



Jude Ranasinghe
Director of Consultancy and Training

jude.ranasinghe@lgfutures.co.uk

01908 424 387

Fair Funding for the South East: Stage 2 Research - Scoping Paper

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FINANCE WITH VISION

1. Introduction

- 1.1 LG Futures has produced initial findings in relation to Stage 1 research, commissioned by South East England Councils (SEEC), which considered public sector funding issues and cost pressures for the South East, with a particular focus upon local government. This report 'set the scene' in relation to the key issues for the SE region.
- 1.2 SEEC have recently commissioned Stage 2 research, which will seek to build upon the initial findings, by considering potential proposals for change to the funding system. The purpose of this note is to set out the potential areas that the Stage 2 research could cover, for consideration by SEEC members.

2. Localisation of business rates

- 2.1 As part of the Local Government Resource Review, central government is currently considering proposals to localise business rates. A number of groupings and thinktanks have already published papers in this area; for example, the Local Government Association, City Finance Commission and Localis. We can undertake analysis that will help SEEC to take a position on the following key questions:
 - Will relocalisation favour high taxbase authorities (as many assume)?
 - Will relocalisation reward growth?
 - Will relocalisation penalise areas in long-term decline?
 - How predictable will the yield be?
 - How will in-year business closures affect an authority?
 - Will relocalisation be linked to council tax and thereby effectively prevent council tax reductions?
- 2.2 Some form of equalisation is inevitable, but the form that it takes will be crucial to authorities in the South East. Point equalisation is the most simple form of equalisation (this is where equalisation is set at a given point and each individual authority can retain any business rate income above this level). The alternative is dynamic equalisation, where the proceeds of any additional business rate income are shared out (say, using taxbase, population or grant allocations).
- 2.3 In general, the South East will benefit from point equalisation, but the impact on individual authorities is not simple: some will benefit from point equalisation, whilst others will favour one of the forms of dynamic equalisation. We can model the various options and recommend a suitable approach for the region as a whole and/or for individual authorities (or groups of authorities).
- 2.4 We estimate that 160 local authorities are currently net contributors to the national business rate pool. This presents the opportunity for individual authorities or regions to buy themselves out of the national system. London Councils have proposed a potential system for London; we could recommend a suitable system for the South East.
- 2.5 There could be various options for the region to buy itself out of the national system, such as paying over a fixed sum or paying over a fixed percentage of any additional yield. We can examine the options and consider the implications both at the outset and, more importantly, over a period of time, which should take account of potential growth rates. Diverging growth rates within the region will make a significant difference.
- 2.6 Revaluation and resource equalisation for business rates has the effect of periodically redistributing growth in business rates away from growth areas. This has the potential to undermine the effectiveness of business rate localisation and to continue to distribute

business rate receipts away from the South East. Principles would therefore also need to be established to minimise the redistributive effect.

3. Regional grant distribution

- 3.1 A regional system for business rates would potentially allow for the development of regional grant distribution. London appears to be the most likely region to have a separate grant settlement. An England minus London settlement would open up the possibility of a flatter distribution of resources, because London has the most extreme needs and the current needs formulae have to take this into account. There is the potential that the South East – or at least many councils within the region – will gain relative to other parts of the country. The South East has the most to gain because its assessed needs are lowest and resources are greatest.
- 3.2 Potential might exist for a South East settlement, if there are sufficient business rates for the region to “buy itself out” of the national system. This would lock-in the total resources to the region, although it would allow the growth (or part of it) in business rates to be retained within the region and redistributed within it. Some form of regional settlement – and governance – would be required, which might not be easy to achieve and which may not be favoured politically; however, the concept in technical terms could be considered.

4. Incentivisation schemes

- 4.1 Schemes that allow authorities to raise more income and/or to keep growth in current income streams are likely to be disproportionately beneficial to the South East. For example, schemes such as the New Homes Bonus, Tax Increment Financing and the Community Infrastructure Levy (in addition to business rates localisation) could assist areas with above average growth rates and property values. We can work through the incentivisation schemes in terms of principles and practice. This could include:
 - Considering the principles that should be established for each of these incentive schemes, such as avoiding ‘excessive’ equalisation and to allow a ‘reasonable’ proportion to be retained locally to allow for self-sufficient autonomous local government. Such schemes could also be included in the “buy out” options, although the South East will want to minimise the exposure to equalisation.
 - Modelling of potential changes to the operation of these schemes (where data permits). For instance, the New Homes Bonus currently takes resources out of Formula Grant, and redistributes these through the scheme).
 - Considering how the various incentivisation schemes fit together.
- 4.2 We can also consider where additional new income sources might be opened up, such as from minor local taxes, and whether they would be beneficial to the region as a whole and to individual local authorities.

5. Grant regime

- 5.1 The opportunity exists to radically change the current grant system: it lacks transparency and credibility; is too complex; and there is significant damping. A number of issues can be considered under this area; for example:
 - **Consideration of non-UK approaches to local government funding and their potential relevance.** Local government finance in England is one of the most centralised in Europe. There may be opportunities to move towards the way in which local government finance works in other countries. This could include: removing specific streams of funding; increasing the range of income that local authorities can raise; and the localisation of key streams of taxation. All of these options have potential for SEEC: centralised funding tends to favour authorities with higher needs. Additional funding streams (specific and special grants) tend to double-fund needs (the removal of the Working Neighbourhoods Fund shows how much these additional streams favoured such areas). Removing these funding streams and including them in a simplified grant

would benefit SEEC. We could run the grant settlement to show how this could be achieved, although there are now many fewer additional funding sources than there were in previous years (in the previous government).

- **Breaking the link between funding and past spending.** One of the criticisms of the current system is that this favours historically higher spending authorities, as the formulae was developed on the basis of regression analysis of indicators against previous spending. This is a difficult area, as there are few reasonable alternatives, but examples of considerations could be:

- **Simplified formula** – this would require some judgement in order to determine the indicators and weighting. Over time, these indicators could be set and revised on a judgement basis.
- **Environmental, Protective and Cultural Services (EPCS) formula** – the current formula is largely based on judgement, because Ministers at the time wanted to break the link between funding and past spending. We could identify other formulae that could be developed in the same way and how this could be undertaken.
- **Fixed costs** – funding for fixed costs is more important for low-need areas. We can identify the fixed cost elements in each formulae and comment on whether these are sufficient. We could create benchmarks based either on statistical analysis or on a bottom-up assessment of fixed costs.

6. Assumed Council Tax

- 6.1 Taxbase per head is very high in the South East and the region is therefore very sensitive to changes in assumptions. The Formula Grant assessment takes into account needs and the ability of each authority to collect council tax to pay for that need. There are, however, two elements of judgement in setting the assumed council tax: the total council tax level and the split in council tax between various tiers of authority.
- 6.2 In general terms, assumed council tax has been increased in line with increases in actual council tax, with the effect that grant has been removed from high taxbase authorities (many of whom are in the South East). However, Ministers have also tended to make changes year-on-year in order to shift grant between different types of authority. The four-block model obscures the judgements made by ministers, particularly around assumed council tax.
- 6.3 We can consider the way that Ministers have set the assumed council tax and whether this has been reasonable against a range of factors (such as actual council tax, target council tax). This will indicate whether there are options that SEEC could ask for that do not remove as much grant from the South East (and particular authorities, such as those in Surrey and parts of Berkshire).

7. A Simple Formula

- 7.1 One type of simple formula involves basic per capita funding, plus top-ups for specific needs. In essence this is an extension of the current four-block model. For the South East, the preference would be to have more weight placed on the per capita (basic needs) element than is currently the case. This ought to be supplemented by greater transparency over the way that this weighting is determined.
- 7.2 An alternative type of simple formula is one that re-creates the current distribution of resources with a handful of indicators. This would give greater simplicity and transparency (which are benefits in themselves). It would make discussions about the allocation of resources less esoteric and possibly move discussion towards funding minimum standards (which could help many authorities in the South East). It would also break the direct link between funding and past spending patterns; although the selection and weighting of indicators would require more judgement.

8. Damping

8.1 Many South East authorities are highly reliant upon damping. The South East and London are the only two regions in England who are net recipients of damping with the current Formula Grant system. Losing this damping – even over a number of years – will have a significant financial impact on the regions and, particularly, on some individual councils. There is a clear benefit from proposing a grant regime which includes damping in any future funding system. Consideration could include

- Establishing principles (stability, predictability)
- Researching other examples e.g. pace of change in the NHS
- Proposing a transparent damping regime

9. Timescales

9.1 SEEC will be holding their AGM on 13 July 2011. The expectation would be that, assuming work starts on the Stage 2 research shortly after SEEC's 7 June meeting; initial findings could be presented to the AGM. It would be likely that this would take the form of a PowerPoint presentation, with a more detailed technical report to follow. Broad timings for the research could be as follows:

| Activity | Week commencing | | | | | |
|--|-----------------|---------|---------|---------|--------|---------|
| | 6 June | 13 June | 20 June | 27 June | 4 July | 11 July |
| Agree scope of research | | | | | | |
| Research into other potential funding approaches (for the system as a whole) | | | | | | |
| Establish principles for operation of potential new system | | | | | | |
| Research into business rate relocalisation | | | | | | |
| Operation of incentivisation schemes | | | | | | |
| Agreement of areas to be modelled | | | | | | |
| Modelling of impact of potential changes | | | | | | |
| Summary reporting | | | | | | |