Written evidence submitted by Pixel Financial Management [FSR 047]

1. This response is from Pixel Financial Management. We advise over 130 local authorities on local government funding. Our subscribers receive briefings and analysis on funding announcements, and we publish forecasting models to help authorities plan their budgets. Further information can be found on our website: http://pixelfinancial.co.uk/

Lessons from previous changes to local government funding

2. Successive governments have added new funding “modules” to the existing funding system: the four-block model was laid over the existing Standard Spending Assessments; on top of this was added the Business Rate Retention System (BRRS). Complexity has been added to complexity. Ideally the Fair Funding Review (FFR) would sweep-away the remnants of these old systems and replace it with something where it is possible to see how everything has been calculated, and how everything fits together. Authorities want to be able to see how their allocations have been calculated, and to replicate these calculations. Expressing simply how funding allocations are calculated is really important (even if the underlying methodology is complicated).

3. In recent years, the multi-year settlement has been very useful because it has provided baseline level of certainty. It has been undermined to some degree by the late announcement of new funding and late announcement of council tax limits. The greatest uncertainty has been about the relatively minor changes around the edge of business rates system

4. The uncertainty and complexity have impacted on authorities’ confidence in their funding forecasts. We would expect some degree of uncertainty about future years, but often this uncertainty can extend to in-year funding. As a result, authorities have tended to hold-back resources and not committed resources until they are sure. This does not represent the efficient use of scarce resources.

5. We would like to see a funding system where there is a clear design of the architecture of the overall system and how the various elements fit together. This should include the funding (Settlement Funding Assessment, SFA) and the BRRS. We would also expect a commitment from MHCLG to be transparent about the assumptions within the system. We recognise that this can cause difficulties for ministers who might want to obscure their decisions, particularly about assumed council tax levels or funding allocations to individual services.

6. Ad hoc policy changes have undermined the effective operation of the funding system, particularly to the business rates system. As a result, authorities focus on the mechanics of the system rather than making informed forecasting of rates growth or understanding of drivers of change in their business rate-base. Authorities’ understanding is growing, but it is obscured by complexity (particularly appeals).
7. We do, however, recognise that governments will always want to introduce new policies that will result in changes within a Spending Review (SR) period. It would be preferable to have a “cooling-off” period of at least 6 months between an announcement and its implementation (an announcement in Autumn Budget is almost too late for following financial year). We would urge the government to pre-announce as much as possible (e.g. council tax thresholds) and to do so by early Autumn so that it fits in with local authority budget setting timetables.

8. Most of the complexity has been in the BRRS in recent years, including new reliefs and discounts, revaluation, pilots (of different types), the switch from RPI to CPI, various section 31 grants. And it is inevitable that change will continue after 2020: the next revaluation is in 2022, new discounts and reliefs will be demanded by ailing business sectors, and it is likely that different retention rates will prevail in different authorities. We are very doubtful that the current system will cope with these changes any better in the future than it does now. In our view, many of the problems with the current BRRS have been caused by the decision to fix baselines and tariffs/ top-ups in 2013-14. “Floating” baselines might have presented a more flexible system capable of coping with changes more effectively. The proposals for an alternative – or simplified – rates system should help, and we understand that “floating” baselines are being considered for this new system.

**Efficiency, fitness for purpose and sustainability of the current system**

9. An increasing share of funding is now distributed based on incentives rather than “needs”. Incentive-based funding now exceeds £3.0bn per year\(^1\), which is 16.1% of total Government funding. It has worked well for many authorities and has changed behaviour: some authorities are now much more focussed on how to grow their taxation receipts.

10. But incentive-based funding has an opportunity cost. It is not an efficient way of funding services because the additional risk encourages authorities into more tentative behaviour. There can be a reluctance to commit resources, with authorities holding-back resources on their balance sheets. It also means that funding is not systematically directed at authorities on the basis of “need”. We would like to see the government setting out the proportion of overall local government resources that are incentive-based, and making clear the levers that it would use to ensure that incentive-based funding remains within these limits.

\(^1\) If we include BRRS, New Homes Bonus, Business Rate Pilots as well as business rates deductions for Enterprise Zones and Renewable Energy.
11. Any new taxation sources should be seen in this context (e.g. tourist tax or additional council tax bands). Whilst they increase the funding quantum for the sector (which is to be welcomed) they will do so in a very uneven way. Some authorities will have enormous capacity to generate additional income both from existing sources and from new types of taxation. Others have very little opportunity (and indeed may have to invest just to manage the decline of their income streams). In its most recent consultation paper on the FFR, the government has sought ways of equalising a wider range of income streams (i.e. equalising fees and charges and car-parking charges) but these proposals have not been widely supported by the sector.

12. There are two ways that the government can share-out the proceeds of growth and of new taxation receipts, as well as to limit the total amount of resources retained by authorities from these sources. One is to place a levy on growth (e.g. the levy in the current BRRS). The other is to have periodic equalisation of income.

13. The role, scope and operation of equalisation of income is going to become increasingly important. We estimate that council tax could account for 59% of total local government resources in 2024-25, compared to 51% in 2018-19. In the current system, council tax equalisation is applied as part of the Needs and Resources assessment (the Settlement Funding Assessment), and business rate growth is equalised through the Baseline Reset. It is by far the most important issue in the 2020 FFR, and it is likely to increase in importance in coming years.

14. There are two elements to the decision on equalisation:
• **How often should income/taxation be equalised?** Until the early 2000s, council tax equalisation was undertaken annually (which effectively neutered the benefit of council taxbase growth). Equalisation has become increasingly periodic, with the effect that when equalisation does take place it is extremely redistributive and, as a result, is now only partially implemented. We would suggest that periodic equalisation is reasonable (and every 4-5 years is about right) but low taxbase (or low-growth) authorities might disagree.

• **How much growth or taxation should authorities be able to keep?** Any system has to allow authorities to keep some taxation gains for a period so that there is an “incentive effect”; authorities might also be using taxation-gain to support investment decisions or to fund the additional services or infrastructure arising from population growth.

15. Equalisation also creates considerable amounts to redistribute to “needs”, which benefits high-need authorities or those with a large share of “needs” (as an example, the Baseline Reset in 2020 might free-up as much as £1.5bn to be redistributed through “needs”). Balancing the interests of high-need and high-growth authorities is going to be a major challenge both in the 2020 FFR and at future resets. In the longer term, a widening and expanding of the taxation base is likely to result in loosening the expectations for equalisation. This means the gainers are likely to keep more of their gains.

16. Turning towards the authorities’ sources of taxation income, it is clear that authorities currently have very little scope to increase taxation yield, either by increasing the taxation rate (Band D, business rate multiplier) or through a buoyant taxbase. We are aware that some authorities are exploring alternative taxation streams, such as hotel tax or additional council tax bands. But these will only be viable options for a minority of authorities.

17. Council tax will remain the primary source of income (and growth) over the medium term. And there is still much to be explored within the current system. For instance, local authorities would welcome the freedom to explore changes in Single Person Discounts and re-banding (particularly towards the top-end, where Band H valuations seriously understate real values).

18. Because there is no buoyancy in the taxbase, increasing yield can only be achieved through Band D increases and growth in the number of houses. Revaluations are politically sensitive and, as a result, rarely implemented. A formal revaluation is always revenue neutral – a zero-sum game – and does not create any buoyancy in the overall system. An alternative system would be one that captures housing-price growth in real-time (such as property tax in parts of the United States).

19. Some authorities are pressing for more flexibility over Band D increases, or even the total removal of the Band D “cap”. Whilst we are sympathetic to greater flexibility, we
would not support the total removal of a “cap”. The last time the “cap” was removed was in 2003-04 and it resulted in 12.9% increase in Band D. This is not good for the image of the sector, and resulted in lurches in government policy (from no limits in one year to very tight limits the next). We would prefer more dynamic thresholds (e.g. no limits for those with below-average or lower-quartile Band D, or cash-based limits, as are currently used for districts and police and crime commissioners).

20. Dynamic thresholds along these lines will leave some high-tax authorities with relatively little scope to increase their resources by raising Band D. The adult social care (ASC) precept has been a successful way of justifying large increases in Band D. Certainly, there is an opportunity here to extend and expand this approach, and this is something we would support. Ideally these precepts would be applied more consistently nationwide (e.g. yield in two-tier areas) and there should be greater clarity about how they fit in with overall Band D limits.

21. There also needs to be greater realism about the lack of buoyancy in business rates. Retained business rate growth has been boosted since 2013-14 because of the way baselines were created. Actual growth in yield is also obscured by the effect of appeals: few if any authorities will know what their underlying growth rates are. The “alternative system” being developed by MHCLG will help here although might also uncover some unpleasant surprises (i.e. that business rate growth is lower than many authorities had assumed).

**Assessing local government funding needs**

22. The uncertainty about funding in 2020-21 is unprecedented, and there is, as a result, considerable nervousness about forecasting funding in 2020-21 and beyond. To help authorities deal with this uncertainty, our suggestion would be that the government announces before this Summer how a damping or transitional regime would work in 2020-21. Ideally such a regime would cover the widest range of funding streams, including business rates growth and New Homes Bonus. Our experience is that those authorities with the largest growth – in business rates and NHB – are feeling very anxious and they are budgeting for 2020-21 based on how they think the damping regime will be constructed. Early clarity about damping would be an enormous help.

23. Within the FFR, proposals to create a flatter funding formula and to remove deprivation from the Foundation Formula have caused controversy. However, our modelling has indicated that council tax equalisation – and judgements made about how to implement it – will be the largest cause of redistribution. Indeed, our modelling indicates even partial equalisation will have to be accompanied by a flatter “needs” distribution. Without such a change, some high-taxbase, low-need authorities (e.g. Surrey County Council) would receive potentially catastrophic cuts in funding.

24. It is an open question whether the evidence can support the shift to a flatter “needs” distribution. Certainly, using multi-level modelling for the children’s and social care
formulae (covering at least 65% of the funding) should deliver a robust answer for these services. It is more difficult to extend this methodology to other services (such as those within the Foundation Formula) because their range and diversity is too great, as is the way that these services are provided. Our judgement is that a deprivation indicator should be included in a future Foundation Formula but that changes in spending patterns since 2010 will only justify a lower weighting. This would be consistent with a move towards a flatter “needs” distribution.

25. The proposals in the most recent consultation paper have also raised questions about whether unmet needs should be recognised and funded. The paper proposes, for instance, that concessionary fares should be funded on a per-capita basis, rather than on the basis of actual cost and usage, as has been the case since the statutory duty was introduced. In our view, this is a judgement and there are arguments both ways: if there were sufficient funds, it would be preferable to fund both existing concessionary fares costs and to support the development of services where they are currently under-provided. In the current fiscal environment, ministers will have to choose to do one or another.

26. This also raises the question of whether the purpose of the funding formula is to fund services (and costs) as they currently exist, or to provide funding for a standard level of service. In theory it is the latter, but in practice tends to be the former.

27. We do not think that the government is properly addressing how population growth is funded. In practice, population growth is funded from a combination of increased government funding (SFA) and increased taxation revenues (largely council tax but potentially also business rates). The government’s proposals are inconsistent because it is proposed that funding will use population projections but will not recognise increases in council taxbase. (Indeed, growth in council taxbase is effectively double-funded through the New Homes Bonus.) We would welcome further work to understand the additional costs that population growth places on local authorities and whether these should be funded from increases in grant funding or from growth in taxation revenues.

28. The converse scenario also needs to be addressed more fully, that is where authorities are experiencing economic contraction and/or population decline. Some authorities, such as Redcar and Cleveland, have suffered large business closures and, as a result, have been below their business rate baseline since 2013-14. There are relatively few of these authorities, but the effect is that these authorities are funded below their assessed needs whilst having to invest and support local regeneration. We would be interested in ways in which authorities with declining ratebases – and funding – can be supported, either inside or outside the main funding settlement.
Local government funding in the 2019 Spending Review

29. Local government has received cash-terms growth in core spending power in every year of the current Spending Review period, with the exception of 2016-17. Although this was a contrast to the cash-terms cuts in spending power between 2010 and 2015, there were still strong indicators showing a deterioration in the financial standing in many local authorities.

30. Few authorities are not maximising Band D increases. And although authorities’ revenue reserves have increased during this period (so far, 2017-18 is the only year where aggregate revenue reserves have fallen), falls in some authorities have been very significant indeed. Unfortunately, there are no measures to show the rate at which authorities are making savings (whether cutting services or making efficiencies) or the success at which authorities are having in implementing these savings.

31. In our forecasting model, which is used by many of our subscribers, we have assumed cash-flat change in funding over the next Spending Review period – with council tax growth in addition. So, overall funding growth would be marginally greater than in the previous Spending Review period. The latest indications are that this is possibly too pessimistic: the Autumn Budget 2018 indicated that growth in unprotected services (which we assume still includes local government) might grow in line with inflation.

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2 It is odd that business rate growth is not included within the government’s core spending power measure because it would show higher growth in spending power. It would also have shown how unevenly distributed this growth is.
(about 2%). Would a settlement with 2% cash-terms growth in funding, combined with retention of taxation growth (council tax, business rates) be sufficient for local government? Not really – this would be insufficient to keep pace with both inflation and growth in demand.

32. As ever, though, whilst such a settlement would be just-about-viable for most authorities, those at the extremes would still be struggling. Some of these reasons are local, for instance, some authorities are experiencing particularly large spending pressures (some county councils might fall into this category). Other authorities will also be put under pressure with changes in the distribution of funding, either from the Baseline Reset or the FFR. But this is a concern of the mechanics of the settlement itself rather than the Spending Review, which we assume is more concerned with the overall financial health of the sector.

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