



National Audit Office

**REPORT BY THE  
COMPTROLLER AND  
AUDITOR GENERAL**

**HC 1090  
SESSION 2010–2012**

**20 JULY 2011**

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**Cross-government landscape review**

Formula funding of local public services

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National Audit Office

## Cross-government landscape review

# Formula funding of local public services

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Amyas Morse  
Comptroller and  
Auditor General

National Audit Office

14 July 2011

This review considers three formula-based grants, under which £152 billion, one-fifth of all government spending, was allocated in 2011-12.

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## Key facts

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**£152bn**

was allocated by three  
formula-based grants  
in 2011-12

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**575**

local public bodies  
are funded by these  
three grants

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**165**

indicators are used  
in the formulae to  
assess needs

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**£1,298-£2,268** variation in per capita allocations for primary care trusts 2011-12

**£4,429-£8,051** variation in per pupil allocations to local authorities based on  
Dedicated Schools Grant 2011-12

**£142-£1,075** variation in per capita Formula Grant allocations to areas for  
council and fire services 2011-12

**£93-£258** variation in per capita Formula Grant allocations for police  
authorities 2011-12

**7 years** since the needs-based formula within the Dedicated Schools  
Grant was updated

**£1.9 billion** was distributed across Primary Care Trusts to enable movement  
towards target allocations, while taking account of the need for  
funding stability in 2011-12

# Summary

**1** Government departments provide funding to local public bodies in a variety of sectors, including health, education, local government, police and fire services. Departments allocate most funds based on complex formulae that apportion total funds available to individual public bodies. This review considers three formula-based grants, under which £152 billion, one-fifth of all government spending, was allocated in 2011-12. They are:

- **Primary Care Trust allocations administered by the Department of Health;** designed to fund services across most aspects of healthcare<sup>1</sup>;
- **The Dedicated Schools Grant administered by the Department for Education;** paid to local authorities but the funding is ring-fenced for schools. Local authorities pass on the funding to maintained schools, based on their own local formulae; and
- **Formula Grant administered by the Department for Communities and Local Government;** distributing funding from national non-domestic rates and revenue support grant to councils, police authorities and fire authorities. Police authorities also receive Police Grant from the Home Office, which the Department for Communities and Local Government takes into account when determining allocations.

**2** Formula funding has been used in local government since at least 1929 and in health since 1976. It offers a rational basis for distribution of funds according to government objectives – in these cases, broadly in response to the relative needs of the bodies concerned. It can also provide transparency and openness to enable public debate. Formula funding also has limitations. The basis for distribution can be unclear as the formulae attempt to reconcile multiple objectives. Key choices in formula design, such as the choice and weighting of needs indicators, are contestable. Approaches to formula design are constrained by data availability.

## Scope of this report

- 3** For the three funding arrangements listed, this report examines:
- the objectives and design of formula funding (Part One);
  - generic issues relating to assessing need and data quality (Part Two); and
  - how departments balance stability with responsiveness (Part Three).

<sup>1</sup> There are some areas, with a budget of £4 billion in 2011-12, that are not fully covered by the formula: primary dental services; pharmaceutical services; general ophthalmic services; and support for joint working between health and social care.

**4** The funding arrangements for all the sectors considered in this report are currently under review. This report examines existing arrangements, with a view to establishing key lessons which new arrangements should address. It is not a full review of systems of local finance and does not consider sources of income beyond the three grants specified. It does not review performance monitoring arrangements used to provide accountability for the use of funds allocated.

### Scale and significance

**5** **Figure 1** sets out the responsible departments and scope of the three largest formula-based grants. The grants within this review are key determinants of the budgets of the recipient organisations, although the extent to which local public bodies depend on these grants, and other central funding, varies by sector. The formulae only help to distribute grant to local bodies; they don't set the totals to be distributed. They are designed to preserve a degree of local discretion in the use of funding received; they don't represent contracts for the local delivery of specific service levels.

### Key findings

**6** The funding formulae reviewed share the broad aim to allocate money to local bodies in response to their relative needs, but the extent to which they have done so varies. The funding models are designed to respond to multiple objectives, which can be in conflict, are open to interpretation, and are prioritised by judgement. This constrains the extent to which funding formulae are responsive to calculated needs. For example, nearly 20 per cent of all authorities funded by Formula Grant in 2011-12 receive allocations more than 10 per cent from their calculated needs. The combination of multiple objectives and the nature of the services being funded results in complex formulae.

### Clarity of objectives and design of models

**7** The objectives for formula funding should be clear; measurable; prioritised where there are multiple objectives; and time-bound where appropriate. **Figure 2** on page 8 sets out the objectives of the funding models reviewed. The Department of Health publishes its objectives clearly, and their relative prioritisation in the formula is quantified. The Department for Education and the Department for Communities and Local Government have not set out clearly, or publicly prioritised, their current objectives for the Dedicated Schools Grant and Formula Grant. The objectives in Figure 2 were taken from a range of sources and confirmed with officials. None of the formulae have objectives which are sufficiently precise or time-bound to allow assessment of the extent to which they have been achieved. Their qualitative nature provides little discipline over key elements in the allocations process, such as the balance between responding to needs and providing funding stability.



**Figure 1**

Formula funding of local public bodies considered in this review

Grant	Administering Department(s)	Services for which need is assessed	Funding provided to	Total amount (2011-12)	Variation in funding by area
Primary Care Trust Allocations	Department of Health	Health	151 Primary Care Trusts	£85 billion	£1,298-£2,268 per capita
Dedicated Schools Grant	Department for Education	Schools	151 Local Authorities	£37.5 billion	£4,429-£8,051 per pupil
Formula Grant	Department for Communities and Local Government; Home Office (for Police Grant)	Children's Social Services	354 Local Authorities	£20.5 billion to Local Authorities	£142-£1,075 per capita (includes local government and fire services)
		Adult's Personal Social Services			
		Environmental, Protective and Cultural Services			
		Highways Maintenance			
		Fire and Rescue	31 Fire and Rescue Authorities	£1.1 billion to Combined and Metropolitan Fire Authorities	
		Police	39 Police Authorities	£7.9 billion to Police Authorities	£93-£258 per capita

**NOTES**

- 1 The Department for Communities and Local Government and the Home Office use the same relative needs formula for policing, but distribute the funding in different ways. See paragraph 1.37 for more details.
- 2 Combined and Metropolitan fire authorities are distinct entities, but the costs of County fire and rescue services are met within general local authority budgets.
- 3 In addition to services, Formula Grant also contains a relative needs formula for capital financing.
- 4 Variation for Dedicated Schools Grant and Formula Grant excludes City of London.

Sources: Department of Health, Department for Education, Department for Communities and Local Government

**Figure 2**  
Objectives of formula funding

Grant	Objectives
<b>Primary Care Trust Allocations</b>	Ensure equal opportunity of access to health care for people at equal risk Contribute to the reduction in avoidable health inequalities
<b>Dedicated Schools Grant</b>	Provide stability of school funding Provide funding to local authorities on the basis of relative needs Address key national and local authority priority areas, such as personalised learning and special educational needs, through funding for 'ministerial priorities' Drive efficiency at school level, by setting the level of the minimum funding guarantee below inflation
<b>Formula Grant</b> (Department for Communities and Local Government)	Provide funding based on the relative needs and the relative resources of each local authority Provide stability and predictability Avoid the previous system's direct links between calculated levels of service need and funding allocations, as the previous Government felt that there was a misunderstanding of the allocations process whereby local authorities used this information to set local budgets and council tax For the 2011-12 settlement period, to ensure those authorities that are most dependent on Formula Grant get smaller reductions
(Home Office)	Allocate funding on the basis of the relative needs of local areas for policing

Sources: *Department of Health; National Audit Office analysis*

**8** Departments have developed complex models to assess need, in part reflecting the complexity of the underlying services. The needs elements of the models mostly use a capitation approach, based on counting local populations and weighting those populations using sets of indicators designed to reflect relative needs. There is a broad consensus that this approach is appropriate, though it has limitations.

**9** Although the models are all grounded in assessment of relative needs, other aspects of their design differ (**Figure 3**). These differences are due to the evolution of additional objectives and differences in the circumstances of the different sectors. For example, Formula Grant is designed to take account of the income that local authorities raise through council tax and is structured to account for the different service responsibilities of different types of local authorities. By contrast, the Dedicated Schools Grant does not take account of other income sources and funds organisations providing a single service.

**Figure 3**  
Structural design of formula funding models

Grant	Structural design	Implications
<b>Primary Care Trust Allocations</b>	<p>The model is based on three elements: hospital and community health services; prescribing; and primary medical services</p> <p>Each element has two components to respond to each of the Department's two objectives</p>	<p>There is a clear link between the two objectives and the structural design of the model</p> <p>The health inequalities component is based on a crude, single metric which was intended to be an interim solution</p> <p>Allocations are significantly influenced by judgement about the relative weighting of the two objectives</p>
<b>Dedicated Schools Grant</b>	<p>The grant has been based on a 'spend-plus' design since 2006-07, with almost all of the allocation to a local authority based on its allocation in the previous year</p>	<p>The model has preserved per pupil allocations to local authority areas at similar levels</p> <p>By prioritising this aspect of stability, allocations have not been responsive to changes in pupil characteristics</p>
<b>Formula Grant</b>	<p>The 'four-block' model is based on:</p> <ul style="list-style-type: none"> <li>• allocating a share of funding on the basis of relative needs;</li> <li>• deducting a share of funding on the basis of relative resources;</li> <li>• allocating a share of funding on a per capita basis; and</li> <li>• adjustments to provide funding stability</li> </ul>	<p>The model has become increasingly complex as it has incorporated multiple objectives</p> <p>Although relative needs and resources are assessed in a complex way, the connection between those assessments and funding allocations has been obscured</p> <p>Some design elements of the model have distributive effects that cannot be reconciled back to objectives</p> <p>Allocations are significantly influenced by judgements about key parameters</p>

Source: National Audit Office

**10** The Department of Health formula plays most directly to its stated objectives. The Department for Education, in reviewing school funding arrangements, has assessed its current approach as unresponsive to changing needs. We agree that current arrangements do not fulfil this objective. For Formula Grant, the impact of the objective to avoid direct links being made between calculated levels of service need and how much local authorities should spend on each service has been to add complexity and reduce transparency – in tension with current government policy on increasing transparency.

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In considering the objectives and design of funding formulae, departments should:

- set clear, precise objectives for funding formulae, articulating measures of success for the distribution process;
  - consider the extent to which a single funding instrument should be based on multiple, and sometimes contradictory, objectives; and
  - design formulae to address objectives directly, in the simplest appropriate way.
- 

## Needs assessment and data quality

### Estimating local populations

**11** The main purpose of the three grants is to fund local services according to the relative needs, and in the case of Formula Grant, relative resources, of local populations. The process of determining local populations varies between formulae:

- Primary Care Trust allocations use GP registration data scaled to the Office for National Statistics (ONS) projections.
- The Dedicated Schools Grant is based on administrative counts of pupils.
- Formula Grant uses ONS population projections.

**12** Administrative data offer timeliness and responsiveness, but have to be controlled for quality, consistency and potential gaming. Annual ONS projections are grounded in the underlying ten-yearly census, then updated by reference to other sources, and cover all sections of the population but are less responsive. There are sometimes significant differences between different data sets. For example, the total of GP registrations exceeds ONS population projections. Differences between the two data sets at the level of a primary care trust have been as high as 25 per cent. Given the central importance of population data to the capitation approach, these variances represent a risk to funding according to needs.

### Assessing the needs of local populations

**13** In addition to the sizes of local populations, the relative needs of those populations are considered. Few indicators directly measure local needs. Departments therefore rely on proxy indicators, based on their association with variations in past service use or expenditure. Examples include benefit claimant rates or health status. The approach taken to identify these indicators is contestable. Areas of concern relate to the under-use of services by specific groups of people, and the extent to which expenditure patterns reflect organisational practices rather than underlying need. Departments are exploring other approaches, but the development and implementation of new approaches is constrained by the availability of adequate data.

### Data limitations

**14** Departments apply criteria to potential data sources to gauge their fitness for purpose. For example, data must be consistently available for all authorities and not open to manipulation or subject to perverse incentives. The range of suitable, readily-available data sets is limited, leading to some weaknesses in the data. For example, a quarter of the indicators used in Formula Grant, and 10 per cent of those used in Primary Care Trust allocations, are entirely based on data sources that are now ten or more years old, usually because they are based on census data. While the most influential indicators for resource allocation, such as population estimates, are more current, indicators based on old data are still important within the parts of the models to which they relate. There is no ready way to quantify the effect of using old data. Departments have not set quality standards about the levels of data accuracy or timeliness that they expect. There is a margin of error in the formulae's expression of relative need, though this is not quantified.

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In considering needs assessment and data quality, departments should:

- base funding models on indicator sets which most validly and reliably represent underlying objectives; and
  - secure reliable, timely data, setting data standards on accuracy and timeliness for data sources, proportionate to their significance to allocations.
- 

### Stability and responsiveness

**15** The formulae themselves have evolved in response to changed circumstances and policies, but major changes can take several years to implement. For example, the Department of Health inequalities objective was set in 1999. It was first met through a separate allocation and first featured within the model in 2003-04. It is now based on a single, crude indicator introduced in 2009-10 that was intended to be an interim solution.

**16** Funding according to relative needs has to be balanced against decisions about funding stability. All of the grants reviewed include provisions to ensure funding stability. A degree of stability supports financial planning and stable service provision. Judgements about the levels of stability have not been based on objective analysis of the changes in income that organisations can cost-effectively absorb, considering their cost structures and financial positions. The operation of stability adjustments has led to some local bodies being funded significantly above or below needs-assessed levels for extended periods.

## Governance

**17** If judgements about definitions of need are a political matter, the interpretation of those needs through indicators and their incorporation into rigorous funding formulae requires technical and management expertise. All the departments use advisory bodies to help secure that expertise, although the bodies have differing roles and levels of independence. Of the three grants reviewed, the advisory bodies for the health formula have the clearest terms of reference, the most independence from departmental control within a defined technical remit, and the greatest influence over funding allocations. As a result, they are more able to provide effective advice and independent scrutiny over the formula's development. However, in contrast to other arrangements, the Department of Health does not consult publicly on changes to its formula.

**18** Given that funding formulae inform the distribution of £152 billion of public money, their operation and control should be of interest to departmental boards. Although some executive board members have been involved in decisions about the design and operation of formula funding, none of the three formulae reviewed are subject to formal oversight from departmental boards. The board could provide useful pressure on issues such as the clarity of objectives, the transparency of the model, data quality and the operation of advisory groups.

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In considering governance, departments should:

- maintain a clear distinction between factors requiring political judgement, and those which should be grounded in empirical evidence and rigorous analysis;
  - draw on technical expertise through advisory groups which have formal, precise terms of reference related to the technical and managerial aspects of the formulae, appropriate funding and support, and requirements for transparent process and reporting;
  - provide sufficient transparency over the operation of funding formulae to enable checking of allocations and challenge to the basis or operation of the formulae; and
  - ensure that formulae management and control arrangements are considered formally by departmental boards.
-

# Part One

## Formula funding objectives and design

### Objectives

**1.1** Government departments provide funding to local public bodies in a variety of sectors, including health, education, local government, police and fire services. Departments allocate most funds based on complex formulae that apportion total funds available to individual local public bodies. Departments should have clear objectives for formula funding so that funding models are designed based on specific priorities, there is transparency about the current basis of funding, and formulae can be monitored and reviewed to understand the extent to which objectives are fulfilled and value for money is achieved.

**1.2** We consider that objectives for formula funding should be:

- clearly stated and comprehensible;
- sufficiently specific to enable measurement of the extent to which the objective is fulfilled;
- prioritised where there are multiple objectives; and
- time-bound where appropriate.

**1.3** The **Department of Health** has had long-standing objectives for its formula. The terms of reference for a working party established in 1975 to consider formula funding set the first objective of the weighted capitation approach: “to ensure equal opportunity of access to health care for people at equal risk”. A second objective was added in 1999: “to contribute to the reduction in avoidable health inequalities”. These continue to be the objectives of the independent Advisory Committee on Resource Allocation, which advises the Department on the funding formula.

**1.4** An independent report commissioned by the Department of Health on behalf of the Advisory Committee on Resource Allocation<sup>2</sup> criticised the inequalities objective as being too broad to enable the design of the formula to target accurately. While the Department of Health is to be credited with setting transparent objectives, the objectives may benefit from further refinement to provide clearer direction and public accountability.

<sup>2</sup> S. Morris et al, *Research on the health inequalities elements of the NHS weighted capitation formula*, October 2010.

**1.5** For Dedicated Schools Grant and Formula Grant, the Department for Education and the Department for Communities and Local Government have not provided clear, current statements that prioritise their multiple objectives. For both grants, objectives can be derived from statements made at the time of settlement announcements, Ministerial statements to Select Committees and introductions to consultations. But over time it is difficult to establish which objectives are still current or most relevant.

**1.6** The **Department for Education** confirmed the following main objectives for the Dedicated Schools Grant, which was established in 2006-07:

- to provide stability of school funding;
- to provide funding to local authorities on the basis of relative needs;
- to address areas such as personalised learning and special educational needs, through funding for 'ministerial priorities'; and
- to drive efficiency at school level, by setting the level of the minimum funding guarantee below inflation.

**1.7** The **Department for Communities and Local Government** confirmed the following main objectives for the model that has been used to distribute Formula Grant, also since 2006-07:

- to provide funding based on the relative needs and resources of each local authority;
- to provide stability and predictability;
- to avoid what the previous Government identified as a misunderstanding associated with the previous system; that there were direct links between calculated levels of service need and funding allocations, which local authorities used to set local budgets and council tax; and
- for the 2011-12 settlement period, to ensure that those authorities that are most dependent on Formula Grant get smaller reductions.

**1.8** The **Home Office** has not set out a clear current statement on the objectives of the Police Allocation Formula, but confirmed that its purpose is to allocate funding on the basis of the relative needs of local areas for policing.



## Design of funding models

**1.9** For each funding model, the following section outlines the department's administration and governance arrangements for formula development, and the key structural components and implications of the model's design.

### Primary Care Trust Allocations

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**Figure 4**  
Key facts about Primary Care Trust Allocations

Main elements set by Government judgement	<ul style="list-style-type: none"> <li>• Overall size of allocation (set in Spending Review)</li> <li>• Weighting between the two components of the formula addressing each objective</li> <li>• Adjustments to provide stability, determining actual allocations</li> </ul>
Main elements set by analytical process	<ul style="list-style-type: none"> <li>• Indicator and data source selection</li> <li>• Relative service needs of primary care trusts</li> </ul>
Approach to choosing new formula indicators	Independent advisory body has responsibility of selecting indicators as part of its role in overseeing development of health formula
Number of unique indicators in formula	51
Estimated administration costs	£640,000

**NOTE**

<sup>1</sup> Estimated administration costs are annual costs (2009-10) to the Department of administering and developing the formula to the nearest £10,000; including related parliamentary work, commissioned research costs and an estimate for departmental overheads including pension and National Insurance and other costs.

Source: National Audit Office analysis

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### Administration and governance

**1.10** The independent Advisory Committee on Resource Allocation (ACRA), supported by its Technical Advisory Group, advises on the development of the health formula. The bodies are more influential than advisory bodies for the other formulae reviewed, which are department-led. For example, in 2010, the Secretary of State accepted all of the advisory committee's recommendations in full, except for one which would be affected by the proposed health reforms.<sup>3</sup> The advisory bodies are independent from the department and have clear terms of reference to advise the Secretary of State on how the formula should be developed to meet policy objectives. The department commissions work on behalf of the Advisory Committee on Resource Allocation. In 2009 and 2010, this amounted to £290,000 to commission independent research. This informed changes to the formula for 2011-12. In contrast to other arrangements, the Department of Health does not consult publicly on changes to its formula.

### Structural design

**1.11** Primary Care Trust allocations are structured around three elements:

- hospital and community health services;
- prescribing; and
- primary medical services.

**1.12** The overall formula combining these three elements is designed to respond to two overarching objectives concerning equal opportunity of access to health services given equal need, and reducing avoidable health inequalities. In 2008, the Advisory Committee on Resource Allocation concluded it was not technically possible to fully achieve both objectives within a robust and transparent single formula for each element. The Committee proposed a second formula applied uniformly for each element to further address the objective to reduce avoidable health inequalities.<sup>4</sup> The Committee also found that there was no technical basis to apply particular weightings for the two formulae designed to achieve each objective. It therefore recommended that the decision about the weightings should be a political decision left to ministerial judgement.<sup>5</sup>

**1.13** Since 2009-10, the overall allocation formula has incorporated two distinct formulae to respond to the objectives. For 2009-10 and 2010-11, the health inequalities formula was weighted at 15 per cent. For 2011-12, the Secretary of State changed the weighting to 10 per cent (**Figure 5**).

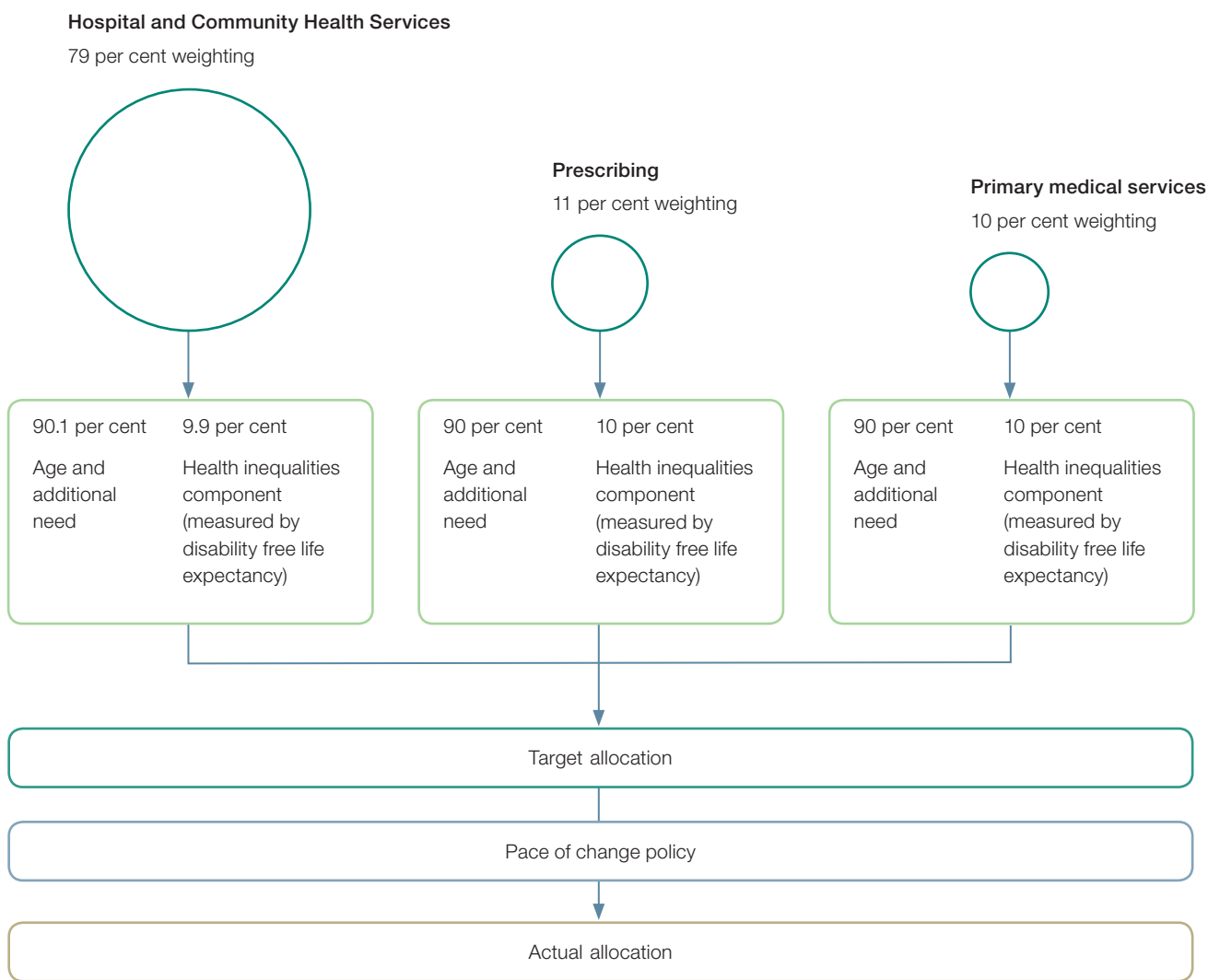
<sup>3</sup> Letter from Secretary of State to Chair of ACRA, 11 October 2011, accessible at [http://www.dh.gov.uk/prod\\_consum\\_dh/groups/dh\\_digitalassets/documents/digitalasset/dh\\_122668.pdf](http://www.dh.gov.uk/prod_consum_dh/groups/dh_digitalassets/documents/digitalasset/dh_122668.pdf)

<sup>4</sup> In 2011-12 allocations, the health inequalities formula has been renamed the Disability Free Life Expectancy formula. It is constructed in the same way (see paragraph 1.15).

<sup>5</sup> Department of Health, *Report of the Advisory Committee on Resource Allocation*, 2008.

**Figure 5**  
The structure of the Primary Care Trust allocations model

**Weighted capitation formula**



**NOTE**

1 The weightings applied are for 2011-12 allocations.

Source: National Audit Office

**1.14** The component of the formula that responds to age-related and additional needs of populations is based on a population count, adjusted according to relative needs. These are determined by demographic, socio-economic and morbidity variables that explain past variation in the use of health services, after taking account of supply effects such as waiting times or the distance to a hospital. Examples of the variables in the current formula include the proportion of people in an area claiming Disability Living Allowance and death rates by five-year age group. There is also an adjustment – the market forces factor – for unavoidable variations in the cost of providing health care in different locations.

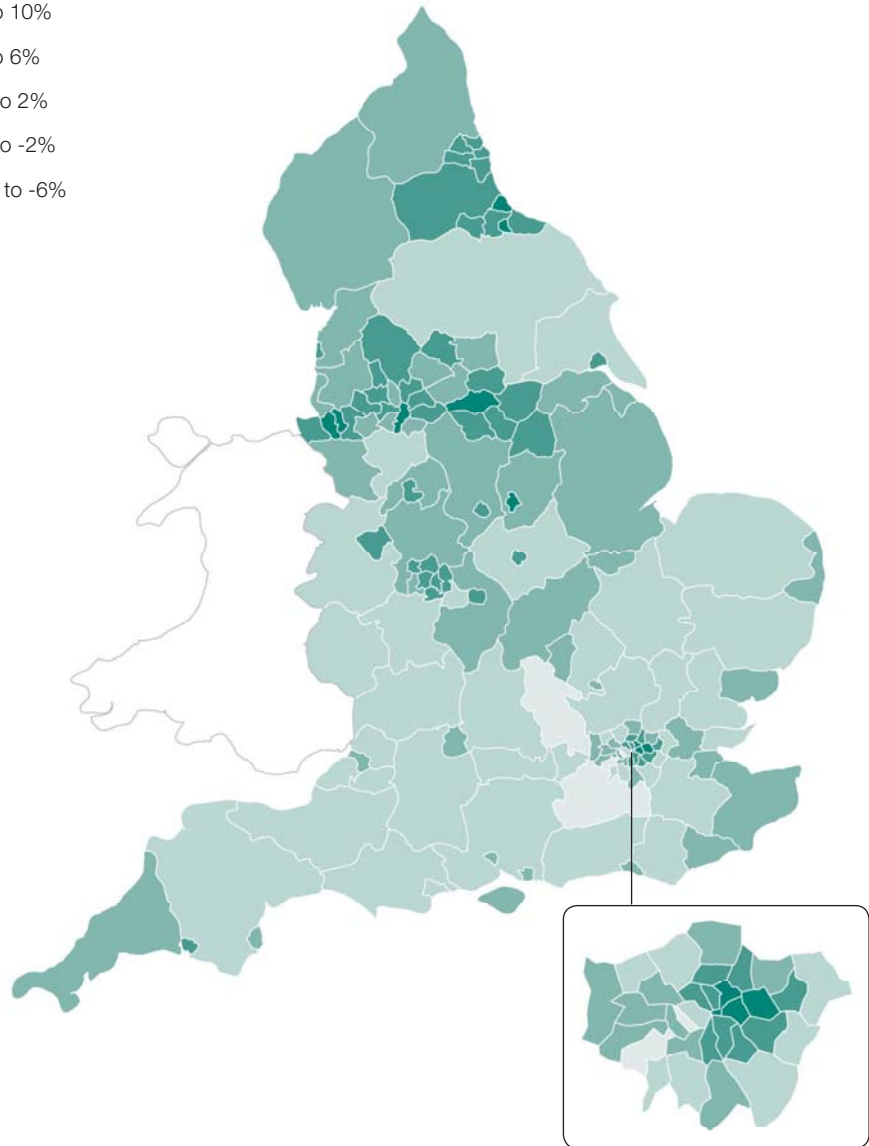
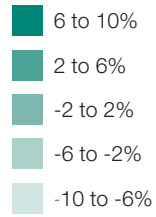
**1.15** By contrast, a single indicator based on disability-free life expectancy is used to respond to the health inequalities objective. The indicator was recommended by the Advisory Committee on Resource Allocation because it was the only one of those considered that captured both quality of life and life expectancy. However, it has limitations. The quality of life measurement is based on a crude indicator, which is not sensitive to the severity of a condition and does not account for within-area health inequalities. Given these and other limitations, the Committee recommended that the health inequalities component was an interim measure. Although the weighting has changed for 2011-12, the indicator itself has remained.

**1.16 Figure 6** illustrates the distributional effects of the weighting of the health inequalities formula. It compares an allocation based only on the needs formula without any weighting for the health inequalities component to the effect of the current health inequalities weighting of 10 per cent. The inclusion of the health inequalities component with this weighting makes a difference of more than 5 per cent to the target allocations of 35 out of the 151 primary care trusts. Increasing the health inequalities weighting moves target funding towards areas with greater mortality and morbidity. In general terms, the effect is to direct funding from Southern and Eastern England to the North of England and inner London.

**Figure 6**

Impact of Health Inequalities component weighted at 10 per cent compared with no Health Inequalities component

Per capita difference in target allocation



**NOTE**

1 A positive figure shows that a primary care trust's target allocation is higher with the health inequalities component set at 10 per cent.

Source: National Audit Office analysis of Department of Health data

## Dedicated Schools Grant

### Figure 7

#### Key facts about the Dedicated Schools Grant

Main elements set by Government judgement	<ul style="list-style-type: none"> <li>• Overall size of grant (set in Spending Review)</li> <li>• Rolling in and distribution method of other grants</li> <li>• Adjustments to provide stability at both local authority and school level</li> </ul>
Main elements set by analytical process	<ul style="list-style-type: none"> <li>• The underlying needs formula for distribution to local authorities has not been updated, due to the 'spend-plus' approach taken</li> <li>• Changes in pupil numbers provide the only means of responsiveness</li> </ul>
Approach to choosing new formula indicators	<p>In the past, a separately convened Formula Review Group has reviewed potential updates to the formula</p> <p>On an ongoing basis, the department works with its School Funding Implementation Group to consider changes to school funding</p>
Number of unique indicators in formula	4 (see notes)
Estimated administration costs	£1,420,000

#### NOTES

- 1 Number refers to those indicators updated annually within the 'spend-plus' methodology. This is based on an existing formula with ten indicators that was used until 2005-06.
- 2 Estimated administration costs are calculated on the same basis for all departments. See note in Figure 4.

Source: National Audit Office analysis

### Administration and governance

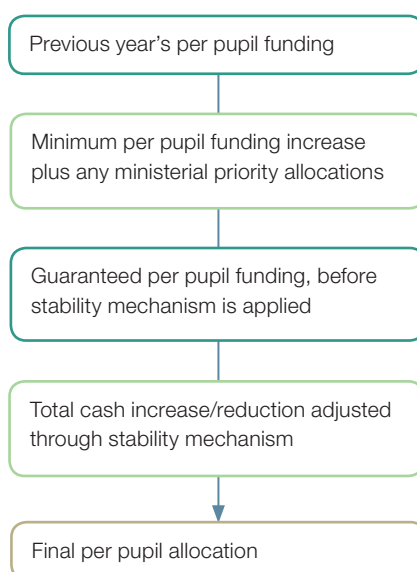
**1.17** The Department for Education leads the development of the Dedicated Schools Grant. The department conducts or commissions technical research and advises Ministers on the options available. The main advisory body, the School Funding Implementation Group, does not have operational independence or funding, and its recommendations are mediated by the department.

**1.18** The department normally consults publicly on significant structural changes to the Dedicated Schools Grant and wider school funding issues. In advance of the current settlement, it consulted on approaches to introducing the new pupil premium and on the rolling in of some specific grants to the Dedicated Schools Grant, but not on the stopping of other specific grants. It is currently consulting publicly on the principles and detail of wider school funding reform.

### Structural design

**1.19** Until 2005-06, education funding was included within Formula Grant to local authorities. It was removed to provide a separate, ring-fenced grant for schools that the department distributes to local authorities, who then use their own formulae to pass on the grant to maintained schools. Since it was established in 2006-07, the Dedicated Schools Grant has been allocated to local authorities mainly on the basis of a 'spend-plus' methodology (**Figure 8**). This means that almost all of the allocation to a local authority (99 per cent in 2010-11) is based on its allocation in the previous year.

**Figure 8**  
The structure of the Dedicated Schools Grant

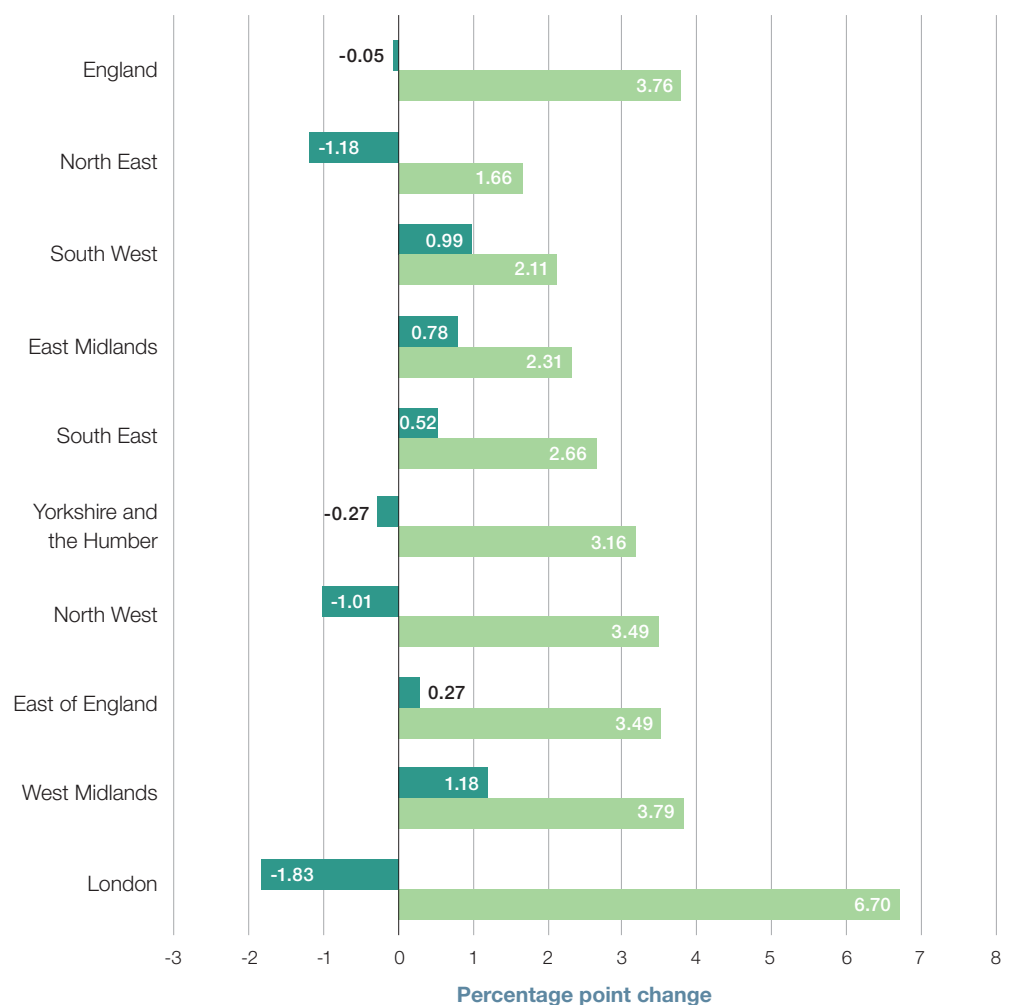


Source: National Audit Office

**1.20** This approach prioritises funding stability but is not responsive to changes in pupils' needs. There have been changes in pupil characteristics in all regions in England. **Figure 9** illustrates the percentage changes since 2005 in pupils eligible for free school meals and those who do not speak English as a first language, both factors that the Department for Education associates with higher levels of need.

**Figure 9**

Changes in pupil characteristics for English regions, 2004 to 2010



■ Pupils known to be eligible for Free School Meals    ■ Pupils with English as an additional language

**NOTE**

1 Includes primary and secondary schools.

Source: Department for Education



**1.21** Despite these changes, the underlying formula designed to assess the relative needs of pupils in different local authorities has not been updated since 2005-06. However, local authorities pass on the funding to schools based on local formulae which are updated, and therefore this local distribution is more responsive.

**1.22** We carried out regression analysis to quantify the extent to which pupil characteristics explain differences in overall funding at school level, and the extent to which changes in those characteristics explain actual changes in income from one year to the next.<sup>6</sup> In 2008-09, 97 per cent of the variation in funding to primary schools could be explained by the pupil characteristics included in the model such as the number of pupils eligible for free school meals, those with special education needs or those who speak English as an additional language. However, when looking at the change in funding from 2008-09 and 2009-10, year on year changes in the same pupil characteristics only explained about a quarter of the resulting change in school funding. This shows that funding is not sufficiently responsive to immediate changes in pupil characteristics. These findings are similar to those published in earlier research by CfBT Education Trust.<sup>7</sup> There are two elements of the Dedicated Schools Grant that are not responsive:

- the ‘spend-plus’ methodology for local authority allocations is driven by changes in pupil numbers, but not their socio-economic characteristics; and
- the setting of minimum funding guarantees at school level constrains local authorities in targeting funding (see Part Three).

**1.23** For 2011-12, the Government introduced a new pupil premium designed to address limitations of the Dedicated Schools Grant by targeting additional funding directly to pupils eligible for free school meals. The pupil premium is, however, overlaid onto an existing funding system that does not target deprivation consistently. The Department for Education has noted that “some areas are now woefully underfunded compared with how they would be if the system reflected need properly, whereas some areas continue to receive funding to which they should no longer be entitled” in its current consultation on school funding reform.<sup>8</sup>

<sup>6</sup> The variables used as proxy indicators for the factors included within Dedicated Schools Grant were: total number of pupils; pupils eligible for free school meals; pupils with English as an additional language; and pupils with special educational needs.

<sup>7</sup> CfBT Education Trust, *Level playing field? The implications of school funding*, 2008.

<sup>8</sup> Department for Education, *A consultation on school funding reform: Rationale and principles*, 2011.

## Formula Grant

**Figure 10**  
Key facts about the Formula Grant

Main elements set by Government judgement	<ul style="list-style-type: none"> <li>● Overall size of grant (set in Spending Review)</li> <li>● Overall amount of grant distribution based on relative needs</li> <li>● Share of above distribution based on relative needs for each service area (set in Spending Review)</li> <li>● Overall amount of grant deducted based on local authorities' ability to raise council tax</li> <li>● Adjustments to provide funding stability (for each authority type)</li> <li>● Rolling in and distribution method of other grants (only in 2011-13 period)</li> </ul>
Main elements set by analytical process	<ul style="list-style-type: none"> <li>● Indicator and data source selection</li> <li>● Relative service needs of local authorities</li> <li>● Relative resources of authorities (i.e. ability to raise council tax)</li> </ul>
Approach to choosing new formula indicators	The department normally consults publicly – and works with its Settlement Working Group – to review and select indicators
Number of unique indicators in formula	110
Estimated administration costs	£1,240,000

### NOTE

1 Estimated administration costs are calculated on the same basis for all departments. See note in Figure 4.

Source: National Audit Office analysis

## Administration and governance

**1.24** The Department for Communities and Local Government leads the development of the Formula Grant. The department, or partner departments, conducts or commissions technical research and advises ministers on options available. None of its advisory bodies, including the Settlement Working Group and the Fire and Rescue Formula Working Group, are funded. They are subject to the operational control of the department and their recommendations are mediated by them.

**1.25** The department normally consults publicly on proposed significant structural changes to Formula Grant. For the current settlement, however, the timing of ministerial decisions meant that it consulted on changes to data sources and indicators but not on structural changes such as the rolling in of specific grants and the introduction of new approaches to providing stability (see Part Three). The department is currently consulting on changes to the business rates system within its Local Government Resources Review.

**1.26** Many stakeholders are unable to conduct developmental modelling with the formula, as they lack access to the full model and the department does not explain an important reconciliation process fully (see paragraph 1.34). This limits the extent to which advisory bodies and stakeholders can effectively challenge and help develop the technical elements of the formulae. Where the department consults on significant structural changes, the influence of the consulted groups is also limited, for example, on the move to the current four-block model, described below.

### Structural design

**1.27** The Department for Communities and Local Government administers the ‘four-block model’ to distribute Formula Grant (**Figure 11**). Formula Grant funds different types of authorities with different functions and statutory responsibilities. In addition to funding on the basis of relative needs, it takes account of the relative resource base of local authorities, reflecting their ability to raise income locally through council tax.

**1.28** The four-block model was designed to respond to a policy objective to avoid direct links between levels of service need and funding allocations for each service. This was due to misinterpretation of the previous system, which included notional amounts of money based on service needs. The previous Government felt that it was a misunderstanding of the allocations process to use this information to set budgets and levels of council tax.

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## Figure 11

The structure of the four-block model used to distribute Formula Grant

### Block 1: Needs Equalisation

Amount allocated according to relative needs, based on seven separate relative needs formulae

*In 2011-12 83 per cent of Formula Grant was distributed through this block*

### Block 3: Central Allocation

Remaining amount allocated on a per capita basis, depending on the services provided

*In 2011-12 43.6 per cent of Formula Grant was allocated through this block*

### Block 2: Resource Equalisation

Amount deducted to account for locally raised revenue (i.e. council tax base)

*In 2011-12 26.6 per cent of Formula Grant was ‘deducted’ through this block*

### Block 4: Floor damping

Provides stability through a minimum ‘floor’ level, paid for by those authorities above the ‘floor’

*Source: National Audit Office*

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**1.29** Because the design of the four-block model incorporates this objective, it has been described as highly complex and not transparent.<sup>9</sup> When the department consulted publicly on the introduction of the model in 2005, it was supported by only 4 per cent of respondents. The majority of those rejecting the proposal considered it “too complex, less transparent than the existing system and subject to more ministerial judgement<sup>10</sup>”. The department introduced further significant structural changes in the 2011-12 settlement to respond to its additional objective to protect those authorities that are most dependent on Formula Grant from the biggest reductions.<sup>11</sup> The department has recently described the current system as “extremely complex<sup>12</sup>”.

### **Threshold authorities demonstrate the sensitivity and complexity of the four-block model**

**1.30** The four-block model introduced a threshold system which funds need above and below the threshold at different rates. The threshold is set, for each type of authority, at the need of the least needy authority. Similar thresholds exist to deduct funding based on resources. Authorities that act as threshold authorities are therefore particularly significant in the model. The following hypothetical example demonstrates the sensitivity and complexity of threshold effects.

**1.31** Wokingham is the threshold authority for upper tier authorities.<sup>13</sup> Wokingham’s formula grant allocation for 2011-12 is £10.4 million.<sup>14</sup> Hypothetically, if the relative needs of Wokingham for its upper tier services had been 5 per cent lower in 2011-12, one might expect that a small proportion of this money would be redistributed across the remaining local authorities.

**1.32** Due to the structure of the model, this relatively minor change would move the threshold and lead to £235 million being redistributed between local authorities despite there being no change in their assessed levels of need. At regional level, it would move more than £111 million out of London. At authority level, the allocations of 11 local authorities would change by more than 5 per cent. Birmingham City Council would lose £14.4 million and the London Fire and Emergency Planning Authority would have a £8.2 million decrease in funding.

**1.33** These changes are driven by differences in the proportions of relative needs and relative resources above and below the threshold for any given authority. They relate to the construction of the model alone, rather than underlying changes in need or resource in other authorities. Due to the complexity of the four-block model, these effects are difficult to predict, or reconcile with core objectives, other than to obscure the link between needs, resources and funding.

9 Local Government Association, Memorandum to the Select Committee on the Barnett Formula (2009).

10 Office of the Deputy Prime Minister, *Consultation on Formula Grant Distribution: Summary of Representations*, 2005.

11 These include the introduction of banded damping for councils; the rolling in of specific grants using tailored distributions; and setting up a related transition grant based on authorities’ spending power.

12 Department for Communities and Local Government Press Release: *Review could end council dependence on Whitehall grant*, 2011.

13 These provide upper tier services including education and social services.

14 This and other amounts in this example refer to allocations prior to the application of the fourth floor damping block. The impact on final allocations would differ based on the parameters of the fourth block.

**1.34** The Department for Communities and Local Government does not provide a public version of the model that enables third parties to carry out their own modelling of Formula Grant. This is because each time a change is made to any inputs to the model, the department applies a reconciliation process. It resets the shares of the total tax base for different types of authorities so that changes in overall allocations to each group of authorities are proportional to changes in their relative needs.<sup>15</sup> The assessments of tax base at authority level in the second block of the model are therefore constrained to totals based on relative needs rather than resources.

**1.35** Unlike other aspects of the formulae, the department does not describe the methodology for this process fully. This hinders transparency over a further complex, but significant, element of the four-block model. It also means that it is difficult to interpret the effects of changes exemplified in consultations because, in reality, the parameters of the model for any settlement will differ to those in consultations.

## Police funding

### Figure 12 Key facts about the Police Allocation Formula

Main elements set by Government judgement	<ul style="list-style-type: none"> <li>• Overall size of Police Grant (set in Spending Review)</li> <li>• Rolling in and distribution method of other grants</li> <li>• Adjustments to provide stability</li> </ul>
Main elements set by analytical process	<ul style="list-style-type: none"> <li>• Indicator and data source selection</li> <li>• Relative service needs of police authorities</li> </ul>
Approach to choosing new formula indicators	Police indicators are included within Department for Communities and Local Government consultations to review and select appropriate indicators. The Home Office also works with its Police Allocation Formula Review Group to consider changes
Number of unique indicators in formula	16
Estimated administration costs	£110,000

#### NOTE

1 Estimated administration costs are calculated on the same basis for all departments. See note in Figure 4.

Source: National Audit Office analysis

<sup>15</sup> The groups are single and upper tier authorities; lower tier authorities; police authorities; and fire and rescue authorities.

### Administration and governance

**1.36** The Police Allocation Formula is administered by the Home Office, which is advised on the development of the formula by the Police Allocation Formula Working Group. This advisory body does not have operational independence and its recommendations are mediated by the department. Changes to the Police Allocation Formula are included in the Department for Communities and Local Government's public consultation on changes to Formula Grant.

### Structural design

**1.37** Police authorities in England receive £7.9 billion funding through Formula Grant. Of this, 58 per cent (2011-12) is provided by the Home Office. The set of indicators used by the Home Office, in the Police Allocation Formula, is the same set as that used to allocate the Department for Communities and Local Government's share of police funding. The difference is that the Department for Communities and Local Government's share is subject to adjustments through the second and third blocks of the four-block model while the Home Office's share is not. The Department for Communities and Local Government then takes account of the Home Office's share of funding in its stability adjustment through the fourth block to determine final allocations. There are no clearly defined current objectives for the funding being split in this way, or in the current proportions.

### Match between formulae and objectives

**1.38** The various formula funding models are designed according to their objectives, though they do not always do this in a well-evidenced or transparent way. To different extents, they have been structured so that they are capable of being responsive to changes in local populations or circumstances. The lack of clearly prioritised, precisely expressed, objectives prevents close analysis of whether the formulae represent the best way to satisfy objectives.

**1.39** Departments take different approaches to administration and governance of formula funding. Although some executive Board members have been involved in decisions about the design and operation of formula funding, none of the three formulae reviewed had been subject to formal oversight from departmental boards. Boards cannot be expected to be involved in the details of the formulae. There is, however, a need for oversight of strategic issues such as the arrangements for decision-making and the role of advisory bodies; their nature, funding and terms of reference; and arrangements for consultation, representation and transparency.

# Part Two

## Generic issues in assessing need

**2.1** This part discusses issues related to needs assessment common to all the formulae. These include the limitations of approaches taken to identify needs indicators and the quality and timeliness of underlying data.

### Limitations of estimating need by way of past use or expenditure

**2.2** With few direct measures of need, all efforts to measure need using proxy indicators are imperfect. A generic limitation of the arrangements reviewed is the analytical approach taken to identify or confirm the proxy indicators. The approach uses statistical regression to identify relationships between indicators and variations in past use or past expenditure for a given service. This assumes that past use or past expenditure is an appropriate basis for understanding underlying need. This has been criticised by academics and stakeholders.<sup>16</sup> This is because:

- levels of past spending may vary significantly as a result of variations in the way services are managed. For example, levels of operational efficiency influence past spending; and
- levels of past use may be higher or lower for various population groups because of their ability to access services; or how well informed they are about services available, rather than because of variations in their needs.

**2.3** In its 2010 consultation, the Department for Communities and Local Government sought to address the first of these issues. The department put forward an option whereby efficiency would be taken into account in the relative needs formula for fire services. It recognised that using updated expenditure data could penalise authorities that had made efficiency savings, as the current approach implicitly assumes that lower past spending equates to lower need for the service. The majority of authorities with fire and rescue responsibilities (28 of 35) opposed the use of efficiency savings data for this purpose and no changes were made. The main reasons for opposition included the difficulty with setting a baseline for efficiency savings, the poor quality of efficiency savings data and the inconsistency with the approaches taken for other services.

<sup>16</sup> S. Asthana & A. Gibson, *Setting health care capitations through diagnosis-based risk adjustment: A suitable model for the English NHS?*, *Health Policy*, 2010; Local Government Association, *Memorandum to the Select Committee on the Barnett Formula*, 2009; A. West, 'Redistribution and financing schools in England under Labour: Are resources going where needs are greatest?' *Educational Management Administration & Leadership*, 2009.

**2.4** This issue has also been examined in the context of schools funding. In 2001-02, the department considered a model based on set service standards and assumptions about variables such as number of taught weeks, taught hours per week and class sizes. That leads to a set of standard unit costs which, when applied to pupil numbers and adjusted for area input prices, leads to area funding allocations. The Department rejected this approach because it involved contestable assumptions about teaching practices. Furthermore, the approach only applies to basic per pupil funding, and alternative methods would still be necessary to assess and allocate funds for Additional Educational Needs. The model was developed further in 2009 and the interest of the department's advisory body in this method remains strong.

**2.5** An example of an approach to the second issue was identified in the health formula. Researchers found that areas with lower levels of education and employment and higher proportions of ethnic minorities have used some health care services less than average. The research also found that the lower levels of utilisation did not represent lower levels of need in these populations. If left unaddressed, the then-current model (used from 2003-04 to 2007-08) would have allocated such areas lower funding levels than average. On the advice of the Advisory Committee on Resource Allocation, the ethnicity and employment indicators that gave rise to the anomaly were corrected for in the formula. This response has been criticised for being too selective in examining the issue only for some indicators, and for not exploring the effect of these decisions on allocations.<sup>17</sup> This illustrates the difficulty of accounting for unmet need when the regression approach used to identify indicators of need produces counter-intuitive results.

**2.6** In 2007, the Department of Health commissioned two exploratory studies of alternative needs-estimation approaches for practice-based commissioning which were peer-reviewed by the Advisory Committee on Resource Allocation. These were designed to address the above limitations of the existing approaches, and to respond to the policy move towards commissioning decisions being made by general practices, which have smaller, more transient populations than primary care trusts which currently receive funding. These studies have so far informed practice-based commissioning, and may also form the basis for allocations to clinical commissioning groups in the future.

**2.7** One of these studies, led by the Nuffield Trust, investigated the potential for supplementing area-based data with individual-based information on users and non-users of acute hospital services.<sup>18</sup> This approach uses data on individual's past encounters with the health system, which can better explain the variation in future service utilisation at an individual level. However, by making predictions of future health care use based on past utilisation, the method is still vulnerable to the issue of past under-utilisation.<sup>19</sup>

17 J. Galbraith & M. Stone, 'The abuse of regression in the National Health Service allocation formulae: response to the Department of Health's 2007 'Resource allocation research paper' *Journal of the Royal Statistical Society*, 2011.

18 Nuffield Trust, *Developing a person-based resource allocation formula for allocations to general practices in England*, 2009.

19 S. Asthana & A. Gibson, 'Setting health care capitations through diagnosis-based risk adjustment: A suitable model for the English NHS?' *Health Policy*, 2010.



**2.8** The other study investigated whether mental health needs could be predicted based on survey data.<sup>20</sup> By moving away from modelling historic utilisation and estimating need directly based on different 'person types', this approach overcomes the issue of perpetuating unmet need. In this case, there were some limitations because available data lacked coverage of, for example, children or residents in nursing homes. The Department of Health nevertheless described it as a step-change improvement in how mental health needs were modelled.<sup>21</sup>

### Control of data quality

**2.9** As with any mathematical formula, the quality of the outputs relies not only on the construction of the formula but also on the underlying data inputs. The data used should fulfil strict criteria to be adequate for formula funding. For example, data must be consistently available for all authorities, not open to manipulation, and not providing any perverse incentives.

**2.10** Departments apply criteria to potential data sources used in formula funding to gauge their fitness for purpose. The Department for Communities and Local Government has developed a checklist, which is also used by the Department for Education, which sets out a series of conceptual and data quality tests on any new data sets that are considered for formula funding. However, there is a limited range of data sources that can be used, and there are weaknesses relating to data quality and timeliness.

### Population data

**2.11** Population data is central to the capitation approach and therefore critical to the accuracy and responsiveness of formula funding. Departments use local population projections produced by the Office for National Statistics, but there is conflicting evidence about the sizes of local populations and criticisms of approaches used to estimate populations.

<sup>20</sup> S. Asthana, A. Gibson, T. Bailey & C. Dibbens, Developing a resource allocation formula at General Practice level based on individual patient characteristics (Person-Based Resource Allocation): *Mental Health*. Department of Health, 2008.

<sup>21</sup> Department of Health, *Practice-based commissioning: Budget guidance for 2009-10. Methodological changes and toolkit guide*, 2009.

**2.12** This is particularly evident in health service funding, where there are two principal sources for population data: the Office for National Statistics population projections and lists of patients registered with GPs. A report prepared for the Department of Health in 2007, highlighted significant differences between the two data sets. These ranged from a primary care trust where GP registrations exceeded Office for National Statistics population projections by 25 per cent (Newham) to a trust where GP registrations were 15 per cent lower than Office for National Statistics population projections (Kensington and Chelsea). For three London primary care trusts, the financial effect of the difference between these two datasets was more than £50 million annually in each trust.<sup>22</sup>

**2.13** The Local Government Association has also raised concerns about the Office for National Statistics methodology to estimate populations. It has cited criticism within local government of the projections being backward looking because they “assume that past population growth trends continue”. For example, they argue that projections do not adequately take into account new housing developments or short-term migration.<sup>23</sup>

**2.14** The Statistics Commission published a critical report on discrepancies between the 2000 mid-year estimate in Westminster and the 2001 census, which suggested a population 26 per cent lower than the previous year’s estimate. Since then, the Office for National Statistics has established an ongoing work programme to develop population projections; including an inter-departmental taskforce on migration estimates. The programme develops methods to incorporate further data sets to improve the projections. For example, GP register data on migrants, student moves post-study and international travel are some of the sources now taken into account in the population projections. The challenge for better estimates will continue to be the availability of data sources which are consistent in all relevant areas and are not open to manipulation.

### Data timeliness

**2.15** The limited range of data sources that fulfil the conditions required for robust formulae can lead to a substantial lag between the dates of data collection and the periods for which funds are allocated. For example, a quarter of the indicators used in Formula Grant, and 10 per cent of those used in Primary Care Trust allocations, are entirely based on data sources that are now ten or more years old, usually because they are based on census data. While the most influential indicators for resource allocation, such as population estimates, are more current, indicators based on old data are still important within the parts of the models to which they relate. There is no ready way to quantify the effect of using old data. **Figure 13** illustrates the timeliness of indicators used to adjust population estimates to account for relative needs for Primary Care Trust allocations and Formula Grant.

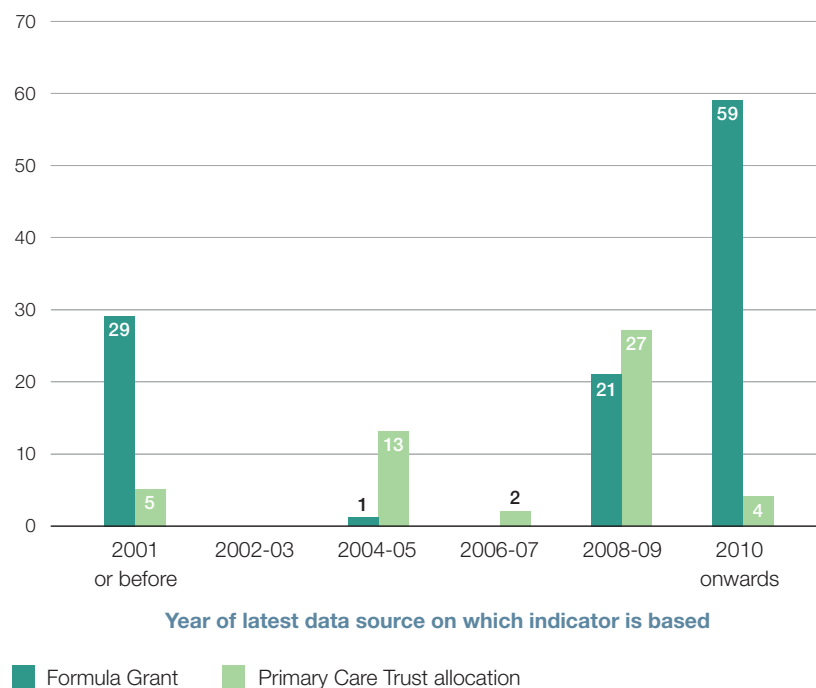
<sup>22</sup> Department of Health, *Review of Population Base for PCT Unified Allocations Post-2008*, 2007.

<sup>23</sup> Local Government Association, *Memorandum by the Local Government Association to the House of Lords Select Committee on the Barnett Formula*, 2009.

**Figure 13**

Age profile of indicators used for Primary Care Trust allocations and Formula Grant, 2011-12

**Number of unique indicators**



Source: National Audit Office analysis of data from Department of Health and Department for Communities and Local Government

**2.16** Particular care is needed where patterns of service provision have changed since the year to which the underlying data relate. In the health formula, some of the indicators used to describe the distribution of need are over ten years old. For example, in one component of the primary care element of the formula, the measure of distribution and type of GP consultations by age group is for 1999 to 2001. Since this data was collected, there have been reforms to primary care, which might have changed the relative need for primary care services between age groups. As such, there is a risk that where formulae rely on data that is out of date, they will not be responsive to current needs.

# Part Three

## Balancing stability and responsiveness

### Approaches to providing funding stability

**3.1** All of the grants reviewed include provisions for funding stability. Without stability, the budgets of funded organisations would vary more greatly from year to year, making financial planning and stable service provision more problematic. But providing stability constrains the extent to which funding matches assessed need. It is also difficult to assess the value for money of local organisations on a comparable basis, given that many authorities receive more or less funding than they are calculated to need. Judgements about the levels of stability required are not based on an objective analysis of the changes in income that different organisations can tolerate, for example, based on their different cost structures and financial positions.

#### How allocations provide funding stability

##### Primary Care Trust Allocations

**3.2** Primary Care Trusts (PCTs) are moved towards their calculated target allocations over a number of years based on 'pace of change' criteria. In 2011-12, £1.854 billion has been redistributed according to these criteria. These set the funding growth that trusts receive on top of their baseline position. The criteria usually include a minimum floor level of growth, set at 2 per cent for 2011-12. An accelerated growth rate is applied to those trusts most under target, but the level of increase is capped at 4.2 per cent. In 2011-12, 10 of the 114 trusts receiving allocations above the minimum floor benefit from an accelerated movement towards target.

##### Dedicated Schools Grant

**3.3** The Dedicated Schools Grant provides inherently stable allocations due to the 'spend-plus' methodology applied (see paragraph 1.19). There is, however, a cash floor for local authorities which mitigates the effect of a fall in pupil numbers. There is also a minimum funding guarantee at school level which has a more significant effect in preserving stability of funding. In 2011-12, the minimum cash floor is set at minus 2 per cent and the minimum funding guarantee is set at minus 1.5 per cent per pupil, before taking into account the pupil premium.

**3.4** In 2010-11, 5,255 schools were supported by the minimum funding guarantee and for 550 of those schools the minimum funding guarantee represented more than 5 per cent of their total budgets. The Audit Commission criticised the minimum funding guarantee because it constrains the ability of local authorities to tackle funding inequalities within their areas and represents an inefficient use of resources.<sup>24</sup>

### Formula Grant

**3.5** The fourth 'floor damping' block of Formula Grant's four-block model sets a minimum floor for four different types of funded authorities.<sup>25</sup> Home Office Ministers decide the level of the floor for police authorities. The amount required to move authorities from below these floors to the minimum level is provided by scaling back the allocations of those authorities above the floor. In 2011-12, £738 million was redistributed for this purpose. In 2011-12, four floor damping bands were introduced for single and upper tier authorities and lower tier authorities. This was to meet the Department's objective to ensure that those authorities that are most dependent on Formula Grant have smaller decreases in funding than those less dependent.

## The impact of stability adjustments

### Short-term effects

**3.6** In any given year, decisions about stability adjustments constrain the extent to which organisations are funded according to their calculated needs. **Figure 14** overleaf illustrates the impact of the stability adjustment for police authorities in 2011-12. The floor has been set at the same level as the aggregate grant reduction. As a result, all police authorities have received the same 5.1 per cent reduction in Formula Grant funding.

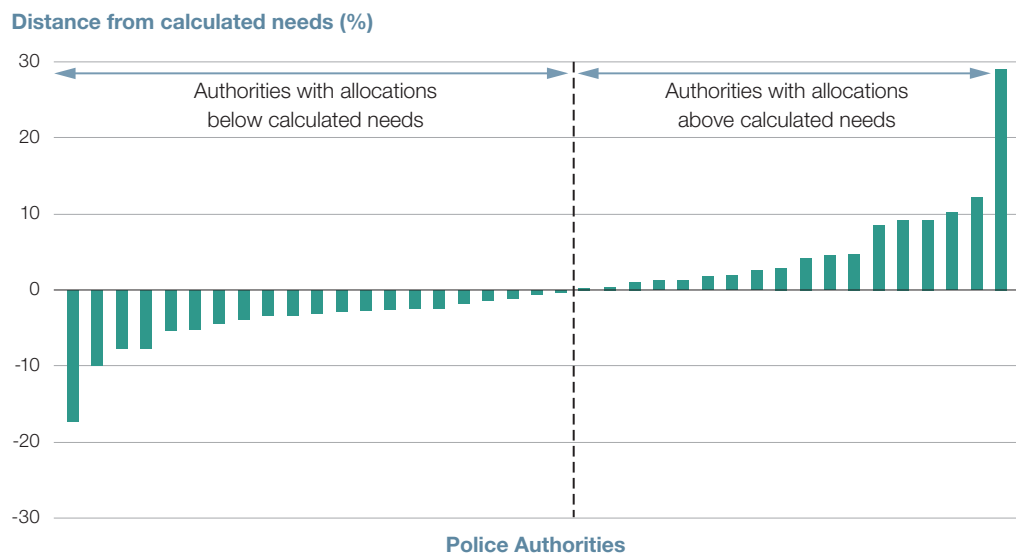
**3.7** Nearly 20 per cent of all authorities funded by Formula Grant in 2011-12 receive allocations more than 10 per cent from their calculated needs, though the proportions vary by authority type. In the NHS, ten of 151 primary care trusts will receive allocations in 2011-12 that are more than 10 per cent from their targets according to the weighted capitation formula. All of these trusts receive more than their target allocation.

<sup>24</sup> Audit Commission, *Education Funding: The impact and effectiveness of measures to stabilise school funding, 2004*.

<sup>25</sup> These are single and upper tier authorities; lower tier authorities; police authorities; and fire and rescue authorities.

**Figure 14**

Judgements about stability determine the extent to which authorities are funded according to calculated needs



Source: National Audit Office analysis of Department for Communities and Local Government data

### Long-term effects

**3.8** If the underlying approaches to calculating needs-based target allocations remained constant, stability adjustments would eventually work to smooth the transition to a fully needs-based allocation. But typically in each settlement period, a combination of the following factors means that calculated funding requirements change. They are:

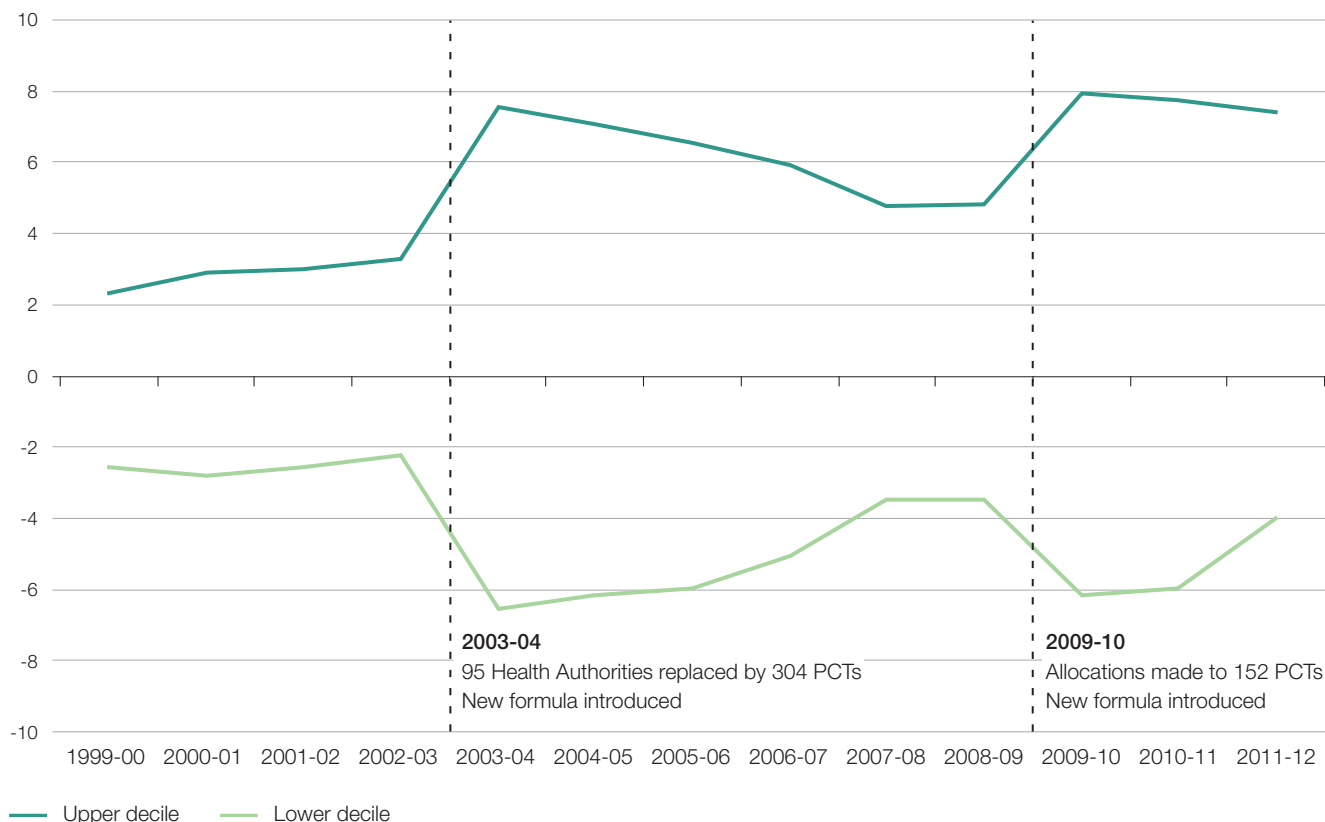
- changes in weightings or relationships between key structural components of the formulae (see Part One);
- methodological and data changes that impact the technical assessment of need (see Part Two);
- policy changes that impact on how local public services are funded; and
- underlying changes in local populations' socio-economic characteristics.

**3.9** **Figure 15** illustrates that for health, in years where there has been significant redesign of funding formulae and this has coincided with reorganisation of the health service, NHS organisations have moved further from their target allocations. This explains why convergence to targets has not occurred and why stability adjustments have become a permanent element of formula funding.

**Figure 15**

Pace of change adjustments move primary care trusts towards targets in settlement periods, but frequent changes constrain convergence

Distance from calculated needs (%)



Source: National Audit Office analysis of Department of Health data

**3.10** The Departments do not set explicit objectives to move towards a full application of the needs-based elements of their formulae. The tension between recognising this objective while delaying its fulfilment was expressed by the Minister for Policing in February 2011, who stated that:

*there is a strong argument for moving at the right time to a full application of the [Police Allocation] formula, recognising the policing needs of each area, but doing so now would have created real difficulty<sup>26</sup>.*

**3.11** For 39 authorities funded by Formula Grant, cumulative allocations for the six-year period since the four-block model was introduced in 2006-07 vary by more than 10 per cent from their calculated needs. Four authorities have received allocations more than 50 per cent above their calculated needs during this six-year period, in order to provide funding stability. In absolute terms, Surrey County Council has been the biggest beneficiary, receiving £739 million in Formula Grant over the six-year period while being calculated to need £385 million. In proportional terms, the London Borough of Richmond-upon-Thames is the biggest gainer, having received £161 million, more than double its calculated need of £75 million.

**3.12** While there have been long-term beneficiaries of floor damping, by contrast there are some authorities that are consistently allocated less funding than their calculated needs. In absolute terms, the West Midlands Police Authority has had the biggest shortfall over the same six-year period, receiving £256 million less than its calculated needs of £3.096 billion. Proportionally, Dorset County Council has received £271 million. This is 12 per cent less than its calculated needs of £308 million.

**3.13** For primary care trust allocations, ten primary care trusts have received at least 10 per cent more than their cumulative calculated targets over the same period. Generally, the outlying trusts are nearer to the target than authorities funded by Formula Grant. For those trusts that are funded below target, this is partly due to the accelerated growth rate applied to those trusts furthest from target under the 'pace of change' policy.









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