LONDON COUNCILS

Leaders' Committee

Assessing Future Funding Options for Local Government

Item no: 5

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Summary

Autumn Statement 2014 provided a broad indication of the public finances up to 2020. It is clear that local government, and the wider public finances, face a period of prolonged financial austerity.

Recently, there have been a number of reports and contributions on the future of the current local government finance system and the options for reform.

This report explores some of the principal issues raised and highlights a number of future funding options, which London's Leaders may wish to consider further.

Recommendations

Leaders Committee is invited to comment on the issues raised in this report confirm the proposal for further research in paragraph 30.

Assessing Future Funding Options for Local Government

Introduction

1. The scale of the challenge ahead for the public sector finances is significant. The Government has already set out plans to cut departmental spending by £8.7 billion in 2015-16, and to achieve the longer term objectives of the deficit reduction programme, further savings of close to £38 billion will be required by 2019-20.

2. The scale of the financial challenge for local government and the wider public finances raises fundamental questions about the funding of local public services. Over the past few months, increasing attention has focused on the sustainability of the current local government finance system and the extent to which more fundamental reform may be required.

3. This report provides an update on the future financial outlook for London and identifies a number of areas, where London's Leaders may wish to explore further.

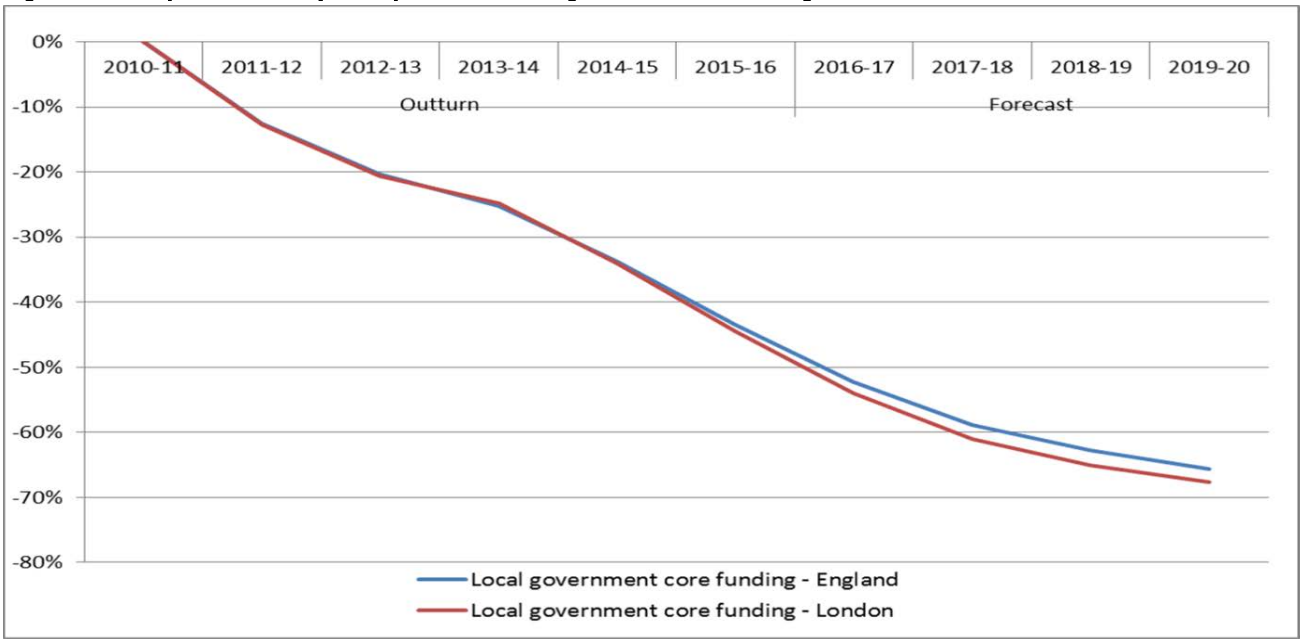
Background

4. The recent Autumn Statement (December 2014) set out the outlook for public finances up to 2020. It confirms that overall public sector expenditure (known as Total Managed Expenditure (TME)) will fall in real terms at the same rate in 2016-17 and 2017-18 as over the period 2010-11 to 2014-15. Total public expenditure in 2018-19 and 2019-20 will be held flat in real terms.

5. Overall Resource DEL – i.e. the element most relevant to local government funding – will fall by £36.6 billion (11 per cent) in cash terms from 2015-16 to 2019-20 or £54.4 billion (17 per cent) in real terms. Within this overall reduction, it is assumed that funding protections will remain in place for health, schools (both in real terms) and international development (0.7 per cent of GDP). Consequently, funding for those departments such as local government (often described as 'non-protected' departments) could fall by approximately 39 per cent in real terms between 2015-16 and 2019-20.

6. London Councils analysis suggests that if this were to take place, London local government could face a real terms reduction in funding of close to 70 per cent from 2010-11 to 2019-20.

Figure 1: The potential trajectory of core local government funding



7. Of course, the level of savings for local authorities is likely to be far higher to reflect the need to address emerging cost pressures, inflation and other local issues.

<u>Budget 2015</u>

8. By the time Leaders' Committee convenes in March, the Chancellor of the Exchequer will have delivered the annual Budget to Parliament (18 March). London Councils officers will circulate a briefing note on the announcement prior to the meeting.

9. While Budget 2015 is likely to update the figures above, changes are likely to be limited with the scale of the challenge ahead to remain broadly as anticipated.

10. In advance of the announcement, London Councils presented a submission to Government, which set out a range of changes that would support London local government to accelerate economic growth, contribute to deficit recovery and shape better public services. It is felt that this submission provides a further opportunity to build on the work carried out prior to Autumn Statement 2014 and a further platform for future discussions with Government in the run up to the general election and the spending review that follows.

<u>The current local government finance system</u>

11. In considering the future funding of local public services, there appears to be universal consensus that the local government finance system is unsustainable in its current form. London Councils has, historically, had four overarching concerns, specifically:

- **Ring-fencing of Whitehall budgets:** The current approach to ring-fencing of Whitehall budgets prevents Government from making strategic and holistic decisions on funding. This not only results in a disproportionate level of funding reduction for local government, but in a series of targeted grants over which local authorities have minimal financial freedom and flexibility to achieve their key outcomes.
- **The finance system is too complex and opaque:** The current local government finance system remains not only heavily centralised but extremely complicated. The previous Formula Grant system was incredibly complex, with very few people understanding the formula. This situation has been exacerbated by the introduction of the business rates retention system, which has not only incorporated an updated version of the formula, but added a further layer of complexity through business rates baselines, tariffs, top-ups, the levy and safety net.
- **A lack of stability undermines long-term financial planning:** There is a concern that the lack of stability within the system undermines the ability of local authorities to plan their finances over the long term. Current short-term grant funding via central silos is inefficient and insufficient to meet the needs of London's diverse communities.
- **The lack of direct financial incentive undermines local economic growth:** The complex business rates retention system creates further instability. London's local authorities remain particularly exposed to the risk of successful rating appeals, accounting for around a third of all business rates appeals in England. The fact that the Government is only retaining half of business rates; that local government is bearing the cost of the RPI inflationary increase on the funding baselines; that any growth benefits could potentially be removed after 7 years at the next reset; and that the definition of growth only applies to physical growth (not revaluation growth), all mean that the direct financial incentive for local authorities to grow their local business rates remains weak.

Emerging Issues and Developments

12. In thinking about the future funding mechanisms for local public services, it is likely that these will be subject to the outcome of the general election and addressed more fully in the Spending Review that follows. In advance of any discussions, the Independent Commission on Local Government Finance[1], SIGOMA[2], the Joseph Rowntree Foundation and the Institute for Fiscal Studies (IFS) have all published reports on local government finance in recent weeks. Although the focus of each report is slightly different, there are some common themes, which run through the respective reports. It is felt that these fall broadly under two main categories – the scope of reform and its nature.

[1] Led by the Local Government Association and CIPFA.
[2] Special Interest Group of Municipal Authorities (outside of London) within the LGA

The Scope of Reform

Greater Freedom and Independence

13. In considering future funding options, there is a question about the extent to which any reform could be introduced within the current finance system or whether a more ambitious and fundamental approach is required. The report from the Independent Commission on Local Government Finance reinforces the idea that local government should have greater financial freedom and flexibility and that the current system is subject to excessive levels of central government control.

14. The report shares many features with the recommendations of the London Finance Commission and the work of London Councils on fiscal devolution such as proposing the retention by local authorities of all business rates. Such a position would also seem to compliment the work advanced by some local authorities, including those in London, with central government on the steps necessary to both retain more local business rates and so, become less reliant on Revenue Support Grant (RSG).

The Impact on the Taxation System

15. In considering what a system of greater financial freedom could look like, the current taxation system, arguably, takes on a greater level of significance at a local level, particularly in relation to both business rates and council tax. The recommendations of the Independent Commission recognise this, specifically:

    - Business Rates: The Commission puts forward the case for greater freedom over the system of discounts and reliefs and recommends that 100 per cent of local business rates (and growth) should be retained by local government.

      It is worth noting that Autumn Statement 2014 announced that the Government will conduct a review of the future structure of business rates to report by Budget 2016. HM Treasury has reiterated the point that any proposals will be fiscally neutral and be consistent with the Government's agreed financing of local authorities. The Terms of Reference are expected to be published prior to the general election and it may well be that further information is provided at Budget 2015.

    - Council Tax: The Report also recommends that sub-national Pioneer areas should be given the power to determine the number and value of council tax bands and the timing of any revaluations. While the Government has ruled out such a move, this is an issue that both the Institute for Fiscal Studies and the British Property Federation have raised in recent times.

Other

16. The report makes a number of other recommendations, including the need for an independent body to consider whether current funding levels are sufficient to allow local authorities to meet their statutory functions and the establishment of Local Public Accounts Committees to scrutinise value-for-money.

The Nature of Reform

17. In considering the possibility of reform, a focus on the nature of the local government finance system is likely to be critical. Historically, the distribution of funding has been wholly focused on assessing 'need' and the unique and relative characteristics of an area. In recent times, reforms to the finance system have seen a shift from need as the principal driver of funding allocations.

18. Prior to the establishment of the business rates retention system in 2013-14, the Government undertook a full review of the methodology for the distribution of formula funding (core funding) to assess whether the formula was fit-for-purpose and as up-to-date as possible. It was at this point that funding allocations were last influenced by an assessment of relative need. During the review, consideration was given to:
    - Updating data[3] where appropriate, including population and tax base data,
    - Revising the formulae for a limited number of relative needs formulae, specifically the cost of providing rural services and concessionary travel,
    - Changing the balance between needs and the estimated level of local resources, and
    - The methodology for transfers in and out of the baseline (e.g the inclusion of the GLA).

19. The results from the formula were then subject to damping according to authority type and grant dependency[4]. This approach was consistent with previous settlements. In 2013-14, London, overall, benefitted from damping by £182 million. Though, the impact of this policy within London is variable. 16 local authorities received £279m from floor damping and 17 local authorities were scaled by £97m.

[3] It is also worth adding that there are over 90 different data metrics used within the formula. Each metric will have had a different weighting and their impact on the final allocations will vary.

[4] Grant dependency is defined as the proportion of each authority's 2010/11 budget requirement that was funded through the 2010/11 formula grant.

20. For 2014-15 and beyond, the Government decided not to re-assess 'need' within the funding allocations and has, in short, scaled down each local authority's funding allocation in line with the overall spending decisions for local government.

21. Such an approach has aligned with an increasing emphasis within the finance system on the concept of financial incentivisation and the appetite to financially reward certain types of behaviour. For example,

- Business Rates Retention: This system has been introduced to provide a baseline against which local business rates income can be used as a financial incentive to reward local authorities for growing their local business tax base.

- New Homes Bonus (NHB): This grant is paid each year for six years and provides a financial reward for those local authorities that are able to increase their domestic tax base. NHB is funded from a topslice to revenue support grant so is funded by all local authorities, irrespective of how much they receive back in NHB grant.

22. Recently, the Institute for Fiscal Studies has sought to explore these reforms in the context of changes in local government spending.[5] In summary, the report suggests that spending per person by local authorities has fallen by 23% in real terms between 2009–10 and 2014–15, using a comparable definition of net spending on services. The report also noted that the size of the reductions vary significantly across the country and that, on the whole, more deprived areas and those that saw faster population growth have seen larger cuts. London boroughs were cited as a group that could be particularly affected by this.

23. SIGOMA has also developed their own analysis of the funding reductions since 2010 and the move away from a strict methodological assessment of need in funding allocations. Their recent report[6] echoes the call for an independent body to oversee the local government finance system.

24. SIGOMA has also considered the impact of the funding reductions on authorities with high levels of deprivation and in response, has developed an alternative future funding model.

25. Key components include:

- The Resource Needs Block: This element would seek to support the delivery of core services across local government and reintroduce equalisation to the system. The report

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[5] http://www.ifs.org.uk/publications/7621
[6] http://www.sigoma.gov.uk/documents/Public.aspx

views this block as the foundation of the model and the element, which would be protected and prioritised above all others.

- Incentivisation block: This element recognises the need for some element of financial incentive and reward within the funding system and could be designed to reward economic growth; provide the basis for a negotiation with central government for new income streams and/or incentivise efficient ways of working.
- Government Share Block: This block would maintain central government's ability to provide targeted funding to local government for specific policy initiatives or activity.

Future Consideration

26. While the Autumn Statement 2014 and Budget 2015 set out the broad trajectory of public sector spending up to 2020, there remains considerable uncertainty about the future funding mechanisms for local government.

27. There is general consensus that the current system is unsustainable in its existing format from a range of different viewpoints. The system appears unable to provide a sufficiently strong direct financial incentive to those local authorities who are able to support the conditions for economic growth. At the same time, it is failing to accurately reflect the changing 'need' of individual local authorities such as the lack of sensitivity to London's growing population.

28. The current local government system also appears unable to accommodate the broader debate on fiscal devolution and new funding streams potentially available through advances on the public service reform agenda. As these discussions develop, there may well be a number of questions about the suitability of the finance system to support such arrangements.

29. With discussions on the next Spending Review (SR) period likely to begin swiftly after the outcome of the general election, London local government is likely to need to set out a strong position for the Capital. In this context, and to frame a potential response to the next SR, consideration will need to be given to a range of strategic issues including, but not limited to:

    - **What is the likelihood that a new government will allow consideration of change to the core planks of local government finance to be included in the Comprehensive Spending Review?** If the next Government considers change to any grant regime or local tax, it will be important that London local government has had time to assess the current position and complete the groundwork for detailed consideration of alternative options. It would be prudent to begin this work in advance of the General Election.

- **To what extent should London local government make the case for new or alternative funding streams?** Building on the work of the London Finance Commission, London local authorities may wish to explore whether tax devolution or assignment provides long term opportunities for financial independence and gain. This could be relevant in the context of discussions on fiscal devolution and public service reform and particularly, following developments in both Scotland and Greater Manchester.

- **To what extent should London local government consider broader reform of existing local funding streams?** London's Leaders may wish to consider the scope to reform existing local taxes (business rates, council tax) as well as current government funding streams (Revenue Support Grant, New Homes Bonus) and the extent to which these are able to deliver on wider financial and non-financial aspirations.

- **How can the local government finance system balance financial incentive and equalisation of need?** While it is recognised that establishing an optimal balance is likely to present a number of challenges, London local government may wish to explore the nature of the finance system and consider whether it is fit-for-purpose. This could be significant in discussing the relative position of London to the rest of the country, particularly on issues such as population and local resources.

30. Given the short time between the General Election and detailed planning on the CSR within Whitehall, it would be prudent to prepare background options to inform discussion that could be required in the light of announcements yet to be made by the Government that emerges following the 7th May. It is proposed that officers be instructed to prepare a range of background papers now to ensure that any discussions required for the CSR can be fully informed following the outcomes of the General Election.

Recommendations

Leaders Committee is invited to comment on the issues raised in this report confirm the proposal in paragraph 30 above.

Financial Implications for London Councils
None

Legal Implications for London Councils
None

Equalities Implications for London Councils
None