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Lessons and issues for sub-national government finances post-COVID



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Executive Summary

This briefing note discusses the impacts of and lessons from the COVID-19 crisis for sub-national government finances, as well as the fiscal roles of and relationships between national, devolved and local government.

For devolved government, the key issues identified are:

- Ad-hoc changes to funding arrangements have enabled devolved governments to respond effectively to the COVID-19 crisis, and their fiscal frameworks provide significant insurance against revenue losses. However, such insurance can act as an incentive to take more stringent measures than if the full revenue costs are being borne, which may increase the likelihood of disagreements over strategy with the UK government (which bears more of the losses). On the other hand, the insurance provided is incomplete, and the devolved governments could see permanent falls in their relative funding levels if the crisis has bigger long-term negative impacts on their economies than England's.
- The crisis has illustrated potential shortcomings with rules around borrowing, and funding allocations via the Barnett formula. Alongside disparities in people's assessment of devolved and UK government performance during the COVID-19 crisis, this may have made upcoming review of the Scottish fiscal framework even more politically contentious.
- Responding to these concerns by, for example, increasing the borrowing powers available to the devolved governments could lead to unfairness to England though. This is because the absence of any specifically English (or regional) governments means there is effectively no spending or borrowing that is England-only: any borrowing by the UK government helps pay for public spending across the UK. Reform of the devolved governments' funding rules could (and should) therefore prompt a renewed focus on the governance and powers of England.

For local government in England, the key issues identified are:

- Increases in spending and reductions in income are likely to persist at least in part. The crisis will therefore exacerbate an already challenging fiscal outlook for councils, whose existing revenue streams are unlikely to keep pace with the rising demand for and cost of service provision.

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- There will likely be an increase in both the need for and difficulties associated with reform of the local government funding system. Impacts on overall funding needs and on the relative needs of different parts of the country make funding reform even more important. But the inevitable redistribution of funding is likely to be even more contentious if resources are tighter, and previous plans for to further shift from grant-funding to reliance on business rates may need to be reconsidered.
- There is potential to catalyse an overdue debate on the role of local and national government in a range of policy issues (including traditional service provision, economic development and crisis management), as well as the extent to which priority is placed on local discretion versus national standards. Lessons may also be learned on coordination and delineation of responsibilities.

Note that this note was originally submitted to the British Academy in November 2020 but has been updated in places for publication in March 2021.

1. Introduction

This briefing note discusses the impacts of and lessons from the COVID-19 crisis for sub-national government finances, as well as the fiscal roles of and relationships between national, devolved and local government.

The COVID-19 crisis follows a decade of significant change to the UK's sub-national government financial structures, relationships and funding levels. This includes: the devolution of substantial tax revenues and powers to the devolved governments in Wales and especially Scotland;¹ a big increase in the extent to which English local government funding depends on locally generated tax and non-tax revenues;² the creation of new regional 'combined authorities' in England, with a focus on skills, transport and economic development;³ and significant reductions in overall funding levels, particularly for English councils.⁴

These factors, alongside continuing demographic change and policy reforms meant the coming years would have seen both opportunities and challenges even in the absence of the COVID-19 crisis:

- Tax devolution and a shift towards locally-raised revenue streams offer the potential for more accountable sub-national government, with stronger financial incentives to support economic development and tackle deprivation, and greater choice for local electorates in determining tax and spend mixes.⁵ But they also increase the financial risks facing devolved and local government as funding depends more on local economic performance, which may be negatively correlated with needs for at least some kind of public spending. Moreover, in England, there can be tensions between funding arrangements and public services policies – such as for schools and social

¹ HM Government & Scottish Government (2016). and HM Government & Welsh Government (2016).

² Harris et al (2019).

³ Sandford (2019).

⁴ Harris et al (2019).

⁵ Phillips (2018).

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care – which have tended to prioritise more rather than less consistency in funding levels and service provision across local areas.

- Looming decisions on the fiscal framework for Scotland, and for the distribution of funding between English councils, could lead to more appropriate funding rules and allocations, but are likely to be politically contentious, as they could have significant effects on powers and resources.⁶
- Ongoing changes to local government structures in England – such as new combined authorities and mayors – could potentially increase engagement with voters and stakeholders. But such changes are progressing unevenly across the country.⁷
- And rising demand and costs for many services – driven in part by an ageing population –, is likely to outpace available funding, especially for English local government which faces effective ceilings on the tax revenues it can raise itself.⁸

The COVID-19 crisis could exacerbate some of these issues – most notably the gap between available funding and spending needs, and the difficult politics associated with funding rules and allocation. But by bringing these and issues into sharp relief, it could also offer a moment of opportunity to debate and address them.

The rest of this note proceeds as follows. Section 2 discusses how the COVID-19 crisis has illustrated a range of issues with the current fiscal frameworks for devolved governments, and one of the risks that exists when trying to address these issues. Section 3 discusses the implications of the COVID-19 crisis for English local government funding levels and systems, including its demonstration of the tensions between localism and centralism. Section 4 offers some overall conclusions, and highlights a three-stage strategy for response to the COVID-19 crisis by sub-national and central government.

Note that this note was originally submitted to the British Academy in November 2020 but has been updated in places for publication in March 2021.

⁶ Scottish Parliament & Scottish Government (2020), MHCLG (2018).

⁷ Sandford (2020).

⁸ Harris et al (2020).

2. Devolved government

The COVID-19 crisis has highlighted several issues in relation to the fiscal frameworks of the devolved governments, and relations between them and the UK government. There is likely to be political pressure to address these, especially from Scotland – where the issues are intimately tied to constitutional debates –, but it will also be important to consider fairness to England and its regions too.

Issues with the current fiscal frameworks

The devolved governments of Northern Ireland, Scotland, and Wales are responsible for wide areas of public spending and policy which have been impacted by the COVID-19 crisis, including health, education, transport, local government, and many areas of economic development and business support.⁹ They rely on block grant funding from the UK government for a large part of their revenues, but in recent years, devolved tax revenues have made up an increasing share of their budgets, with this going furthest in Scotland and least far in Northern Ireland.

These spending responsibilities and tax powers are subject to HM Treasury's statement of funding policy, which sets out how block grant funding is determined, and separate fiscal framework agreements,¹⁰ which set out a range of other rules such as: the calculation of block grant adjustments (BGAs) to account for the revenues obtained from devolved taxes; on powers to borrow and to hold reserves; and on what happens when one government's decisions affect the revenues or spending of the other. A review of Scotland's framework has long been planned for 2021, and experience and perceptions of the COVID-19 crisis is likely to influence the policy and public debate.

⁹ The responsibilities of each devolved government differ somewhat; Scotland and Northern Ireland have responsibility for justice and policing, for example, whereas Wales does not.

¹⁰ HM Government & Scottish Government (2016) and HM Government & Welsh Government (2016).

During the initial phase of the COVID-19 crisis, a number of benefits and drawbacks of these frameworks were identified by researchers.¹¹ For example, the frameworks provide a significant degree of fiscal insurance for the devolved governments, at least in the short-term and for shocks affecting the UK as a whole:

- The fact that the UK government is responsible for large amounts of spending on economic support measures,¹² and much of the devolved governments funding comes in the form of a block grant, insulates them from a significant proportion of the spending and revenue pressures associated with the COVID-19 crisis.
- Furthermore, the BGAs for the devolved taxes will also be updated to reflect what happens to revenues in England and Northern Ireland. In particular, the expected fall in revenues in England and Northern Ireland will mean the BGAs are reduced – so less is taken off the devolved governments’ budgets to account for tax devolution. As a result, the Welsh and Scottish governments will only lose or gain if their revenues fall by more or less than those in the rest of the UK: the updating of the BGAs insulates them from the common shock affecting the whole of the UK.
- Moreover, for the most significant devolved tax – the Scottish and Welsh Rates of Income Tax –, pre-COVID forecasts of 2020-21 revenues are being transferred to the Scottish and Welsh governments to pay for their spending this year. Revenue outturns are likely to be substantially lower as a result of the COVID-19 crisis, but these lower outturn figures will only have to be reconciled in 2023-24, giving some breathing space.

However, as well as providing insurance to the devolved governments, these mechanisms also mean that the devolved government are also insulated from a significant proportion of the revenue effects of COVID-19 restrictions. The UK government bears the impact on non-devolved revenues – such as VAT, National Insurance and Corporation Tax – and the impact on devolved revenues for any measures that affect the whole of the UK (because of the way the BGAs are updated to reflect what happens to revenues in England and NI). This means the devolved governments may choose more stringent restrictions and lobby for more stringent restrictions at the UK-wide level than if they bore the full revenue costs

¹¹ Fraser of Allander (2020), Ifan (2020) and Phillips (2020a).

¹² Such as via the welfare system, the furlough and self employment income support schemes, and guarantees for business loans.

themselves. This *may* have been a factor in the more stringent measures taken during the first lockdown, and the slower relaxation of that lockdown in Scotland and Wales.¹³ And while England's rules are currently most stringent (with lockdown 2.0), this may affect policy going forwards.

A number of other potential shortcomings of the fiscal frameworks, have also been highlighted by researchers and the devolved governments themselves:

- The borrowing and reserves powers available to the devolved governments – especially that of Scotland – may be insufficient to allow the devolved governments to rapidly respond to changing conditions and smooth any asymmetric effects of the COVID-19 crisis on revenues.
 - The borrowing powers were not designed to deal with situations like the COVID-19 crisis when: there can be a need to develop, cost and announce new measures very rapidly; and there is the potential for the nations of the UK to be affected by the COVID-19 crisis in significantly different ways. This is because the rules preclude borrowing to cover the day-to-day costs of new policy measures; instead it is generally only allowed to address revenue shortfalls as a result of forecasting errors.¹⁴ This means that the devolved governments are very reliant on funding from the UK government in order to be able to fund additional policy measures. If there is not good communication by the UK government in advance of its own announcements, the devolved governments could find themselves having to play catch-up once they know how much funding they will receive as a result of those announcements. This risks additional uncertainty for residents of the devolved nations and even delays to implementation of policies.

¹³ Examples include: more stringent rules on construction activity during lockdown in Scotland; more stringent rules on property viewings; slower reopening of non-essential retail and hospitality businesses; and stricter social distancing rules for the hospitality sector in Wales.

¹⁴ Normally, Scotland is able to borrow up to £300 million per year (up to a total limit of £1.75 billion) to address forecast errors (i.e. where revenue outturns are lower than forecasts, or the associated BGAs are higher than forecast). If there is a Scotland specific economic shock – which is defined as Scottish GDP increasing by less than 1% *and* increasing by 1 percentage point less than the UK as a whole – the limit is £600 million per year, and Scotland can also borrow to smooth forecast shortfalls in revenue as well as for forecast errors. Similar rules are in place in Wales. And the devolved governments can borrow for capital investment purposes: up to £450m a year in the case of Scotland and up to £150m a year in the case of Wales. See HM Government & Scottish Government (2016) and HM Government & Welsh Government (2016).

- The amount of borrowing that is possible to address even forecast errors may be insufficient given stringent rules (that require a ‘Scotland-specific economic shock’) to access the maximum possible borrowing. Moreover, the fact that forecasts for revenues are made by the Scottish Fiscal Commission (SFC) and those for the BGAs are made by the OBR means borrowing needs can be amplified if the SFC forecasts were initially over-optimistic on revenues and the OBR forecasts over-pessimistic on the size of the BGAs. This is because a large reconciliation will be needed when outturns data becomes available and revenues turn out to be lower and BGAs turn out to be higher than expected. Such a scenario has already arisen for revenue forecasts in 2018-19, requiring a reconciliation in 2021-22 that may exceed the borrowing powers available to Scotland.¹⁵ The potential for asymmetric impacts of the COVID-19 crisis and the difficulties in forecasting at this time mean the risk of similar scenarios arising over the next few years must be heightened.
- Increments to (or decreases to) block grant funding – such as those made during the COVID crisis – are calculated using the Barnett formula. This adds to (or subtracts from) the block grant, an amount equivalent to the per capita change in funding for comparable spending in England.¹⁶ This formula is simple and automatic. But there are many reasons why the share of spending needed in each nation may differ from such a population-based approach. This includes the prevalence of COVID-19; differences in the demographic, socio-economic and health status of populations; and differences in economic structures and the importance of different sectors, such as hospitality.

It is notable that while the UK government has not addressed any of these issues, the devolved governments have had sufficient funding to fund their COVID-19 responses and existing commitments. But this may reflect the fact that UK government has done two other things instead:

- First, it has announced significant new funding well before it actually needed to be spent. This includes additional money for public services announced in the July Summer Economic Update.
- Second, it has provided upfront guarantees of funding for the devolved governments in Northern Ireland, Scotland and Wales, that exceed the funding so far allocated to England. This has enabled the devolved governments to plan their spending and policy

¹⁵ Scottish Government (2020).

¹⁶ Except in Wales, where it is 105% of the per capita change in funding for comparable spending in England.

responses with more confidence, but could be deemed unfair to England and is unlikely something that can be repeated on an ongoing basis.

The COVID-19 crisis should therefore be a prompt to re-consider the fiscal frameworks, including the limits and rules around borrowing, and the allocation of block grant funding.

In addition, while the way the BGAs are updated each year largely protects the devolved governments from economic shocks affecting the whole of the UK, it means they bear the full cost (or benefit) of any short or long-run divergence in revenue performance relative to the rest of the UK. Such arrangements are unusual internationally and mean the devolved governments could lose or gain permanently if the COVID-19 crisis has a bigger or smaller negative impact on their economies in the long run.

A review of the Scottish fiscal framework is due in the coming year, and the Scottish Government and Scottish Parliament Finance and Constitution and Social Security committees have produced a joint report suggesting a wide-ranging review,¹⁷ with the aim of securing substantial further borrowing powers and more flexibilities over, for example, allocations for capital and resource spending. It explicitly states that the “experience of addressing COVID-19 should now be part of the review”. Perceptions that the Scottish Government has handled this crisis better than the UK government, which has seen support for Scottish independence increase,¹⁸ combined with its statements on what it feels are shortcomings with the frameworks, may have made this review more contentious and difficult for the UK government. Not only have the stakes risen, but the relative bargaining power of the Scottish Government has likely increased too.¹⁹ The implications for Northern Ireland and Wales where political debates are different is less clear though.

The risk of creating new asymmetries

The COVID-19 crisis has exposed one form of asymmetry in the UK’s fiscal architecture: that the UK government, which is the government of both the UK and England, controls

¹⁷ Scottish Parliament & Scottish Government (2020).

¹⁸ Ipsos MORI (2020).

¹⁹ Although, it should be noted that the COVID-19 crisis means that an independent Scotland would have even weaker public finances than previously projected, which could have an offsetting effect on bargaining power. See Phillips (2020b).

the overall fiscal stance – including the level of borrowing. There have been concerns that this has led to borrowing to support COVID-19 policies in England (such as the extension of the furlough scheme to coincide with the second national lockdown) but being unavailable to support COVID-19 policies in the rest of the UK (such as Wales’ “firebreak” lockdown).²⁰ Reforming the devolved government’s fiscal framework to give them more scope to borrow (whether to fund day-to-day spending, capital investment, or lower taxes) would lessen this asymmetry.

However, it would potentially worsen another asymmetry that results from the absence of any English government or regional governments with distinct budgets and fiscal powers. This absence means that while there is spending and borrowing that is specifically Scottish and Welsh, there is no spending or borrowing that is specifically English, except by councils. This is because any borrowing by the UK government either supports spending on UK-wide functions like defence or most social security spending, or generates additional funding for the devolved governments via the Barnett formula if it supports spending on England-only functions like health and schools. Thus England (and its regions) lack the ability to choose a different fiscal stance to that determined by the UK government for the UK as a whole. Significant expansions in borrowing powers of the devolved governments (which come on top of any borrowing done on their behalf by the UK government) could therefore be seen as unfair to England, which would lack such powers.²¹

If the COVID-19 crisis increases the likelihood of significant reforms to the devolved fiscal frameworks, it will therefore be important to consider whether the fiscal arrangements for England are appropriate as well. The “English question” which seemed to have been resolved with the “English Votes for English Laws” process may therefore rear its head again.

²⁰ See <https://www.theguardian.com/world/2020/nov/01/not-fair-welsh-and-scottish-leaders-hit-out-at-furlough-extension-for-england-covid-lockdown>.

²¹ In principle, one could also be concerned about the risk of a fiscal externality: the devolved governments would not take account of the impact of their borrowing on the borrowing costs of the UK government (which may explicitly or be perceived to implicitly underwrite devolved government borrowing). However, in practice, the quantum of borrowing involved even if borrowing limits are increased substantially will be only a very small part of the UK’s total debt stock – now approximately £2 trillion.

3. Local government

The COVID-19 is exacerbating the financial pressures facing local government, and this is likely to persist into the medium-term. However, it has also brought the tensions between localism and centralism into sharp relief, which may help prompt a proper debate about the role of national and local government.

The impact of COVID on council finances

The COVID-19 crisis follows a decade during which councils have had to make substantial cuts to their spending on local public services. For example, between 2009-10 and 2019-20, spending per resident in England fell by 23% in real-terms.²² And because services such as adults' and children's social care services were relatively protected from these cuts, reductions in spending per resident on culture and leisure, housing and planning and development services exceed 50%. Moreover, despite their relative protection, pressures for adult's social care services and especially children's social care services have been evident.²³

Short-term financial pressures

But where are we now? Analysis of councils' forecasts for the current financial year suggests significant increases in spending and reductions in locally-generated revenues as a result of the COVID-19 crisis. This is illustrated in Figure 1 which shows forecast increases in spending and falls in non-tax income (the yellow bars), estimates of the extra central government funding provided (the dark red bars) and the resulting funding shortfall.

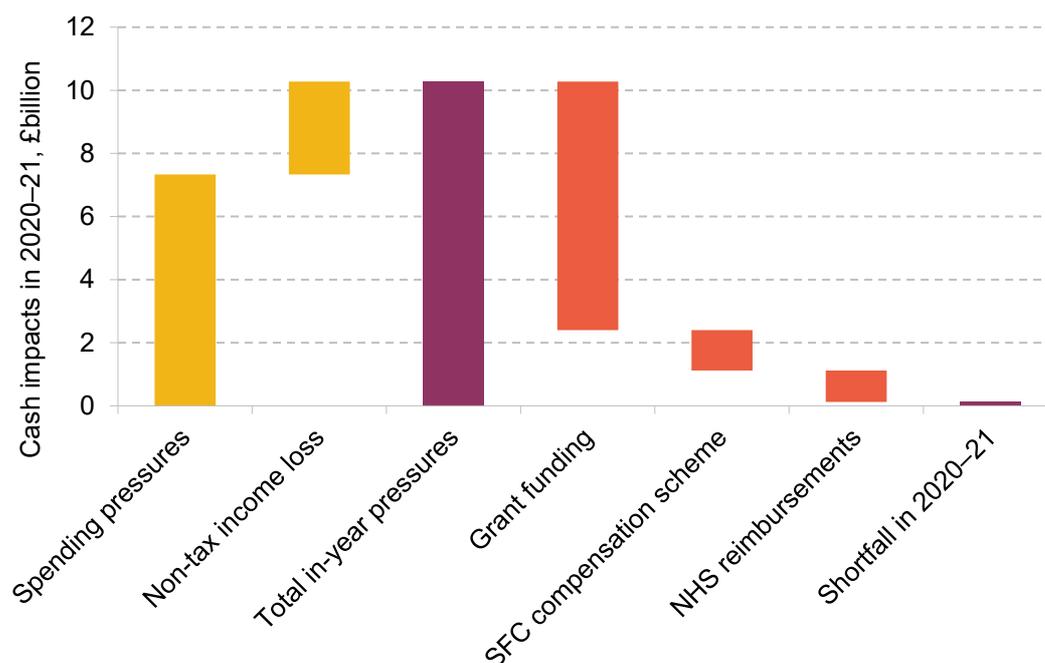
Altogether, councils' forecasts – which were made in January – imply an increase in spending of £7.3 billion, with adult social care (£3.2 billion) being the largest component. They also imply a £2.9 billion reduction in incomes from sales, fees and charges and commercial and investment activities, with lower parking and leisure and cultural services income being major contributors.

²² Harris et al (2019).

²³ Institute for Government (2019).

The government has provided billions in additional grant funding as well as a scheme to compensate for reductions in sales, fees and charges income. Councils have also shared some social care costs with the NHS and been able to furlough some staff.

Figure 1 Financial pressures and additional funding for 2020-21



Source: Author's calculations using councils' February 2021 financial returns.

After accounting for this, our baseline estimate is a remaining shortfall of approximately £0.1 billion across the sector as a whole. This is subject to significant uncertainty though. First, forecasts for spending and income pressures are subject to revision as the COVID-19 crisis evolves. Second, when estimating how large unfunded pressures may be, one wants to only account for extra funding provided to councils if councils have included the associated spending pressures in their forecasts. This is not easy to ascertain, and it is possible that we have been either too generous or conservative in our assumptions about which funding to account for.

It is also worth noting that the financial impacts and remaining funding shortfalls vary significantly across councils – with much of this due to differences in the extent to which

they rely on SFCs and commercial and investment income.²⁴ For example, 106 councils (31%) appear to have received more funding in 2020-21 than they have forecast for in-year pressures. The remaining 233 councils are collectively ‘under-funded’ by a total of around £800 million, equivalent to 3.2% of their pre-COVID-19 crisis revenues.

Significant variation in effects across councils makes it a difficult task for the MHCLG to allocate funding to councils upfront: some will likely get too little, others relatively too much. We have therefore highlighted the importance of considering the role of ex-poste compensation schemes, use of reserves, and for councils with limited reserves, greater flexibility on borrowing: each of which has been taken up by the government to at least some extent.²⁵

Medium-term financial pressures

Previous IFS research suggested that councils faced a growing gap between spending needs and available funding, if council tax increases are capped at 2% per year – which is the default position.²⁶ If council tax is increased by substantially more, this gap could be narrowed or even eliminated, but without redistribution of grant funding, councils covering poorer areas would need to increase their council tax *rates* by significantly more than councils covering richer areas. This is because they have smaller council tax *bases* on which tax increases are levied.

The COVID-19 crisis is likely to increase these pressures, as some of the increases in spending and falls in income seen this year are likely to persist – at least for a few years.²⁷ This includes the cost of measures designed to limit the spread of COVID (e.g. Test and Trace and changes to social care hygiene and working practices), falls in parking income (especially if there is some permanent shift in shopping habits and working arrangements) and reductions in local tax revenues (again, reflecting changes in shopping and working habits, and rises in unemployment).

To address these impacts in 2021-21, the government is providing councils with over £3.5 billion of COVID-19 related funding:

²⁴ Ogden and Phillips (2020a) and the associated council-level risk and resilience dashboard (<https://www.ifs.org.uk/research/local-dashboard>)

²⁵ This includes the aforementioned scheme compensating for (75% of) losses in sales, fees and charges income; an analogous scheme to compensate for (75% of) losses in tax collections; and authorisation for a number of councils to borrow to fund day-to-day spending.

²⁶ Harris et al (2019).

²⁷ See section 3 of Ogden et al (2020).

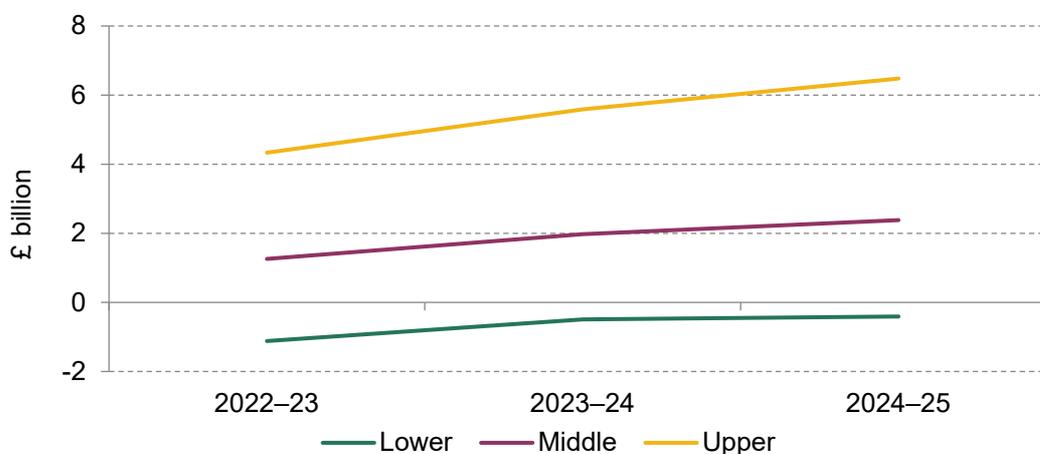
- £1.55 billion in general grant funding;
- £400 million for local Test and Trace and associated public health and enforcement activities;
- £341 million to pay for enhanced infection control measures and rapid testing in adult social care services;
- £670 million in funding to help pay for more generous and more numerous means-tested council tax discounts ('council tax support');
- An estimated £762 million in funding to cover 75% of the losses in council tax and business rates collections in 2020-21, which accounting rules mean actually affect councils' budgets between 2021-22 and 2023-24.
- An extension of the sales, fees and charges compensation scheme to the end of June 2020.

In addition, councils with responsibility for delivering social care services have been granted the power to increase council tax by up to 5%, and non-COVID grant funding is being increased by just under £300 million overall.²⁸

Our assessment is that this funding should be sufficient to address spending and income pressures in 2021-22 if the COVID-19 pandemic largely abates by the summer. But it is uncertain whether this will come to pass. Such uncertainty is also pervasive when it comes to the medium-term funding outlook where the the scale and persistence of the effects of the COVID-19 crisis on service delivery and the economy – as well as the evolution of other factors such as underlying changes in service demands and public sector productivity – will matter greatly. In recent work we have therefore looked at a range of scenarios for the medium-term funding gap: low, middle and upper scenarios, illustrated in Figure 2.

Under our middle scenario, spending needs are projected to increase by almost 11% in real-terms between 2019-20 and 2024-25, while revenues are projected to increase by less than 7%. This would mean councils need a further £2.4 billion on top of existing (real-terms) grant funding levels by 2024-25 to maintain services at 2019-20 levels. Addressing a pre-existing gap in what councils pay for adult social care services and what benchmark prices imply providers need, as well as potential increases in pension contributions, would require further funding on top of this.

²⁸ Ogden and Phillips (2020b) provides further discussion of these plans.

Figure 2. The projected funding gap under three scenarios

Source: Ogden et al (2020), updated for 5% council tax increases in 2021-22.

Our upper scenario shows funding needs could be much greater if COVID-19 has larger long-run effects on spending and income, and if underlying demands grow more quickly and productivity less quickly. Our lower scenario shows that a substantial slowdown in underlying demands and improvement in productivity performance, as well as a complete abatement of COVID-19 impacts, would be needed to close the funding gap without additional funding or large council tax increases.

These scenarios do not account for any direct effect of the COVID-19 crisis on the demand for local government services because the potential scale of these effects is very uncertain. However, evidence from past economic crises and emerging evidence from the current COVID-19 crisis suggests a range of factors – such as long-COVID and an increase in chronic illness, the impacts of lockdown on children and families, and the potential for an increase in homelessness – could push up demand, further increasing pressures on council budgets.

Addressing medium-term funding issues

There are a range of options for providing additional funding to councils to help address these medium-term funding pressures.

First is an increase in central government grant funding, funded by national taxation or borrowing. Such an approach would allow the government to target additional funding according to its assessment of funding needs (see below). However, in the context of a weak outlook for the national public finances and many competing pressures for additional

funding, the extent to which central government is willing and able to provide additional funding is unclear.²⁹

Second is an increase in existing local taxes. Legislation prevents above inflation increases in business rates – and as discussed below, both economic and political factors are likely to reduce this revenue stream. Council tax could be increased by more if the government relaxes the requirement to hold a referendum to authorise increases above a certain percentage (that has varied between 2% and 5% historically), or if councils hold and win referendums for above-ceiling increases. However, councils covering more affluent areas can raise much more from council tax than councils covering more deprived areas. Reliance on this source could therefore lead to increased inequalities in service provision and/or tax rates, unless the funding provided by government is redistributed to offset differences in council tax bases.

Third is to devolve additional revenue-raising powers to local government. Not all taxes are suitable for devolution, but there are options such as a local income tax.³⁰ However, there would be a range of administrative issues to address, and tax bases for new devolved taxes are also likely to vary significantly across the country, again necessitating equalisation arrangements.

Reform options and issues

This brings us to the issue of local government financial reform. Prior to the COVID-19 crisis, the government was planning to implement significant reforms to the system and distribution of funding in April 2021. This included: increasing the share of business rates revenues retained by local government to 75% (from 50%), and reducing grant funding accordingly; and beginning the redistribution of funding between councils in line with updated estimates of their spending needs and own revenue-raising capacity (the ‘Fair Funding Review’).

The government announced early during the crisis that these reforms would not be implemented in April 2021, but did not initially confirm whether they were simply delayed or may be shelved entirely. However, alongside the 2020 Spending Round it did confirm that the ‘Fair Funding’ review at least will go ahead – potentially in April 2022.

²⁹ Emmerson and Stockton (2020) and Zaranko (2021).

³⁰ Amin-Smith et al (2019).

In relation to business rates, the COVID-19 crisis and other recent developments may have affected the calculus for moving to 75% retention:

- Businesses that account for around 40% of the business rates tax base are exempted from business rates this year.³¹ While the government is compensating councils for the loss of revenue associated with these exemptions this year, it is unclear whether full or partial exemptions will continue for some businesses into next year and beyond. And changes in shopping and working habits, if they persist, may reduce the size of the business rates tax base in the medium and longer-term too.
- HM Treasury announced a fundamental review of the business rates system in March, for which the consultation period was extended as a result of the COVID-19 crisis.³² As well as changes to tax bases, rates and administration of the current system, the review is considering more fundamental reform – including replacement with alternative taxes. The economic and fiscal effects of the COVID-19 crisis are likely to have led to increased pressure for reform, but also a greater desire to avoid long-term revenue losses on the part of government.

It seems sensible to await the outcome of the fundamental review of business rates before going forwards with a policy that increases councils' reliance on this revenue source. Discussions with local government suggest their appetite for moving to 75% retention has somewhat lessened as a result of increased concern about the future yield (and the certainty/risk of that yield) as a result of the COVID-19 crisis.

In relation to the Fair Funding Review, the COVID-19 means it is both more important and potentially more difficult to complete and implement the review:

- The medium-to-long-term socio-economic effects of the COVID-19 crisis are likely to differ across England, driven by differences in economic structure and population vulnerabilities. As a result, a funding system and spending needs formulas that are already out of date could become even more so.
- However, these effects are uncertain and data is likely to become available with a lag. And if the overall funding situation is more challenging, those areas set to see a decline in their relative funding levels may object even more vociferously to reform. This could make updating and implementing spending needs formulas and funding allocations technically and politically more challenging. One option would be to update

³¹ See <https://www.gov.uk/government/statistics/national-non-domestic-rates-collected-by-councils-in-england-forecast-for-2020-to-2021>.

³² HM Treasury (2020).

needs assessments and funding allocations more frequently in future, as data on how the crisis has affected the relative needs of different areas becomes available.

Tensions between localism and centralism

The COVID-19 crisis has illustrated the tensions that exist between a desire for greater local power and discretion, but at the same time concerns about unfair or confusing ‘postcode lotteries’. This includes debates about the role of and performance of central and local government ‘Test and Trace’ programmes, as well as about whether it is better to have nationally consistent and/or determined, or locally varying and/or chosen restrictions on movement and assembly.

However, such tensions are not new. For example, there has been for several years a tension between reforms to the local government funding system (which emphasise local incentives and responsibility) and concerns about and reforms to the social care system (which emphasise common eligibility criteria and service standards).³³ And while government has been engaged in reviews and reforms of both the local government funding system and public services, it is not clear that the interactions between the various strands of work are being systematically accounted for.

As the government tries to learn lessons from the COVID-19 crisis and improve policy going forwards, there could therefore be an opportunity to have a proper assessment and discussion of the role and powers of national and local government, and local discretion versus national consistency.

³³ Amin-Smith et al (2018).

4. Concluding remarks

This briefing note has focused on the impacts of and lessons from the COVID-19 crisis for devolved and local government finances and fiscal relationships.

Overall, the system has functioned – in part because central government has bypassed the usual rules, which is something the flexibility of the UK’s budget process and ‘constitution’ makes easier than in many other countries. However, several issues are likely to prove more challenging and/or contentious over the next few years as a result of the COVID-19 crisis:

- The fiscal frameworks for the devolved governments – most notably in relation to borrowing and reserve powers;
- The distribution of funding between English councils, and the future balance between central and local funding for council services;
- Ensuring the level of funding for services is sufficient to meet the rising costs, demands and expectations for services – which could be higher in a post-COVID world.³⁴

But there are also some opportunities that could come from the crisis. Most notably, the crisis could be used to catalyse a proper assessment and debate about the role and funding of local government in England. Communication and coordination between tiers of government could also be further strengthened, although political differences between the governments of different parts of the UK may make this challenging.

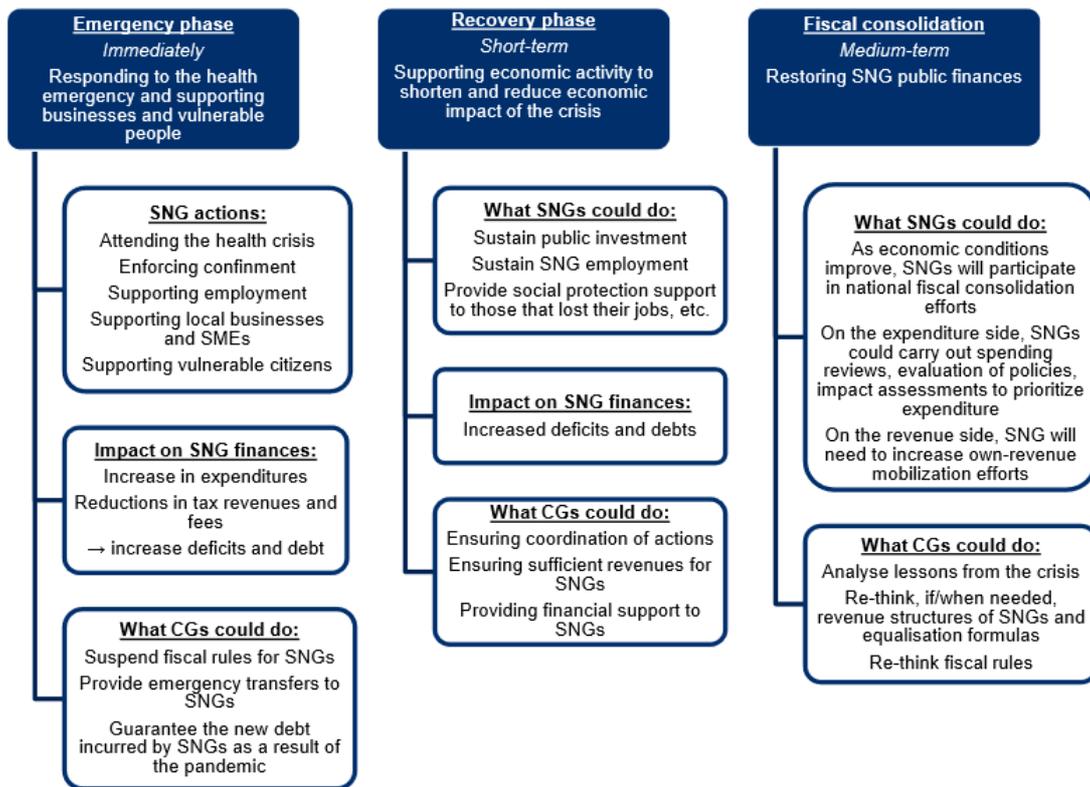
It is important to recognise that the UK is not alone in facing such challenges and opportunities. In a recent review of ‘fiscal relations across levels of government’ during the COVID-19 crisis,³⁵ the OECD highlights a range of issues including: communication and coordination between tiers of government; the delinearisation of the responsibilities of different tiers of government; availability of funding and geographic variation in this; and the flexibility of fiscal rules and ‘exit clauses’ during extreme conditions. While the UK’s flexible funding system has helped it support devolved and

³⁴ Although, as discussed in Institute for Government (2020), there may be scope for some improvements in efficiency via continuing the use of new technology and working practises in some instances.

³⁵ OECD (2020).

local governments through the crisis so far, there may be lessons from other countries and the OECD’s suggested three-phase approach, which is illustrated in Figure 3. This sets out the impacts of the COVID-19 crisis on sub-national governments (SNGs), how they can respond to the crisis, and how central government (CGs) can support them.

Figure 3. The role of devolved and local governments immediately and in the short and medium-term to address the Covid-19 crisis



Source: OECD (2020).

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