



Department for
Communities and
Local Government

Business Rates Reform

Fair Funding Review: Call for evidence on Needs and Redistribution



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Department for Communities and Local Government
Fry Building
2 Marsham Street
London
SW1P 4DF
Telephone: 030 3444 0000

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1. Introduction

- 1.1. In October 2015, the Government announced that, by the end of this Parliament, local government will keep 100% of the income raised through business rates, and will take on new responsibilities to be funded from this additional income as central government grants are phased out.
- 1.2. The design of a new finance system will shape the future of local government. This is an exciting opportunity for local government to put forward its own proposals and guide the reform process from the early stages of development.
- 1.3. The Department for Communities and Local Government (DCLG) has been working with the Local Government Association (LGA), local authorities and other interested parties to develop proposals. The Government's consultation, *Self-sufficient local government: 100% Business Rates Retention*, which is published alongside this document, and is available at:
<https://www.gov.uk/government/consultations/self-sufficient-local-government-100-business-rates-retention>
- 1.4. The Government has asked for responses to this consultation by 26 September 2016.
- 1.5. The assessment of the relative needs of local councils is a fundamental part of the reforms to business rates. Alongside the 2016/17 Local Government Finance Settlement, the Government announced the Fair Funding Review that will conduct a thorough review of what the needs assessment formula should be in a world in which local government spending is funded by local resources not central grant.
- 1.6. To help shape the Fair Funding Review, the Government has been engaging with representatives from across local government through a technical working group. Based on feedback from this group, we have developed this initial call for evidence on needs and redistribution. The Government wants to give local government every opportunity to consider the best approach to measuring their relative needs. The needs assessment does not require legislative changes to implement. This means that decisions do not have to be made now, and allows work to progress with local government to a different timetable. The Government is aiming to consult on the principles for the needs assessment in the autumn 2016, and expects to have a final consultation on the formulae in the summer of 2018. This will allow a new mechanism to be in place in time for the introduction of 100% business rates retention across local government by the end of the current Parliament.

How you can respond

1.7. The Government invites you to submit your views on the questions below, either in writing, or by attending a seminar. Your response to this discussion paper is invited by 5:00 pm on 26 September 2016, and can be provided to either:

- NeedsAndResources@communities.gsi.gov.uk
- Local Government Finance Reform (Fair Funding Review)
Department for Communities and Local Government
2nd floor SE, Fry Building
2 Marsham Street
London
SW1P 4DF

2. Needs and Redistribution

- 2.1. In 2013-14, the previous Government introduced the business rates retention scheme, under which local government retains 50% of the business rates income. To determine the starting position of funding for local authorities, the Government carried out an assessment of the relative level of needs and resources of councils across England.
- 2.2. Many councils now feel that too much time has passed since the last fundamental review of the approach to assessing a council's relative needs, and the costs it can be expected to incur in delivering services. The demographic pressures affecting particular areas – such as the growth in the elderly population, and the cost of providing services – may have affected different areas in different ways.
- 2.3. Therefore, the Government announced that it will undertake a Fair Funding Review of what the relative needs assessment formula should be following the implementation of 100% business rates retention.
- 2.4. The Fair Funding Review will deliver an assessment of relative needs within a fixed amount of business rates income. For the services currently supported by the local government finance system, the outcomes of the Fair Funding Review will establish the funding baselines for the introduction of 100% business rates retention. The distribution of funding for new responsibilities will be considered on a case by case basis once these responsibilities are confirmed; they are likely to have bespoke distributions.
- 2.5. The following sections set out the key questions that will need to be addressed as part of this review. A summary of the questions can be found at Annex A.

The approach to measuring relative need

- 2.6. The use of formulae to distribute grant funding to local authorities can be traced as far back as the 19th century. However, until advancements in computing in the 1970s, the scope for basing grant formulae on detailed statistical analyses was very limited. Formulae necessarily relied on a substantial element of judgement, though they were generally based on objective data.
- 2.7. Since the 1970s, analysis has been carried out to try from time to time to ascertain which indicators should be used to distribute funding, and how much weight one indicator should be given compared to another. Over recent years, funding formulae have become increasingly complicated in attempting to capture as many possible factors that may have an influence on local government spending.
- 2.8. There is a balance to be struck in determining the approach to measuring councils' relative needs. Simple formulae may make it easier for councils to

explain to their local electorates why they have received particular amounts of funding and may also be simpler to update. However, simpler formulae may also lead to a less nuanced distribution between local authorities.

2.9. While more complex formulae may lead to a nuanced distribution of funding they may be less transparent and more difficult to update.

Question 1: What is your view on the balance between simple and complex funding formulae?

Question 2: Are there particular services for which a more detailed formula approach is needed, and – if so – what are these services?

2.10. The most recent needs assessment used a mixture of statistical techniques to arrive at the formulae for distributing funding, including:

- **Expenditure based regression** – This technique attempts to explain the variation in spending between local authorities by using the characteristics of areas and their populations. The most recent needs assessment makes use of this technique using expenditure data up to 2011-12 and population projection data up to 2013-14.
- **Non-expenditure based regression** – This is where indicators of need are calculated using data from key service statistics. The technique has previously been used to assess the funding needs for police authorities.
- **Multi-level modelling** – This technique is needed to take account of the nested sets of data available on local authority services. For example, data may often relate to the spending on an individual member of the public, in receipt of a particular service within a particular local authority. Multi-level modelling allows needs indices to be calculated based on how well they predict expenditure within a typical local authority, as opposed to between them. It has previously been used to create the Children's Social Services funding formula.

2.11. In the past, expenditure based regression has been the most widely used statistical technique for assessing councils' needs. This is because data on local authorities' spending on services is readily available and has often been the best available proxy of their need to spend on those services.

2.12. However, past expenditure has previously been criticised by some local authorities, including most recently in responses to the consultation on the provisional Local Government Finance Settlement 2016-17. These authorities argue that previous patterns in spending may not necessarily be representative of the actual need to spend of local authorities and that the technique leads to a self-fulfilling outcome, whereby the highest spending authorities are assumed to need the most income, which therefore allows them to remain the highest spending. Some authorities have also argued that it forces councils who have

relatively less grant compared to their other sources of income to look to other revenue streams to make up for shortfalls in grant funding.

2.13. To take into account the potential deficiencies in using data on past expenditure, previous governments have made adjustments to needs formulae by increasing/decreasing the weighting applied to certain factors, for example to take into account the additional costs of delivering services in rural areas. An approach to measuring councils' needs that does not use previous patterns of expenditure may lead to a more equitable distribution of funding for all councils, and make adjustments such as these less necessary.

Question 3: Should expenditure based regression continue to be used to assess councils' funding needs?

Question 4: What other measures besides councils' spending on services should we consider as a measure of their need to spend?

Question 5: What other statistical techniques besides those mentioned above should be considered for arriving at the formulae for distributing funding?

Question 6: What other considerations should we keep in mind when measuring the relative need of authorities?

The treatment of growth in local taxes

2.14. In determining a distribution of funding, it is inevitable that any assessment of councils' funding needs will also need to take into account some measure of their available resource. Since the introduction of the Business Rates Retention scheme in 2013-14, local authorities across the country have seen growth in their council tax and business rates bases. There is therefore a question of whether this growth in local resource should be taken into account as part of the resource available to councils, or treated as being 'outside' of the overall assessment.

2.15. Allowing councils to retain this growth would incentivise them to build the additional income into their budgets and enable them to use it for delivering vital local services. However, it would reduce the amount of funding available to be allocated according to the needs assessment and might disadvantage those authorities whose local tax growth has not kept up with their demand for services, with a knock on effect on local services.

Question 7: What is your view on how we should take into account the growth in local taxes since 2013-14?

Transitioning to a new distribution of funding

- 2.16. It is inevitable that whatever method is used to arrive at new formulae, the resulting distribution of funding will be different to the existing one. In addition, this difference may be greater, and local authorities made aware of it later, due to the amount of additional technical work required, if a fundamental change is made to the approach to measuring authorities' relative needs, such as moving away from the use of expenditure based regression.
- 2.17. Recognising that councils require time to adjust to changes in their level of funding, previous governments have tended to limit the degree of change in local authorities' income through the use of damping mechanisms. For example, a system of floors and ceilings was introduced in 2001, which ensured that no local authority could see their funding increase or fall by more than a set percentage each year.
- 2.18. However, some councils have argued that the adjustments relating to these damping mechanisms have driven local authorities' income to a greater extent than the changes in their underlying needs assessment. Councils have also questioned the value of conducting detailed needs assessments when the end result is substantially adjusted to minimise the scale of discontinuity from the previous distribution of funding.
- 2.19. Therefore, in transitioning to a new funding distribution, it may be desirable to consider options such as phasing it in over a number of years or setting a fixed period over which the damping will be phased out. This may be particularly desirable if a fundamental change is made to measuring authorities' relative needs, where more time will be required before a distribution of funding is known.

Question 8: Should we allow significant step-changes in local authorities' funding following the new needs assessment?

Question 9: If not, what are your views on how we should transition to a new distribution of funding?

The geographical level at which need is measured

- 2.20. The current local government finance system assesses authorities' funding needs at the individual local authority level. However, due to the large variations in need between authorities, this will often mean that neighbouring councils will receive very different levels of funding.
- 2.21. An alternative approach could be to distribute funding to larger geographical areas, as the variation in need between these larger areas is likely to be far less than the variation within them. It would then be the role of the councils within the area to manage the distribution of funding between them.

2.22. A model such as this may have other benefits, such as greater collaboration between councils and more efficient spending on services within an area¹. This is because the councils within an area are likely to have a better understanding of their relative spending needs than central government. However, it would almost certainly require councils led by different political parties to work together to reach an agreed distribution of funding, which may be difficult to achieve.

2.23. In the devolution deals that have recently been negotiated with areas across the country, Combined Authorities have provided the means for the radical devolution of services and funding to local government. Allocating funding to Combined Authorities and allowing them to lead the distribution of funding to their constituent councils may therefore be one way of introducing this approach in areas where there is a complex political landscape.

Question 10: What are your views on a local government finance system that assessed need and distributed funding at a larger geographical area than the current system – for example, at the Combined Authority level?

Question 11: How should we arrive at the composition of these areas if we were to introduce such a system?

Question 12: What other considerations would we need to keep in mind if we were to introduce such a system?

'Resetting' the needs assessment

2.24. The Government intends to have resets in some form. Further detail on the Government's thinking on resets is outlined in Chapter 4 of the consultation, *Self-sufficient local government: 100% Business Rates Retention*.

Incentives within the local government finance system

2.25. Since the introduction of the business rates retention system in 2013-14, the incentive for councils to grow their council tax and business rates tax bases has been a key feature of the local government finance system. This incentive will be strengthened with the introduction of 100% business rates retention.

2.26. These reforms provide an opportunity to consider whether new incentives should be introduced into the system, such as for efficiency or collaboration across authority boundaries or other organisations.

Question 13: What behaviours should the reformed local government finance system incentivise?

¹ Independent Commission on Local Government Finance (February 2015), *Financing English Devolution*

Question 14: How can we build these incentives into the assessment of councils' funding needs?

Annex A – Summary of key questions

Question 1: What is your view on the balance between simple and complex funding formulae?

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Question 13: What behaviours should the reformed local government finance system incentivise?

Question 14: How can we build these incentives in to the assessment of councils' funding needs?

About this discussion paper

This discussion paper has been planned to adhere to the Consultation Principles issued by the Cabinet Office. Information provided in response to it may be published or disclosed in accordance with access to information regimes (primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004). Please be aware that, under the Freedom of Information Act, there is a statutory Code of Practice with which public authorities must comply and we cannot give an assurance of confidentiality in all circumstances. The Department for Communities and Local Government will process your personal data in accordance with the Data Protection Act and in the majority of circumstances this will mean it will not be disclosed to third parties.