Can Councils Live Without the Formula Grant?

LOCALIS

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About Localis

Who we are
Localis is an independent think-tank dedicated to issues related to local government and localism. We carry out innovative research, hold a calendar of events and facilitate an ever growing network of members to stimulate and challenge the current orthodoxy of the governance of the UK.

Our philosophy
We believe in a greater devolution of power to the local level. Decisions should be made by those most closely affected, and they should be accountable to the people which they serve. Services should be delivered effectively. People should be given a greater choice of services and the means to influence the ways in which these are delivered.

What we do
Localis aims to provide a link between local government and the key figures in business, academia, the third sector, parliament and the media. We aim to influence the debate on localism, providing innovative and fresh thinking on all areas which local government is concerned with. We have a broad events programme, including roundtable discussions, publication launches and an extensive party conference programme.

Find out more
Please either email info@localis.org.uk or call 0207 340 2660 and we will be pleased to tell you more about the range of services which we offer. You can also sign up for updates or register your interest on our website.

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About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities to achieve their potential.

Ernst & Young in Local Government
Ernst & Young is helping clients from across local government reach their potential through the allocation a cross-disciplinary team dedicated to the unique circumstances of local public services. Importantly we don't sell one-size-fits-all solutions; we deliver on the specific needs of our clients.

Why is Ernst & Young supporting this initiative?
Localism requires a radical shift in mindset. At Ernst & Young we pride ourselves on making difficult things happen. This often means we have to challenge the accepted norms of the environment in which our clients operate. That's what this project aims to do and we're delighted to support it.

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Can Councils live without the Formula Grant

Introduction

Localism is all the rage. The new coalition government has loudly and proudly pledged to make decentralisation of power one of its defining policy strands and, so far, the signs are pretty promising with a flurry of announcements about new powers to be given to councils. However, there is one aspect of the local government landscape that is almost untouched by the coalition's plans – finance. The balance of funding between central and local government is, arguably, the greatest challenge this government faces in achieving genuine decentralisation.

Money is power. Without control of their financial revenues, councils will always be cajoled and manipulated by higher tiers of government. Be it ring-fencing, rate-capping or even the formula grant allocation process, there are many instruments that the Whitehall machine can use to make certain that its will supersedes the wishes of local authorities. While this is the case, people will naturally turn to their MPs rather than their local councillors for action over local issues.

Only a quarter of the total amount that local authorities spend is raised locally. By comparison, in almost every other developed country in the world, local government is between 50% and 85% locally funded. In other words, the UK is one of the most centralised countries in the developed world.

This financial emasculation is a relatively recent phenomenon. Only twenty years ago, before 1990, more than half local authority revenue was locally raised. And going further back to the nineteenth century, the dawn of local government, councils were almost entirely locally funded.

Self financing local government in comparable countries[1]

Country	State/Province/Lander	Local Government
Australia	55%	87%
Canada	82%	83%
Germany	82%	66%
Denmark		59%
France		72%
South Africa		64%
Netherlands		32%
UK		25%

But why does the centralisation of local government funding matter? It matters because denying local government a proper degree of control of its finances undermines councils, creates needlessly complicated lines of accountability and, with central government pulling the strings, leads to unnecessary and wasteful standardisation in the provision of public services.

This pamphlet will briefly describe some of the potential approaches to remedying the current balance of funding, particularly looking at the use of business rates, and then ask the question: Can councils live without the Formula Grant? However, this pamphlet is only the beginning – in coming months, Localis in collaboration with Ernst and Young, will be examining these issues in detail before publishing a full report early next year.

Some potential solutions

In a truly decentralised world councils would raise the vast majority of their income locally, but reaching this goal is likely to take a number of years. So what are the options for greater levels of autonomy in local government finance in the shorter term, and are they financially and politically feasible? Some of the more popular options are:

1 Gough, R., 2009, *With a Little Help from our Friends*, Localis

Reduce ring fencing – Ring fencing is the protection of grant funding for a specific purpose identified by central government. It is based on the belief that central government knows what local government should be spending money on and that local government cannot be trusted to spend such money without strict controls. The coalition government is, quite rightly, already committed to ending of ring fencing of grant, which will give local authorities full control over how that money is spent, so allowing them the flexibility to spend in the interests of local people.

End council tax capping – Council tax is, of course, at least set, collected and spent at the local level. However the last Government introduced council tax capping – the limiting, by central government, of the scale of increase in council tax. This was established to prevent extreme, and highly unpopular, rises in council tax. While this may be a politically successful policy, the fact remains that it is a centralised solution applied universally to a wide variety of individual local circumstances. If councils want to raise council tax in order to pay for vital services for the local area, that is a judgement for them to make, and for which they should be held accountable by their residents. Therefore the coalition government's policy of ending council tax capping makes sense.

However there are reasons to believe that the effect of ending capping on the balance of funding between central and local government will be small, particularly in the short term. Firstly, the government is strongly encouraging councils to freeze their council tax for at least one year. Secondly, many have suggested that the coalition's proposed policy of council tax referendums will, in most cases, have a not dissimilar effect to capping on councils' revenue raising capability. But most importantly, with council tax only accounting for a quarter of local authority revenue funding, the gearing effect means that in order to raise the required amount to increase in a council's budget by 1%, council tax would need to be increased by 4%.

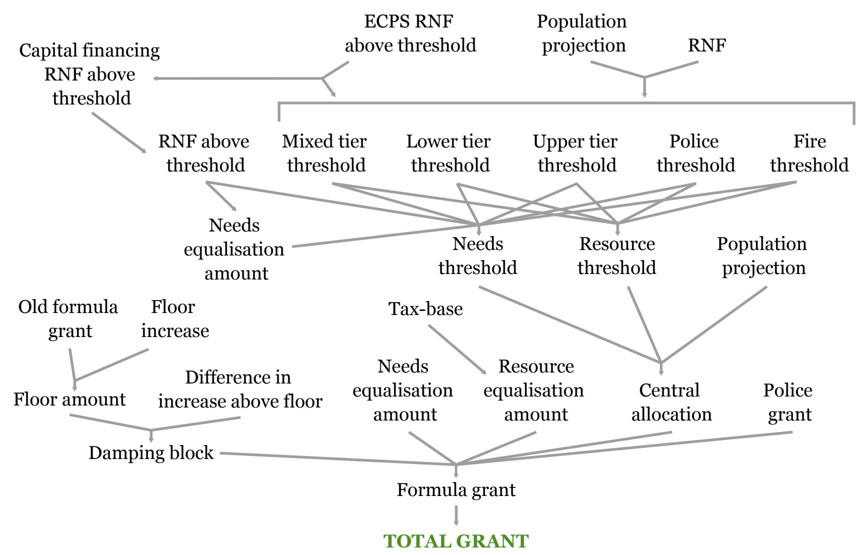
Create new local taxes – Giving local authorities new tax raising powers has long been discussed as the possible answer to the balance of funding question. There are a number of options for new local taxes including a local income tax, a local sales tax and a land value tax. In addition to the specific implementational challenges that

the introduction of such taxes would pose, and the likely wish of the Treasury for any redesign of the tax system to be revenue neutral, all of these options are likely to prove highly politically contentious. As such, and notwithstanding the merits or otherwise of such ideas, the introduction of any new tax raising powers for local government certainly cannot be foreseen in the immediate future.

What about business rates?

National Non-Domestic Rates (NNDR), as business rates are technically known, are collected locally by unitary and district councils. However councils cannot then use the money they collect as a revenue stream. Instead, all the business rates paid in England are remitted by these councils to the Department for Communities and Local Government. This pot of money, with a small top-up, is then reallocated to local authorities in the guise of "formula grant", according a fiendishly complicated distribution model called the four block model.

Complexity of formula grant



The four-block model is composed of the following elements:

1 **Relative Needs** – A relative block of redistributive funding based on the needs of local authorities, as assessed by central government. It currently makes up approximately 73% of the total pot, and is allocated according a series of extremely complicated formulae.
2 **Relative Resources** – A negative block designed to take account of local authorities' differing ability to raise their own money through council tax. The overall impact is to 'take away' approximately 27% of the total pot.
3 **Central Allocation** – This block distributes the remaining amount left over after the needs and resources allocation has been made, and so accounts for 54% of the total grant amount.[2] It is allocated to councils on an extremely convoluted version of a per-head basis.
4 **Floor Damping Block** – This is a zero-sum reallocation of the totals produced by the first three blocks which ensures that authorities receive a guaranteed minimum percentage increase in grant compared to the previous year. Different 'floors' are set for different categories of local authorities. The money required to pay for a guaranteed minimum increase for all authorities is found by scaling back increases in authorities whose grant increases are above the floor. The purpose of this fourth block is to stop councils suffering significant swings in grant levels and so provide some form of financial stability.

There are a number of problems with the current business rates system:

1. It undermines accountability

The key point about the four block model is that it is a creature of central government. Business rates may be collected at the local level by local authorities, but it is Whitehall that controls what happens to that money by manipulating the model in order to achieve specific policy or political goals. For instance, in 2008-09 the Relative Needs block's share of the funding pot was increased from 71% to 73%, with a counterbalancing change in the Relative Resource block from -25% to -27%. The impact of this change was a net £440m movement in how the formula grant was allocated which benefited high needs, low taxbase authorities.

The link between the taxes businesses pay and the local services they receive is therefore extremely opaque. Given this kind of disconnect, it is fair to say that NNDR as a national tax masquerading as a local tax, and the £18bn or so in business rates paid annually across the country is wholly unaccountable.

2 100-(73-27)=54%

2. It creates perverse financial incentives

As well as being unaccountable, the system of business rates redistribution creates perverse financial incentives. Local authorities do not directly benefit from the business rates collected in their area, thus have no incentive to increase their NNDR taxbase. Any resource spent attracting new businesses into an area will not result in a single additional pound in formula grant.

On the other hand, many councils can benefit substantially from the operation of the four block model if they can persuade government either to amend in a particular way the criteria used to assess the relative need, or that their 'need' has increased.

This means that councils are encouraged to use their time and resources not to face outwards and work to grow the number of local businesses, but to Whitehall to demonstrate how needy they are.

3. It is inefficient

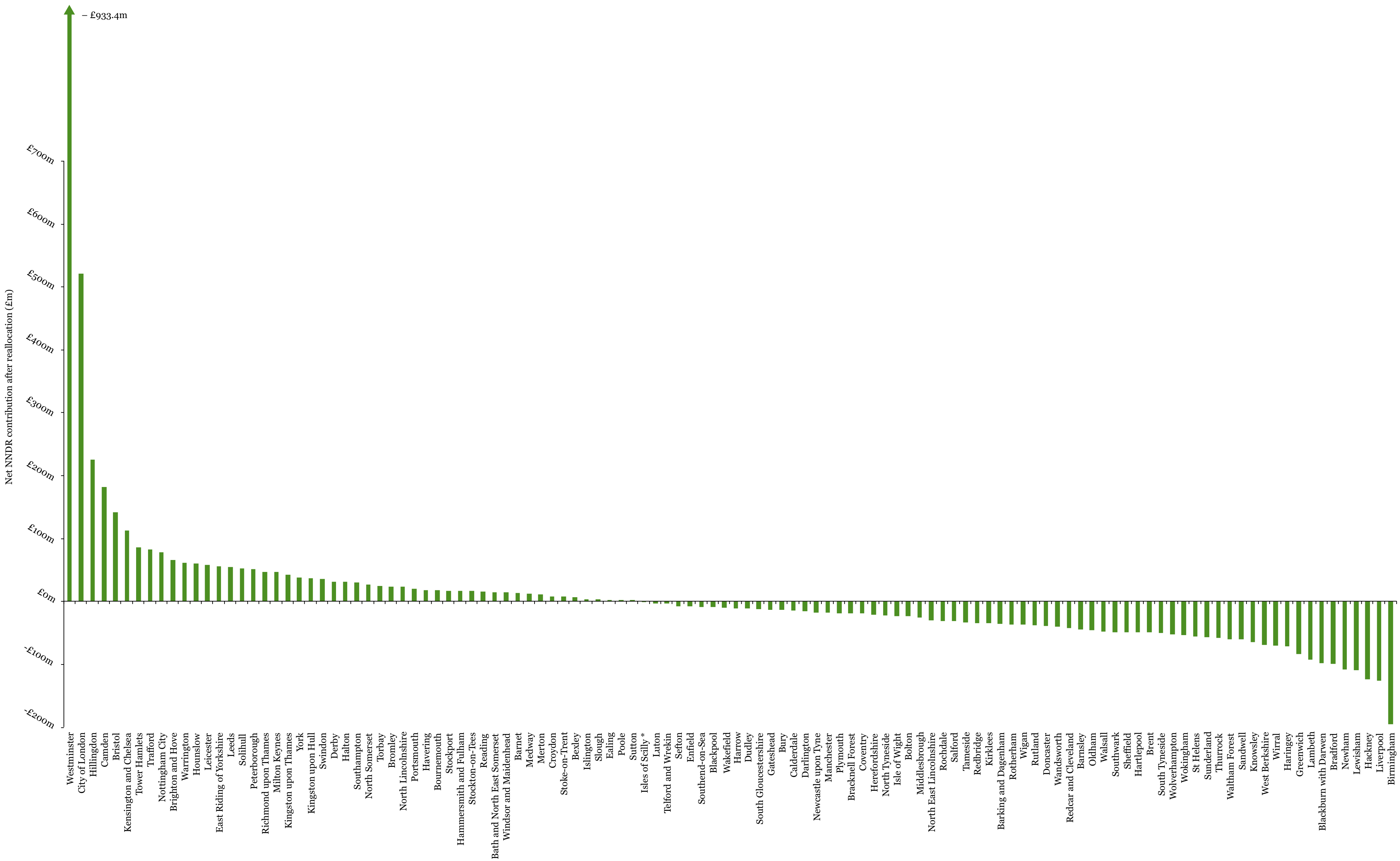
For most councils, the difference between the amount they collect in NNDR and the amount they eventually get back is not very large, as the graph on the following pages shows.

Ealing is one of the many councils for whom the operation of the four block model seems unnecessarily long-winded. Ealing expects to collect £125.3 million in business rates in 2008/9 which it sends to Whitehall. But it also receives £122.9 million back in redistributed NNDR. Overall, therefore, is contributing £2.4 million (1.9% of its take) to contribute to resource equalisation. But why is it surrendering £125.3 million only to get back £122.9 million – wouldn't it be easier just to send a cheque for the £2.4m difference?

Large numbers of councils sending the NNDR money they collect to central government only to get a very similar sum back some months later is not efficient. And even for larger net gainers/contributors, the system is still opaque and unnecessarily bureaucratic.

In addition, the complexity of the four block model and its susceptibility of its outputs to arbitrary changes from Whitehall make it very difficult for councils to take long term financial positions on their investments. Instead there is a natural tendency for councils to focus on more short-term investments, which in many cases will be an inefficient allocation of their resources.

Net contribution of NNDR by upper tier council areas (2008/09)



The end of the formula grant?

With the perverse financial incentives, combined with inefficiency and low levels of accountability, clearly the current business rates system is not fit for purpose. So what can be done? The coalition government has pledged to "provide incentives for local authorities to deliver sustainable development, including for new homes and businesses", with details to be announced when it publishes its White Paper on sub-national growth later this year. While this is a positive step, this is unlikely to provide a significant degree of financial autonomy for local authorities.

There is a radical option that would solve the problems outlined above while preserving the crucial redistributional element of the current system – **giving local authorities the chance to buy themselves out of the formula grant system**.

The price of buy-out would be negotiated between each council and DCLG but would be based on their historic net contribution to the NNDR pool. So for some this would be a negative figure and for others it would be positive. Crucially, however, this would provide certainty – councils would know exactly how much they had to submit to/receive from the centre, and they would know that any additional growth in their taxbase would be theirs and theirs alone.

Reaching such an agreement would make any council that bought out substantially more financially independent and give them a very strong incentive to focus on growing their local economy. At the same time, wealthy councils would continue to subsidise those with lesser resource capacity. It would help accountability because local residents and businesses would know that what the local authority could raise in taxation, what levers it had to increase that tax take and where and why it needed to pay or receive subsidy to/from the centre.

Of course, making any adjustments to the tax system is highly complicated as it involves balancing the competing requirements and demands of numerous interested parties. There are a number of substantial questions which would need to be addressed before this idea would be ready to implement: Will this tie central government into funding commitments it can afford to make? Will some councils just not be interested in buying out of the formula grant? How should district and county councils be dealt with? What about those councils who are the largest net recipients/contributors – do they need to be dealt with differently? What would happen during a prolonged period of economic failure?

What next?

This pamphlet is the start of the discussion, not the end. Localis have teamed up with leading consultants Ernst and Young to conduct extensive research into the questions raised by this pamphlet to explore whether it is possible for Councils to be independent of the formula grant in the coming months and will be publishing a definitive report on this issue in early 2011.

Can Councils Live Without the Formula Grant?

The balance of funding between central and local government is, arguably, the greatest challenge this government faces in achieving genuine decentralisation. Central control of local finances undermines councils, creates needlessly complicated lines of accountability and produces an unnecessary and wasteful standardisation in the provision of public services.

Localis, working with Ernst and Young, will be exploring this issue in more detail. In this pamphlet we describe the problems with the current system and touch upon some of the potential solutions, particularly looking at the use of business rates, to ask the question: Can councils live without the formula grant?

But this pamphlet is merely the start of the discussion. We will be conducting extensive research into the questions raised by this pamphlet, and publishing a definitive report in early 2011.

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