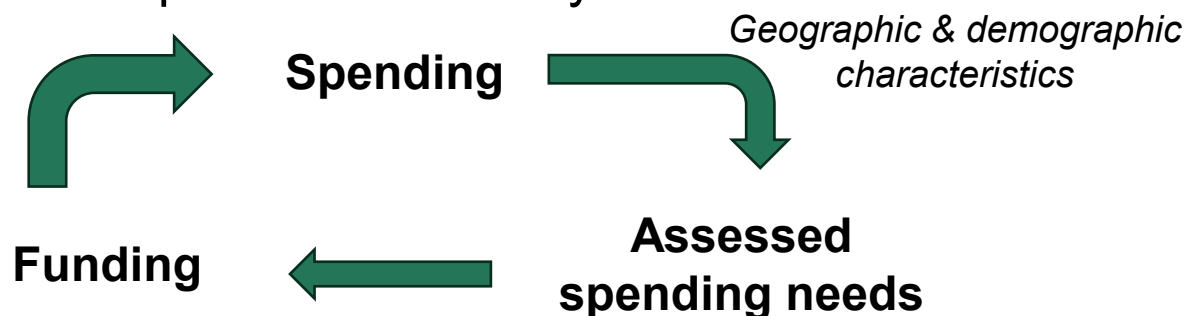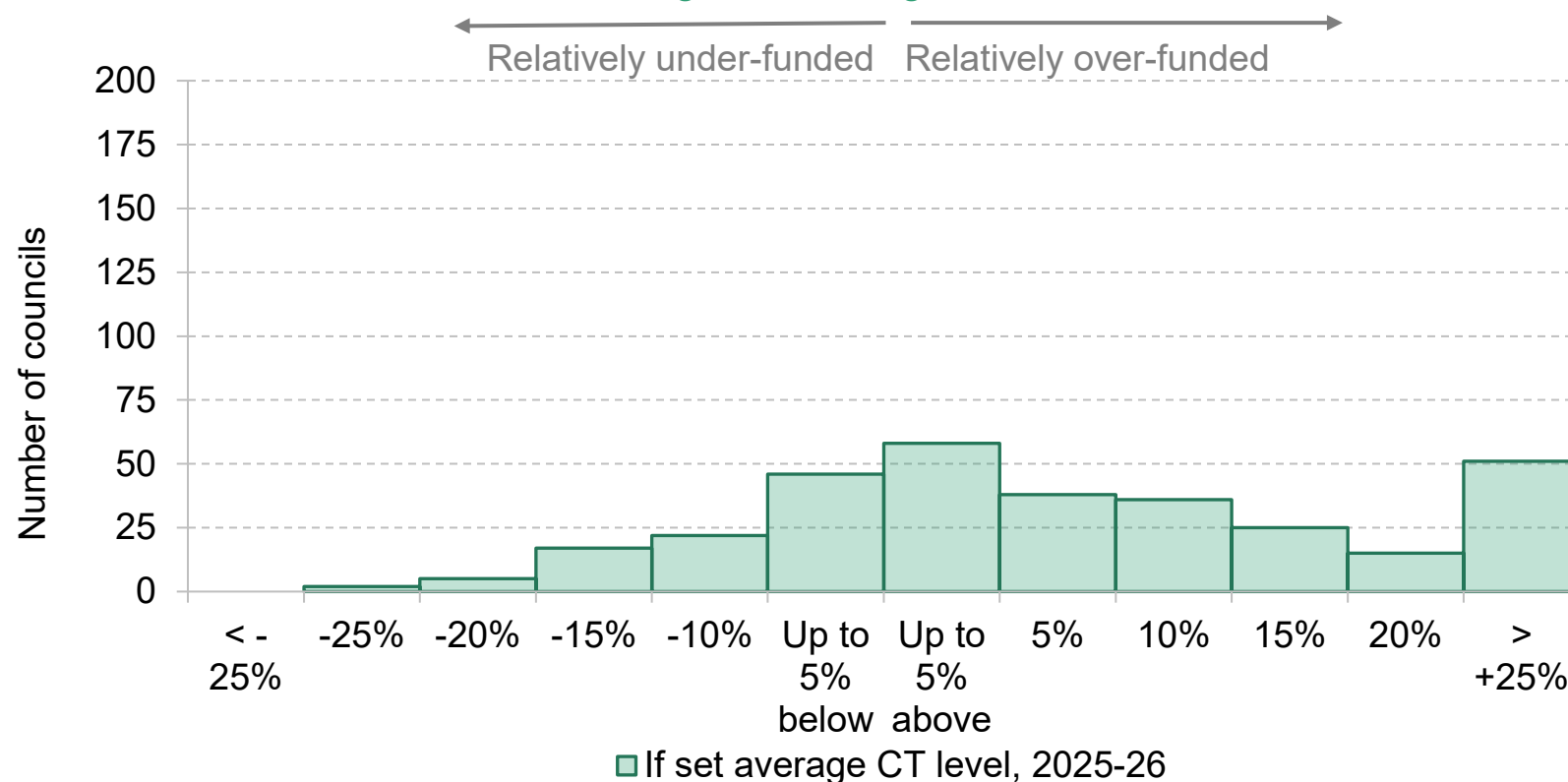
- Can use sub-council variation in spending to help avoid this problem

  - But requires granular data on spending

  - Doesn't solve problems entirely

Challenge: moving from status quo

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- Breakdown of equalization system and changes in local characteristics means funding was far from assessed needs

Distance between share of funding <u>with average CT</u> and share of assessed needs

← Relatively under-funded | Relatively over-funded →

Number of councils (y-axis: 0, 25, 50, 75, 100, 125, 150, 175, 200)

x-axis categories: < -25%, -25%, -20%, -15%, -10%, Up to 5% below, Up to 5% above, 5%, 10%, 15%, 20%, > +25%

☐ If set average CT level, 2025-26

Estimated CSP if CT level was in line with assumed notional level by type of council, rather than actual level set in 2025-26 or assumed level set in 2028-29. Excludes City of London, Isles of Scilly, fire and combined authorities.

Sub-national funding in the UK

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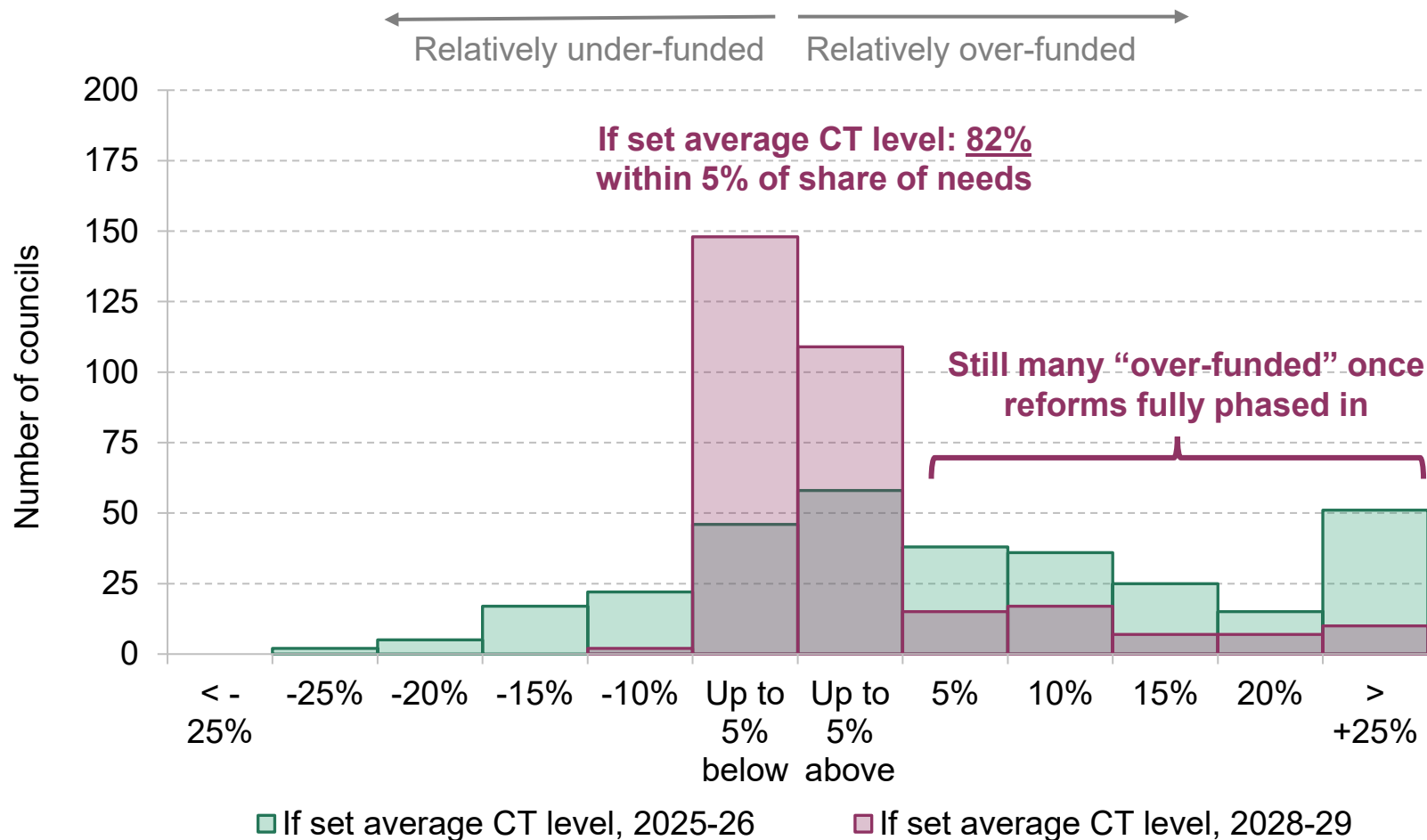
Breaking the deadlock

- Process for designing new system started in 2016

  - But after repeated delays no agreed plan by 2024 when government changed

- New government rapidly committed to reform with key principle to align funding with assessed spending needs

  - Consulted on principles in late 2024 / early 2025

  - Consulted on more detailed design in summer 2025

  - Less co-working with local government than previous approach

- New system to roll out from April 2026 and will result in major changes in funding for different councils

Key aspects of new system

- Updated assessments of spending needs and revenue raising capacity for all services bar public health

  - Aim to fully account for these (100% equalization)

  - Spending assessments use sub-council data where possible

- Aim to balance redistribution with incentives

  - Only update needs and revenue assessments every 3 or 6 years

  - Partial retention of local business property tax growth until horizontal equalization is reset

- Transition to the new funding allocations over 3 years

  - Funding floors for those facing the biggest cuts in funding

  - Councils serving poor areas allowed to retain 'temporary' top-up funding originally introduced in 2025-26 as a stop-gap measure

Big shift in funding – closer to 'needs' **IFS**

Distance between share of funding <u>with average CT</u> and share of assessed needs

← Relatively under-funded   Relatively over-funded →

**If set average CT level: <u>82%</u>
within 5% of share of needs**

**Still many "over-funded" once
reforms fully phased in**

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Key lessons

1. If equalization system atrophies, funding becomes arbitrary

    - Many councils with funding over 20% different from 'needs'

    ➔ Keep equalization system well-maintained

2. Funding system design inherently subjective and political

    - e.g. service expectations, redistribution versus incentives

    ➔ Clear principles needed (linked to constitution & citizenship)

    ➔ Strategy for dealing with politics

3. Data and technical capacity will determine needs and revenue capacity assessment approaches

    - e.g. statistical analysis, judgement-based etc.

    ➔ Careful balance between simplicity and potential 'accuracy'

Final lessons

Key lessons

- Difficulty of reforming funding arrangements, even if clear problems – get it right when you have the chance

- Importance of a clear set of principles underpinning system

    - There are trade-offs between these

- Inherently subjective and political nature of funding systems

    - Build politics in or try to design it out

    - Needs to align with constitutional and political reality

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