



National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 888
SESSION 2012-13

30 JANUARY 2013

Department for Communities
and Local Government

Financial sustainability of local authorities

Key facts

£147bn

local government
revenue income, 2010-11

£103bn

central government
grant funding to local
government, 2010-11

£44bn

other local government
revenue income, 2010-11

- 353** local authorities in England
- 24 per cent** local government expenditure as proportion of total managed public spending in the UK in 2010-11
- £7.6 billion** real-terms reduction in funding from central government to local authorities, 2010-11 to 2014-15, planned at 2010 spending review
- 14 per cent** real-terms reduction in local authority income, 2010-11 to 2014-15, estimated at 2010 spending review
- 0.2 per cent** increase in average band D council tax rates in cash terms, 2010-11 to 2012-13
- £3.6 billion** total local authorities' unallocated general reserves, at 31 March 2012
- 4 per cent** total local authorities' unallocated general reserves as a proportion of total local authorities' revenue expenditure, at 31 March 2012
- 1,335** statutory duties on local authorities as at June 2011

Summary

1 There are 353 local authorities in England, providing a diverse range of services. Local government's revenue income was £147 billion in 2010-11, of which £103 billion was central government grants and £44 billion was other revenue income, including council tax of £22 billion. Local authority spending in England accounts for around a quarter of total public spending in the UK.

2 Local authority councillors are elected by, and accountable to, the people in their local authority. However, central government fundamentally influences the funding system for local authorities and is responsible for the statutory framework for the services they deliver. Local authorities are required to deliver 1,335 statutory responsibilities and, to be financially sustainable, must meet their service obligations within their available funding. A number of government departments are responsible for policy and funding for local authorities; the lead department is the Department for Communities and Local Government.

3 This report examines central government's approach to local authority funding, and reviews local authorities' financial sustainability against a background of changes to their funding. It has three parts:

- **Part One: Funding local authority services**, sets out the background to the current funding arrangements and the reduction in local authority funding from the government's 2010 spending review.
- **Part Two: Local authority budget management**, sets out how local authorities have responded to their reduced income.
- **Part Three: Maintaining financial sustainability**, covers the growing challenges to local authorities' financial sustainability; managing financial risks and opportunities; and the increasing need for central government to make informed decisions as financial and service pressures increase.

4 We have drawn in this report upon work done by the Audit Commission in its report *Tough Times 2012*. In line with our current statutory audit remit, we have not undertaken detailed fieldwork at individual local authority level, nor have we engaged directly with local auditors to assess the response of individual local authorities to the recent funding changes. We outline our audit approach and evidence base in Appendices One and Two.

5 The government is introducing a Local Audit Bill in 2013. This will provide for the abolition of the Audit Commission, clarify the NAO's powers to carry out value-for-money work on local authorities, and provide the NAO with statutory access to information held by local authorities in support of such work.

Key findings

6 As part of its fiscal deficit reduction plan, central government planned at the 2010 spending review to reduce funding of local authorities by 26 per cent (£7.6 billion) in real terms, between April 2011 and March 2015 (excluding police, school and fire). Including council tax, the overall reduction of local authority income was forecast to be 14 per cent in real terms. The effects on local authorities vary. In 2012-13, the overall reduction in spending power ranges from 1.1 per cent to 8.8 per cent in cash terms. Twelve local authorities experienced the highest reduction in spending power of 8.8 per cent in 2011-12 and 2012-13 (paragraphs 1.14 to 1.15).

7 By reducing ring-fencing of its grants, central government aims to give local authorities greater spending flexibility. In addition, from April 2013, local authorities will have a financial incentive to achieve growth in business rates and will be able to decide which council tax payers should benefit from council tax support. Central government has also introduced policies that reduce local authorities' flexibility, for example by requiring those that wish to raise council tax by more than a set percentage to hold a local referendum (paragraphs 1.10, 2.7, 3.12 to 3.19).

8 So far, local authorities have absorbed reductions in central government funding but there is some evidence that services have been reduced. Using data from the Audit Commission we estimate that local authorities are planning to make £4.6 billion of savings by April 2013. The majority of local authorities have so far not drawn on financial reserves to make up for reduced income. Although 93 used reserves in 2011-12, the remaining 260 either made no changes to their reserves or added to them. There is evidence that local authorities are reducing services, for example in adult social care and libraries (paragraphs 2.2, 2.10, 3.7 and 3.10).

9 Local authorities may find it harder over the rest of the spending review period to absorb funding reductions and maintain services. We estimate that local authorities still need to find about half of the savings to be made before March 2015 after considering the latest figures for inflation, council tax and government grants. At the same time, demand for high-cost services, such as adult social care and children's services, is increasing. The scope for absorbing cost pressures through reducing other, lower cost, services is reducing, as authorities have already reduced spending on these services. Nationally, the largest percentage reductions so far have been to services such as planning and development, where total spending by local authorities has reduced by 36 per cent. In contrast, adult social care has reduced by 6 per cent (paragraphs 2.3 to 2.4, 3.30).

10 The government is making changes that create financial opportunities for local authorities but also increase their financial risks and uncertainty. Two of the most important changes – the partial localisation of business rates and the arrangements for council tax benefit – come into effect in April 2013. The business rates change will incentivise local authorities to promote local business growth, as they will keep a share of increased business rate income. They will also be more exposed if income falls, although they will receive some protection from this. The changes to

council tax support mean that instead of paying benefits according to rules that the Department for Work and Pensions sets, local authorities can have their own schemes but nationally they will have 10 per cent less money to do so. The opportunities and risks of both changes will be influenced by wider economic conditions, which are inherently uncertain (paragraphs 1.12, 3.11 to 3.20).

11 Local authorities' ability to make savings while maintaining service levels depends on local circumstances. Using information from local auditors, the Audit Commission identified 12 per cent of local authorities as at risk of not balancing future budgets. We surveyed local authority finance directors with most of the 52 that responded expected to make the largest savings through efficiency improvements. However, nearly all saw reducing the services their local authorities provided as contributing to their savings requirements (paragraphs 3.4 to 3.5, 3.34).

12 While individual government departments assessed the impact of the changes being made, their approach was not comprehensive. We looked at the information three departments provided for the 2010 spending review. One, the Department for Education, could not estimate the scope for savings across the entirety of their service area (children's services), but it did consider the pressures and scope for efficiencies in a number of major areas of spend, such as caring for 'looked after' children. In addition, all three departments did not identify regional or other variations in the demand for, or cost of, services (paragraphs 3.25 to 3.32).

13 With a range of changes to local government funding being implemented over the spending review period, it becomes increasingly important to understand the cumulative effects of the changes as these may affect local authorities differently. For example, local authorities that do not experience economic growth might, simultaneously, see a fall in their business rates and a rise in council tax benefit claimants. The Department for Communities and Local Government has recently started to provide the basis for such an analysis, by assessing the combined impacts of a range of changes on the financial risk profile of individual local authorities (paragraphs 3.20 to 3.21).

14 The accountability framework for local government to address widespread financial failure is untested. The framework, as described in the Department for Communities and Local Government's *Accountability System Statement*, relies heavily on the long-established safeguards and assurances within local authorities. The framework has not yet faced a case of widespread financial failure and where there have been 'one-off' failures requiring central government intervention, the failure regime has managed to resolve them. However, past failures in the local government sector have generally related to services or corporate governance, or both, and not financial failure. How the system responds in the case of multiple financial failures during possibly more challenging times for local authorities is therefore, at present, untested (paragraphs 3.35 to 3.42).

Conclusion

15 So far, local authorities have generally been able to absorb central government funding reductions. However, there is emerging evidence that some service levels are reducing. Funding reductions are continuing, along with changes to the resourcing mechanism of local authorities. These changes increase financial uncertainty and more local authorities are facing the challenge to avoid financial difficulties while meeting their statutory responsibilities. This risk will not manifest itself evenly across the sector, with some local authorities being more affected than others.

16 This risk must be identified early so it can be managed effectively. The Department for Communities and Local Government will need arrangements to detect where risks will emerge. Its response will need to be flexible and coordinated with local and sector-wide support mechanisms. Central government must also satisfy itself that it understands the cumulative impact of funding changes and can make informed decisions about the funding required for local authority services.

Recommendation

17 **The Department for Communities and Local Government should build on previous work and, together with other government departments, better evaluate the impact of decisions on local authority finances and services – before and after implementation.** With other departments, the Department has assessed the impact of funding reductions and other changes to the system of local authority financing, such as business rates. To develop its approach the Department should:

- work with other departments to understand the information needs to support decisions affecting local authority finances and services. This may not mean requiring more information, but understanding what is the right information for that purpose. For transparency, it should discuss and share the framework with local authorities;
- ensure that decisions on financing local authorities are made with an assessment of their service obligations including statutory responsibilities; and
- satisfy itself that the assurances provided by the accountability framework are robust enough for the more challenging financial and service delivery conditions facing local authorities. Informed decision-making requires a feedback loop so the Department can make adjustments in the light of performance; and identify evidence of potential difficulties early enough to intervene.