National Audit Office

Local government finance in the pandemic

Ministry of Housing, Communities & Local Government

REPORT

by the Comptroller and Auditor General

SESSION 2019–2021
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Key facts

£9.7bn

of COVID-19 cost pressures and income losses estimated for 2020-21 as reported by local authorities in early December 2020

£9.1bn

estimated additional financial support from government for the sector in 2020-21, announced by early December 2020

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chief finance officer has issued a section 114 notice in 2020-21, indicating that the authority is at risk of failing to balance its budget, which would be unlawful

75% of irrecoverable council tax and business rates losses in 2020-21 will be covered by government

0% of local authorities' losses from commercial investments covered by the government's income compensation scheme

75% of authorities have a reported 'funding gap' in terms of their forecast pressures and estimated government support

46% of chief finance officers from single tier and county councils, those with social care responsibilities, in our survey told us they had or were planning to use reserves to address COVID-19 pressures in 2020-21

94% of chief finance officers in our survey from single tier and county councils expect to make cuts in service budgets in 2021-22

5% increase in local council tax support claimants from quarter three in 2019-20 to quarter two in 2020-21

Summary

1 The COVID-19 pandemic has been an unprecedented public health and economic emergency. Local authorities in England have made a major contribution to the national response to the pandemic, working to protect local communities and businesses, while continuing to deliver existing services. The pandemic has in turn placed significant pressure on local authorities' finances, which in many cases were already under strain going into the pandemic.

2 Local authorities need to be able to absorb these pressures. Individual or system-wide financial failures are poor value for money and are likely to have significant impacts on local communities.

3 The overall financial framework for local government is the responsibility of the Ministry of Housing, Communities & Local Government (the Department). Its responsibilities include:

- distributing the majority of funding voted by Parliament to support local authorities to deliver services;
- taking the lead across government in supporting HM Treasury on decisions about local government funding at major fiscal events; and
- maintaining a system of local accountability that assures Parliament about how local authorities use their resources, including preventing and responding to financial and service failure.

4 Other government departments have policy responsibilities for statutory services delivered by local authorities. They are responsible for establishing their own arrangements to assure themselves that services remain sustainable and statutory responsibilities are met. Departments can provide specific funding to local authorities if required.

5 Departments' core responsibilities remain unchanged by the pandemic. In particular, the Department remains responsible for a framework that provides assurance on the financial health of the sector, and allows for intervention in individual cases and in response to system-wide risks. Accordingly, the Department has had to work across government to ensure the framework can respond to the pressures and demands this unprecedented emergency has caused for authorities. The Department assesses financial sustainability using authorities' capacity to deliver their statutory services while also taking into account whether they have flexibility to respond to events and emergencies, and are able to provide the broader local leadership expected by communities.

Our report

6 Our report examines if the Department's approach to local government finance in the pandemic enabled it to assess and fund the costs of new services which local authorities have been asked to deliver and fulfil its responsibilities for securing financial sustainability across the sector. We expect the Department to:

- have a clear understanding of the implications for authorities' finances and services of COVID-19 pressures;
- have worked effectively with other departments to understand service cost pressures in the sector; and
- have a clear and robust plan to secure the sector's financial sustainability over both the short term and the medium term.

7 Our report is in four parts:

- Part One looks at the financial health of the sector before the pandemic and the financial impact of the pandemic in 2020-21.
- Part Two examines action taken by the government to support the sector in 2020-21.
- Part Three assesses the effectiveness of government measures to support the sector in 2020-21.
- Part Four examines the steps taken by government to support the sector's financial sustainability in 2021-22.

Scope of our work

8 Our report focuses on pressures and funding that have potentially direct impacts on authorities' financial sustainability.[1] We exclude COVID-19 business grants and rates relief schemes operated by authorities on behalf of government. This reflects the focus of the Department's own monitoring.

9 Our fieldwork was completed in early January 2021 and does not include the impact of the January national lock-down. The most recent data in our report on the financial impact on the sector were provided by local authorities in early December 2020.

10 Much of the analytical work in this report is forward-looking and relies on authorities' forecasts of financial impacts and our own estimates of potential funding available from government. Where findings in this report are based on estimates they should be treated as indicative rather than formal forecasts.

1 We define 'local authorities' as principal councils. These include metropolitan borough councils, unitary authorities, London borough councils, county councils and district councils. See Appendix Two.

Key findings

Financial impacts of the pandemic in 2020-21

11 **Local authorities have forecast that COVID-19 will create £6.9 billion of cost pressures in 2020-21.** Local authorities have faced a range of cost pressures due to the pandemic including the need to deliver new programmes and services; increases in the costs of, and growing demand for, some existing services; and reduced opportunities to deliver savings programmes (paragraphs 1.9 to 1.16, Figures 2 and 3).

12 **Also, local authorities face reductions in non-tax income amounting to a forecast loss of £2.8 billion in 2020-21 due to the pandemic.** Authorities have reported losses in their sales, fees and charges (£2.1 billion), commercial (£523 million) and other income streams (£221 million). Authorities have also forecast losses in council tax (£1.3 billion) and business rates (£1.6 billion) income for 2020-21. However, local authority accounting means that these tax losses will only affect authorities' budgets next year (paragraphs 1.17 to 1.21, 4.2 and 4.3, Figure 4).

13 **Combined cost and non-tax income pressures (£9.7 billion) are significant for the sector at 17.6% of revenue expenditure, but impacts vary across authorities.** The forecast impacts are greatest among district councils (equivalent to 20.4% of 2019-20 revenue expenditure) due to their exposure to income-generating services. County councils (16.2%) appear to be the least vulnerable owing to their more limited exposure to income losses. There are also marked variations in combined cost pressures and income losses among authorities of the same type. These are likely to be driven by differences in data-reporting alongside a range of local conditions and decisions (paragraphs 1.22 to 1.25, Figures 5 and 6).

Government's response in 2020-21

14 **Officials told us that the government's overall approach has been to provide support that is "timely, targeted and temporary" rather than an open-ended guarantee.** The government's aim throughout the pandemic has been to support the sector to respond to COVID-19 while also enabling the sector to deliver mainstream services. Given the uncertainty about the duration and the impact of the pandemic, officials told us the government's ambitions have not extended to blanket guarantees for local government. The sales, fees and charges compensation scheme announced in July 2020, for instance, provides partial compensation on authorities' losses. However, our case studies, workshops and stakeholder discussions indicate that ministerial statements in March 2020 that government would do "whatever is necessary" to support councils were taken by some finance directors and stakeholder bodies as meaning that a guarantee was in fact offered by government at the outset (paragraphs 2.1 and 2.2).

15 **The government's approach, led by the Department, to this unprecedented emergency has evolved from prioritising immediate action to a more strategic approach.** In unprecedented circumstances, the Department did not have a ready-made strategic framework to apply at the outset of the pandemic and early initiatives, such as the initial tranche of funding provided in March, were based on the limited information available. As the Department's evidence base improved, by July 2020, its response to the pandemic had evolved into a multi-stranded approach that addresses authorities' cost pressures through tranches of unringfenced grants; partially compensates for authorities' lost income; and provides an exceptional financial support safety net for authorities with severe financial challenges (paragraphs 2.3 to 2.5, 2.29 to 2.31, and Figure 7).

16 **The Department has collected data on the financial impact of the pandemic on local authorities from the beginning of 2020-21**. From April 2020, the Department introduced a monthly survey of financial pressures in the sector. Despite some data quality issues, and in the absence of any other equivalent data sources, it is an important and powerful data set, which several departments have used to shape their responses. The Department deserves credit for introducing this survey, as do local authorities for engaging with it fully (paragraphs 2.9 to 2.14 and 2.22).

17 **The Department has engaged well with the sector, but there is room for improvement in how other departments engage with local authorities.** During the pandemic, Department officials have engaged intensively with the sector and we have received very positive feedback from the sector on this engagement, the Department's understanding of local government finance issues and its response to sector feedback. It was felt to be a two-way process, with feedback and information from the sector informing decision-making in the Department. However, a common perception in our case studies, workshops and stakeholder interviews was that some other government departments lacked the Department's understanding of local government finance and related practical details of delivering specific schemes. This reflects findings from our previous work on local authority financial sustainability (paragraphs 2.15 to 2.18).

18 **The Department's incremental approach to the provision of funding in-year does not support good financial planning.** The Department has allocated four tranches of unringfenced funding totalling £4.55 billion. However, the approach of keeping the need for future funding under review for continuing or new pressures creates uncertainty in the sector and does not allow good financial planning. Finance directors do not know how long a tranche of funding is supposed to last or if there will be another (paragraphs 2.24, 2.29 to 2.34, and Figure 7).

19 The Department has set up an exceptional financial support safety net for authorities facing unmanageable financial pressures. The Department can provide exceptional support, primarily through capitalisation directions, for authorities facing "unmanageable pressures" and has done so for four authorities. However, other than referring to a "small number of authorities" when questioned by the Committee of Public Accounts the Department has not shared the number of authorities that have enquired about exceptional support or those where the Department has concerns about the financial health of the authority. The Department told us its conversations about exceptional support are confidential and sharing information on the number of these authorities or of those it considers to be at risk more generally would invite public speculation about the authorities involved. We recognise the value to the Department of having a safe space to engage with individual authorities. However, it is not possible to understand the full picture of stress in the sector or to evaluate the Department's effectiveness in addressing it without knowing the level of demand for exceptional support or the Department's views on financial risk in the sector more generally. The Department has not yet found a way of being more transparent about the level of financial stress in the sector while nonetheless maintaining a safe space to engage with individual authorities (paragraphs 2.42 to 2.46 and 3.25).

Outcomes for local authorities in 2020-21

20 There is a 'funding gap' between forecast pressures and estimated funding at the national level, with many authorities 'under-funded' relative to the pressures they have reported. Government has so far announced £9.1 billion[2] in financial support to offset forecast financial pressures of £9.7 billion for 2020-21, leaving a deficit of £605 million. This net deficit results from £323 million of over-funding in 85 authorities, and £909 million in under-funding in 252 authorities[3] (74.8%) (paragraphs 3.5 and 3.6, Figures 10 and 11).

21 The reported 'funding gap' is substantial for some authorities. Some 30.0% of authorities will see a gap between their total COVID-19 financial pressures and their additional funding equal to 5% or more of their revenue expenditure in 2019-20. District councils have the highest funding gaps: 49.7% have estimated funding gaps equivalent to 5% or more of their revenue expenditure. Among single tier and county councils, those with social care responsibilities, 5.3% have estimated funding gaps of more than 5% of their revenue spend (paragraph 3.11, Figure 14).

2 The estimate of financial support includes our understanding of government grant funding up to early December 2020 (further funding has been received since this date), and our estimate of sales, fees and charges income compensation of £1.23 billion for the whole of 2020-21.

3 Note that the case-level analysis of over- and under-funding excludes Isles of Scilly and City of London. The disaggregated gross over- and under-funding therefore does not add up to the overall balance.

22 **During 2020-21, local authorities have undertaken a range of unplanned actions in response to COVID-19 pressures.** Many authorities have taken unplanned in-year actions. For example, 53% of respondents to our survey from single tier and county councils said they had made unplanned in-year savings to service budgets in response to COVID-19 pressures. Some 67% of our survey respondents from these types of authorities said that they had made unplanned in-year savings from other budgets (paragraph 3.12, Figure 15).

23 **Many authorities still need to take further steps to balance their 2020-21 budgets.** In our survey, 26% of respondents from single tier and county councils indicated that as of late December 2020 their forecast year-end position, ahead of any further action, was a "material overspend". Most of these respondents (81%) said they planned to apply their reserves to their overspend. Overall, 46% of survey respondents from single tier and county councils said that they had already used reserves this year, or planned to, to address COVID-19 pressures (paragraphs 3.13 to 3.14).

24 **A combination of high reported funding gaps and low reserve levels means that some authorities are at risk of financial failure**. The Department has created a risk metric using funding gaps and reserve levels that provides indicative information to inform its internal monitoring of risk. Applying this metric to our estimates of funding gaps indicates that very few authorities (1.5%) would be regarded as being at acute risk. However, 5.9% are in the high-risk category and 27.3% in medium-risk. Some 9.4% of single tier and county councils fall in the acute or high-risk categories compared with 5.9% of district councils (paragraphs 3.21 to 3.24, Figure 18).

25 **By 10 February 2021, the Department had provided exceptional financial support to four authorities.** This support is in the form of capitalisation directions totalling £50.5 million. There are two further councils where non-statutory reviews commissioned by the Department have suggested that a capitalisation direction may be necessary. These are Croydon Council, where a section 114 notice is in place, and Nottingham City Council (paragraphs 3.25 and 3.26).

Local authority finances in 2021-22 and beyond

26 **Local authority finances will continue to be under significant pressure in 2021-22**. In addition to any ongoing costs and income losses due to the pandemic, authorities will need to replenish reserves where necessary, deliver delayed savings programmes and address tax deficits from 2020-21. They are also likely to be operating with reduced tax bases and increased service demand as their local communities and businesses recover. The pace and scale of recovery in income-earning services and commercial investments is uncertain (paragraphs 4.1 to 4.6).

27 Authorities have developed their 2021-22 budgets in the context of significant uncertainty about the normal funding they would receive or have access to. It was not until 17 December that authorities received information on the actual grant funding levels they would receive and other key financial parameters to support their 2021-22 budgets. Council tax billing authorities must set their budgets by 11 March, with precepting authorities by 1 March. Some authorities we spoke to said that not having financial information until late in the budget process did not support value-for-money decision-making. For instance, authorities lack time to review savings options and make well-considered decisions. Late decisions about government funding are not new and we have reported previously on this issue, but this year finance directors considered that circumstances were more detrimental than normal owing to the additional uncertainties created by the pandemic (paragraphs 4.8 to 4.10).

28 The 2021-22 local government finance settlement is only designed to provide certainty on a short-term, time-limited basis. The finance settlement provides the sector with certainty through to the middle of 2021-22 rather than for the whole year. This time-limited approach is a continuation of arrangements for this year, and there are lessons that the Department can learn from how it performed in 2020-21. Many finance directors we spoke to regretted that the financial settlement was not on a multi-year basis, which they consider supports improved financial planning and provides better value for money (paragraphs 4.11 to 4.13).

29 The settlement will allow authorities to set balanced budgets for 2021-22 but with significant uncertainties and risks. Most respondents to our survey (93% of respondents from single tier and councils and 92% from district councils) indicated that they currently felt able to set a balanced budget for 2021-22, a legal requirement. However, 83% of survey respondents from district councils and 84% of respondents from single tier and county councils said their budget-setting process for 2021-22 was more challenging than for 2020-21. Respondents also indicated that there is a degree of risk and uncertainty in their budgets. Only 52% of respondents from single tier and county councils said that they were both able to set a balanced budget currently and were confident in both the estimates in their budgets and the adequacy of their reserves (paragraphs 4.18 to 4.21, Figure 19).

30 Many authorities will reduce service budgets in 2021-22. Our survey indicates that 94% of respondents from single tier and county councils and 81% from district councils expect to reduce service budgets. Some respondents considered that service users would be affected by their savings plans, due to reduced service levels from cutting staffing and general efficiencies. In other cases, authorities indicated that specific savings or income-generation measures would have direct and immediate effects on service users (paragraphs 4.24 to 4.25, Figure 21).

31 Authorities' finances have been scarred by the pandemic and will not simply return to business as usual once the pandemic ends. A key theme from our case study discussions, stakeholder interviews and workshops was the long-lasting impact the pandemic is expected to have on authorities' finances. Survey respondents indicated that they thought financial recovery would be a medium- to long-term process. Only 20% of single tier and county council respondents and 15% of districts indicated that their finances would return to pre-pandemic levels in the next two financial years. Some 53% of respondents from single tier and county councils indicated that they would need to build up their reserves in the next two to three years, but only 16% of these respondents felt confident that they would be able to do this (paragraphs 4.27 to 4.30, Figure 22).

Conclusion on value for money

32 Local authorities have played an important role in the public response to the pandemic, despite being under significant financial pressure. Steps taken by the government, led by the Department, have supported authorities in this pandemic response. The Department's successful monthly collection of data and continued intensive engagement with the sector provided a good evidence base to underpin the financial and other support provided by government. Action by the Department and wider government to support the sector has averted system-wide financial failure at a very challenging time and means that the Department has managed the most severe risks to value for money in the short term.

33 Notwithstanding these actions to support the sector, the financial position of local government remains a cause for concern. Many authorities will be relying on reserves to balance their 2020-21 year-end budgets. Despite continuing support into 2021-22 the outlook for next year is uncertain. Many authorities are setting budgets for 2021-22 in which they have limited confidence, and which are balanced through cuts to service budgets and the use of reserves.

Recommendations

34 To ensure that risks to value for money are managed going forward, the Department needs to learn lessons from 2020-21.

To maintain successful elements of its approach:

a the Department should continue with the effective aspects of its approach to supporting the sector during the pandemic: intensive sector engagement, improved monitoring and providing unringfenced general grants.

To further improve other elements:

b other departments, drawing on the support of the Department, should improve their links with, and understanding of, local authorities, drawing on learning from the Social Care Sector COVID-19 Support Taskforce;

c the Department and HM Treasury should explore how to provide the sector with greater clarity over future funding both during the pandemic and the recovery including:

- signalling clearly on a timely basis the likelihood of further funding or support; and
- supporting value for money in local decision-making by looking for ways to reduce uncertainty in time to be of use to next year's local authority budget-setting process.

d In recognition that the sector remains under significant financial stress in the short term, the Department should:

- maintain its exceptional support offer, with appropriate capacity within the Department to ensure timely consideration of requests; and
- consider how it can present information about levels of financial stress in the sector without undermining engagement with individual authorities.

To address long-standing issues and ensure the government and the sector are prepared for the future:

e the Department, working with other departments, should focus more fully on risks to service sustainability. Government, led by the Department should:

- assess authorities' 2021-22 budgets to understand the impact on service budgets and the implications for service users, other service providers and long-term value for money; and
- use this service-level information, alongside its financial monitoring data, to inform in-year and future funding decisions.

f The Department, supported by the rest of government, should carry out a review of the lessons from the pandemic in order to understand better the information it needs to manage financial risk in the sector, including:

- the Department's reliance on its additional COVID-19 monitoring activities to identify the broad range and high level of risk in Croydon Council, and the implicit limitations of its standard risk monitoring work; and
- the problems that the pandemic has exposed with data on authorities' reserves, which led to the Department collecting experimental data on reserves in-year.

g In time to be of use to authorities' 2022-23 budget-setting processes the Department and HM Treasury should produce a long-term financial plan for the sector that:

- sets out when the various paused elements of the local government finance reform programme will be restarted; and
- considers any further steps that will be needed to support the sector to recover from the financial scarring from the pandemic.

h In preparation for, and to mitigate the impacts of, future pandemics or similar crises, the Department needs to:

- incorporate an assessment of the sector's resilience to a future pandemic or similar crisis as part of its ongoing monitoring and assessment of financial sustainability; and
- undertake a review of the government's response in relation to local authorities and use this information to create an emergency financial response framework.