The Fair Funding Review: the big questions and the tricky issues

IFS – CIPFA Roundtable
12th September 2018
Major changes afoot for English councils

- Big cuts to grant funding and overall budgets
  - Larger in more deprived areas
  - Social services relatively protected
- Big shift towards using funding system to incentivise growth/development
  - New Homes Bonus
  - Business rates retention system
- Big questions about how social care fits in with such a funding system
  - Tension between national standards and local responsibility?

The IFS has a major research programme on these & related policy issues

www.ifs.org.uk/research/local-finance
The Fair Funding Review

- Big picture questions about aims of local government finance system
- Tricky issues of measuring spending needs and revenue-raising capacity
- And a plan on how we transition to a new system
Big picture questions

- What services should fall under general local government finance system, and what are responsibility of national government to fund?

- How should we trade off redistribution according to need, with incentives for councils to tackle needs and boost local tax bases?

- What is the appropriate role of judgement versus empirical analysis in determining funding allocations?

- How much weight should we put on the current distribution of funding?
The Review in practice

• A new system for redistributing between councils according to differences in their revenue-raising capacities and their spending needs

• Updated methods and assessments of
  – Revenue-raising capacities
  – Spending needs
## Timeline

<table>
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<tr>
<th>Date</th>
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<tr>
<td>Feb. 2016</td>
<td>Review announced</td>
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<td>Autumn 2018</td>
<td>Further consultation</td>
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<td>Summer 2019</td>
<td>Set out and consult on specific options</td>
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<td>Autumn(?) 2019</td>
<td>Treasury’s Spending Review</td>
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<td>Late 2019</td>
<td>Set out final plans (alongside settlement?)</td>
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<td>April 2020</td>
<td>Implementation – with transition</td>
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The Review in practice

• A new system for redistributing between councils according to differences in their revenue-raising capacities and their spending needs

• Updated methods and assessments of
  – Revenue-raising capacities
  – Spending needs

• Two IFS reports published last month consider key issues

• Today’s discussion will feed into our future work on the Review
Assessing Spending Needs
Assessed needs vary a lot across councils

- In one-in-ten upper-tier areas, assessed needs per person <85% of national average; in another one-in-ten, >125%
  - High assessed needs for inner-London boroughs and major urban areas
  - Low assessed needs for leafy suburbs and counties

- But existing assessments based on ‘need formulas’ devised in mid-2000s.
  - An update to these assessments is long overdue
Government’s priorities for new assessments

• Simple and transparent

• Contemporary and sustainable

• Robust, evidence-based and objective

• Example of practical proposal for new method:

⇒ Environmental, protective and cultural services (EPCS): develop formulas based on relationships between spending and council-level characteristics
Council-level regression approach to needs

- Spending is indicator of need – but influenced by factors other than need
- Instead calculates (past) relationships between council spending and needs indicators to construct need formulas
  - Needs indicators: deprivation, population size, population density etc.
- Contemporaneous data plugged into formulas to calculate needs assessments for councils

- But there are certain problems:
  - Circularity: patterns in place at the start of the process will be perpetuated
  - Chosen ‘need indicators’ may be related to other things that drive spending (preferences, efficiencies, funding decision) which will bias our needs assessments
- The impact of government funding decisions especially relevant in current context
Funding cuts have been bigger in areas more dependent on central government funding

Decile of formula grant dependence (2009–10)

Change in service spending per person between 2009-10 and 2016-17

Most  2  3  4  5  6  7  8  9  Least

-35%  -30%  -25%  -20%  -15%  -10%  -5%  0%  5%  10%  15%  20%  25%  30%  35%
To see how big an impact this could have we construct our own formulas for EPCS using deprivation, population, and rurality as needs indicators.

Choice of year is subjective – when was funding distribution ‘fairer’?

Year of data used can matter a lot.

- Formula based on 2009-10 data
- Formula based on 2016-17 data
Year of data used can matter a lot

- In all formulas we examine, use of 2016-17 will mean:
  - Lower assessed needs for those with highest existing assessments
  - Higher assessed needs for those with lowest existing assessments

- Using 2016-17 data, areas with lots of in-commuters likely to see lower assessed needs than under existing formulas (or 2009-10-based formulas)
  - Existing formulas allocate more to such councils – like inner-London
  - But these councils no longer have higher net spending on EPCS
Assessed needs are sensitive to choice of ‘needs indicators’

• Changing ‘needs indicators’ included in formulas can make quite a difference for certain councils’ outcomes
  – Westminsters’ assessed need ranges from 84% to 159% of the national average
  – Including ‘non-white ethnicity share’ means that Tower Hamlets’ assessed need increases from 135% to 148% (of the national average)

• Need estimates of high-need councils (according to the existing assessments) are most sensitive to choice of ‘needs indicators’

• Correlation with spending might not be indicative of correlation with need
  – Final choices about indicators to include are ultimately subjective
Adult and children’s social care: sub-council analysis

• Using sub-council level data helps ameliorate problems we've just discussed
  – Focusing on variation in spending within councils - more representative of need
  – Reduces the effects of ‘other factors’ (aside from need) that can drive council spending

• Thus, assessments based on sub-council-level relationships between spending and socio-economic characteristics
  – Existing formulas: ward-level spending and socio-economic data used
  – New formulas: likely to use LSOA-level/individual-level data

• But this approach is still not perfect
Assessing needs: key takeaway messages

- Better data on small areas and individuals would be very helpful (and help operations and planning too?)
- Choice of data-year(s), indicators, etc., likely to matter a lot, and unwise to base decisions just on statistical ‘best fits’
- Assessing needs is inherently subjective – will necessarily require application of expert and political judgement

- **Question** – how do we ensure such judgement is exercised transparently and subject to scrutiny?
Measuring revenue-raising capacity
Council tax revenues per person vary a lot

Revenues at actual tax rate

Captures variation in tax RATE and BASE

Revenues at average tax rate

Captures variation in tax BASE

Metropolitan district ▶️
Unitary authority □
County council ▲
London borough ×
Council tax revenues per person vary a lot

Metropolitan district
Unitary authority
County council
London borough
Within London, high assessed needs is associated with lower council tax rates.
Tax base or tax revenue equalisation?

• Accounting for actual tax revenues would undermine council tax as a revenue source
  – Would compensate (penalise) councils with low (high) tax rates

• Accounting only for variation in tax bases avoids these issues
  – Budgetary impact of higher/lower council tax rates borne locally
  – Councils with low tax rates can put big increase to a local referendum

• Seems fairer, but there are some caveats
Choice of base/revenues matters most for a few inner London boroughs
Sales, fees, charges (SFC)

- Councils raise large sums from SFCs
  - But the importance of SFCs is variable across councils
- No obvious measure of capacity to raise SFCs income
  - Using actual revenues would mean incentive to cut SFCs
- Current approach is to net them off gross spending when assessing spending needs
  - Only accounted for to the extent that indicators included in formulas relate to variation in capacity to general SFCs income
- Should all SFCs income be treated the same?
  - e.g. adult social care, where explicit asset and income means-tests
  - e.g. parking, where ability to charge based on supply/demand
Transparent but flexible funding systems
Incentives versus redistribution

• After assessing needs and revenue-raising capacity, need to decide to what extent differences in these should be offset by funding system
  – Offset more of the differences – more likely councils could offer comparable services given comparable council tax rates
  – Offset less of the differences – councils have stronger incentives to tackle spending needs and boost tax bases

• Classic trade off between redistribution and incentives

• Factors that will affect how you want to trade these off
  – How willing are we to tolerate differences in services and tax rates?
  – How large are differences between assessed needs and revenue-raising?
Differences can be big...

Council tax-raising capacity per person (average = 100)

Assessed spending need per person (average = 100)

- Metropolitan district
- Unitary authority
- County council
- London borough
Incentives versus redistribution

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  - Offset more of the differences – more likely councils could offer comparable services given comparable council tax rates
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- Classic trade off between redistribution and incentives
- Factors that will affect how you want to trade these off
  - How willing are we to tolerate differences in services and tax rates?
  - How large are differences between assessed needs and revenue-raising?
  - How much influence do councils have over local needs and tax bases?
  - How responsive will they be to financial incentives?
Flexibility and transparency important

- Different governments could have different views on trade-off
  - Therefore flexibility to vary degree of equalisation is useful
- Last system (Four Block Model) allowed this but it was...
  - Unstable – small changes for one council could have big impacts on implied funding for other councils
  - Complex – difficult to see how assessed needs and revenues translated into funding allocations
  - Opaque – complexity meant government decisions not easily scrutinised
The rhetoric...

[We have] taken unprecedented steps to protect councils most reliant on central government [grant] funding.

... the reality

Decile of formula grant dependence (2009–10)

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-35% -30% -25% -20% -15% -10% -5% 0%
The old standard spending assessment was much more transparent

Can be adapted to allow less-than-100% equalisation of needs and revenue-raising capacity

- Although only possible to offer same % equalisation to all councils if system just redistributes between councils, not if its also used to allocate grant funding too

What matters for incentives is that councils gain/lose from *future changes* in assessed needs and revenues

- Full initial equalisation, then partial updates for subsequent changes in assessed needs and revenue-raising capacity?
A rolling reset better than fixed resets?

- Government plans to allow councils to bear changes in needs / revenue raising capacity in full for a period
  - Although may adjust for forecast population changes

- Fixed resets (e.g. every 5 years) risk distorting incentives
  - Stronger incentives to boost revenues at start of period
  - Just before reset, actually want to delay revenue boost until after reset?

- Rolling resets can avoid this
  - Reset each year based on needs/revenue-capacity \( X \) (e.g. 5) years previously
  - Always benefit in full for \( X \) years from lower needs / higher revenue capacity
Publish as much information as possible

• While simpler than Four Block Model, such a system still complex
  – Impacts on specific councils will not be immediately obvious

• To enable scrutiny, publish for each council:
  – Assessed spending needs
  – Estimated revenue-raising capacity
  – Pre- and post- damping/transitional arrangements funding allocation
  – Relative funding as a percentage of relative assessed needs
  – How these have changed over time

• Allow critique of system and analysis of trends
Back to the big picture...
Big takeaways

• Transparency as a goal
  – The impact of the chosen system should certainly be made as clear as possible
  – At what stage in design process should this be?

• Review can be evidence based but cannot be ‘objective’
  – Better subcouncil-level data would improve evidence-base
  – Subjective judgements required at many points
  – How do we ensure such judgement is subject to proper scrutiny?

• Potentially big impact on funding allocations
  – Inner London councils likely to lose out? County areas to gain?

• It's not just a technical exercise
  – Do we prioritise local responsibility or national solidarity?
And remember...
Questions for Discussion
Questions

• What is a ‘fair’ system, overall?
  – How should redistribution and incentives be balanced? Differ by service?
  – Are spending needs and revenue-raising capacity under council influence?

• How can necessary judgements be exercised transparently?
  – Should principles be decided before impacts on specific councils shown?
  – Is there a role for independent bodies?

• Will the new assessments ever be fully implemented?
  – Will transition have to involve extra funding?

• What role can improved data and business intelligence play?
  – In measuring spending needs and revenue-raising capacity
  – In helping councils improve?