

The Fiscal Implications of 'Levelling Up' and UK Governance Devolution

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Abstract

In order to understand the long-term economic challenges that any devolution-type reforms face when trying to promote the interregional Levelling Up of productivity, it is essential to consider the likely financial and fiscal issues arising in the relationships between central and sub-central government. The reason is that the changes in these fiscal relationships may either narrow or exacerbate interregional productivity inequalities, depending on their form and implementation.

It is therefore important to set the UK central-sub-central governance features in the context of the OECD-wide experience of central-sub-central government financial and fiscal relationships. This allows us to better understand the nature and financial performance of the UK governance system and to identify the opportunities and challenges associated with any potential reforms in Levelling Up.

Introduction

The UK today exhibits one of the world's most centralised governance systems while at the same time also exhibiting amongst the highest interregional productivity and income inequalities of any industrialised country. It is this combination of centralised governance and unbalanced productivity growth which has given rise to the Levelling Up agenda, because centralised policy making has so far largely undermined efforts to foster appropriate structural changes to the UK's city and regional economies, especially in England (McCann 2016; Travers 2018). These realities are at odds with the patterns evident in most other advanced economies, and especially in contrast to other large and industrialised countries, where governance systems tend to be much more decentralised and devolved and interregional productivity imbalances consequently are much lower. There is now a large OECD-wide literature that points to the fact that decentralised sub-central governance systems are largely conducive to stronger and more balanced interregional growth and development processes and less economic dominance by any particular city-region than are highly centralised governance systems (Carrascal-Incera et al. 2020). In the light of this literature, the UK appears to be an extreme outlier, and there is now a large body of evidence that the UK's governance system itself partly accounts for the UK's regional imbalances (McCann 2016; Carrascal-Incera et al. 2020). Indeed, it is this link between governance centralisation and regional imbalances which underpins that argument that the UK's *over-centralised* or *hyper-centralised* system needs to be significantly devolved to levels akin to competitor countries in order to foster stronger and more inclusive productivity growth.

These economic realities are brought into an even sharper political focus, given the fact that the levels of trust in central government in the UK are currently ranked at 34th highest amongst the OECD countries¹, and have been falling since 2007 (OECD 2020a). This is one of the lowest scores in all of the industrialised world. In contrast, UK residents' trust in local government decision-making remains much higher than that of central government (LGA 2018). If the UK were already highly devolved, as is the case in Belgium, then the combination of low scores for central government allied with higher scores for local government may have little real economic or governance significance, whereas in a hyper-centralised country such as the UK, this potentially has serious long-term political as well as economic consequences. This all bolsters the case for devolution and decentralisation.

Since the Second World War there have been many attempts, proposals and commissions calling for reforms to local government in England (Travers 2018; Jeffrey and Swinney 2020). But in spite of these calls, in the UK there has been something of a reluctance regarding fiscal devolution, even though OECD-wide evidence suggests that it is generally a good thing.

One of the arguments justifying this reluctance to devolve, and which from time to time has been deployed in the UK in favour of a centralised governance systems, has been that it allows for a strong fiscal equalisation system to operate, whereby economically stronger regions are able to assist economically weaker regions (Rogers and Evans 2018). As such, if the UK governance system were to be less centralised, then this might risk exacerbating regional

¹ <https://data.oecd.org/gga/trust-in-government.htm>

inequalities (Amin-Smith et al. 2018a; McGough and Bessis 2015). Yet, the experience of UK sub-central government over the last decade paints a rather different picture to this. In the years following the global financial crisis, UK sub-central government faced severe cuts². However, these cuts were not equally distributed across the country in that they have been larger in more deprived than more affluent areas (Amin-Smith and Phillips 2018), and especially in deprived urban areas (Harris et al. 2019), although these areas still receive and spend more than other areas (Harris et al. 2019). As such, cut-backs in the current system have themselves helped to exacerbate regional inequalities, and the Covid-19 pandemic is likely to exacerbate many of these trends. Even within the current system, central government still is able to effect profound change, according to its political preferences, and this appears to be part of the reason why the governance system has been a contributor to the polarised geography of productivity.

A second argument justifying the reluctance to devolve is that fiscal decentralisation may also lead to something of a postcode lottery regarding the scale and quality of local public services provision (McGough and Bessis 2015). However, while there are some well-founded concerns that devolution and decentralisation might make the UK service provision more of a postcode lottery, under the current highly centralised grant-based local government funding system there is already divergence in the quality of services delivered and local outcomes, as well as in the ability to raise revenues (McGough and Bessis 2015). More prosperous localities are already able to raise a higher share of their revenues from property-related taxation, and these same localities tend to be net contributors to the fiscal equalisation system (McGough and Bessis 2015), because property taxes revenues as a whole are closely correlated with local income tax generation (McGough and Bessis 2015), as long as the property price rating system is regularly revalued (CFC 2020a,b). At the same time, the current system often disincentivises sub-central government from engaging in economic development activities, and changing these incentives is a key intention of the reforms. However, whether these reforms will actually have the outcomes anticipated is far from clear, and this requires a much deeper understanding of the relationships between fiscal governance and economic development.

In addition to these two reasons, another reason why the UK state has been reluctant to devolve is likely to be a profound mistrust on the part of Whitehall regarding the competence of local government in prudent fiscal management (MHCLG 2018b), allied with the fact that powerful institutions rarely volunteer to give up power. However, these issues are intrinsically associated with the hollowing out of local governments over the last four decades which has undermined their capacity for many activities and roles, as well as the centralising and monopolising tendencies of both Westminster and Whitehall and their inflexible of accounting. As we will see from OECD-wide evidence, there is nothing intrinsically weak about sub-central government regarding fiscal management or local economic development. These weaknesses

² Local government revenues, comprised of grants plus property taxes, fell by some 25% between 2010 and 2016 and this meant that local governments in the UK faced increased debt servicing costs on their capital investments and growing challenges in maintaining existing investments (NAO 2016). By 2018, government funding for local authorities had fallen by an estimated 49.1% in real terms since 2010-11 (NAO 2018), which adjusting for council tax revenues equated to a 28.6% real-terms reduction in local government spending power (NAO 2018; Amin-Smith and Phillips 2018), with the large bulk of cuts made between 2009-10 and 2015-16 (Harris et al. 2019). Local government spending power was projected to fall a further 5.4% by 2019-20 (NAO 2017) such that by 2020 168 councils received no revenue support grant (LGA 2018).

appear to be inherent to the current set-up of the UK state, and involve major failures on the part of central government which are at least as significant as those by sub-central government. These systemic structural failures are likely to play a key part in limiting the efficacy of public policy responses to the UK's sluggish productivity performance and also narrowing its interregional productivity imbalances.

In order to understand the long-term economic challenges that any sub-central government reforms face when trying to promote more balanced economic development via an agenda such as Levelling Up, it is essential to consider the likely financial and fiscal issues faced by any devolution-related reforms to the UK relationships between central and sub-central government. The reason is that the changes in these fiscal relationships may either narrow or exacerbate interregional inequalities depending on their form and implementation, as well as the current functioning of the UK sub-central fiscal system. It is therefore important to set the UK central-sub-central governance features in the context of the OECD-wide experience of central-sub-central government financial and fiscal relationships. This allows us to better understand the nature and financial performance of the UK governance system and to identify the opportunities and challenges associated with any potential reforms in Levelling Up.

The rest of the paper is organised as follows. The next section provides a brief overview of the key features of the UK fiscal governance system in the light of the OECD-wide evidence, and then in the third section each of these features is discussed in detail. The fourth section then discusses the current reforms aimed at greater fiscal decentralisation, and the fifth section examines the long-term options and implications of moving forward with more devolved sub-central government in the UK.

The UK Sub-Central Governance Features in the Light of OECD-Wide Evidence

When we set the UK in the context of other OECD economies, as we will see below, the UK does not have a fiscal equalisation system which is strongly related to the UK inequalities (Vammalle and Bambalaite 2021a). Nor does the international evidence imply that devolution or decentralisation per se will help to reduce the UK's interregional inequalities. It depends on the particular design and features of the devolution process (Vammalle and Bambalaite 2021b). As such, reforming the UK's interregional fiscal system in a manner which will help with 'Levelling Up' is complicated by the fact that it is in many ways such a strange system by international standards. As well as being a governance system in which local (Ladner et al. 2019) and regional government (Hooghe and Marks 2021) has amongst the least authority and autonomy in the industrialised world, it is also a system in which the control and accountability systems are almost unique, and there are nine aspects to this.

(i) The UK increasingly has more of a cost-based than a revenue-based interregional fiscal equaliser system, and cost-based systems tend to provide much weaker fiscal stabilisation underpinnings than do revenue-based systems (Dougherty and Forman 2021).

(ii) The levels of UK sub-central government revenue, expenditure and investment which are decentralised are very low by international standards, as are the levels of sub-central government autonomy (Ladner et al. 2019) and authority (Hooghe and Marks 2021).

(iii) The UK distribution of sub-central government liabilities is unusual, in that the only other OECD country with a similar composition of liabilities close to that of the UK is Australia (Herold 2018), although the sub-central governance systems of the two countries are profoundly different.

(iv) The shares of UK sub-central government debt which are securitised are amongst the lowest of any OECD country, and are the lowest amongst any large OECD country. As such, the UK is not only unlike federal countries, but also unlike most other unitary countries, especially large unitary countries.

(v) The UK central government exerts direct controls on almost all aspects of UK sub-central government, thereby creating distortions in policy objectives and limiting local policy-making discretion.

(vi) In the UK all sub-central government powers and responsibilities derive from central legislation, leading to a system of very strict rules and regulations (Sutherland et al. 2006). In many other countries, the relevant legislation is local or regional. The UK also differs from most other countries in that its shift to performance budgeting at the sub-central government level, combined with high-powered grant-seeking incentives, tends to skew local decision-making towards meeting the priorities of central government (Sutherland et al. 2006).

(vii) In the UK, one of the most significant obstacles to devolution or decentralisation is the issue of constitutional checks and balances, and this inherently concerns the nature of parliamentary sovereignty and public accountability in the British constitutional worldview (Sandford 2017).

(viii) The legal changes in Scotland following the recommendations of the Calman and Smith Commissions (HMT 2020), and in Wales following the Silk Commission (HMT 2020) mean that the UK is now rapidly becoming a quasi-federal state with highly unequal national governance components, each with very different sub-central governance arrangements, and an unclear definition of the centre of government (Keating 2012).

(ix) The over-centralised UK governance system militates against both central government learning and local government institutional capacity-building. The reason for this is that the extreme pyramidal nature of the UK governance system, combined with a lack of any meaningful meso-level governance tiers outside of the three devolved administrations or London, automatically disincentivises citizen engagement with government, especially in the weaker parts of the country. At the same time, this strange governance architecture curiously incentivises both short-termism in policy-making and large-scale interventions.

These nine features mean that the UK displays a unique sub-central government fiscal and decision-making system in comparison to all other industrialised countries. Moreover, the long-run combination of only mediocre economic growth allied with very high interregional inequalities suggests that this over-centralised system has poorly served the UK. As we have already mentioned, in certain quarters there is currently widespread enthusiasm for devolution and decentralisation as part of a broader Levelling Up agenda. However, any devolution or decentralisation needs to be undertaken very carefully because if poorly implemented, UK

devolution and decentralisation could easily worsen the already-high interregional imbalances (Carrascal-Incera et al. 2020). Some economically weaker cities are already increasingly exposed to financial headwinds involving city infrastructure assets (Pike et al. 2019), and finding ways to ensure that such places remain financially robust is essential for Levelling Up. Therefore, any movements towards some forms of greater devolution and decentralisation under the banner of ‘Levelling Up’ must be well thought-out in advance and implemented within a clear long-term strategy which takes on board and constructively builds on the likely impacts of each of the individual governance reforms.

In this paper we will examine the evidence on each of these points, in order to assess the extent to which the ongoing and proposed changes to the sub-central governance of the UK may alter the scale of the UK’s interregional inequalities. For the rest of this paper, and for the purposes of terminology, we refer to any government decisions or activities undertaken in the three devolved administrations, in the English combined authority city-regions and also in local government areas as ‘sub-central government’ (SCG) activities, and this terminology is also consistent with the nomenclature of the OECD.³

The Unique Features of the UK Sub-Central Governance System

On point (i), namely the nature and scale of the UK’s interregional fiscal stabiliser system, Rogers and Evans (2018) argue that London and the South East of England act as the primary source of taxation revenue for the UK government. However, as the fiscal breakdown outlined in Appendix 1 makes clear, this is not quite correct. In aggregate, as Appendix 1 details, the UK interregional fiscal stabiliser system amounts to little over 1% of GDP, even though the UK’s interregional productivity levels differ by more than 100 percentage points, while the UK’s regional development policies typically amount to no more than 0.2% of GDP during the last forty years (McCann 2016).

The UK today has more of a cost-based fiscal equaliser system than a revenue-based fiscal equaliser system (Dougherty and Forman 2021). Revenue based systems directly compensate for the lower local revenue-raising powers of economically weak regions, whereas cost-based systems aim to ensure equality of service provision in all regions. Almost all countries exhibit a mixture of these different systems and hardly any country operates a pure system (Blöchliger et al. 2007), but the balance between these systems differs between countries. Primarily revenue-based systems which operate in countries such as Germany, Canada, Sweden, Belgium, Switzerland and Denmark, provide much stronger interregional fiscal equalisation underpinnings than cost-based systems (Dougherty and Forman 2021) which tend to operate in countries which are already interregionally relatively equal, such as Finland, Japan, Austria and The Netherlands. Prior to the 2008 global financial crisis, the UK already displayed fiscal equalisation levels which were below the OECD average (Blöchliger et al. 2007; Blöchliger and Charbit 2008), and especially so when compared to countries with similar income levels or with similar levels of interregional inequality. Since then, no evidence on the UK fiscal

³ The fiscal federalism and governance literatures also variously refer to ‘sub-national’ or ‘sub-state’ governance activities, but in the UK context both of these terms can cause confusion.

equalisation system which is comparable to other OECD countries is available, although such data are publicly available for almost all other OECD countries. What we do know is that the post-2010 public sector cutbacks further weakened the UK's already-weak interregional fiscal stabiliser system. The English local government funding system therefore remains only slightly redistributive, and much less so than in the past (Harris et al. 2019). Moreover, if we separate out transfer payments related to unemployment, welfare etc., from those growth-enhancing investments which involve infrastructure and R&D, the more prosperous regions actually benefit the most from such growth-enhancing public investments (Blagden et al. 2021; Rogers and Evans 2018).

On point (ii), namely the very low levels of sub-central government revenue raising powers or decision-making autonomy and authority, the UK is an outlier when compared with OECD countries in terms of its levels of governance and fiscal centralisation, especially when compared to other large countries or countries of similar income levels. In general, the share of sub-central revenue in OECD countries with a federal structure is larger, on average, than in unitary countries (Dougherty et al. 2019), although there are also large variations within each of these groups, such that local revenue shares in federal and unitary countries somewhat overlap. The very low levels of UK sub-central government revenues (Forman 2020) as well as decision-making autonomy and authority are outliers even amongst unitary countries, and have also become slightly more centralised over the last three decades (Blöchliger and King 2006; OECD 2019; Hooghe and Marks 2021). Indeed, the UK is the only large OECD country whereby sub-central revenues have fallen relative to total revenues, the only other countries where this is also the case being small countries, namely Norway, Hungary and The Netherlands (Forman et al. 2020). Today, UK sub-central government accounts for less than 10% of total general government revenues, the second lowest share amongst OECD countries after the Republic of Ireland (OECD 2020a). Currently council tax raises £39.9bn and business rates raise some £23.8bn, and these figures represent just 4.9% and 2.9% of the total UK tax take, respectively (IFS 2021). In terms of expenditure shares, at some 20% the UK exhibits the third lowest share of local government expenditure in the OECD after just the Republic of Ireland and New Zealand. Regarding investment, the UK is outside of the top 25 OECD countries in terms the share of public investments relative to both total government expenditures and also relative to GDP. Within this low overall share, the share of investment accounted for by UK local government is the third lowest in the OECD⁴. In England there are no local income or sales taxes, and the devolved administrations' discretion on varying income taxes is very limited. Although UK business rates are currently amongst the highest property taxes faced by businesses in the OECD (HoC 2019), UK urban authorities have an underdeveloped tax base that has not been exploited via land value capture mechanisms (McLean 2018). Policies such as the Community Infrastructure Levies or Section 106 Agreements are only poor substitutes for a properly constructed land value capture system (McLean 2018).

⁴ After Turkey and Hungary, and equal to Slovakia and Greece (OECD 2020a). In 2018/19, local authorities in England received 31% of their funding from government grants, 52% from council tax, and 17% from retained business rates (IFG 2020).

In general, these low financial and fiscal shares reflect the fact that the levels of local autonomy (Ladner et al. 2019) and authority (Hooghe and Marks 2021) of UK sub-central government are typically akin to countries a tenth of the size of the UK and with much lower levels of development. UK local governments are able to access far fewer revenue streams than in most other countries (LGA 2020). It is only in the cases of Scotland and Wales that serious and substantive proposals have been made to devolve new taxes and also to reform how they operate (Travers 2018). Yet, the fact that this has been possible in these cases demonstrates that these types of reforms are of themselves intrinsically not impossible to deliver in the UK context (Travers 2018), as long as there is the political will to do so.

On point (iii), namely the patterns of UK sub-central government debt liabilities, the only other OECD country with a similar composition of liabilities close to that of the UK⁵ is Australia (Herold 2018). UK sub-central government securities are only a tiny (1-2%) share of overall liabilities, while pension insurance or standardised guarantees account for more than a third of sub-central government liabilities, the highest share in the OECD (Herold 2018). Yet, Australia displays a totally different governance system which is federal in nature, with a gap-filler system of fiscal equalisation (Dougherty and Forman 2021) and with low interregional inequalities. However, as well as being different to federal countries, the UK sub-central financial system is also different to many other unitary countries. Unitary countries mainly use traditional loans from central government, public banks or commercial banks which across the OECD constitute an average share of 60% of debt liabilities (OECD23) compared with some 15% in federal countries (Herold 2018). The UK has much lower overall sub-central government debt liabilities than the OECD average due to higher than average direct grants from central government.

Overall, by OECD-wide standards, the UK has very low levels of securitised borrowing on the international markets because almost all sub-central government borrowing is mediated via the PWLB Public Works Load Board, an arm of the DMO Debt Management Office of HM Treasury. UK local authorities are required to distinguish between capital and revenue finance in their accounting, and the legal basis for this is detailed in Sandford (2020a). Local authorities can access capital finance for infrastructure investment from a number of sources, but borrowing is the most common of these (Sandford 2020a). The practices regarding local government borrowing and investment, including commercial property investments, are matters of local government capital finance, and are covered CIPFA's Prudential Code for local authority finance (Sandford 2020b). In addition, local authorities must take account of CIPFA's treasury management guidance for local authority funds, and the DCLG's statutory guidance on local authority investments and on MRP minimum revenue provisions (Sandford 2020b). A new edition of the Prudential Code was published in December 2017; and the DCLG published new editions of two sets of statutory guidance in February 2018 (Sandford 2020b).

Within this centrally approved and regulated sub-central government borrowing remit, the acquisition of commercial property has become a significant area of activity for some

⁵ As demarcated according to loans ($\approx 50\%$), currency and deposits ($\approx 0\%$), debt securities ($\approx 1-2\%$), insurance pension and standardised guarantees ($\approx 35-40\%$).

authorities in recent years, with the period between 2016 and 2019 seeing a rapid (14-fold) increase in local government commercial property acquisitions over the preceding three-year period (NAO 2020). However, there is a strong geographical skewness to these trends, with authorities in the South East accounting for 53% of acquisitions by value (NAO 2020). Government guidance (MHCLG 2018b) aims to address the three key risks which local authorities face in this regard, namely issues of high levels of exposure, and low levels of transparency and expertise (MHCLG 2018b). Finding ways to foster a greater commercial acumen and enterprise on the part of a local state bodies is likely to be essential for turning places around, rather than identifying individual cases to blame or shame for primarily political purposes (Mills et al. 2021).

On point (iv), namely the tiny share of UK sub-central government debt which is securitised, the UK has one of the very lowest levels in the OECD, except for in very small countries (Herold 2018). The three devolved administrations have very slightly more leeway than English local government to borrow, including via bonds issues by the devolved administrations (HMT 2020). However, even in these cases borrowing is still tightly controlled and very small, and the overall shares of borrowing remain tiny in comparison to the OECD averages. Yet, these tiny securitised borrowing shares are in spite of the fact that as well as the three devolved administrations, UK local authorities have always had the power to issue bonds, and municipal bonds were used regularly throughout the early and mid-20th century (Sandford 2020a). However, they tended to fall into disuse during the 1970s and 1980s, during the period when central government introduced controls over capital finance (Sandford 2020a), and since then, the Public Works Loan Board (PWLB) became the main source of borrowing at favourable interest rates during this period (Sandford 2020a). Only something of the order of 1-2% of UK sub-central government debt is currently securitised (Herold 2018), the majority of which is accounted for by the three devolved administrations. As such, the UK is not only unlike all federal countries which often display 40-50 times higher shares of sub-central government debt, but also unlike most other large unitary countries, many of which display 20-40 times higher shares of sub-central government securitised debt than the UK (Herold 2018). Recently, however, following interest from a number of English local government authorities in issuing municipal bonds, there has been an exploration of alternative sources of borrowing, and the Local Government Association is now in the process of establishing a joint agency to issue bonds, the Municipal Bonds Agency, which has just issued its first bond in February 2020 (Sandford 2020a). In addition, as well as Transport for London, eight local authorities have now also obtained credit agency ratings, which would allow them to borrow on the open market (Sandford 2020a) at different premia and terms. Yet, UK sub-central government securitised borrowing is still only embryonic.

In many other OECD countries, sub-central government securitised borrowing is much more mature and governed largely by bond market-based disciplines, allied with domestic national oversight, the frameworks for which are managed variously at the central government level and some also at the sub-central government levels. This means that numerous market participants and their knowledge networks and syndicates are able to appraise offerings and

undertake the necessary due diligence to make decisions, and in turn the institutional capability of sub-central governments increases the more that they interact with these market processes. This enhanced local institutional capability and market experience in turn increases the future capacity for the design and delivery of local public or public-private investments. In other words, the market diversity of potential investors is an essential element of good governance, whereas the current UK practice of borrowing via the PWLB reduces the market diversity to effectively zero, inhibiting capacity-building or learning. The odd nature of these sub-central government borrowing arrangements is even more marked, given the fact that for four decades, so many of the principles governing the UK regulatory, competition and procurement arenas revolve around the notion of enhancing competition and the engagement of multiple interested parties.

In the aftermath of the 2008 global financial crisis, across the OECD reductions in central government transfers to sub-central governments and more stringent expenditure or deficit objectives meant that sub-national governments faced much more limited room for delivering services or implementing investments (Vammalle and Hulbert 2013). This was exacerbated by the fact that central governments also often pushed down part of fiscal adjustment efforts to the sub-national level, (Ahrend et al. 2013). The bond market response was to punish lower rated sub-central governments, as reflected in a dramatic widening of sub-central government bond yield spreads (Vammalle and Hulbert 2013; OECD 2014), unless there was decisive central government support to counter the spreads. These lessons were learned and applied in the covid-19 pandemic, with decisive central government intervention limiting such effects (Campbell and Wessel 2021; Haughwout et al. 2021; Bi and March 2021). Importantly, whereas the standard arguments are that sub-central borrowing has contagion risks and central government faces ongoing moral hazard as the lender of last resort, the post-2008 crisis experience suggests that there was no clear evidence of a direct or horizontal contagion effect associated with the downgrades on sub-national government bond yields, in that markets seemed to anticipate rating agencies' downgrades rather than react to them (Vammalle and Hulbert 2013). Nor did sub-central credit ratings falling from investment grade to speculative grade generate above-average effects, in that these changes of credit rating category did not generate larger direct or contagion-related impacts on the yields than did any downgrades within the same category (Vammalle and Hulbert 2013). Moreover, any vertical contagion effects were primarily inked to the application of the sovereign ceiling rule, rather than to contagion effects per se (Vammalle and Hulbert 2013). These observations suggest that mature fiscal and financial relationships between central government and sub-central government in primarily market-based fiscal systems are no more risky or damaging to national fiscal and financial positions than is the case in any other form of fiscal management framework.

On point (v), namely the fact that UK central government exerts direct controls on sub-central government, there are four main aspects to this.

First, the UK exerts a strongly direct fiscal control system in comparison to most other countries. Across the OECD, there are four types of systems for ensuring sub-central governments' fiscal sustainability, namely *market-based systems*, *a cooperative approach to*

debt controls, rules-based systems, or direct controls systems (Vammalle and Bambalaite 2021a). These four systems can be understood as representing a continuum in terms of decentralised versus centralised control systems. Federal systems such as Germany, Canada and the USA reflect the market-based systems in which the raising of capital via the issuance of sub-central bonds is a major feature of sub-central governance financing. Other decentralised countries such as the Sweden, Switzerland, Korea and Japan, display a largely cooperative approach to securitised sub-central borrowing. In contrast, the UK at the opposite end of the spectrum with a strong direct control system along with a rules-based system for the three devolved administrations. In practice, most national frameworks consist of a mix of these four systems, although some lean more towards one or the other (Vammalle and Bambalaite 2021a).

In the *direct control system*, the controls can take different forms, such as the setting of annual limits on individual sub-central securitised government borrowing, ex-ante central government reviews and approvals of sub-central government debt transactions, the centralisation of all borrowing at the central government level, and on-lending to sub-central governments for specific public investment projects (Vammalle and Bambalaite 2021a). In *rules-based systems*, decisions on borrowing are made by local governments within the limits prescribed by central government-set fiscal rules, rules which apply to debt ratios, and borrowing for specific investment purposes. The role of central government is primarily to ensure compliance with the rules (Vammalle and Bambalaite 2021a), and therefore vertical coordination mechanisms are important, as well as monitoring and enforcement mechanisms (Herold 2018). Crucially, these systems provide for both transparency and also flexibility on the part of sub-central governments to decide their policies because central government rarely interferes in the choice of the investments (Vammalle and Bambalaite 2021a). As such, these systems therefore require a high level of capacity from sub-central governments to design strategic plans, procure the projects, develop the financial instruments, and so forth (Vammalle and Bambalaite 2021a). The UK sub-central government system is very much a direct control system, except for the devolved administration which are closer to rules-based systems. No other large countries exhibit a direct control system of this degree of centrality. At the same time, the efficacy of the top-down direct control system itself is distorted because even within the highest echelons of government there are serious imbalances and frictions which militate against coordinated policies (Richards et al. 2020). As various commentators explain (Wilkes and Westlake 2014; Kerslake 2017; Warner et al. 2021), part of the issue is that the power of HM Treasury has traditionally become both excessive and distorted and in many cases a robust barrier to devolution, while at other junctures, such as in the city devolution deals, it has been an enabler, albeit within a framework specified by the Treasury (Kerslake 2017). As such, significant further devolution across the UK would require further changes in the way that the Treasury itself works (Kerslake 2017; Warner et al. 2021).

Second, the need for performance improvement in public services means that in the UK expenditure rules are often specified at the sub-programme level in order to facilitate output-budgeting⁶. This tends to lead to central supervision and micro-management, making it difficult

⁶ This began in the late 1990s with the establishment of (PSA) Public Service Agreements and the (PMDU) Prime Minister's Delivery Unit (Panchamia and Thomas 2014), and even though PSAs were terminated by the Coalition government in 2010, largely the same culture has continued within the civil service (Warner et al. 2021) during

to create a coherent set of rules for improving standardised services while also encouraging greater autonomy and local choice (Sutherland et al. 2006; Warner et al. 2021). Indeed, the difficulty of specifying expenditure rules without becoming intrusive helps to explain why they are the least frequently found type of sub-central budget rules among the OECD economies (Sutherland et al. 2006), and why in this regard, the UK is an outlier amongst industrialised economies.

Third, in most other unitary countries, the central government does not levy a property tax, although there are some exceptions, primarily amongst small countries. In contrast, since 1990 the UK has levied business rates on a uniform basis across the country (Slack and Bird 2014), and although local governments levied residential property taxes, i.e., the council tax, this was on a sliding scale determined by central government. Business rates are calculated on the basis of a non-residential property valuation adjusted by a multiplier (Sandford 2021a). England and Wales have a unified valuation process whereas the valuation process is devolved in Scotland and Northern Ireland. The multiplier calculations are devolved to each of the three Devolved Administrations, with both local and Devolved governments in Northern Ireland setting multipliers (Sandford 2021a). Few other countries exhibit such a centralised system, and as we will see below, this system is likely to undergo fundamental reforms, the effects of which are also entirely unclear.

Fourth, another major obstacle to devolution is the administrative and practice-related features of the UK fiscal system, in that the UK's tax system is not set up to collect tax revenue, or provide disaggregated revenue figures, on a geographical basis (Sandford 2017). Sandford (2017) argues that these obstacles mean that it is therefore no accident that new forms of taxation have been considered for devolved governance systems, such as land value capture (LVC) frameworks, including pilots of a DRAM Development Rights Auction Model (TFL 2017), but whether these will be deployed is as yet unknown.

Importantly, however, the direct control that central government has over sub-central government itself creates distortions which do nothing to narrow interregional imbalances and indeed, are likely to exacerbate them.

On point (vi), namely the fact that all UK sub-central government powers and responsibilities derive from central legislation, this is atypical across the OECD. The UK displays amongst the lowest levels of sub-central government autonomy (Ladner et al. 2019) or authority (Hooghe and Marks 2021) in the industrialised world, even allowing for the activities and powers of the three devolved administrations. UK sub-central authority levels declined sharply between 1982 and 1990 and again between 2010 and 2015 in response to the prevailing central government political priorities, and the UK now has lower levels of devolution than at any stage since the post-war era (Hooghe and Marks 2021). In contrast, most unitary states legislate for many decentralised and devolved powers to be deployed at the sub-central government level, while federal states have formal constitutional rules to avoid the centralisation of government powers.

the post-crisis austerity era and beyond, including with the Implementation Unit and subsequently the Number 10 Delivery Unit. See: <https://quarterly.blog.gov.uk/2014/04/16/making-things-happen-at-the-implementation-unit/>

In federal countries fiscal rules are also set at the levels of regional governments as well at the central government, and importantly, there is no loss of overall fiscal management and control from having sub-central governments also setting fiscal rules. The effect of fiscal rules in the constitution of both central-national and regional governments are remarkably similar at the national and regional levels (Gründler and Potrafke 2020). Moreover, in federal countries fiscal rules are suitable for decreasing budget deficits and public debt, but constitutional fiscal rules at the national and regional levels both promote economic growth (Gründler and Potrafke 2020).

On point (vii), namely the fact that in the UK today, one of the most significant obstacles to devolution or decentralisation is the issue of constitutional checks and balances, and this inherently concerns the nature of parliamentary sovereignty and public accountability in the British constitutional worldview (Sandford 2017). In the UK there are profound constitutional implications in that with power concentrated at the centre, there are fewer checks and balances on power than in more constitutionally-separated systems of government (Travers 2018). In particular, there is no role for representatives of sub-national government within Parliament (Travers 2018). In this setting, civil and public servants are responsible for safeguarding public money, while also ensuring that the collective principles of economy, efficiency and effectiveness⁷ are adhered to, and when parliament votes in favour of taxation for given purposes, its intentions must be honoured (Sandford 2017). For this role, the parliamentary accountability and responsibility framework is largely based around the Accounting Officer model, which has persisted since the 1870s. Given that only 5% of total tax revenue is raised locally, means that de facto almost all taxation is raised directly via central Whitehall departments (HoC 2011). Parliament has virtually no role in either the setting of taxes or determining the public spending priorities (Travers 2018), and while there is detailed scrutiny by the Public Accounts Committee and other select committees of previous expenditure, there is no scrutiny of the proposed future use of moneys (Travers 2018). This is the context in which parliamentary accountability operates. As such, potentially the most difficult challenge to be overcome in order to allow for a much more devolved and decentralised fiscal system to be successful, is the issue of constitutional checks and balances, and this inherently concerns the nature of parliamentary sovereignty and public accountability in the British constitutional worldview.

The UK accountability and responsibility framework based around the Accounting Officer model, in which only 5% of taxes are locally raised, means that in effect, the use of some 95% of taxes are centrally controlled (DCLG 2011; HoC 2011). Ministers work alongside departmentally-based Accounting Officers to ensure that taxpayers moneys are correctly spent. As such, movements toward a more hands-off approach or a system tilted more towards local electoral accountability rather than centralised and top-down parliamentary financial accountability are resisted (DCLG 2011). The only exceptions are the devolved administrations, which are taken to be the responsible authorities. The combined effect of (vi) and (vii) mean that English local government is more accountable today to central government

⁷ <https://www.nao.org.uk/successful-commissioning/general-principles/value-for-money/assessing-value-for-money/>

than it is to local voters and stakeholders (Jeffrey and Swinney 2020). However, the use of the Accounting Officer model in the devolved administrations also potentially contributes to centralising tendencies within the devolved administrations.

From the perspective of parliament, accountability differs between direct and decentralised services whereby direct refers to those activities undertaken by central government (such as HMRC) or via its arm's length bodies or contractors, while decentralised refers to locally accountable bodies, such as local government, or alternatively NHS Foundation Trusts for which the minister is ultimately accountable (DCLG 2011) but for which a local accountable dimensions need to be developed in the national framework (DCLG 2011). For centrally directed actions, Accounting Officers are directly accountable to parliament, whereas for decentralised actions, Accounting Officers are responsible for ensuring that there is an effective system in place to ensure that decentralised funding is used appropriately, and in a manner which secures value for money (DCLG 2011). As such, there needs to be a strong alignment between responsibilities and accountabilities, and a means of demonstrating that in practice the accountability systems and mechanisms are robust (DCLG 2011).

On point (viii), namely the fact that the UK is now rapidly becoming a quasi-federal state (McCann 2016; Jeffrey and Swinney 2020), there is no modern precedent for devolution towards a highly unbalanced quasi-federal state and therefore no real lessons regarding what this entails in terms of long run economic development are available from international comparators. Both Spain and Canada exhibit a small number of regions which are very different in governance terms to all of the country's other regions, but these differences take place in the context of a devolved country. The UK in contrast is highly centralised polity, in which some 15% of the population are resident in the three somewhat devolved administrations of Scotland, Wales and Northern Ireland, while 85% of the population live in a hyper-centralised polity of England, which itself is interregionally exceptionally unbalanced while also to some extent also cross-subsidising the devolved administrations.

In the three devolved nations, the Sewel Convention stops Westminster from legislating on any devolved matter in Scotland, Wales or Northern Ireland without the consent of these nations. In the three devolved administrations residential property taxes and business rates are all retained. At the same time, the Barnett formula calculates the annual change in the block grant to the Devolved Administrations, although it does not determine the total size of the block grant (HMT 2020; Keep 2021). Grant funding flows automatically to the devolved governments and there are no further assurance requirements, because the parliaments and assemblies of the other devolved administrations, are treated as the accountable bodies. The only exception here is when it comes to the raising of securitised debt, in which case there are central-devolved limits and controls (HMT 2020), although the limits on the levels of securitised debt raised by the devolved administrations are approximately twelve times the total securitised debt moneys which have been raised in England by local governments via the Municipal Bonds Agency and three times to the total value of bonds issued by English local governments during the last decade (Sandford 2020a).

In terms of revenues, following the Scotland Act 2012 which implemented the recommendations of the Calman Commission, and also the 2016 Scotland Act which implemented the recommendations of the Smith Commission, the share of the Scottish Government's revenue which is locally raised increases to more than 50% (HMT 2020; DTWG 2020; OECD 2015a). Alongside the transfer of these new powers, the Scottish Government's block grant is adjusted such that the block grant is increased when a devolved administration takes on responsibility for additional areas of spending and reduced when taxes are devolved or assigned (HMT 2020). The Scottish Government has further powers to directly vary the level of tax and spending in Scotland as well as the ability to design new taxes, subject to agreement of the Scottish Parliament and the UK Parliament (HMT 2020). Meanwhile, for Wales, the most recent reforms means that the Welsh Government will self-fund around a quarter of its spending (HMT 2020). As such, Scotland's devolved tax autonomy is now approaching the levels evident in federal countries as well as in some decentralised unitary countries, whereas Wales is still quite a way away from this point. However, even with these revenue-raising and borrowing differences between the three devolved administrations and English local government, in general the devolved administrations still do not have the levels of fiscal autonomy typically enjoyed by many regions in federal countries regarding borrowing, and the implications of any forms of further UK-wide devolution in such an unbalanced quasi-federal state are unknown.

On point (ix), namely the fact that the structure of the UK governance system militates against both central government learning and local government institutional capacity-building, the basic problem is one of design and architecture of the governance system, and how this distorts or undermines good governance incentives. The architecture of the UK governance system is hyper-centralised, top-down and largely sectoral rather than spatial in thinking. As such, it is overwhelmingly pyramidal, and best depicted as Λ -shaped, i.e., an inverted V-shape, in which sub-central government is overwhelmingly dependent on central government funding, policy decisions and control systems. This is in marked contrast to the governance system of other large economies, which are best characterised as an A-shape, in which the hierarchical governance system has a key meso-level of governance operating at the levels of states, provinces, länder, cantons, autonomous communities, prefectures, or regional levels, and typically with populations of 3m-5m. The key failure of the UK's pyramidal Λ -shaped governance system is that the central government fails to learn any new knowledge from local citizens, communities, and local governance activities. Expert knowledge flows down the ultra-hierarchical governance system but almost no experiential and locally-specific knowledge flows up the system (Coyle and Muhtar 2021). This results in policy-making which is largely devoid of any context or nuances, and in addition, a tendency towards short-termism and the dominance of political and ideological preferences rather than addressing strategic priorities (Coyle and Muhtar 2021).

The reason is that a pyramidal Λ -shaped governance system maximises the degrees of separation between local citizens 'on the ground' and the key policy-makers whose decisions impact most directly on their lives. The maximum degrees of separation are also necessarily

accompanied by congestion at the top of the pyramid, in which numerous interest groups and lobbyists compete for hearings and influence with central government. The result of this structure is that it automatically disincentives almost all citizens, businesses and civil society interest groups on the ground from even attempting to engage with high-level decision-takers and policy-makers, because they know that it is almost entirely a pointless exercise. The only parties who tend to get hearings with central government are large and influential global companies, along with primarily London-based think-tanks, research institutes, lobbyists and benefactors. As such, the knowledge inputs that central government receives in an ongoing manner are not reflective of the wider economy, but primarily of the concerns and priorities of those already located in and around London and its hinterland. In a country with such huge interregional inequalities as the UK, the concerns of London and its hinterland barely reflect those of the country as a whole and this institutional-architectural design problem reflects a profound knowledge failure on the part of the national governance system. It is not a *market failure* problem as economist might think about organisational issues, but rather a *knowledge problem* associated with poor institutional-design of a form very familiar to those working at the boundaries of economics, sociology and political science on governance failures (Stiglitz et al. 2009; Ostrom 2015; Barca 2009).

In marked contrast, other countries aim to address these problems in one of two ways (McCann 2016). One alternative is for the country to be small (Alesina and Spolaore 2005), and this by definition, minimises the degrees of separation between citizens and decision-makers. The short lines of communication in small countries automatically incentives citizens, business, and civic society interest groups to engage with central government, and in turn, for central government to take on board new bottom-up knowledge from local citizens. The other alternative is for large countries to decentralise and devolve real powers to meso-level areas, sometimes by being federal and sometimes via constitutional reforms, as in the case of Japan and France, in order to reduce the degrees of separation and the top-heavy congestion for influence. This produces a A-shaped governance system. These meso-level areas, variously described as states, cantons, provinces, länder, prefectures, autonomous communities or regions, deploy real powers independently of central government, and in particular they are the powers which most directly impact on the lower-level local municipalities. In this type of governance set-up, the key lines of communication are between local citizens and the meso-level governance institutions, and these shorter lines of communication and fewer degrees of separation incentivise citizen engagement with the key meso-level governance authorities, whose governance systems thereby continuously learn new knowledge. In addition, the meso-level governance authorities are better able to help coordination between lower-level local government bodies, while also continuously interacting directly with central government bodies in order to ensure that the interests of their local citizens are continuously represented to central government. This type of A-shaped governance architecture better facilitates the deployment of effective forms of industrial, regional and economic development policies in both federal and unitary states (Coyle and Muhtar 2021); policies in which two-way flows of knowledge between the local and the centre are ongoing features of the policy logic, and which also permit the realistic assessment of outcomes and value-for-money. The current UK institutional set-up almost entirely militates against such activities (Coyle and Muhtar 2021).

The near total lack of such institutions and systems in many parts of the UK means that local leaders and decision-makers in both UK local government and also city-region combined authorities are thereby incentivised to lobby continuously for central government funding in order to reduce the shares of any local project that are locally funded (Travers 2018). This increases even greater dependency on central government (Jeffrey and Swinney 2020) and further militates against any genuine place-based ways of thinking. At the same time central government cannot know the details of small local schemes (Coyle and Muhtar 2021; Travers 2018), so this combination of incentives also tends to favour large and flagship schemes (Travers 2018) rather than many of the much-needed small-scale locally designed and locally tailored interventions. It is no surprise therefore that the UK's governance architecture and systems is associated with very low civic engagement scores (McCann 2016) when compared with other industrialised economies.

Taken together, these nine points (i)-(ix) set out the key features and failures of the UK governance system in the light of the evidence derived from OECD-wide comparators. The UK is an outlier on multiple dimensions and no other large industrialised economy shares the UK's governance features. The only countries whose governance systems are similar to the UK across a range of dimensions are very small countries, typically no bigger than individual UK regions. In contrast, and especially so in other large countries, devolved governance systems tend to lead to more balanced interregional growth, and the current nature and functioning of the UK governance system means that it is uniquely ill-equipped and poorly-designed for the challenges that need to be addressed. The need to close the interregional gaps therefore means that the UK's sub-central governance and fiscal system will need to be reformed, but any reforms will start from a position of already highly unbalanced levels of growth and development, and there is a real danger that if not sufficiently well considered in advance, any reforms may exacerbate the inequalities.

The Current Reforms to Sub-Central Government Fiscal and Financial System

Within England, the government's current reforms to local government finance have three main elements to them, namely: increasing the proportion of business rates retained by the sector (MHCLG 2019); introducing reforms to the business rates retention system, and; reviewing the funding formula that determines funding allocations through the annual local government finance settlement (MHCLG 2019). The move towards a greater local retention of business rates is aimed at ensuring that local authorities have more control over the money they raise and powerful incentives to grow and reinvest in their local economies (MHCLG 2019; NAO 2017). Prior to the onset of the covid-19 pandemic the government planned to increase the share of business rates that local authorities will be able to retain locally from 50% to 75% in 2020/21 (IFG 2020), but the government has also more recently extended the concept towards a 100% business rate retention scheme, with pilots being run in several places. The overall challenge for the government is to design the 100% business rate retention system so as to maximise the scheme's potential to deliver economic growth rather than just tax base growth, as well as to ensure that the benefits of the scheme are widely spread (NAO 2017). However, detailed information on the funding distribution formulas and the underlying systems of

stabiliser grants (HoC 2018) is not yet available because the review of local government funding needs (MHCLG 2018a) and the Fair Funding Review (DCLG 2017b), which was originally set to take effect from April 2021, is still further delayed.

There are many arguments and much evidence which underlies the case for devolved sub-central government finances. Bartolini et al. (2016) find that across OECD countries, decentralised public finances, whereby local spending is paid for by local taxation, is generally associated with more balanced economic growth. Fiscal decentralisation, defined either in terms of revenue or expenditure shares, is also associated with higher GDP per capita (Blöchliger 2013) and higher labour productivity (Blöchliger and Égert 2013; Blöchliger et al. 2013). We also know that decentralisation is strongly and positively associated with PISA educational scores (Blöchliger 2013; Blöchliger et al. 2013; Forman et al. 2020), while higher levels of decentralised fiscal competition and a lower reliance on grant funding are also associated with more rapid expansion of commercial and residential land use (Buettner 2021) and a higher share of productive government expenditures (Hailemariam and Dzhumashev 2019). On the basis of OECD-wide data 1995-2011, Van Rompuy (2021) finds that autonomous local tax revenues and vertical central-local fiscal transfers do not act as substitutes in terms of promoting regional convergence. Weaker regions can gain from greatly expanding their tax base (Blöchliger et al. 2016), given that they tend to be further from the production frontier and therefore have broader margins to improve their competitive position relative to more prosperous regions. If the subnational tax base is sufficiently large, then tax autonomy tends to foster interregional convergence via the incentives for sub-central government to pursue growth-oriented fiscal policies. The result is that revenue-based decentralisation indicators – such as decentralised tax revenues or tax autonomy - have a larger effect than the expenditure-based decentralisation indicators, and this is the case for both unitary or federal states (Blöchliger and Égert 2013). However, the incentives to broaden the tax base are weakened according to the extent to which the sub-central governments are dependent on vertical transfers (Van Rompuy 2021), and a greater dependence on fiscal transfers also reduces the marginal convergence effect of transfers, which eventually turn negative (Van Rompuy 2021). Overall, the empirical results also point to the virtuous equalizing role of sound budgetary policies that enable poorer jurisdictions to avoid future tax burdens that hamper growth while also incentivising growth-oriented fiscal policies around a broad tax base (Van Rompuy 2021).

It is this broad body of evidence which underpins the current momentum or even enthusiasm in certain UK policy quarters for the local devolution and retention of business taxation (McGough and Bessis 2015; LGA+CIPFA 2014) and also the curtailing or abolition of local government grant support system by central government. As Mor and Sandford (2017) explain, the tacit economic arguments favouring the devolution of business rate revenue to English local authorities are threefold. Firstly, it is assumed that local government will be able to systematically increase their business rate revenues via local policy decisions (Mor and Sandford 2017). Secondly, it is assumed that increasing business rate revenues correlate with local economic growth, and thirdly it is tacitly assumed that the structural effects of the business

rate system upon local government behaviour and revenue outcomes will be negligible (Mor and Sandford 2017). In turn, these tacit assumptions derive from a more fundamental assumption that what is observed from OECD-wide evidence regarding the regional economic effects of devolved financing can be transferred and grafted on to the UK sub-central fiscal system *in its current institutional and governance context*.

This is a very strong assumption which has never been tested or substantiated, and this assumption needs to be considered from three different perspectives.

From a conceptual perspective, grafting such reforms onto an already extremely unbalanced interregional system is risky, and there is no precedent for this in OECD countries. This is because decentralised finance may not help all areas, due to the effects of different channels through which decentralisation can affect disparities, namely taxing powers, spending autonomy and the vertical fiscal imbalances (Bartolini et al. 2016). The more deprived English councils rely both absolutely and relatively more on central government funding for their revenues than do less deprived councils (Harris et al. 2019), because economically weaker councils are able to raise less in council tax both in overall revenue terms as well in terms of their overall revenues in comparison to the more affluent localities while also typically facing the greatest needs in terms of service provision (Harris et al. 2019). This is a critical issue in the UK context, because fiscal decentralisation or devolution in an already severely unbalanced economy threatens to further unbalance and fragment the interregional economic system, unless the underlying fiscal stabiliser system is both sufficiently large and also sufficiently well designed to counteract the fiscal destabilising and fragmentation pressures (Amin-Smith et al. 2018b,c). This is especially so where powerful and localised agglomeration forces in certain regions permit tax rises without any loss of economic activity (Collier and Venables 2018), thereby enhancing the local provision of services, whereas weaker regions with no real agglomeration effects may be forced more towards tax competition and poorer service-provision, in order to maintain local economic activities. Where fiscal revenues are increasingly devolved, regional policy may also be needed to offset the either negative economic development incentives of fiscal equalisation (Blöchliger and Charbit 2008) or the local development risks associated with fiscal fragmentation, particularly if funding is based on policy results rather than a jurisdiction's wealth (Blöchliger and Charbit 2008). However, as yet in the UK we do not know the details of the Shared Prosperity Fund (SPF), the intended replacement for EU regional development funds, and how the SPR will interact with other fiscal reforms including those to be launched under the wider Levelling Up agenda. On a conceptual and analytical perspective, there is currently genuine uncertainty around these matters (McCann et al. 2021). Moreover, the recent UK experience of these types of policy programmes is not auspicious, as the experience of the EU Cohesion Policy programmes makes clear. Over the years 2007-2017 spanning two programming periods of the EU Cohesion Funds, the actual UK spending as a share of the planned investments and also the UK shares of unabsorbed funding were some of the lowest amongst the western and northern EU economies. This suggests that in the UK there were serious coordination problems (Forman et al. 2020) in the aftermath of the 2008 global financial crisis and the subsequent centralisation of EU funding systems (Forman et al. 2020). This was a period when England moved to a level of top-down and centralised policy coordination was management was

organised on the basis of a territorial unit which was five times larger than anywhere else in Europe (McCann et al. 2021).

From an empirical perspective, there is also uncertainty regarding the implications of the reforms, because the UK the empirical evidence in favour of devolved and retained business rates on these issues is very thin, to say the least. The learning experience associated with the 50% business rates retention programme has centred primarily implementation issues, such as those associated with the problems and volatility and costs associated with appeals (NAO 2017; DCLG 2017a), and not on the three tacitly-held economic assumptions outlined by Mor and Sandford (2017). In particular, the government does not know precisely how much funding individual local authorities have retained from the 50% scheme (NAO 2017), and how this has changed since the implementation of the scheme in 2013-14 (NAP 2017). Nor has the government examined systematically whether the incentive in the scheme has driven different types of local authority behaviour that might promote economic growth (NAO 2017; Murphie 2018). Yet what the pilot schemes do point to are that the links between local policy and revenue growth are subject to macroeconomic changes; the links between the revenues generated by business rates and economic growth are ambivalent (Mor and Sandford 2017), and the structure of the system does have a decisive effect on individual authority outcomes (Mor and Sandford 2017). The early evidence on the outcomes of the business rates retention scheme suggest that they are largely driven more by chance than by strategy per se (Mor and Sandford 2017). The relationship between business rate revenues and social care needs is zero (Murphie 2018), and changes in local government revenue raising powers were found to be uncorrelated with changes in local per capita GVA, median wages and levels of deprivation (Amin-Smith et al. 2018a; Murphie 2018). Indeed, if London boroughs are excluded, then the relationship between local assessed needs and local revenue-raising capacity is actually negative (Phillips 2018). As such, there appears to be no particular geographical pattern to business rate changes which in any way relates in any way to the geographical variations in needs and revenues, and this problem is even more challenging in the context of ratings pools (Murphie 2018). In other words, across the country the increasing retention of business rates allied with a removal of compensating grants will most likely be associated with a widening of the divergence in funding ratios generated by different localities (Amin-Smith et al. 2018b). Overall, the empirical evidence based on the first four years of the scheme (Mor and Sandford 2017) suggests that all three of the tacit assumptions underpinning the economic case for local business rate retention can be challenged, and this also raises questions regarding the strong underlying assumption underpinning the whole reform case.

These reforms therefore imply that for English local government there is now a growing tension between the national responsibility for fiscal equalisation and the local responsibility to increase local revenue growth, as well as a tension between the local tailoring and discretion in policy prioritisation and provision and the desire for national consistency in standards and service accessibility (Phillips 2018). This tension may in part be due to English local governments' very narrow tax raising powers associated with household and business rates (Amin-Smith et al. 2018a) and to help counter any such destabilising effects, Amin-Smith et al (2018a) argue that periodic full or partial re-equalisations of revenues and assessed needs are required. Yet, even after the reforms, as a share of either GDP or public sector finances, English

local government revenues, expenditures and investments will still be tiny by OECD-wide standards, and the overall hyper-centralised fiscal and institutional architecture of the UK sub-central governance system will still remain largely unchanged. In marked contrast, across the OECD, decentralised sub-central government finance tends to be a metaphor for much more widely devolved powers and decision-making, bottom-up policy formulation, and devolved fiscal control systems, whereas what is taking place in the UK at present, at least prior to the publication in late 2021 of the Levelling Up White paper, is the devolving of local taxes within largely the same straight-jacket of the top-down fiscal direct control and accountability systems. Even after 100% business rate retention, locally-generated revenues in English regions will still only increase by 2-3 percentage points, barely altering the overall fiscal architecture. As such, even with the proposed changes, the UK fiscal governance system is still primarily a *direct control* system, with some tiny elements of a *rules-based* system being added, without actually becoming one (Vammalle and Bambalaite 2021a). The only exceptions to this are the three devolved administrations, which are currently moving towards operating under a primarily rules-based system (Vammalle and Bambalaite 2021a). However, even here the central government control systems remain very powerful, even though the devolved administrations themselves would prefer to move towards more of a *cooperative approach* to fiscal governance. Countries which are federal tend to display a high level of *market-based* fiscal management systems, whereas the UK is becoming a quasi-federal state with a greatly unbalanced mix of direct control and rules-based fiscal governance systems. There is currently no precedent for this in the industrialised world.

As such, it is hard to see how the current reforms address the reality that increased local fiscal discretion and also nationwide standardisation of service-provision inherently move in opposite directions to each other. Reforms of this nature in a country which is interregionally very equal in terms of productivity and incomes is relatively straightforward, whereas this is not the case in a country where fiscal decentralisation is superimposed on a very unbalanced interregional economic system. This is on top of the fact that over the last two decades the UK fiscal stabiliser system as a whole has become less redistributive, and more recently now also faces the reality of the withdrawal of EU regional development funds. In this context, these business rate reforms are likely to accelerate these pre-existing regional divergence trends, unless the underlying fiscal stabiliser is both sufficiently large and sufficiently well-designed to counter such destabilising and fragmentation pressures. From a national productivity and ‘Levelling Up’ perspective, as well as new local development opportunities, there are also serious risks involved in these reforms, especially for the economically weaker localities. That is, unless these reforms are in reality the first stage of a much more comprehensive programme of UK sub-central government institutional and governance reforms addressing each of the nine points (i)-(ix) raised earlier. Otherwise, the fundamental mismatch between the UK’s interregional inequalities and its over-centralised governance system still remains.

Looking Forward? Discussion and Conclusions

The fiscal structure of the UK polity is very unusual on many levels when compared with other OECD countries. Indeed, the specific combination of nine features of the UK fiscal system, as

captured by the points (i)-(ix), means that the UK fiscal system is unique. Unfortunately, the highly top-down, centralised and unbalanced nature of the UK's governance system militates against any serious role for local knowledge generation to shape higher-order decision-making, and this undermines the efficacy of many areas of industrial, regional and local economic development policies (Coyle and Muhtar 2021). In terms of the Levelling Up challenges, the UK's very high interregional inequalities, allied with the OECD-wide evidence on sub-central fiscal systems, suggests that the UK's governance arrangements are both a significant causal part of these inequalities (McCann 2016) and also a significant hindrance to addressing these problems. At the same time, the enthusiasm for fiscal decentralisation and devolution which is underpinning some current sub-central fiscal reforms appears to be based largely on optimism bias (NAO 2017) rather than either hard evidence or structured long-term thinking. Fiscal decentralisation and devolution can help countries provide better households and firms with better public services (Forman et al. 2020) and, if well-designed, can also help to promote more even interregional growth patterns. However, fiscal decentralisation and devolution can make inter-governmental frameworks more complex, and therefore can also make the equity of service principle more difficult to achieve (Forman et al. 2021). As such, devolution and decentralisation may involve complex and difficult trade-offs which need to be carefully considered

While the OECD-wide evidence is generally supportive of a country such as the UK being far more decentralised and devolved than it currently is, getting to that point is a far trickier question. The reason, as already explained, is that the UK is already extremely interregionally unbalanced, so fiscal devolution and decentralisation may have fragmentation and exacerbating effects, unless the fiscal stabilisation system is carefully designed.

As point (ix) detailed, in order to overcome the endemic knowledge failures of the UK governance system, the crucial issue is how to change the governance system from being as Λ -shaped, i.e., an inverted V-shape, to an A-shape.

The crucial missing element is that of meso-level institutional capacity-building (Jeffrey and Swinney 2020), which should be the cornerstone of steps towards decentralisation and devolution. The sub-central governance authorities should be empowered with resources and tools, including appropriate legal frameworks, strategic and accountability frameworks, to shoulder the responsibilities associated with taking many of the decision locally which are currently reserved to Westminster and Whitehall. Otherwise, it is hard to see how any genuine place-based approach to economic development can be initiated.

In the UK, one of the most notable steps in this direction is the recent creation of the city-region combined authorities. In the case of functional urban areas, under the right conditions of a high quality of local or regional government and low institutional fragmentation, governance decentralisation is positively linked to productivity growth (Jong et al. 2020). As such, in the modern globalised economy, given the key roles played by cities in shaping national economic growth, a key challenge for devolution processes would be to facilitate the decentralisation of responsibilities to urban governments (Boadway and Dougherty 2018). This will involve new thinking about revenue decentralisation, policy harmonisation and the likely restructuring of intergovernmental transfers so that cities can implement their policies effectively and

accountably (Boadway and Dougherty 2018). However, in the UK context this is very challenging because so much of the UK productivity problem is related to the under-performance of the UK's large cities outside of the south of England (McCann et al. 2021). This is also reflected in the fact that in the post-crisis period although cities in general were still more productive in terms of generating taxes than other types of places, apart from London, it was actually smaller cities that increased their tax generating shares relative to larger cities (McGough and Piazza 2016). Relative taxation declines were clearly evident in the less prosperous cities relative to the more prosperous cities with a taxation change geography reflective of the general regional shocks (McGough and Piazza 2016). Not surprisingly, therefore, over recent decades, the nationwide reliance on London as a tax generating location has therefore increased over time. The share of London's urban tax take has increased so much that whereas in 2004/05 London generated as much economy tax as the next 24 biggest cities, by 2014/15 London was generating almost as much as the next 37 largest cities (McGough and Piazza 2016).

Given these realities, it is hard to see how the nationwide devolving and retention of business rates will favourably alter these inter-urban imbalances, imbalances which underpin the UK interregional inequalities. Nor is it possible to see how the city-region combined authorities, as currently constructed, can make a major impact on UK interregional imbalances. In terms of population sizes, UK city-region combined authorities are typically between only 20% and 50% of the average OECD-wide size of devolved meso-level governance institutions, and especially of those in other large OECD countries (McCann 2016). In addition, as we will see shortly, on the basis of OECD-wide evidence they are also greatly underpowered in terms of scale, resources and legal powers. This is exacerbated by the fact that, as we see in Appendix 3, the current situation of microscopically small combined authority annual funding allocations⁸, limited financial and legal leverage beyond that of their constituent local authorities, and the ability of central government to change many policies and priorities without regard to city-region preferences, thereby incentivises the metro-mayor combined authorities to develop into 'grant coalitions' (Sandford 2019), seeing central funds as the only available route to generating local impact (Sandford 2019). As such, today in England, the levels of direct control by central government over city-region and local government mean that in reality, these institutions are more accountable to central government than they are to local voters and stakeholders (Jeffrey and Swinney 2020). This naturally limits any potential transition from a Λ -shaped governance system to an A-shaped system.

In order to move beyond the current dysfunctional system and towards something that looks more like a genuinely devolved governance and decision-making system, Jeffrey and Swinney (2020) argue therefore that devolution discussions in the UK should not begin with which powers to devolve, but rather the building of institutional capacity and accountability via a better linking of political geography with the economic geography so that existing powers can be better deployed, as well as further devolved ones (Jeffrey and Swinney 2020). On this point, various arguments have been put forward that it would make far more economic sense and also

⁸ Annual funding levels in the three larger city-region combined authorities (Manchester, West Midlands and West Yorkshire) is of the order of only 0.1% of annual city-region GDP.

risk-management sense for the pooling of rates and council tax to take place over much larger areas, such as city-region combined authorities (McGough and Bessis 2015) or even regional areas (LGA+CIPFA 2014). This mirrors the calls to develop serious policy-making and governance institutions at the region-wide areas (UK2070 2020; ISC 2021; OPC 2020) for those activities for which very local framing makes little or no sense, such as for inward investment, supply-chain development, various infrastructure-related issues, many environmental challenges, R&D and innovation, and entrepreneurship. Both the Northern Powerhouse and Midlands Engine initiatives were aimed at addressing precisely these issues, although in recent years these appear to have drifted off the government's agenda. Within the UK, the devolved administrations, and especially Scotland, and to a lesser extent also London, are the closest to what appears to be the OECD-wide optimal scale of sub-central and meso-level governance and institutional configurations that exist, when compared with OECD-wide evidence. In contrast, most English city-region authorities are tiny by OECD-wide meso-governance standards, and under any further England-wide city-region devolution or devolution to counties, would mean that the average scale of such institutions would be even smaller by OECD standards, and would not address the broader regional issues, including the economic development links between cities and their hinterland towns and rural areas. For this reason, it may well make sense for regional governance functions regarding many broader economic development issues to be developed at the meso-level of the 9 large ITL1/OECD-TL2 former Government Office statistical regions in England (ISC 2021; UK2070 2020) alongside the three devolved administrations, or at even larger meso-combinations of regions for issues such as spatial planning (One Powerhouse 2020).

Alternatively, for those civil society actions which are hyper-local in context and operation, then greatly enhancing the decision-making autonomy and resources of very local and municipal governments would make more governance sense. In the UK at present, local government is emaciated and emasculated and regional governance is almost non-existent, apart from the devolved administrations and to a lesser extent London. Indeed, UK-wide regional authority and local autonomy are presently at similar orders of magnitude to small eastern European countries which were formerly communist economies (Hooghe and Marks 2021). The critical issue would be to ensure that very local decision-making also coordinates with higher meso-level decision-making, as takes place in other large and decentralised countries, irrespective of whether they are federal or unitary. As we see in Appendix 3, various proposals have already been put forward about the fiscal workings of a more devolved UK governance geography (Bell et al. 2021; Jeffrey and Swinney 2020) and how or whether these could be built into a reformed sub-central government framework, needs to be considered carefully. In particular, the better alignment at different spatial scales of different tiers of governance and functional economic geographies would appear to be critical for different economic issues, and also to internalise externalities and spillovers into decision-making. In England, the current patchwork of local development institutions is rather chaotic and defies any real implementation or fiscal logic related to economic geography (Westwood et al. 2021).

Regarding how sub-central government reforms might be considered, it is necessary to recall from earlier that there have been various calls to develop serious policy-making capabilities and governance institutions at the region-wide areas (UK2070 2020; ISC 2021; OPC 2020;

Raikes 2020) for those arenas where localised policy-framing makes little or no sense. At the same time, there have also been calls from various quarters for devolution and decentralisation to be primarily at a very local or even neighbourhood levels where wider-scale policy-framing make no sense. The central question here is therefore how to design a sub-central institutional framework which allows us to achieve the right balance the relationship between the size of the sub-central governance units and the specific roles and responsibilities they are required to take on, and to do this in a manner which overcomes some of the underlying constraints inherent in the sub-central fiscal system.

In order to respond to this question, it is necessary to begin with the fact that sub-central city governance bodies have four distinct functions (Clark et al. 2010), three of which have similar geographical and size-related implications and one of which has very different geographical and size-related implications. The first three roles of sub-central government are what are known as ‘citizen facing’ roles (Clarke et al. 2010) and these are, namely: the representation of citizens in the actions of the elected officials; the provision and delivery of household, personal and amenity-related activities and services; and the regulation of activities associated with the provision and enforcement of guidelines necessary for maintaining social order and community wellbeing (Clark et al. 2010). These three citizen-facing roles can often be carried out effectively in terms of local government areas or even at smaller scales, but this is not the case for the fourth role of sub-central government, namely, the ‘market facing’ role of stimulating investment and economic development (Clark et al. 2010). The ‘market facing’ role of sub-central government aimed at fostering investment and economic development can rarely be justified at the very local level, and typically is better framed at either a city-region or at an even wider regional level (UK2070 2020; ISC 2021), as the case in other large federal or highly devolved unitary countries. In these other cases, economic policy is typically carried out at spatial levels of between 3m and 5m for issues related to foreign direct investment, supply chain development, skills training, innovation and R&D promotion, because these economic development and investment activities operate in the context of wider and diverse market areas, geographies, timeframes, financing, partners and stakeholders, tools and audiences, well beyond very local areas (Clark et al. 2010). As a result, these more complex and varied ‘market facing’ activities often require different structures and organisational arrangements from the other three ‘citizen facing’ roles (Clark et al. 2010), involving different vertical and horizontal governance relationships which extend well beyond local areas or even the individual functional urban area, and undertaken with regard to very different time frames to the other more localised citizen facing roles.

Moreover, this is further complicated by the fact that the distinction between the ‘citizen facing’ and ‘market facing’ roles of sub-central government is not a question simply a question of economic versus non-economic activities. While the provision of local transport services is often argued to be best deployed at the level of a functional urban economic area in order to enhance local agglomeration effects, this is still fundamentally a citizen facing role, whereas city-region governance arrangements may not actually be the appropriate spatial scales for some of these other market facing roles associated with attracting foreign direct investment, supply-chain development, or the enhancement of innovation and R&D. These may well be more appropriately handled at the level of groups of cities or city-regions and their hinterlands,

under a wider regional agenda. In other words, a key challenge in moving the governance of a country such as the UK from an Λ -shape to an A-shape is also to allow for variegated geographies associated with different roles and functions. Such variegated geographies are inherent in federal systems or devolved unitary states, with different governance roles and responsibilities operating at different spatial scales, nested within the hierarchical institutional and fiscal system. In the UK consideration therefore needs to be given as to how this might be possible, given the fiscal and legal implications of this outlined above. Given that the market facing economic development issues are typically associated with different economic geography scales and timeframes to the more localised citizen facing roles, then a fiscal system which allows for these different roles needs to be constructed by adapting the existing system, as defined by points i-ix above. This is complex, as it depends on how the geography of economic development policy maps onto, or is grafted onto, the pre-existing fiscal and institutional structures.

A major part of the challenge here is to allow for coordination which spans jurisdictions. In this regard, across the OECD there are four types of sub-central governance arrangements (OECD 2015b) which are used to facilitate the coordination of these ‘citizen facing’ and ‘market facing’ activities across municipalities, either within or between cities and city-regions. These four types of governance arrangements in ascending order of legal stringency are (OECD 2015):

- *informal arrangement* based on soft powers, information sharing and consultation, but with no legal basis or powers. Across the OECD, *informal arrangements* account for some 52% of governance arrangements, with tiny budgets of some \$3 per inhabitant allocated to these activities (OECD 2015).

- *inter-municipality bodies*, which are set up to share the costs and responsibilities in addressing a particular purpose or a small number of specific purposes. Sometimes, these may also involve bespoke arrangements for coordinating with either higher levels of government or sectoral. Across the OECD *inter-municipality bodies* account for 24% of metropolitan governance arrangements and cities displaying these bodies typically are of the order of 2 million, with large budgets of some \$184 per inhabitant allocated to these activities (OECD 2015).

- *supra-municipal authorities*, are a layer of governance above individual cities or city-regions and these can be established either by central government or by elected actions by groups of cities. Across the OECD these arrangements account for 16% of governance arrangements, and typically cities with these arrangements are of the order of 2.5 million, with small budgets of only \$14 per inhabitant allocated to these types of activities (OECD 2015).

- *metropolitan city governance* systems are the most stringent forms of governance, and this is where cities are granted autonomous powers equivalent to the next upper tiers of government. Across the OECD these bodies account for just 8% of governance arrangements and the average size of such cities is typically of the order of 4 million people, with very large budgets of some \$2759 per inhabitant allocated to these activities and roles (OECD 2015).

The least stringent forms of metropolitan governance, namely informal arrangements, have little power and resources. They are attractive to potential stakeholders precisely because the

legal and financial commitments are very limited, but these same features can also be debilitating, inhibiting the realisation of any significant economic development changes (OECD 2015; McCann 2016). At the other end of the spectrum, greater stringency provides a more robust legal basis on which to effect change. If greater stringency is combined with greater resources, then the ability to bring about change is significantly enhanced, although as we see above, across the OECD, stringency and resources do not map directly on to each other. In the case of the UK, London displays some elements of both the metropolitan city governance model and also the inter municipality bodies, especially regarding transport and land use planning issues. In contrast, most of the city-region combined authorities in the UK more closely resemble informal soft governance arrangements, at the same time, using the prospect of additional central government funding to incentivise local governance behaviour more closely associated with inter-municipality and supra-municipality bodies.

In terms of the efficacy of institutional and governance arrangements in driving productivity growth across cities and regions, as well as a lack of coordination over appropriate spatial scales, another danger is institutional fragmentation which can entirely undermine agglomeration economies (Ahrend et al. 2014; 2017). As such, devolving policy-making to areas which are too small is counter-productive, as is failing to provide the requisite powers, autonomy and resources to allow coordination across localities, jurisdictions and administrative boundaries in order to build effective scale. If devolution involves decentralising economic development powers to spatial units which are either too small and local or unrelated to any meaningful economic geography, then the likelihood of such governance reforms fostering Levelling Up is low. In other words, the decentralisation and devolution of economic development powers must be undertaken with respect to the appropriate economic scale, devolved powers and resources, and the necessary coordination arrangements. As it is, devolved city-region combined authority government within England is only of the order of 20%-50% of the typical OECD-wide average scale, and if the further extension of devolution within England is primarily framed around the proliferation of even smaller units below 1 million people, then this will further inhibit the much-needed leveraging of scale required to help turn around economically weaker regions.

In terms of enhancing local productivity, and especially in the economically weaker parts of the UK, finding ways to move the UK's governance system from being primarily a Λ -shape to an A-shape is a critical issue, and the efficacy of any sub-central government fiscal and institutional reforms to the UK's sub-central fiscal and governance system (described by points i-ix above) must be assessed essentially in the context of these scale-related and coordination-related governance challenges. The fiscal arguments and evidence outlined in this paper suggest that, while the current city-region initiatives have been very useful steps forward, of themselves, these types of arrangements cannot be a long-term solution to the Levelling Up challenges.

When assessing how the UK's steps towards greater devolution or decentralisation as part of a Levelling Up agenda measure up, in the light of the various fiscal arguments outlined in this paper, and based on fifteen years of OECD country surveys, it is necessary to take on board

the major diagnostic observations of Forman et al. (2020) which synthesise the key challenges facing all forms of fiscal federalism into three broad sets of recommendations and priorities, namely Fiscal Capacity recommendations, Delineation recommendations, and Coordination recommendations:

Fiscal Capacity recommendations: strengthen sub-national taxation and spending powers to allow governments to respond better to local needs and regional variations.

Action 1. Better align own-source revenues with sub-central spending.

Action 2: Raise sub-central tax autonomy to ensure sufficient capacity

Action 3. Strengthen fiscal equalisation systems

Delineation recommendations: clearly delineate responsibilities both horizontally and vertically to improve efficiency and equity.

Action 4. Delineate functions and responsibilities across levels of government clearly

Co-ordination recommendations: minimize barriers to internal trade and enhance inter-governmental co-ordination.

Action 5. Improve transparency, data collection and performance monitoring to enhance co-ordination

In order to undertake these actions so as to respond to these recommendations, the OECD (2019) provide an important set of issues to focus on when considering devolution and decentralisation, and these are pertinent to the current UK context. These ten guiding principles which apply to all OECD countries (OECD 2019; Forman et al. 2020) are:

1. Clarify the policy areas assigned to different government levels to avoid duplication, waste and loss of accountability.
2. Clarify the functions assigned to different government levels such as financing, regulating, strategic planning, implementing, or monitoring.
3. Ensure balance in the way different policy areas and functions are decentralised. This allows for complementarity and integrated policy packages for territorial development.
4. Align responsibilities and revenues while enhancing the capacity of sub-central governments to manage their own resources.
5. Actively support sub-national capacity building. More responsibilities at the sub-central level need to be complemented with the human resources to manage them.
6. Build adequate co-ordination mechanisms across levels of government to manage shared responsibilities
7. Support cross-jurisdictional co-operation through specific organisational arrangements or financial incentives to increase efficiency through economies of scale.

8. Allow for asymmetric arrangements and pilot experiences to ensure flexibility in implementation.
9. Effective decentralisation requires complementary reforms in land-use governance, citizen participation and public service delivery.
10. Enhance data collection and strengthen performance monitoring to provide useful data for decision-making and peer learning

Implementing further fiscal devolution and decentralisation in the UK therefore involves a comprehensive and wide-ranging set of changes, which need to be implemented in the context of the UK's specific and unusual characteristics, described earlier as the key points (i)-(ix). The UK sub-central governance system is already rather ad hoc (APPGD 2021), as is the centralised logic underpinning the regional patterns of major public investments (Coyle and Sensier 2020). In addition, the governance structure of the UK is very asymmetric with no clear definition of the centre, given that Westminster is both the parliament of the UK and also of England (Keating 2012). In contrast, successful devolution and decentralisation reforms will need to be based on carefully designed principles and a well-crafted underlying institutional logic of the system. This in turn will require answering fundamental questions about what Levelling Up is, including what the specific devolution-related objectives are that any reforms are aimed at addressing (Shearer et al. 2021), which decision-making and fiscal powers should be devolved, and what the distributive and democratic issues that need to be addressed are (Cox 2017). Fiscal decentralisation in OECD countries is typically a metaphor for the devolution of real decision-making powers, and genuine local and regional autonomy and authority. As such, simply changing one or two features of the UK sub-central fiscal system while largely maintaining the top-down and centralised governance arrangements is unlikely to fundamentally alter the nature or efficacy of the UK governance system or address any of the Levelling Up challenges. Indeed, this type of policy-tweaking may even worsen the current regional imbalances if the changes are poorly designed and implemented.

Rather than being a specific feature of the UK fiscal system, it is the combination of nine features (i)-(ix) of the UK central-sub-central fiscal system which makes Levelling Up so difficult. In particular, the current system both contributes to the (v) creation of regional distortions, while also explicitly (ix) militating against place-based thinking and policy actions. Levelling Up cannot be achieved by minor or even major changes to one or two of these features, because the systemic features of the fiscal framework will not allow it. Major fiscal reform is required alongside institutional and governance reforms if Levelling Up is to be a reality. Reforming the UK fiscal system should be an urgent priority for enhancing UK economic policy making (Chadha et al. 2021), and if Levelling Up is to genuinely work in the long run, wholesale reform of the UK sub-central fiscal system must be a key part of an overall overhaul of the overly top-down and centralised UK governance system. However, the fact that it has taken the UK more than thirty years to get into this situation of regional imbalances, also suggests that genuine Levelling Up is likely to be something of a two or three-decade process. There are already various outlines of the how this devolution process might proceed and the requisite spatial and non-spatial elements of process (UK2070; OPC 2020; Cox et al. 2014a,b;

Raikes 2020), but the one common theme amongst all of these schema is that, in order to be successful, Levelling Up has to be a long term agenda spanning parliaments and governments, and spatial as well as institutional and fiscal issues all need to be addressed in conjunction with each other. Indeed, alongside such reforms, progress in implementing and delivering such an agenda would potentially need to be overseen by an independent body, akin to the role that the OBR Office for Budget Responsibility plays in fiscal and macroeconomic matters.

A final word relates to the impacts of the covid-19 pandemic. During the covid-19 pandemic, across the OECD sub-central government fiscal positions have tended to hold up better than in the aftermath of the 2008 global financial crisis, as many central governments have this time stepped in to shore up sub-central finances (Dougherty and di Biase 2021), and this is also the case in the UK. Although local government took the lead on many issues and there was unprecedented central-sub-central government cooperation during the pandemic lockdowns across the OECD (OECD 2020b) and in the UK (LGA 2021). However, greater central government financial intervention in sub-central affairs also implies that the role of central government relative to sub-central government has become relatively more important (McCann and Ortega-Argilés 2021), and such will tend to move against devolution or decentralisation in the post-Covid era.

In the light of all of the OECD-wide evidence as well as UK-specific evidence marshalled here, the key insight is that for the productivity gaps between UK regions to be narrowed (or ‘Levelled Up’ in contemporary parlance), profound governance and fiscal reforms are required to the structure of the UK’s central-sub-central government relationships. The reason is that the design and logic of the UK’s central-sub-central fiscal system itself militates against Levelling Up. As such, tweaking one or two of the nine features (i)-(ix) of the UK central-sub-central fiscal feature system will not foster levelling up unless genuine and widespread decision-making powers, resources, autonomy and authority are devolved downwards to both a regional and local levels. As it is, the ultimate obstacle to Levelling Up is that the British constitution is founded on parliamentary sovereignty, without any geographic checks and balances.

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Appendix 1. The UK Interregional Fiscal Stabiliser System

There are many frequent claims that the UK provides a strong interregional safety net and regional development programmes. In particular, these claims tend to focus on the importance of the fiscal surpluses generated by London and neighbouring regions in supporting other UK weaker regions. However, in order to assess the veracity of these claims, it is important to set these discussions in the OECD-wide evidence.

In terms of the relationship between regional economic development and fiscal equalisation it is often very difficult to distinguish between tax sharing, fiscal stabiliser grants and earmarked economic development grants (Charbit 2009; OECD 2014) and consistency of definitions is important (Blöchliger and Petzold 2009a) in order to begin to disentangle the effects of these different, but closely related, fiscal mechanisms. Blöchliger and Petzold (2009a) find that across the OECD, sub-central revenue is composed of 33% of autonomous taxes, 8% of strict tax sharing, 14% of tax sharing and 45% of intergovernmental grants. Yet, in strict definitional terms, the UK has no tax sharing properties (Blöchliger and Petzold 2009a), only grants and fiscal stabiliser systems. On this basis, as we have already seen in the main text, UK fiscal stabiliser systems are typically of the order of 1%-2% of UK GDP while regional development programmes are typically of the order of just 0.1%-0.2% of UK GDP (McCann 2016). By international standards these are low numbers, especially given the scale of the UK inequalities. Moreover, as we have also seen in the main text, the UK interregional fiscal stabiliser system has become increasingly a cost-based fiscal equalisation system, a type of system which does very little to redress interregional inequalities.

There is also the question of what interregional fiscal transfers actually imply. In a country whose productivity performance is very equal spatially, such as The Netherlands, Australia, Japan, Finland, or New Zealand, then there is little need for interregional transfers by definition. On the contrary, the need for high transfers implies that the economic systems of cities and regions is not working properly and that some parts of the interregional system are far behind others, as in the case of the UK. As such, one might expect that interregional transfers in the UK are very high by international standards precisely because the interregional inequalities are so high. Yet, this is not what we see.

In order to demonstrate this, we know that if the various UK interregional fiscal flows are very high by international standards then the cross-country ranking of the Gini coefficient of interregional inequality (calculated on the basis of regional GDP per capita) will be much greater than the equivalent ranking calculated on the basis of regional disposable household income⁹. However, in McCann (2020) we see from line 4 of Table 1 that there is no real difference in the relative OECD-wide rankings. Indeed, the relative ranking of the UK in terms of regional disposable incomes (RDI) is actually slightly worse than the ranking calculated on the basis of regional GDP per capita. This suggests that interregional fiscal transfers in the UK

⁹ On average, across the OECD, in the year prior to the global financial crisis, sub-central government (SCG) fiscal disparities, as measured by the coefficient of variation of fiscal capacity before and after fiscal equalisation, decrease by almost two thirds in response to fiscal equalisation measures (Blöchliger and Charbit 2008).

are not high by international standards, especially in the context of the UK's extreme interregional inequalities, and as also already explained in point (i) of the main text.

The latest ONS data (ONS 2021a) suggests that currently London runs a fiscal surplus of £36.1bn per annum, a surplus which has increased steadily since the aftermath of the 2008 global financial crisis, at which point the London's fiscal surplus was close to zero. The South East region also produces an annual fiscal surplus currently of some £20bn, and the East region has a small fiscal surplus of some £4bn. All other regions run fiscal deficits. The ONS (ONS 2021b) also calculates that the GDP of the London economy is £503.65bn, so a £35bn surplus represents outward interregional transfers of 6.94% of the London economy. The GDP of the South East is £327.1bn and the East is £190.96bn, so their regional fiscal surpluses currently represent 6.1% and 2.1% of the regional GDP figures, respectively. These three regions together currently generate a combined fiscal surplus of some £60bn, which is approximately equivalent to annual UK defence expenditure. In contrast, the regions which run fiscal deficits collectively amount to regional deficits of some £116bn, which are some £56bn greater than the combined fiscal surpluses of the London, South East and East regional economies, and this fiscal gap would need to be paid for by borrowing. The fiscal surplus generated by London plus its hinterland regions only pays for part of the public services and investments in other parts of the UK. Typically, UK government new borrowing after the 2008 crisis and prior to the onset of the Covid-19 crisis in 2020 has increased annually at approximately 80bn per annum. All regions contribute to the UK-wide tax take of over £800bn per annum (IFS 2021), and the majority of the services and investments in other regions are therefore paid for by a combination of locally-generated taxes plus public borrowing.

It is possible to argue that these figures are misleading because London displays such widespread interregional employment commuting the fiscal surplus contribution of the London economy (including local indirect and induced multipliers) calculated on the basis of the ITL1 geographical definition of the London region in reality is a lower bound estimate – and that it may in reality be bigger than the simple London calculation above suggests. We can address this point directly by using the OECD Metropolitan Urban Area definition of London of 12.43m people, based on commuting shares and contiguity of built-up areas. This is some 3.47 million people (or 38.7%) larger than the 8.961m population of the Greater London region. Even though the fiscal surpluses of the South East and East regions are largely generated according to workplace locations, it is possible to argue that – as an upper bound estimate – the local GDP in the parts of these regions immediately neighbouring to Greater London is largely a derived demand associated with London-centric economic activities. As such, it could be argued that the true fiscal surplus of London is larger than what is calculated above, given that incomes and property taxes paid in the hinterland of London are being paid out of profits and wages generated in London workplaces. On a simply pro-rata basis, the fiscal surplus of the wider London Metropolitan Urban Area economy would therefore be something of the order of £50.1, an increase of £14bn on the Greater London definition of London, or equivalently 9.94% of the Greater London GDP. This upper-bound would put London's fiscal surplus at something of the order of 10% of its GDP.

On this argument, and given that London is broadly monocentric, and also that the South East region encircles approximately two-thirds of the Greater London region while the East encircles approximately one-third of the Greater London region, then we could ascribe two-thirds of the additional London surplus to parts of the South East and one third of the additional surplus to parts of the East. (The fact that land and house prices per square metre tend to fall away with distance from central London means that this is likely to be an over-estimate). This would imply that the fiscal surplus of the remainder of the South East is £20bn-£9.33bn = £10.66bn (or some 5.6% of its regional GDP) and for the remainder of the East is £4bn-£4.66bn = -£0.33bn (or approximately zero % of its regional GDP). However, irrespective of which way we calculate this, these figures put London's fiscal surplus at between 7% and 10% of its GDP. These figures are very much in line with figures suggested by earlier research (CCL 2012, 2014). The earlier pre-2008 crisis and post-crisis estimates on the scale of these interregional transfers suggest that the fiscal transfers out of London are typically of the order of 4-9% of London's GVA, but in the post-crisis period this fell to close to zero (McCann 2016). Net outflows from the South East were the greatest followed by the East, as the recent Onward paper 'Levelling Up the Tax System' (Blagden et al. 2021) also shows.

Moreover, if we separate out interregional transfer payments related to unemployment and welfare, from those growth-enhancing investments which involve infrastructure and R&D, the more prosperous UK regions actually benefit the most from such growth-enhancing public investments (Blagden et al. 2021; Rogers and Evans 2018). The former transfer payment funds help to stop localities from completely collapsing but they play little or no role in fostering economic development processes. In contrast, new infrastructure, R&D as well as heritage and cultural investments, all have the potential to foster economic development via improvements in market access for either input or outputs, to facilitate greater local and interregional knowledge spillovers, and also to enhance the skills profile of the locality via better job-matching and human capital migration processes. Even within the category of infrastructure investments, when it comes to growth and development the kinds of infrastructure assets we need to consider as particularly important are assets of transport and digital networks, rather than installations of power stations or incinerator systems.

Overall, however, the fact that London has a GDP per capita premium of something over 70% above the UK average¹⁰ and some 90%-130% above most of the regions outside of the south of England, then all of these various figures mean that London still has a net GDP per capita premium of somewhere between 153% and 158% above the UK average, even after taxes are paid. Therefore, to conclude, the unwarranted claim that a lot of money is transferred from the UK's more prosperous regions to its economically weaker regions in the form of fiscal stabilisers and regional development grants is not true, and this distorted narrative highlights the very problem underlying the whole system because this is not how the UK fiscal system works. All UK regions contribute locally to the tune of 90% of the total UK tax take of over £800bn per annum (IFS 2021), with some 10% paid for by borrowing, and the combined fiscal surplus of London, South East and East regions is of the order of £60bn per annum, such that

¹⁰

<https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/regionaleconomicactivitybygrossdomesticproductuk/1998to2018>

the maximum possible interregional fiscal stabiliser amounts to no more than 7.5% of public finances, in the case that all surplus tax revenues generated by the fiscal surplus regions are transferred to fiscal deficit regions. However, it is clear that this is not how UK interregional fiscal transfers work and there are three reasons for this. Firstly, the majority of the shortfalls in UK public investment are paid for by public borrowing rather than by interregional fiscal transfers. Secondly, the UK only has small interregional transfers in comparison to other OECD countries of similar income levels and with similar high interregional inequalities, and thirdly, the UK also has shifted over the last two decades towards more of a cost-based than revenue-based fiscal stabiliser system, and cost-based systems only act as very limited interregional stabiliser mechanisms in comparison to revenue based fiscal stabiliser systems. At present, all decentralised economic development policies in England are something of the order of £23bn per annum (Shared Intelligence 2016), or equivalently less than 3% of public investment and 1% of national output GDP. However, only a tiny share of these funding streams are explicitly tilted towards favouring economically weaker places. As such, what might be considered regional policy is typically only of the order of 0.1%-0.2% of GDP (McCann 2016).

Appendix 2 The Fiscal Arrangements in the Three Devolved Administrations

In terms of revenue raising powers, Scotland retains 100% of council tax revenues and also 100% of non-residential business rates as well as 100% of all other property and land-related taxes (HMT 2020). Meanwhile, following the recommendations of the Silk Commission the Welsh Government was afforded more devolution for a range of tax and borrowing powers (HMT 2020), and the full devolution of business rates took effect from April 2015, bringing the Welsh Parliament's powers in line with those already in effect in Scotland and Northern Ireland (HMT 2020). The Wales Act 2014 also provided the Welsh Parliament with further powers so that stamp duty, land tax and landfill tax were devolved on 1 April 2018, and replaced by land transaction tax and landfill disposals tax, while the first Welsh rates of income tax were set for the 2019-20 tax year (HMT 2020). These reforms means that the Welsh Government will self-fund around a quarter of its spending (HMT 2020). In Northern Ireland, domestic rates are set by a combination of the Northern Ireland Executive - the regional rate component - and the individual local councils - the district rate component (HMT 2020). Decisions on spending allocations between Northern Ireland departments and councils are also devolved matters (HMT 2020), and the Northern Ireland Executive and local councils also have full control over the level and structure of non-domestic business rates, and on spending the income generated (HMT 2020). Other provisions are largely similar to Scotland and Wales.

In terms of borrowing, the Scotland Act 1998, as amended by the Scotland Act 2016, enables Scottish Government ministers to borrow for capital expenditure up to a cumulative maximum of £3 billion (HMT 2020). The annual capital borrowing is subject to a limit set by HM Treasury ministers. The annual limit on capital borrowing is 15% of the overall borrowing cap, i.e., £450 million per year (HMT 2020). Capital borrowing may be undertaken via the Secretary of State for Scotland from the National Loans Fund, or by way of a commercial loan directly from a bank or other lender, or through the Scottish Government issuing their own bonds (HMT

2020). The Scotland Act 1998, as amended by the Scotland Act 2012 and the Scotland Act 2016, also enables the Scottish Government ministers to borrow for purposes other than capital expenditure up to a cumulative maximum of £1.75 billion in circumstances where such borrowing is necessary (HMT 2020). The types of situations where this is allowed for are to help smooth fluctuations in tax receipts or welfare spending, in particular where devolved tax receipts fall short of forecasts or welfare spending is above forecasts (HMT 2020), or to provide a working balance or meet an in-year excess in expenditure over income within the Scottish Consolidated Fund (HMT 2020). Meanwhile, a prudential borrowing regime for local authorities in Scotland was introduced in 2004-05, and from 2011-12 all borrowing undertaken by Scottish local authorities became self-financed (HMT 2020). In terms of the devolved revenues and expenditures, on many levels, the devolved conditions in Scotland are now approaching those in other federal countries and also other decentralised unitary countries, except regarding borrowing powers.

The Wales Act 2017 enables Welsh Government ministers to borrow for capital purposes up to a cumulative maximum of £1 billion (HMT 2020). The annual capital borrowing limit was also increased to £150 million (15% of the overall cap) from April 2019. Borrowing may be via the Secretary of State for Wales (from the National Loans Fund), via of a commercial loan (directly from a bank or other lender) or through the Welsh Government issuing their own bonds (HMT 2020). The Government of Wales Act 2006, as amended by the Wales Act 2014 and Wales Act 2017, enables Welsh Government ministers to borrow for purposes other than capital expenditure up to a cumulative maximum of £500 million (HMT 2020) in circumstances where such borrowing is necessary to help smooth fluctuations in tax receipts, in particular where actual devolved tax receipts fall short of forecasts or to provide a working balance or meet an in-year excess in expenditure over income within the Welsh Consolidated Fund (HMT 2020).

Both Scottish and Welsh Government ministers can borrow both to fund capital expenditure and for a defined range of purposes not related to capital expenditure. Borrowing, like spending within departmental expenditure limits or annually managed expenditure, affects the UK's fiscal position and is therefore subject to a range of legislative and administrative controls, as is the case with Scotland (HMT 2020). Similarly, both nations also have a reserve to facilitate fiscal management with annual drawdown limitations (HMT 2020). If either government wishes to carry forward funding outside of their respective reserve, Scotland Reserve, they have to make a formal request to the Chief Secretary to the Treasury (HMT 2020). If this is agreed, although this is only permitted in exceptional circumstances, it is then treated as a claim on the UK Reserve (HMT 2020).

The UK government also provides other grants to the devolved administrations outside of the block grant, grants which are often for less predictable demand-driven spending, and as such are negotiated between the UK Government and the devolved administrations (Keep 2021). Scotland's block grant 2021/22 from central government was £33.1bn, for Wales it was £18.8bn and for Northern Ireland it was £15.6bn (HMT 2021).

Appendix 3 Urban Financing

For English city-region combined authorities, the way that the financing arrangements are currently constructed means that central government funding transfers are assuming a disproportionate influence on the functions and priorities of mayoral combined authorities (Sandford 2019), due to the particular type of deal-based meta-governance framework within which they operate, in which their legal basis and powers are partly dependent on both other local government institutions as well as central government in Whitehall. If metro-mayors seek to transcend the meta-governance framework by pursuing different local policy priorities that are local rather than national in nature, then, they face an absence of available funds. As such, for much of the time, metro-mayors simply cannot exercise the ‘powers’ available to them – unless they can negotiate commitment and cash from local partners (Sandford 2019). Thus, in matters that are low in terms of central government priorities, their policy discretion still remains strongly limited (Sandford 2019). Amongst all of the major forms of taxation, Amin-Smith et al. (2019) argue that a flat rate local income tax would be the most effective of devolved taxes to help localities address their funding challenges, although devolving taxes of itself will not address the funding challenges (Amin-Smith et al. 2019).

Various other local urban financing models have also been trialled in the UK since 2012, although none has as yet been widely up taken (Sandford 2020s). The Government introduced tax increment financing schemes, founded on the Business Rates Retention Scheme introduced in 2013-14 (Sandford 2020a). Under these schemes, local authorities may borrow for infrastructure projects, against the future growth in business rate receipts which will result from the projects (Sandford 2020a). However, this model is only likely to be suitable where substantial business rate growth is a realistic prospect (Sandford 2020a). Another new model is the ‘Earn Back’ or ‘gainshare’ approach piloted by the Manchester City deal agreed in 2012 (Sandford 2020a) and then upgraded in the Greater Manchester Devolution Deal in which up-front transport investments then offer the possibility to generate subsequent income streams above what would be generated via business rate retention (Sandford 2020a). Which models will be used more generally is still unclear, and their success or otherwise would also appear to depend on the local institutional context and how it relates to the particular logic of the local economic geography. Fiscal reforms without appropriate institutional reforms would appear to be a governance cul-de-sac.

In order to address these issues of spatial-economic mismatches and to better align sub-central government decision-making with economic realities, Jeffrey and Swinney (2020) therefore propose a series of English governance reforms aimed explicitly at linking economic geography to political geography whereby England moves away from the existing 349 local and combined authorities each with economic powers down to 69 directly-elected mayor-led authorities responsible for local economic growth. Commuting behaviour means that more than half of UK workers live in different local government areas than where they work (McGough and Bessis 2015), and this creates distortions in terms of the geography of local service provision needs and tax raising incentives between residential taxes and also between residential and non-residential taxes. Local taxation pooling helps to overcome these problems. A reform of this nature will entail that all two-tier systems to be changed to unitary authorities

with populations between 300,000 and 800,000 in order to maintain both scale and local control and accountability (Jeffrey and Swinney 2020) and with enhanced powers similar to those of the Mayor of London (Jeffrey and Swinney 2020). They will also entail complete local flexibility and autonomy over the use of revenues without the annual balanced budget 'straitjacket' requirements (Jeffrey and Swinney 2020) or the ad hoc and fiat interventions of central government.