

The Fair Funding Review: accounting for resources

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The views presented in this briefing note are those of the authors alone. Any errors or omissions are also their responsibility.

Executive Summary

English local government finance 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 boost local revenue-raising capacity. However, that does not mean that redistribution will cease to play any role in the local government finance system: abolishing it completely would see 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 devise a new system for allocating funding between councils, which would be based on updated and improved methods for estimating councils' differing abilities to raise revenues themselves and their differing spending needs. The government has stated it wants the new system to be simpler and more transparent – but robust and evidence-based.

The outcome of this review has the potential to have profound effects on the capacity of local government across the country to provide services. There is no single correct answer to the question “how should resources be allocated between councils?”

In this report we 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 to the government to vary the extent to which it prioritises redistribution and financial incentives. We also analyse how differences in revenue-raising capacity can be measured, and the pros and cons of different options. A companion paper looks at the assessment of spending needs.

The overall system: redistribution, incentives and transparency

England started the 21st century with a local government finance system aimed at fully equalising differences between councils' revenue-raising capacity and their spending needs. But there have been many changes since then. Sometimes, as estimates of these factors changed, councils saw big changes in funding, so a system to “damp” year-to-year budget changes was brought in in 2002–03. 2006–07 saw a more radical set of reforms aimed at giving the government more discretion over how much to redistribute between councils – but via an opaque system that was almost impossible to understand. Further reforms mean spending needs assessments have not been updated for five years. And cuts in the grant funding the government gives to councils have been based on actual tax revenues in 2015-16, rather than an assessment of taxable capacity. **This has left the system in need of change – one cannot have a system where funding in many years time simply depends on grants and council tax revenues in the mid 2010s.**

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 would 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 the 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.

How should council tax revenue-raising capacity be measured?

Just over half of councils’ core spending in England is paid for from Council Tax. But for individual councils this proportion varies from just under a quarter (in Westminster) to just over three quarters (Buckinghamshire). The differences reflect differences in council tax revenues, of course. But they also reflect 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.

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 (using the complex and opaque Four Block Model). 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 local authorities 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 a 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. The choice matters: a third of councils see funding differences of 5% or more under systems of tax revenue or 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.

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 formulas 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.

1. Introduction

Recent years have seen big changes to the way English local government is funded. Perhaps most significantly, the introduction of the business rates retention scheme (BRRS) in 2013–14 means that councils now see their funding rise or fall as local business rates revenues rise or fall in real terms; previously, these gains or losses accrued to central government. At the same time, spending needs assessments used to allocate funding between councils, which were previously conducted each year, stopped being updated.

The aim of these changes was to provide councils with stronger incentives to boost local revenues and take efforts to tackle spending needs. Of course, they also increased councils' exposure to financial risks associated with short-term volatility and longer-term divergences in local tax revenues and spending needs. To avoid such divergences growing too big, the government plans to continue updating the redistributive funding flows between councils – just on a periodic rather than annual basis.¹

It is in this context that the government announced the so-called 'Fair Funding Review' to update the way councils' differing relative spending needs and abilities to raise revenues themselves – through local taxes such as council tax and through sales, fees and charges – are measured and taken account of in the funding system. The aim is for the new system to be in place for 2020–21.

Assessing councils' spending needs and revenue-raising capacity is difficult as neither can be measured directly – they need to be inferred from something we can measure, such as actual spending, tax revenues or tax bases, and local socio-economic or geographic characteristics.

The companion paper to this briefing note² looks at the issues involved in assessing councils' spending needs and examines how sensitive needs estimates for different councils could be to methodological choices.

This briefing note begins by looking at some of the key issues for the revenues side of the review. Section 2 focuses on council tax, while Section 3 focuses on income from sales, fees and charges. Revenue from both these sources can vary because of differences in underlying capacities to generate revenues – for example, due to differences in the number and council tax bands of local properties – and because of the different choices made by councils – for instance, the level of council tax to charge. We discuss the pros and cons of taking account of differences in revenues due to both these factors – including the effects on councils' incentives for raising revenues – and how big an impact decisions could have on the distribution of funding across the country.

¹ It also plans to retain so-called 'safety net' payments to compensate councils seeing large short-term shortfalls in their business rates revenues. See Department for Communities and Local Government, '100% business rates retention: further consultation on the design of the reformed system', 2017, <https://www.gov.uk/government/consultations/100-business-rates-retention-further-consultation-on-the-design-of-the-reformed-system>.

² T. Harris and D. Phillips, 'The Fair Funding Review: is a fair assessment of councils' spending needs feasible?', IFS Report 148, 2018, <https://www.ifs.org.uk/publications/13275>.

Once one has an estimate of spending needs and of councils' own ability to raise revenues, decisions need to be taken on how these are used together to determine the funding each council receives. There can be trade-offs between transparency and flexibility and between incentives (to boost revenues and tackle spending needs) and redistribution (in order to allow councils to fund comparable services irrespective of their ability to provide for their own needs). This is the focus of Section 4, which begins by assessing past approaches to taking account of estimated spending needs and revenue-raising capacity, before moving on to discuss options for the future. Section 5 concludes.

2. Council tax – tax base or revenues?

The biggest source of locally raised revenues for councils is – and will continue to be – council tax. In 2016–17, council tax revenues in England amounted to £23.2 billion, or 53% of councils’ (and fire authorities’) estimated ‘core spending power’.³ However, the proportion varied significantly – from a low of 24% in Westminster to a high of 77% in Buckinghamshire. In part, this will reflect differences in how much councils were historically assessed to need to spend – which will have affected the grant and other funding councils received in that year – but it will also reflect differences in their council tax revenues, whether due to differences in the strength of their council tax bases or the council tax rates they set. If no account was taken of these differences, there would have been very big differences in councils’ ability to provide services to their residents.

In this section, we first discuss how council tax has historically been taken account of by the funding system, before discussing the implications of different approaches – both in terms of the incentives created and in terms of what they may imply for service quality across the country. We then look empirically at how council tax revenues, bases and rates vary between councils – which allows us to examine how different options could affect the distribution of funding across the country.

How has council tax been accounted for historically?

Historically, councils’ differing ability to raise revenues via council tax has been measured in two broad ways:

- **Differences in tax bases.** As shown later in this section, a large part of the variation in council tax revenues across councils reflects differences in the underlying tax base: that is, the number of homes in an area, the council tax bands those homes are in, and the proportion subject to exemptions or reduced rates (such as for households with only students or with one adult or with a low income).

Between 1993–94, when council tax was introduced, and 2013–14, the local government finance system took account of the amount of council tax councils could raise if each set its tax rate equal to some assumed standard rate. This varied only because of variations in tax bases – not tax rates, which councils had choice over.

As discussed more in Section 4, the funding systems in place up until 2005–06 were designed to fully compensate for variation in this ‘notional’ council tax revenue, while the system in place between 2006–07 and 2013–14 was designed to allow government ministers choice over how much equalisation to undertake (and in practice could imply quite different equalisation for different councils).

³ The revenue figure excludes council tax paid to police and crime commissioners and to parish councils, which provide services outside the scope of the Fair Funding Review. Source: Ministry of Housing, Communities and Local Government, ‘Final local government finance settlement 2018 to 2019: core spending power, supporting information’, 2018, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/679611/Core_Spending_Power_Supporting_Information.xlsx.

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- **Differences in tax revenues.** From 2016–17 onwards, the finance system has taken account of the actual amount of council tax raised by each council in 2015–16.⁴ This reflects variations both in the tax bases and in the tax rates set by each council.

This means that the current funding system does not account for any changes in council tax bases or rates since 2015–16. It also means that as well as compensating councils with small tax bases as of 2015–16, the system now compensates councils that had a low tax rate as of 2015–16.

What are the implications of different approaches?

Whether the local government finance system accounts for variation in tax bases or tax revenues can have a big impact on the nature of redistribution between councils, the financial incentives councils face and the information required to operate the system.

Equalisation and fairness

Of the two options, equalisation based on variation in tax revenues more closely aligns the distribution of spending power with assessed relative spending needs, since any differences in council revenues can be equalised away by grants or transfers between councils if the government so chooses.

However, council tax revenues are partly a choice, with differences between councils reflecting variation in the tax rates, not just variation in the underlying capacity to generate tax revenues. For example, a council with a tax base that was smaller than average could end up with above-average council tax revenues if it set its council tax rate high enough. It might choose to do this if there were a local preference for a higher standard or broader range of council services, or if actual relative spending needs were greater than assessed relative spending needs and additional revenues were required even to provide a typical standard of services. Irrespective of the reason for the high tax rate chosen, tax revenue equalisation would offset these efforts through lower grants or net transfers. This could be seen as ‘penalising’ the council for setting a higher tax rate to support local service provision. Local people would be paying higher tax rates and at least some (and perhaps all) of the resulting revenues would be being taken off them. Conversely a council setting a lower tax rate would be ‘rewarded’ by higher grants or net transfers. Equalising on the basis of council tax bases, on the other hand, would not offset differences in the ‘tax effort’ (i.e. tax rates) of different councils – only differences in their underlying tax-raising capacities – avoiding these issues.⁵

In practice, it is worth noting that councils’ ability to choose their council tax rate has been restricted to a greater or lesser extent for many years. Historically, the government has, at times, used capping powers to prevent councils increasing their council tax and budgets by more than a certain percentage. And since 2012–13, councils

⁴ In 2014–15 and 2015–16, reductions in grant funding did not take account of council tax. See Section 4 for further details.

⁵ Given that the property valuations on which council tax is currently based are from 1991 – since when there have been big changes in the relative value of homes in different parts of the country – one could argue that differences in current council tax bases may not accurately reflect differences in what could be raised in different council areas from a better-functioning council tax system. Future work by researchers at IFS will examine this issue.

have had to hold a referendum if they wish to increase council tax by more than a set percentage, with strict rules on the type of information councils can publish justifying a proposal for a bigger increase. In neither case has the existing level of council tax been taken account of: the same percentage limits have applied to those with low council tax rates and to those with high rates.

One could therefore argue that councils have only limited control over their council tax rate in the short term: high or low rates are largely the legacy of past decisions that cannot simply be overturned. Such a line of reasoning could provide a justification for equalisation based on tax revenues as opposed to tax bases. It would avoid 'penalising' councils that were to some extent 'locked in' to their lower tax rates.

But, unlike under capping – when central government forbade large council tax increases – since 2012–13, increases of any size are possible if local residents vote for them in a referendum. If a council with a low tax rate chooses not to put an increase to a referendum, or residents reject an increase, should residents of other councils with higher tax rates be expected to effectively subsidise them via higher grants and transfers (which is what a system of revenue equalisation would imply)?

Moreover, concerns about large overnight changes in funding to councils with low or high tax rates under a system of tax base equalisation could be addressed via the transitional arrangements that will be required to smooth transition to the new finance system when it is introduced.

It is worth noting that the level of equalisation provided by a system using notional tax revenues, i.e. equalising based on variation in tax bases, could be varied according to where the notional tax rate was set. If it was set at the national average rate, this would represent full equalisation of taxbases. However, it could be set above or below this, which would imply more than or less than full equalisation of taxbases, respectively.

Because the distribution of council tax rates (see Figure 3 below) is skewed such that there are few councils with tax rates significantly higher than the average but some councils with tax rates well below the average, setting a notional tax rate below the average would also protect those councils with particularly low rates from large losses relative to revenue equalisation.

Box 1 discusses how two further issues – the fact that a large fraction of council expenditure is likely to be spent on a small fraction of the local population; and that differences in council tax rates are likely to be reflected in house prices and rents – relate to the 'fairness' of tax base or tax revenue equalisation. It concludes that these issues, while worth bearing in mind, cannot offset the other drawbacks of tax revenue equalisation.

Overall then, equalising on the basis of tax bases rather than tax revenues would seem 'fairer'

Box 1. The concentrated benefits of local government spending and the capitalisation of council tax bills – caveats to the fairness case for tax base equalisation?

Many costly services provided by councils directly benefit only a small proportion of the population. For example, less than 1% of working age adults and 6% of adults aged over 65 were in receipt of long-term social care services in 2016–17.⁶ This means that the benefits (costs) of higher (lower) levels of spending are likely to be particularly concentrated on a small subset of local residents – those with a need for these costly services. In contrast the cost (benefit) of the higher (lower) council tax rates required to pay for such higher (lower) spending will be spread across the population.

If one is particularly concerned about the subset of people needing costly services – who are often relatively deprived and vulnerable –, that could provide a rationale for taking account of actual tax revenues rather than tax bases when equalising between councils. This is because this group has to bear most of the cost (in terms of worse services) if the council has a low council tax rate and equalisation is on the basis of tax bases. Moreover this subset of people may find its votes in a council tax referendum swamped by the larger group of council taxpayers who do not benefit much from council spending.

Tax revenue equalisation, on the other hand, would provide a council setting a low tax rate with additional funding to offset (at least in part) its low council tax revenues. That would ensure those reliant on council services do not suffer (or suffer as much) from their neighbours' unwillingness to pay higher council tax rates.

However, there are probably better ways to ensure services for vulnerable residents at least meet some agreed minimum standards than providing additional funding to councils setting low tax rates – which is undesirable in many other ways. For example, councils have a set of statutory services that they must provide, and there are quality checks for key services like social services, to ensure councils are meeting their statutory duties. These checks and duties could be tightened up if it were felt that they were not strict enough to ensure compliance with minimum service standards. Those councils where funding availability was preventing them from meeting minimum service standards would have to raise revenues. This could be facilitated by easing council tax referendum requirements in such circumstances.

Another issue that could seem to provide a rationale for tax base equalisation is the fact that variations in council tax rates and service quality are likely to be capitalised into house prices.⁷ All else equal, house prices are likely to be higher where council tax rates are lower, and lower where rates are higher. And, house prices are likely to be higher where council services are better, and lower where services are worse.

⁶ NHS Digital, *Adult Social Care Activity and Finance Report: Detailed Analysis – England 2016–17*, 2018, <https://digital.nhs.uk/data-and-information/publications/statistical/adult-social-care-activity-and-finance-report/adult-social-care-activity-and-finance-report-england-2016-17>.

⁷ A. Høj, M. Jørgensen and P. Schou, *Land Tax Changes and Full Capitalization*, Fiscal Studies, forthcoming.

A return to equalising funding on the basis of council tax bases (as opposed to council tax rates) could therefore see the house prices of areas with low tax rates – who would have to cut spending or increase tax rates – fall. That would mean a large part of the cost would be borne by whoever happened to own property in such councils the time a shift back to tax base equalisation was announced. That could be seen as unfair.

However, such arguments could be used against many changes to tax and spending. For instance, a council tax revaluation could see the prices of properties moving up bands fall, and properties moving down bands rise. Changes in council spending needs formulas – discussed in our companion paper – could affect the prices of properties in councils seeing more or less funding as a result. Changes to the relative amount of tax and spending faced by different areas or groups of people will always create winners and losers. Politically this makes such reforms challenging. But it does not mean those reforms are a bad idea in principle.

Incentive effects of different options

By increasing (reducing) the grants or net transfers councils receive when they set lower (higher) tax rates, revenue equalisation provides a financial incentive to councils to reduce their tax rates. This could undermine the viability of council tax as a source of funding for local public services. Equalisation based on tax bases does not have such an effect: councils see their income fall (rise) in full if they set lower (higher) tax rates.

It is equalisation arrangements going forwards that matter for incentives though. Incentives to reduce council tax rates could be avoided if, after an initial equalisation based on tax revenues, subsequent updates took no account of further changes in individual councils' tax rates – only their tax bases. To work, the initial equalisation would have to use revenue figures from before the new system was announced – otherwise councils could still respond to the announcement by cutting their council tax rates, affecting the initial equalisation. And there would still be the question of whether it was fair to reward (penalise) councils for historically setting low (high) council tax rates – even if they were not incentivised to reduce tax rates going forwards.

Both equalisation on the basis of revenues or tax bases reduce the financial incentive councils have to grow their tax bases. This is because changes in grant or transfer funding would at least partially offset the additional revenues that would be generated from a larger tax base – for example, from an additional property, or a household no longer entitled to an exemption or reduction in its tax bill. Weaker incentives could mean, for example, that councils would work less hard to get people into work (or higher paid jobs) so that they no longer needed local council tax support, which would result in an increase in tax base. Councils might also put less effort into encouraging property development in their areas (e.g. by streamlining planning processes).

Revenue equalisation affects such incentives in the same way for councils setting high or low tax rates. But tax base equalisation can mean the scale of distortion to incentives varies depending on whether a council has a 'high' or a 'low' tax rate.

Consider a system where differences in tax bases are entirely equalised away and a scenario where a council's tax base increases by the equivalent of one property. If the council had a 'high' tax rate, the extra revenue from that bigger tax base would exceed the reduction in grant/transfer funding based on the 'standard' tax rate used in tax base equalisation. That means the council would still see at least some increase in its overall revenues, meaning some (albeit a much reduced) incentive to boost the tax base. In contrast, if the council in question had a 'low' tax rate, the extra revenue from the bigger tax base would be smaller than the reduction in grant/transfer funding. That means the council would actually see a reduction in its overall revenues, thereby providing an incentive to the council to *reduce* its tax base. This somewhat perverse incentive would be stronger the lower a council's tax rate relative to the standard (or 'notional') rate used for calculating revenue-raising potential under tax base equalisation.

Practical issues in implementing different approaches

In order to implement any equalisation regime, one needs to be able to measure (or at least estimate) the variable that forms the basis of the equalisation.

Measuring council tax revenues is relatively straightforward. Councils must forecast their council tax revenues (the so-called 'council tax requirement') before the start of each financial year, and subsequently record revenue out-turns once a financial year is over. This information could be used for revenue equalisation.

Measuring council tax bases in a consistent way is a little more complex. Councils must also provide information on their council tax bases to the government. This records the number of properties by council tax band – the main driver of local tax bases – as well as changes in tax bases both due to mandatory policies that grant exemptions or reductions to certain households (e.g. those consisting solely of students or with only one adult present) and due to discretionary policies that mean higher or lower payments are required on certain properties (e.g. empty or holiday homes).

The rationale for tax base equalisation is to avoid offsetting revenue differences due to councils' own discretionary tax policy decisions through changes in grant/transfer funding, but still offset differences due to other factors. That means one would want to fully account for differences in tax bases that are a result of mandatory policies, but not for differences in tax bases that are a result of discretionary policies. Instead, as well as using a 'standard' tax rate for calculating revenue-raising capacity, one would want to use 'standard' versions of these discretionary policies.

For many such policies, that should be fairly straightforward: a 'standard' policy can be relatively easily defined (e.g. charging the same council tax on empty and holiday homes as other homes) and discretionary policies vary in relatively simple ways (e.g. charging 0.75 or 1.5 times the usual council tax on empty and holiday homes).

Adjusting council tax bases for variation in policies to help low-income working-age households with their council tax bills is a particular challenge. This was not an issue the last time equalisation was based on council tax bases (as opposed to revenues): local councils have only set policies on 'council tax support' since 2013–14, with a national scheme designed, managed and funded by central government in place until then. Now, though, there is a great diversity of schemes, with different maximum tax reductions and means-testing rules and other eligibility criteria. And stripping out the effect of this

variation would require data on the incomes and other characteristics of all low-income residents of all council areas, as well as full detail on each council's specific scheme.

These data and information are not currently available to the government and collecting it would be costly. But using estimates of tax bases based on councils' actual schemes rather than a 'standard' scheme would provide councils with an incentive to make their schemes more generous – at least part of the cost would be met by additional grant/transfer funding.

These issues mean that deciding what to do about council tax support for poorer households is perhaps the most technically challenging task on the 'revenues' side of the Fair Funding Review; it is an issue we will look at in a follow-up publication.

How big an impact could different approaches have on funding for different councils?

In addition to understanding the implications of different equalisation approaches on a conceptual level, it is also worth examining how big a difference to funding levels the choice of equalisation could mean for different councils. To do this, we need to know how much council tax revenues, council tax bases and council tax rates vary between councils, and how they correlate with each other and local area characteristics.

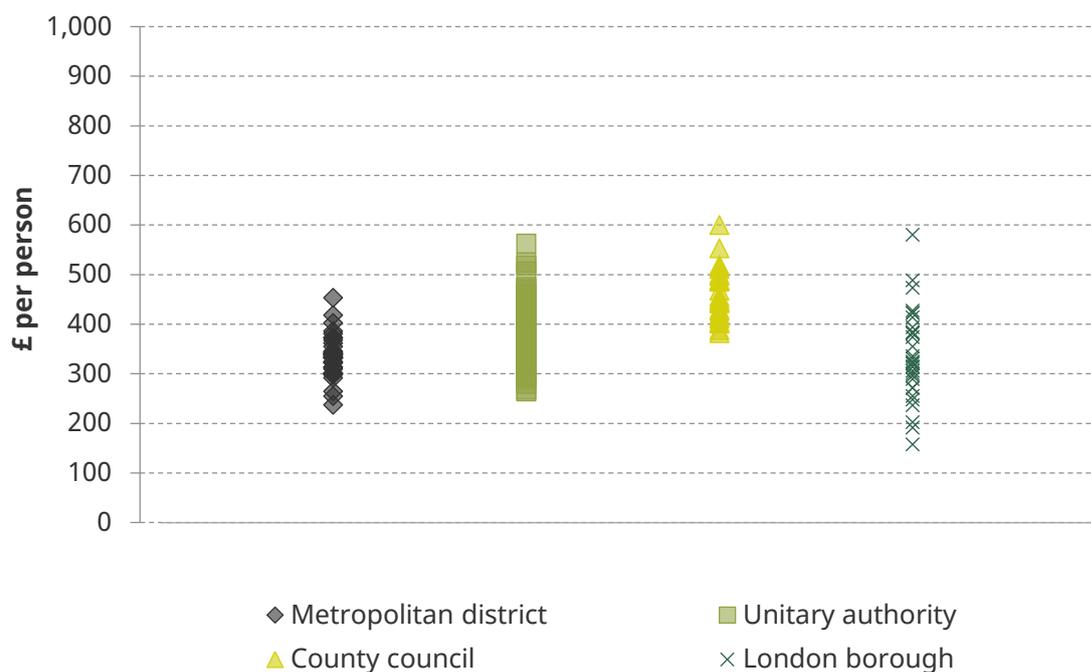
Variation in council tax revenues, bases and rates

Figure 1 shows how council tax revenue per person varied across upper-tier council areas in 2016–17, by type of council.⁸ **Average 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) than in the area with the lowest revenue (£158 in Wandsworth).** Council tax revenues were less than around £290 per person in one in ten upper-tier council areas and more than around £486 per person in another one in ten areas. Given that, on average, councils derived 53% of their core spending power from council tax, such variation would imply large divergences across areas in their levels of funding per person – and hence potentially large variations in service provision – in the absence of equalisation.

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 (£325) and in London boroughs (£330) – which had the greatest variation in council tax revenues across councils. There was also significant variation in council tax revenues per person in unitary authorities (UAs) – with low figures in more deprived northern UAs and high figures in more affluent southern UAs – where the average was £388, a little lower than the average for areas covered by county councils (£457).

⁸ We use upper-tier council areas so that we can make comparisons between areas with single-tier and two-tier local government.

Figure 1. Council tax revenues per person, 2016–17, by council and council type



Notes: Analysis in this paper is performed at the level of upper-tier councils. In two tier areas, we pool revenues between the county and constituent districts. Also, for the purposes of all analysis in this paper we exclude parish precepts from councils' revenues and tax rates. We also exclude council tax levied by the GLA and by police authorities. Some councils provide their own fire services which are part-funded by their council tax. We have chosen to use these councils' actual tax rates in this paper to ensure consistency with the published rates for these councils. This also improves the accuracy of modelling of tax revenue and tax base equalisation later in this section. However, it does make comparisons in tax rates across councils more difficult as some council provide fire services in addition to other services. We have examined patterns of council tax revenues (and rates) stripping out an estimate of the amount for fire services in areas with fire services and all key patterns hold.

Source: Authors' calculations using Chartered Institute of Public Finance and Accountancy (CIPFA), *Finance and general estimates: 2016–17, 2017*, <https://www.cipfa.org/policy-and-guidance/publications/f/finance-and-general-statistics-201718-estimates>.

To examine how much of this variation is due to variation in tax rates and tax bases, we estimate the council tax revenue per person for each upper-tier council area if each council set its tax rate at the average tax rate for England as a whole.⁹ Figure 2 shows that there was a strong relationship between these 'notional' council tax revenues and actual council tax revenues, albeit with some significant outliers.

For councils as a whole, variation in the council tax base explained 44% of the variation in council tax revenues, with each additional £1 of 'notional' revenue per person being associated with an additional 67p of actual revenue per person. In other words, areas with larger tax bases, on average, charged lower tax rates, and raised lower revenues than they would have received if they had charged an average tax rate.

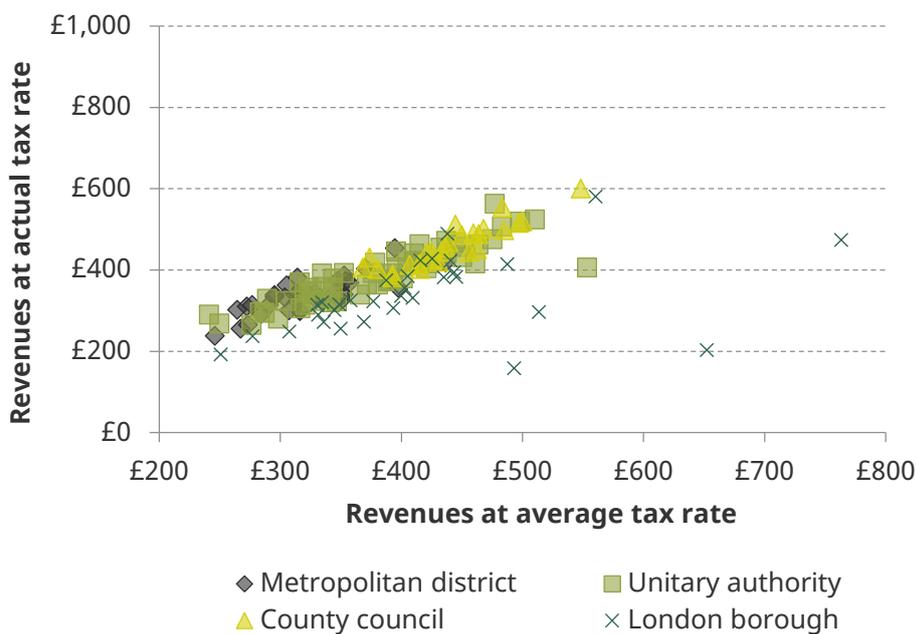
Excluding London – where nearly all the outliers are – from the equation increases the share of variation in revenues that was driven by variation in tax bases to 84%. And

⁹ This is an estimate as data are not available to allow detailed modelling of how changes in councils' tax rates (to the average tax rate) would affect the cost of providing support to low-income households with their tax bills.

outside the capital, each additional £1 of 'notional' revenue per person was associated with an additional 96p of actual revenue per person (which is not statistically significantly different from £1). On the other hand, focusing only on London, each additional £1 of 'notional' revenue per person was associated with just 37p of actual revenue per person.

In other words, outside London, while the relationship between notional tax revenues and actual tax revenues is not perfect – i.e. there is variation in council tax rates – the differences between these are not systematically related to councils' tax bases. But inside London, there is a clear pattern of areas with large tax bases setting low council tax rates and raising less in reality than they notionally could with a more typical tax rate.

Figure 2. Council tax revenues per person at average and actual rates, 2016–17



Source: As Figure 1.

Our previous research has showed that London is also atypical in that the parts of London with the largest tax bases also often have high assessed spending needs (according to the most recent assessment in 2013–14).¹⁰ **Thus, as well as falling as tax bases increase, council tax rates set by councils in London fall as the level of assessed spending need (according to the most recent assessment) increases.** This is illustrated in Figure 3, where the dark green line shows a clear trend of band D rates set by councils being lower in London for councils with the highest levels of assessed spending needs. Similar patterns are not seen for other types of councils.

Several factors could explain the systematic patterns found within London:

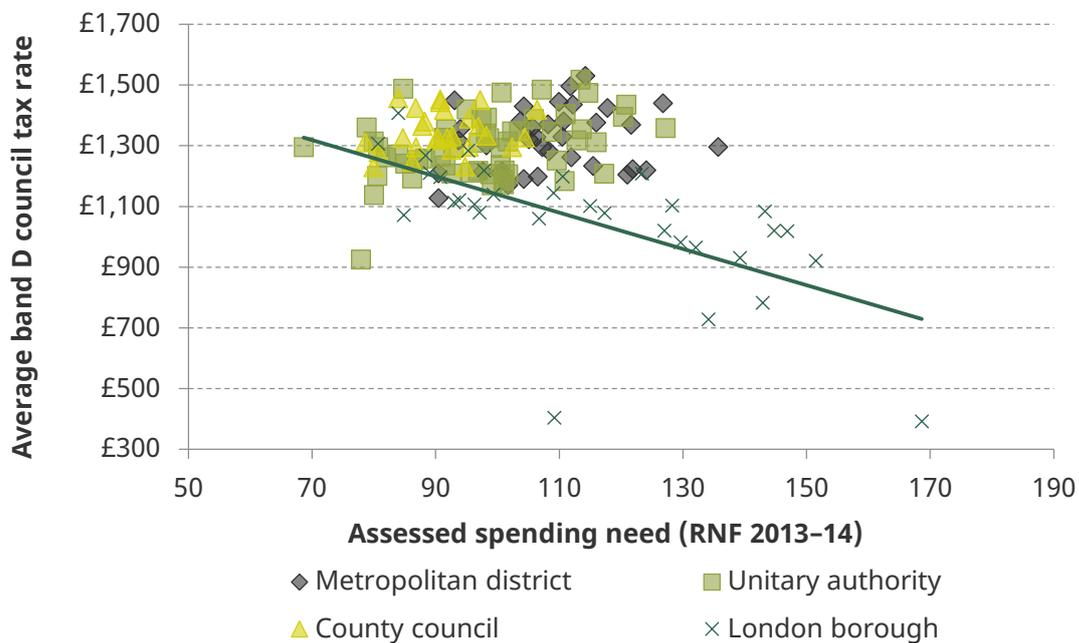
- local residents (or at least the politicians who represent them on the council) in councils with high assessed needs could have a preference for lower taxes and lower levels of service provision than residents (or politicians) elsewhere in London;

¹⁰ See N. Amin-Smith, D. Phillips and P. Simpson, *Spending Needs, Tax Revenue Capacity and the Business Rates Retention Scheme*, IFS Report R141, 2018, <https://www.ifs.org.uk/publications/10542>.

- councils serving such areas may be more efficient at delivering services, allowing them to spend and tax less;
- their actual relative spending needs may be lower than their assessed spending needs, meaning that they receive more funding from grants and the BRRS than they should, allowing them to tax less.

More generally, London had the lowest average band D rate (£1,031). This compares with £1,298 for metropolitan districts, £1,297 for unitary authorities and £1,343 for areas covered by county councils. The same types of reasons could lie behind this cross-England pattern.

Figure 3. Assessed spending needs (2013-14) and band D council tax rates (2016-17)



Note: The dark green line is the trend line for London boroughs.

Source: Authors' calculations using CIPFA (2017) as Figure 2.1, and Department for Communities and Local Government (DCLG), *Calculation of 2013-14 Formula Funding*, 2013, <http://www.local.communities.gov.uk/finance/1314/CalcFFs.pdf>.

Illustrating what difference tax base or tax revenue equalisation could make for different councils

To illustrate the impact that significant variation and – in the case of London – systematic differences in council tax rates could have for the funding different councils would receive under tax base or tax revenue equalisation, we simulate the following scenario using the IFS local government finance model:

- Councils' assessed relative spending needs are set equal to those from the latest official needs assessment in 2013-14.
- All funding for councils' core services comes from retained business rates and council tax revenues.

- Councils retain 75% of business rates revenues, with a system of ‘tariffs’ and ‘top-ups’ continuing to redistribute between areas with high revenues / low needs to those with low revenues / high needs. Business rates revenues are measured as of 2016–17.¹¹
- Tariffs and top-ups are set so that business rates revenues plus either council tax revenues (tax revenue equalisation) or notional council tax revenues (tax base equalisation) are equal to assessed spending needs. Council tax revenues are measured as of 2016–17.

Of course, in reality, an updated needs assessment will be carried out (which will take into account new responsibilities such as public health being rolled into councils’ general funding); grant funding for core services may not be fully abolished; the system may not equalise away 100% of the differences between assessed spending needs and the chosen measure of revenue-raising capacity; and the new system is likely to be phased in using ‘transitional arrangements’. So our modelling cannot say *exactly* what impact choosing tax revenue or tax base equalisation will have on different councils’ funding in future. Instead, our aim is to illustrate the potential scale and pattern of the impacts *in the long run* (after any transitional arrangements have expired).

Figure 4 shows how much funding each council would get under tax revenue equalisation as a ratio of the funding it would receive under tax base equalisation. A value of 100% (indicated by the red line) means that funding allocations would be the same under both approaches, while a value X% more (lower) than 100% indicates that funding would be X% higher (lower) under tax revenue equalisation than under tax base equalisation. For example a value of 105% indicates that funding would be 5% higher under tax revenue equalisation than tax base equalisation.

The figure shows that for some areas, the choice of equalisation arrangement could have a profound impact on funding levels. For example, the London boroughs of Wandsworth and Westminster – which have the lowest rates of council tax in the country – would receive 84% and 69% more funding, respectively, under tax revenue equalisation than under tax base equalisation. Another three councils would receive at least 25% more under tax revenue equalisation. On the other hand, Rutland and councils in Dorset (a two-tier area) would receive 13% and 10% less, respectively, under tax revenue equalisation.

More generally, almost one in three councils would see funding either at least 5% more or 5% less under tax revenue equalisation than under tax base equalisation; conversely, just over two-thirds would see an impact equivalent to less than 5%.

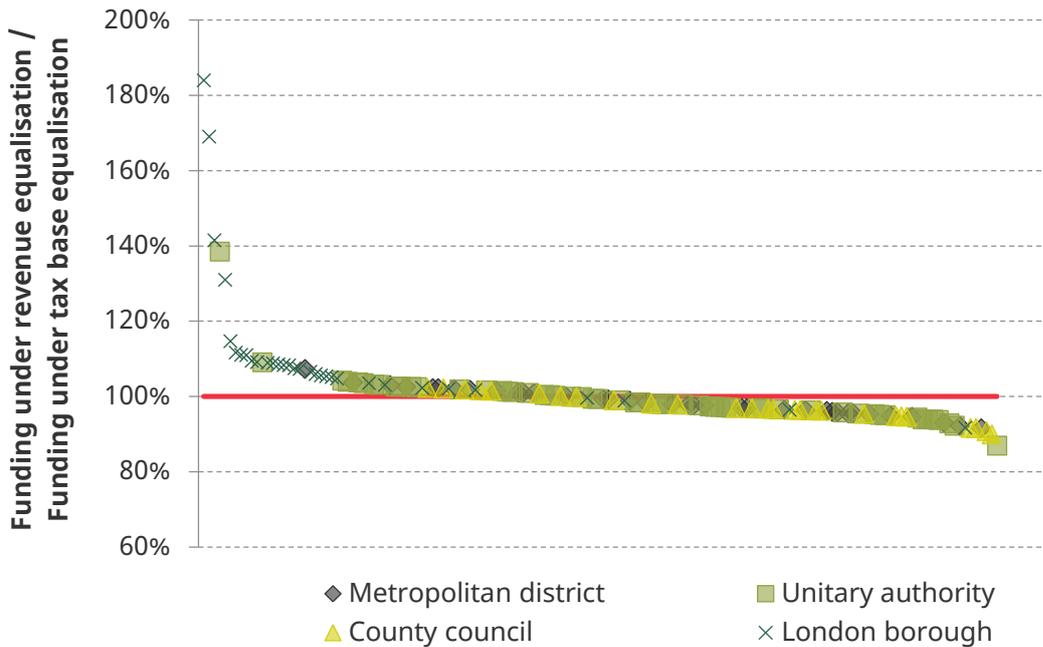
The systematic differences in council tax rates discussed earlier mean that there are also systematic differences in impacts across types of councils:

- 28 out of 32 London boroughs (and all 12 inner London boroughs) would receive more funding under tax revenue as opposed to tax base equalisation;

¹¹ As we do not include the GLA council tax precept in our calculations, we similarly reduce the business rates revenues raised in London councils by 36% for the purposes of this calculation. This reflects the tier share allocated to the GLA under the London business rates retention pilot.

- in 20 out of 27 two-tier shire county areas, councils would receive less funding under tax revenue as opposed to tax base equalisation;
- the majority of unitary authorities (34 out of 55) would receive less under revenue equalisation, while fewer numbers of metropolitan districts would receive more (12) than would receive less (24) under revenue equalisation.

Figure 4. Illustrative scenario for funding under tax revenue equalisation relative to funding under tax base equalisation (%), using 2016–17 tax revenue data



Source: As Figure 3.

Figure 5 and 6 show the gains/losses councils would see under (full) tax revenue equalisation compared to (full) tax base equalisation, by councils' levels of deprivation and assessed spending needs per person, respectively. **There appears to be little systematic pattern across either the distribution of deprivation or assessed spending needs per person for councils outside London.** In other words, outside London, while there would be winners or losers from tax revenue equalisation (as opposed to tax base equalisation), there would not be systematic patterns of gains or losses for more (or less) deprived or needy councils. This reflects the lack of relationship between council tax rates and assessed spending needs outside of London illustrated in Figure 3.

However, within London, a trend for councils with higher assessed spending needs to do relatively better under tax revenue equalisation is evident (this is illustrated by the dark green trend line in Figure 6). This again reflect a pattern illustrated in Figure 3: London boroughs with high assessed spending needs per person tend to set low council tax rates (such that they would benefit from a system of revenue equalisation that compensated for the lower revenues that result from this).

Figure 5. Funding under tax revenue equalisation relative to funding under tax base equalisation (%) compared to deprivation

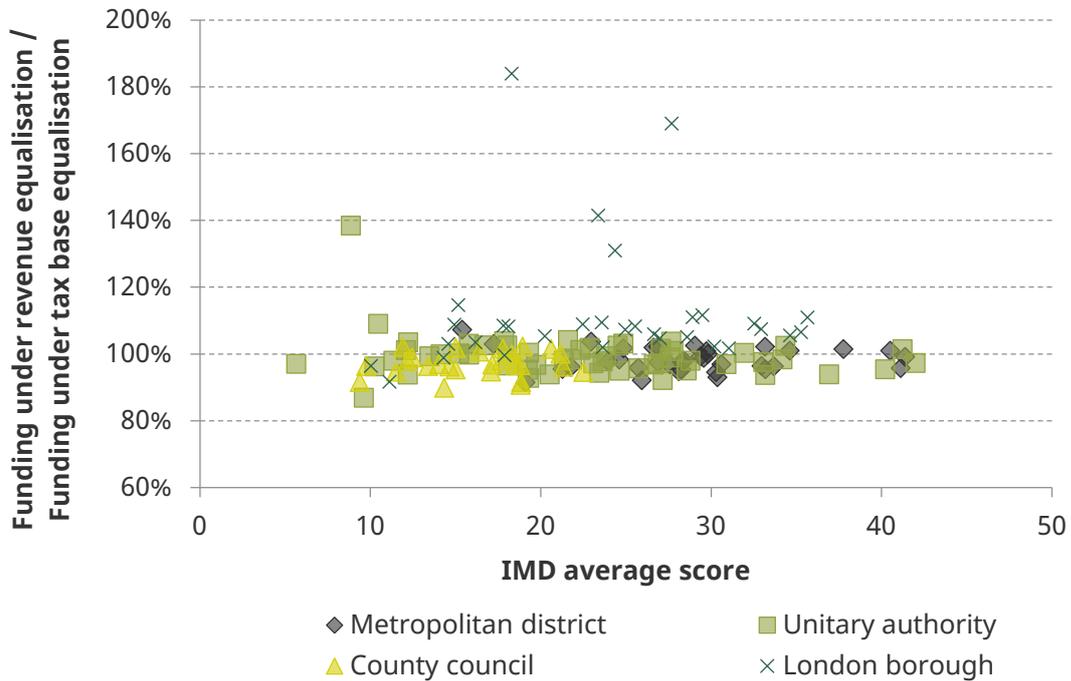
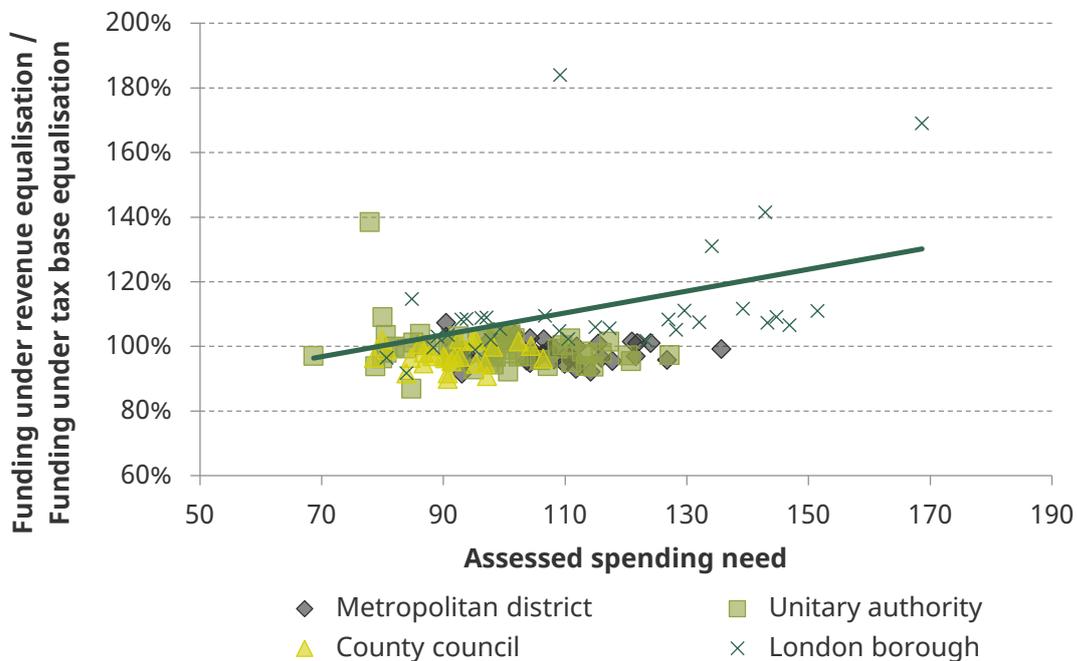


Figure 6. Funding under tax revenue equalisation relative to funding under tax base equalisation (%) compared to assessed spending needs per person



Note: The dark green line is the trend line for London boroughs only

Source: As Figure 3. IMD data from DCLG, *English indices of deprivation 2015*, 2015, <https://www.gov.uk/government/statistics/english-indices-of-deprivation-2015>.

Summary

This section has examined the two main options for taking council tax into account in the local government funding system from empirical, practical and conceptual angles.

Empirically, significant variations in local tax bases and tax revenues mean that without some form of equalisation for council tax, available funding for local services would differ very significantly. Substantial variation in council tax rates also means that whether equalisation is on the basis of tax bases or tax revenues could have a significant impact on a substantial minority of councils. Broadly speaking, London boroughs tend to have lower tax rates and would therefore receive more funding under revenue equalisation, while county areas tend to have higher tax rates and would therefore receive more funding under tax base equalisation.

Practically speaking, tax base equalisation is more challenging than tax revenue equalisation given that for this approach to work in the way intended, adjustments need to be made to reported tax bases to strip out the effect of councils' own tax policy decisions – with local 'council tax support' schemes for low-income working-age households being trickiest to deal with.

Conceptually, one must consider issues related to local accountability and discretion and the financial incentives provided to councils. It is on these bases that there are clear advantages to tax base equalisation compared with tax revenue equalisation.

Tax revenue equalisation provides additional funding via grants or transfers (such as tariffs/top-ups) to councils with low tax bases and/or low tax rates. As such, it weakens the incentive of councils to grow their tax bases, and distorts incentives towards *cutting* tax rates: councils are at least partly compensated for the resulting loss in tax revenues. A council that chose to raise its council tax to fund higher-quality local services would, on the other hand, see at least part of the extra funding siphoned off to pay for council tax elsewhere. Equalisation based on council tax bases will still affect councils' incentives to grow their tax bases – but as councils bear any changes in revenues that result from setting tax rates higher or lower than the notional 'standard' tax rate, their incentives and discretion to raise more or less revenue via council tax are not distorted.

Historically, when central government directly capped council tax increases, it was sometimes not possible for councils and local residents with low council tax rates to increase them substantially. That could provide a rationale for taking account of actual tax revenues as opposed to notional revenues which, in practice, are unattainable due to decisions on council tax rates potentially taken many years ago.

But since 2012–13, council tax referendums give local residents the final say on whether or not council tax can increase by 10%, 20%, even 50%. Of course, people do not like tax rises, and it may be hard for councils to win referendums proposing large tax rises. But is it fair to ask residents of other areas to effectively subsidise the service provision of councils whose residents are not willing to pay the same council tax rates?

3. Sales, fees charges and other income

In addition to their income from council tax and business rates, councils also raise significant sums from sales, fees and charges (SFCs): £9.8 billion in 2016–17 from services other than education (which sits outside the general local government finance system).¹² SFCs income helps fund many service areas, with the biggest sums for adult social care (mostly co-payments for care from adults aged 65 or over) and highways and transport services (including on- and off-street parking). Other examples include fees for planning or licensing applications and charges to use local leisure centres.

As with local tax revenues, there is significant variation between councils in how much they raise from SFCs. To the extent that this reflects differences in councils' capacities to raise income from SFCs (as opposed to different *choices* over what to raise), such variation implies differences in councils' abilities to help fund local services from SFCs. Thus equalisation arrangements for revenue-raising capabilities may want to take into account SFCs income as well as local taxes.

In this section, we start by documenting the variation in SFCs income across councils, before evaluating how this income is currently accounted for in the existing funding system and discussing possible alternative approaches.

Variation in sales, fees and charges

Figure 7 shows that SFCs income varied widely in 2016–17, from less than £100 in Wakefield, Thurrock and Wolverhampton, to around £600 in Kensington & Chelsea and Westminster.¹³ More generally, in one in ten upper-tier council areas, SFCs income amounted to less than £114 per person, while in another one in ten it amounted to more than £290 per person, more than 2.5 times greater. Even if we compare the bottom quarter (less than £133 per person) with the top quarter of councils (more than £209 per person) in terms of SFCs income, the difference is at least 57%. These are bigger proportional differences than for council tax revenues.

The figure also shows that SFCs income per person was highest in London, with 15 of the 20 councils with the highest such incomes being from London. Moreover, 9 of the 12 inner London boroughs were found within this group. On the other hand, SFCs income was generally lower than average in the metropolitan boroughs serving urban areas in the north and West Midlands: they accounted for 9 of the 20 councils with the lowest SFCs income, and there was only one metropolitan district among the 40 councils with SFCs incomes higher than £200 per person.

Variation in SFCs income could reflect a range and combination of factors.

¹² This figure is for general-purpose authorities and excludes single-purpose authorities (such as for police or fire services), combined authorities serving metropolitan areas, and the Greater London Authority.

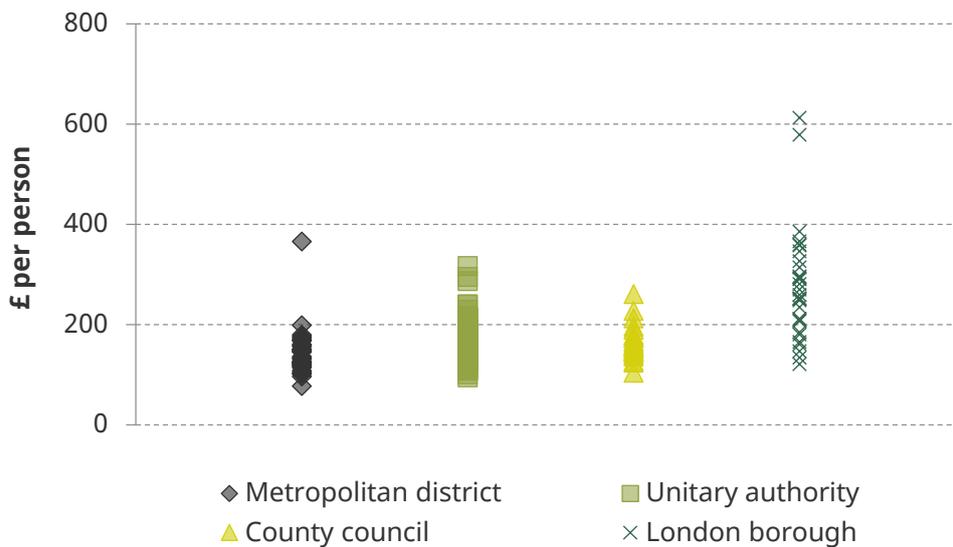
¹³ Southwark reported SFCs income of £2.26 per person in 2016–17, but this appears to be the result of an error in the way income is recorded: reported SFCs fell by over 85% between 2015–16 and 2016–17, while recorded receipts of other income doubled.

First, it could reflect differences in councils' underlying abilities to raise revenues from this source: councils with richer residents may be able to charge more for their leisure centres and events; those with many shops and offices and limited space may be able to charge more for parking; and those with lots of people needing adult social care services may be able to raise more from co-payments.

Second, it could reflect policy decisions from local government based on local political preferences. Some may choose to set higher fees and charges to pay for higher-quality services – plusher leisure centres or a speedier planning system – or enable lower council tax rates. Others may prioritise keeping fees and charges low to help poorer residents access paid-for services, even if that means lower-quality services or higher tax rates.

Third, it could reflect councils having to raise more or less from SFCs to support 'standard'-quality services, if variations in their spending needs and revenue-raising capabilities are not being fully reflected in the existing finance system.

Sales, fees and charges income per person, 2016–17



Note: SFCs income excludes that income related to education, fire, and police services. Southwark is not shown as its reported per person income from SFCs (£2.26) appears erroneously low and out of step with previous years' figures.

Source: Authors' calculations using DCLG, *RSX – Service Expenditure Summary 2016-17, 2017*, <https://www.gov.uk/government/collections/local-authority-revenue-expenditure-and-financing>.

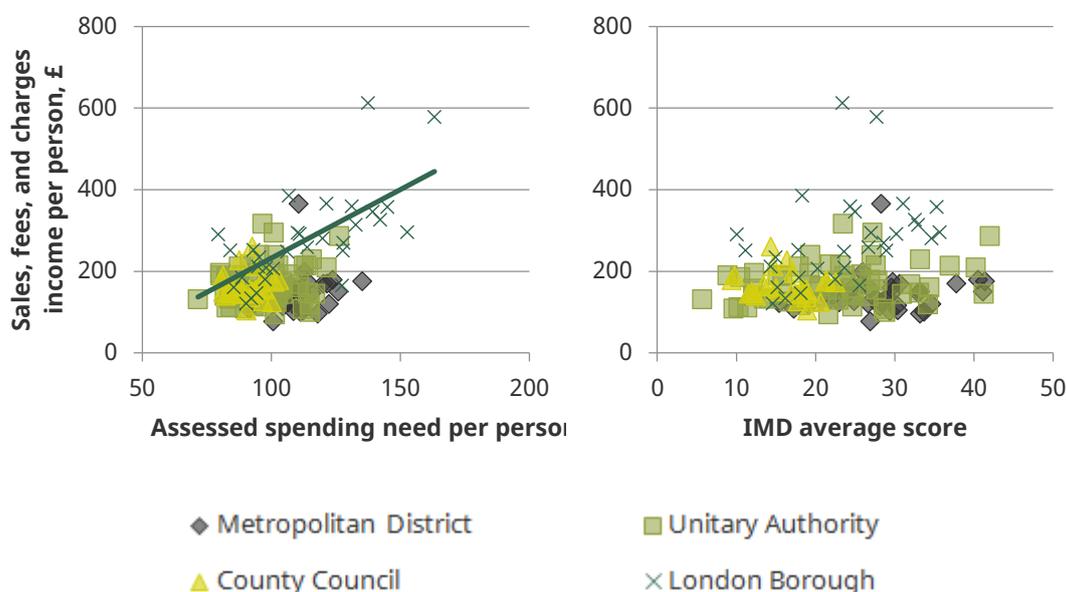
Figure 8 shows how SFCs income per person varies according to the assessed spending needs per person and deprivation levels of councils.

Outside of London there is little relationship between SFCs and either assessed spending needs or deprivation. This suggests there are no systematic relationships

between these council characteristics and capacity, preferences or need to raise SFCs income outside of London.¹⁴

Inside London, however, there is a clear pattern of councils with high assessed spending needs raising more revenues from SFCs. This is the reverse of the pattern seen for council tax rates, where within London, high assessed spending needs are associated with low council tax rates. This is suggestive evidence that the high income raised from SFCs in ‘needy’ parts of London is more likely to reflect high capacity or a strong preference to raise revenues from SFCs, rather than a need to. (If there were a need for additional revenue we would not expect council tax rates to be so low in areas of London with high assessed spending needs).

Figure 7. Sales, fees and charges income per person compared to assessed spending need per person and deprivation, 2016-17



Note: As Figure 7. Furthermore, the dark green line is the trend line for London boroughs only.

Source: Authors’ calculations using DCLG (2017), DCLG (2013), and DCLG (2015).

In any case, equalisation arrangements would want to take account of the first kind of variation – this is akin to variation in tax bases for council tax. They would not want to take account of the second kind though – cutting funding as councils raise more themselves to pay for higher-quality services would penalise and disincentivise such behaviour; conversely, it would subsidise councils that cut their SFCs. The third case is somewhat more complex, and depends on the extent to which the funding system is designed to fully compensate for differences in spending needs and revenue-raising capabilities.

But separating variation in SFCs income into these components is even harder than for council tax, where centrally defined rules mostly determine the tax base. No such specific rules exist for SFCs, meaning equalisation arrangements for SFCs have to rely even more on estimation than for council tax.

¹⁴ Or that if there are systematic patterns in these variables that they offset each other.

How is SFCs income currently taken into account?

Under the current funding system, differences in SFCs income are not accounted for directly. Instead, they are taken account of through the estimates of councils' spending needs, which are for spending *net* of SFCs income.

As discussed more in the companion paper on needs assessment,¹⁵ these estimates are typically based on regressions that examine the relationship between spending on a service area (e.g. social services for the over-65s) and local area characteristics (such as the number of over-65s, their housing tenure and their receipt of benefits) that are assumed to be drivers of spending need. The idea behind using *net* spending in these regressions is that doing so will account for the fact that councils' ability to raise revenues from SFCs may also be correlated with these same spending needs drivers. For example, if councils with more old people living in rented accommodation and claiming means-tested benefits can recover less in co-payments for social care services, their net expenditures would be higher than they otherwise would be (as less SFCs income would be being subtracted from their gross expenditure). The net expenditure regressions would pick up these correlations, and such councils would be assessed to need higher levels of net expenditure.

Such an approach has a clear benefit over using actual SFCs income (and subtracting that from estimates of gross expenditure needs): it avoids the incentive to reduce SFCs that using actual SFCs would create. That is because a council's SFCs income does not directly determine how much it is assumed to be able to generate. That instead is a function of the patterns of SFCs income across all councils, which a single council can generally do little to influence.

However, there are no guarantees that the estimated relationships between net spending and local characteristics are simply picking up differences in councils' gross spending needs and ability to raise revenues from SFCs. Councils' preferences for higher quality services or lower tax rates, and/or historic under- or over-funding relative to needs – could also be correlated with the characteristics included in the regressions. And that means the estimates of spending needs – and implicitly ability to raise revenues from SFCs – could be biased.¹⁶ To the extent that important drivers of spending needs or capacity to raise revenues from SFCs are omitted from the regressions, they could also be very imprecise (even if not systematically biased).

Our paper on spending needs assessment concludes that despite such problems, regression-based approaches are probably the least bad option, especially if one can make use of sub-council level data on expenditure (and implicitly SFCs income).¹⁷ But it is worth considering whether spending needs and SFCs income should continue to be taken account of jointly using regressions of *net* expenditure or whether separate regressions should be estimated?

¹⁵ T. Harris and D. Phillips, 'The Fair Funding Review: is a fair assessment of councils' spending needs feasible?', IFS Briefing Note BN242, 2018, <https://www.ifs.org.uk/publications/13248>.

¹⁶ T. Harris and D. Phillips, *ibid*, discuss this issue in much more detail as it is a key issue for spending needs assessment.

¹⁷ Using sub-council level data allows one to control for council-specific factors other than need (such as preferences) that impact the average level of spending (and SFCs income) for that council, but do not affect

Separate regressions for SFCs income?

One potential benefit of having separate regressions for gross expenditure and SFCs income (instead of a single regression for net expenditure) is that it would allow different characteristics to be included in the different regressions. For example, availability of on-street parking relative to residential and commercial demand for parking may be a key determinant of parking income (councils where demand exceeds supply may be able to and indeed feel the need to charge more for parking). But it may not affect the need for spending on road maintenance or other services. So it might seem to be better to include some measure of supply/demand for parking in a “SFCs income” regression, but not a “spending need” regression.

That might help with transparency. But it would only help with the accuracy of the spending and revenue-generation assessments under certain circumstances. One such circumstance is if we thought that including this measure in the “spending need” regression would cause that regression to be biased, perhaps because it is strongly correlated with local preferences for higher (or lower) levels of spending on the service in question. In that instance, estimating separate equations may allow one to avoid introducing bias into the assessment of spending needs.

In other circumstances though, running separate regressions can either make no difference (e.g. if there are no problematic correlations with non-needs / capacity drivers of spending and SFCs income), or can reduce the accuracy of needs assessment (e.g. if in fact there are problematic correlations with non-needs / capacity drivers for both spending and SFCs income).

So the choice of whether to move towards separate regressions for SFCs income and gross expenditure is complex. Without hard evidence on just what factors are driving variation in SFCs income and gross expenditure (actual needs/capacity or other factors), the choice may simply come down to what is seen as most transparent and least complex.

What about commercial and investment income?

As well as generating SFCs income from public services they provide to local residents and organisations, councils can also generate income from commercial trading and investment activities.

The distinction between income from SFCs and commercial trading relates to whether the services in question are being provided for the purpose of making a profit via a council-owned company, or as part of the council’s role in providing public services. Thus, if a council sets up a company providing car parking on a commercial basis, that is trading income. But if it is provided by the council itself as part of its role in managing local highways and transport, any income received is recorded as SFCs.

As it stands, unlike income from SFCs, income from trading and investment activities is not accounted for in the equalisation regime. The rationale for this seems to be that:

1. **Estimating councils’ ability to raise revenues from commercial and investment activities is even more challenging** that estimating their net expenditure needs (or

their ability to raise revenues from SFCs), especially given councils activities' in this area are changing rapidly.

2. **But using actual income from commercial and investment activities could disincentivise councils from undertaking such activities** – increases in profits would be at least partially offset by reductions in grant / transfer funding.

These are legitimate reasons. To the extent that differences in commercial and investment income reflect differences in how proactive, entrepreneurial, or risk-taking different councils have been, it may be deemed unfair to redistribute these revenues. But differences may also reflect the differing opportunities available to different councils. For example, areas with larger or richer populations may allow for more profitable commercial operations. The profits shire districts could generate may make a bigger difference to their (small) overall budgets than for councils with costly social care responsibilities. Not taking account of income from commercial and investment activities at all means that such differences in revenue generation capacity could allow some councils to subsidise their core services more than others. That could allow lower council tax and/or higher quality services in such areas.

As it stands, with profits from commercial and property investment activities amounting to just £267 million in 2016–17 (less than 3% of SFCs income in that year), and forecast to be £372 million in 2018–19 (likely less than 4% of SFCs income), the impact should not be too great for the sector as a whole (although it may matter for a few councils).

It is worth keeping the treatment of income from commercial and investment activities under review though. Many councils see 'commercialisation' as an opportunity to boost revenues in a tough public spending environment so the importance of these sources could grow. And the differing treatment of SFCs income and trading income could mean that councils have an incentive to reorganise their operations so SFCs income could be classified as trading income instead and therefore not be accounted for in equalisation arrangements. The use of regression-based approaches to account for SFCs income (rather than an individual council's actual SFCs income) helps ameliorate such distortions to incentives. But as groups of councils (e.g. in Greater Manchester or Greater London) cooperate more closely, if they are able to coordinate such reorganisations of income, they may be able to influence SFCs income or net expenditure patterns enough to skew regression-based funding allocations at least a little in their favour.

Summary

Accounting for SFCs income and potentially commercial and investment income is even more tricky than accounting for council tax, as unlike for the latter are no well defined measures of revenue-raising capacity for these sources. Therefore either actual revenues or statistical relationships estimated from those revenues and local characteristics must be used. The former approach would distort incentives, encouraging councils to reduce SFCs, knowing that additional grants or transfers would at least partially offset the loss in income. The latter risks reflecting only a small part of the variation in how much different councils can reasonably be expected to raise from SFCs – that correlated with the characteristics included in the regressions –, and yet still be conflating variation in revenue-raising capacity with other factors (such as local preferences and choices) that

could also be driving patterns of SFCs income across the country. These are the same sorts of issues that plague attempts to estimate councils' spending needs. Even so, regression-based approaches are almost certainly preferable to using actual income from SFCs: they are the 'least bad' option.

4. Bringing resources together with needs: redistribution versus incentives

Whatever way is chosen for measuring the revenue-raising capacity of councils, decisions will also have to be taken on how that capacity assessment fits into the overall local government finance system. That means considering how it will sit alongside the spending needs assessment – which the companion paper discusses in more detail – and the business rates retention scheme. One key issue is the trade-off between redistributing the resources available to councils and providing incentives for councils to tackle spending needs and boost their revenue-raising capacity. Another is ensuring that potentially complex systems remain as transparent as possible – which can be helpful in making sure the system actually achieves what the government says it is trying to achieve.

In this section, we first review how assessments of revenue-raising capacity and spending needs fitted together under past finance systems. We then discuss the options for future finance systems, concluding that a sensible approach could blend elements of past practice in England and practice in other countries.

How have revenue-raising capacity and spending needs assessments been taken into account in the recent past?

The period since 2000 has seen four major changes to the way revenue-raising capacity and spending needs are taken account of in the funding system. With each of the first three changes, the link between councils' assessed revenue-raising capacities and spending needs and their funding allocations was weakened and made less transparent. The fourth change was designed to increase the extent to which revenue-raising capacity was taken into account in funding decisions, but the approach can be considered a stopgap only.

Full redistribution – to a point: the SSA and FSS approaches

Under the standard spending assessment (SSA) approach – used between 1990-91 and 2002-03 – the general grant funding provided to councils was designed to fully compensate for differences in the capacity of councils to raise revenues via council tax. The grant, termed the revenue support grant (RSG), was calculated according to the following formula:

$$\text{RSG} = \text{Assessed spending need} - \text{Council Tax revenue capacity}$$

where, as discussed in Section 2, council tax revenue capacity was assessed at an assumed standard tax rate, and assessed spending needs were expressed in cash figures.

This approach had the benefit of being transparent in how assessed spending needs and revenue-raising capacity were used to determine the amount of RSG received by each council. However, it attracted two main criticisms:¹⁸

- **First, that it did not provide enough certainty to councils year-to-year in terms of grant levels**, impacting their ability to undertake medium-term financial planning. This is because updates to the variables and formulas underlying the needs assessments could sometimes lead to fairly sizeable changes in assessed spending needs, which would translate into even larger percentage changes in RSG amounts.
- **Second, that the cash-terms spending needs assessments could be seen to be centrally determined spending targets that councils should adhere to**. This was not the intention as councils had discretion both over the overall level of spending (by varying their council tax levels) and over its allocation between service areas.

Partly as a result of this, two changes were made. First, from 2002–03 onwards, changes in grant allocations were ‘damped’. This involved setting minimum and maximum percentages by which any council’s RSG could change each year in an effort to provide more stability. However, it also reduced the extent to which the funding system redistributed (and insured) according to (changes in) assessed spending needs and revenue-raising capacity. If, for example, a council was to see consistent large increases (decreases) in its spending need, the ‘damped’ RSG it was allocated would increasingly fall behind (exceed) the amount it was actually deemed to need.

This damping became a core part of the new Formula Spending Share (FSS) approach, in place between 2003–04 and 2005–06. The other change this approach brought was to express assessed spending needs for each service area as a percentage of the national total – emphasising the fact that the spending needs assessment was of relative as opposed to absolute need. However, the RSG amount to provide to each council was then calculated by first converting each council’s overall FSS into an absolute cash-terms spending need, and then subtracting revenue-raising capacity and applying the grant damping rules for that year. Thus the approach remained very similar to the SSA approach in terms of its effects.

Obfuscation to maximise discretion? The Four-Block Model

More substantial changes were made with the introduction of the so-called Four-Block Model in 2006–07.¹⁹ It was called this because it combined four main sets of calculations (or ‘blocks’):

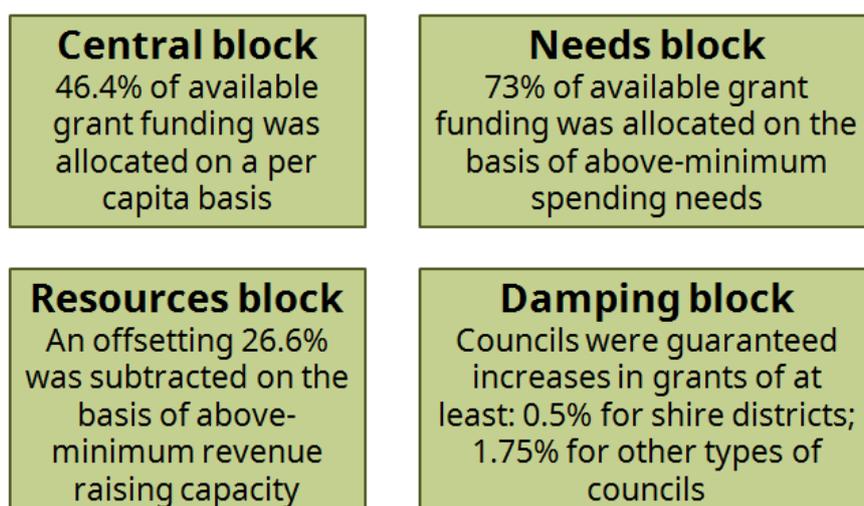
- The central block provided a fixed per-capita amount per service area to each council providing that service.

¹⁸ There were additional criticisms of how the underlying spending needs assessments were carried out. Further detail is provided in the companion paper on needs assessments (T. Harris and D. Phillips, ‘The Fair Funding Review: is a fair assessment of councils’ spending needs feasible?’, IFS Report R148, 2018, <https://www.ifs.org.uk/publications/13275>).

¹⁹ The analysis in this section draws on A. Gibson and S. Asthana, ‘Resource allocation for English local government: a critique of the Four-Block model’, *Journal of the Royal Statistical Society: Series A (Statistics in Society)*, 2011, 174, 529–46, who provide a more technical and detailed discussion of the Four-Block Model.

- The relative needs block provided funding according to the extent to which a council's assessed spending need for each service area per capita exceeded the minimum assessed need per capita for any council (this minimum need was provided for via the central block).
- The relative resources block subtracted funding according to the extent to which a council's assessed council tax revenue-raising capacity per capita exceeded the minimum for any council (this minimum revenue-raising capacity was accounted for via the central block).
- The floor damping block ensured that the percentage change in grant for each council met a floor set for councils of that type. To pay for this damping, grants for other councils were proportionately reduced.

The government could choose the weights given to each of the first three blocks. For instance, in 2009–10, the year prior to the beginning of cuts to local government budgets, the blocks were weighted thus:²⁰



The stated aim of this approach was to provide flexibility over the extent to which the funding system took account of the relative spending needs and revenue-raising capabilities of different councils. In contrast, the previous SSA and FSS systems did not provide any such flexibility: except to the extent that large changes in grants were 'damped', differences in and changes in relative needs and revenue-raising capacity were fully compensated for by design.

Such flexibility to allow for less than 100% equalisation and differential equalisation of relative needs and revenue-raising capability is a good thing. But the way the Four-Block Model delivered this was flawed and opaque. It could lead to inequitable treatment of different councils and its complexity meant government decisions on how to allocate funding across councils were subject to less scrutiny than they otherwise would have been.

²⁰ Department for Communities and Local Government, 'Local Government Finance Report 2009-10', 2009, <http://webarchive.nationalarchives.gov.uk/20120919132947/http://www.local.communities.gov.uk/finance/0910/lgfr0910s/index.htm>.

Unequal equalisation

For example, this approach meant the amount of funding allocated per unit of assessed spending need could differ significantly between councils. That is because funding for assessed needs above the level of the council with the lowest assessed needs was allocated via the relative needs block; and funding for assessed needs up to that level was allocated by the central block. And the share of overall needs that was above this lowest-needs threshold differed significantly across councils, such that for some (with high assessed needs) the majority of funding came via the relative resources block while for others (with low assessed needs) virtually all of it came from the central block. Similar issues arose on the resources side, where for some authorities (with small tax bases) virtually all of the adjustment took place via the central block, whereas for others much of the adjustment took place via the resources block. Gibson and Asthana (2011) show that in practice, these issues led to lower levels of funding per unit of need in high-needs areas and to bigger offsetting adjustments per pound of council tax base in areas with low council tax bases. It is not clear this was the intention when the model as put in place.

Instability

The use of the thresholds based on the council with the lowest assessed needs and revenue-raising capacity per capita to determine which needs and resources are accounted for in the needs and resources blocks (as opposed to the central block) also made the model very unstable. For instance, if the relative needs of the council with the lowest needs changed, this could have had big impacts on the relative funding levels of other councils, even if the relative needs (and revenue-raising capacity) of those other councils remained unchanged. Again, this seems undesirable.

Complexity and confusion

The complexity of the Four-Block Model could also lead to confusion about the actual impacts of the government's decisions on the parameters of the model.

For instance, changing the weights on the needs and resources blocks was the main way in which the degree of equalisation according to needs and resources could be changed.

It would be intuitive to expect that once the weights had been set to deliver the desired degree of equalisation, they could be held fixed. However, this was not the case. If the weights were not updated to take account of the changing fraction of councils' overall spending power that came from the grants determined by the Four-Block Model and their own council tax revenues, the degree of equalisation achieved could change quite dramatically.

This issue arose from 2010–11, when the government started cutting the grants paid to councils. The reduction in grants meant that the share of overall spending power derived from council tax revenues increased substantially over the following few years. But the weight applied to the resources block was not increased to reflect the fact that councils' own revenue-raising potential was now more important for their overall spending power. The upshot was that grants did progressively less to redistribute between councils; and councils with lower revenue-raising capacity (and hence greater dependence on grant

funding) saw much bigger cuts to their overall spending power during this period than councils with higher revenue-raising capacity.²¹

This was a policy choice. The government could have updated the weight applied to the resources block to account for the increasing importance of locally raised revenues for overall spending powers. But it did not until 2013–14 (and then damping arrangements undid much of the re-equalisation that this would otherwise have achieved), allowing the system to become less redistributive.

But because of the complexity of this system, the government was able to claim that it had ‘taken unprecedented steps to protect councils most reliant on central government [grant] funding’.²² This refers to the fact that the damping block capped the cut in grants a council could face by different levels according to how dependent on grants that council was. For instance, in 2011–12, those most dependent on grants had their cuts capped at 11.3%, while those least dependent had them capped at 14.3%. However, grant dependence varied by much more across councils than the factor of 1.26 by which the banded caps varied in that year. Thus the cuts to overall spending power could still be much greater for the most grant-reliant councils than for the least grant-reliant councils. And this approach left unaffected the underlying cause of the larger cuts to councils more reliant on grants – use of outdated weights in the Four-Block Model.

A system which is so complex and opaque that the real effects of government policy decisions are not readily apparent again seems undesirable.

After the Four-Block Model: stopgap measures

Following the end of the Four-Block Model in 2013–14, the system for setting grants to councils was significantly simplified.

First, there have been no further updates to the relative needs formulas (RNFs) underlying the needs block of the old Four-Block Model. The aim of this was to ensure that councils have financial incentives to tackle underlying spending needs as well as boost local tax-raising capacity (incentives for which are provided by the business rates retention system). When funding is updated according to changes in needs, as was at least the idea previously, such incentives can be significantly weakened.

Second, the treatment of revenue-raising capacity was changed. In 2014–15 and 2015–16, no account was taken of revenue-raising capacity (or assessed spending needs): the grant to each council with a given set of service responsibilities was cut by the same percentage. For instance, grants to each county council were cut by 19% and grants to each shire district council were cut by 25% in 2014–15. This led to cuts falling even more heavily on those councils most dependent on grants than happened under the Four-Block Model.

²¹ See N. Amin-Smith, D. Phillips, P. Simpson, D. Eiser and M. Trickey, *A Time of Revolution? British Local Government Finance in the 2010s*, IFS Report R121, 2016, <https://www.ifs.org.uk/publications/8705>. D. Phillips and P. Simpson, ‘Changes in councils’ adult social care and overall service spending in England, 2009–10 to 2017–18’, IFS Briefing Note BN240, 2018, <https://www.ifs.org.uk/publications/13066> show that the larger cuts for more grant-dependent councils also led to larger cuts in councils serving more deprived populations.

²² Department for Communities and Local Government, ‘2011–12 Settlement and Provisional 2012–13 Settlement – Formula Grant: Written Statement by the Parliamentary Under Secretary of State, Bob Neill MP’, 2010, <http://webarchive.nationalarchives.gov.uk/20140505110052/http://www.local.communities.gov.uk/finance/1112/grant.htm>.

In 2016–17, the treatment of revenue-raising capacity was changed again. As discussed in Section 2, from that date onwards, calculations of the cut to grants have taken into account the actual council tax raised (rather than the notional council tax revenue potential if council tax were set at a standard rate) by councils in 2015–16. In particular, cuts in grants are varied so that the percentage cut in grant *plus* council tax revenues as of 2015–16 is the same for each council with a given set of service responsibilities.

Both these treatments of revenue-raising capacity have the benefit of being much simpler and hence more transparent than the Four-Block Model. But neither seems a suitable long-term option. First, the system in place in 2014–15 and 2015–16 would just see grants rising and falling by the same percentage for all councils delivering particular sets of services. This would mean the level of funding in 2030–31 would depend arbitrarily on the level of funding in 2020–21, which would itself depend arbitrarily on the systems in place in previous years (including the flawed Four-Block Model). This hardly seems compatible with the aims of the Fair Funding Review. It would also beg the question of why a review of how to measure needs and revenue-raising capacity was being undertaken in the first place!

Second, as discussed in Section 2, making use of actual council tax revenues as opposed to notional council tax revenue-raising capacity has a big drawback: it can provide an incentive to councils to cut their tax rates, as increases in grants will offset the loss of revenue. This could be avoided by holding fixed the year in which council tax revenues are measured. But that would mean taking no account of changes in underlying tax bases as houses are built and demolished and as socio-economic conditions change (e.g. the numbers eligible for single-person discounts or council tax support change). Again, this might be seen to conflict with the aims of the Fair Funding Review.

What options are there for the future?

But if the government is serious about the future system being transparent, it must avoid a return to a system as complex and difficult to understand as the Four-Block Model. If it wants there to be flexibility over the extent to which differences in assessed spending needs and revenue-raising capacity are taken into account by the funding system, it should ensure that the chosen equalisation arrangements are clear. And it will also need to ensure the redistributive system accords with wider policy objectives for local government finance – such as the provision of incentives to councils to boost tax revenues and tackle spending needs – and sits alongside the business rates retention policy.

So what options are available?

The SSA/FSS approach

The first would be to resurrect the SSA/FSS approach – which is still used in Wales. Unlike the Four-Block Model, each unit of assessed spending need and revenue-raising capacity is treated the same for all councils. The role of assessed spending needs and revenue-raising capacity is clear and transparent: the transfer paid into the system or received from the system is the difference between the two, subject to any damping or transitional arrangements. Funding would be redistributed such that – once damping / transitional arrangements have worked their way out – the relative spending levels of different councils would match their relative assessed spending needs if they all set their

council tax at the notional level underlying the revenue-raising capacity assessment. But councils would have flexibility to spend more or less by setting their council tax at a higher or lower level than this notional level.

If the assessments of spending needs and revenue-raising capacity were updated annually, this full equalisation would significantly weaken the financial incentive councils have to tackle spending needs and boost revenue-raising capacity: doing so would lead to near-immediate offsetting changes to transfers.²³ One might therefore not want to update the needs and revenue-raising capacity assessments every year to reflect the most recent changes in socio-economic characteristics and tax bases. In particular, one could:

- **Hold fixed for several years the spending needs and revenue-raising capacity assessments used in the funding model.** If the assessments were updated every 5 (or 10) years, for instance, councils would have up to 5 (or 10) years to bear in full any changes in their assessed spending needs or tax bases. The longer between resets, the stronger the financial incentive to tackle needs and boost tax bases would be, although the trade-off is that this could allow for bigger divergences to open up between funding levels and assessed spending needs.

It is also important to note that such an approach with fixed reset dates every so many years would have different incentive effects over time. Just following a reset, councils would have much stronger incentives to tackle needs and boost tax bases as they would retain the benefit in full until the next reset. However, just before a reset, councils would have much weaker incentives – and could, indeed, have an incentive to allow needs to rise and tax bases to fall: that would increase the transfer they receive from (or reduce the transfer they pay into) the system in subsequent years.²⁴

- **Use a rolling reset,** whereby the spending needs and revenue-raising capacity assessments used in a given year are based on local characteristics from, for instance, 5 (or 10) years previously. This would mean funding in 2025–26, 2026–27 and 2027–28, for example, being based on assessed spending needs and revenue-raising capacity in 2020–21, 2021–22 and 2022–23, respectively, if a 5-year cycle were used.

Such an approach would avoid the potentially distorted incentives around fixed reset dates, but would mean that funding was always based on assessments 5 (or 10) years out-of-date. To limit difficulties caused by this while maintaining incentives to tackle needs drivers, it would be possible to update assessments for some characteristics (e.g. overall population) but not others (e.g. levels of deprivation).

It is worth noting, of course, that we cannot be sure how the provision of incentives would translate into changes in council's behaviour or outcomes. The effectiveness of incentives would depend both on councils' responsiveness to incentives and on how much councils are able to affect levels of spending needs and revenue capacity. If it were the case that

²³ Note that if councils set tax rates higher or lower than the notional level used in the calculation of transfers, changes in grants would not exactly offset changes in assessed spending needs or revenue-raising capacity. Section 2 provides further explanation of what this might mean for councils' incentives.

²⁴ Such issues would be more (less) acute when transitional/damping arrangements at resets last for a shorter (longer) period. That is because a shorter (longer) transitional period means a council's funding would move more (less) quickly to its new assessed funding level.

both of these things were largely determined by external economic shocks, the provision of incentives would have little effect on outcomes but would expose councils to increased risk from such shocks.

Since funding of English local government has in the past placed greater emphasis on redistribution than on incentives, there is a lack of historical evidence that can be drawn on to assess the effectiveness of incentives. Past IFS work has found little evidence of a strong relationship between business rates revenue growth and growth in either employment or Gross Value Added – suggesting that incentives to increase revenues may not necessarily lead to increased local economic growth although, of course, this does not answer the question of whether councils are able to influence revenue growth itself.²⁵

Allowing for less-than-full equalisation at resets

Both the approaches above would, subject to damping / transitional arrangements, still be delivering funding based on 100% equalisation of assessed spending needs and revenue-raising capacity – it is just that those assessments would not be updated immediately as needs indicators and tax bases change. But the government might also want to vary the extent to which differences in the assessed needs and tax revenue capacity used in the model (whether based on up-to-date or five-year-old data), from 100% to 80% or 60%, for example. Doing this would provide additional incentives to councils to tackle spending needs and boost tax bases: they would retain a portion of the benefit even after a (fixed or rolling) reset of spending needs and revenue-raising capacity assessments. Lower equalisation percentages would provide stronger financial incentives but also greater potential for divergences between funding levels and assessed spending needs.

If general grant funding is abolished

If, as is currently planned, general grant funding is abolished, then the spending needs and tax revenue capacity assessments would be used to transfer funding between councils only. In that case, relatively simple modifications to the RNF/SSA approach would allow for less-than-full equalisation. For instance, multiplying the difference between assessed spending needs and tax revenue capacity of each council by X% would result in transfers delivering X% equalisation of those differences.

$$\text{Transfer} = X\% \text{ multiplied by } \left(\text{Assessed spending need} - \text{Tax revenue capacity} \right)$$

As under the SSA approach (and latterly under the FSS approach), damping and transitional arrangements could be used to phase in large changes to the transfers paid to or paid by councils.

It would also be possible to compensate for different percentages of differences in assessed spending needs and revenue-raising capacity, respectively. To do this, one would follow these steps:

²⁵ N. Amin-Smith, D. Phillips, P. Simpson, *Spending needs, tax revenue capacity and the business rates retention scheme*, IFS Report R141, 2018, <https://www.ifs.org.uk/publications/10542>.

1. Calculate each council's revenue-raising capacity per capita (RPC_i) and cash-terms assessed spending needs per capita (NPC_i).
2. Calculate the average revenue-raising capacity (\overline{RPC}) and assessed spending needs per capita (\overline{NPC}) across all councils. Note that $\overline{NPC} = \overline{RPC}$ when there is no grant funding from central government and all spending is funded by local government.
3. Choose the percentage equalisation rate for assessed spending needs (A) and for revenue-raising capacity (B).
4. The (pre-damping/transitional-arrangements) transfers between councils can then be calculated as²⁶

$$\text{Transfer} = A\% \times (NPC_i - \overline{NPC}) + B\% \times (\overline{RPC} - RPC_i)$$

If general grant funding is retained or reintroduced

However, given existing and likely future pressures on councils' budgets, and the limited extent to which tax revenues from council tax and business rates are likely to grow over time, there is a strong possibility that grant funding either will not be abolished in 2020–21 or will be reintroduced at some point after that.

When there are grants from central government to local government, the approaches described above would not work. That is because as well as scaling redistributive transfers between councils, they would also scale transfers from central government to councils, affecting the overall level of funding for the sector, not just its distribution. Indeed, in such circumstances, it is *impossible* to equalise the same percentage of differences between assessed spending needs and revenue-raising capacity for each council, unless that percentage is 100%.

This means that the retention or reintroduction of grant funding – which could prove vital in ensuring sufficient resources are available for local public services – could necessitate a more complex equalisation system, with different councils seeing different degrees of equalisation of assessed spending needs and revenues.

However, as far as possible, the Ministry of Housing, Communities and Local Government (MHCLG) should seek to ensure that the way assessed spending needs and revenue-raising capacity are taken into account in the equalisation system is as transparent as possible. Estimates of assessed spending needs, revenue-raising capacity and pre- and post-damped/transitional-arrangements funding should be published so that the extent of equalisation for different councils can be ascertained. This will allow stakeholders to critique the chosen approach to equalisation and highlight whether certain councils (or groups of councils) are being treated particularly favourably or unfavourably by the system.

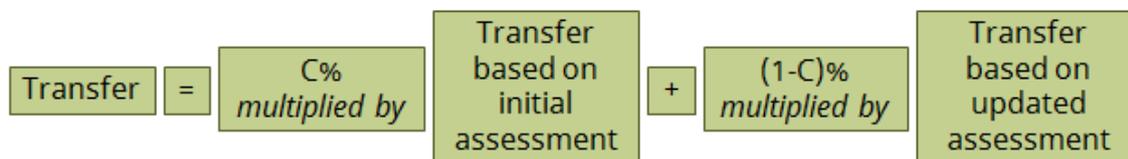
²⁶ It is also possible to apply different equalisation proportions to different components of assessed spending needs (e.g. for different service areas) and tax revenue capacity (e.g. for council tax and business rates) using this approach.

Marginal equalisation matters for financial incentives

It is also worth noting that even if the first equalisation when the new funding regime is due to come into effect in 2020–21 accounted for 100% of the differences in assessed relative spending needs and revenue-raising capacity, subsequent re-equalisations need not. And it is the treatment of future *changes* in assessed spending needs and revenue-raising capacity that is what matters for providing incentives to councils to tackle needs and boost local tax bases. This provides an opportunity to fully redistribute funding according to the new needs assessment in 2020–21 and then allow councils to bear some of the changes in their assessed relative spending needs and revenue-raising capacities at subsequent resets. This is the approach that has previously been discussed when planning the extension of the business rates retention scheme.²⁷

Such an approach is feasible both if local government is totally self-funding and if grants are retained or reintroduced. The steps required for implementation are:

1. Calculate transfers to/from each council required to fully equalise differences in assessed spending needs and revenue-raising capacity as of the initial assessment.
2. Calculate transfers to/from each council required to fully equalise differences in assessed spending needs and revenue-raising capacity as of the updated assessment.
3. Choose the percentage of the change in relative assessed needs and revenue-raising capacity that councils have to bear (C).
4. Calculate the pre-damped/transitional-arrangements grant as



This approach could also be adapted to provide different equalisation rates for changes in assessed relative spending needs and changes in revenue-raising capacity (and indeed components of these, such as changes in capacity to raise revenue from council tax and business rates).

Summary

As the MHCLG designs its new approach to accounting for assessed spending needs and revenue-raising capacity, it is important to learn lessons both from the past and from other places.

Looking first at the past, if the MHCLG really does want the system to be fair and transparent, it must make sure it avoids a system as opaque and complex as the Four-

²⁷ Department for Communities and Local Government, '100% business rates retention: further consultation on the design of the reformed system', 2017, <https://www.gov.uk/government/consultations/100-business-rates-retention-further-consultation-on-the-design-of-the-reformed-system>.

Block Model. The SSA/FSS approach used until the mid 2000s – and still used in Wales – has merit, as it both makes clear how assessed spending needs and revenue-raising capacities are being treated, and effectively equalises in a way that the Four-Block Model failed to do.

The SSA/FSS approach could also be adapted to allow for less-than-full equalisation, either from the initial equalisation due in 2020–21 or for marginal *changes* in assessed relative spending needs and revenue-raising capacities in subsequent re-equalisations – these changes are what matter for the financial incentives councils will face. Exactly what is possible will depend on whether the system will simply redistribute funding between councils or also be used to allocate grant funding from central government to top up local revenues.

The Four-Block Model aside, systems in the UK historically aimed at full equalisation, but those in other countries – such as Germany – have often aimed at equalising only a portion of the differences in revenue-raising capacity and/or assessed spending needs. Examining the approach and experience of other countries would therefore also be worthwhile.

5. Conclusion

The thrust of reforms to the local government finance system in recent years has been to increase the financial incentives councils have to boost local property construction and tax revenue, and tackle deprivation and other drivers of spending needs. But redistribution of spending power between councils will remain a fundamental part of the system: without it, big differences in spending needs and revenue-raising capacity would imply very different levels of service provision and/or tax rates in different council areas.

In this context, the so-called 'Fair Funding Review' is designed to update the system for redistribution to make use of better techniques and data, and reflect the changes in the services councils are providing and the ways they are delivering those services. It also provides an opportunity to make the system more transparent, especially in relation to how financial incentives and redistribution, and responsiveness and stability, are being balanced.

This report has considered two issues. First how councils' capacity to raise revenue via council tax and sales, fees, and charges (SFCs) income can be measured or estimated. And second, how the system uses estimates of councils' revenue raising capacities and spending needs to determine transfers between councils and potentially grants from central government. Different options in each of these can have big implications for the funding provided to different councils, as well as the incentives for growing tax bases, setting tax rates and SFCs, and tackling spending needs.

Looking first at council tax, there are strong reasons to prefer using notional council tax revenues that take account of variations in council tax bases but assume a common 'standard' tax rate across all councils. Using actual council tax revenues instead would both reduce councils' discretion and financial accountability, and would incentivise them to set council tax rates lower than they otherwise would, potentially undermining council tax as a source of revenue. That is because the higher (lower) revenues that would result from setting a higher (lower) tax rate would be at least partially offset by lower (higher) transfer or grant funding.

Relative to using council tax revenues, using council tax bases would hit two councils very hard – Wandsworth and Westminster, the two councils with the lowest tax rates in the country. More generally, London councils would do less well under such a system, while shire county areas would do better. But this reflects the fact that London councils would be bearing the cost of their generally lower-than-average council tax rates themselves; and county areas retaining the proceeds of their generally higher tax rates. And with centrally imposed capping having been replaced by referenda that give local residents the final say on their council tax level, the idea that councils with low tax rates are 'locked in' to those tax rates is less true than in the past. The people have the final say.

For SFCs income, using actual income is again unattractive – it would incentivise councils to set SFCs at lower levels than they otherwise would, as they would be at least partly compensated by higher transfer or grant funding. But there is no equivalent to the council tax base; no direct measure of councils' capacity to raise revenues from SFCs. That means trying to estimate revenue raising capacity by statistical means. Currently, this is done by netting off SFCs income from expenditure when using regressions of expenditure on local area characteristics. This constrains the extent to which variation in SFC revenue raising

capacity can be accounted for: only that part of the variation which is correlated with the local characteristics included in the spending needs regressions can be taken account of. Given the wide variation in revenues generated from SFCs and the systematic pattern of inner London boroughs raising more from SFCs (especially, but not exclusively, from parking) – which arguably is more likely to relate to ‘capacity’ as opposed to ‘choice’ –, there is a good case for ensuring characteristics that can help capture this variation are included in any regressions. This could also be achieved by splitting up current regressions of net expenditure into separate regressions of gross expenditure and SFCs income, potentially with different sets of characteristics included – although this is far from a no-brainer.

The final section of this report looked at the options for using estimates of revenue raising capacity and spending needs – however they are derived –, to determine redistributive transfers between councils and potentially grants from central government.

Whatever the precise details of the new system, it is important that that it avoids the problems of the last system: the Four Block model. That was not only complex and confusing in its operation – which allowed governments of the time to make misleading statements about how they were using the model –, but also inherently unstable.

However, the Standard Spending Assessment (SSA) and very similar Formula Spending Shares (FSS) approaches in place prior to the Four Block model could provide a useful starting point for a new system. The role of assessed spending needs and revenue raising capacity in these systems was much clearer.

The drawback of these approaches was that by fully equalising away differences in assessed spending needs and revenue-raising capabilities they limited ministerial discretion and removed councils’ financial incentives to boost revenue-raising capacity and tackle spending needs. But these systems can be modified to avoid these issues. If the system is used only to determine redistributive transfers between councils, these transfers could be scaled to compensate for less than 100% of the variation in revenue-raising capacity and assessed spending needs. Lower rates of equalisation would allow councils to reap more of any increase in their revenue-raising capacity or reduction in their spending needs, providing them with stronger financial incentives. Higher rates of equalisation would do more to ensure different councils could afford a ‘standard’ quality and range of services for a ‘standard’ rate of council tax.

It turns out that if the system is also designed to allocate grant funding from central government, it is not possible to deliver the same rate of equalisation to all councils unless that rate is 100%. But it is possible to equalise for 50% or 75% or any $X\%$ of the *change* in assessed spending needs and revenue raising capacity between an initial equalisation and any subsequent re-equalisation. It is the treatment of these changes that is what matters for the financial incentives councils face. Undertaking a full initial equalisation and then partial re-equalisations of subsequent changes could provide a way to maximise the amount of redistribution provided, while maintaining incentives for future efforts from councils to improve the economic and social lot of their residents.

Just how far to prioritise incentives versus redistribution is a political question. But the funding system should ensure that the choices being made and their impacts are transparent and subject to stakeholder and public scrutiny.