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Title: **Needs & Resources Technical Working Group**

Paper: NR TWG 18/14: Discussion paper regarding the Area Cost Adjustment by the Ministry of Housing, Communities and Local Government

Date: 10 July 2018

Venue: MHCLG, 2 Marsham Street, London

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## **POLICY DEVELOPMENT: NOT A STATEMENT OF GOVERNMENT POLICY**

### ***Introduction***

- 1) The cost of delivering public services varies between local authorities for a number of reasons. The needs assessment is designed to account for those reasons which are outside of authorities' control; it consists of a number of Relative Needs Formulas (RNFs) and specific Area Cost Adjustments (ACAs). Area characteristics, such as numbers of children or cumulative length of road, which determine the number of interventions required are additive cost drivers and are accounted for in RNFs. Factors which affect the cost of making the same intervention are accounted for by ACAs. RNFs are then multiplied by ACAs in order to assess need. Where the current RNFs were constructed using analysis of past spending, this spending is divided by the ACAs beforehand in order to give equal influence to the response of each Local Authority to cost drivers.
- 2) ACAs are supported by both precedent – an ACA has been applied to the Settlement since 1977/78 – and arguments from ‘fairness’. Adjustments reduce the undue influence of higher cost areas on expenditure-based regressions. Compensating higher cost areas also reduces the potential for higher levels of unmet need in those areas and helps to equalise both the need to raise local resources and standards of public service. There is also a precedent in considering variation in local costs across police funding, national funding for schools, and the NHS, which uses a Market Forces Factor.
- 3) The current funding formula ACAs reflect two sources of differences in costs between areas:
  - a. Differences in labour costs (the ‘Labour Cost Adjustment’ or LCA); and
  - b. Differences in business rates paid on local authority premises (the ‘Rates Cost Adjustment’ or RCA).

- 4) This paper suggests that the ACAs continue to adjust for the existing LCA and RCA factors. This paper also examines the leading potential additional factors proposed in representations to the December 2017 consultation; it discusses further adjustments using robust evidence on journey times that could be made for sparsity and density (collectively referred to as ‘accessibility’ below) and remoteness. This paper also explores options for how to implement the ACAs, including a discussion on the geography at which adjustments are made, the treatment of national pay agreements, weighting ACA factors together, and applying the ACAs to RNFs.

### ***Selection of factors to adjust for***

- 5) To design an ACA starting from a blank sheet of paper, simple principles are needed to determine the factors to adjust for. We have considered responses from the December 2017 consultation, testing these against the principles that we brought to the TWG in September 2017. These principles are:
- Significance:** The impact of a factor on local authority spending must be sufficiently large.
  - Variation:** The impact of a factor must vary sufficiently between local authorities.
  - Data availability:** There must be sufficiently detailed data available at the right level of geography.
  - Appropriate incentives:** The ACA should maintain incentives for local authorities to design services which deliver at the lowest possible cost.
- 6) This paper consists of the following sections:

#### *Existing factors:*

- Labour Cost Adjustment (LCA)
  - The treatment of national pay agreements
- Rates Cost Adjustment (RCA)
  - Other building costs
- The geography of adjustments

#### *Factors raised at December 2017 consultation:*

- Accessibility (sparsity and density)
- Remoteness

#### *How to adjust*

#### *Next steps*

## ***Existing factors***

### **a) Labour Cost Adjustment (LCA)**

- 7) The current LCA was based on what is sometimes called a ‘general labour market’ approach. The underlying rationale for the LCA was that local authorities have to compete for staff with all other potential employers. Hence, in order to secure and retain various categories of staff of a given quality, they will need to pay the local ‘going rate’. This is calculated as an index of average weekly pay for all workers in each area, using data from the ONS Annual Survey of Hours and Earnings (ASHE).
- 8) In order to avoid comparing very different workers between areas – due to differences in demographics or economic activity - we are seeking the group’s views on controlling for differences in industry and occupation, age, gender, hours worked and public/private sector, when calculating the index by estimating averages conditional on these variables.
- 9) We are considering the possibility of “future-proofing” the LCA for subsequent years in a multi-year settlement, for example by uprating pay in the ASHE dataset which would be affected by announced changes to the National Living Wage – as the proportion of workers affected may differ between areas – and by OBR forecasts of wage inflation. We suggest aligning this with consideration of population projections as cost drivers in RNFs.

### **Question 1: Does the group agree with this approach to estimating local labour costs?**

#### **i. The treatment of national pay agreements**

- 10) Some responses to the consultation suggested that the wages of LA employees vary less between areas than private sector wages. This might be due in part to the differing demographic and economic factors discussed above.
- 11) National pay agreements also have the potential to raise the wages of LA employees above the local ‘going rate’ measured by the LCA. In order to account for this, a lower limit or floor was applied. This effectively increased the LCA in areas with the lowest local wages. Ministerial judgement was used to set the appropriate ‘floor’ level in the current LCA.
- 12) This approach had the merit of simplicity, but did not reflect the fact that the LCA also applied to the costs of indirect employment, i.e. the wages of social workers paid by providers, and therefore unaffected by national pay agreements. The lower limit therefore potentially resulted in an “under-adjustment” in the current LCA.
- 13) We are therefore considering potential alternatives to a broad lower limit. These might include: keeping the existing approach; seeking sources of evidence to inform a revised ‘floor’; treating direct and indirect expenditure on labour separately within the ACAs; or removing the lower limit.

### **Question 2: Does the group have any views on taking account of the effect of national pay agreements on an LCA?**

### **b) Rates Cost Adjustment (RCA)**

- 14) The current Rates Cost Adjustment reflected variation in the (revenue) costs of buildings used to deliver services, in particular the business rates payable. This accounted for variation in the cost of using equivalent space between areas due to differences in local supply and demand. This was done using an index of average VOA rateable values per square metre of office space, which is used as a proxy for the market value of built space in general.
- 15) As characteristics such as car parking, building floor and internal divisions can affect rateable value and therefore local averages, we are pursuing permission to have access to the VOA's full ratings list. We are seeking the group's views on maintaining the current methodology but controlling for variation in these characteristics between areas to improve accuracy.

#### **i. Other local building costs**

- 16) The arguments above also apply to the total of rents paid for space and the rental income foregone when an LA occupies space that it owns – as opposed to only business rates. Market rents also reflect other costs, such as maintenance, which result from using buildings. We are therefore considering adjusting for differences in all building and premises costs relating to service delivery, using the RCA index.

### **Question 3: Does the group agree with this approach to estimating local building costs?**

### **c) The geography of adjustments**

- 17) The current LCA was calculated at the county level with each district authority within a county treated the same. Outer London was split into two areas to reflect significant wage variation and counties neighbouring London were split into fringe and non-fringe areas, following the practice for teacher's pay. The current RCA was calculated over even larger areas.
- 18) We now suggest using a local authority district level of geography. This will make the adjustment more accurate and will allow a more robust weighting of cost drivers. County councils and combined authorities would receive the population-weighted average of their districts.

### **Question 4: Does the group agree with this approach to the geography of local costs?**

### ***Factors from consultation***

- 19) Responses to the December 2017 consultation identified five leading potential additional factors to consider adjusting for in the ACAs: sparsity; density; remoteness; housing costs; and deprivation. The following sections include a discussion of how to account for the first three of these.

- 20) Housing costs are strongly correlated with wages and may affect the cost of providing homelessness services and residential care. However, more evidence is required to show that the labour cost adjustment does not already account for this variation in need and that a separate adjustment for housing costs is required.
- 21) Similarly, deprivation will typically relate to the volume (number) and type of services required (additive costs), rather than the cost of the same intervention (multiplicative costs). Elements of deprivation may be useful proxies for some specific costs, e.g. the market conditions faced by providers of children's social care. A discussion of how to tailor ACAs to different RNFs to capture service specific impacts is included later in this paper.

**d) Accessibility (sparsity and density)**

- 22) Economic theory and evidence presented at TWG of September 2017 suggest that labour productivity might be lower in areas with longer journey times – whether caused by longer distances, poorer transport links, or traffic congestion – due to the time spent travelling. This implies that areas with longer journey times may have to pay staff for more hours in order to deliver the same interventions.
- 23) Therefore, there might be an increased wage cost to deliver services to households that are less 'accessible' in terms of journey times. Following the September 2017 TWG, MHCLG have been working with DfT and Defra to investigate two potential robust and evidence-led measures of accessibility:
- i. 'Dispersal' – journey times from households to service 'hubs', reflecting travel to households for service such as domiciliary social care;
  - ii. 'Traversal' – journey times between households, or very small groups of households, to reflect delivery routes for services such as waste collection.
- 24) Providing that these measures can be robustly estimated, we suggest applying both to the LCA in order to reflect that areas with higher journey times may have to pay staff for more hours to deliver an equivalent volume of services.

**Question 5: Does the group agree with this journey times approach?**

**e) Remoteness**

- 25) Economic theory and evidence presented at the TWG of September 2017 suggest that separation from major markets – which we refer to as 'remoteness' – may increase costs. However, this differs from any effects of pockets of very low population density (sparsity). This is because some specialised inputs may only be produced where demand is sufficiently concentrated, e.g. specialised training for fire officers will not be available in areas remote from major towns and cities. Similarly, areas with low or dispersed demand for services support a smaller number of providers, potentially reducing competition and thus increasing the cost of purchased/tendered goods and services (such as social care beds).
- 26) Authorities may choose to support production at a smaller scale, for example if this is less costly than providing transport to or from major markets. Adjusting for remoteness by assuming that journeys are made to or from major markets

compensates authorities while maintaining their incentive to deliver services at the lowest possible cost.

- 27) We suggest a separate adjustment for remoteness, using a proxy measure of journey times from small groups of households to major towns and cities. We would expect the impact of remoteness on labour and building costs to be reflected in the LCA and RCA discussed above. However, this factor might affect up to an additional 20% of total spending, based on Subjective Analysis Return data (see below).

**Question 6: Does the group agree with this approach to considering increased costs due to ‘remoteness’?**

**How to adjust**

- 28) Following the current methodology, the factors above - the LCA (inclusive of accessibility), RCA (inclusive of rents), and potentially remoteness – would be weighted together into a single index for each RNF using the relevant proportion of local authority expenditure on the relevant service(s). These weights were based on evidence from the Subjective Analysis Return (SAR) completed by local authorities and Companies House accounts filed by larger outsourcing firms.
- 29) In the paper we presented to the TWG of September 2017 (NR TWG 17/04<sup>1</sup>), we suggested a possible alternative would be to use more sophisticated analytical techniques to estimate weights directly from expenditure data, simultaneously with the weights given to cost drivers in RNFs. This would estimate the relationship between the different factors and higher costs per intervention more contemporaneously.
- 30) To increase accuracy, the weight given to each component of the current ACAs varies between RNFs. Specific multiplicative adjustments are also applied to some RNFs. The Children’s Social Care RNF, for example, is adjusted to account for factors which affected the supply of – and therefore the costs of arranging – suitable foster carers within an area.
- 31) Alternative approaches would be to simplify ACAs by applying the same weights to each RNF (which would be inconsistent with the option to use analysis to derive weights discussed above); or to include any specific adjustments for costs within an ACA tailored to each RNF.

**Question 7: Does the group have any views on applying the ACAs to RNFs?**

**Next steps**

- 32) Following discussion and feedback at this Technical Working Group, we plan to test a proposed methodology with the sector more widely through the next consultation on relative needs and resources, which we aim to publish this autumn.

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<sup>1</sup> <https://www.local.gov.uk/sites/default/files/documents/NR%20TWG%2017-04%20Discussion%20paper%20regarding%20the%20approach%20to%20Area%20Cost%20Adjustment%20and%20rurality%20in%20the%20Fair%20Funding%20Review.pdf>

This will set out our proposal for the ACA alongside the emerging shape of the needs assessment, and a high level treatment of resources and principles for transition.

- 33) In spring 2019 we will aim to publish a further consultation, which includes exemplifications of the proposed ACAs on RNFs. Final decisions on the ACA will be made following representations made to that (spring 2019) consultation.