

# **A guide to the Local Government Finance Settlement**

(This guide replaces the 'Plain English Guide to the Local Government Finance Settlement' which was first issued in 1998)

Office of the Deputy Prime Minister

January 2006

# A guide to the Local Government Finance Settlement

## Introduction

Local government finance has a well-deserved reputation for being complicated and difficult to understand. Because of this, in 1998 the Government provided a “Plain English” guide to the aspects of English local government finance debated and agreed by Parliament. This guide has been updated and includes further information which the Government hopes will be helpful. It is not definitive.

A glossary of terms used in this guide can be found at the end of the document. Terms explained in the glossary are shown in **bold** type throughout the guide.

## What is the local government finance settlement?

Central Government has set up three separate systems to fund the three main blocks of local authority spending in England. These blocks are:

- spending on capital projects such as roads, school buildings or computers;
- revenue spending on council housing; and
- **revenue expenditure**, mainly on pay and other costs of running services other than council housing. Government supports local councils’ revenue expenditure through formula grants and ring-fenced grants. From 2006/07 funding for schools has switched from formula grant to the ring-fenced Dedicated Schools Grant. Together formula and specific grants total some £62 billion in 2006/07 and £65 billion in 2007/8.

The annual *Local Government Finance Settlement* is concerned with the distribution of Formula Grant, which is made up of Revenue Support Grant, redistributed business rates and principal formula Police Grant. Formula Grant totals some £25 billion in 2006/07 and £26 billion in 2007/08.

Ring-fenced and specific formula grants are not part of this annual settlement but are usually announced around the same time. On currently announced plans these will total some £37 billion in 2006/7 and £39 billion in 2007/08, including the Dedicated Schools Grant.

## Deciding the Overall Amounts of Grant

In its Spending Reviews, the Government decides how much it can afford to spend, reviews its expenditure priorities and sets targets for the improvements which are to be delivered from additional funding. Each Spending Review covers a three year period.

In July 2004, the Government announced the results of its latest Spending Review. This set the framework for Government grant support to local government in 2005/2006, 2006/2007 and 2007/2008. The first year of the next Spending Review will be 2008/09.

The Spending Review determines the total level of grant to local authorities, for the following three years.

Government grant (of all kinds) and business rates together are known as **Aggregate External Finance (AEF)**. **Formula Grant** (made up of Revenue Support Grant, redistributed business rates and principal formula Police Grant) is part of AEF.

Councils also fund their spending by raising Council Tax.

Changes do occur between the plans laid out in the Spending Review and the grant available for distribution in any one year. This is because the responsibilities placed on councils by Government change. If a change involves more work for councils, then Government gives them more grant. If it involves less work, then grant is taken away. These changes in funding are often known as ‘transfers’. The principle is that funding follows responsibility.

## Different types of revenue grants

**Formula Grant.** Distributed by formula through the Local Government Finance Settlement. There are no restrictions on what local government can spend it on.

**Specific formula grants** are distributed outside the main settlement. Some of these are known as **ring-fenced grants** which control council spending. These usually fund particular services or initiatives that are a national priority. For example, funding for schools is paid through the Dedicated Schools Grant reflecting the priority the Government place on education.

Other specific formula grants are **unfenced** and are sometimes called **targeted grants**. They are distributed outside of the annual settlement, because the general formulae are not appropriate. There are no restrictions on what councils can spend the money on.

It is worth noting that, except for grants intended for schools, there is generally no ring-fencing of grants for authorities judged “excellent” in the Comprehensive Performance Assessment. The rating for this freedom is currently being reviewed and it is worth checking on the Office’s website ([www.odpm.gov.uk](http://www.odpm.gov.uk)) for the latest information.

A list showing examples of the main grants of each type, as currently proposed for 2006/07, is shown below.

	2006/07	2007/08
<b>FORMULA GRANT</b>	<b>£m</b>	
Revenue Support Grant	3,378	4,105
National Non Domestic Rates	17,500	17,500
Police Grant	3,936*	4,028*
<b>Total</b>	<b>24,814</b>	<b>25,633</b>
<b>EXAMPLES OF UNFENCED (TARGETED) GRANT</b>		
Neighbourhood Renewal Fund	525	525
Planning Delivery Grant	104	92
Children's Services Grant	152	193
Access and Systems Capacity	546	546
Carers Grant	185	185
<b>EXAMPLES OF RING-FENCED GRANT</b>		
Dedicated Schools Grant	26,576	28,172
Mental Health Grant	133	133

\* Includes Metropolitan Police special payment

## Allocating Formula Grant

This year, for the first time, the Government has decided to produce forward allocations of most grants for 2006/07 and 2007/08. One of the main exceptions to this is in the funding of some capital projects where allocations cannot be forecast.

The arrangements for allocating ring-fenced and specific formula grants vary: some schemes use formulae or other rules on entitlement; others allocate funds on the basis of appraising bids. Formula Grant is allocated among authorities by mathematical formulae – with the changes limited by 'floors'.

This process of allocating Formula Grant each year is known as the Local Government Finance Settlement, and the following sections give more detail about how this is done.

## The Local Government Finance Settlement Timetable

This year the Government have announced final allocations for 2006/07 and indicative allocations for 2007/08. From 2008/09, Government intends to announce settlements for three years at a time, in line with the Spending Review timetable.

The timing of the 2006/07 announcement is constrained on the one hand by local authorities needing to have sufficient time to set their budgets for the start of the following financial year, and on the other by the need to use the most up-to-date information possible to determine grant allocations. To fit this timetable, the Secretary of State usually announces a provisional Finance Settlement to Parliament and to local authorities in late November or early December each year.

After the Secretary of State's announcement there is a period of consultation, when local authorities can put their views on the proposals to Government, and point out any errors that may have been made. Once all the points from local authorities have been considered and any amendments have been incorporated, the final Local Government Finance Settlement is approved by the House of Commons in late January or early February. This allows enough time for authorities to finalise their budgets for the next financial year.

It is not possible for the Government to announce final 2007/08 formula grant allocations at the same time as the 2006/07 settlement without a change in the law. As a result, we will follow the timetable and process given above for the provisional and final 2007/08 settlement announcements. The difference will be that we do not anticipate making changes to the 2007/08 allocations that are announced with the final 2006/07 settlement.

### Sharing out resources

From 2006/07 the government has introduced a new system to distribute Formula Grant. Under the new system the distribution of Formula Grant is determined wholly by the Relative Needs Formulae (and Police Grant formulae in the case of police authorities), the Relative Resource Amount, the central allocation (an amount per head) and the floor damping scheme. The way the system works is described in more detail below.

### Relative Needs Formula

To work out each council's share of Formula Grant the Government first calculates the **Relative Needs Formula** (RNFs). The RNF's are mathematical formulae that include information on the population, social structure and other characteristics of each authority.

The Government (in consultation with local government) has developed separate formulae to cover the major services which local authorities provide. RNF's are divided into these major service areas, because there are different factors influencing each service area. For example, the factors which appear to explain variations in the cost of providing social services for the elderly, are very different from those which appear to explain variations in the cost of maintaining roads. These formulae apply to all authorities providing a particular service.

The funding blocks for services areas are shown in the following table:

<b>Service Block</b>	<b>Sub-block (where relevant)</b>
<b>Children's Services</b>	
<b>Composed of:</b>	<i>Youth and Community Local Education Authority Central Functions</i>
	<i>Children's Social Care Children's Social Care damping</i>
<b>Adults' Personal Social Services</b>	
<b>Composed of:</b>	<i>Social Services for Older People Social Services for Younger Adults Social Services for Younger Adults damping</i>
<b>Police</b>	
<b>Fire</b>	
<b>Highway Maintenance</b>	
<b>Environmental, Protective and Cultural Services</b>	
<b>Composed of:</b>	<i>Services provided predominantly by non-metropolitan district councils in non-metropolitan areas (District level EPCS) Services provided predominantly by county councils in non-metropolitan areas (County level EPCS) Fixed Costs Flood Defence Continuing EA Levies Coast Protection</i>
<b>Capital Financing</b>	
<b>Composed of:</b>	<i>Debt charges</i>

Relative Needs Formulae are designed to reflect the relative needs of individual authorities in providing services. They are not intended to measure the actual amount needed by any authority to provide local services, but to simply recognise the various factors which affect local authorities' costs locally. They do not relate to the actual monetary amount of grant that a council needs for providing services for its residents. The amount of grant a council will receive from Government depends also on the results of the other three blocks detailed below.

The formula for each specific service area is built on a basic amount per client, plus additional top ups to reflect local circumstances. The top ups take account of a number of local factors which affect service costs, but the biggest factors are deprivation and area costs.

Because the RNFs are only intended to reflect the relative differences in the cost of providing services in different areas, they are expressed as a proportion - or ratio - of the total relative needs in 2005/06. It should be borne in mind that in 2005/06 schools were funded via the settlement and in 2006/07, schools are funded outside the settlement via the Dedicated Schools Grant. The total relative needs in 2006/07 is therefore approximately two-thirds of that in 2005/06.

Once we have calculated RNFs for the service blocks for all authorities, the next step is to use this to generate cash amounts that are correlated to the measure of relative need. To do this fairly, Government has to group the individual service formulae into six groups so that councils are only being compared to authorities providing the same range of services.

For example, an 'Upper tier RNF' is determined from the RNFs for Children's Services, Adults PSS, Highways Maintenance, County level EPCS and Continuing Environment Agency Levies as these are all provided by the same group of authorities (county councils, metropolitan district councils, unitary authorities, London boroughs, the City of London and the Isle of Scilly).

The table below shows which services are included in the six RNF service groups.

<b>Service Block</b>	<b>Upper Tier Services</b>	<b>Lower Tier Services</b>	<b>Police Services</b>	<b>Fire Services</b>	<b>Mixed Tier Services</b>	<b>Capital</b>
<b>Children's Services</b>	✓					
<b>Adults' Personal Social Services</b>	✓					
<b>Police</b>	✓		✓			
<b>Fire</b>	✓			✓		
<b>Highway Maintenance</b>	✓					
<b>Environmental, Protective and Cultural Services</b>						
<i>County level EPCS</i>	✓					
<i>Continuing EA levies</i>	✓					
<i>District Level EPCS</i>		✓				
<i>Fixed Costs</i>					✓	
<i>Flood Defence</i>					✓	
<i>Coast Protection</i>					✓	
<b>Capital Financing</b>						✓

The RNFs are added together to give a total RNF for each group. The total RNF for each group is then divided by the total population for that group of councils as measured by the mid-year population projections for the year in question. The minimum RNF per head across all councils providing the group of services is then subtracted from the RNF per head for each council. The sum of the RNFs above the minimum for each council is then calculated and this is then multiplied by the mid-year projected population. The control total for the Relative Needs Block is then distributed in proportion to this.



## Relative Resource Amount

The Relative Resource Amount is a negative figure. It takes account of the fact that areas that can raise more income locally require less support from Government to provide services. The negative Relative Resource Amount is balanced against the positive proportion calculated for each authority by the Relative Needs Amount.

This block recognises the differences in the amount of local income which individual councils have the potential to raise. This is done by looking at authorities' council taxbase data (a measure of the number of properties equivalent to Band D for council tax in an area). The greater an authority's taxbase the more income it can raise from a standard increase in band D council tax.

Negative Relative Resource Amounts are then generated using the amounts above the minimum council tax base per head. Again, to do this fairly, the Relative Resource Amount is applied to four separate groups of authorities depending on the services they provide. The four groups of authorities provide: upper tier services, lower tier services, fire authorities and police authorities.

## Central Allocation

Once we have taken account of the Relative Needs and Relative Resources of local authorities, there is still an amount of money left in the overall grant pot for distribution to local authorities.

The Government shares this out on a per head basis; the per head amounts are based on the appropriate minimums for each authority already calculated for the needs and resources blocks.

## Floor Damping Block

The mechanism for damping grant changes remains the same as in the previous grant distribution system.

Following the calculations in the three blocks described above, each authority will have a grant amount allocated to it. However, Government ensures that all individual local authorities receive a reasonable grant increase year-on-year.

In order that authorities are protected from detrimental grant changes, the Government sets a guaranteed minimum increase in grant. It is important to note that all floor calculations (as with all the comparisons of grant that Government makes from one year to the next) are adjusted to make sure they are on a like-for-like basis. For instance, in 2006/07, the transfer of the Residential Allowance grant into formula grant means that upper tier authorities need more formula grant than before.

So when floors are calculated, the baseline year (2005-06, for the 2006-07 settlement) is adjusted to include the Residential Allowance grant transfer. That is why the quoted increase in grant may not be the same as the change in the cash an authority receives. The Government knows that this appears to make the system more complicated – but local government agrees that it is fair.

Separate floors levels are set for four groups of authorities: authorities with education and social services responsibilities; single-service police authorities; single service fire authorities; and shire districts. Separate parts of the Formula Grant calculations for the GLA are included in the floor arrangements for police and fire authorities.

These groups are treated separately because each group receives a different overall grant increase, and the Government believes it would be wrong for groups of authorities with radically different responsibilities to cross-subsidise each other.

### Levels of floors in 2006/07 and 2007/08

The Government has set the floor levels to give the fairest distribution of the money available, and to ensure that all authorities receive a fair formula grant increase.

The levels for floors for 2006/07 and 2007/08 are shown in the table below.

<b>Type of Authority</b>	<b>2006/07 Floor</b>	<b>2007/08 Floor</b>
Education/social services authorities	<b>2.0%</b>	<b>2.7%</b>
Police authorities	<b>3.1%</b>	<b>3.6%</b>
Fire authorities	<b>1.5%</b>	<b>2.7%</b>
Shire districts	<b>3.0%</b>	<b>2.7%</b>

As all the Formula Grant to be paid to local authorities must come from within the finite overall pot, the cost of providing the guaranteed floor must also be met from this pot. In order to do this grant increases above the floor are scaled back. The amount of grant scaled back is then used to pay for the floor guarantee.

### Total Grant Allocation

The actual amount of Formula Grant which an authority receives is calculated using the four blocks detailed above. Full details of how the calculations work are set out in the Local Government Finance Report which is approved by Parliament each year.

## Setting Council Taxes

Local authorities need to start preparing their budgets for the coming year several months before they know exactly what funding they will get from the Government. After the settlement, once an authority knows the level of funding, it can make final decisions on:

- how much it expects to spend in the coming year;
- what income, other than that from Government, it expects to raise next year; and
- how it can use its financial reserves to fund spending or keep down its Council Tax.

A local authority's planned spending, after deducting any funding from reserves and income it expects to raise (other than general funding from the Government and the Council Tax), is known as the **budget requirement**. The amount of Council Tax an authority needs to raise is the difference between its budget requirement and the funding it will receive from the Government.

Each local authority then sets its Council Tax at the level necessary to raise this amount.

## Capping

In the past, the Government set a 'cap' or budget requirement limit, for each council. This limit was announced before councils set their budget requirements. The Government has not done this since 1998/99.

The Government has reserve powers to cap local authority budget requirements where it judges authorities to have set excessive increases. Capping action was taken against 14 authorities in 2004/05 and against 9 authorities in 2005/06.

For 2006/07 and 2007/08, the Government has made clear its expectation that the average council tax increase in England should not exceed 5% in either year; and that that it will not hesitate to use its capping powers if that proves necessary.

## **Amending Reports**

The Government can amend a previous year's local government finance settlement, if errors in the original settlement come to light after it has been approved. When such data corrections are needed, an Amending Report for the settlement year in question is issued.

The Government has decided to issue an Amending Report for the 2004/05 and 2005/06 settlements to incorporate changes to the population data used in the original 2004/05 settlement. Population estimates for 2002, which were used in the 2004/05 settlement, were revised by the Office for National Statistics on 9<sup>th</sup> September 2004. The Amending Reports for 2004/05 and 2005/06 will be implemented at the same time as the 2006/07 settlement.

The Amending Report will not alter the overall amount of grant which was distributed in the relevant settlements, but it will change how the money was distributed. Differences in a council's amount of grant for 2004/05 and 2005/06 after the amendments have been made, will be paid out with the 2006/07 settlement, or taken off the amount the council will receive in 2006/07.

## Glossary

### ***Aggregate External Finance (AEF)***

The total level of revenue support the Government provides to local authorities for their core functions. This support is normally made up of Revenue Support Grant, police grant, specific formula and ring-fenced grants and the amount distributed from business rates.

### ***Amending Report***

The means of correcting errors in a settlement, after the settlement has been approved.

### ***Area Cost Adjustment (ACA)***

The scaling factor applied to RNF to reflect higher costs – mostly pay – in some council areas.

### ***Billing authorities***

These are the 353 authorities that collect Council Tax - district councils, London boroughs, and unitary authorities.

### ***Budget requirement***

This is the amount each authority estimates as its planned spending, after deducting any funding from reserves and any income it expects to raise (other than from the Council Tax and general funding from the Government i.e. Formula Grant and sometimes in the past, certain special grants). The budget requirement is set before the beginning of the financial year.

### ***Business rates***

These rates, called National Non-Domestic Rates, are the means by which local businesses contribute to the cost of providing local authority services. Business rates are paid into a central pool. The pool is then divided between all authorities.

### ***Capping***

When the Government limits an authority's budget requirement, and hence the council tax it sets.

### **Control Totals**

These are the totals of all authorities' Relative Needs Formulae for each major service area. They are set out in Annex E to The Local Government Finance Report.

### **Council Tax**

A local tax on domestic property set by local authorities in order to meet their budget requirement.

### **Council Tax base**

The Council Tax base of an area is equal to the number of band D equivalent properties. To work this out, the Government counts the number of properties in each band and works out an equivalent number of band D properties. For example, one band H property is equivalent to two band D properties, because it pays twice as much tax. The amount of revenue which could be raised by Council Tax in an area is calculated allowing for discounts and exemptions but, for the purpose of the Formula Grant calculation, assuming that everyone pays. How this is calculated is set out in Annex C to the Local Government Finance Report.

### **Council Tax bands**

There are eight Council Tax bands. How much Council Tax each household pays depends on the value of the homes. The bands are set out below.

<b>Council Tax bands</b>		
	<b>Value of home estimated at April 1991</b>	<b>Proportion of the tax due for a band D property</b>
<b>Band A</b>	under £40,000	66.7 %
<b>Band B</b>	£40,001 - £52,000	77.8 %
<b>Band C</b>	£52,001 - £68,000	88.9 %
<b>Band D</b>	£68,001 - £88,000	100.0 %
<b>Band E</b>	£88,001 - £120,000	122.2 %
<b>Band F</b>	£120,001 - £160,000	144.4 %
<b>Band G</b>	£160,001 - £320,000	166.7 %
<b>Band H</b>	over £320,001	200.0 %

***Council Tax discounts and exemptions***

Discounts are available to people who live alone and owners of homes that are not anyone's main home. Council Tax is not charged for certain properties, known as exempt properties, such as those lived in only by students.

***Damping***

'Damping' is sometimes used to describe the way limits are applied to the effect on grant funding of changes to the distribution formulae or data used. Minimum increases, floors, on Formula Grant changes from one year to the next are now the major damping mechanism. There is also damping specifically for children's social care and younger adults' social services RNF's.

***Distributable Amount***

This is the estimated total amount in the business rate pool that is available to be distributed to local authorities. The business rates are collected by local authorities and paid into a national pool and then redistributed to all authorities. The total amount is set out in Section 5 of the Local Government Finance Report. The basis for distribution is set out in Section 6 of the Local Government Finance Report.

***Fixed Costs***

An element of an authority's costs which do not vary with size; this mainly consists of the costs of running the corporate and democratic core of an authority, sometimes described as "the costs of being in business, not the costs of doing business".

***Floor damping***

A method by which stability in funding is protected through limiting the effect of wide variations in grant increase. A floor guarantees a fixed level of increase in grant. The grant increases of authorities who receive more than the floor are scaled back by a fixed proportion to help pay for the floor.

***Formula Grant***

Comprises Revenue Support Grant, redistributed business rates, and (for relevant authorities) principal formula Police Grant.

### **Indicators**

In this context, information used in the calculation of the Relative Needs Formulae, such as projections of population, numbers of school children, numbers of elderly people or lengths of road. The indicators are generally defined in Annex D to the Local Government Finance Report.

### **The Local Government Finance Settlement**

The Local Government Finance Settlement is the annual determination of formula grant distribution as made by the Government and debated by Parliament. It includes:

- the totals of formula grant;
- how that grant will be distributed between local authorities; and
- the support given to certain other local government bodies.

### **Lower Tier Authorities**

Authorities that carry out the functions that, in shire areas with two tiers of local government, are carried out by shire districts. They are the same councils as **billing authorities**.

### **Net Revenue Expenditure (NRE)**

This represents an authority's budget requirement and use of reserves.

### **Non-Domestic Rates**

See business rates.

### **Precept**

This is the amount of Council Tax income county councils, police authorities, the Greater London Authority, parish councils and fire authorities need to provide their services. The amounts for all local authorities providing services in an area appear on one Council Tax bill, which comes from the billing authority.

### **Precepting authority**

This is an authority which sets a precept to be collected by billing authorities through the Council Tax bill. County councils, police authorities, the Greater London Authority, some fire authorities and parish councils are all precepting authorities.



**Receiving authorities**

These are the 432 authorities that are eligible to receive Revenue Support Grant.

**Relative Needs Formulae (RNF's)**

These are the first stage in the calculation the Government uses to distribute formula grant. The relative needs formulae for each service block are set out in Section 4 of the Local Government Finance Report.

**Reserves**

This is a council's accumulated surplus income (in excess of expenditure) which can be used to finance future spending.

**Resource Equalisation**

The way in which the formula grant distribution system takes account of councils' relative ability to raise council tax.

**Revenue Expenditure**

Expenditure financed by AEF grants, council tax and use of reserves.

**Revenue Support Grant (RSG)**

A Government grant which can be used to finance revenue expenditure on any service. The total amount is set out in Section 2 of the Local Government Finance Report.

**Ring-fenced grant**

A grant paid to local authorities which has conditions attached to it, which restrict the purposes for which it may be spent.

**Specific Grants**

Targeted or ring-fenced grants are sometimes referred to as specific grants.

**Specified Body**

This is the term used for bodies (such as the Local Government Improvement and Development Agency and the National Youth Agency) that are directly funded from Revenue Support Grant, and that centrally provide services for local government as a whole.

**Targeted grant**

A grant which is distributed outside the general formula, but has no conditions attached.