The Fair Funding Review: Executive summary

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The Fair Funding Review: a review of the key issues

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Preface

This is a summary of two reports that have been written as part of a major programme of research and analysis supported by IFS's Local Government Finance and Devolution Consortium. Consortium members include Capita, the Chartered Institute of Public Finance and Accountancy (CIPFA), PwC and the Economic and Social Research Council (ESRC). Support provided by the Municipal Journal, and a range of councils across England, including those represented by the Society of County Treasurers, is also gratefully acknowledged.

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Introduction

The English local government finance system is part way through a series of major changes that will see its focus shift from being based on redistribution according to spending needs, towards more emphasis on providing financial incentives to tackle needs and to boost local revenue-raising capacity. However, this does not mean that redistribution will cease to play any role in the local government finance system: if there was no redistribution, there would be very large variations in different councils' ability to fund local services.

It is in this context that the government is undertaking a 'Fair Funding Review' in conjunction with councils. The aim of this review is to propose a new system for allocating funding between councils, which would be based on updated and improved methods for estimating councils' differing revenue-raising capacities and differing spending needs. The government has stated that it wants the new system to be simpler and more transparent – but robust and evidence-based.

The outcome of a review like this has the potential to have profound effects on the capacity of councils across the country to provide services. But there is no single correct answer to the question "how should funding be allocated between councils?".

This is a summary of two new reports addressing this question: the first examines how councils' spending needs might be assessed in future, and the second discusses options for the overall design of the new funding system.

In the first report,[1] we focus in particular on the approaches to assessing spending needs that the Ministry of Housing, Communities and Local Government (MHCLG) has suggested for different service areas. We discuss their benefits and drawbacks and whether the drawbacks seem to be an issue in practice. We also highlight the potential sensitivity of the estimates of spending needs for different councils to the specification of spending-needs formulas and the data used in their construction.

In the second report,[2] we first analyse how differences in revenue-raising capacity can be measured, and the pros and cons of different options. We then discuss options for the overall design of the new funding system. We focus in particular on ensuring that the way revenue-raising capacity and spending needs are assessed is transparent and consistent across councils. It is also important to have a system which provides flexibility over the balance between redistribution and financial incentives: preferences over these can vary between governments and over time.

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[1] Harris, T. and Phillips, D. (2018), 'The Fair Funding Review: is a fair assessment of councils' spending needs feasible?', Institute for Fiscal Studies (IFS), IFS Report R148 (https://www.ifs.org.uk/publications/13275)
[2] Amin-Smith, N. and Phillips, D. (2018), 'The Fair Funding Review: accounting for resources', Institute for Fiscal Studies (IFS), IFS Briefing Note BN141 (https://www.ifs.org.uk/publications/130247)

Accounting for councils' spending needs

The spending needs of councils cannot be observed directly. Instead, they must be inferred or estimated from something we do observe – such as local socio-economic and geographical characteristics, and councils' actual spending.

For a number of service areas – including environmental, protective and cultural services (EPCS) – the MHCLG proposes to estimate spending-needs formulas based on the relationship between council spending and various needs indicators. The idea is that these relationships – which would be estimated via a statistical approach called regression analysis – reflect the effect of the different needs indicators on councils' spending needs.

The proposed approach has benefits compared with other methods. It is less subjective and potentially more transparent than determining formulas by judgement and negotiation only, and it is much less affected by the decisions of individual councils than when using each council's actual spending. In particular, such an approach does not 'reward' a council with a higher estimate of spending needs just because it chooses to spend more (whether due to preferences, efficiency or the availability of government funding) – what matters is the relationship between spending and needs indicators across all councils.

But the approach still has significant issues.

- **Formulas can be inaccurate or biased if important determinants of spending needs are omitted from the estimation process**.

- **Factors other than needs (e.g. local preferences or efficiency) can distort estimated formulas if they are correlated with the chosen needs indicators**. This is because the formulas would be picking up not only the relationship between the needs indicators and spending needs, but also the relationship between the indicators and these other factors that affect councils' spending.

Past funding policy decisions have changed spending patterns

A particular concern is that spending patterns will depend in part on previous government decisions on how to allocate funding.

These decisions will matter in practice: cuts to government funding for councils since 2009–10 have been accompanied by a reduction in the degree of redistribution. For most of this period, the size of cuts to grants did not (or did not fully) take into account the fact that councils with high assessed spending needs (and/or low revenue-raising capacity) relied on those grants for more of their overall budget. The result was much bigger cuts to funding – and spending – for the most grant-dependent councils.

The tenth of councils most dependent on grant funding reduced spending on services by 31% between 2009–10 and 2016–17, compared to 13% for the tenth of councils least dependent on grant funding.

These policy-driven funding and spending changes have led to significant changes in the relationships between spending and needs indicators. Most notably, the positive relationship between levels of deprivation (as measured by the index of multiple deprivation) and spending has become much weaker.

To illustrate the potential impact of this, we estimate spending-needs formulas for EPCS based on population, deprivation and rurality – the set of needs indicators suggested by the MHCLG for these services – using data from 2009–10 (just prior to the funding cuts), and from 2016–17 (the most recent data available at the time of writing, which is the MHCLG's preferred option).

A formula based on the most recent data could hit deprived areas

The formula based on 2016–17 data produces a lower estimate of needs for deprived councils than the formula based on 2009–10 data, as shown in Figure 1 below. This mirrors the particularly large impact of funding cuts on the spending of such councils.

Figure 1. Average assessed EPCS spending need per person under 2009–10 and 2016–17 – based formulas and existing spending needs formula by deprivation level (mean = 100)
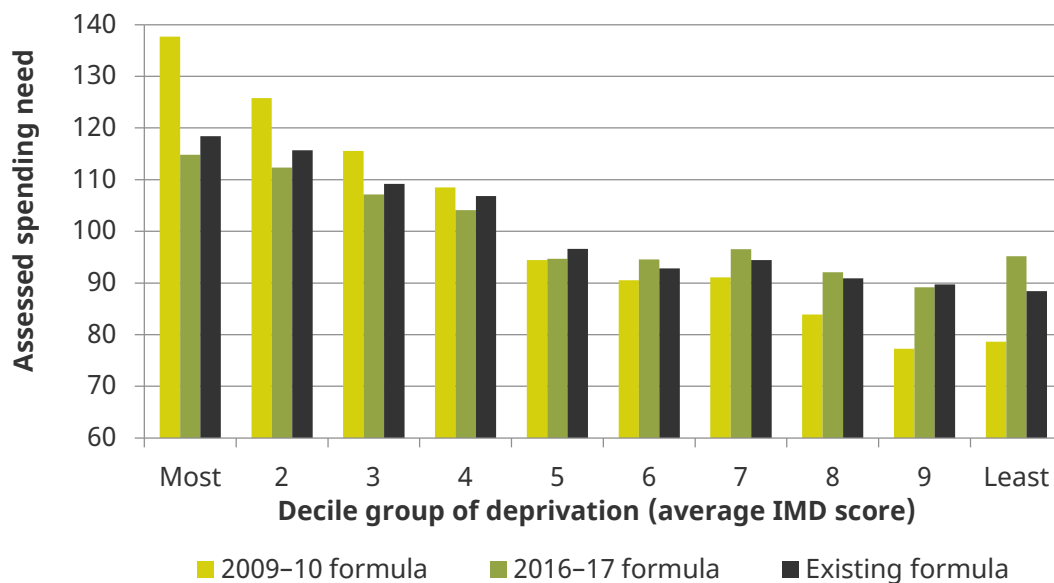
Sources: See Figure 4.3 of Harris, T. and Phillips, D. (2018), 'The Fair Funding Review: is a fair assessment of councils' spending needs feasible?', Institute for Fiscal Studies (IFS), IFS Report R148 (https://www.ifs.org.uk/publications/13275).

For example, for the tenth of councils with the highest levels of deprivation, the formula based on 2016–17 data produces an average estimate of spending needs per person of 15% above the national average (see Figure 1). By contrast, the formula based on 2009-10 data would suggest they needto spend 38% above the national average. Conversely, the average estimate for the tenth of councils with the lowest levels of deprivation is 5% and 21% below the national average, respectively, for the formulas based on 2016–17 and 2009–10 data. Taking two specific councils as an example:

- The estimate of spending needs per person for Knowsley (one of the most deprived councils) is 13% above the national average when using a formula based on 2016–17 data, but it is 41% above the national average when using a formula based on 2009–10 data. In comparison, its spending need according to the existing formula is 11% above the national average.

- On the other hand, for Wokingham (one of the least deprived councils) the estimates are 6% and 31% *below* the national average using the formulas based on 2016–17 and 2009–10 data, respectively, while the existing formula estimates its spending needs per person to be 17% below the national average.

This begs the question – which formula best reflects spending needs? Unfortunately, with council-level data only, there is no objective way to tell. This is because any attempt to assess needs will be affected by the MHCLG's funding policy regarding the year of data used to estimate the spending-needs formulas.

Judgement and subjective decisions will therefore have to play a key role in the spending-needs assessment. In which year was the funding system fairest? How, if at all, should estimated formulas be 'tweaked' following consultation with local government or technical experts? Different people will have different views on these issues – illustrating the inherently subjective nature of 'spending needs' as a concept.

Clearly, one option is simply to use the formula from the most recent year of data available – which is the MHCLG's preference. Figure 1 shows that the formula based on 2016–17 data leads to estimates of spending need that are, on average, closer to estimates under the existing formula – minimising any subsequent funding reallocations. But we should not be under any illusions that this approach represents the most 'objective' approach.

It could also hit areas with lots of employment, such as central London

Judgement will also play a very important role when it comes to the selection of needs indicators and the way they enter the spending-needs formulas (e.g. linearly or in a way allowing for non-linear effects).

One indicator we expected to have a potentially major impact on our estimated spending needs formula was the employment density. This indicator, which we measure by the ratio of workers to residents based in an area, would capture the effect of the additional costs to councils that have a large net inflow of commuters and, more generally, that are major employment centres.

This indicator is very strongly positively correlated with the existing measure of EPCS spending needs: on its own, it statistically 'explains' 40% of the variation in needs per person according to the existing formula. This is not surprising, as a very similar indicator (daytime population) is included in the existing formula.

This indicator was also positively correlated with spending in 2009–10, so its inclusion in a new formula estimated using that year's data benefits councils with a high worker–resident ratio. For example, Westminster's estimated spending needs per

person are 39% above the national average if the formula excludes employment density and 129% above the national average if it does includes this indicator. By way of comparison, its estimated spending needs using the existing formula are 153% above the national average, and its actual spending in the most recent year, 2016–17, was 12% *below* the national average.

But employment density is now slightly negatively correlated with spending on EPCS. For most councils, its inclusion or exclusion in a spending-needs formula therefore makes little difference if 2016–17 data are used to estimate the formula. This may provide a rationale for the MHCLG's current intention not to include such an indicator, given that its preference is to use data from 2016–17 (or later) to estimate its formulas.

For the councils with the very highest or lowest employment densities though, whether employment density is included can matter. Take Westminster: estimated spending needs per person are 28% and 3% above the national average, respectively, if employment density is excluded or included from a formula based on 2016–17 data. Therefore, the inclusion of employment density in a new spending-needs formula could hit rather than help Westminster.

Impact of updated formula likely greatest – but also most uncertain – for those currently with the highest or lowest assessed needs

We also test the sensitivity of formulas – and hence spending-needs estimates – to the inclusion or exclusion of a series of indicators. These include: the fractions of the population aged under 16 or over 75, or the fraction who are non-white (to reflect potential differences in spending needs driven by demographics); benefit receipts per person (an additional proxy for deprivation); and population density (to reflect potential differences in spending need driven by congestion or other factors associated with densely built-up areas).

Our results are demonstrated in Figure 2, which shows how sensitivity our average estimate of spending need is for each decile group of councils ranked according to their spending need under the existing ECPS spending needs formula. In this fan chart, each coloured band (from lightest green to darkest green and back to lightest green) represents 10% of the distribution of our estimates of spending needs (from different formulas with different combinations of needs indicators).

The figure shows that estimates of spending need are most sensitive to the choice and number of indicators for those councils that have the highest levels of spending and highest levels of assessed spending need according to the existing formula.

- For example, for the tenth of councils that have the highest levels of assessed spending needs under the existing formula, depending on which indicators are included, the average of our new estimates of their spending needs per person ranges between 121% and 144% of the national average: a difference of 23 percentage points.

- However, for councils with average levels of need according to the existing formula, the choice of indicators makes less of a difference. The average of our new estimates

of their spending needs per person ranges from 91% to 95% of the national average, depending on the choice of indicators: a difference of 4 percentage points.

Figure 2. Sensitivity of average estimate of spending needs based on 2016–17 data, by decile group of EPCS spending needs per person according to the existing formula (mean = 100)

Decile group of EPCS spending need as assessed by existing formula

◆ Mean assessed spending need, existing formula
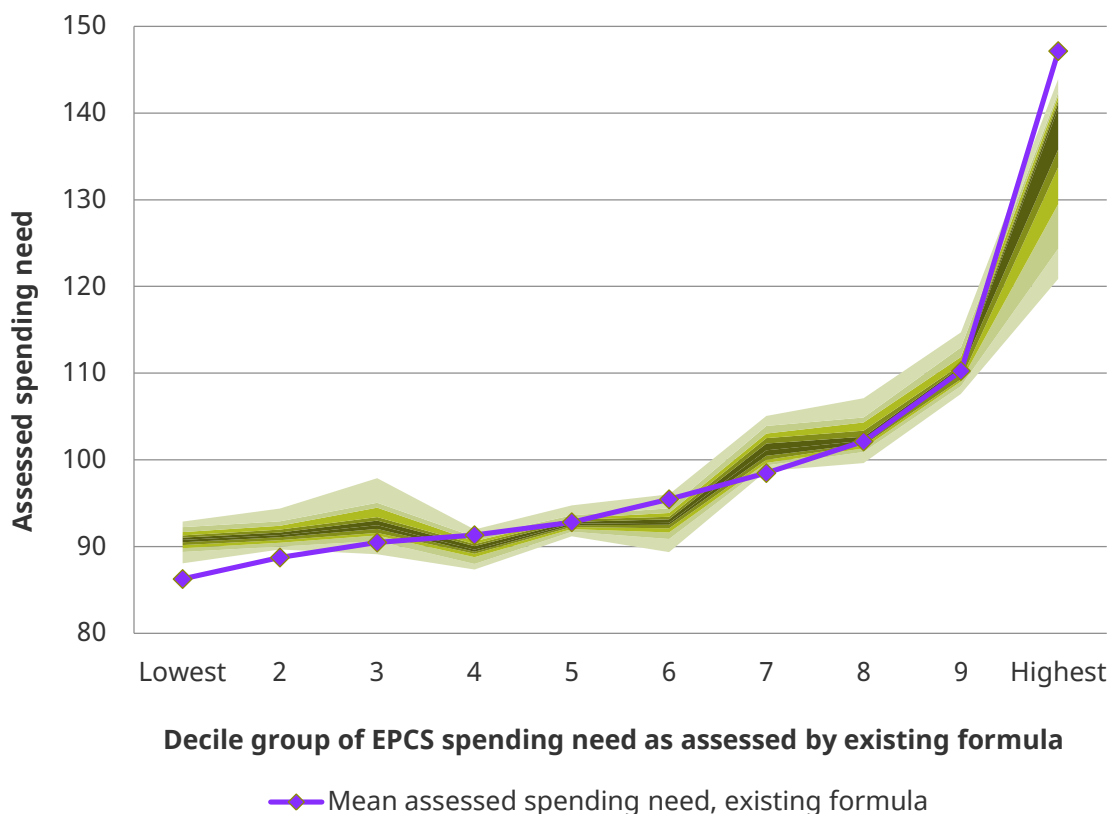
Sources: See Figure 4.7 of Harris, T. and Phillips, D. (2018), 'The Fair Funding Review: is a fair assessment of councils' spending needs feasible?', Institute for Fiscal Studies (IFS), IFS Report R148 (https://www.ifs.org.uk/publications/13275)

In all the specifications that we test, the councils with the lowest assessed needs currently see, on average, an increase in their assessed needs, and those councils with the highest assessed needs currently see a decrease.

- For example, the tenth of councils with the lowest assessed spending needs currently have an average spending need per person of 86% of the national average. However, the average of our new assessment for them varies between 88% and 93% of the national average, depending on which indicators are used.

- However, for the tenth of the councils that have the highest assessed needs under the existing formula, their current average (147% of the national average) lies above our new estimates, which vary from 121% to 144% of the national average, depending on the indicators used in the formula.

This means that councils with high assessed spending needs for EPCS under the existing formula are likely to lose funding as a result of the updating of the EPCS

spending-needs assessments – and those councils with low assessed spending needs for EPCS under the existing formula are likely to gain funding.

This does not mean that these groups of councils will lose or gain from the Fair Funding Review overall. This will depend on decisions taken in relation to the measurement of councils' revenue-raising capacity, and about how redistributive the overall funding system should be. It will also depend upon the updates made to spending-needs assessments for other services, including adult social care and children's services.

For social care, the government proposes to use subcouncil-level data

For social-care services, the government proposes to use subcouncil-level data to estimate spending-needs. This will be at the level of lower super output areas (LSOAs) – which, on average, contain 1,500 people – for adult social care, and possibly at the individual- level for children's services. This builds on the use of ward-level data – wards, on average, contain 7,000 people – for the construction of existing spending-needs formulas for these services.

The estimates of spending needs produced by these approaches will still depend upon subjective decisions about what needs indicators to include. Comprehensive sensitivity analysis – including for 'outlier' councils – will therefore be important for properly informed decisions. Such testing has taken place for the new adult social care formula.

The major benefit of this approach is that it allows us to include statistical controls for each council, and to estimate formulas using relationships between spending and needs indicators *within* councils. This allows one to 'strip out' the effect of any non-needs factors – such as preferences, efficiency or funding availability – that affect the overall level of spending on a service by different councils.

This makes such an approach more robust than using council-level data, but it does not mean that it is unaffected by the influence of non-needs factors.

- For example, suppose that some councils receive more funding relative to their 'true' needs than others. Including and stripping out a council 'indicator' in the regression formula can control for the impact of this on the average spending of these councils. But a higher level of spending may also be associated with a different distribution of spending across small areas or individuals with different characteristics: more or less concentrated on the most deprived, for instance.

In such circumstances, regression analysis using subcouncil-level data can still lead to biased regression formulas. Sensitivity analysis to the set of councils on whose data the formula is based on would therefore also be wise. Such testing does not appear to have taken place.

Final thoughts on spending need

While our report focuses on the issues and sensitivities of the methods proposed by the MHCLG, we must not be too negative. Assessing councils' spending needs is both

conceptually and practically difficult. The principles set out by the MHCLG for the needs assessment (simplicity, transparency, robustness and being evidence-based) are sensible and the methods reasonable given data availability. Indeed, the proposal to use individual-level data for children's services would be innovative.

But three things are important going forwards.

- **Being clear that no assessment of spending needs can be objective** – although it can and should be evidence-based. Judgement inevitably plays a part in deciding what year of data to use, what indicators to include, and what (if any) adjustments to make to formulas estimated by regression analysis if there is a concern that they are being biased by non-needs factors.

- **Being as transparent as possible about the impact that different choices (e.g. years of data, needs indicators) will have for different councils**. Our analysis shows that these things can matter a lot for specific councils – especially those that have quite different characteristics to the country as a whole. More generally, they will affect the relative levels of funding distributed to different types of council – deprived or affluent, urban or rural, county or borough. It is important that these effects are understood and debated.

- **Investing in improvements in subcouncil-level and individual-level spending (or service utilisation) and socio-economic data**. The aim, if possible, should be to wean ourselves off the use of council-level regression analysis in spending-needs assessment for all services. This approach could become increasingly untenable over time if the new funding system is designed so as to *not* fully equalise with respect to spending needs and revenue-raising capacity.

Accounting for councils' revenues

The biggest source of locally-raised revenues for councils is and will continue to be council tax. **In 2016–17, council tax revenuesaccounted for 53% of councils' estimated 'core spending power'**.

However, there is significant variation between councils in the amount of council tax revenues each raises per person. Figure 3 below shows how council tax revenue per person varied across upper-tier council areas in 2016–17, by type of authority.[3]

Figure 3. Council tax revenues per person, 2016–17, by council and council type

Notes & Sources: See Figure 1 of Amin-Smith, N. and Phillips, D. (2018), 'The Fair Funding Review: accounting for resources', Institute for Fiscal Studies (IFS), IFS Report R148 (https://www.ifs.org.uk/publications/13275)

A**verage council tax revenues per person were £393 and the figure shows that they were nearly three times higher in the area with the highest revenue (£600 in Surrey, a county are) than in the area with the lowest revenue (£158 in Wandsworth, a London borough).**

The figure also shows the distribution of council tax revenues by type of council. Average council tax revenues per person were lowest in the metropolitan districts covering urban areas in the West Midlands and north of England and in London boroughs – which had the greatest variation in council tax revenues across councils.

Such variation is reflected in the fact that for individual councils the proportion of core spending power represented by council tax revenues varies from just under a quarter (in Westminster) to just over three quarters (Buckinghamshire). However,

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[3] We use upper-tier council areas so that we can make comparisons between areas with single-tier and two-tier local government.

this also reflects differences in assessed spending needs: those with higher needs will, other things equal, receive more grant funding, thereby funding a smaller fraction of their spending from council tax.

How should council tax revenue-raising capacity be measured?

Any method for distributing funding to individual councils needs to take some account of the amount of council tax they can, or do, raise. Not to do so would result in very large differences in available resources.

Council tax revenues vary both because of differences in tax bases – driven in large part by the number of properties in different tax bands – and differences in the tax rates charged by councils. Until 2013–14 council tax bases were used to determine redistribution between councils, although from 2006–07 onwards the extent to which they were taken account of was subject to ministerial discretion. From 2016-17 onwards the finance system has taken account of the actual tax revenues raised by each council in 2015-16. This means that the current funding system:

- Takes no account of changes in either tax rates or tax bases since 2015-16;

- To some extent, compensates councils with small tax bases in 2015-16;

- Also, to some extent, compensates councils which had low tax rates in 2015-16.

A key decision for the Fair Funding Review is the extent to which tax bases or actual revenues should be used for determining funding levels going forward.

Actual tax revenues are easier to measure, and equalising on this basis would mean the relative funding levels of different councils would more closely match their assessed relative spending needs.

But equalising on the basis of tax bases seems preferable given the other drawbacks of tax revenue equalisation. Tax revenue equalisation reduces the discretion and financial accountability of councils: part of the revenues of any increases in local tax rates get siphoned off; and councils do not bear the full cost of setting lower tax rates. This would provide councils with an incentive to set lower tax rates than they otherwise would, with that incentive stronger the higher the degree of equalisation, potentially undermining council tax as a source of revenue. In short there is a fundamental problem associated with giving more money to some councils because they *choose* to impose lower rates of tax.

In fact, outside of London, nearly 90% of the variation in tax received by councils is driven by tax bases. Different tax rates are responsible for only a small fraction of differences in receipts.

Within London, however, tax rates play a much more important role in determining tax receipts. This is because there is much wider variation in tax rates charged, with those councils with the highest tax bases systematically setting below-average council tax

rates. It is also the case that council tax rates in London are *lower* in those boroughs with *higher* assessed spending needs.

The result is that tax revenue equalisation would particularly benefit the two London councils – Wandsworth and Westminster – with the lowest tax rates (who have benefited from the system currently in place). On the other hand, areas covered by county councils, which typically have higher tax rates, would nearly all do better under tax base equalisation.

Figure 4 shows, for all councils, how much each council would receive under tax revenue equalisation as a ratio of the funding it would receive under tax base equalisation. A value X% above (below) the red line indicates that funding would be X% higher (lower) under tax revenue equalisation than under tax base equalisation. The graph makes it clear that the choice matters: a third of councils see funding differences of 5% or more between systems of tax revenue and tax base equalisation. Nearly all London boroughs would do better under tax revenue equalisation and nearly all shire county areas better under tax base equalisation.

Figure 4. Illustrative scenario for funding under tax revenue equalisation relative to funding under tax base equalisation (%), using 2016–17 tax revenue data
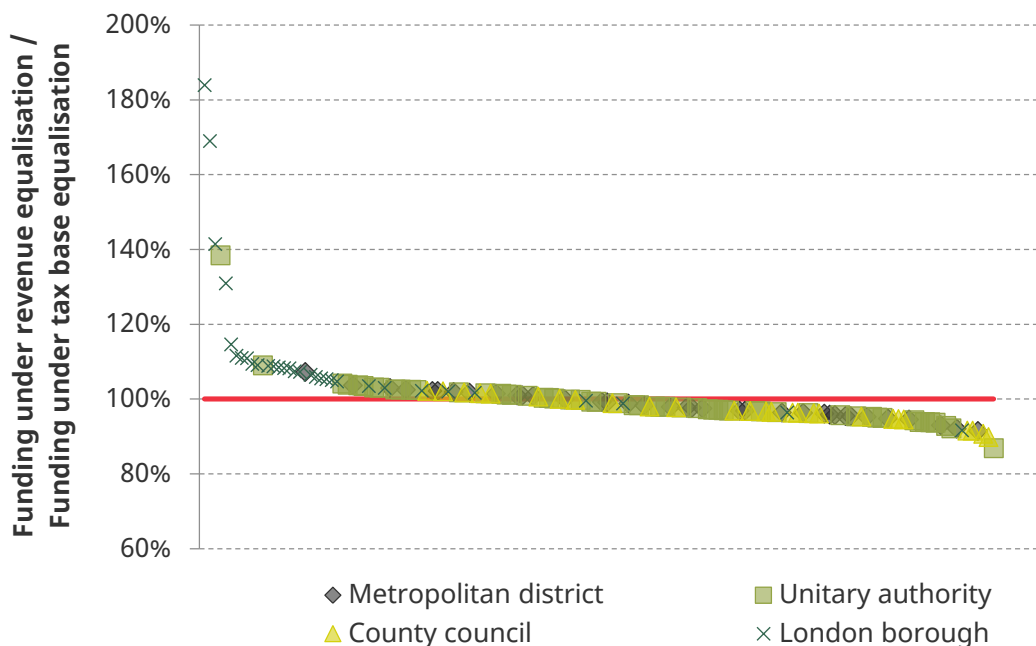
Sources: See Figure 4 of Amin-Smith, N. and Phillips, D. (2018), 'The Fair Funding Review: accounting for resources', Institute for Fiscal Studies (IFS), IFS Briefing Note BN141 (https://www.ifs.org.uk/publications/130247).

Arguments that councils with the lowest tax rates are 'locked in' to them and should not be penalised for this by the funding system are less strong now than in the past. In the past, central government has directly capped large council tax increases. Now local residents have the final say via council tax referendums, and councils can ask permission for any size council tax increase they wish. If residents of low-tax areas are not willing to approve higher taxes, it is arguably unfair to expect residents of other areas to subsidise

this choice, as would in effect happen under tax revenue equalisation. Tax base equalisation avoids this issue. Of course, councils would have greater flexibility over council tax rates if the referendum requirement were removed entirely; and residents could still have their say at the ballot box in local council elections.

Is a new approach needed for sales, fees and charges income?

Councils also raise significant sums of money – almost £10 billion a year in 2016-17 – from levying fees and charges. This sum includes, among other things, co-payments for adult social care, parking charges, fees for planning applications and charges to use leisure facilities.

The amounts raised vary dramatically around the country from less than £100 a head in councils such as Wakefield, Thurrock and Wolverhampton, to more than £600 a head in Kensington & Chelsea and Westminster. 15 of the 20 councils with the highest incomes per person from fees and charges are in London – many of which also charge low council tax rates.

It is much harder to know how to take account of differences in sales fees and charges income when devising a funding system.

There is no well-defined measure of revenue-raising capacity for income from sales, fees and charges (SFCs), unlike council tax, where the tax base can be used. One could use actual income. To the extent that actual income today reflects revenue raising capacity that might be reasonable but it is not something that could be used going forward as it would incentivise councils to reduce income from this source. In any case incomes today may reflect policy decisions or responses to funding pressures elsewhere which do not align with revenue raising capacity. Using statistical techniques to infer capacity from observed patterns of income would clearly be preferable.

Currently income from SFCs is accounted for by using a measure of *net* (rather than gross) expenditure in spending needs assessments. This means it is only possible to account for differences in SFCs income to the extent to which they vary in line with the local characteristics taken into account in the needs assessments. There could therefore be benefits from including characteristics that reflect capacity to raise revenues from SFCs in the spending needs assessments. As with selecting characteristics for inclusion in spending needs formulae more generally, careful judgement must be used that chosen characteristics will reflect variation in *capacity* to raise revenues as opposed to variation in preferences over levels of SFCs.

The overall system: redistribution, incentives and transparency

Perhaps the most important policy decision that will need to be taken for the new system is the extent to which it prioritises redistribution between councils, or financial incentives for councils to improve their own socio-economic lot. A system that fully and immediately equalises for differences in assessed spending needs and revenue-raising capacity will help ensure different councils can provide similar standards of public services. But it would provide little financial incentive for councils to tackle the drivers of spending needs and boost local economies and tax bases: such efforts would be offset by reductions in transfers from other councils and/or central government grants.

The new system should therefore allow for flexibility in the degree of redistribution and scale of financial incentives provided. Different governments may have different preferences over this, and should be able to change the degree of equalisation provided, as well as the time between updates to spending needs and revenue-raising capacity assessments. Allowing councils to bear more of any change in assessed needs or revenue-raising capacity for longer provides them with stronger financial incentives. But it also means greater financial risk of revenues and needs moving significantly out of alignment.

In designing such a system it is important to avoid the complexity of the last system – the Four Block model in place between 2006–07 and 2013–14. Not only did the complexities lead to confusion and a lack of transparency about the true intentions and impacts of the government's decisions, but they also meant the system was unstable and its impacts seemingly arbitrary.

The approaches in place between 1990–91 and 2006–07 provide a better starting point. The so-called Standard Spending Assessment and Formula Spending Share models took account of assessed spending needs and revenues in transparent ways. While historically they aimed at full equalisation, the approaches could be adapted to provide partial equalisation, thereby providing stronger financial incentives to councils.

If grant funding is retained or re-introduced at some point, which seems likely given growing spending pressures, it is in fact impossible to provide the same degree of equalisation for all councils unless it is 100% equalisation. This is because in such circumstances changing the equalisation percentage would not only change the scale of transfers between councils, it would also change the scale of transfers from central government to councils.

But it would be possible to do a full initial equalisation, and then equalise the same percentage of subsequent *changes* in assessed needs and revenue-raising capacity for each council. And it is the treatment of these changes in assessed needs and revenue-raising capacities that is what matters for councils' financial incentives. In particular, councils still have an incentive to tackle needs and boost revenues even if there is a full initial equalisation, provided that thereafter they retain at least some of the benefits (or bear some of the costs) of subsequent changes in spending needs and revenue-raising capacity.