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978-0-521-11269-7 - Central Grants to Local Governments: The Political and Economic Impact of the Rate Support Grant in England and Wales

R. J. Bennett

Excerpt

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## CHAPTER 1

CENTRAL GRANTS TO LOCAL GOVERNMENTS

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**1.1 Introduction**

Central grants to local government have attracted major controversy and debate in recent years. They have been attacked as inequitable, wasteful, encouraging inefficient government and expansion of public expenditure, and as too heavily influenced by the political ‘pork-barrel’ in the competition for governmental funds. As a result, programmes such as the British Rate Support Grant, US Revenue-Sharing and Community Development Block Grant, Australian Income Tax Sharing, the French VRTS, and the German income tax sharing have increasingly become political footballs in election contests and debate. Central grants form a very significant proportion of public expenditure in all western countries and it is not surprising, therefore, that they should attract the attention alike of ‘tax-cutters’ and ‘social reformers’. This book is concerned in various ways with these important social, political and economic issues. It employs detailed discussion of the Rate Support Grant in England and Wales as a means of highlighting many general issues of central grants common to most western countries.

Central grants to local governments are one method of sharing responsibility for taxation and expenditure between levels of government within a country. The constitutional organisation of most western countries involves some division of political power between central and local governments, with many countries possessing, in addition, a highly developed set of intermediate governments, such as the States of USA and Australia, the Provinces of Canada, the German Länder or the Swiss Cantons. As a result a major aspect of the organisation of the public sector in the modern state involves *intergovernmental* co-operation. Most important in such co-operation is the manner in which the local and intermediate levels of government are financed. Although methods of revenue-sharing, intergovernmental tax credits and deductions, loans, and even horizontal transfers between local governments, are employed to an important extent in many countries, it is grant transfers from central to local government which usually form the major component of intergovernmental financial co-operation. Certainly these are the most important transfers in both the USA and UK.

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The aims of central grants to local governments have been variously ones of improving social equity, increasing economic efficiency, or stimulating economic growth. However, the issue of equity has most often been the overriding criterion adopted, and it is certainly the criterion which has occupied most attention in the literature. The distribution of grants has profound implications for both the level of public services available to individuals in different locations, and the external framework within which industrial and commercial enterprises must make decisions. Hence grants have a significant effect on both the 'social wage' and commercial 'externalities'. Moreover, the distribution of grants, and the behaviour of the local governments to which they are directed, are fundamentally geographical phenomena. They have profound impacts on the differential costs of location decisions and on the level of benefits received from the state by residents in different political subdivisions. Hence, grants are a major determinant of the degree of equity or inequity in public finance and, hence are a fundamental component in the economies of the space economy, determining what some commentators have termed: 'who gets what, where, at what cost'.<sup>1</sup>

The issues surrounding the procedures used to allocate central grants to local governments have received increasing debate in recent years in both academic and governmental circles. The main reasons for this growth in concern have, perhaps, been twofold. First, in most countries the last ten years has seen increasing criticism of the overall size of the public sector. As a result, central grants, because they tend to underprice local services, have been seen as a major cause of the expansion of public spending. Second, over the period since the late 1960s the proportion of local expenditure funded by grants has increased more rapidly than most other components of public spending. This has been mainly the result of the necessity for central government to expand local revenue bases which are often inflexible and non-buoyant to rises in incomes and the underlying rate of inflation. This, combined with calls for devolution and a reduction in central control, has given rise to calls for new sources of local finance based on local income taxes, or for the sharing of central revenues with central government. The subject of central grants is, therefore, not only topical but of major recurrent importance. However, grants are only one aspect of a complex interplay between the revenue and service responsibilities assigned to central, local and intermediate levels of government. Hence, in this book it is found necessary not only to discuss grants, which is the book's major purpose, but also to relate questions concerning grants to the related governmental environment. In particular three main aspects of the size, type and distribution of grants are developed at various points below: first, the relation of grants to the service responsibilities at each government level; second, the relation of grants to the distribution of revenues, their size and their buoyancy; and third, the relation of grants to

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the total tax and expenditure system as a question of total fiscal incidence as between different income groups, and between people and industry. Throughout the discussion it is the aim to use the grants of England and Wales to highlight general issues which are common to most western countries.

**1.2 The Rate Support Grant (RSG)**

The Rate Support Grant (RSG) has existed in Great Britain since 1967. Its form differs considerably between England and Wales on the one hand, and Scotland on the other. Most of this book is concerned solely with the RSG in England and Wales. The Rate Support Grant is an immensely important policy programme. Amounting to over £11 000 m. in 1982/3, it is responsible for the major proportion of transfers from central to local government in England and Wales. At this level of funding it must also rank as one of the most significant intergovernmental grant programmes in the western world.

The Rate Support Grant is a very complicated programme which has been modified continuously since its inception. However, it has possessed a common underlying theme of being concerned primarily with equalisation. Equalisation has been consistently tackled through three main aspects.

- (i) *Domestic rate relief*: a per capita subsidy to local residential taxpayers as opposed to commercial and non-domestic taxpayers.
- (ii) *Resource equalisation*: a component aimed at equalising differences in the tax base of different local authorities.
- (iii) *Needs equalisation*: a component aimed at equalising differences in the expenditure requirements of different local authorities.

The form of the RSG in Britain is not dissimilar from equalisation grants adopted in other countries. For example, the emphasis on attempting to equalise differences in local tax capacity is an important constituent in many US grant programmes (such as Revenue Sharing and Community Developments Block Grant), and is a major element in the transfer of funds from the federal level to Länder in Germany, Switzerland and Austria, to the Provinces in Canada, and to the States of Australia. In contrast the use of a component aimed at equalising the expenditure need of different local governments constitutes a more significant element of British grant programmes than in most other countries. The domestic element of the Rate Support Grant represents a specific subsidy element which has no relevant counterpart in the intergovernmental grant programmes of other countries.

The RSG has a complex history, which is detailed in later chapters, but over the years it has grown to become an enormously significant component of both UK local finance and of total public finance in Britain. The England and Wales rate support grant in 1981/2 represented about 13% of

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the total public sector expenditure at all levels of government. As such it is the largest single item of public expenditure excepting only defence. Moreover, it is enormously significant for local governments where, in 1981/2, it constituted about 40% of total local expenditure.

With such large sums of public expenditure involved, it is important that the eligibility criteria used for allocating grants to local governments are based on sound criteria of economic efficiency, social equity, and economic management. However, it has become increasingly clear that the manner in which the RSG has been organised does much to encourage economic inefficiency and although it attempts to be equitable, has been a major cause of inequalities in the social wage and commercial externalities between areas. As a result, a barrage of criticism has been directed at the RSG, and various suggestions have been made for its reform. Perhaps the most significant suggestions have derived from the 1971 Green Paper *The Future Shape of Local Government Finance*, the Layfield Report produced from the *Committee of Enquiry into Local Government Finance* in 1976, and the 1977 Green Paper *Local Government Finances* (see G.B. Government 1971, 1976, 1977). The *Local Government, Planning and Land Act* (1980) and the 1981 Green Paper (G.B. Government, 1981b) have attempted to overcome some of these criticisms but, as later chapters will demonstrate, many difficulties still remain.

#### 1.3 Economic and political hypotheses

The literature on intergovernmental grants falls into *four* broad classes. First, there is the major body of works from economics and public finance. This emphasises the effects of grants on the price of goods and hence upon economic efficiency in the allocation of resources.<sup>2</sup> Second, and springing from the economic literature, is a subset of economic theory concerned with fiscal federalism.<sup>3</sup> This places emphasis on the division of public functions between levels of government and concludes that grants are appropriate for attacking problems of inefficient pricing, and perhaps even for local stimulation of economic growth, but are inappropriate for income redistribution or stabilisation of the economic cycle. The literature on fiscal federalism is particularly important in suggesting which grants are most appropriate for achieving a given social or economic goal. A third body of literature derives from political science.<sup>4</sup> This emphasises the interplay of power at each level of government and the political behaviour of actors in both the allocation of funds and in their subsequent use. A major component of this literature emphasises the role of grants in purchasing support for 'log-rolling' or 'pork-barrelling' votes; and this model has been applied particularly to US House and Senate Committees, and to the German Bund, but somewhat less successfully to the Westminster Parliament.<sup>5</sup> An additional component of the political science literature

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has emphasised the effect of grants on local financial behaviour. This analyses local behaviour as selfish political action and seeks to assess whether new programmes have been implemented, if new programmes have been substituted for old, whether tax cuts made, or whether salary rises and other forms of economic inefficiency have been fostered.<sup>6</sup> A fourth group of literature derives from economic geography. This has placed most emphasis on the expenditure side of local finance: the spatial distribution of social and economic benefits deriving from grant programmes.<sup>7</sup> Recently, however, a new emphasis has grown on the revenue side of the local sector examining the effect of grants on local tax bills and the distribution of costs for local programmes.<sup>8</sup> Each of these groups of literature has been mutually overlapping, and some flavour of each approach will be found in the following chapters.

Previous research on the Rate Support Grant has flowed from each of these groups of literature. For example, there has been a considerable economic literature concerned with the price and equity aspects of the RSG.<sup>9</sup> In addition, both the Layfield report and the debate on devolution in Great Britain stimulated a large range of research studies concerned with amendments to the RSG to integrate it with national economic management, to improve its aspects of equalisation, and to assess its effects on fiscal incidence.<sup>10</sup> The political science literature has also attacked these questions, but in addition has encompassed aspects of political party, and managerial or organisational effects.<sup>11</sup> In economic geography a diverse range of literature has been concerned with assessment of local expenditure need, measurement of access to local benefits, and comparison of revenue and expenditure positions of local authorities.<sup>12</sup>

This literature has brought us to the position of possessing a number of well-understood economic and political hypotheses of the Rate Support Grant and, in addition, it has allowed formulation of a series of partially confirmed, and often controversial, hypotheses of the economic and political impacts of RSG. As a consequence there are, perhaps, now four fairly well-accepted features of the Rate Support Grant which should be emphasised. First, there has been the effect of the dominance of the grant. Because it is so large and because it constitutes such a large proportion of local revenue it has often been claimed to have adversely affected economic efficiency by underpricing of local services, markedly reduced local autonomy, and greatly confused the lines of accountability for governmental services.<sup>13</sup>

A second feature of the Rate Support Grant has been the extent to which it has been allocated on purely objective principles and the extent to which it has been affected by political and other influences. Despite many criticisms, the RSG is, by international standards, a programme which has allowed a high degree of equalisation of expenditure and tax burdens between local authorities. However, it has often been claimed that there

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have also been significant political influences operated by central government, in general to favour urban areas under Labour administrations and rural areas under Conservative ones.<sup>14</sup>

A third feature of the Rate Support Grant, which is common to all grant programmes, has been the difficulty of measuring expenditure need. Considerable research<sup>15</sup> has been devoted to this issue from various points of view: analysing past expenditure patterns, quantifying service inputs, assessing service outputs, and measuring client groups. The method of need assessment used since 1981/2 is some improvement on the previous complex set of methods, but the issue is still far from resolved.

A fourth feature of the Rate Support Grant has been the difficulty of coping simultaneously with important area and service differences within a single grant programme. Allowance for service differences between rural and urban areas, Welsh and English counties, and London and non-London areas has been incorporated into the distribution formula for the RSG in various ways, but the procedures used have been essentially ad hoc, have been claimed to allow political influence, and certainly leave considerable room for improvement.

The literature on central grants to local governments, and the particular results of analysis of the Rate Support Grant, lead, therefore, to a number of outstanding questions as to the economic and political impact of the RSG. It is the intention of this book to resolve some of these questions. Particular attention is directed, in the following chapters, to the question of economic efficiency, means of improving autonomy and accountability, the extent of political influence on local spending through the level of grant allocations, the problems of needs assessment, and the question of the appropriate weighting for different types of jurisdiction within the same grant programme.

### 1.4 Research approach

The analysis reported in this book concerns the whole period of the existence of the Rate Support Grant in England and Wales, from 1967/8 up to the present. However, because of the reorganisation of local government in 1974, the reorganisation of London government in 1963, and a number of other factors, comparisons between years are not always reliable. For this reason detailed analysis is concentrated mainly on the years since 1974/5 for which reliable and comparable data are available. However, where possible comparisons are drawn from the period 1967/8 to 1973/4, and in addition some analysis also includes the later years of the General Grant and Rate Deficiency Grants for 1962/3 to 1965/6.

The analysis for the years 1962/3 to 1973/4 involves 163 local authorities in England and Wales: the Counties, County Boroughs and London Boroughs (some omissions of data result in a reduction from the total of



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168 authorities which were extant over this period). The way in which the data for these years were handled is described in Appendix 1. For the period since 1974/5 the analysis uses the 116 local authorities: the non-metropolitan Counties (18 in Wales, 39 in England), 36 metropolitan Districts, and London Boroughs (12 Inner London and 20 Outer London, plus the City). The Isles of Scilly is omitted from the analysis in all cases. These units represent the so-called ‘need authorities’ used for initial distribution of the Rate Support Grant needs element up to 1980/81. The use of these units allows a simplified and more general analysis, but does require aggregating non-metropolitan Districts to give the County totals. In the case of most variables the County total is given as the sum of the representative District variables. For tax rates (rate poundages), the average rate poundage of the County is given as the rateable value of each District multiplied by its rate poundage, summed for all Districts, and then divided by the County rateable value. The calculation of the County averages in this way maintains the veracity of the original data and eliminates any distortion of the results. The post-1974 local authorities are shown in figure 1.1. The data sources used for this period are listed in Appendix 1.

For various purposes in the subsequent analysis classifications of local authorities are used. The definition of most of these is made clear in the text, but for two groups it is useful here to describe the definitions employed. The definition of party colour of the local council was derived by finding the controlling party and then grouping councils into four groups, as follows:

| <i>Party colour</i> |  | <i>No. of authorities 1974–8</i> |
|---------------------|--|----------------------------------|
| A.                  | Conservative-controlled Councils   | 57                               |
| B.                  | Labour-controlled Councils   | 40                               |
| C.                  | Other party-controlled Councils  | 8                                |
| D.                  | Councils which change party control<br>or which have no overall majority | 11                               |

This party control was averaged over periods corresponding to different party control at Westminster, i.e.

- |    |         |                                   |
|----|---------|-----------------------------------|
| 1. | 1962–64 | Conservative party at Westminster |
| 2. | 1964–70 | Labour party at Westminster       |
| 3. | 1970–74 | Conservative party at Westminster |
| 4. | 1974–79 | Labour party at Westminster       |
| 5. | 1979–   | Conservative party at Westminster |

Use of this averaging process overcame two difficulties in subsequent analysis. First, it allows inclusion of a party continuity effect (cf. Alt, 1971). Second, this approach allows for the well-established feature of local government elections in Britain, that local party control tends to swing in the reverse direction of that at Westminster. However, as noted in Bennett (1982*a*), this classification has five main difficulties: first, it ignores

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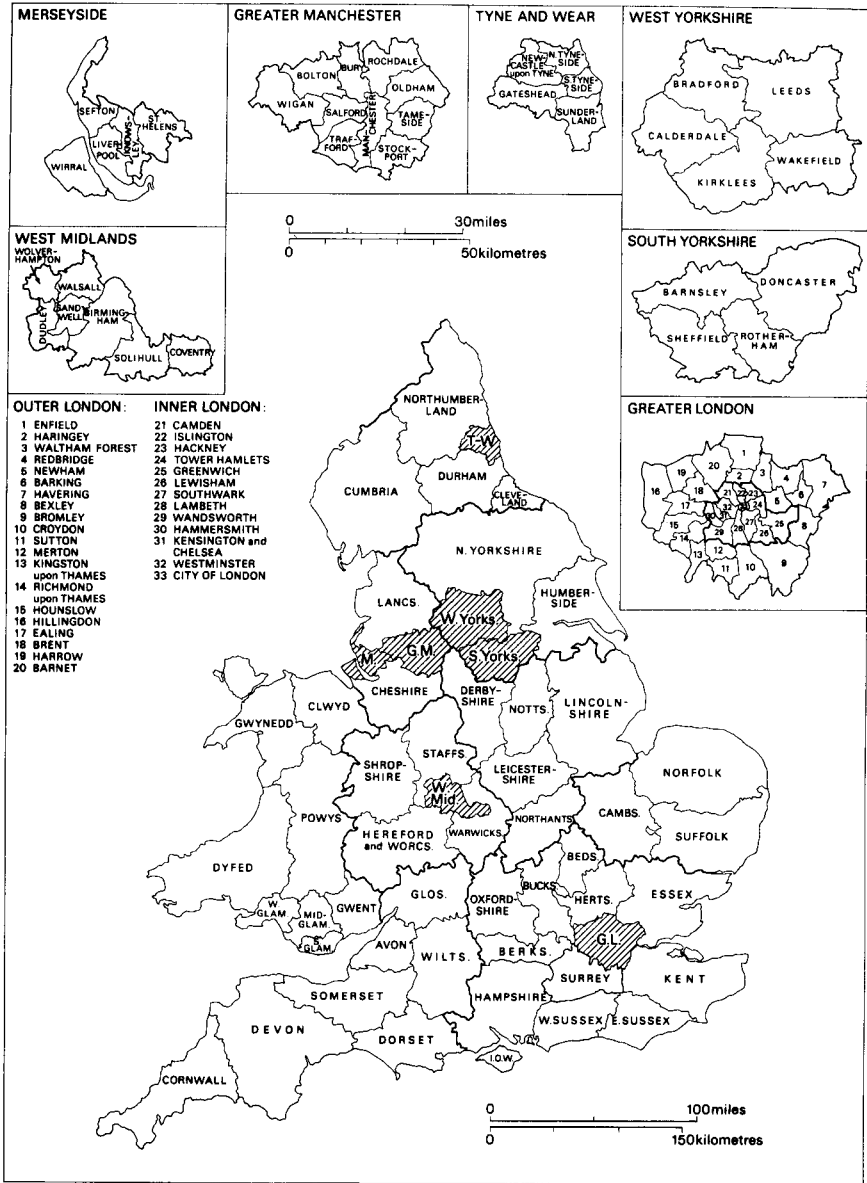


Fig. 1.1 Administrative areas in England and Wales. The map shows the 'needs authorities' as used for distribution of the rate support grant 1974-80 and are as constituted after reorganisation of local government in 1974. The insets show the metropolitan Districts within each metropolitan County and the London Boroughs within the Greater London Council.



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differences in opposition parties; second, it ignores major differences in 'other party' attributes (group three in the classification); third, it ignores major differences in the majority party holding power; fourth, it ignores coalitions of non-partisan councils which often act as Conservative authorities under another name over this period; and fifth, it ignores the effect that party changes before or during the study period take time to have a significant effect on expenditure or grant patterns. Nevertheless, the classification employed is a simple and workable one, but the definitional difficulties, especially with respect to group three of 'other party' control, must be carefully borne in mind in interpreting the results.

This definition of party colour was one of the most difficult of the classifications to resolve. There have been a variety of approaches to measurement of local political party colour in expenditure and grant studies and these have followed four main approaches

- (1) Dummy variables; e.g. code an independent variable as 1 for Labour areas and 0 for Conservative or other areas.<sup>16</sup>
- (2) Absolute majority of a given party; usually, absolute Labour majority, in Britain.<sup>17</sup>
- (3) Degree of marginality of a Council's party control; e.g. ratio of controlling party to total seats.<sup>18</sup>
- (4) Political interaction variables; multiplicative relation of party majority or marginality with grants or other variables.<sup>19</sup>

These approaches differ in that methods (2) and (3) attempt to measure party effects as an interval or ratio variable, and this approach has also characterised method (4), whilst method (1) uses dummy variables to measure party effects at a purely nominal level. The interval data approach has obtained some important results. For example it allows the marginal shift in degree of party control to be assessed. Thus Oliver and Stanyer (1969) were able to estimate that a 10% increase in the number of Labour councillors in County Boroughs in 1964/5 produced a 2.31% increase in local rate poundage ( $r^2 = 0.168$ ). This result was subsequently confirmed by Jackman and Sellars (1977*b*) who found a 10% increase in Labour councillors in metropolitan Districts in 1977/8 to produce a 1.57% increase in rate poundages ( $r^2 = 0.111$ ). Similarly Gibson (1980) has found a multiplicative variable (using method (4)) of Labour councillors as a proportion of total members multiplied by needs elements of the RSG to be statistically significant and positively related to expenditure levels.

Despite these encouraging findings, however, it is the contention here that party control is fundamentally a categorical variable. A council is either controlled by one party or it is ruled by a coalition, and recent history of British local finance demonstrates that in many cases councils are willing to enact policies strongly in line with the ideology of the controlling party, even when this has the slenderest majority. Moreover, the evidence to support increasing enactment of party politics in relation to size of majority is not strong. It seems therefore, that party is best measured by

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the presence or absence of a particular party control, i.e. as a nominal variable. In the research that follows four categories are employed reflecting Labour, Conservative, other party, and no overall majority or party change. Since measurements of party control are derived from time averages this last category includes councils which have had particular party control but which have changed control over the period in which an average is taken. However, one feature of the interval scale methods of political variable measurement is used at many points below; this is the concept of multiplicative interactions with other variables.

The main consequences of adopting a nominal scale of measurement for party effects is that subsequent analysis must adopt particular statistical methods. Hence, for initial statistical hypothesis testing, analysis of variance (ANOVA) methods are frequently employed below; for estimation of the marginal changes resulting from given changes in grants, needs or other variables, categorical regression methods must be employed. Both methods mark a major departure from most previous approaches to the estimation of party effects used both in Britain and other countries. Using this classification, the distribution of party control over the 1974–78 period is shown in figure 1.2. For this period it is clear that the Conservative party had dominant control of the Counties and many metropolitan Districts, whilst for 1979–83, when central government control switched to the Conservatives, the Labour party took control of most of the metropolitan councils and many County councils.

A second grouping used extensively below is that of areas of differing urban stress. Various definitions of this variable could be employed: for example, in the USA considerable research has been devoted to obtaining an adequate index of urban stress.<sup>20</sup> However, for the purpose of the present analysis, the urban areas defined in the 1978 *Act* (G.B. Government, 1978) are employed. These define two classes of urban policy areas: partnership areas, and areas with urban programmes or special powers. As noted by Bentham (1980), these areas do not correspond very satisfactorily with normal indications of urban stress such as housing quality, social class, unemployment, and so forth. However, these areas do define local authorities which themselves recognised special urban problems and which were also accepted as urban problem areas by the Labour government of the mid-1970s. Whilst some political bias has undoubtedly entered these definitions, they nonetheless provide a useful basis for classification, and one which has been followed to a large extent by the Conservative government since 1978 in defining Enterprise Zones and Urban Development Corporations. The four classification groups which result are shown in figure 1.3 and are defined as follows