



Office of the  
Deputy Prime Minister  

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Creating sustainable communities

# *Three-year Revenue and Capital Settlements*

Consultation Paper

December 2004



Office of the  
Deputy Prime Minister  

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# Three-year Revenue and Capital Settlements

## Consultation Paper

December 2004

Office of the Deputy Prime Minister: London

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# About this consultation

1. The Government introduced three-year settlements for central Government Departments in the Comprehensive Spending Review in 1998. For the full benefits of three-year plans to feed through into improved public service delivery, it is important that they are cascaded from Departments to executive agencies and other budget holders.
2. This consultation paper seeks views on the Government's proposals for the implementation of three-year revenue and capital settlements for local government in England. It fulfils a commitment in the Government's 2004 Spending Review to consult on these proposals with local government and other stakeholders with a view to agreeing local authority finance settlements for 2006/07 and 2007/08 during 2005.
3. Three-year funding settlements for local authorities, police authorities and fire and rescue authorities will offer greater certainty and stability in funding for local services. They will increase the planning horizon, strengthen financial management and support efficient use of resources at the local level – supporting the delivery of high quality services.

## **WHO SHOULD READ THIS CONSULTATION PAPER?**

4. The consultation will be of interest to local authorities, police authorities and fire and rescue authorities in England that receive grant via the formula grant settlement, specific grants and support for capital spending. The consultation paper will also be of interest to bodies which fund local authorities, for example Regional Development Agencies, and organisations which directly benefit from funding from local authorities, including the private and voluntary sector, as well as other stakeholders with an interest in local government.
5. A copy of the consultation paper is also available on the web site of the Office of the Deputy Prime Minister (ODPM) at the following address:  
**<http://www.odpm.gov.uk>**

## **RESPONSES AND ENQUIRIES**

6. The Government would like your views on the proposals and issues in this consultation paper. Specific questions and issues for comment are posed throughout the paper and set out in Annex A. Please make sure that your response reaches us by **11 March 2005**.
7. We would prefer to receive responses electronically.  
Please send responses by e-mail to:  
**[Threeyearsettlements@odpm.gsi.gov.uk](mailto:Threeyearsettlements@odpm.gsi.gov.uk)**

8. Alternatively, if you are not able to respond by e-mail, please send your response to:  
Chris Howsham  
ODPM  
Zone 5/E2  
Eland House  
Bressenden Place  
London SW1E 5DU
9. It would assist our analysis of the responses if you could set out your comments under the relevant chapter headings used in this paper and clearly mark to which paragraphs and/or consultation question they refer. Furthermore, respondents should explain, where relevant, who they represent.
10. All responses will be made public unless confidentiality is specifically asked for. Should you wish your comments to be treated in confidence please clearly indicate this in your response. However, correspondents should be aware that confidentiality cannot always be guaranteed, for example where a response includes evidence of a serious crime. Any automatic confidentiality disclaimer generated by your organisation's IT system will not be respected unless you specifically include a request in the main text of your response. All responses will be included in statistical summaries of comments received and views expressed.

## **NEXT STEPS**

11. A summary of responses will be published by summer 2005 and a copy will be available on the web site of ODPM at the following address:  
**<http://www.odpm.gov.uk>**

A paper copy of the summary of responses can be obtained from:

Chris Howsham  
ODPM  
Zone 5/E2  
Eland House  
Bressenden Place  
London  
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12. The Government will carefully consider the responses to this consultation paper and take them into account in deciding the way forward. The Government will announce its conclusions in summer 2005. Subject to the outcome of the consultation, work will need to be taken forward on a range of detailed matters. Discussions will take place with local government and other stakeholders with further consultation where appropriate.

## **COMMENTS AND COMPLAINTS**

13. This consultation is being undertaken in accordance with the *Code of Practice on Written Consultation*. The consultation criteria are set out in Annex B to this consultation paper.

# Executive summary

1. Building a coherent and stable relationship between central, regional and local government is at the heart of the Government's commitment to deliver high quality public services and improve the effectiveness of local government in their leadership and delivery to all communities. A move to a more stable system of funding for local government underpins this goal. Chapter 1 sets out the Government's objectives for introducing three-year revenue and capital settlements for local authorities in England, covering police and fire and rescue authorities. It explores some of the design principles to support delivery of this new system and the timetable for introduction.
2. Local authorities received £46.1 billion annual formula grant in 2004/05 from Government to fund their on-going core activities. This is made up of revenue support grant, business rates and, in the case of police authorities, police grant. The allocation is based on a formulaic system which takes into account the relative costs of providing different services in a particular local authority area and the relative ability of each authority to raise council tax. With three-year settlements an appropriate balance will need to be struck between transparency and predictability of three-year figures against the need to allocate resources closely to need and reflect the most up to date information available. Chapter 2 explores different formula grant methodology to support delivery of three-year revenue settlements which remains both transparent and fair. In particular, it invites views on whether the formula grant system should be fixed using the same formulae and data for each of the three years or if forward projections should be considered for some data, for example population growth.
3. In addition to formula grant, local authorities receive some £28 billion (in 2004/05) of funding (excluding police grant) in the form of specific grants from different Government Departments. These grants vary widely. They may be paid to all or to only selected authorities. They may be "ring-fenced" and so must be spent on a defined activity or "targeted", with no conditions on how they are spent. Delivering greater forward certainty in specific grants through three-year settlements will enable local authorities to better plan their budgets and where appropriate, allow grants to be passed on to other organisations such as neighbourhood groups. Chapter 3 proposes that local authorities receive three-year allocations of specific grants unless there are overriding reasons against this. It invites views on circumstances under which it may not be desirable or in authorities' interest to allocate certain specific grants over a three-year period.
4. Approximately £12 billion of annual support for conventional capital investment is also made available in the form of supported borrowing and capital grants. This supports a mixture of ongoing programmes, largely for maintaining existing assets, and one off projects to provide new or substantially enhanced assets. Revenue grant is also provided to authorities to fund the Private Finance Initiative. The allocation methodology for capital investment varies: some is based on formulae and some on assessment of plans prepared by authorities. Longer lead-in times make forward certainty particularly

important for capital programmes. Chapter 4 proposes that as far as practicable, there should be firm three-year certainty for capital allocations. It invites views on circumstances where there may need to be some exceptions to this approach.

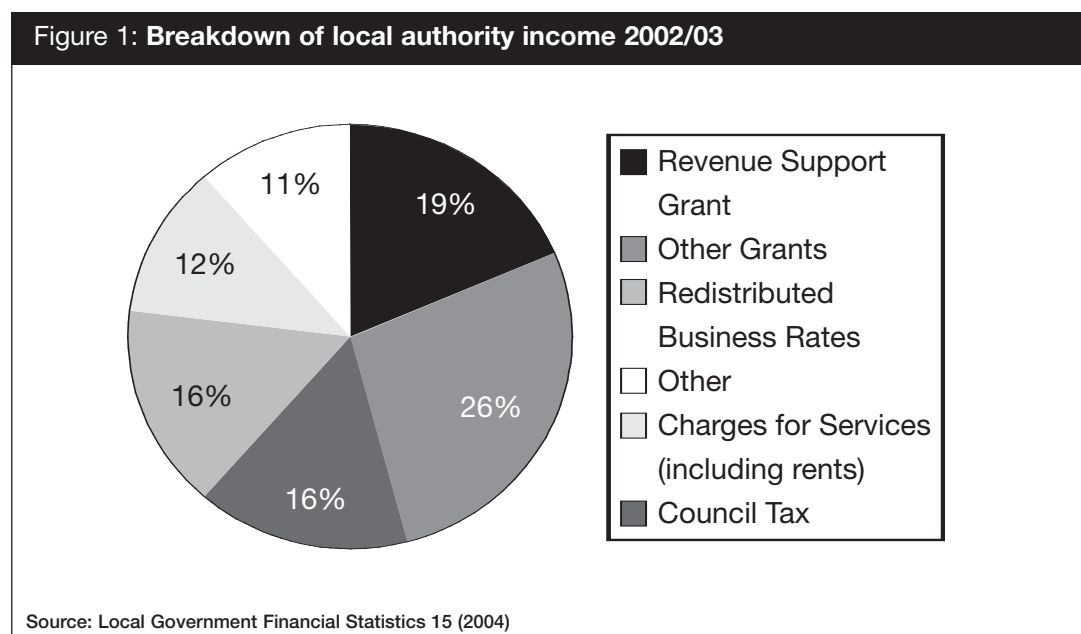
5. Greater certainty and stability in funding for local services will strengthen financial management, forward planning and efficient use of resources at authority level. Better management of risk at the local level should offer greater stability in future council tax. This would enable authorities to publish forward indications of budget levels and council tax providing greater certainty to council tax payers. Chapter 5 invites views on how this approach could operate in practice.
6. The practical and legislative implications of three-year settlements and their links to wider reforms also need to be considered. Chapter 6 explores implementation issues and wider reforms, including Sir Michael Lyons' independent inquiry into local government funding and the Efficiency Review. Devolving decision making, including Local Area Agreements, is also addressed.

# CHAPTER 1

## The Government's overall approach to three-year settlements

### CURRENT FUNDING REGIME FOR LOCAL GOVERNMENT

- 1.1 Local authorities, police authorities and fire and rescue authorities' income comes from a range of sources. On the whole, revenue expenditure is financed through a balance of central Government grant, including redistributed business rates and the locally raised council tax. There is also significant revenue from fees and charges. Capital expenditure is principally financed through central Government grant, borrowing and capital receipts.
- 1.2 The total income of local government has increased steadily from £77.2 billion in 1997/98 to just under £107 billion in 2002/03. About 61% of income in 2002/03 took the form of government grants.



- 1.3 Local authorities, police authorities and fire and rescue authorities receive an annual formula grant settlement from ODPM to fund their on-going core activities. This is made up of revenue support grant and business rates. Authorities can use this funding for any of their activities, including capital investment. In addition, police authorities also receive police grant from the Home Office as part of the settlement. The Government consults on the formula grant settlement, usually in November, before Parliament approves the allocations to individual authorities, usually in January ahead of the financial year to which they apply. The Welsh Assembly Government is responsible for the settlement in Wales except for police grant which the Home Office pays to both English and Welsh police authorities.
- 1.4 Specific revenue grants are distributed to authorities separately from the annual formula grant settlement. Specific grants may be “ring-fenced” for particular activities or initiatives or “targeted” with no restrictions on how they can be spent. The arrangements for allocating these grants vary: some schemes use formulae or other rules on entitlements; others allocate funds following bids from authorities. Allocations of many grants are settled before the start of the year, while others are allocated throughout the year.
- 1.5 The Government allocates support for capital investment to authorities in the form of funding for borrowing costs through the annual formula grant settlement and as capital grants. Authorities’ allocation of supported borrowing depends on annual decisions by Government Departments, often on the basis of formulae for the service concerned. Capital grants are often given for specific projects following bids from authorities. The grants are allocated by Government Departments before the beginning of, or during the year, depending on the individual programme.

### **LIMITATIONS OF ANNUAL ALLOCATIONS**

- 1.6 Local authorities and their police and fire counterparts have highlighted difficulties they experience with the present system of an annual formula grant settlement and annual allocations of many specific revenue and capital grants. Similarly residents have queried why their council, police authority and fire and rescue authority does not find out how much money it has to spend until shortly before the start of the year.
- 1.7 Both the formula grant settlement and capital allocations are made to authorities close to the start of the financial year. This leaves authorities very little time to plan their budgets with certainty. The task is made more difficult still when changes to functions and corresponding changes in finance are made very late in the day. In addition, allocations of specific grants may come too late for these to be taken into account in budget setting decisions.
- 1.8 The advantage of annual settlements and grant allocations is that the grant that authorities receive is based on the latest available data and information. In this way funding is more closely aligned to actual needs of an authority and its residents. However there is a trade off. Annual settlements and allocations can hinder effective medium term financial planning. It is difficult for authorities to predict with any confidence the resources that will be available to them for the following and subsequent financial years.

- 1.9 As a result it is difficult to take strategic decisions on longer term projects. Authorities are not well placed to negotiate long-term contracts with suppliers, so may not achieve best value for money. Council tax rises can be volatile as a result of the inability to plan. In addition, authorities may be unable to offer future certainty to organisations which they themselves fund, for example voluntary and community sector bodies.
- 1.10 Under the prudential regime, authorities prepare their three-year capital expenditure plans and revenue forecasts and plans for prudential borrowing over three years based on them. But the benefit of these plans is reduced if authorities do not have a clear indication of the funding they will receive from central Government beyond the current year.

### **KEY OBJECTIVES FOR INTRODUCTION**

- 1.11 The Government believes that the introduction of three-year settlements for authorities should support the following objectives:
- There should be greater certainty in funding for local services delivered by local, police and fire and rescue authorities. Authorities should know earlier than they do now how much funding they will receive from Government and should have as much certainty as possible about funding for the second and third years of the Spending Review period.
  - Authorities should use this greater certainty to considerably strengthen their financial management, especially forward planning and using resources more efficiently. A longer financial horizon will give authorities more clarity about what is affordable and provide a firmer basis for making decisions about priorities.
  - Organisations and projects that rely on authorities for funding should also benefit and authorities should introduce their own multi-year approach to funding. It would be beneficial for organisations other than Government that fund local authorities, for example Regional Development Agencies, to also provide three-year funding certainty to authorities.
  - There should be better management of risks at the local level, leading to greater stability in council tax. Keeping budget and council tax increases to a reasonable level will remain essential and authorities should be expected to mirror greater stability in funding with greater stability in both of these.
  - Increasing flexibility, autonomy and accountability at the local level. Giving authorities funding certainty over three years will offer them greater freedom to plan, and give council tax payers greater certainty on future levels of council tax.

## **DESIGN PRINCIPLES**

- 1.12 In meeting the objectives set out above, the Government believes the design of three-year funding arrangements should meet the following principles:
- The approach should mirror that for Government Departments in the Spending Review, with three-year settlements being rolled forward every two years. This means that relevant Government Departments should seek to cascade their own three-year settlement from the Spending Review to authorities to the maximum extent possible.
  - The approach should apply to revenue and capital settlements, including specific and targeted grants, except where there is a clear, principled rationale for not doing so – for example, when fixed amounts for later years are neither sensible, nor in the authorities' best interests. In such cases, authorities should still be offered as much forward certainty as possible.
  - Funding certainty should be balanced with fairness and equity, and the Government should continue to allocate resources to authorities in a transparent way.
  - To carry out effective forward financial planning, and to improve clarity and accountability, authorities should publish three-year plans for budgets and the consequences for council tax in these years. To support this, it would be sensible for parishes and levying bodies to inform local authorities of their intended precepts and levies over the three year period.
  - The timetable for changes in local, police and fire and rescue authority functions – both new responsibilities and the ending of responsibilities – should be aligned with the Spending Review, so that they can be taken into account in making three-year settlements and allocations. Unplanned functional changes should not generally be made during the three year period, unless there is a strong case for doing so.
  - Any new arrangements will need to recognise that the Home Office pays police grant to both English and Welsh police authorities.

## **THREE YEAR CYCLE**

- 1.13 Three-year settlements for local authorities will follow the Government's Spending Review framework; firm and fixed spending plans will be set for three years going forward, and reviewed every two years. This means that the last year of one review is also the first year of the next such that Spending Reviews set new plans for years two and three, with the overlap year remaining set.
- 1.14 The Government plans to move to three-year settlements in 2006/07. It proposes that firm revenue and capital allocations, including specific and targeted grants are announced wherever possible for 2006/07 and 2007/08 in autumn 2005. There will need to be special arrangements for this first settlement. The first settlement can cover only the two remaining years of Spending Review 2004 and the 2007/08 formula grant settlement will need to reflect council tax revaluation which is due to be implemented on 1 April 2007.

- 1.15 In the 2001 White Paper *Strong Local Leadership – Quality Public Services* the Government made a commitment not to change the overall council tax yield as a result of revaluation. However, the revaluation will affect local tax bases with consequences for grant distribution. The precise implications for local tax bases and grant will not be known until the Valuation Office Agency has published the statutory draft council tax valuations lists on 1 September 2006.
- 1.16 The Government believes that delaying the introduction of three-year settlements on the grounds of the council tax revaluation in 2007 is not justified. A delay would postpone, for no good reason, the advantages of three-year settlements for all stakeholders. There are no grounds for supposing that the need to recalculate council tax bases and grant entitlements in the light of revaluation would invalidate the significant degree of forward certainty that would be provided by a first three-year settlement in 2006/07. Its preference is therefore to introduce three-year settlements for that year, on the understanding that grant figures for later years would be provisional and subject to alteration as a result of revaluation, but would provide a useful basis for the necessary recalculations and year on year comparisons.
- 1.17 The Spending Review 2006 will set in the summer of that year spending plans for Government Departments for 2007/08, 2008/9 and 2009/10. The Government will then in the autumn announce wherever possible firm three-year revenue and capital allocations, including specific grants. In this way, the approach will mirror that for Government Departments in the Spending Review, with three-year settlements being rolled forward every two years.

## **FUNCTION CHANGES**

- 1.18 Assigning new functions to or transferring responsibility for functions away from authorities can cause significant uncertainty about future funding levels, particularly for individual authorities. The overriding priority must remain improved delivery of public services. There are clear advantages to planning changes in functions as part of the two-yearly Spending Reviews. This will enable corresponding changes to be made to funding totals (which could be in year two or three) to be made at the outset and firm three-year formula grant settlements to be delivered.
- 1.19 The annual local government finance settlement has provided an opportunity to add funding to formula grant for particular initiatives which would have increased local government spending, but were not taken into account in original spending plans. This has enabled the Government to comply with the “new burdens” principle that the Government should not place new responsibilities on local government without providing the funding necessary to carry them out. With three-year settlements it will be important to engage with stakeholders in a way that ensures effective planning of changes to be implemented as part of the Spending Review process.
- 1.20 It is not possible to rule out entirely the need to make unplanned changes within the period covered by a three-year settlement. Any new functions or burdens on authorities during this period will be funded by specific grant with the strong presumption that this will roll into revenue support grant at the next opportunity.

- 1.21 Once authorities have received their three-year allocations of formula grant, the Government will not transfer away from authorities responsibility for the functions these allocations cover unless there are extremely pressing reasons for doing so. If this step were necessary, the Government would consult authorities about the best way to alter their allocations.

### **DEALING WITH UNFORESEEN CIRCUMSTANCES**

- 1.22 At first sight moving to three-year settlements might appear to increase the challenges of coping with contingencies which authorities genuinely cannot predict or control. In practice though this should not be the case. The Government has already put in place a number of measures to ensure that all authorities budget for an adequate level of reserves. Sections 32 and 43 of the Local Government Finance Act 1992 require billing and major precepting authorities to calculate the financial reserves which they estimate will be appropriate to raise in the year to meet estimated future expenditure. Section 25 of the Local Government Act 2003 requires the Chief Finance Officer to report on the adequacy of these proposed reserves. The authority must have regard to this report when making decisions. For certain unforeseen emergencies involving danger to or loss of life or property, local authorities will still be able to claim Bellwin grant.
- 1.23 The remainder of the consultation paper considers in more detail the Government's proposals for three-year revenue and capital settlements and delivering on the objectives set out in this chapter.

# CHAPTER 2

## Formula grant settlement

### INTRODUCTION

- 2.1 This chapter seeks views on the key issues raised by moving the formula grant system onto a three-year basis.
- 2.2 Formula grant is distributed by central Government to local authorities, including police and fire and rescue authorities, by means of a formulaic system which takes account both of the relative social, economic and other characteristics of each authority's area that affect the relative costs of delivering services; and of each authority's relative ability to raise council tax.
- 2.3 Formula calculations result in a total Formula Spending Share (FSS) for each authority, made up of individual FSS figures for the main blocks of service delivered by that authority. Before the operation of the grant floors and ceilings, Government grant and the redistributed total of business rates are calculated so that if each receiving authority were to set its budget requirement at the level of its FSS, or FSS plus police grant where appropriate, then all billing authorities could set broadly the same council tax for dwellings listed in the same valuation band, subject to certain qualifications (for example, parish precepts).
- 2.4 Two modifications to this system provide a measure of stability. First, the operation of this system is subject to a guaranteed minimum year on year increase in grant ("floors") which are funded – within a fixed total amount of grant – either by setting maximum ("ceiling") grant increases, or scaling back the grant increase above the floor, or both. The Welsh Assembly Government does not operate a floor arrangement for police authorities. In recent years, the Home Office has paid specific grant to Welsh police authorities to bring them up to the same floor as their English counterparts. Second, the Government have also adopted the practice of leaving the FSS formulae undisturbed for a period of years ("formula freeze" – typically three years).

### HOW SHOULD THE FORMULA SYSTEM CHANGE TO BE ABLE TO SUPPORT THREE-YEAR, FORWARD LOOKING SETTLEMENTS?

- 2.5 The current freeze on formula change comes to an end with the financial year 2005/06. The Government will therefore need to consider changes to the formulae from 2006/07. Research and exploratory work is already under-way on a number of formula issues. It will also be desirable to consider, to the same timetable, the extent to which the current formula system is suitable for forward planning.

- 2.6 The role of grant floors is central to this reconsideration. Floors are a permanent – and widely welcomed – part of the grant system as it is now, and one central element of the Government’s proposals for three-year settlements would be an advance announcement of the grant floors for each of the three years. However that stronger role for floors serves to draw attention to the fact that the underlying rationale for the formula system, that of “equalising” notional council tax levels at a particular assumed level of spending (see paragraph 2.3 above), no longer holds good. The emphasis of three-year settlements on providing each authority with greater financial certainty also suggests that the formula grant system should reflect this more and give less weight to theoretical calculations based on notional assumptions about relative costs of delivering services.
- 2.7 One option would be to redesign the grant system, to offer each local authority a minimum fixed increase – the equivalent of the floor, but calculated up front – and two variable amounts on top of that, representing relative service costs calculated by formulae and resource equalisation. This would be clearer than the present combination of formula and floors and ceilings, would focus on grant not notional spending and would lend itself relatively easily to rolling in new funding for new functions at the margin. It may be argued that this approach will result in a reduction in the equity advantages of treating each service in the same way whatever the local authority structure. At the level of individual authorities, the cash outcomes of the current system are already different depending on the operation of grant floors.
- 2.8 A second possible approach starts from the fact that fixing settlements for three years will inevitably mean less precision in the calculation of grant for each year. Given that, there is a case for considering greatly simplified formula systems. These might consist for example of flat rate percentage increases over the three year period. A more sophisticated version would be based on an underlying basis for allocation (which could itself be complex or simple) plus a variable pace of change towards that – i.e. the percentage increases in grant would be differentiated between groups of authorities according to how close they are to the underlying grant distribution. A third variant of a simpler system would be to use very much simpler formulae with perhaps just three or four indicators. A greatly simplified formula system would be easier to operate in advance and consistent with a transparent and predictable set of three year figures. However (depending on the variant) it would have the disadvantage of relatively little differentiation between areas with different characteristics and may therefore be criticised as being low in equity.
- 2.9 Whatever the future shape of the formula grant system, in the short run, since we cannot specify in advance the exact split between revenue support grant and the Distributable Amount of business rates within the funding totals, it will be necessary to calculate the distribution of the two together for forward years. The split can then be published with each year’s settlement.

*Question 1: In the Government’s view there is merit in considering a system involving a basic (“floor”) increase for each type of authority and a variable top up depending on characteristics of each authority. Views are invited on the future shape of the formula grant system for three-year settlements.*

## **WHEN ARE CHANGES IN THE GRANT FORMULAE, DATA AND FUNDING TOTALS ALLOWED TO HAPPEN?**

- 2.10 Three-year firm allocations of formula grant are at the heart of the Government's proposals. To deliver this in the context of three-year Spending Reviews, the Government proposes the following process. Firm three-year allocations will be announced for the first full Spending Review cycle after three-year settlements are introduced. The third year of that Spending Review becomes the first year of the next. However, the spending totals in that year are not normally reopened. Nor would the grant allocations to local authorities be reopened; if new funding were introduced, for example, to enable local government to take up a new responsibility that funding would be distributed as specific grant for the one year and subsequently rolled into the settlement.
- 2.11 The Government will continue to examine selected parts of the formulae as well as collecting updated data during the three-year settlement period. The Government proposes to use the resulting revised formulae and new data to calculate allocations for years two and three of the new Spending Review period. In order to provide a base year for that and for the purposes of exemplification, the Government would also recalculate the settlement for the third year of the previous Spending Review; but that recalculated settlement would not be implemented that year.
- 2.12 This arrangement would mean that there would always be fixed allocations up to year three of the current Spending Review; and, because year one of each new Spending Review would not be reopened but firm allocations for years two and three would be announced in the autumn following the Spending Review announcement, authorities would always have at least 18 months' notice of any year's allocation.

*Question 2: Views are invited on when changes in the grant formulae, data and funding totals should be allowed to happen.*

## **WHEN, HOW AND HOW FAR TO UPDATE THE DATA USED IN THE FORMULAE?**

- 2.13 Moving to a three-year settlement will mean making a choice about whether to freeze data (i.e. only update every three years) or project all or some data forwards. The simplest way of fitting data change into the overall structure would be to introduce updated data sets into the cycle at the same point as revised formulae and grant totals, as described in paragraphs 2.10 to 2.12 above. There would need to be a decision on the extent to which data would be frozen within each three-year period, or updated by means such as projections.
- 2.14 It is already possible to "freeze" some data on the characteristics of an area. Census data changes only every ten years; we already use three year averages for some other data items for example labour costs and benefit claims; and flawed data sets in certain years have in fact already led to ad hoc decisions to "freeze" – that is to use one or two year old data sets.
- 2.15 The Barker review of housing supply *Delivering Stability: Securing our Future Housing Needs* recommended that the formula grant system should be made more forward looking, so as to reflect expected population growth. Three-year settlements provide the framework to deliver this.

- 2.16 Consistent with this approach, consideration will need to be given to the treatment of the dominant data drivers of population and council tax base. There are clearly trends over time in these data which a freeze would not pick up. At the moment there is no standard methodology of projecting either of these forward that has been tested for suitability for large scale grant distribution. The broad choices to make these data items more forward looking are to incorporate formal projections for each authority into the formula system; or to consider a separate element of the formula that would distribute a top-sliced amount of grant to councils with the largest likely changes, calculated on the basis of the pattern in recent years.

*Question 3: At this stage, the Government believes that the best way forward would involve using some form of forward looking data for population and council tax base and frozen multi year averages for other data items. Views are specifically sought on when, how and how far to update the data used in the formulae.*

### **HANDLING VOLATILITY**

- 2.17 When data are updated, after a period of being held constant or based on projections, we can expect greater volatility i.e. mismatches between the frozen/projected data and the updated set. Long period averages can help smooth this risk for some frozen data sets, but projected data sets will inevitably show some mismatches.
- 2.18 Largely because of these possible data mismatches, at the end of a three year period, the grant distribution among authorities might be substantially different from what it would have been had we continued recalculating settlements annually.
- 2.19 Amending the distribution retrospectively may be seen as fairer by those who stood to gain. And we can never rule out the possibility of such a systematic and large scale error in data, whether projected or frozen, justifying some correction. However, regularly reopening past settlements would seriously diminish the advantages of predictability and stability of setting three-year settlements in the first place.
- 2.20 In planning a three-year settlement, it would be feasible to set higher grant floors in the year in which changes in grant distribution are introduced. Whether this is desirable is likely to depend both on the choice of formula grant system, and the general level at which floors are set in fixed years (the higher these are, the less need there would be for special treatment in a change year).

*Question 4: In the Government's view no retrospective amendments to the formula grant settlement as a rule is likely to be the best option, though it is possible that these could be considered if a major systematic error were discovered. Views are invited on this issue, and on whether floors should be set at higher levels in change years.*

## **SUPPORT FOR CAPITAL EXPENDITURE THROUGH THE FORMULA GRANT SYSTEM**

- 2.21 Chapter 4 on capital allocations makes clear the Government's intention that these should in the main be provided on a firm three-year basis. That will enable formula grant support for capital allocations to be calculated in advance just as it is now on an annual basis. There will be some exceptions to this rule, and if these are to receive revenue support through formula grant there will inevitably be a need to revisit each year's revenue allocations for all authorities to ensure that revenue support for the exceptional capital projects gets to the right authorities. Views are invited on these issues at paragraphs 4.18 to 4.21.

# CHAPTER 3

## Specific revenue grants

### BACKGROUND AND OBJECTIVES

- 3.1 Whilst formula grant is the Government's preferred method of allocating funding for authorities' functions, it is not always appropriate. In addition to formula grant, authorities receive some £28 billion (in 2004/05) of funding (excluding police grant, which is about £4.5 billion), through specific grants from various Government Departments. These are distributed separately from the annual formula grant settlement. Some £15.6 billion of specific grants are paid through local authorities for national services such as student awards (these are termed non Aggregate External Finance – non AEF). There are also specific grants for authorities' own functions and services (these are termed Aggregate External Finance – AEF). These total some £12.2 billion or 15% of their spending. Most of these are distributed by formula, but some are based on eligible expenditure, performance or bids. The size of specific grants varies from less than £1 million for grants such as Secure Accommodation to £1.8 billion for the Supporting People Grant. Specific grants may be paid to a whole group of authorities, such as the Standards Fund which goes to all authorities with education responsibilities; or to only relevant authorities such as Rural Bus Subsidy which goes to those authorities with particularly rural populations.
- 3.2 Some of these grants are “ring-fenced”, which means the Government has set conditions on how authorities spend the money. This may be because the funding is for a national priority such as education or to protect the vulnerable as with Mental Health Grant. However Government policy is to restrict ring-fencing in order to allow authorities greatest flexibility. Non ring-fenced specific grants, such as the Neighbourhood Renewal Fund, are distributed outside of formula grant so as to better reflect the need to spend. In addition a few revenue specific grants are paid on the basis of performance improvements.
- 3.3 Forward funding certainty about specific grants is important for several reasons. Authorities take account of funding from these grants, which represent substantial sums of money, in considering their likely future spending, budgets and council tax levels. Most specific grants are for services such as education and social services, so knowing how much specific grant funding they will receive is particularly important to budget setting for upper tier authorities. If specific grants were excluded from three-year settlements their disadvantages compared to formula grant would be further increased as they would be less predictable.
- 3.4 A greater degree of certainty, particularly about targeted grants or non ring-fenced grants with no restrictions on how they can be spent, but also for ring-fenced grants would assist authorities in providing accurate forecasts for three-year budgets and council tax intentions. This in turn would be beneficial to improving public services. Authorities will be better able to plan ahead and commit to a programme

of action. Ring-fenced grants are often passed to other bodies, such as schools or neighbourhood groups. Three-year settlements would allow these organisations also to create more long-term sustainable plans. Some flexibility may still be needed in order to deal with sudden fluctuations in funding requirements.

## PROPOSED GENERAL APPROACH

- 3.5 The Government proposes that in the future specific revenue grants should generally be allocated on forward three-year basis. It recognises that it may not be possible to achieve this in year one of three-year allocations for all grants. There should also be a presumption against designing future grants which cannot be operated within a three-year settlement.
- 3.6 The Government recognises that there may be some specific revenue grants where it is neither sensible nor desirable to move to a three year approach. Types of grant where this may be the case are discussed below.
- 3.7 **Grants which are paid on an expenditure basis** Some grants are only paid on eligible expenditure. These are typically where there is a particular volatility in pressures between years and the Government accepts the full or a given percentage of the risks or in the case of housing and council tax benefit the payments that are eligible for full subsidy are those made in accordance with the regulations. These grants are paid after the authority submits a claim for the work it has done. In some cases interim payments of subsidy based on up to date authority estimates are paid during the year in advance of the audited claims submitted after the end of the year. Other grants are only paid on eligible assets – for example the maintenance of roads from when they are actually de-trunked. In such cases, making fixed allocations in advance may not represent best value and could increase pressure on council tax from unmet volatile pressures.
- 3.8 The Government will look to ensure that greater stability can be achieved by announcing the rules and criteria and how grants will be calculated, for example grant per head, for such grants on a three-year basis so that authorities can better estimate entitlements themselves
- 3.9 **Bid-based grants** Local authorities are invited to bid for funding from some specific grants, such as the Bus Challenge Funds. Funds are then allocated after the Government considers which proposed projects offer best value. The timetable for these projects and bids does not usually fit with the Spending Review.
- 3.10 The successful authorities usually receive funding allocations for the lifetime of the project which the authority bid for. In the future the Government will ensure that this happens in all cases, so as to give the projects maximum security. This would be subject to projects being delivered effectively. The Government will also consider the timing of other bid allocation rounds, particularly on the capital side, so that where possible funding streams can complement each other.
- 3.11 **Grants based on performance** These are typically grants which allocate a small element of funding to pump-prime improvements and reward authorities for reaching a certain performance over a certain period. The main current examples are Local Public Service Agreement (PSA) reward grant and Planning Delivery Grant (PDG).

Clearly it is not possible to forecast in advance the actual performance in the relevant periods. However authorities should generally have a good idea what their potential entitlements are.

- 3.12 In the case of Local PSAs, each local authority knows from its agreement the timing and the amounts of future potential reward grant. In the case of PDG for example, the promise of reward for improved performance is an incentive to the authority to improve quickly, and this incentive would be dampened if a three-year period were used. It could be argued that authorities were not being rewarded for recent improvements and could prove controversial if an authority was rewarded but performance had since declined.
- 3.13 Performance grants therefore to an extent already provide local authorities with some forward planning information. The Government will seek to provide more stability with all performance grants. This can be done by announcing the criteria in advance and/or providing minimum entitlements.
- 3.14 **Pilots** The Government sometimes tests a new approach through funding a pilot in a small number of authorities. If the pilot continues for more than one year the Government may need to adapt the allocations as the new approach develops.
- 3.15 The Government will maintain close communications with pilot authorities to prevent projects running into financial trouble or spiralling costs which would impact on the pilot authority's budget.

*Question 5: For three-year settlements to work effectively, specific revenue grants need to move to a three-year basis unless there are compelling reasons which suggest an alternative approach for particular grants. To this end, the Government invites views on:*

- *whether there are ways in the which categories identified above could be better incorporated into a three-year framework; and*
- *whether the types of grants identified are indeed those where allocation on a three-year basis would be most difficult.*

### **INCREASING PREDICTABILITY OF ANNUAL GRANTS**

- 3.16 Where a three-year approach is not desirable, steps can be taken to increase the predictability of annual grants. A number of these have been discussed above. The Government will always consider the importance of stable funding for local authorities when allocating grant. If it cannot announce three-year runs of allocations, it will where possible announce in advance the total amount for allocation, the allocation mechanism, the necessary criteria or rules and/or a minimum allocation per authority.

*Question 6: Views are invited on the Government's proposals for increasing predictability of annual grants.*

# CHAPTER 4

## Capital allocations

### BACKGROUND AND OBJECTIVES

- 4.1 The Government provides conventional capital support (approximately £12bn per annum) in two different ways: in the form of revenue support for borrowing costs which is distributed through the formula grant settlement (as discussed in chapter 2); or in the form of capital grants. Revenue grant is also provided to authorities to fund the Private Finance Initiative (PFI). The allocation methodologies for distributing funding for capital investment vary. Some are formulaic, though there is less dependence on annual data than is the case with revenue grant; some are based on assessment of plans prepared by authorities. Some allocations also include some kind of performance reward element.
- 4.2 Capital works are a mixture of ongoing programmes, largely aimed at sustaining an existing asset base, and one off projects to provide for new or substantially enhanced assets. The latter can be “lumpy” in terms of their short term impact on the authority’s capital expenditure. Also the lead times for planning, procuring and delivering capital programmes and projects tend to be longer than for revenue ones. Some types of project are also subject to uncertainty and delay because of external factors such as the need for statutory consents.
- 4.3 Longer lead times make forward funding certainty particularly important for capital programmes. The reduction of ring-fencing and the new financial freedoms available under the prudential system are intended to help authorities to use their capital resources more flexibly, allowing them to deliver service improvements more quickly or obtain better value for money, for example by reducing slippage or providing bridging finance. However, if authorities are to maximise the benefits of these changes they also need greater certainty about future funding. Later announcements affect authorities’ ability to accurately assess the affordability of their capital plans as required by the Prudential Code and increase pressure on council tax. Three-year certainty would allow authorities to plan ahead with confidence, making sure that projects were properly prepared while minimising the risk of abortive expenditure. It would enable authorities to take a more strategic, long term view across all their capital programmes, and in particular to join up funding streams both across the authority’s own programmes and in working with partners. It would also allow authorities to pass on three-year certainty to bodies they fund, for example Local Education Authorities’ (LEAs) allocations to schools. It would also lead to increased market certainty, which has benefits for suppliers and clients alike.

## PROPOSED GENERAL APPROACH

- 4.4 **Allocation methodologies** It is proposed that, as far as practicable, there should be firm three-year certainty for capital allocations. There will need to be some limited exceptions, discussed below, but it should be possible to provide firm three-year allocations for the majority of capital support. However, this will require some changes to the way in which allocations are currently made.
- 4.5 Government Departments would retain their present freedom to decide which allocation methodology was appropriate for their particular types of project, subject of course to the normal consultation processes, but as with revenue support grant, changes would need to be decided and announced in the autumn following a Spending Review and would take effect from year two of the relevant period. Where allocations were formulaic, decisions would need to be taken on whether data should be frozen for the period or projected forward.
- 4.6 For three-year settlements to operate effectively, decisions on programmes need to be made in time to fit in with the wider allocation timetable. This raises some issues, for example on education and on housing where allocations are made on the advice of regional housing boards. These boards allocate housing resources between authorities and other delivery agents, so these agents too would benefit from the certainty of three-year settlements.
- 4.7 **Bid-based programmes** A proportion of central Government capital support to authorities is provided through bid-based programmes. Timescales vary at present but most involve an annual process where authorities are invited to bid at some point in the previous financial year with results announced some months later, either before the start of the financial year or even in the early part of the year in which funding starts. Bid-based programmes will continue to operate, but in future bidding rounds would need to cover the full three years, and be rolled forward every two years. In most cases decisions should be announced to the same timetable as other three-year allocations but this may present problems for some programmes, notably Schools Targeted Capital.
- 4.8 These changes would involve some loss of flexibility in that Government Departments would only be able to introduce new initiatives every two years instead of annually. However, this should be more than offset by the benefits. Aligning bidding and allocation rounds would make it very much easier to join up funding across programmes and between partners. At present the timing mismatches between different bidding rounds mean that opportunities for joining up cannot always be made to work or require authorities to hold on to funding from other sources while they wait to see if a bid will be successful. If it is not, then they may well have missed other opportunities for using the held back funding to best effect. Also authorities are reluctant to commit significant resources to developing projects until they know if a bid is successful, but then often only have a short time to get a project up and running. Increased forward certainty would avoid abortive expenditure and allow successful bids to be delivered more cost effectively.
- 4.9 **Performance rewards** There are no individual capital performance reward grants at present. Performance is taken into account in setting mainstream programme allocations. To provide three-year certainty it would need to be applied for two years and with a lead time of a third year. This would be done as part of the normal arrangements

whereby Government Departments consult on changes to their methodologies. This change would inevitably make the performance reward less immediate and might affect Government Departments' views as to the size or weighting of the performance element compared with present practice. The alternative would be to keep back an element of funding, separate from three-year allocations, and award it annually as a specific performance grant. This would provide greater immediacy between performance and reward. However, short term fluctuations in funding are disruptive to good capital planning and additional resources provided at short notice will not generally be used as effectively as when they have been properly planned for as part of a wider strategy.

*Question 7: Views are invited on the Government's proposals for treating bid-based programmes and performance rewards.*

### **CASES FOR A MODIFIED APPROACH TO THREE-YEAR CERTAINTY**

- 4.10 There are some limited circumstances where making fixed allocations for up to three years ahead would not be in the best interests of either central or local government in terms of aiding planning certainty and improving delivery of outcomes. These fall into two main categories: funding to respond to genuine emergencies that arise between Spending Reviews and where remedial action needs to be taken quickly; and funding for certain very large projects where the timing is subject to major uncertainty and where, if slippage occurs, the resources are too great to be sensibly redeployed on other projects within the authority. There may also be a limited category of small-scale programmes where it may be difficult to extend predictability to three years.
- 4.11 **Emergency funding** For some capital programmes, an element of funding is retained centrally when annual allocations are made in order to provide support to deal with emergencies. For example about £30-£40 million per year of transport capital is allocated to deal with unexpected urgent needs such as rebuilding a road that has been swept away by a landslip. Similar issues arise in other programmes, for example dealing with urgent health and safety issues in schools, or urgent remedial works on contaminated land and to tackle air pollution hotspots. It is proposed that programmes where such issues arise should continue to retain an element of provision outside three-year allocations. Otherwise such provision would fall wholly on the authorities concerned, at least until the next round of three-year allocations, and would therefore fall heavily on council tax payers.
- 4.12 Such funding would be specifically for dealing with emergencies and should normally be maintained at comparable levels to present provision. However, at present some urgent funding needs are addressed through normal annual bid-based programmes. If these programmes move to three-year allocations, it will be necessary to set aside specific sums to deal with emergencies arising between bid rounds. However, the sums set aside should still be based on evidence of actual demand.

*Question 8: Views are invited on the proposed handling of funding for emergencies.*

- 4.13 **Large one-off projects** There are some large projects, particularly certain transport and police schemes, which are high value and involve significant timing uncertainties, especially when progress depends on the outcome of public consultation or statutory approvals. Such projects can also be subject to significant cost increases. For smaller value projects or ongoing programmes, authorities should normally be able to manage slippage by accelerating progress on other parts of their capital programme and switching resources back when the slipped project is ready to start. However, if a large project slips, an authority may not be able to bring forward enough alternative high priority projects to use the funding effectively.
- 4.14 Under the present system, Government Departments will normally provide firm allocations to authorities based on the best view at the time of which projects will start and their priority for funding. For large projects authorities are often given indicative allocations for projects expected to start over the next few years as well. However, there is normally an expectation that if a large project slips, the allocation will be “given back” to the centre so that another authority’s project that is ready can be brought forward. It is proposed that this flexibility to switch funding between very large projects to reflect readiness to start should be retained. This would need to apply to Building Schools for the Future projects and large transport schemes, though there may also be other projects.
- 4.15 It is proposed to provide maximum forward certainty for these projects as follows. Funding for individual large projects would be allocated for three years ahead in the same way as other capital allocations, but for new projects starting in the period the figures would be indicative. If the project was ready to start as planned and at the profiled cost, the allocation would stand. If however it slipped or the cost profile changed materially, the Department concerned would be able to switch resources to another project. Hence revisiting the allocation ensures funding support is provided more effectively when it is needed where it is needed.
- 4.16 There is no uniform definition across Government of a ‘large capital project’. For the purposes of three-year settlements, there are at least two alternatives that might be adopted for defining such projects, though there may be more. One approach would be to use simple cash thresholds. However, while a cash threshold has the benefit of being both clear and simple, there are wide variations in the size of local authorities’ capital programmes. A large local authority could probably cope with a threshold of £10 million or more for example, which would not be appropriate for some smaller authorities, such as district or fire and rescue authorities. For instance, a coastal defence project with a value of £1m could represent a substantial addition to the capital programme for at least some district authorities. To deal with these variations a low cash threshold could be set, but this would be unlikely to catch only the target projects. An alternative approach would be to set thresholds based on a percentage of an authority’s ongoing capital programme.

*Question 9: Views are invited on how major projects should be defined. Should there be one or more cash value threshold(s) and, if so, what value should they be set at and why? Or should thresholds be set as a percentage of an authority’s ongoing capital programme? Or are there other approaches that could be used?*

- 4.17 There may be some instances of small-scale bid-based project programmes, such as contaminated land, or air quality which, by their nature, mean the potential for benefiting from fixed three-year certainty is limited. While some projects may be sufficiently predictable, most are more rapid responses to needs which were not easy to foresee, arising from inspection duties. They may involve uncertainties such as whether or how much work is needed, or whether the authority needs to pay for it (for contaminated land, the “polluter” should pay, but may be impossible to find or hold liable). Such uncertainties may not be resolved until late on in the process, while the projects may be relatively small compared to other capital schemes, and take only a year or two to complete.

*Question 10: Views are invited on whether the benefits of three-year allocations would outweigh the advantages of the current arrangements for small bid-based programmes.*

### **IMPLICATIONS OF THESE PROPOSALS FOR FORMULA GRANT SETTLEMENTS**

- 4.18 Support for local authority borrowing, known as Supported Capital Expenditure Revenue (SCE(R)) is provided either as revenue support grant (RSG) through the main formula grant settlement, or, for housing, as Housing Revenue Account (HRA) subsidy. For the settlement calculations, included in an authority’s Formula Spending Share (FSS) is an element concerned with capital investment, the Debt Charges Formula Spending Share (DCFSS), which leads to additional RSG. This is based on a notional financing costs calculation and each SCE(R) feeds into this calculation.
- 4.19 The proposals described above for delivering three-year certainty for capital would mean that the majority of local authority capital allocations would be fixed for three years and to timescales that would allow SCE(R)s to be taken into account in fixing three-year formula grant settlements. However, this would not work for capital allocations that were not firmly fixed for three years ahead, principally funding for emergencies and very large one-off projects. There is no problem where the support takes the form of capital grant since the actual grant would not have to be issued until the allocation became firm, but any SCE(R)s not settled at the time of the settlement could not be taken into account until the next settlement, thereby potentially adding to pressure on council tax in the interim.
- 4.20 A possible solution to this would be for funding for emergencies or large one-off projects to be provided as capital grant rather than SCE(R). For some cases it might be possible to do this by shifting round existing support. For example education programmes already include significant levels of capital grant as well as supported borrowing, although these might not be sufficient to provide the necessary flexibility. However, virtually all the funding for major transport capital schemes (2004/05 allocation £466m) would need to be provided through grant. Some programmes are at present all supported borrowing so there would need to be some switch from SCE(R) to capital grants to deal with these circumstances.

*Question 11: Views are invited on whether a move to capital grants for emergencies or large one-off projects would be helpful.*

- 4.21 More generally, to move to three-year settlements a series of assumptions would need to be made as regards the DCFSS, the most important of which would involve making assumptions on short and long term interest rates and debt-profiles, which are used in the calculations, for the period of settlement. The simplest approach would probably be to freeze the interest rate and debt profile at the start of the three years, updating data at the beginning of the next three year cycle.

### **HOUSING CAPITAL AND REVENUE SUPPORT GRANT INTERFACE**

- 4.22 Housing capital is provided as unringfenced support. Arrangements for three-year settlements would need to work in such a way as to maintain this position. At present, if a housing SCE(R) is used for local authority housing investment support it is provided via the HRA. If it is used for a non-local authority housing purpose, the support is RSG. ODPM makes the split using a calculation that is broadly a pro rata split based on historic HRA and non-HRA housing spend. Accordingly, if three-year forward allocations for housing capital support are to be given as SCE(R), as now, the arrangements for splitting support between HRA subsidy and RSG would have to be changed. Consideration will be given to the scope for bringing forward the regional housing board allocation process which at present operates to a later timetable than that proposed for three-year settlements.

### **THE PRIVATE FINANCE INITIATIVE (PFI)**

- 4.23 PFI projects in the main already fit with the principle of three-year certainty in that the lead time between Government making the commitment to support a project and the start of funding is often three years or longer. However, there are some projects where the lead time can be shorter than three years, for example maintenance projects where there is no upfront capital asset to be delivered before start of contract payments. Also, the scope of PFI projects and the associated Government support can change after the initial project approval where authorities can make a strong case for this. Moreover, ODPM would not want to retreat from the important principle that support only starts to be paid once the project is delivered.
- 4.24 For all these reasons it will not be possible to provide absolutely fixed three-year forward allocations for PFI. The question is whether more can and should be done to provide increased certainty about PFI support.
- 4.25 In order to achieve three-year settlements more generally, it would be necessary to determine in advance the amount of the PFI topslice to achieve the DCFSS formula grant control total, but at the aggregate level it should be possible to make a reasonable forecast of this. The Government is committed to a level playing field between conventional and PFI support. We would, therefore, also need to consider whether any other technical changes that may have to be made to the way in which traditional borrowing support is calculated require changes to the calculation of PFI support in order to maintain the level playing field.

*Question 12: Views are invited on what more might be done to provide three-year certainty for PFI.*

# CHAPTER 5

## Three year budget and council tax information

- 5.1 The Government believes that greater certainty and stability in funding for local services will strengthen financial management, forward planning and efficient use of resources at the authority level. Better management of risks at the local level should offer greater stability in future council tax. It would therefore enable authorities to publish forward indications of budget levels and, as far as practicable, council tax. This could provide tax payers with more stability and greater certainty about future council tax levels; increase transparency and accountability, giving authorities a chance to consult the public on rises; help to keep council tax increases to reasonable levels; and in any case it should be an integral part of better budgetary planning by authorities. Firm forward indications of budgets and council tax are a way of ensuring that the greater certainty provided to authorities through three-year settlements is in turn passed on to council tax payers. The Government proposes to retain its capping powers under a three-year settlement regime, but will examine the interrelationship between these and any future statutory requirement for authorities to publish three-year budgets and council tax.

*Question 13: Views are invited on the proposed general approach to providing greater stability and certainty through the publication of forward indications of budget levels and council tax.*

### **HOW FIRM SHOULD THE FORWARD YEAR FIGURES BE?**

- 5.2 There is currently no formal requirement for authorities to set forward year budgets. However, under the Prudential Code, as a matter of policy, authorities should already be looking ahead to future years.
- 5.3 With certainty about their grant entitlement, authorities should be able to fix their budgets three years ahead. This will in turn mean that they can provide council tax payers and the Government with an indication of likely trends in future expenditure and council tax. Authorities cannot guarantee the actual level of final council tax bills, because even with co-ordination of information between billing authorities and major preceptors this will depend in most cases on parish precepts and levies by other public-sector bodies, which do not receive support from the local government settlement. But it should be possible for billing and precepting authorities to indicate, on the basis of their budgets, what their own contributions will be to overall bills in future years, and there is a strong case for encouraging parish councils and levying bodies themselves to plan ahead on a three-year basis.

*Question 14: Should there be legislation, similar to that which we are proposing for local authorities, requiring parish councils and levying bodies to publish forward projections of budgets and in the case of parishes corresponding figures for contributions to council tax to mirror three-year settlements?*

## **PUBLICATION OF FORWARD YEAR FIGURES**

- 5.4 Publication of budget and council tax figures for forward years could take the form either of information on local authority web sites, or of information on council tax bills or in the documentation accompanying them.
- 5.5 As council tax bills are really about the amount to be paid in year, it would not make sense to include forward year information on the bill itself. The Government believes it is more appropriate for this to be part of the information which accompanies the bill. If the Government uses powers to specify what goes with the bill, it will be the billing authority which sends this information to the taxpayer, even though some of the information will be supplied by the preceptors. Including information with bills would, in the Government's view, do much to support accountability to local tax payers.
- 5.6 There is no requirement under current legislation for publication of forward year council tax figures. However, the Government believes that in order to provide tax payers with information about future plans, the requirement to publish three-year budgets and corresponding figures for contributions to council tax bills should be mandatory. In advance of that, authorities would be encouraged to do this on a voluntary basis, as a number already do.

*Question 15: The Government believes that there should be a legal requirement to publish forward projections of budgets and corresponding figures for contributions to council tax to mirror three-year settlements. Views are invited on how this might best be achieved.*

*Question 16: In the absence of a statutory basis for three-year budget requirements, the Government also invites views on the options for, and practicality of, a voluntary arrangement to the same effect, in advance of any introduction of a statutory basis.*

## **FREEDOM TO DEPART FROM PUBLISHED FIGURES**

- 5.7 Provision needs to be made for unforeseen circumstances, as discussed in Chapter 1. There may, however, be circumstances – for instance a change in local administration – where it may be appropriate for an authority to change its projected budget requirement.

*Question 17: Views are sought on:*

- *what types of circumstance might merit alteration to three-year budget plans and council tax forecasts, consistent with the aims of transparency and stability underpinning three-year settlements; and*
- *what controls could be put in place to ensure that alterations are made only in these circumstances, on either a statutory or a voluntary basis.*

# CHAPTER 6

## Context for implementation

### BACKGROUND

- 6.1 The Government's proposed approach to three-year settlements for local authorities, police authorities and fire and rescue authorities should be considered in the context of reforms that are currently being taking forward. On finance these are Sir Michael Lyons independent inquiry into local government funding in England, Sir Peter Gershon's efficiency review and three-year settlements for schools. On local government as a whole, the Government is developing a ten year vision and strategy, which will look at how to improve authorities' effectiveness in leadership and delivery of services to all communities, including measures for further devolved decision making and deregulation. The introduction of three-year settlements also raises the issue of a three year approach to the Housing Revenue Account which is separate from local authorities general finances.
- 6.2 Consideration also needs to be given to legislative changes that will need to be made to support the introduction of three-year settlements in local government. These issues are explored in this chapter.

### LYONS INQUIRY

- 6.3 At the request of the Chancellor and the Deputy Prime Minister, Sir Michael Lyons is undertaking an independent inquiry into local government funding in England. He is due to report by the end of 2005. The Government will take account of his work in deciding whether to introduce changes to the council tax system at the time of revaluation as well as in wider consideration of long-term options for local government finance. The introduction of three-year settlements should not prejudice these future decisions.

### EFFICIENCY REVIEW

- 6.4 Achieving greater efficiency across the whole of the public sector is essential to support the Government's continuous drive for improved public service delivery. Local government has a key role to play in this ambitious agenda, and many authorities are already securing efficiencies through investment in technology and rationalisation of back office and procurement functions. The 2004 Spending Review proposed efficiencies in local government of 2.5 per cent per annum to deliver at least £6.45 billion of efficiency gains by 2007/08, releasing additional resources to front line services.

- 6.5 Sir Peter Gershon saw the cascading down of three-year settlements across the public sector as an important means of taking forward the efficiency agenda. Three-year settlements will support partnership working and greater flexibility at the local level to deliver the most from available resources to enhance services to local people.

### **RING-FENCED FUNDING FOR SCHOOLS**

- 6.6 The Government's Five Year Strategy for Children and Learners, published by the Department for Education and Skills on 8 July 2004, announced that:
- schools would be given guaranteed three-year budgets, aligned with the academic year; and
  - that the dedicated schools budget will be guaranteed by central Government and delivered through local authorities.
- 6.7 The existing "passporting" regime – under which authorities are expected to pass on increases in Schools Formula Spending Share to their schools – will therefore no longer apply.
- 6.8 Local authorities will continue to play an important strategic role in school funding. They will remain responsible for determining the distribution of funding between schools at local level in a way that best reflects local needs and priorities, and will be able to "top up" the Schools Budget using their own resources if they consider that appropriate. The introduction of three-year settlements for local authorities will mean that they will be able to offer more certainty to schools about the level of any top up.
- 6.9 Local authorities will be responsible for delivering three-year and academic year budgets for schools and for ensuring that all schools receive the minimum increase in funding guaranteed by the Government. The Government will consult with its education partners on how the minimum funding guarantee should work for 2006/07 and beyond; in particular the level at which it should be set to strike the right balance between stability and the effective targeting of resources.
- 6.10 The Department for Education and Skills will be issuing a consultation paper early in 2005 on the introduction of the ring-fenced grant and three-year, academic year budgets for schools. This consultation will address the issue of transitional protection where local authorities have spent more than their formula allocation in the past. No authority will receive less funding for education than its current level of spending, and the government will seek to ensure that there are no adverse effects for the rest of local government.

### **STRATEGY FOR LOCAL GOVERNMENT**

- 6.11 The Government is developing, in discussion with others, a strategy for local government, which it will publish in 2005. This will provide the framework for a new relationship between central and local government, as well as addressing the relationship between local government and other national, regional and local bodies which have a stake in delivering services at a local level. The strategy will consider

the impact of a move to three-year settlements on these relationships, and also what further changes to these relationships would help the introduction of three-year settlements.

## LOCAL AREA AGREEMENTS

- 6.12 Local area agreements (LAAs) provide a mechanism for bringing together the variety of supplementary funding streams that are directed to local authorities (often as specific grants) and other partners depending on particular characteristics of their area. Piloting of LAAs is only beginning and their scope has yet to be determined but in principle they offer opportunities to:
- merge funding streams (as with the safer and stronger communities fund);
  - remove constraints on the use of funds either by removing ring-fences completely or by allowing their use across a wider set of outcomes;
  - reduce the number of different allocation mechanisms so that the processes for distribution of funds are simplified; and
  - secure greater pooling of resources across sectors to address agreed outcomes.
- 6.13 The Government has not yet reached a decision on whether LAAs should be rolled out across England. If there is a roll out, the Government has said that it will start with effect for 2006/7 but will take more than one year to complete. LAAs will probably be agreements with targets that are set for a number of years but are subject to annual review. Once initial LAAs are in place, the Government's intention would be to align them with the cycle of three-year settlements allowing areas to negotiate a deal that reflects their expectations for mainstream funding for that period as well as allowing much greater flexibility on the use of remaining specific grants.

*Question 18: Views are invited on the merits of such an approach and its practicability.*

## REGIONAL FUNDING

- 6.14 *'Devolving Decision Making: A consultation on regional funding allocations'*, published alongside the 2004 Pre-Budget Report, set out proposals to establish regional transport funding allocations for the first time, and to supplement the regional transport, economic development and housing funding allocations set over the 2004 Spending Review period with guidance on long term planning assumptions for the regions beyond the spending review period. These regional funding allocations and longer term planning assumptions will give regions a far stronger base on which to plan, and by submitting proposals consistent with these assumptions regions will have an even stronger voice in the next Spending Review, leading to decisions that better reflect regional priorities. However, that advice from the regions would need to recognise the implications for Government Departments of introducing three-year settlements for local government.

## THE HOUSING REVENUE ACCOUNT AND THREE-YEAR SETTLEMENTS

- 6.15 The Housing Revenue Account (HRA) is an account that any council with more than 50 council dwellings must keep. It is a ring-fenced account within the authority's General Fund, meaning that local authorities have no general discretion to transfer sums into or out of the HRA. The ring-fence prevents either council tax payers being required to subsidise council housing or council house rents being used to subsidise general council expenditure. Local housing authorities are entitled to HRA subsidy. This is deficit subsidy, which is paid to meet any shortfall between expenditure and income.
- 6.16 An annual general HRA subsidy determination is made in December each year by ODPM. The subsidy determination itself sets out the formulae and rules that apply to all authorities. Annexes to the determination give the values that are specific to each authority and will be applied in the formulae. The subsidy calculations are based in part on information collected from the authorities earlier in the year. This includes the information necessary to calculate almost all the HRA subsidy for the authority. HRA subsidy, forming part of the ODPM's Annually Managed Expenditure (AME) budget, is heavily influenced by local authority dwelling numbers and type, which of course fluctuate on a constant basis. The current arrangement, with data from authorities informing an annual determination, provides local authorities with the certainty they require to set their annual budgets.
- 6.17 The nature of the HRA (ring-fenced, AME expenditure) means that some of the considerations may be different. To adapt to the proposed regime, the current annual subsidy determination might be extended to cover not one but three years. Freezing formula and the data used to inform calculations would mean making assumptions about requirements for years two and three. The ability of the regime to respond to changes in local authority requirements might be maintained in, for instance, changing the focus of the subsidy regime to a per-dwelling allowance.
- 6.18 As the determination moves into its second and third year authorities will increasingly be budgeting on assumed stock levels and so on but generating subsidy on actual levels. The further the data moves away from the time for which it is determining subsidy entitlement, the greater the risk any of a possible shortfall for local authorities compared to needs. The introduction of damping measures, such as floors, ceilings or caps on subsidy could reduce this risk, as would a move to a per-dwelling basis. Determining the workings of the HRA subsidy system on an annual basis allows the regime to be responsive to changes in housing strategy and offers the opportunity for refinement of the regime. Losing the ability to respond on an annual basis may well require ensuring greater flexibility initially.

*Question 19: In the light of these issues, views are invited on how best to move to a three-year settlement for HRA subsidy consistent with the principles in paragraph 1.12.*

## LEGISLATION

- 6.19 The existing legal framework is designed for annual, not three-year settlements and allocations. Although this framework does not prevent the Government awarding specific revenue and capital grants over more than one year, changes will be needed to the statutory arrangements for the formula grant settlement. Given the long lead time for changing primary legislation, the Government will initially design arrangements to operate within existing primary legislation. For instance, the formula grant settlement requires a Local Government Finance Report to be approved by Parliament. This Report concerns the distribution of revenue support grant and national non-domestic rates (NNDR). It is only possible to set the amount of NNDR to be distributed for a particular year when the retail price index (RPI) for the two previous Septembers are available. This means that, pending changes to primary legislation, there will need to be a Local Government Finance Report each year. It will not be possible to approve Reports for two or more years at the same time.
- 6.20 Despite this constraint, the Government can announce allocations of formula grant for individual authorities for the second (and third) year at the same time as allocations for the first year. The approach would be as follows. At the same time as announcing the draft settlement for 2006/07, the Government would announce its “firm intentions” as to the revenue support grant and NNDR to be allocated to each authority in 2007/08. The Government would, however, consult on 2007/08 allocations in November 2006 and would take points raised into account. Under existing legislation the possibility that final allocations might differ from the intended allocations cannot be ruled out altogether.
- 6.21 For the longer term the Government will need to establish how to adapt the legislation to tailor it to three-year settlements and grant allocations. The main change required is to allow the Secretary of State to set the amount of NNDR to be distributed in years two and three at the same time as the amount for the first year of the settlement. Other changes may include underpinning the requirement for authorities to give forward indications of council tax levels for the second and third years, and perhaps making provisions requiring levying bodies to give forward indications of their levies for years two and three.

# Annex A

## Summary of Questions

### **FORMULA GRANT SETTLEMENT**

1. Views are invited on the future shape of the formula grant system for three-year settlements.
2. Views are invited on when changes in the grant formulae, data and funding totals should be allowed to happen.
3. Views are sought on when, how and how far to update the data used in the formulae.
4. Views are invited on the Government's preference for not as a rule making retrospective amendments to the formula grant settlement, and on whether floors should be set at higher levels in change years.

### **SPECIFIC REVENUE GRANTS**

5. Views are invited on:
  - whether there are ways in which the categories of grants identified for exclusion from three-year settlements could be better incorporated into a three-year framework; and
  - whether the types of grants identified are indeed those where allocation on a three-year basis would be most difficult.
6. Views are invited on the Government's proposals for increasing predictability of annual grants.

### **CAPITAL ALLOCATIONS**

7. Views are invited on the Government's proposals for treating bid-based programmes and performance rewards.
8. Views are invited on the proposed handling of funding for emergencies.
9. Views are invited on the options for defining major projects.
10. Views are invited on whether the benefits of three-year allocations would outweigh the advantages of the current arrangements for small bid-based programmes.
11. Views are invited on whether a move to capital grants for emergencies or large one-off projects would be helpful.
12. Views are invited on what more might be done to provide three year certainty for the Private Finance Initiative.

### **THREE YEAR BUDGET AND COUNCIL TAX INFORMATION**

13. Views are invited on the proposed general approach to providing greater stability and certainty through the publication of forward indications of budget levels and council tax.
14. Should there be legislation requiring parish councils and levying bodies to publish forward projections of budgets and in the case of parishes corresponding figures for contributions to council tax to mirror three-year settlements?
15. Views are invited on how a legislative basis for requiring forward projections of budgets and corresponding figures for contributions to council tax to mirror three-year settlements might best be achieved.
16. Views are invited on the options for, and practicality of, a voluntary arrangement to the same effect.
17. Views are sought on:
  - what types of circumstance might merit alteration to three-year budget plans and council tax forecasts, consistent with the aims of transparency and stability underpinning three-year settlements; and
  - what controls could be put in place to ensure that alterations are only made in these circumstances, on either a statutory or a voluntary basis.

### **CONTEXT FOR IMPLEMENTATION**

18. Once initial Local Area Agreements are in place, they could in principle be aligned with the cycle of three-year settlements. Views are invited on the merits of such an approach and its practicability.
19. Views are invited on how best to move to a three-year settlement for HRA subsidy consistent with the principles in paragraph 1.12.

# Annex B

## The Consultation Criteria

The Government has adopted a code of practice on consultations. The criteria below apply to all UK national public consultations on the basis of a document in electronic or printed form. They will often be relevant to other sorts of consultation.

Though they have no legal force, and cannot prevail over statutory or other mandatory external requirements (e.g. under European Community Law), they should otherwise generally be regarded as binding on UK Departments and their agencies, unless Ministers conclude that exceptional circumstances require a departure.

- 1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.**
- 2. Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.**
- 3. Ensure that your consultation is clear, concise and widely accessible.**
- 4. Give feedback regarding the responses received and how the consultation process influenced the policy.**
- 5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.**
- 6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.**

The full consultation code may be viewed at:

**[www.cabinet-office.gov.uk/regulation/Consultation/Introduction.htm](http://www.cabinet-office.gov.uk/regulation/Consultation/Introduction.htm)**

Are you satisfied that this consultation has followed these criteria? If not, or you have any other observations about ways of improving the consultation process please contact:

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