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Financing Regional Government in the UK: Some Issues

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I. INTRODUCTION

Over the last decade there has been a resurgence of interest in the possibility of some measure of devolution to regional governments for at least parts of the United Kingdom. In Scotland, the debate has been particularly advanced, and three of the four main political parties in Scotland are committed to substantial devolution. As in the unsuccessful devolution proposals of 1979, the proposals for Scotland are echoed by similar, though less unequivocal, devolution proposals for Wales. Devolution in England has attracted less enthusiasm, and much less vigorous debate, except in a few regions, notably the North East.

Regional government raises a number of finance questions, which are the subject of this paper. The issue of finance has been most prominent in the debate over devolution in Scotland, with intense interest focusing on, at one extreme, the fiscal position of Scotland if it were wholly dependent on Scottish tax revenues to finance Scottish expenditures, and, at the other extreme, on the adequacy and/or effects of giving a Scottish Parliament power to vary income

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tax rates within a three percentage point band. There has been much less discussion of other finance issues.

This paper aims to contribute to a discussion of the appropriate basis for financing regional government in the UK.[2] Section II provides a brief overview of the regional structure of governance in the UK at present. A central theme of the paper, set out in Section III, is that financing questions cannot be considered independently of the purpose that regional government is intended to serve. The role envisaged for regional governments will determine both the scale of the resources they require and the extent to which they, themselves, should exercise control over the level of resources they receive. Following on from this discussion, Sections IV and V then consider issues concerning the financing of regional government through fiscal transfers from central government and through regional taxes, respectively. A concluding section summarises a number of key issues.

Before embarking on the main analysis, a number of preliminary observations should be made.

First, 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, in the design and financing of a system of regional government, there are also issues of economic substance at stake, and not just issues of political strategy or attitude, and it is these that we address in this paper.

Second, there are a range of possibilities. This paper is not a description or costing of a single scheme, but a discussion of issues common to some (though by no means all) of the arrangements for decentralisation that might be contemplated.

Third, the development of regional government may well happen gradually. The Constitution Unit's (1996a) study of regional government outlines one possible process for regional government in England, moving through a system of regional Chambers to regional Assemblies. It is only at the latter point that significant financial resources would be required. Even then, the level of finance needed would depend on the scale of devolution envisaged for the major spending functions — health, education, etc.

Fourth, devolution to regional governments may also be an uneven process.

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[2] To avoid cumbersome circumlocutions, the paper refers to `regions'. However, the analysis is, in the main, applicable to Wales and Scotland as much as to the English regions. In general, Northern Ireland seems to be left out of the devolution debate, although many of the economic issues discussed here are also relevant to Northern Ireland.

Scotland may move sooner and faster than other parts of the UK, and, within England, some schemes for regional government would make the move to regional Assemblies contingent on a region voting in favour.[3] Financial arrangements may thus need to cope with uneven regionalisation. Also, finance may have a considerable impact on the decision-making regarding the transfer from Chambers to Assemblies. There are, as we discuss later, some important requirements for a system of regional government finance, if fiscal gains and losses from regionalisation are not to have a major bearing on the pattern of regional interests in moving towards greater decentralisation.

II. REGIONAL GOVERNMENT FUNCTIONS AND FINANCING

As well as elected central and local tiers of government, the UK already has a certain amount of decentralisation in the existing organisation of central government. The extent of the responsibilities exercised by this regional tier varies between Scotland, England, Wales and Northern Ireland.[4]

Within Scotland and Wales, the Scottish and Welsh Offices, respectively, are responsible for many of the major responsibilities of central government, such as health, industrial policy and overseeing local government responsibilities such as education and social services. One major difference is that Home Office functions are devolved to the Scottish Office but not to the Welsh Office.

Within England, regional governance is more diverse and does not conform to a simple pattern of standard regions. A network of 10 ‘Government Offices for the Regions’ was established in April 1994 to co-ordinate the regional dimensions of expenditure for a number of central government departments. These are responsible for the work previously carried out by the regional offices of the Departments of the Environment,[5] Transport, Employment, and Trade and Industry. The establishment of these offices was intended to co-ordinate the regional agencies of central government departments rather than to decentralise additional central government functions.

Many central government responsibilities are carried out on its behalf by decentralised single-service agencies. Some of these have a regional dimension, most notably in the case of the Regional Health Authorities (RHAs). The regional boundaries used by such decentralised agencies often differ. For example, the Environmental Protection Agency bases its regions on water basins rather than on standard regions, and Greater London is served by two Regional Health Authorities[6] but one Integrated Regional Office. Alongside the

[3] See, for example, the discussion in Tindale (1996).
[4] We do not discuss Northern Ireland.
[5] The responsibilities of this department are now split between the DTI and the Department for Education and Employment.
[6] Until the 1 April 1994 RHA reorganisation, four Regional Health Authorities served the Greater London area.

decentralised agencies of central government, there are also a number of English Regional Associations of local authorities, which are voluntary bodies aiming to facilitate regional co-operation and co-ordination between authorities. Their main activities include regional planning, transport, waste and economic development. The level of activity of these bodies varies between regions, with that for the North of England being particularly active.

III. OPTIONS FOR DEVOLUTION

The Constitution Unit's recent study of options for regional government in England observes that `a workable and durable regional tier requires clear analysis of the reasons why it is to be established and the role and functions it is to perform' (Constitution Unit, 1996a, p. 6). The study sets out both 'democratic' and 'functional' reasons for the establishment of regional government. In the former category, it includes arguments that regional identity requires democratic recognition, that regional government might provide an outlet for political expression in parts of the country where the national governing party commands little support, and that the existing administrative layer of regional agencies needs democratic supervision at regional level. The latter category includes certain functions (strategic land-use planning, transport, economic development, and co-ordinating bids for and management of EU-funded projects) whose effective operation needs areas larger than local authorities but smaller than England as a whole.

The study also reviews a range of possible institutional arrangements for some measure of regional government in England. The possibilities include a regional parliamentary assembly of MPs (along the lines of the Scottish Grand Committee), a confederation of local authorities, a directly-elected assembly, or a body based on the merger of existing regional bodies (police, health, regional quangos, etc.). It concludes that the two most promising models would be either regional 'Chambers' or regional 'Assemblies'. Regional Chambers would provide a forum in which delegates from local authorities could co-ordinate the region-wide aspects of local government functions; they could constitute an interim stage to more comprehensive regional government or be permanent institutions in their own right. Regional Assemblies would be directly elected, and might have more extensive functions, involving the possible transfer of some significant spending responsibilities from central government.

Scottish and Welsh devolution could involve similar arrangements, although some proposals for Scotland go considerably further. Thus, for example, the Constitution Unit's parallel study of arrangements for a possible Scottish Parliament includes control of all the expenditure functions currently exercised by the Scottish Office, together with some measure of taxation powers, in the form of scope to vary the rate of income tax within a given range (Constitution Unit, 1996b).

The appropriate basis for financing regional government will depend in part on prior decisions concerning its scale and the expenditure functions that are allocated to the regional level. Regional Chambers, operating to co-ordinate the policies of local authorities, may spend little and have correspondingly little need for financial resources. They could be financed by much more straightforward arrangements than those that might be appropriate for institutions with more extensive spending powers. One implication of this, if (as much of the discussion seems to assume) different levels of devolution would be appropriate for Scotland, Wales and the English regions (and, indeed, possibly with differences between the English regions, too), is that the financial arrangements that would be appropriate for regional government may well not be uniform across the UK as a whole.

Whether regional government needs to be able to levy its own tax revenues also depends on the fundamental role that regional government is intended to perform. In particular, there is a difference between regional government institutions intended to perform a 'choice' function and those with an 'agency' function. Although in both cases these might be democratic institutions, perhaps based on directly-elected Assemblies,[7] the scope of the decision-making powers of the Assembly would be fundamentally different, and consequently the need for regional taxes would be different, for each case.

In the former case, regional government would be intended to make it possible for regional voters to determine the standard of public service provision in their region; where regional voters demand higher-quality services than the national standard, for example, these could be implemented. For this to be possible — and for the decision to have higher-quality services to be made in the light of the costs of higher quality — it is desirable that the region should be responsible for raising the resources for higher-quality services through taxes on its residents.

It is not easy to identify major areas of central government spending where there is a strong demand, currently unmet, for differentiated standards of provision across regions. It is far from clear that there is great support for differentiated standards of, say, health, education or social services across the English regions.[8] There is, perhaps, a larger group of public services, currently provided by local government, where it would be feasible to permit a greater degree of discretion in service provision if these services were provided at regional level rather than at the current, local, level. These could include local services where a significant proportion of the benefits accrues to residents outside the authority concerned; such spillover effects are liable to be given

[7] It will be noted that, in describing the `agency' model, we are not referring to regional offices of central government, such as the Government Offices for the Regions established in April 1994.

[8] In the case of Scotland and Wales, the position may be different; the clear cultural and linguistic differences from the rest of the UK might lead to very different choices being made regarding education, broadcasting, culture, etc.

inadequate weighting in local decisions. Examples of services with significant spillover effects might include land-use planning, transport, cultural policy and, in some areas, the police. Moving such services upwards to the regions might then allow them to be operated without as much limitation on decentralised choices as at present, since the decision-making area would comprise a greater proportion of those affected. It is possible, therefore, that a considerable proportion of the 'choice' functions that might be given to regional governments might be transferred from local government rather than devolved from the centre.

In the 'agency' model, regional decisions are more constrained and the need for regional taxes is less. National standards of provision may be set by central government, and the purpose of having regional government may not be to allow regions to choose to depart from these standards. Regional elections function, in this case, not as an opportunity for regions to make differentiated choices, but as a *control* device allowing regional voters the opportunity to demand efficient performance from the regional bodies charged with implementing centrally-determined policies (Helm and Smith, 1989). Whether regional elections would function as a more efficient control device than the arrangements for administrative monitoring of nationally-provided services will probably depend on the particular field of policy concerned. The control function is likely to be more effective in the case of high-profile services, where service quality can easily be monitored and where there is little disagreement about basic objectives, and may be correspondingly weak in less prominent areas, especially those where there is major disagreement between regional voters and the central government about the underlying aims of policy.

These models are, of course, a simplification of the complex roles that decentralised government institutions would, in practice, play. However, it is perhaps too readily assumed that the purpose of government decentralisation is represented by the choice model, and that the purpose of decentralisation is negated by elements of central control. It is clear that, in the post-war period, local government in the UK has increasingly come to perform the `agency' role described, rather than the 'choice' role, and it is conceivable that a similar role could be envisaged for regional government. Regional governments would then determine *how* money is spent, not *how much* is spent.

IV. FINANCE THROUGH GRANTS FROM CENTRAL GOVERNMENT

1. Own Taxes or Block Grants?

A need for regional tax revenues will arise only in certain circumstances — in particular, where the regional authority is intended to have the power to make independent decisions about the level of public service provision. For financing other types of regional government — and, indeed, as a major source of revenues even for those authorities with the power to vary service provision — financial transfers from central government have some strong attractions.

The Case for Grants

Financial transfers — 'block grants' — have the merit of simplicity and low cost in administration. In contrast, 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 regions, reflecting differences in their expenditure needs or in their tax-raising powers. This could, of course, be done without central-to-region transfers, by making 'horizontal' transfers of revenue between regional governments. However, it is possible that, in practice, such arrangements would prove rather less durable than equalisation through differentiated transfers from the central government. Horizontal transfers involve more transparent redistribution and may become a focus of resentment in the areas that are net contributors.

Of course, financing regional governments largely, or exclusively, from resources provided by central government may also be seen as advantageous by central government, since it would allow it 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 on either macroeconomic or microeconomic considerations, for central government 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.

The Case for Taxes

If regional governments are intended to be able to determine the level of public spending in their area, rather than simply to determine the allocation of a budget fixed by central government, they would need to have 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. Likewise, a system of 'matching' grants, where central government offers to pay a given percentage of the cost if the region incurs certain expenditures, 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 governments' behaviour merely through the threat of changes in grant level or regional distribution.

Accountability in regional governments' decisions about the level of spending is generally a matter of the relationship between spending and taxation at the margin. If regional voters are to weigh decisions about extra service quality against the costs of its provision, it is necessary that extra spending is paid for by extra taxes on the region's residents, and that national taxpayers, or residents of other regions, are not asked to foot the bill for a region's decision to spend more. This does not necessarily require that, overall, regional spending is financed entirely through regional taxes; the bulk of regional spending could, indeed, be financed by block grants from central government. The key requirement for accountability concerns the relationship between tax and spending at the margin, i.e. that *extra* regional spending results in *extra* regional tax.

Assigned Revenues

In some countries, regional governments are partly financed through 'assigned' or 'shared' taxes. In the former case, the revenues from some taxes controlled by central government are assigned in their entirety to regional government. In the latter case, regional governments have an entitlement to some proportion of the total revenues derived from a particular tax. In both cases, the ultimate responsibility for setting tax rates lies with the central government. However, the revenues from the assigned tax, and a fixed proportion of revenues from the shared tax, 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 regions do not have power to control the tax rate, they do not gain the autonomy that would come from having a tax source under their 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 would 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 pressures give them no power to increase the tax rate in practice. Thus, for example, if regional governments were given the power to precept on the local authority (council tax) base, this would be unlikely to give regions any real financial autonomy, since the tax rates levied on this rather narrow and unsophisticated tax base are already high.

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. Where the functions of regional government involve very limited levels of spending (as perhaps in the case of the regional Chambers discussed by the Constitution Unit), it may be possible to consider a simple financing formula of this sort. However, if regional government is to take over any of the major public expenditure functions currently exercised by central or local government, per capita financing would be liable to provide some regions with inadequate financial resources to maintain the current level of regional spending, whilst others would be over-resourced compared with current spending.

Table 1 illustrates this point. It shows official figures for the regional and territorial pattern of per capita public spending in the UK in 1993-94, presented in relation to per capita spending in England as a whole. The figures are derived from an annual Treasury exercise to allocate 'general government expenditure' (the combined spending of central and local government) between regions and territories. They aim to reflect where the benefit from public spending falls, rather than where the money is spent; in the case of some spending (such as on defence, overseas aid, etc.), the benefits do not accrue to an identifiable part of the UK, and no regional allocation is therefore made. About three-quarters of general government expenditure is allocated between England, Scotland, Wales and Northern Ireland in the Treasury's figures; a rather lower proportion of spending in England is then allocated to a specific region. It should be borne in mind in interpreting the figures in Table 1 that, because of this difference, the figures for the division of spending between territories (i.e. between England, Scotland, Wales and Northern Ireland) are not strictly comparable with those for the allocation between English regions.

TABLE 1

Per Capita Public Spending in the Territories and Regions of the UK, 1993–94

(a) Pattern of 'identified' spending across territories

Index, England = 100

	Total	*Social security*	*Health and social services*	*Education*
England	100	100	100	100
Scotland	124	106	126	135
Wales	118	117	114	103
Northern Ireland	141	112	115	144

(b) Pattern of 'allocated' spending across English regions

Index, England (regionally-allocated total) = 100

	Total	*Social security*	*Health and social services*	*Education*
North	107	114	101	99
Yorkshire & Humberside	99	100	101	101
East Midlands	91	92	92	98
East Anglia	89	91	91	92
South East (including London)	103	98	105	103
South West	92	97	95	91
West Midlands	96	99	93	99
North West	107	112	103	104

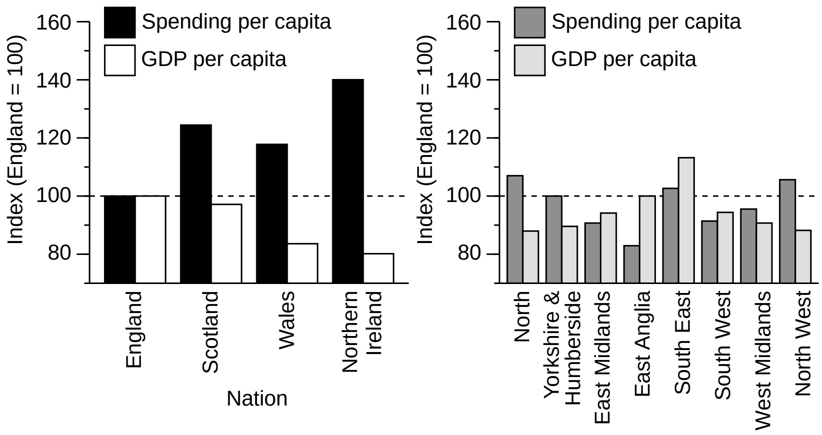
Source: Tables 7.5B and 7.9, *Public Expenditure Statistical Analyses 1996–97*, Cm 3201, HM Treasury, March 1996.

Table 1 indicates that there is considerable variation in per capita public spending between England, Scotland and Wales: total per capita spending in Wales and Scotland exceeds spending in England by almost one-fifth and one-quarter, respectively. There is also some (though rather less) variation in per capita spending across the English regions. These spending differences are shown in relation to regional GDP in Figure 1. Figure 2 shows that per capita social security spending tends to be high where unemployment is high. The regional and territorial variation in other spending categories may also be — at least partly — driven by the application of uniform national policies to areas where the `need' for spending varies.[9]

[9] However, it is not clear that all the variation in per capita spending shown in Figures 1 and 2 can be satisfactorily explained in this way. Whilst it should be stressed that the figures for per capita spending in the North of England and in Scotland are not wholly comparable, per capita spending in the North of England appears to lie well below the level in Scotland, whilst unemployment rates and per capita GDP might suggest

FIGURE 1

Per Capita GDP, and Per Capita 'Identified' (Territories) and 'Allocated' (English Regions) Spending, 1993-94



Sources: tables7.5B and 7.9, *Public Expenditure Statistical Analyses 1996-97,* Cm 3201, HM Treasury, March 1996: Table 12.1, Regional Trends, 1996 edition, *Office for National Statistics*.

'Equalisation' in the grant allocation to regional government could be used to reflect differences between the regions in terms of their expenditure requirements. The amount of grant to be paid to a region would then vary according to an assessment of each region's 'need' to spend on the services assigned to the regional level.

Also, where the regional government is assigned certain taxes to cover some part of regional expenditures, the pattern of grant payments might be differentiated to take account of per capita variation in taxable resources.

Equalisation of this sort, to compensate for differences in regional governments' 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).[10] Grant is

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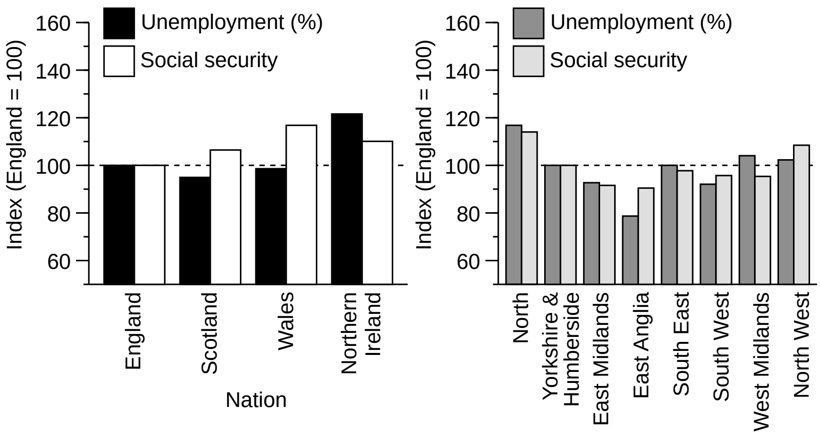
higher levels of service need in the North of England. In 1993, for example, the unemployment rate was 11.9 per cent in the North of England and 9.7 per cent in Scotland, while per capita GDP was 12.1 per cent below the average for England in the North of England and 3.2 per cent below the average for England in Scotland.

[10] The pattern of spending `needs' across regions may be harder to assess than that across local authorities, since there are many fewer regions than local authorities. With only 11 regions, the regression analysis techniques used to estimate the determinants of spending could only include a handful of needs indicators as explanatory variables. This problem would, of course, be substantially eased if accurate data on subregional

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 the population, area, etc.).

FIGURE 2

Unempl;oyment and Per Capita 'Identified' (Territories) and 'Allocated' (English Regions) Social Security Spending, 1993-94



Sources: tables7.5B and 7.9, *Public Expenditure Statistical Analyses 1996-97*, Cm 3201, HM Treasury, March 1996: Table 5.18, Regional Trends, 1996 edition, *Office for National Statistics*.

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. Without equalisation, living standards will be affected by demographic and other pressures on public spending and the tax- raising potential of each region. Residents of poor regions, with high spending needs and little scope for raising tax revenues, will face a greater regional tax burden than similar people living in richer areas, where there is less pressure on public services and more potential for raising tax revenues.
- Second, equalisation may prevent fiscally-induced migration. Without equalisation, `rich' regions, with a large tax base and/or little need for

public spending patterns and needs were available, and if the subregional spending pattern could be believed to reflect a process of expenditure allocation that is responsive to needs.

spending, can set lower tax rates and/or offer higher-standard services than `poor' regions. This may encourage some businesses and individuals to move into the rich region, where they would benefit from the lower taxes and/or higher-standard services. These movements, purely for fiscal reasons, may lead to costs of inefficient location.[11] They could also 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 areas to try to escape from poor regions 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.

[11] Some migration may be efficient, where, for example, it reflects different preferences for public spending. Thus an individual with above-average preferences for public services may choose to move to an area with above-average standards of provision, even if it also has a higher tax burden. In this case, or in other cases of 'benefit taxation' (where tax payments closely proxy benefits received), migration may help to obtain a better match between preferences and service provision; the problems arise when taxes do not closely proxy individual benefits received.

V. REGIONAL TAXATION

1. Criteria for Regional 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? Table 2 summarises the revenues derived from the main UK taxes.

Some of the key issues in assessing the merits of possible regional taxes are set out below. Since we are considering the transfer of existing taxes to regional government, rather than the establishment of new taxes, the relevant questions

TABLE 2

Breakdown of Tax Revenues, UK, 1995–96

	Revenue (£ billion)	*Percentage of total tax revenue*
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%
Total	254.2	100%

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

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 increase the dead-weight burden of raising tax revenues, over and above the level with a uniform national tax rate? Would regional tax differences distort the pattern of private sector economic activity across regions?
- *Administrative feasibility and cost.* For each regional tax, is it possible to devise workable arrangements for regions to set tax rates and for tax revenues

to be allocated to the region from which they are derived? Also, how much does regionalisation add to its costs of assessment and collection, and to the costs and effectiveness of enforcement activities? 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, these additional administrative costs are likely to vary between taxes.

- *Budgetary aspects.* It is desirable that regional taxes should have reasonably stable and predictable revenues, especially if regional governments have only a limited number of tax instruments and are not able to borrow freely to cover any shortfall of revenue.
- *'Accountability' properties.* The amount of the tax and the government authority responsible for levying it should be clearly perceived by taxpayers, and the incidence of the tax should be broadly distributed across the regions' taxpayers.
- *The need for equalisation.* If the regional tax base is unevenly distributed across areas, larger equalisation payments may be required to equalise the taxable resources of different regions.
- *Equity.* Few issues of `fairness' or equity are raised by the transfer of a central government tax to regional government. Regardless of the distributional incidence of the regional tax, if its rate remains the same as that previously levied by central government then the overall distribution of income will be unaffected by transferring the tax to regional level. The only issue — and it is probably a relatively minor one — concerns the distributional impact of significant *changes* from the average, or initial, tax rate, if the region were to choose to depart from the rate previously levied by central government. Where the regional tax is highly regressive, for example, the additional burden of local taxation to finance higher regional public spending might be unduly borne by poorer households.
- *Impact on the financial resources available to other levels of government* If regional government taxes a base (for example, income) shared with central government, the income tax rates set by either level of government could, in principle, adversely affect the other level, by reducing 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. Destructive inter-tier interactions of this sort may be limited by relatively simple measures — for example, by placing an upper limit on the regional income tax rate — although these measures may themselves have costs in terms of diminished independence and accountability of local government.

On the basis of these criteria, we suggest that there are three main candidates for a regional tax, each of which would be comparatively easy to allocate to regions, would be capable, if required, of raising significant amounts of revenue and would have a broadly stable and predictable yield. These three candidates for a regional tax are income tax, VAT (or, more generally, a sales tax) and a regional assignment of the national non-domestic rate (`business rates').

2. A Regional Income Tax

In many respects, the best available candidate for a regional tax 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? Particular issues arise in relation to three of the criteria.

- *Efficiency.* A regional income tax levied at a rate fixed by residence might induce some population movements towards areas with low tax rates. These tax- induced migrations would be likely to be limited (except, perhaps, for high- income individuals), 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 and preferences for particular locations. Second, the gains from migration may be reduced by 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.

  The extent of migration could be further limited by appropriate design of the regional income tax system. First, provisions 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.
- *Administration.* Proposals for a local income tax in the UK have, in the past, had to confront a number of practical administrative difficulties. 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 (Layfield Committee, 1976; Kay and Smith, 1988; Isaac, 1992).

Many of these administrative problems 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. The difficulties experienced with poll tax registration might suggest that this could be problematic. However, as Kay and Smith (1988) note, there are important differences that should make the process more straightforward for income tax. Many of the difficult cases for poll tax have negligible incomes and therefore are not involved in income tax registration. Also, the nature of the process involved differs: the process of allocating a given list of national income taxpayers 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) for local income tax.

- *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. Also, 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 taxpayers, 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.

3. A Regional Sales Tax

Like a regional income tax, a regional sales tax would raise particular issues concerning efficiency, administration and accountability.

- *Efficiency.* Regional differences in sales tax rates could distort the geographical pattern of consumer spending and retail activity. Individuals might make ‘cross- border’ shopping trips to neighbouring regions with lower sales tax rates, and, over time, there might be a tendency for some retail businesses, such as superstores, to move to areas where tax rates are lower. To the extent that these developments simply reflect the tax advantage of low-tax regions, they involve economic inefficiency.

  These distortions in consumer spending and retail activity are, however, likely to be small, so long as sales tax rates do not vary by more than a few percentage points between regions. With small differentials in tax rates, the saving from shopping in another region is unlikely to cover the additional time and travel costs, except for certain large, high-value purchases and for consumers living very close to the boundary between regions.
- *Administration.* A fully-integrated system of regionally-varying VAT would be complex to administer. The most practical option would be a supplementary retail sales tax, over and above existing national VAT. This would apply only at the point of sale to final consumers. It could be integrated closely with existing VAT administrative procedures and accounting, and could, for example, use common definitions of taxpayers and tax base. However, unlike VAT, it would be necessary for taxpayers to distinguish between sales to final consumers and sales 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 (Hall and Smith, 1995).
- *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.

A final issue concerns the compatibility of a regional sales tax with EU rules. The Sixth VAT Directive places considerable limits on the design and operation of indirect taxes in member states, and other EU agreements place some limits on the rates that member states can levy. The need to secure agreement from other EU member states for modifications to these rules might be seen as an obstacle to a regional sales tax.

4. A Regional Business Rate

Business rates — a tax on the 'rateable' value of business premises — raised £13.6 billion in 1995-96, about 5 per cent of total fiscal receipts. Although they are administered by local government, a uniform tax rate is set nationally and the revenues are pooled and distributed to local authorities in proportion to their population.

Business rates would have some important advantages as a regional tax. The tax base is fairly immobile, evasion is relatively difficult and it would be very simple to allocate the tax base, and the revenues collected, to individual regional authorities. However, as a possible regional tax, business rates have two major — and probably overriding — drawbacks. The first is that regional business rate differentials could affect business location decisions, and the second concerns accountability.

- *Efficiency*. 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 bases available to different areas.

  Evidence on the scale of such locational distortions from the pre-1990 period, when business rates varied between local authorities, is somewhat mixed. Bennett (1986) shows that rate differentials led to considerable differences in the potential profitability of locating an investment in different areas. On the other hand, there is little systematic statistical evidence that business rates actually distorted the location of business investment and employment, though this may be partly because the long time scale over which such effects would arise makes it difficult for the available techniques to detect any effects that do arise (Denny, Hall and Smith, 1995).
- *Accountability.* The burden of business rates is not 'transparent': it may be `passed on', in whole or in part, to the employees of the business in the form of lower wages, or to customers through higher prices, or to landlords in the form of lower property rents. These people may be unaware of how these costs arise. They may also not live in the area of the authority imposing the rate. As a result, the region's electors would not face taxes reflecting the full cossts of their voting decisions

5. Conclusions on Regional Taxes

Whilst income tax, sales tax and non-domestic rates are all potential sources of revenue for a regional tier of government, the choice between them would depend on how much weight is attached to each of the criteria listed above. A regional income tax seems to be the strongest candidate, since it would be relatively easy to operate and equitable, and could be made easily perceptible to residents. On the downside, tax yields would be strongly pro-cyclical, and accountability would be limited for poorer households which would not pay any tax. A regional sales tax might have a less cyclical yield but could cause economic distortions through `cross-border' shopping. It would be less easily perceived and might involve a greater additional administration and compliance burden than a regional income tax. The introduction of a regional business rate would involve the least administrative burden but would limit accountability, since the incidence of the tax is unclear and the distribution of the tax base is highly uneven, suggesting that complex equalisation arrangements would be necessary.

VI. CONCLUSIONS

Many of the arrangements for regional government that might be envisaged for the UK would raise no significant issues concerning finance. For example, regional Chambers, which would provide a forum for local authorities to co-ordinate their policies and service provision where these have a region-wide dimension, would entail little expenditure by the regional level of government (Constitution Unit, 1996a). Moreover, given the structure envisaged for the Chambers, which would be controlled by delegates from the constituent local authorities, and the fact that the Chambers' spending would largely reflect functions transferred from local government, it would seem logical to finance the Chambers by allowing them to precept on the council tax base in a similar way to some other multi-authority agencies (the former Inner London Education Authority, police authorities, etc.).

Regional governments to which major spending responsibilities had been transferred from central government could, in principle, be financed wholly through `block grant' transfers from central government. Whether, in addition, regions should have tax-raising powers depends fundamentally on the role that regional government is intended to perform. Independent powers of taxation would give scope for autonomy in regional decisions about the level of provision of public services; also, a clear link between the service level chosen and the tax burden on regional residents is an essential element of accountability if regional government is to have the power to decide to spend more (or less). If, instead, the purpose of regional government is simply to provide more democratic input, and more- informed control, over the regional implementation of nationallydetermined services, regional taxes are unnecessary. In Section V, we outlined three plausible candidates for a regional tax — income tax, sales tax (based perhaps on VAT) and a regional business rate. Of these, regional income taxation (with regional control limited to variation of the basic rate) is perhaps the most attractive option, combining (relatively) uncomplicated additional administration requirements with a relatively limited risk of economic distortions from regional differences in the tax rate.

How are these issues affected if regional government is to be introduced into only part of the UK, or in different regions at different times? Such 'variable geometry' in regional government would seem likely to impose additional constraints on the design of a system of regional finance. There could, for example, be implications for the costs of administration of the system. A considerable proportion of the administration costs involved in new arrangements for decentralised finance might be incurred if decentralised arrangements were introduced in any region; for example, the need for an administrative mechanism for determining the region in which a taxpayer is resident arises as soon as any region is given powers to vary the rate of income tax on its residents.

However, the most significant issue concerning variable geometry is that the basis of financing regional governments could affect the interests of particular regions in participating in devolution. Unless the outcome of regional decisions about regional government is to be unduly influenced by the financial gains or losses that might be anticipated, extensive equalisation in relation to both needs and resources is a pressing requirement. Otherwise, those regions most favoured by the financial arrangements for regional government will tend to opt for regional powers, leaving the remainder of the UK facing a more adverse relationship between tax revenues and spending than at present.

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