

**15 September 2010**

**Government consultation on the formula grant distribution methodology**

**Report by the Treasurer**

Contact: Sarah Pook, Deputy Treasurer Telephone: 01962 847045

## **1 Summary**

- 1.1 The Department for Communities and Local Government (CLG) published a consultation paper 'Local Government Finance: Formula Grant Distribution' on 28 July 2010. The paper requests views on proposed options to amend the grant distribution formula. Formula grant includes revenue support grant and the redistribution of non-domestic rates.
- 1.2 The deadline for responses to the consultation is 6 October 2010. Changes will be determined by the Government for implementation in 2011/12. Any revisions to data as a result of this consultation are likely to be used for at least the first two years of the expected four-year Spending Review period. The Secretary of State has said that he is considering a more fundamental review to take effect from 2013/14, but that has not yet been confirmed by Government.
- 1.3 The consultation paper emphasises that, "...The Government has been clear the Spending Review will require tough decisions at both national and local levels and the proposals in this document do not prejudge the outcome of the Spending Review or other possible options."
- 1.4 A template has been provided for responding to the 26 questions included in the consultation response. This report considers the questions relevant to the Fire and Rescue Authority. Further points will be incorporated at the end of the response under 'any other comments'. The draft response using the template is attached as Appendix 1.
- 1.5 From the Fire and Rescue Authority perspective, the relevant consultation proposals are:
  - changes to the fire and rescue formula, set out in detail in paragraphs 5.2 to 5.12.
  - generic changes affecting all authorities with an impact on the Hampshire Fire and Rescue Authority, including floor damping and the use of child tax data, described in paragraphs 5.13 to 5.36.

## **2 Recommendation**

- 2.1 That the draft response to the Government's consultation on Formula Grant Distribution [as set out in Appendix 1 to this report] be approved.

## **3 Introduction and background**

- 3.1 The four-block model was introduced in 2006/07 with the same methodology used for 2007/08. A review of the formula then took place in 2008, following which the methodology for the three year settlement period to 2010/11 was again frozen.
- 3.2 Since then, there have been ongoing discussions between Government and representatives of local authorities on a wide range of possible changes to the methodology. Some of these changes have been included in the consultation paper published on 28 July 2010. The results of the consultation will be published towards the end of 2010, as part of the local government finance settlement. The review proposes updating and fine-tuning the existing system. If agreed by ministers, changes to the methodology are expected to be introduced from 2011/12, possibly as a two-year settlement also covering 2012/13, rather than a fundamental overhaul of the system.
- 3.3 Due to local government reorganisation and the creation of new unitary authorities during the last Spending Review period, the Government has not been able to use the 2010/11 settlement figures to show the effect of each consultation option. Instead, the Government has exemplified the effect of most of the proposals using an adjusted formula grant settlement for 2010/11 as the base. The adjustment to the underlying calculations for the 2010/11 settlement produces indicative allocations to include reorganised authorities in existence at 1 April 2010.
- 3.4 There are limitations to the exemplifications. The four-block model was designed by Government to distribute one overall pot of funding to the various classes of authorities offering different services, as outlined in more detail below. This methodology causes 'leakage' between the authority groups. So, the Authority could be affected by formula changes not directly relating to fire and rescue authority activities, such as changes of indicators used in the highways maintenance formula.
- 3.5 Government's exemplifications based on the 2010/11 indicative allocations only give an illustration of the effects of each option. Detailed effects of options in the context of the 2011/12 settlement would be different, partly because the overall impact of several changes put together into the system is not the same as the sum of the individual changes. The Spending Review will produce new totals for the various formula blocks, probably much lower amounts of grant, and will use updated data.
- 3.6 It is noted that the options set out in the consultation may be further refined or respondents may propose new options. The components of the revised system

may not necessarily be drawn from the list provided for the consultation.

- 3.7 Most of the options have a relatively minor effect on the Authority's formula grant. As the Authority is above the floor and may continue to be so, results shown by exemplifications are likely to be scaled back by the damping mechanism.

#### **4 Four-block model**

- 4.1 The previous Government introduced the four-block model for calculating formula grant in 2006/07, in the face of almost universal criticism from local authorities. The four blocks cover:

- relative needs – to reflect differences in the needs of individual authorities as assessed by the Government using formulae for the main service headings
- relative resources – to reflect differences in the council tax resources of individual authorities. This block is negative and so authorities with higher resources suffer larger reductions in their grant than those with lower resources
- central allocation – to provide each class of authority with a basic amount of grant
- floor damping – to make sure each authority receives a minimum increase in grant, with the cost met by scaling back the increases of authorities with above-floor grant increases.

- 4.2 Despite some minor changes in the 2008 formula review, the four-block model is still very complex and opaque. This makes it difficult to understand the reasons behind the results or to trace through the effect of changes in the input to the model. Government can influence the results by the application of 'ministerial judgement' to key parts of the model, including the extent to which needs and/or resources are equalised. Ministerial manipulation and heavy damping reduce the relevance of individual service needs formulae.

- 4.3 The response to the consultation should register the Authority's continued objection to the four-block model and urge the Government to return to a more transparent system, for example, if a more fundamental review is undertaken for use from 2013/14.

#### **5 The consultation proposals**

- 5.1 The consultation paper covers the following issues of relevance to the Authority:

- changes to formulae for fire and rescue (FIR1, FIR2, FIR3, FIR4) – see paragraphs 5.2 to 5.12 below
- update the weights given to the labour cost adjustment within the area cost adjustment (ACA1) – see paragraphs 5.13 to 5.16 below
- change to judgemental scaling factor for central allocation, relative resources and relative needs (CAS1, CAS2) – see paragraphs 5.17 to 5.25 below
- review to the floor damping scaling factor (question 17) – see paragraphs 5.26

to 5.30 below

- update existing formulae within Children's Services RNF (DATA2) – this also has a potential impact on Fire and Rescue, see paragraphs 5.31 to 5.33 below
- change to student exemptions used for taxbase projections (DATA3) – see paragraphs 5.34 to 5.36 below.

#### **Fire and Rescue – relative needs formula**

- 5.2 There are two options, (FIR1 or FIR2), that would affect the current fire and rescue relative needs formula (which is based on the regression of past expenditure). This is used to determine the coefficients for the basic amount, coastline, deprivation and fire risk top-ups. For the current Spending Review period, regressions were based on net current expenditure averaged over 1998/99 to 2000/01.
- 5.3 Under the first option (FIR1), the Government proposal is to update the regression expenditure base with the latest available data. This would use the average net current expenditure for 2006/07 to 2008/09.
- 5.4 Under this option, the Authority would gain £1.993 million grant per annum, before damping. It is suggested that the Authority supports the Government's proposal FIR1, to use the most up-to-date data in the relative needs formula.
- 5.5 As an alternative option (FIR2) – arising from discussions at the Fire and Rescue Formula Working Group – the Government is proposing to adjust net expenditure to add back annual cashable efficiency savings, averaged over 2006/07 to 2008/09. This adjustment may help overcome the perception that authorities are in some way penalised for making efficiency savings.
- 5.6 Under this option, the Authority would gain £1.839 million grant per annum, before damping, from this proposal – slightly less than the £1.993 million gain from the first option. Recognising that there is some merit in adjusting for previous efficiency savings, the cash difference is relatively small. But on balance, it is suggested that the Authority does not support this option.

#### **Fire and Rescue – risk index factors**

- 5.7 The risk index relates to the number of incidents that fire and rescue services attend, covering all types of incidents, not just fires. A fire risk index analysis was originally completed in 2002. The consultation proposals are the result of the first re-run of the analysis since then. The original risk index has been used from 2003/04 with some minor revisions in 2006/07. Following the same procedure as in 2002, the re-run analysis has used a complex statistical process to select the most relevant indicators from over 200. The options selected by Government are those considered to be the most statistically sound, intuitively relevant and shown to perform well as a group within the regression model.
- 5.8 As there have been changes to fire and rescue services since 2006/07 and the risk index analysis has been re-run, there is no expectation that the new indicators should be highly correlated with the current fire index. Two alternative risk index

options have been proposed, FIR3, based on five new or updated indicators and a population sparsity factor, or FIR4 based on four of the indicators plus the sparsity factor.

- 5.9 The Government proposal FIR3, for five indicators, includes ACORN Group G: starting out (reflecting type 24: young couples, flats and terraces and type 25: white-collar, single and sharers, terraces). ACORN is an acronym for 'a classification of residential neighbourhoods'. ACORN defines every UK postcode according to the characteristics of their residents. The five indicators are:
- proportion of people of working age with no qualifications
  - proportion of people of working age who are not in employment (ie are on New Deal, receive Incapacity Benefit or Severe Disablement Allowance, or receiving apprenticeship training)
  - proportion of people receiving Income Support/Income-based Jobseeker's Allowance/guarantee element of Pension Credit
  - proportion of people in ACORN Group G: starting out (reflecting type 24: young couples, flats and terraces and type 25: white-collar, single and sharers, terraces)
  - Standardised Mortality Ratio: 0 – 74 years.
- 5.10 Option FIR4 is the same as FIR3 but omits the ACORN Group G category.
- 5.11 The two proposals set out the range of risk categories considered by the Government as the most relevant for fire and rescue incidents. The inclusion of ACORN Group G within FIR3 seems to produce the more relevant option for Hampshire. The Fire and Rescue Authority would gain £1.066 million per annum from FIR3, but would lose -£1.600 million from FIR4, the four-indicator option.
- 5.12 It is suggested that the Authority supports updating the fire risk index with option FIR3 ie the five indicators, plus a sparsity adjustment.

#### **Area cost adjustment**

- 5.13 The area cost adjustment (ACA) reflects differences in the cost of service delivery around the country, predominantly labour costs.
- 5.14 The Government is proposing changes to labour cost adjustment (LCA) weights in the services which use a significant share of third party labour, replacing the judgement based approach with an evidence based approach for highway maintenance, children and younger adults' social services and older people's social services, (ACA1). Due to limited third party labour in education, police and fire and rescue services, these labour weights remain unchanged. Company account estimates of the labour share in the various service groups have been used to find the labour share of third party contractors.
- 5.15 Despite no change to fire and rescue services' weights, the Authority could gain £0.091 million per annum, before damping, from this proposal. Even though the weights have not been changed, ACA1 could be supported as it incorporates more up-to-date data, better reflecting labour costs.

5.16 Although not proposed as an option in this consultation, the Authority has previously made a case for a change to the ACA geography. It is suggested that the Authority raises this again, by submitting the view that a change to ACA geography is required to remove the Isle of Wight from any ACA grouping for Hampshire. If special funding is required for the Isle of Wight Council because of its position as an island authority, a notional ACA factor should be applied in a similar way to the factor already applied to the Isles of Scilly. The cost of the additional funding for the Isle of Wight would then be met by all authorities nationally, not just by Hampshire, as at present.

**Central allocation, relative resources and relative needs**

- 5.17 The four-block model enables the Government to decide what proportion of its formula grant should be distributed in accordance with authorities' relative needs, their relative resources or as a basic amount per head of population (the central allocation).
- 5.18 The Government controls the total grant available for distribution via the central allocation. If the calculated central allocation for all authorities does not equal the control total, a scaling factor is used to bring the calculated figure to the control total.
- 5.19 The Government proposes that the scaling factor for the central allocation should be close to '1.0', as this might be more statistically sound than the current approach with a variable scaling factor. It is suggested that the Fire and Rescue Authority does not support this proposal, due to the possible loss to the Authority from option CAS2, as set out below.
- 5.20 Where authorities support the option to keep the central allocation scaling factor close to '1.0', the Government proposes two further options regarding the relative needs and relative resources blocks.
- 5.21 All three blocks must add up to the total amount of formula grant provided. If the scaling factor for the central allocation is to be set as close to 1.0 as possible then this means that ministers can specify the size of either the relative needs amount relative resources amount, but not both.
- 5.22 Relative needs formulae have been designed by Government to reflect the relative needs of individual authorities in providing services.
- 5.23 The relative resource amount is a negative figure assessing each areas' ability to raise more income locally from council tax, then providing less formula grant support from Government. The negative relative resource amount is balanced against the positive relative needs amount calculated for each authority. Government proposes reducing the relative resources amount, so less will be deducted from the central amount. This would provide the better settlement for Hampshire authorities which are deemed to have higher levels of council tax resources.

- 5.24 CAS1: The proposed reduction to the relative resource amount, outlined in paragraph 5.23, with a central allocation of 1.0 and no change to relative needs, will produce a gain for the Authority of £0.130 million per annum, before damping. It is therefore suggested that the Authority indicates a preference for CAS1.
- 5.25 CAS2: This option would also set the central allocation at 1.0. It would keep the relative resources block unchanged and increase the relative needs block. Authorities assessed as being high need would benefit from this option, any deduction for resources would be offset by a greater share of the formula grant allocation based on relative needs. The Fire and Rescue Authority would lose -£0.200 million per annum from this option. The Authority could repeat its preference for CAS1 in response to this option, suggesting that more of the formula grant should be allocated as a basic amount per client and less as a top up to reflect higher assessed 'need' to spend per client in some areas.
- 5.26 **Floor damping**  
Damping is intended to smooth the distributional turbulence caused by formula and data changes. By setting a 'floor' the Government guarantees that no authority will get less than the floor increase in formula grant support. Over the next Spending Review period it would still be possible for Government to set a range of floor levels, including setting negative floors.
- 5.27 The fire and rescue group of authorities is self-funding, so those authorities receiving a below the floor increase through the formula have their grant increased to the floor level. This is paid for by those authorities (including Hampshire) that receive an above-the-floor increase; with their increases above-the-floor being scaled down.
- 5.28 If the floor is set close to the damping group's average increase in formula grant, the distribution of formula grant will be very similar to that for the adjusted prior year's grant. Fewer formula changes will feed through.
- 5.29 In question 17, the Government asks whether authorities would prefer the floor level to be set close to the average change or to allow some formula change to come through for authorities above the floor.
- 5.30 As a low or negative floor is anticipated, it is likely that Hampshire will remain above the floor. The Authority currently loses 59.14% of its grant increase, (-£0.600 million) so it is suggested that the option to allow some formula change to come through for authorities above the floor is supported.
- Use of child tax credit data**
- 5.31 In option DATA2, the Government proposes changing indicators used in the formula grant methodology to replace average data of children from income support claimants, which is no longer available, with children of out-of-work families claiming child tax credit data. As children from income support claimants data is currently a category used to calculate the fire risk index, this proposal has a potential impact on fire and rescue authorities, as well as a more significant impact on the Children's Services formula.

- 5.32 Following a lengthy and thorough review of the fire risk index, neither of the consultation proposals, described above, include child tax credit as an indicator. So, if either FIR3 or FIR4 are adopted, proposal DATA2 would be irrelevant for fire and rescue authorities. In terms of replacing children from income support claimants data, statistically, child tax credit data is proven to have a good correlation, but the proposals for updating the risk index indicate that as one of a group of indicators, child tax credit data would be less relevant than those indicators selected for FIR3 and FIR4.
- 5.33 It is suggested that the Authority opposes DATA2 in principle as, despite a strong statistical relationship, the three year average still seems to introduce turbulence in the distribution of grant. If the fire risk index remains unchanged apart from this proposal to bring in child tax credit, the Authority would lose -£0.626 million grant per annum. It is not clear from the exemplification what proportion of this grant loss is caused by the proposed update to the current fire risk index and what proportion is leakage from the changes to the Children's Services formula. The Authority should repeat its preference for the FIR3 the risk index update, as outlined above.

#### **Taxbase projections**

- 5.34 The Government proposes a change to the way student exemptions adjustments in the taxbase are calculated from using both May and October data, to just the use of May data (DATA3). In some areas, students are thought not to have registered by early October, so May only data could be a better gauge of student exemptions.
- 5.35 It is suggested that in some metropolitan areas such as Manchester, 'May data' might provide a more accurate snapshot of student exemptions. An alternative view suggests that regardless of the adjustments made, taxbases grow fairly steadily and that the historic growth rate of the whole taxbase provides a good predictor of future levels. Government research indicates that whatever adjustments are made to account for the level of student exemptions in the taxbase, the overall distribution of differences between the projected and actual levels remains fairly stable. Exemplifications seem to indicate that any adjustment made has the effect of moving authorities around within the distribution by bringing the forecasts of some individual authorities closer to their actual taxbases, and moving some of the forecasts further away from the actual figures.
- 5.36 The Authority could lose a -£0.009 million grant per annum, before damping from DATA3. As the potential of this option to improve accuracy of taxbase projections is in doubt it is suggested this option is not supported.

## **6 Supporting our corporate aims and objectives**

- 6.1 Our ability to deliver some on some of the priorities and targets we have set over the next three years could be threatened if the outcome of this review significantly reduces our share government grant. So, as we head into a period of severe financial restraint, it is essential that we do all we can to protect the Authority's financial interests. This includes lobbying for the best possible outcome for

Hampshire under this review of formula grant distribution methodology.

## **7 Risk analysis**

- 7.1 There are no significant or specific risks arising from the recommendation of this report. We are confident, from our analysis of the options set out in the consultation paper, that the proposed response is one that is in the best financial interests of the Authority.

## **8 People Impact Assessment**

- 8.1 There are no specific issues arising from the recommendation of this report and the proposed response to the Government (set out in Appendix 1) are considered compatible with the provisions of the European Convention on Human Rights, the Human Rights Act 1998, and the Race Relations (Amendment) Act 2000.

## **9 Resource implications**

- 9.1 There are no resource implications arising from the recommendation of this report. The only cost involved is the officers' time in analysing the consultation paper and preparing the draft response.

## **10 Background papers**

- 10.1 The document described below discloses facts or matters on which this report is based and has been relied upon in the preparation of the report:
- Communities and Local Government (CLG) report: 'Local Government Finance Formula Grant Distribution: Consultation paper'. It can be accessed on the CLG website at: <http://www.local.communities.gov.uk/finance/1112/sumcon/consult.pdf>

Note: The list excludes: (1) published works; and (2) documents that disclose exempt or confidential information defined in the Act.