Leaders' Committee

Assessing Future Funding Options for Local Government: Update

Item 4

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Summary

At its meeting in March 2014, Leaders Committees considered a paper on future funding options for local government.

During these discussions, London Councils officers were asked to further consider possible future funding options to support potential discussions that may follow with Government as part of the Spending Review 2015 process.

Work has focused on the four principal elements of the current local government finance system, namely:

- The grant regime,
- The role of financial incentives,
- Council tax, and
- Business rates.

This report provides an update of the work carried out to date.

Recommendations

Leaders Committee is invited to comment on the issues raised in this report and in particular the questions raised in paragraphs 23, 30, 38 and 46.

Assessing Future Funding Options for Local Government: Update

Introduction

1. The approaching end of the current Spending Round period (2015-16) represents a significant moment for London local government to influence government thinking about the future financial relationship between the centre and localities.

2. In anticipation of the forthcoming Spending Review 2015, Leaders Committee considered a report[1] in March, highlighting some of the issues that could potentially emerge from efforts to reform how local public services are funded. While there are no current commitments to wholesale reform, London Councils officers were commissioned to further consider how fiscal reform could support London local government during what will undoubtedly remain a challenging financial climate. Following the discussions at Leaders Committee in March, London Councils have focused their work on the four principal elements of the current finance system, namely:
   - The grant regime,
   - The role of financial incentives,
   - Council tax, and
   - Business rates.

3. This paper provides an update on this work and seeks guidance from Leaders on the key issues within each area.

Context: The Financial Outlook for London local government

4. London's Leaders have considered a series of linked reports over the last three years on the long-term financial prospects for London. Previously, it has been reported that London local government faced a potential funding gap (between total projected income and total forecast expenditure) of as much as £3.4 billion by 2019-20 (projecting from 2012-13).

5. Since this analysis, there have been a number of developments, which have allowed an improved understanding of the potential financial pressure on local authorities in London, including:
   - A series of Government announcements, including Autumn Statement 2014 and Budget 2015, that have provided further information on the likely future trajectory of public expenditure up to 2019-20,

[1] http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5916

- Greater understanding of emerging policy issues and their financial impact. This includes the Care Act, No Recourse to Public Funds and the Transfer of 0-5 Health Responsibilities, and
- More detailed and up-to-date data and information on service demand driven by population projections, demographic changes and inflation.

6. In light of the above, London Councils has updated and refined its modelling on the long term financial prospects for London local government The latest modelling suggests a potential funding gap of as much as £2.4 billion (23 per cent) over the course of the next Parliament (2015-16 to 2019-20).

7. Previously, it had been reported that London local government faced a financial pressure of £3.4 billion from 2012-13 to 2019-20. On a like-for-like basis, the position has stayed broadly the same; however, the current modelling prudently assumes local government funding will share some of the anticipated growth in public spending in 2019-20 (outlined at Budget 2015), that each borough will raise its council tax by 1.5 per cent each year and that business rates will continue to grow. These are assumptions for modelling purposes only, however, and it is likely that there will be divergence from these which will impact on the scale of the forecast funding pressure.

8. Putting the potential uplift in public spending in 2019-20 to one side, public spending is forecast to fall faster in the next three years than previously thought. Analysis suggests that over the next three years to 2018-19, the financial outlook for London local government is set to worsen by a further £0.3 billion compared to the previous model.

9. While the modelling has focused on the next five years, it is acknowledged that both Spending Review 2010 and Spending Round 2013 have significantly reduced the resources available for local government since 2010-11. Taking this period into account, core government support to local government potentially set to fall by 60 per cent over the decade to 2019-20.

10. In the absence of a detailed reduction in statutory responsibilities[2] or additional resources, local authorities are likely to experience steady erosion in their level of control over spending decisions. Population growth and demographic change will, arguably, mirror the trend in central government where greater levels of expenditure are driven towards health and social care. By 2020, this analysis suggests that the principal statutory responsibilities of local

[2] As at March 2011, local authorities had over 1,300 statutory duties. This figure excludes responsibilities introduced such as Public Health, local council tax support schemes or those under the Care Act.

government – namely, social care[3] and waste – could account for 75 per cent of all revenue expenditure (£5.3bn).

11. Given their statutory nature, these costs are to a certain extent, unavoidable and the subsequent impact on the wider range of non-statutory and other services could be considerable. On this basis, funding for non-protected services could be squeezed by as much as 44 per cent from 2014-15 to 2019-20 as local authorities in London seek to operate within their assumed resource constraints.

12. Modelling so far into the future is obviously dependent on a number of assumptions and there remains considerable uncertainty about the funding trajectory for local government. Some further detail may emerge from the Summer Budget (8 July), but Spending Review 2015 (late autumn) is likely to provide the more definitive picture. That said; the model does confirm our previous conclusions – that, in the absence of radical changes to service delivery models, the existing system of local government funding appears less and less sustainable in its current format.

Potential Options for Reform

13. In considering future funding options, London Councils officers have focused on the four principal elements of the current finance system, namely:
    - The grant regime,
    - The role of financial incentives,
    - Council tax, and
    - Business rates.

14. These are considered to be the fundamental building blocks of the finance system and the principal drivers behind local income levels. It is also recognised that there is a high level of interaction between all four issues and as such, it is difficult to consider change to one without acknowledging the possible impact elsewhere within the system. Indeed, HM Treasury consider these holistically when making their own assessment of local government spending levels.

15. In discussing change, there appear to be two principal considerations, namely:
    - *The Scope of Reform:* This is principally about the extent to which any reform could be introduced through changes to the current finance system or whether a more ambitious

[3] Includes the ring-fenced public health

and fundamental approach is required – whether that is at a national level or another spatial level below this.

- *The Nature of Reform:* This issue focuses on the principles underpinning the local government finance system and the balance between incentivising certain behaviours (such as the delivery of economic growth or house building) and recognising need.

The Grant Regime

16. Historically, the distribution of funding has been wholly driven by an assessment of ‘need’ and the unique and relative characteristics of an area. When the formula was frozen in April 2013, there was a clear shift from need as the key determinant of funding levels to one where certain behaviours were incentivised such as the growth of the domestic and/or non-domestic taxbase (New Homes Bonus and business rates retention respectively).

17. London Councils officers have undertaken analysis to consider the extent to which local population, demographics and other characteristics have changed since the formula was frozen in 2013. From this work, it is clear that there are two factors which have the most significant impact on pre-damping funding levels in London. These are population estimates and taxbase figures.[4] Analysis suggests:

- London’s population has increased by c.181,500 compared to the figures contained within the formula and for some boroughs, the difference is as much as 5 per cent. London’s population growth rate of 2.1 per cent is also significantly higher than the England average of 0.7 per cent, representing just over half of the total population growth in England despite representing 16 per cent of the population.
- London’s taxbase has increased by c. 186,500 (6 per cent) compared to the figures contained within the formula and for some boroughs, the difference is as much as 13 per cent.

18. It is clear from the above that London’s funding allocations are becoming less and less representative of the size of its population and that large numbers of its residents are not recognised within the formula. This does raise the question of fairness within the funding allocations. It is highly likely that if the formula was updated for the latest population figures, London local government would see an uplift in its grant allocation. Of course, it is also likely that any benefit may be partially offset by London’s growing taxbase and the assumption that local authorities in London are able to raise more of its income locally (via council tax). It is also unclear how any future damping policy would interact with the reopening of the formula and the extent to which it sought to manage any significant swings in the formula.

[4] This metric is included to reflect the amount of council tax an individual authority can generate to fund local services.

19. London Councils has a long history of involvement with CLG on the funding formula. On-going analysis, combined with previous work, has highlighted other areas where the formula has historically failed to reflect London's characteristics. These include day visitors, population mobility, the Area Cost Adjustment and levels of deprivation.

20. Related to the mechanics of the formula is the issue of damping. In 2013-14, London, overall, benefitted from damping by £182 million. The impact of this policy within London however, is variable. Sixteen local authorities received £279 million from floor damping and 17 local authorities were scaled by £97 million. Of course, the extent to which local authorities see themselves as benefitting from this policy or not will depend on how they view the funding formula itself and its perceived level of accuracy. That said, freezing the formula in 2013 has introduced a secondary type of unfairness within the system as damping levels have been locked in at 2013 levels.

21. Of course, discussions on equalisation and the assessment of need focus on the distribution of resources <u>between</u> local authorities. It does not address the overall quantum of money available to local government as a whole. Under a scenario where the government reopened the assessment of need and London local government were to benefit by 10 per cent, this would equate to £375 million in 2015-16. While this level of additional funding is not insignificant and should not be discounted, it remains relatively insignificant when compared to the overall size of the funding challenge ahead. As such, equalisation is likely to form a limited, but nonetheless important, part of a much wider package.

22. As the formula currently stands, it is complex and contains a large number of different, interrelated metrics. As such, it is difficult to unpick and confirm, with any certainty, the impact of any one change on the funding allocations for any one local authority. At the present time, there is no indication that the Government will reopen the formula until the system is potentially reset in 2020. If it is assumed that an assessment of need should underpin funding allocations, there remain questions about when this should happen and the scope and ambition of any reform. Some may favour a complete overhaul of the current formula and all of the metrics within it. Others may prefer a focus on a limited number of cost drivers, which are likely to have the most material impact on service delivery and subsequently reflected within the funding allocations.

23. **Government has not yet indicated any specific plans to change the grant regime. In that context Leaders are asked to offer guidance on the emphasis that officers should**

place on developing different approaches to reform that could be incorporated in CSR submissions in the near future. In particular:

- **What priority should be given to pressing for reforms to the grant regime?**
- **Should either simple reforms or a fundamental re-design of needs assessment have a higher priority?**

<u>The role of financial incentives</u>

24. In considering the nature of the local government finance system, there have been longstanding concerns from some that a model of funding purely based on ‘need’ may create some perverse incentives and foster a culture of dependency within local government. There may well be some local authorities who wish to operate outside the broader grant funding regime and any needs assessment.

25. One way could be to allow local authorities to retain more local business rates, thereby removing the need for the Government to distribute revenue support grant (RSG) to some authorities. While this could be a possibility for some local authorities in London, it is unlikely to work for all boroughs. Consideration would then be needed about the extent to which any ‘RSG-free’ local authorities would then be subject to a system reset and other scheme parameters (such as the levy and safety net).

26. In response to some of the challenges on this issue, the Government has, over recent years, attempted to introduce greater levels of financial reward and incentive – whether that is the business rates retention system, the introduction of New Homes Bonus or as part of negotiated arrangements within individual Growth Deals.

27. Given the scale of the challenge ahead for the overall public sector finances, it is highly likely that the debate on devolution to England’s cities and beyond will continue to be underpinned by a drive for more integrated and cost-effective approaches to local public services. Based on other initiatives such as the business rates pilots, the Government may pursue funding models that are based on risk and reward principles, allowing only those local authorities that can exceed agreed performance targets to benefit financially.

28. In considering further how financial incentives should influence funding allocations, London’s Leaders may wish to consider how these concepts should apply to the funding of local government services. For example, should they apply to all services or do some services require a level of funding stability that would be impossible to guarantee under a risk and

reward scenario? For example, it may be felt that services such as children's safeguarding play such a critical role in supporting the most vulnerable that they need a high level of funding certainty and stability. As such, this could lead them away from a funding model that solely relies on the performance (and potential volatility) of the local economy.

29. In turn, there could be an argument to say that there are other issues, which are more naturally linked to models of financial risk and reward and whose resource-base could be more responsive to economic cycles. There may also be an aspiration to link certain services and activities to specific funding streams and taxes. For example, it could be argued that landfill tax, and control over its operation, could be devolved to London government. In return, there could be performance targets that would aim to facilitate a faster shift to improved recycling rates and other activities that impact on climate emissions.

30. **Leaders Committee is asked to provide a steer on the extent to which financial incentives should influence funding allocations within local government.**

Council Tax

31. Council tax remains a significant and stable source of funding for local government, representing 37 per cent of principal income. While the Government has not expressed plans for change, council tax has nonetheless been the focus of much debate within other reviews of local government finance.[5]

32. As agreed at the last Leaders Committee, analysis has been undertaken of the council tax system in London and across England. Consideration has also been given to a broader range of measures linked – both directly and indirectly – to council tax, including population, income and wealth.

33. From this analysis, the key headlines are that:
    - London's tax base is proportionately larger than the rest of the country with the higher valued properties in the capital meaning a greater proportion of properties in the higher bands.
    - However, there is large variation between boroughs with outer London boroughs, in general, having a much smaller relative tax base.
    - London has a disproportionate number of properties for all bands from Band C upwards compared to the national average.

[5] London Finance Commission (2013) Independent Commission into Local Government Finance (2015), Institute for Fiscal Studies (2015).

- London has a consistent share of population, households and dwellings at c.15 per cent of the national total.
- Its share of overall council tax yield is higher at 17 per cent, reflecting its higher property values and therefore its larger tax base.
- Its share of both national income and estimated housing wealth is yet larger still at 24 per cent.

34. From the above, there are perhaps a couple of initial conclusions that could be drawn in discussing reform, namely:
    - Council tax continues to be regressive in nature,
    - There is a weak link between levels of council tax and the housing market, including levels of housing wealth, and
    - Were the system to more closely reflect the current property market in London, this could increase the net income to London boroughs – acting either as an additional source of income or when combined with greater control of the discount system, address some of the perceived unfairness within the current charging regime.

35. In considering the efficacy of the current system, attention inevitably focuses on council tax bands and the ratios between them. As such, it is felt that three broad scenarios exist, which could help to draw out some of the key issues within council tax. These include:
    - *Scenario One:* An update of individual property values with an overall fixing of the tax base.
    - *Scenario Two:* An update of both the current band system and individual properties with band ratios either fixed or readjusted.
    - *Scenario Three*: In line with other proposals, additional bands could be created either as additions to the existing system or as part of a more fundamental approach.

36. Consideration would also need to be given to the spatial level at which any reforms could be introduced – whether that was nationally, regionally or locally (including individual authorities or groupings).

37. **London Leaders are asked to provide a steer on what further analysis may be helpful.**

<u>Business Rates</u>

38. The business rates retention scheme is currently entering its third year. London Councils has consistently put forward a view that the current system lacks a sufficiently strong financial incentive. The fact that the Government only retains half of business rates; that any

growth could potentially be removed at the next reset; and that the definition of growth only applies to physical growth (not RPI or revaluation growth), all mean that the direct financial incentive for local authorities rates remains weak. At the same time, local authorities in London remain disproportionately exposed to the risk of successful rating appeals.

39. Analysis of publicly available data on business rates suggests that the financial impact of business rates retention in London appears limited at best. In overall terms, London local government (excluding the GLA) retained £1.833 billion of business rates in 2013-14, representing a shortfall of £85.4 million (4.5 per cent) when compared to the Government's expected target of £1.918 billion.[6] While the position appears to improve in future years, the financial gain remains relatively small, particularly when set against the scale of the financial challenge ahead. The table below sets this out in more detail.

	2013-14	**2014-15**	**2015-16**
	Final Outturn	**Forecasts**	**Forecasts**
Number of boroughs growing	7	19	17
Number of boroughs declining	26	14	16
Gross growth (£m)	12.4	40.6	65.3
Gross decline (£m)	-97.8	-27.2	-15.9
Net growth (£m)	-85.4	13.4	49.4
Number of boroughs in safety net	4	2	0
Value of safety net payments (£m)	51.7	4.9	0
Number of boroughs paying levy	0	5	4
Value of levy payments (£m)	0	-4.3	-9.1
Net retained growth after levy & safety net (£m)	-33.7	14	40.3

40. Since the introduction of the system, the Government has sought to reform the wider business rates system. Over the past few years, the Government has launched three different reviews and is due to report on its current review at Budget 2016. London Councils' proposed response to the current review is covered elsewhere in this agenda. For the purposes of this paper, it appears that the scope (and ambition) for change is limited, particularly given the fact that any reform must be fiscally neutral.

[6] This is the baseline sum of business rates that the 32 London boroughs and the City of London are permitted to retain after the respective payments to central government (50 per cent) and the GLA (20 per cent). Known as the business rates baseline, this is the figure against which top ups and tariffs are set and against which 'growth' is judged.

41. That said; greater control over reliefs and discounts does appear to offer an opportunity for local authorities to develop a local system that meets the needs of their local economies. This would give local areas the ability to create new reliefs and discounts, and alter the suite of existing mandatory reliefs in order to encourage and incentivise certain types of business to their area. In 2013-14, mandatory and discretionary reliefs totalled £663 million in London. Arguably, this funding could be used more constructively by local areas to shape their local economies, than under the current rigid and centralised system.

42. Traditionally, business rates income has been earmarked to fund local authority services and local government should not lose sight of the fact that business rates represents an increasingly important income stream not only for itself, but for HM Treasury too. Analysis suggests that as total business rates income rises and the local government control total reduces, there will soon be significant surplus of business rates in the system. This could potentially be as much as £9 billion by 2020. Budget 2015 recognises the importance of business rates as a funding source with figures suggesting that it will rise as a proportion of overall departmental revenue expenditure from 8 per cent in 2014-15 to 10 per cent in 2019-20.

43. In theory, this emerging surplus could be used to fund existing activity historically met through general taxation and other Whitehall departments. Alternatively, it could fund specific Government-led initiatives. (Equally, the Government could choose a combination of the two.) If the Government is minded to adopt the first approach, it does raise questions about the link between business, business rates and local services (and their ability and/or appetite to have a stronger influence over local spending decisions). The second approach would, arguably, strengthen central government's already considerable influence over local government spending through the use of ring-fencing and targeted grants. Both approaches would also raise familiar questions about equalisation and the extent to which fairness underpins any form of redistribution.

44. Of course, reform to business rates should be seen in the context of the wider discussion on fiscal devolution. Budget 2015 announced that there will be pilots in Cambridgeshire, Peterborough, Greater Manchester and East Cheshire where 100% of any additional growth in business rates <u>above</u> expected forecasts will be retained. As a minimum, it would be argued that these arrangements are extended throughout local government.

45. Leaders will be aware that it is a longstanding position that London government should retain more of its business rates. Though, it has been recognised that such an arrangement would need to be fiscally neutral at the outset and would increase the financial risk for local

authorities as other funding streams fall away to compensate for the increased levels of retention.

46. **In this context, Leaders may wish to consider whether they would wish to return to previous discussions on business rates pooling as a way of managing potential future financial risk.**

47. It remains difficult to see how business rates reform would, by itself, completely address the scale of the financial challenge ahead. Meaningful financial gain, through business rates growth, appears limited in London, particularly when the impact of RPI and revaluation growth is neutralised within the system. This remains an area where further reform could deliver a financial uplift for London overall, In addition, greater control of the business rates system could be used to provide more focused support to local businesses, providing the opportunity for more qualitative improvements to the finance system such as greater financial flexibility, stability and certainty.

Conclusion

48. It is clear that the financial challenge ahead remains significant, particularly over the next three years and this continues to raise questions about the form and nature of local public services in London and how to fund them. There is a general consensus that reforms to the finance system are required, particularly as funding levels in London are becoming less and less reflective of local communities and local spending patterns.

49. This paper looks at the four fundamental building blocks of the local government finance system. In each area, there is arguably a question about the potential for reform, the scope and nature of any changes and the subsequent balancing of financial risk and reward.

50. Even with potential changes to the finance system, the scale of austerity is likely to remain considerable. While fiscal reform could form part of an effective financial strategy, it is likely to offer only partial solutions for any local authority. Arguably, only a more ambitious and transformational approach is likely to support London government to address the financial challenge ahead. One which both devolves fiscal responsibility and freedom to London government and seeks to reform public services within London.

Recommendations

Leaders Committee is invited to comment on the issues raised in this report and in particular the questions raised in paragraphs 23, 30, 38 and 46.

Financial Implications for London Councils
None

Legal Implications for London Councils
None

Equalities Implications for London Councils
None