Lessons from previous changes to local government funding

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).

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.

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.

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).

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.

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

An increasing share of funding is now distributed based on incentives rather than “needs”. Incentive-based funding now exceeds £3.0bn per year, 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.

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.

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.

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). 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).

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).**

The adult social care (ASC) precept has been a successful way of justifying large increases in Band D and provides a useful source of funds for rising demand pressures in social care services. Certainly, there is an opportunity here to extend and expand this approach (maybe to support costs related to children’s social care), 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.

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
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.

Ideally the proposed funding changes should either be damped to such an extent that there is minimal funding volatility in 2020/21 or their implementation postponed until 2021/22. This conclusion should be reached as soon as possible in order to provide some clarity and funding certainty to local government when authorities will be starting to plan their budgets for 2020/21; a process which has already commenced.

Within the FFR, proposals to create a flatter funding formula and to remove deprivation from the Foundation Formula have caused controversy. However, 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 would receive potentially catastrophic cuts in funding. 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 significantly lower weighting. This would be consistent with a move towards a flatter “needs” distribution.

Local government funding in the 2019 Spending Review
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. Sustainability of local government funding needs to be addressed after ten years of austerity budgeting, which has seen local authority services cut to the bone. Without a funding increase to cover basic demand caused by client numbers and general inflationary costs local government will need to make savings every year. Given the magnitude of those already made this will not be sustainable.

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