

A

UNDERSTANDING THE CURRENT GRANT DISTRIBUTION SYSTEM

INTRODUCTION

A.1 This annex reports on work by the Inquiry team which investigates the four block model method of distributing Revenue Support Grant and redistributed business rates. This analysis was undertaken to support the team’s modelling work, particularly on the role of business rates, assignment, grant, equalisation and incentives. It describes each of the blocks, compares the model with its predecessor and makes some qualitative assessments of the model. It also identifies elements of the model where it is necessary for policy and political judgment to be exercised. There is also a discussion of the amount of grant needed for equalisation to take place, and consideration of the scope for using benchmark measures of local authority expenditure.

HISTORICAL CONTEXT

A.2 For the last few decades, the English local government finance system has been designed so that the distribution of non-ring-fenced revenue grant takes some account of both the relative needs and the relative resources of each local authority. Although both the terminology involved and the precise extent to which ‘equalisation’ has occurred have varied over time, the underlying approach has remained similar, even if each system has been presented as different from its predecessor.

A.3 Such an approach can be traced at least as far back as 1929, when block grant was introduced, following proposals for an equalisation formula made by Lord Balfour at the start of the 20th century which were not implemented.¹ The 1929 block grant calculation took account of both needs and resources, albeit not in a very transparent way. The process of equalisation developed in the ensuing decades, with the introduction of an explicit Exchequer Equalisation Grant in 1948 whereby central government contributed to bring authorities’ rateable value per head up to the national average.

A.4 Equalisation calculations have usually involved an ‘approved’ measure of expenditure, variously called ‘needs assessment’, ‘standard expenditure’, ‘Grant-related expenditure assessment’, ‘standard spending assessment’ (SSA) and ‘formula spending share’ (FSS). Each of these has involved an assessment – based on demographic, economic and social data – of the appropriate share of revenue spending for each local authority given a fixed national total. Although these have tended to be a measure of the relative – rather than absolute – need to spend, the extent to which the size of the national total has differed from the amount that authorities have actually been spending collectively has varied over the years.² The current way of reflecting relative spending needs in the calculations is discussed later in this annex.

A.5 Similarly, account has usually been taken of a local authority’s capacity for raising tax locally. In recent years, this has been done by using information on each authority’s tax base (the number of band D-equivalent properties in its area) and multiplying it by an assumed national average council tax for the appropriate class of authority. The capacity for raising other income – such as fees and charges – is not taken into account.

¹ Foster, Jackman and Perlman, *Local Government Finance in a Unitary State*, 1980

² For example, the FSS control totals were increased to reflect actual spending in 2003-04.

A.6 By 2005-06, the calculation for each local authority could be summarised as:

FSS (allocated for a range of service blocks using various formulae)

less assumed income from council tax (allocated as taxbase multiplied by a share of an assumed national council tax level)

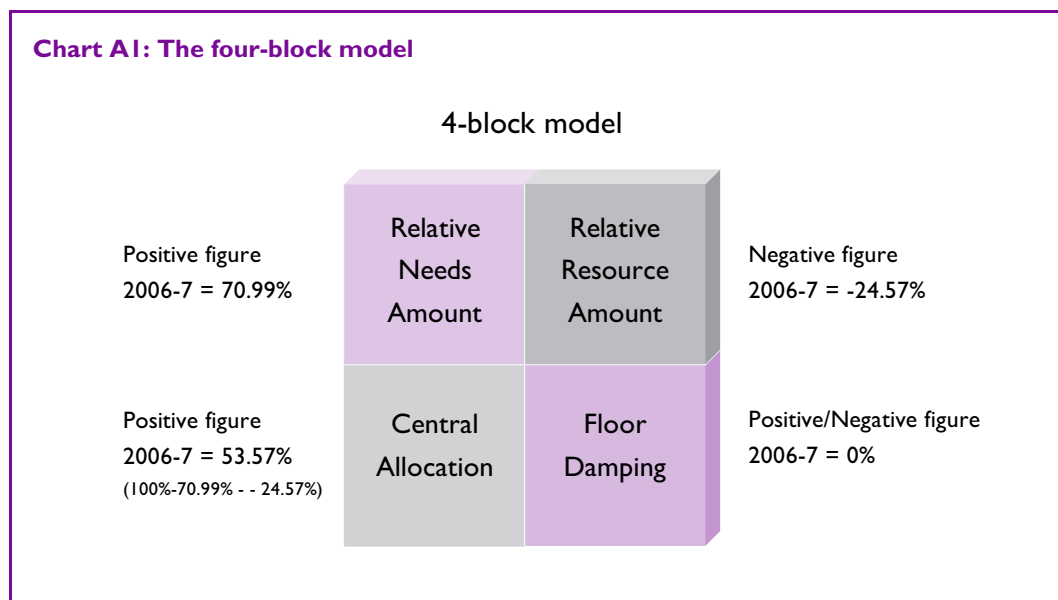
less income from redistributed business rates (allocated on a per head basis)

equals Revenue Support Grant (RSG), before floor damping.

A.7 The amount of RSG was then modified - by means of floor damping - to guarantee a minimum percentage increase in Formula Grant (the combined total of RSG, redistributed business rates and principal formula Police Grant).³

THE FOUR-BLOCK MODEL

A.8 The four-block model has replaced the previous system for 2006-07 onwards. It is summarised in Chart A1 below:⁴



A.9 It was introduced largely to get away from what the Government regarded as the widespread misinterpretation of some of the components of the previous system – particularly in relation to FSS and assumed national council tax figures. This is discussed later in this annex. When the four-block model was introduced a commitment was made not to change the underlying distribution. Over time, fresh judgments about the percentage shares that should go into each block will need to be made. The percentage share attributed to each block depends upon a policy and ministerial judgment, and there is scope for the model to move away from the previous approach for future years. The only change so far is that the percentage shares applied to each block for 2006-07 are also being applied for 2007-08, resulting in some small distributional effects as a result of data changes.

³ Police Grant was distributed using a formula almost identical to that used to distribute the police element of FSS.

⁴ Taken from a slide from a presentation on *Distribution of Formula Grant to Local Authorities* given to the 2006 Government Statistical Service (GSS) Methodology Conference. This is available at <http://www.statistics.gov.uk/events/gss2006/downloads/A1Sussex.ppt>.

A.10 Taking each block in the order in which they feature in the distribution of RSG and redistributed business rates:

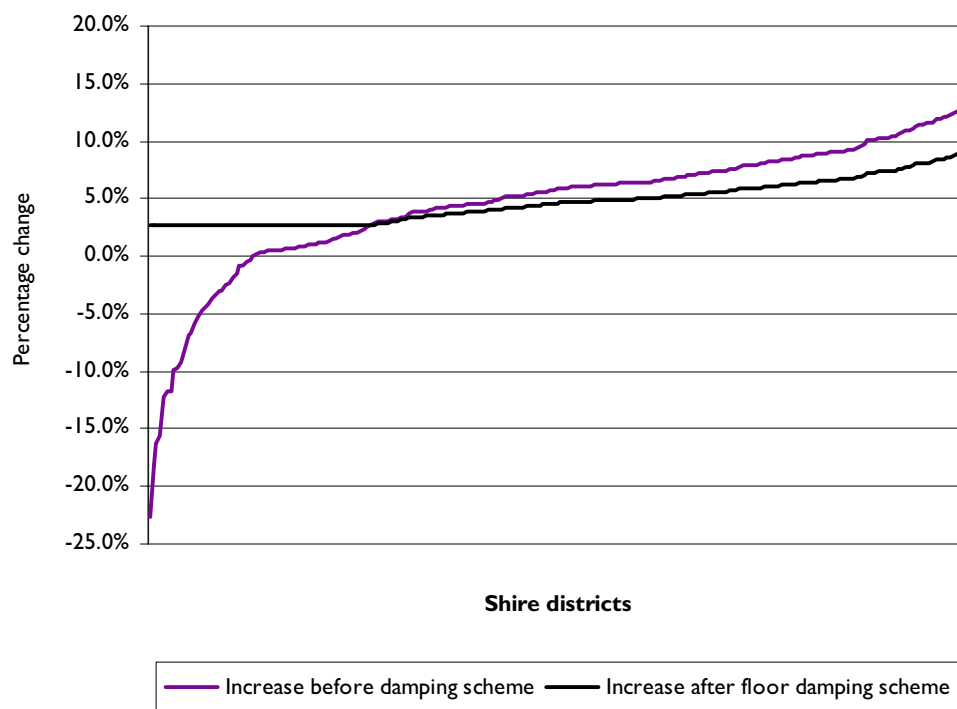
- The **Relative Needs** block takes account of a range of relative needs formulae to cover the major services which local authorities provide. They recognise the various factors which affect local authorities' costs locally in a similar way to FSS formulae. They differ from FSS, however, in that they are measured with reference to the extent to which relative needs factors per head of population exceed the minimum figure for the group of authorities that provides the same range of services. The national Relative Needs Amount for 2006-07 is £14.82 billion, which is allocated to give a separate figure for each local authority.
- The **Relative Resource** block is a negative figure which takes account of each local authority's capacity for raising money locally through council tax. It differs from the calculation of assumed council tax income used in the previous system in that it uses the amounts above the minimum council tax base per head of population, rather than the figures for the total tax base. The total Relative Resource Amount for 2006-07 is -£5.13 billion. This particular amount depends upon a combination of taxbase figures and the level of resource equalisation inherited from the previous system. While it could theoretically be a positive amount, the model is designed with it being negative due to the constraints that apply to the total amount of grant available, following the outward transfer of RSG to pay for the Dedicated Schools Grant (see below). Again, the Relative Resource Amount is allocated to give a separate figure for each local authority. It can then be set against the Relative Needs Amount to give a further figure for each local authority which takes into account their relative needs and relative resources.
- The **Central Allocation** is the amount left in the overall grant pot for local authorities once account has been taken of the Relative Needs and Relative Resources of each authority. It totals £11.19 billion for 2006-07 and is allocated on a per-head of population basis, based on the minimum figures calculated for the needs and resources blocks. Although it can be seen as a basic allowance per head – albeit with at least one caveat – it is too simplistic to regard this, in isolation, as being the required contribution to the cost of local services.⁵ There was no exact parallel to the Central Allocation in the previous system.⁶
- The **Floor Damping** block is entirely self-funding (i.e. it sums to zero nationally). It reallocates the amounts calculated in the previous three blocks to ensure that each local authority receives a guaranteed minimum percentage increase in Formula Grant over the comparable figure for the previous year. Different minimum percentage increases are set for different groups of authorities. In practice, floor damping has a significant effect for many authorities, eclipsing large changes in grant that would otherwise result from applying the first three blocks. This is shown in Chart A2 below

⁵ The caveat is that the amount calculated as the Central Allocation for a local authority cannot be guaranteed to feed into Formula Grant, even before damping, because some of it is in effect 'used up' for authorities where the negative Relative Resource Amount exceeds the positive Relative Needs Amount.

⁶ The first three blocks can, however, be shown to be equivalent to the sum of RSG and redistributed business rates (NNDR) in the old system, in that: $RSG + NNDR = FSS - Taxbase \times Assumed\ National\ Council\ Tax\ (ANCT) \times Share\ of\ Assumed\ National\ Council\ Tax\ (SANCT) = \{FSS - \min(FSS)\} - \{Taxbase \times ANCT \times SANCT \times \min(Taxbase \times ANCT \times SANCT)\} + \{\min(FSS) - \min(Taxbase \times ANCT \times SANCT)\} = Relative\ Needs\ Amount + Relative\ Resource\ Amount + Central\ Allocation.$

which shows, for shire district councils for 2006-07, the extent to which increases, or decreases, before floor damping (the thin blue line) are 'trumped' by the effect of floor damping (the thick black line). More details of the effects of floor damping are given in Annex E.⁷

Chart A2: Floor damping for shire district councils, 2006-07



Source: Communities and Local Government

A.11 This means that, for many local authorities, the indicators used in the relative needs and resources calculations (such as sparsity, or numbers of student exemptions from council tax) do not strongly influence the amount of Formula Grant that the authority receives in practice. This may not be fully understood by all the local authorities which put time and energy into lobbying for particular needs indicators to be added, altered or removed.

A.12 The amount resulting after applying floor damping is then split between RSG and redistributed business rates simply on the basis of the split between the national totals of the two amounts. These are £3.38 billion and £17.50 billion, or about 16% and 84% respectively, for 2006-07. The overall total (£20.88 billion) is agreed in the spending review process, with the redistributed business rates element being calculated a few months in advance of the financial year (as the 'distributable amount'), taking account of the latest estimates of business rates income available for distribution from the central and local lists. Over time, business rates that are paid to central government are distributed back to local authorities but are in effect treated as the proceeds of a national rather than local tax.

⁷ Taken from *Distribution of Formula Grant to Local Authorities*, presentation given to the 2006 GSS Methodology Conference. This is available at <http://www.statistics.gov.uk/events/gss2006/downloads/A1Sussex.ppt>.

A.13 In effect, a fifth block is applied for police authorities. This is the calculation of principal formula Police Grant. It is essentially a further relative needs block, which totals £3.94 billion for 2006-07. Not taking account of differences in resources in this calculation is consistent with the approach that is usually taken when distributing specific grants more generally. It is assumed that variations in raising resources have already been fully reflected in the Relative Resource block.

A.14 The sum of RSG, redistributed business rates and -- where relevant -- principal formula Police Grant -- is usually known as Formula Grant. This therefore totals £24.81 billion for 2006-07 (being the sum of £3.38 billion, £17.50 billion and £3.94 billion, as above, after rounding).

Dedicated Schools Grant and related changes for 2006-07 onwards

A.15 As well as moving to the four-block approach, 2006-07 has seen a significant reduction in the scope of the local government finance system, and a correspondingly significant reduction in the total amount of Formula Grant, from £49 billion for 2005-06 to about £25 billion for 2006-07. This is largely due to the outward transfer of about £25 billion schools funding, which is now funded wholly from the specific Dedicated Schools Grant (DSG). CLG reflected this in the national totals by deducting the whole of the £25 billion from RSG, this being the main reason for its large decrease, from £26.7 billion for 2005-06 to £3.4 billion for 2006-07.

A.16 The large reduction in RSG meant that it was no longer large enough nationally to allow the equalisation that had previously been carried out by taking account of authorities' relative spending needs (through FSS figures) and resources (through figures for assumed income from council tax). As a result, redistributed business rates -- which had previously been distributed on a per head of population basis -- were added to the pot to be used for equalisation. This is why the four-block model covers redistributed business rates in addition to RSG (as explained above), whereas the calculation used for 2005-06 was for the amount of RSG only, albeit taking account of the amount of redistributed business rates that each authority was receiving.

Reconciliation of percentage shares for the four blocks with national grant totals

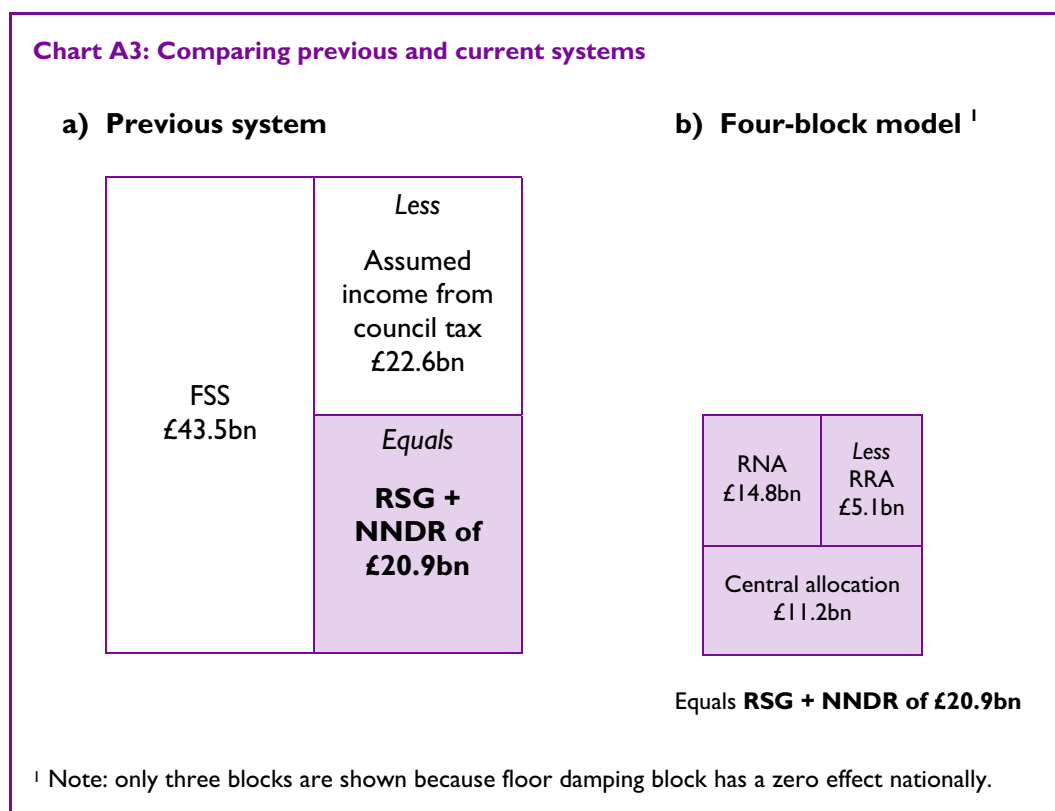
A.17 The percentage shares that are typically referred to when examining the four block model - such as those in the diagram at Chart A1 - can be confusing. This is partly because the share associated with the Relative Resource block is negative. The Central Allocation block share is, effectively, the residual that is left when deducting the (positive) Relative Needs block share and the (negative) Relative Resource block share from 100 per cent, as shown in the diagram. The shares are percentages of the sum of RSG and redistributed business rates, which total £20.88 billion for 2006-07, as explained above.

Assessment of the four-block model

A.18 Views on the four-block model vary. The Government regards it as a positive move away from notional spending (FSS) and assumed tax income (assumed national council tax figures, or ANCT) which were being misunderstood and misused for a variety of purposes – e.g. with FSS being regarded as a spending target and the percentage increase in ANCT being regarded as a forecast of the percentage increase in council tax. In contrast, Anna Capaldi of CIPFA, who has re-assembled the 2006-07 Settlement on a 2005-06 basis (giving an FSS of £42.52 billion, an assumed income from council tax of £22.624 billion and an assumed national council tax of £1,258), has concluded that the new system is less transparent and more complex, with its introduction coinciding with a significant increase in specific grant funding (due to DSG).⁸ She has observed that the notional spending and tax figures still underlie the system, and that ministers exercise a considerable degree of judgment.

A.19 Despite the fact that a local authority's Relative Needs Amount is not directly comparable to its FSS, it is possible to scale up its Relative Needs Formulae by a particular scaling factor to give amounts in £, where the resulting figure is equivalent to its FSS.

A.20 The two systems are compared in Chart A3, where the areas of each block are roughly proportional to the amounts of money involved. Both diagrams give figures for 2006-07: Anna Capaldi's representation of the previous system in a), and actual figures in b).⁹



⁸ Anna Capaldi *Basics of Local Government Finance and introduction to New Grant System and 2006/07 and 2007/08 Settlements*, 2006

⁹ Only three blocks are shown in the diagram of the four-block model because the floor damping block has a zero effect nationally

A.21 The diagrams show that the blocks of the four-block model are effectively building blocks that combine to give the total amount of grant available (albeit with one of them being negative). In contrast, under the previous model, grant was defined as the difference between two larger elements.

A.22 Grants calculated under the four-block model, and its predecessors, depend on the exercising of policy and political judgment in the following areas:

- setting the national control totals for each service block;
- some of the relative needs formulae, such as those for Environmental, Protective and Cultural Services; and
- setting the level of the damping floors.

A.23 In addition, there would be further scope for policy and political judgment to be exercised within the four-block model if it were decided to move away from the policy adopted for 2006-07 of constraining the system to give similar results to the previous system, based on fixed relationships between the needs and resources calculations.

A.24 Further details of the four-block model are available from a Guide to the Local Government Finance Settlement at:

<http://www.local.communities.gov.uk/finance/0607/simpguid.pdf>

and a paper presented at the 2006 Government Statistical Service Methodology Conference, available at:

<http://www.statistics.gov.uk/events/gss2006/downloads/A1Sussex.doc>

HOW MUCH GRANT IS NEEDED FOR EQUALISATION TO TAKE PLACE?

A.25 It is not easy to determine how much grant is needed for equalisation to take place, either under the four-block model or its predecessors. The equalisation that takes place under the four-block model is – as was the case for the previous system - only partial, and even that is inevitably distorted to some extent. The reasons for this are that:

- although there remains a strong commitment to equalisation across communities, there is no consensus on what ‘full’ equalisation means in practice, or on how it might be carried out to a greater extent than at present;
- current and previous systems have a range of objectives and therefore have not been designed with the sole intention of maximising the extent to which equalisation can be achieved in practice;
- on the needs side, the Relative Needs block does not fully reflect the actual level of need of, or spending by, local authorities, and efforts have been made to ensure that the national control totals have matched actual spending levels only at certain points in the past (see footnote 2). This is, in part, a reflection of the fact that there is an incomplete evidence base on the factors which drive costs (e.g. efficiency), and the extent to which they do so. This suggests that needs equalisation could only ever be partial, even if the formulae were correctly identifying relative needs. In addition, some

formulae, such as those for Environmental, Protective and Cultural Services, are based on judgment rather than analysis because it is not possible to carry out a robust and objective analysis of relative spending needs for these blocks;

- on the resources side, no account is taken of income from sources other than council tax, such as fees and charges; and the council tax figures are subject to certain assumptions, such as a 100 per cent collection rate, and that all second homes discounts are 50 per cent, even if the discount has been reduced in reality;¹⁰
- the national control totals for each relative needs service block are set by central government in the light of information gathered in spending reviews and when assessing new pressures and burdens, rather than drawing on detailed local authority level information on the relative levels of need for services across blocks; and
- a further – and significant – distortion is that the floor damping block waters down or cancels out some shifts in grant that would contribute to equalisation if they were allowed to feed through. While grant figures before floor damping can be extracted from the system, they have no practical application.

A.26 Further, the structure of the four blocks mean that it is not possible to disentangle needs equalisation and resource equalisation. Any attempts to quantify the amount needed for these separate elements of equalisation would, therefore, be constrained by this unless the system were changed. This was also true for the previous system.

A.27 Various figures have nevertheless been suggested as the amount of grant needed for equalisation to take place. In one sense, there is not currently enough money provided for Formula Grant to equalise for needs and resources, given that the Relative Resource Amount is negative, making it necessary to reallocate resources. However, an approximation of the amount needed to achieve equalisation, can in practice be made by regarding the Relative Needs and Relative Resource blocks as contributing to equalisation. The Central Allocation block does not contribute to equalisation, except where an authority's Relative Resource Amount exceeds its Relative Needs Amount, so that part of its Central Allocation is eroded in order to fully deduct the Relative Resource Amount.¹¹ This means that about £10.0 billion (excluding principal formula Police Grant) was needed for equalisation for 2006-07.¹²

A.28 While conceptually similar, this is not the same as the amount of grant needed to ensure that all authorities receive a positive grant for 2006-07, which is estimated to be £15.8 billion excluding police grant. The difference between the two calculations is set out in Chart A4.

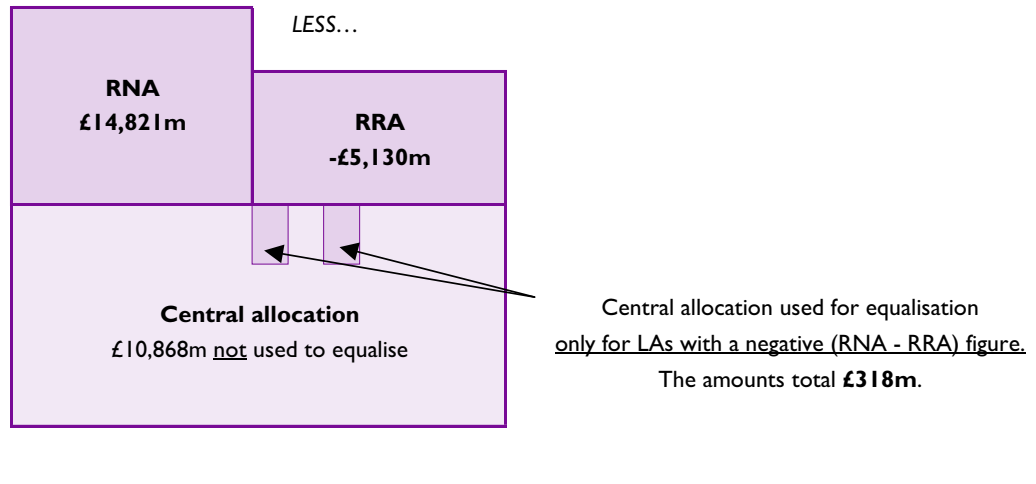
¹⁰ The assumption regarding second homes is made to ensure that the additional council tax yield resulting from a reduction in the discount is not clawed back by central government.

¹¹ That is, there is not enough money in the system for Relative Needs Amount minus Relative Resource Amount to be greater than or equal to zero for all local authorities.

¹² This leaves an amount of some £10.9 billion as the benchmark for local assignment. This is made up from Formula Grant minus police grant minus amount for equalisation

Chart A4: Amounts of grant needed for equalisation and implications of seeking to ensure that no local authority receives a negative grant

Amount needed to equalise = £10,009m (excluding police grant)



EXPENDITURE AND COUNCIL TAX BENCHMARK FIGURES

A.29 The four-block model does not involve the use or production of any explicit expenditure and council tax benchmark figures in the way that the previous system used FSS and levels of, and increases in, ANCT. Indeed, as explained above, one of the main reasons for moving away from the previous system was to avoid the misinterpretation of FSS and ANCT. There is therefore no benchmark within the current system to enable assessment of whether a local authority is spending above or below an expected level.

A.30 Furthermore, there are no measures of expenditure or council tax which can be used generically as benchmarks. While some measures might be used in some contexts – such as actual average council tax levels and budgets, retrospectively, once budgets and council taxes have been set – no measure can be regarded as a pure measure of need.¹³ Ways can, however, be found to summarise local authority financial decisions and activities when explicit measures of need are not required, such as in assessing the effects of policy options modelled by the Inquiry team.

¹³ For example, an individual authority's budget requirement and band D council tax are both clearly affected by its own policy decisions and level of efficiency. However, whilst moving to a class average council tax and the corresponding budget requirement (effectively Formula Grant plus council tax requirement if the authority set its Band D council tax at its class average) might be seen positively, as diluting the effects of policy decisions and varying efficiency levels, it might also be seen negatively as moving away from a locally-based response to needs.