Special Article

THE POLITICAL ECONOMY OF LOCAL GOVERNMENT FINANCE

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Introduction

The field of local government finance has recently taken on increasing prominence in national affairs both in terms of its expenditure and the sources of income necessary for its financing. Central government through the Secretary of State for the Environment in England and the Secretaries of State for Scotland and for Wales, has taken on new powers to control local expenditures.[1] However, it is not always clear what the consequences of such actions are for other agents in the economy. Hence this article attempts to trace such consequences, particular attention being paid to the Scottish experience.

There are two avenues of approach in conducting such an investigation, derived from the dual nature of the British system of local government finance. First, local government finance has been used as a macro-economic instrument whereby income and expenditure have been manipulated to aid central government's control of the economy. How do the new powers recently given to the Secretary of State for Scotland further such control? Secondly, will the exercise of such powers necessarily be to the detriment of the equalising properties of the system of local government finance.[2] This article attempts to provide an answer to both questions.

(A) Local Government Finance as an Instrument of Macro-economic Control

Whilst local authorities have a considerable degree of autonomy "the Government, however, has overall responsibility for all public services including those provided by local authorities, and for national economic objectives. Neither local government nor local taxpayers are in a position to assess either the relative claims of local services as a whole to national resources or the overall economic impact of local expenditure. These are matters on which the government must take a strategic view in the course of its management of economic policy. For these reasons it is essential that the Government should be able to influence local revenue". This is the view of the present government, expressed in its Green Paper on "Alternatives to Domestic Rates" December 1981 (Cmnd 8449, paragraph 1-11).

Such a view of the responsibilities of central government has in fact been shared by many previous incumbents. The points of divergence from other governments lie in the emphasis given to the effects of both the relative claims of local services and their economic impact. First, the present government believes that public expenditure is primarily at the

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*The views expressed are those of the author and not necessarily those of the Fraser of Allander Institute.

expense of private expenditure which is "crowded-out" as a consequence of the public sector's prior claim on resources via either taxation or borrowing.[3] Hence public expenditure does **not** lead to a real growth in national product, rather it merely produces a redistribution between the two sectors. Furthermore, in that economic growth is generated by the private sector, the overburgeoning public sector starves the private sector of resources hence leading to a diminution of growth potential. Secondly, the economic impact of the taxation and borrowing necessary to support the public sector is analysed in terms of the so-called "monetarist view" namely the effect on the money supply, interest rates, investment and inflation. Such views are, of course, subject to considerable controversy. The purpose of this paper is not to add to that debate but rather, taking the present government's view as given, explain and analyse the recent events pertaining to local government finance.[4]

As officially defined, public expenditure as a whole has consistely comprised more than two fifths of the UK's Gross Domestic Product (GDP), standing at 43.5% in 1980/81.[5] Of the total public expenditure outturn of £93.5 billion in 1980/81, central government accounted for £67.7 billion and local government some £25.1 billion (Table 1). Local government spending is dominated by current expenditure which accounts for four fifths of the total (Table 2).

TABLE 1 CENTRAL AND LOCAL GOVERNMENT EXPENDITURE: UNITED KINGDOM

£ million cash: UK	1976-77 Outturn	1980-81 Outturn	1981-82 Estimated Outturn	1982-83 Plans
Central Government				
Total central government excluding adjustments	36,498	67,701	77,819	84,127
Local Authorities				
Agriculture, fisheries, food and forestry	77	169	186	210
Industry, energy, trade and employment	67	131	167	187
Transport	1,241	1,990	2,069	2,146
Housing	2,214	2,007	1,313	1,677
Other environmental services	1,429	2,568	2,557	2,764
Law, order and protective services	1,290	2,380	2,778	3,042
Education and science, arts and libraries	5,783	9,495	10,346	10,447
Health and personal social services	902	1,697	1,876	1,962
Social security	206	370	577	662
Scotland	1,678	2,791	2,986	3,188
Wales	713	1,103	1,149	1,249
Northern Ireland	212	407	467	502
Total local authorities excluding adjustments	15,812	25,109	26,471	28,036
Planning total	54,649	93,475	106,130	115,150

Source: Cmnd 8494

Note: Data for Scotland, Wales and Northern Ireland includes only expenditure by local authorities themselves. Expenditures by the respective Secretaries of State on their own account together with expenditures which are the responsibility of other Ministers are excluded.

TABLE 2 SELECTED PUBLIC EXPENDITURE BY SPENDING AUTHORITY AND ECONOMIC CATEGORY

£ million cash: UK	1976-77 outturn	1980-81 outturn	1981-82 Estimated outturn	1982-83 plans
Central Government				
Current:				
Goods and services	15,892	29,473	33,616	36,328
Subsidies and grants	16,676	32,159	37,455	41,871
Capital:				
Goods and services	1,363	1,866	2,202	2,421
Grants	1,292	1,920	2,048	1,876
Net lending to nationalised industries and some public corporations	404	2,778	1,964	1,211
Other net lending and capital transactions	871	- 496	534	420
Total excluding debt interest and other adjustments	36,498	67,701	77,819	84,127
Local Authorities				
Current:				
Goods and services	10,541	18,351	20,249	21,230
Subsidies and grants	1,102	2,327	2,720	2,520
Capital:				
Goods and services	4,016	3,929	2,559	2,781
Grants	92	190	252	399
Net lending and other capital transactions	61	311	691	1,106
Total excluding debt interest and other adjustments	15,812	25,109	26,471	28,036
Planning Total	54,649	93,475	106,130	115,150

Source: Cmnd 8494

Within this the education service accounts for over half (Table 3). Capital expenditure is relatively small (Table 2), usually with over two-fifths being spent on the Housing Service (Table 3). Current expenditure itself is primarily on wages and salaries which account for over three quarters (Table 4). Unlike central government expenditure, which is dominated by subsidies and grants, local government expenditures are almost wholly incurred on goods and services (Table 2).

In seeking to reduce the relative importance of public expenditure in terms of GDP, central government must be able to exercise effective control over local government expenditure. The present economic recession has led to an increase in central government's payments of

TABLE 3 PUBLIC EXPENDITURE BY LOCAL AUTHORITIES IN GREAT BRITAIN

£ million cash	1980-81 Outturn	1981-82 Estimated Outturn	1982-83 Plants
Current Exenditure			
Education and science, arts and libraries	10,580	11,646	11,926
Local environmental services	2,391	2,610	2,717
Law, order and protective services	2,552	2,926	3,218
Personal social services	1,900	2,146	2,223
Transport	1,658	1,806	1,758
Housing	646	573	503
Other Programmes	598	846	957
Total (current)	20,324	22,553	23,302
Capital Expenditure			
Education and science, arts and libraries	597	488	427
Local environmental services	886	662	805
Law, order and protective services	64	113	127
Personal social services	96	88	127
Transport	798	765	922
Housing	1,810	1,189	1,657
Other Programmes	126	146	166
Total (capital)	4,377	3,451	4,231
Total (capital and current)	24,701	26,004	27,533

Source: Cmnd 8494

TABLE 4 PROPORTION OF WAGES AND SALARIES IN MAJOR SERVICES

Service	1972	1974	1976	1978	1980
		%			
Total	65.9	65.5	65.1	62.9	62.0
Central Government	55.1	55.7	54.8	52.8	51.9
Local Government	82.2	80.6	80.4	78.2	78.2
Police	89.1	89.7	87.1	84.1	85.9
Education	78.6	78.1	80.7	79.4	77.1
Social Services	70.6	67.4	66.2	65.1	68.0

Source: National Income and Expenditure Blue Book, 1981

Taken From: Public Money, June 1982, p6.

Note: Proportions are of net current expenditure for the UK.

grants and subsidies, for example, in the form of increased payments of unemployment benefit and social security, simultaneous with a loss of tax revenue.[6] Given the predominance of goods and services in local government expenditures, a reduction in such expenditures could be used to offset the automatic increase in grants and subsidies paid out by central government. However, the predominance of labour costs in local government spending implies that such a reduction would require substantial redundancies to the extent that they could not be achieved through natural wastage (ie retirement and resignations). The Education Service provides great scope for such manpower reductions, being by far the largest single service, having the highest proportion of labour costs after the Police Service (which is actually planned to increase in size) and currently experiencing a major decline in pupil numbers due to demographic trends.[7]

Examination of the breakdown of local authority expenditure in Scotland reveals a picture similar to that for Britain as a whole (Table 5). Local authority current and capital expenditure accounts for over half of all expenditure within the programme of the Secretary of State for Scotland. He has direct cash control over capital expenditure (again a very small proportion of total spending) but no direct control over current expenditure. This arises because British local government has its own revenue raising powers and, in the extreme case, could offset any grant reductions by increasing its income from indigenous sources, especially local rates. This would require significant rate increases given that the grant subsidy is equal to more than half of local expenditure in total and some two-thirds of Scottish expenditure relevant for grant purposes (Table 6).

Various governments have in fact managed to reduce real total local government spending since 1975, even before adopting new powers (Table 7). However, such cuts have primarily been achieved by reducing the capital expenditures of Scottish local authorities by 40% in real terms between 1975-76 and 1980-81. This may result in an imbalance between current and capital expenditures, assuming an optimal ratio between present and future consumption exists.[8] Furthermore, a continuing reduction in capital expenditures will ultimately exhaust central government's ability to offset what it regards as excessive current expenditure by local government.

The 1982 Public Expenditure White Paper (Cmnd 8494) reviews the degree to which plans for public expenditure in Scotland published in the 1981 White Paper (Cmnd 8175) were met. It states that local authority capital expenditure in 1980-81 was lower than planned whilst current expenditure on services relevant for grant (excluding housing) was 4% greater than planned. An even greater overspend was budgeted for 1981-82 by local authorities and hence the Secretary of State took selective action under the Local Government (Miscellaneous Provisions) (Scotland) Act 1981 together with a general abatement of grant in an attempt to reduce the excess of actual spending over central government's plans.

The macro-economic implications of "excessive" local government expenditures can be considered separately for capital and for current expenditure. **Capital** expenditure is almost wholly financed by borrowing, the predominant source being central government via the Public Works Loan Board (PWLB) which accounted for over half of total borrowings in 1980/81. This may have implications for the growth of the money supply.

TABLE 5 LOCAL AUTHORITY EXPENDITURE IN SCOTLAND

£ million cash	**1976-77**	**1980-81**	**1981-82**	**1982-83**
Current Expenditure				
Agriculture, fisheries, food and forestry	2	2	2	2
Industry, energy, trade and employment	6	11	13	13
Transport	98	235	215	235
Housing	36	83	102	71
Other environmental services	175	340	327	370
Law, order and protective services	117	222	247	289
Education and science, arts and libraries	604	1,062	1,107	1,211
Health and social work	110	193	239	262
Housing benefit(*)	17	41	64	75
Other public services	21	34	37	41
Total Current Expenditure (PES basis)	1,186	2,223	2,352	2,569
Capital Expenditure				
Agriculture, fisheries, food and forestry	1	2	3	2
Industry, energy, trade and employment	-	-	1	2
Transport	83	102	148	133
Housing	220	260	280	306
Other environmental services	123	166	180	167
Law, order and protective services	10	13	14	15
Education and science, arts and libraries	82	65	69	65
Health and social work	11	13	15	16
Total Capital Expenditure (PES basis)	530	621	710	706

(*) The figures reflect expenditure on rent rebates and allowances

Source: Cmnd 8494

If the government sells debt to the banking sector then reserve assets held by the commercial banks increase and, for a given reserve asset ratio (ie the ratio between reserve assets and eligible liabilities, or basically deposits), allows a multiple expansion of deposits. About 85% of the money supply as officially defined is made up of bank deposits. An increased money stock is held to lead to higher prices through adjustment of holdings of financial and real assets, whereby prices of the latter would rise as the private sector attempts to reduce its now surplus holdings of money.[9] The expansion of the money supply consequent upon local authority borrowing from the PWLB assumes no offsetting variation by the government (through the Bank of England) in the reserve-asset ratio, that banks do in fact expand deposits by granting loans and overdrafts and, more fundamentally, that the reserve-asset ratio is effective in controlling the expansion of credit.[10]

The relevance of such a possibility is further diminished by the sources of central government borrowing, which forms part of the Public Sector Borrowing Requirement (PSBR). This is subdivided between the own account borrowing requirements of central government, public corporations and local authorities. For four of the five years up to and including 1980/81 there was a net redemption of Treasury Bills (ie the Bank of England redeemed more than it sold), issues of Gilts accounting for at least two-thirds and at most 100% of PSBR. Furthermore, the non-bank private sector (eg pension funds) had already become the major source of finance for the PSBR by 1970 and accounted for 70% by 1980/81.

TABLE 6 LOCAL AUTHORITY EXPENDITURE IN GREAT BRITAIN RELEVANT FOR RATE SUPPORT IN 1981-82

	England	Scotland	Wales	Great Britain
	£ million, 1980 survey prices			
Current expenditure (PES definition)	13,016	1,689	819	15,523
of which				
Relevant current expenditure(1)	12,130	1,633	772	14,535
	£ million, estimated outturn prices			
Relevant current expenditure	16,180	2,195(2)	1,032	19,407
Rate fund contributions to Housing Revenue Accounts	254	-	11	265
Revenue contributions to capital expenditure	582	19	50	651
Loan charges	1,674	408	108	2,190
Interest receipts	- 267	- 10	- 15	- 292
Total relevant expenditure	18,423	2,612	1,187	22,221
of which				
Aggregate Exchequer Grant	10,895	1,742	871	13,508
At a rate of(3)	59.1%	66.7%	73.4%	-
of which				
Block Grant(4) (cash limited)	8,364	1,583	697	10,644
Other cash limited grants(5)	421	-	41	462
Domestic Rate relief grant(6)	663	14	48	725
Specific grants not cash limited(7)	1,447	145	85	1,677

Notes:

(1) Relevant current expenditure is that part of local authority current expenditure as defined for this White Paper which is included in relevant expenditure for RSG purposes. The main differences are that relevant current expenditure excludes certain items met almost entirely from central government funds such as expenditure on mandatory student awards and expenditure met by central government grants for rent rebates and allowances.

(2) Unlike RSG in England and Wales, RSG in Scotland is not paid at estimate outturn prices. This column shows the figures implied by the cash limit on Scottish RSG.

(3) This is consistent with an overall rate of grant support of 60% in England and Wales.

(4) In Scotland, the cash limited part of Rate Support Grant.

(5) In England and Wales, Transport Supplementary Grant and National Parks Supplementary Grant.

(6) Named the Domestic Element in Scotland.

(7) Law and order services account for three-quarters of expenditure met by these grants.

Source: Cmnd 8175

TABLE 7 LOCAL AUTHORITY EXPENDITURE IN SCOTLAND

£ million at 1980 survey prices	1975-76	1980-81	1981-82
Current Expenditure			
Agriculture, fisheries, food and forestry	-	-	-
Industry, energy trade and employment	8	10	10
Transport	167	171	166
Housing	72	59	61
Other environmental services	292	270	252
Law, order and protective services	196	200	200
Education and science, arts and libraries	875	812	792
Health and personal social services	141	180	181
Other public services	27	30	26
Total current expenditure (PES basis)	1,777	1,733	1,689
Capital Expenditure			
Agriculture, fisheries, food and forestry	1	2	2
Industry, energy trade and employment	-	-	-
Transport	130	107	97
Housing	386	210	235
Other environmental services	224	132	131
Law, order and protective services	18	12	11
Education and science, arts and libraries	114	58	50
Health and personal social services	12	12	11
Total capital expenditure (PES basis)	885	532	537

Source: Cmnd 8175

TABLE 8 THE EROSION OF RATE SUPPORT GRANT IN SCOTLAND

	Official Grant %	Actual Grant as % of Relevant Expenditure	Actual grant as % of Near-Actual Expenditure
1975-76	75.0%	75.4%	71.0%
1976-77	72.5%	70.8%	70.6%
1977-78	68.5%	68.2%	70.5%
1978-79	68.5%	68.2%	67.6%
1979-80	68.5%	64.5%	64.6%
1980-81	68.5%	64.5%	62.1%
1981-82	66.7%		
1982-83	64.2%		

Source: Hansard, 19 February 1981, cols 213-214 (updated from unpublished sources)

Notes: The figures are at outturn prices and include loan charges. From 1976-77, the amounts of aggregate grants have been restricted by the operation of cash limits. The actual grant percentages for 1981-82 and 1982-83 could be as much as 5 percentage points below the official percentages.

Taken From: The Government's Economic Strategy: The COSLA Critique, Convention of Scottish Local Authorities, Edinburgh, May 1981

This reflected the increasing attention given to growth of the money stock as an objective of policy under "Competition and Credit Control" introduced in 1971. Greater control over the broad money aggregates was sought, rather than over just the lending of specific types of financial institutions (ie the clearing banks). In addition the new system was intended to stimulate competition in banking and other financial markets. Hence the growth of credit and the money stock would be controlled by interest rates and the allocation of credit would be determined by the rates that different types of borrowers were prepared to pay. There was therefore a shift from direct controls (eg lending ceilings) to reliance on market forces. The two main instruments intended to achieve this were changes in the Bank of England's Minimum Lending Rate and open-market operations.

Other things being equal, sales of gilt-edged securities to pension funds or borrowing directly from individuals via National Savings will cause them to run down their bank deposits so reducing the money supply. Other things were not always equal, however, since whilst over the longer term the Bank of England was able to sell government securities to the non-bank private sector, the timing of sales sometimes caused problems. This arose due to the unwillingness of investors in gilt-edged securities to buy when they expected interest rates to rise (ie prices of government securities to fall). This was particularly the case when growth of the money supply appeared excessive and in such cases the government was often forced to borrow temporarily from the banking sector via the issue of Treasury Bills. Hence an unduly large borrowing requirement by, or on behalf of, local authorities could still have implications for the growth of the money supply.[11] It could also have implications for the level of interest rates since in order to induce investors to purchase an excess supply of bills their prices have to be reduced, with the result that, since a fixed cash payment is commanded by each bill, the interest rate rises. This could be detrimental in that higher interest rates may tend to dissuade investment in industry and in house construction, and could also lead to instability in the exchange rate and/or balance of payments as foreign funds are attracted by the now higher interest rates. This assumes a high degree of interest-elasticity of investment and of foreign funds and ignores other factors such as expectations of profits to be derived from investment.[12]

While the foregoing text has analysed the macro-economic implications of borrowing to finance capital expenditures, these arguments have **not** formed the prime justification for controlling such spending by Scottish local government. Rather, its reduction has been used to offset central government's lack of effective control over current expenditure, both for local government as a whole and as a punitive measure against individual authorities. Indeed it has already been noted that capital spending was **lower** than planned by central government in 1980/81.

The macro-economic implications of "excessive" **current** expenditures are held to work primarily through local rate bills. The latter have recently been subject to particular publicity in terms of their effects on business profits, rising from 16% of (non-North Sea) gross trading profits in 1973 to 52% in 1980. Non-domestic rates are only a small proportion of costs but they have to be paid irrespective of profit levels. However, over 20% of these are paid by the public sector itself and non-domestic rates are an allowable expense against corporation and other company taxes. Furthermore, businesses do receive services from local authorities which they would otherwise have to pay for directly, and the theory of tax incidence would suggest that some of the burden is passed on in higher prices. Domestic rates cannot be passed on and hence could lead to inflationary wage claims. This is reinforced by the inclusion of rate payments in the Retail Price Index upon which wage claims tend to be based. In addition, if grant reductions are offset by higher rate bills then central government will be less able to achieve its twin objectives of reducing income tax levels (rates being a form of direct taxation) and reducing public expenditure at the same time.[13] Given the predominance of current expenditure in total spending central government must be able to control rate levels if it is to achieve its objectives.

This explains the adoption of new powers by the Secretary of State for Scotland under the 1981 Act, referred to earlier. It should, however, be noted that the Secretary of State has had powers to reduce the grant of individual authorities since the Local Government (Scotland) Act 1966. Under that Act he could reduce grant going to those authorities whose actual expenditure was deemed to be excessive and unreasonable. The 1981 Act extended those powers from actual to estimated expenditure so that action could be taken before, rather than after, an overspend. Such excessive expenditure is judged with respect to guidelines published by the Scottish Office and having regard to the expenditure levels of comparable authorities, general economic conditions and any other criteria the Secretary of State considers appropriate. Such comparisons are, of course, subject to considerable controversy.

Scottish authorities could do little to offset such grant reductions immediately. Firstly, they cannot use sums from their loans fund to finance current expenditure for which grant has been withdrawn. Secondly, they are prohibited from levying supplementary rate increases during the course of the financial year. Increases in fees and charges are also impractical in the short-term and, besides, they are anathema for many authorities, although central government has recently passed enabling legislation for authorities to raise more income from this source. Hence, if individual authorities are determined to maintain expenditure levels in opposition to central government wishes, they must formulate speculative budgets, setting their rate poundage levels sufficiently high to offset any future grant reduction. Any **general reduction** in grant is announced several months prior to the financial year to which it relates. Hence authorities could budget to cover such a general loss of grant, if they so wished. However, it would be much more difficult to budget in advance of **selective action** directed against **individual** authorities during the course of the financial year after budgets have been prepared. Furthermore, these powers assume that, if a clear trade-off between reduced grant and increased rate bills for an individual authority was apparent, it is unlikely that a local authority would openly defy central government policy at the expense of the ratepayer. This assumption has not always been borne out, and in practice the effectiveness of the 1981 Act's powers of selective grant withdrawal would appear to be limited. In June 1981 the Secretary of State asked for a total reduction of £63 million from seven Scottish local authorities. Selective action under the 1981 Act yielded only £33.7 million and only after considerable publicity and airing of views opposed to the government (eg the Lothian Region case).

Not surprisingly, therefore, the government adopted new powers under the Local Government and Planning (Scotland) Act 1982. In addition to his previously existing powers, the Secretary of State can now also propose a reduction in the rate determined by an individual local authority.

He may also, at any time after the estimated aggregate amount of grant (namely the Rate Support Grant) has been fixed for any year, redetermine the amount for that year. This latter power will serve to reduce the ability of local authorities as a group to engage in speculative budgeting. The Secretary of State can now enforce a reduction in expenditure after budgets have been set simply by redetermining (ie reducing) **aggregate** current expenditure. The other power (called "rate-capping") allows the Secretary of State to control the rate income of individual authorities in addition, subject to the approval ofthe House of Commons. Hence, he can also enforce a reduction of expenditure of an individual authority as well as of all authorities in aggregate. These powers would appear to give the Secretary of State almost total control over the incomes and hence expenditures of local authorities. Such powers may prove unwieldy in their implementation, however, especially where House of Commons approval is required.

Two questions arise: firstly, whether such controversial new powers are really necessary to control aggregate expenditure and, secondly, whether they are in abrogation of the constitutional right of local government to determine its own level of expenditure. The first question strictly concerns the economist. The reader must form his or her own judgement on the second. It is clear that the system of cash limits on expenditure, introduced in 1976, have failed to control **current** spending. Under the annual Public Expenditure Survey (PESC) an upper limit was placed on the compensation for inflation during the course of the forthcoming financial year. Since actual inflation was greater than forecast during the later 1970's this served to reduce grant paid to local authorities in real terms, compounding the reduction in the official grant percentage. For Scotland this resulted in the actual grant being 4% points below the official grant in 1979/80 and 1980/81 (Table 8). Local authorities were able to maintain current expenditures with their own rate income. However, whilst cash limits were not originally designed as a means of reducing the volume of services below approved levels they are now being so used by thepresent government as part of its cash (rather than volume) planning of public expenditure. The latest Public Expenditure White Paper (Cmnd 8494) allows for annual net increases in cash terms for Scottish local authority total spending of 6% in 1982/83 and 3.5% in each of the two following years. If inflation is greater than these figures then it implies a real reduction in spending, if rate levels are successfully controlled by means of the new powers.

Nonetheless, the constrained nature of the new powers means that it is still the case that "reforms of the grant system have been designed to provide clearer incentives to prudence..... Ultimately, however, the effectiveness of all such measures depends on local authorities' own sense of responsibility towards their ratepayers and towards national needs". (Cmnd 8449, paragraph 1.13) Hence macro-economic control via local government expenditure may remain imprecise. Indeed, the estimate for British local authority current expenditure in 1982-83 in the 1982 White Paper was £1.3 billion higher than the cash figures based on the 1981 White Paper (see Cmnd 8494-I, paragraph 47).

B. Local Government Finance as an Instrument of Equalisation

The grant system as a whole is based on the concept of equity. In particular, many local government services are either public goods or merit goods where equity dictates that such services should be made available to all persons at an equalised cost, rather than being allocated by the price mechanism.[14] Hence central government grants to local authorities attempt to compensate for variations in their need to spend per capita in providing comparable levels of services and also for variations in their local per capita taxable capacity. Variations in the need to spend per head of population will arise, for example, if an authority has a relatively high proportion of children of compulsory school age in its population. Even if it spends the same amount per pupil as other authorities it will nonetheless spend more per head of population. This would impose a relatively high cost on ratepayers in such an authority and hence the grant system attempts to compensate for differences in the need to spend per head of population.

Similarly the uneven distribution of domestic and non-domestic properties throughout the country, upon which the local tax or rate is levied, results in authorities having differing local taxable capacities. Areas with relatively low taxable capacities would have to levy relatively high tax rates on local ratepayers in order to finance levels of services comparable with other authorities. This would, at the margin, encourage migration of mobile ratepayers from poor (high tax) areas to prosperous (low tax) areas. Hence, a system of local government finance based solely on local taxation would accentuate such disparities, poor areas being made poorer by out-migration and vice versa. Economic and demographic decline in certain cities and regions would be exacerbated. The British system of local government finance therefore incorporates a regime of central government grants to local authorities with the stated objective of compensating both for variations in local taxable resources per head of population and simultaneously for variations in the need to spend per head of population in providing a comparable standard of service.[15] The main instruments for payment of central government grant are the Rate Support Grant (RSG) and Specific and Supplementary Grants (Table 6). These are paid in respect of "relevant expenditure" (ie relevant for grant purposes) which includes most current expenditure and finance for capital expenditure.[16] Whilst there are differences between Scotland and the rest of Britain in terms of the administration of the grant mechanism, the underlying objectives are the same.

The RSG is, as its name implies, a grant in support of the local rates, whereby the local ratepayers are spared the full burden of financing local expenditure. In Scotland this is divided into three elements. The "Needs Element" compensates local authorities for difference in the need to spend per head of population. The "Resources Element" compensates for differences in local taxable resources (namely the rateable value of domestic and non-domestic hereditaments), again per head of population. The "Domestic Element" was originally introduced as a temporary subsidy to domestic ratepayers so as to alleviate the acknowledged anomalies of the rating system but has in fact become permanent. It is paid direct to rating authorities which then pass on the benefit to domestic ratepayers by reducing domestic rate poundages (ie the tax rate) by a corresponding amount. Its share of total RSG is insignificant.[17] This tripartite grant structure was introduced into Britain as a whole in 1967 although it has recently been modified for England and Wales.

The total size of the Needs Element is more than sufficient to compensate for differences in the need to spend per head and hence the residual is distributed on a per capita basis, resulting in central government taking on a larger share of the cost of local services than is necessary simply for the purpose of equalisation.[18] By contrast the Resources Element does not achieve complete resources equalisation between local authorities. This is largely due to the enhancement of certain local authorities' indigenous taxable resources (rateable value) caused by recent North Sea oil-related developments (most notably Orkney and Shetland). Given that negative resources grants are ruled out in Scotland it would be extremely expensive for central government to credit all other authorities with sufficient notional rateable value so as to equalise rateable value per head for all authorities. Rather central government arbitrarily prescribes a national standard net penny rate product per head, ie the product of a rate poundage of once pence applied to the taxable per capita rateable value in an authority. This is set so as to result in the distribution of the whole of the Resources Element. Local authorities whose actual penny rate products per head are below the national standard are said to have a "deficiency" of rateable value. The government pays rates upon the deficiency just in the same way as an ordinary ratepayer pays rates on a rateable property. Hence the higher the rate poundage levied against this notional rateable value the greater the payment of Resources Element to an authority. This results in the Resources Element being "open-ended" and if most authorities levied higher than expected rate poundages the government would pay out more than the expected Resources Element. Hence the national standard is an estimated amount per head and it will be reduced if actual rate poundages are higher than expected so as to constrain the size of this element to its planned total.

Nonetheless, this still benefits high spending authorities who gain grant by raising rate poundages. The subsequent reduction in the national standard penny rate product per head causes **all** authorities who previously had a deficiency of taxable resources to lose grant, underspenders as well as overspenders. Hence the gain to a high spending authority will be greater than the subsequent loss. In an attempt to prevent this the government has resorted to reducing the relative importance of the Resources Element. The ratio of the Needs to Resources Element is arbitrarily prescribed by central government and this was reduced in several steps from 4:1 to 7:1 between 1979-80 and 1982-83 so as to limit the scope for "overspending" by individual authorities. This makes no difference to central government's control over the total size of the element, rather a higher proportion of grant is now distributed via the Needs Element. Again, however, the reduction in the national standard rateable value per head necessary to achieve this change in proportions causes all authorities previously in receipt of Resources Element to suffer a reduction. They will only benefit in net terms if their loss of Resources Element is more than offset by their gain via the Needs Element. The only authorities sure to benefit are the high resource authorities who previously received little or no Resources Element and who now receive increased Needs Element allocations via the increased amount paid per head of population, whilst still retaining their resources advantage. In addition the Secretary of State for Scotland can use his powers under the 1981 Act to reduce the amount of Resources Element paid to individual authorities by using a lower rate poundage than actually levied in calculating this element of grant.

Although they increase the Secretary of State's control over the grant of individual authorities, and hence ultimately over their spending, these changes in the structure of the grant could lead to the grant regime as a whole failing to meets its equalisation objectives. This arises firstly from the reduction in resources equalisation under the Resources Element. The disparity between the high resource authorities and other authorities has been increased. A second change which will tend to reduce the equalising properties of the grant structure relates to the size of the Needs Element. It was noted earlier that the total size of the Needs Element is more than sufficient to compensate for differences in need to spend per head of population. However, as the proportion of relevant expenditure funded by grants is reduced this will tend to reduce the size of the Needs Element until ultimately it is not sufficient to compensate for such differences in need at existing expenditure levels. The government could argue that it would be sufficient if local authorities reduced their expenditures in line with its plans. However, to the extent that all local authorities maintain current expenditures by placing an increasing burden on the ratepayer then such compensation ultimately will no longer be complete.

Conclusions

Whilst the provision and financing of local government services was originally intended to achieve greater equality in the consumption of national output it has increasingly been used as a macro-economic tool to control the level of aggregate demand. In the postwar period up to the early 1970's local government expenditure accounted for an increasing share of GDP. In a period of rising expenditures local government finance was able to serve both as a macro-economic tool (ie increasing aggregate demand to maintain full employment) and as an instrument of equalisation in the consumption and finance of public services. More recently its use as a macro-economic tool has been directed to cutting public expenditure. A diminishing real grant, together with other changes in the internal structure of the grant regime, creates a danger that equalisation may no longer be achieved. If central government wishes to achieve both macroeconomic control and equalisation then there must be changes made to the internal structure of the Scottish grant regime. The Needs and Resources Elements could be combined into a unitary grant. This would allow for complete resources equalisation with a lower grant total simply by applying negative resources grants to high resource authorities. When unified with the needs grant this process would still yield positive net grants. The separate "Block Grants" for England and Wales have recently adopted this unitary structure.

Such changes would ensure continuing equalisation with a smaller grant total. In addition, to the extent that rate levels are successfully controlled by the new legislation, macro-economic control will also have been achieved. However, it could be argued that such micro-economic controls over individual local authorities are not necessary for macro-economic purposes. Rather than being the logical outcome of a series of assumptions about the functioning of the economy (ie the monetarist view), it could be argued that the recent attempts to curtail the budgetary freedom of local authorities are the result of purely political ideology. This ideology is characterised by antipathy towards the public sector in general, holding the view that individuals should be free of state control and free to spend their income as they think fit, rather than as decreed by central or local governments.

Many parts of the public sector are currently being "privatised".[19] For local government, recent measures include the contracting out of refuse disposal and council house sales. Such decisions are the responsibility of individual authorities and hence progress towards privatisation in the short-run is likely to be limited. However, in the long-run, central government could introduce privatisation into further and higher education falling within the responsibility of local government, or a voucher system for compulsory school education with directly elected school boards. Whilst unlikely in the near future, such developments would be feasible in the longer-term under a re-elected Thatcher government. Hence, as a short-term measure central government is simply trying to reduce the spending of the local government sector in general, and of those authorities with opposing political ideologies in particular. The newly legislated powers have cast doubt on the future constitutional autonomy of local government. In following such a course the next logical steps are for central government to tell local authorities what they should spend on individual services (rather than on services as a whole) and to deprive all authorities of their independent sources of income (namely the rates). When that happens local government will be transformed into a local agency system for central government. In the longer-term even this agency function may be downgraded if major services such as education are privatised.

NOTES

1. The new powers relating to Scotland and the steps taken against individual authorities are described in "A time to listen - a time to speak out" **Convention of Scottish Local Authorities,** February 1982.

2. Equalisation is in respect of different local authorities rather than individuals. This is explained more fully in Section B.

3. Standard economic textbooks usually adopt the Keynesian view, assuming that all government expenditure represents a net addition to aggregate demand (ie the crowding-out effect is zero). In this case government expenditures would have a major impact on output and employment.

4. Persons not familiar with that debate will find a useful summary in PM Jackson, The Public Expenditure Cuts: Rationale and Consequences, **Fiscal Studies,** Vol 1 No 2, March 1980 pp66-82.

5. The definition of public expenditure is essentially arbitrary. The official definition excludes such items as the capital expenditures of the nationalised industries.

6. The Treasury's **Economic Progress Report** No 130, February 1981 estimated that the cost to the Exchequer of rising unemployment in 1980-81 was £340 million for an increase of 100,000 in the number of people out of work. Unofficial estimates are provided by A W Dilnot and C N Morris "The Exchequer Costs of Unemployment" **Fiscal Studies,** Vol 2 No 3, November 1981.

7. The latest forecasts of Scottish pupil numbers are contained in the **Scottish Education Department's** Statistical Bulletin, No 7/B2/1981, July 1981.

8. A useful discussion of capital and current public expenditure is provided by the Treasury's **Economic Progress Report,** No 135, July 1981.

9. This view of the Transmission Mechanism is expounded in theTreasury's **Economic Progress Report,** No 123, July 1980. It holds to the belief that money is broadly neutral in the longer term, in that any reduction in its supply affects the price level rather than real economic activity, temporary effects notwithstanding.

10. Many of the same qualifications hold for direct borrowing by local authorities from the banking sector, from overseas (subject to Treasury consent) or from the public at large (via deposits or bonds).

11. Nonetheless research has revealed that "less than half of thevariance in the change in the money supply between 1963 and 1978 is accounted

for statistically by the PSBR": Savage, D Monetary Targets and the Control of the Money Supply, **National Institute Economic Review**, No 89, August 1979.

12. Whilst evidence from the United States suggests that investment is sensitive to interest rates, there is no clear evidence for Britain. The apparent lack of sensitivity in Britain may be due to a mis-specification of research (eg the lack of disaggregation between types of investment, the use of nominal rather than real interest rates, the lack of attention paid to the trade cycle) or it may be due to institutional factors such as the fact that public corporations have accounted for as much as a fifth of UK fixed investment (1976) and they are known not to be sensitive to interest rates when undertaking investment.

13. The importance of domestic rates should not be over-emphasised, however, since they constitute less than 3% of personal disposable income. Nonetheless, this porportion could rise dramatically in the future if the financing burden is switched from central to local taxation.

14. In his book, **The Strategy of Equality: Redistribution and the Social Services** (1982), J Le Grand casts doubt upon the effectiveness of public services in general, and local government services in particular, in allocating such services equally to all classes in society.

15. In his book, **"Equalisation and the Future of Local Government"**, (1966) L Boyle concludes that equalisation between individual ratepayers (rather than between individual authorities) cannot be achieved based on the rating system. This arises because there is no direct functional relationship between the tax and the incomes of those subject to it. Rather, the tax is a function of the rateable value of the property occupied by the local taxpayer and there is no direct relationship between rateable values and income. The ultimate beneficiaries are owners of capital and land, grant being capitalised into their market values. See R Barnett and N Tophan "A Critique of Equalising Grants to Local Governments" **Scottish Journal of Political Economy**, Vol 27 No 3, November 1980.

16. Finance for capital expenditure here refers to revenue contributions to capital outlay and debt charges accruing from borrowing.

17. The Needs Element for 1982-83 accounts for some 87% of total RSG, with the Resources Element some 12% and the Domestic Element less than 1%. RSG itself accounts for over 90% of Scottish Exchequer Grants. Data for 1981-82 is in Table 6.

18. There has, however, been a considerable amount of ongoing controversy about the assessment of the need to spend per head of population.

19. Privatisation measures are summarised in the Treasury's **Economic Progress Report**, No 145, May 1982. The philosophical arguments antipathetic towards the public sector are provided by F A Hayek in his book **"The Road to Serfdom"** (1976).