




Pacing Lyons

Forecasting the Shape
of Local Governance

Funding Reform

Driving Autonomy, Innovation & Effectiveness



The New Local Government Network (NLGN) is an independent think tank that seeks to transform public services, revitalise local political leadership and empower local communities. NLGN is publishing this collection as part of its programme of research and innovative policy projects, which we hope will be of use to policy makers and practitioners. The views expressed are however those of the authors and not necessarily those of NLGN.

© NLGN July 2006
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Published by NLGN
ISBN 1 903 447 51 8

Prepared and printed by NLGN
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Publications in this Series

Pacing Lyons

Forecasting the Shape of Local Governance

In July 2004 Sir Michael Lyons began a major inquiry into the funding of local government. In September 2005 the inquiry was expanded to cover the role and functions of local government. Sir Michael will report at the end of 2006.

The extension of Sir Michael's inquiry has converted it into the central mechanism analysing the long term design of not only local government but also all other locally delivered public services and state policies. Not since 1976 has any assessment of local government had so wide a remit supported by such high expectations. The 1976 Layfield Inquiry is still discussed in local government circles today.

The Inquiry will have a major impact on the political landscape. It could have implications for issues including the taxes used to fund councils, how councils deliver services and the rules governing relationships between councils and other bodies including the health service, police, job centres and economic development agencies such as RDAs and Business Links.

NLGN has therefore embarked on the *Pacing Lyons: forecasting the shape of local governance*, policy project to feed into the Inquiry's findings and recommendations. This project is supported by PricewaterhouseCoopers.

Between January and June 2006, we are holding a series of high level seminars with presentations from key players in local government and Whitehall. Combined with other research, the outputs from these seminars will be the basis for an integrated package of recommendations to the Lyons Inquiry. Both the output of our work and the process of developing policy will be used as a platform to intervene in the growing debate on the future of local public services.

This document represents NLGN's fourth submission. NLGN is using each seminar to issue discussion documents addressing key aspects of the debate.

New Local Government Network was founded in 1996 by a group of senior local government figures whose aim was to make local government more relevant and credible to local people.

A non-profit making, independent think tank, NLGN seeks to transform public services, revitalise local political leadership and empower local communities. NLGN is also the primary advocate of New Localism.

NLGN works closely with individual local authorities, national agencies, central government and the private sector to promote ideas about how our objectives can be achieved in practice. For more information, please visit www.nlgn.org.uk.

1 Introduction

The English local government finance regime is probably the most complex in the world. This complexity has grown over decades as successive governments have attempted to improve the system through marginal reforms. Radical approaches to reform have been either ignored, as with the Layfield Report, or disastrous, as with the Poll Tax. Against this background, it can seem as if there are few new ideas left. A kind-of policy fatigue has spread over the debate.

However, the debate about local funding reform is taking place in a changing environment. This creates opportunities for national government to redesign the finance system, giving local government incentives and capabilities to perform a new role.

Previous papers in the *Pacing Lyons* series have argued that this new environment presents two challenges. The first of these is intensification of public expectations. Successful public service reform has not sated public demand, but instead increased it. People are no longer demanding more police officers, but safer communities. People no longer ask for more doctors and nurses, but better health outcomes.

The second challenge is a wave of change approaching the UK. Differences in the stability and size of families will probably increase; demands for more skilled staff will probably grow; and technological change and economic globalisation will probably offer more varied life chances across different areas.

These developments will present bigger challenges to the state. Local government's unique accountability and understanding make it the most appropriate arena within which to face these challenges. Councils have shown that they can use these attributes to join-up public services, engage citizens in service design and build consensus on regulation.

Co-production of employment services will require different approaches in different areas. Helping a long-term unemployed ex-miner in Newcastle find a job, for example, presents a different set of challenges to improving the employability of a young economic migrant in London. In this sense, national policy objectives can be best achieved by taking varied approaches at the local level.

However, the current finance system has negative effects on local government's use of its unique strengths. The system's overriding weakness is that local government is encouraged to look up to central government and not out to local citizens. The aim of a new finance system therefore should be to empower local government to reform delivery, address performance and reinforce local accountability.

It is helpful to look first at the weaknesses of the current system. No single reform or new tax is likely to foster a more positive relationship between tiers of government, while at the same time harnessing local discretion. Successful reform is more likely to consist of a package of measures that, when applied together, will mend the local government eco-system.

2 Symptoms of the Existing System

Five failures of the current finance system emerged from NLGN's research for the *Pacing Lyons* project. The gearing ratio; issues of fully funding local authority duties; specific grants; the loss of connection between economic well-being and income; and lastly, accountability, all undermine local government effectiveness. Together, the management of these failures has created a sixth symptom; complexity.

- **Gearing**

The "gearing ratio" is a commonly identified symptom of failure in the current system. It describes the effect of the current balance of funding in which councils must, on average, raise council tax by four percent in order to raise local spending by one percent. This ratio is even higher in local authorities with low council tax bases. In some areas, councils will have to raise council tax by £9 for every £1 increase in local expenditure.

This reduces local discretion over spending. If local government chooses to spend more than central government expects, the council is forced to make a decision between politically unpalatable council tax rises and reduced spending. Also, central government reserves the right to cap council tax rises that it deems excessive, further undermining the link between local taxation and local people.

This symptom of the balance of funding can be addressed in one of two ways. The proportion of revenue raised locally can rise, or local discretion over spending can be reduced. However, taking spending responsibilities away from local government will further undermine local discretion.

If local government raises all its revenue through local taxation, a gearing problem remains. As councils gain the tools to oversee the whole of the local state, a new gearing ratio emerges. For every £1 that local government spends, the rest of the public sector spends £4.

In this scenario, central government will still spend much more than local government on local public services. This by-product of devolution would leave councils in a similar position to now. If a council chooses to increase spending on a given policy area, each council will have to raise taxes by £5 for every extra £1 of spending. Wider change will therefore be necessary to offset this effect.

- **Full Funding**

The central government grant to councils has increased by 39 percent since 1997. Over the same period, council tax has increased by above the rate of inflation every year. Part of the explanation is the gearing ratio, but there is another explanation.

Central government has used councils' unique strengths to deliver national undertakings. But, these new obligations have not always been fully funded, eroding local discretion over resources. More is needed to ensure that new obligations are fully funded.

- **Specific Grants**

More than half the Government grant is allocated to specific areas. Specific grants have risen to 57 percent of spending since the Dedicated Schools Grant was instituted in 2005.

This requires local government to react to central government edicts in lieu of local discretion over spending. It is often based on outdated assumptions that central government can drive continuous improvement from Whitehall. It adds to the burden of regulation and reinforces the need for councils to look up to central government rather than outward to local citizens.

- **Connecting to the Local Economy**

The nationalisation of Business Rates in 1990/91 ended the direct financial connection between local authorities and economic growth. Nationalisation may have ended a poor dialogue between local government and business, but did so by eliminating any dialogue at all.

The current National Non-Domestic Rates (NNDR) system sees central government distribute Business Rates on a formula basis. Increases in the NNDR are pegged to the rate of inflation, ensuring that the recent steep rises in council tax could not be reduced by equal rises in business taxes. Since nationalisation, the contribution of business as a proportion of local government spending has fallen from 29 percent to 20.4 percent.¹ This is the equivalent of an annual saving for business of £6 billion.

National government recognises this broken link as a disincentive for councils to promote sustainable economic growth. The Local Authority Business Growth Incentive (LAGBI) and Business Improvement Districts (BIDs) are tentative steps towards

re-establishing the link and the incentive. LAGBI allows councils to keep a proportion of the tax revenue from growth above the regional economic average. BIDs allow businesses to volunteer for extra levies on business rates. These are retained and spent locally.

However, these schemes contribute only a very small proportion of local authority income. It seems unlikely that they will restore incentives alone. A more significant financial link between sustainable growth and local government should be established.

- **Accountability**

The effects of the current system curtail local government's accountability to local people for the balance between spending and services. The power to reduce spending is curtailed by specific grants while the gearing effect curtails the power to increase spending. Local political debate on how to balance and allocate spending is therefore limited.

Surveys for the recent Balance of Funding Review and the current Lyons Inquiry show that people have a very limited awareness of how councils raise revenue. Survey respondents were surprised to learn that national government provides 75 percent of council revenue through grants and that Council Tax accounts for only 25 percent. Most thought this balance reversed. However, most also thought that the balance of funding was not the main issue and that discretion over spending was the most important element in accountability.^{2 3}

¹ Balance of Funding Review: Papers for Meeting 6, *Paper 21: The Balance of Funding – A Combination Option*, Local Government Association (June 2003)

² Alison Palmer & Dorte Laursen, *Public knowledge and attitudes to the balance of funding for Office of the Deputy Prime Minister*, NOP World (October 2003)

³ BMG Research, *report of Wave 1 Survey for Lyons Inquiry into Local Government* (2004)

Therefore, raising more tax locally will not by itself create transparency. For as long central government retains operational power over resourcing decisions, it seems local government will struggle to earn trust.

- **Complexity**

These five issues come together to create the sixth: complexity. Local government's curtailed ability to use local discretion requires central government to step into the breach, allocating resources on councils' behalf. The general grant regime is a symptom of this requirement.

This grant is calculated according to a complex interplay of statistics, trying to account for varying delivery costs and relative needs across different areas. The possibility that this might predict the future accurately is undermined by the inaccuracy of the data used. The statistics fed into the machine can be up to ten years old.

This statistical model often produces big swings in funding between years for individual authorities. To compensate for these, the outputs of the model are subject to "floors" and "tapers", re-distributing funds from councils above a line to those below it. Three-year settlements are an attempt to make funding more predictable. Though still hitting local government's focus on the locality, they help predictability. But, this change is only a partial answer.

Complexity draws local government into an ongoing conversation with central government on the impact of changes to the formula. This gives councils a strong interest in emphasising deprivation as a means of influencing the grant. It is unlikely

that a council can be both champion of its area and at the same time its chief critic.

Examination of these failings shows that gearing and the grants system inhibit local government in facing the demands of the future. However, reforming these alone is unlikely to be successful. Wider reforms are necessary to remove blocks on local government's discretion.

3 Aspirations for Funding

To construct a new local government finance system, it is helpful to examine the underlying principles of the present system. In doing so, it becomes apparent that destructive complexity undermines its main aim.

Central government intervenes in local government finance to ensure equality between areas with vastly differing tax bases. Without this intervention, some of the poorest parts of England would sink. Without equalisation, a lack of resources would mean that autonomy in poor areas would be worthless. It would be no use having the freedom to make positive changes without the money to do so. In this sense, national support is an essential defence against social fragmentation.

The current system is successful in equalising from the top down but not in providing direct financial rewards for councils to address the causes of deprivation. It undermines incentives for local government to develop a sustainable local economy and forces them into detailed conversation with central government on resource allocation. This relationship distracts councils from engaging with local people to design ways of raising standards.

The current proportion of central government funding could be reduced while better promoting equality between areas. The Balance of Funding Review found that in 2003/04, £12.1 billion was needed to address inequality between communities. To remove inequalities without taking funds from the richest communities would cost national government £16.9 billion.⁴

4 Balance of Funding Review: Papers for Meeting 2, 7: *Equalisation and Gearing* (June 2003)

4 Lessons for Lyons

The dominant challenge for the reform of the local government finance system is to create a solution that empowers local government to address the challenges of the future. It is not a coincidence that this is similar to the challenge faced in other areas of local government reform. Adjusting the gearing ratio and reforming the grants system might be a part of a solution. But these changes alone will not empower local government.

Empowerment could rest on a number of reforms that, when applied together, would harness the power of local involvement. Piecemeal reform could risk achieving unwanted effects. Increasing local government's power to raise revenue would better link spending decisions with local outcomes in the eyes of voters.

Local government should also be reconnected with sustainable economic growth. LAGBI and BIDs are steps in the right direction, but measures that provide greater incentives for councils to drive sustainable growth are needed.

The specific grants regime could be abolished to empower local government to use its local knowledge to better pursue national policy priorities. Such a reform could be designed to be self-reinforcing, increasing levels of accountability and transparency to local citizens.

Local government could also be empowered to have greater influence over local behaviour. There is a case for allowing councils to create new taxes where there is enough public support and where these taxes would have positive effects on specific local behaviour.

The effects of reform of the local finance system should be to allow national government to address inequalities between regions and localities while at the same time giving local government more autonomy. These aspirations need not be in conflict.

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The policy project Pacing Lyons: forecasting the shape of local governance will produce a number of papers in 2006, of which this ***Funding Reform: Driving Autonomy, Innovation and Effectiveness*** paper is the fourth. This series will be broken into the following five areas:

- Challenges to the Local State (April 2006)
- Local Political Accountability (June 2006)
- Strategic Leadership (June 2006)
- Funding Reform (July 2006)
- Pacing Lyons: a route map to localism - (July 2006)
(Final published report)

These papers will be available in various format.
Please visit www.nlgn.org.uk for further information.