The local government finance system in England: overview and challenges

REPORT

by the Comptroller and Auditor General

SESSION 2021-22
10 NOVEMBER 2021
HC 858

We are the UK's independent public spending watchdog.

We support Parliament in holding government to account and we help improve public services through our high-quality audits.

This overview sets out the nature of the local government finance system in England, the pressures it is facing, and the challenges and opportunities facing government as it reforms the system.

The local government finance system in England: overview and challenges

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 9 November 2021

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act

Gareth Davies
Comptroller and Auditor General
National Audit Office

4 November 2021

HC 858 | £10.00

Contents

This report can be found on the National Audit Office website at www.nao.org.uk

If you need a version of this report in an alternative format for accessibility reasons, or any of the figures in a different format, contact the NAO at enquiries@nao.org.uk

The National Audit Office study team consisted of:

Andrew Denney, Stephen Jobling, Robindra Neogi, Cameron Paton and Philip Taylor, under the direction of Vicky Davis.

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

020 7798 7400

www.nao.org.uk

@NAOorguk

About this overview

We have produced this overview to enhance financial transparency about local government in England.

This NAO overview looks at what local government in England spends, how this spending is funded and the effect of changes in recent years.

The overview covers England only as local government is devolved in Scotland and Wales. We focus on five types of English local authority – London boroughs (including City of London), metropolitan boroughs, unitary authorities, county councils and district councils. This does not include town and parish councils, combined authorities, or stand-alone police and fire authorities.

The overview is structured as follows:

- Part One provides a brief introduction to local government funding.
- Part Two considers government policy and actions since 2010.
- Part Three describes some results or consequences of these changes.

The overview draws on relevant findings from past NAO work. Further information on our data sources and methodology is provided on page 44.

For further information about activities of local government, and different types of local authority, please see our previous departmental overviews (available at: www.nao.org.uk/search/keyword/overview/sector/local-services) and our latest data visualisation (available at: www.nao.org.uk/other/financial-sustainability-of-local-authorities-visualisation-update).

This overview will be of interest to:

- members of Parliament and select committees.
- the government and the local government sector.
- members of the public interested in local government and how it is financed.

Background

Local authorities provide a broad range of universal services along with targeted services for the most vulnerable in society. They have also been pivotal in the local response to the COVID-19 pandemic.

Local authorities are funded through multiple funding streams, including government grants, taxes and charges for services.

The Department for Levelling Up, Housing & Communities (the Department), previously the Ministry of Housing, Communities & Local Government, is responsible for a framework that provides assurance on the financial health of local government, and allows for intervention in individual cases and in response to system-wide risks.

This Overview aims to provide clarity at a moment of potentially significant change

The government set out its spending plans in the Spending Review on 27 October 2021 alongside an autumn Budget. In relation to local government HM Treasury announced:

- £4.8 billion of new grant funding, equivalent to £1.6 billion each year, will be available to local government over the Spending Review period;
- separately, £3.6 billion of the previously announced £5.4 billion of investment in adult social care will be routed through local authorities;
- expectations for council tax referendum thresholds (2% per year, and 1% per year for the adult social care precept) and estimated Core Spending Power over the period. Full details to be set out in the local government finance settlement; and
- business rates changes to support businesses, noting that local authorities will be fully compensated for these. Business rates revaluations will move to a three-year frequency from 2023. The government will shortly consult about the possible introduction of an Online Sales Tax. If introduced, the revenue from this tax would be used to reduce business rates for retailers in England.

The Spending Review did not contain announcements about the government's intentions in relation to the fair funding review or increases in the level of locally retained business rates.

Further information can be read in the *Autumn budget and Spending Review 2021 papers* published on the GOV.UK website. Available at: www.gov.uk/government/publications/autumn-budget-and-spending-review-2021-documents

Due to the timing of our publication this overview does not address the Spending Review 2021 announcements further.

Separately, from March 2020, the COVID-19 pandemic led to a dramatic reduction in local authority income and increases in cost, which has seen the Department provide significant financial support. It has also heightened uncertainty about the future shape of finances in local government.

This overview provides analysis up to the last complete year of finalised financial data available, which is 2019-20 for most data series and 2020-21 for other data relating to the impact of the COVID-19 pandemic on local government. Data and policy changes mean that it is generally not possible to trace time series back further than 2010.

The overview draws on our past work on local government and local government finance, as well as our wider audit work.

It sets out – based on this analysis of data and our previous work – the challenges and issues that the government may wish to consider as it sets about planning and delivering reforms to local government finance.

Structure of the overview

Part One

Local government spending and income 2019-20

Local authorities meet the costs of their statutory and discretionary services through a combination of revenue and capital expenditure. Revenue spending covers day-to-day costs such as salaries. Capital expenditure relates to investments in assets such as buildings and transport infrastructure.

This part of the overview sets out:

- local authority day-to-day and capital spending in 2019-20 – the last complete year of financial data available, and also the last year before the COVID-19 pandemic – and the resources that paid for it.

Part Two

Developments in local government finance policy since 2010

Since 2010 successive governments have reduced funding for local government in England as part of their efforts to reduce the fiscal deficit, while making a range of changes to provide local authorities with greater flexibility and local accountability over their income.

This part of the overview sets out:

- the extent of government funding reductions since 2010;
- policy developments intended to provide flexibility and local accountability;
- actions government has taken to support funding challenges including COVID-19; and
- key intended reforms to the local government finance system that have been delayed and remain undelivered.

Part Three

Impact on local government finance

The changes implemented by government have impacted on local authorities and caused behaviour change with greater reliance on local sources of income.

This part of the overview sets out:

- the impact of funding reductions on patterns of local government spending;
- the impact of increased reliance on locally generated funding, including commercial investment;
- the impact on local authority finance of delays to reform; and
- evidence of strain on the financial resilience of local authorities and the mechanisms established to protect them.

Local Government spending and income 2019-20

Local authorities meet the costs of their statutory and discretionary services through a combination of revenue and capital expenditure. Revenue spending covers day-to-day costs such as staff salaries. Capital expenditure relates to investments in assets such as buildings and transport infrastructure.

Capital and revenue spending are accounted for separately, and operate within different sets of rules.

In 2019-20, authorities made £64.4 billion of revenue expenditure to support services, and £18.7 billion of capital expenditure.

This part of the overview sets out detail on the patterns of spending in 2019-20, which represents:

- the last complete year of financial data available, and
- the last year before the COVID-19 pandemic.

Local authority day-to-day service spending, 2019-20

Local authorities provide a variety of services to their communities, both mandatory and discretionary. The Local Government Association reports that local authorities in England provide more than 800 services, most of which are mandatory (available at: www.local.gov.uk/our-support/councillor-development/new-councillor-hub/introduction-local). Services are mandatory where Parliament has created legal duties for local authorities. These include social care services to adults and children, waste collection, planning and housing services.

Some mandatory services are subject to a great deal of central influence, most obviously social care services. Legislation or statutory guidance describes duties in detail, and inspectorates monitor service quality. Local authorities have a broad discretion over the delivery of other mandatory services, however, such as libraries.

Local authorities have the power to deliver discretionary services in line with their local priorities, but are not obliged to provide them. Wholly discretionary services include sport and recreation, economic development, business support and additional provision that supports mandatory services.

In 2019-20, local authorities spent £64.4 billion of revenue funding in support of services, with statutory services dominating expenditure. Adult and children's social care together accounted for 50% of revenue expenditure. Each other service area accounted for at most around 10% of expenditure (**Figure 1**).

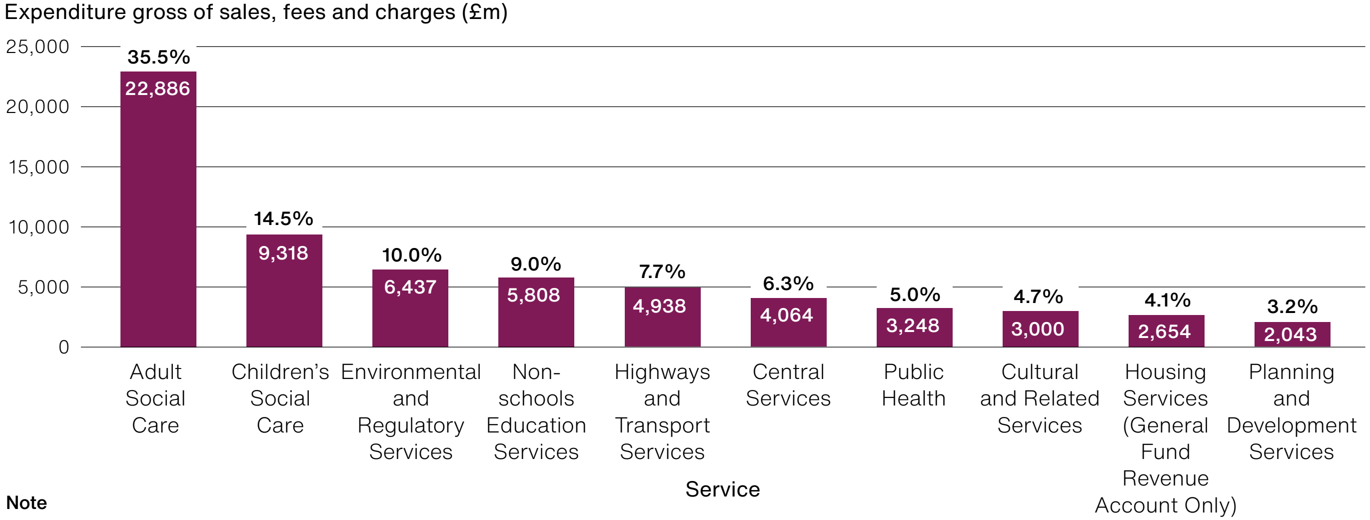
The analysis in this overview excludes some areas of service spend, but this does not imply that there are no issues in these services. For example, in 2019, we reported that the system for supporting pupils with special educational needs and disabilities in England was not financially sustainable with many local authorities failing to live within their high-needs budgets and meet demand.

Local authorities also incur expenditure that cannot be directly attributed to individual services. Non-service revenue spending includes costs related to local authority borrowing, such as interest payments and money set aside to repay loans. Further information on finance costs can be seen on page 30. Expenditure of this kind does not appear in Figure 1; nor does money added to reserves.

Figure 1

Revenue service expenditure by English local authorities, gross of sales, fees, and charges, 2019-20

Social care accounted for the largest share (around 50%) of revenue spending by service



Note

1 This analysis of revenue spending excludes:

- significant levels of schools expenditure, where this funding passes through local authorities to be spent by schools themselves. (However 'Non-schools education services' such as central support services are included.) Please see Appendix: Methods for a full explanation; and
- revenue spending on council-owned housing stock. Where local authorities have such holdings, they account separately for them in a ringfenced Housing Revenue Account.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Local authority revenue income, 2019-20

Local authorities fund their day-to-day spending from a range of sources. In 2019-20, council tax provided the largest single income stream (**Figure 2**).

Government funding to local authorities is made up of formula-based and application-based grants. The local government finance settlement provides a formula-based funding level through a combination of locally retained business rates and the revenue support grant. Other formula-based grants include the public health grant. Additionally, local authorities may receive general grants from government to secure specific policy objectives such as the Better Care Fund and the New Homes Bonus. General grants may be allocated according to criteria, be based on competition, or be un-competed.[1]

In addition, the new burdens doctrine commits the government to assessing and funding extra costs for local authorities from introducing new powers, duties and other government-initiated changes.

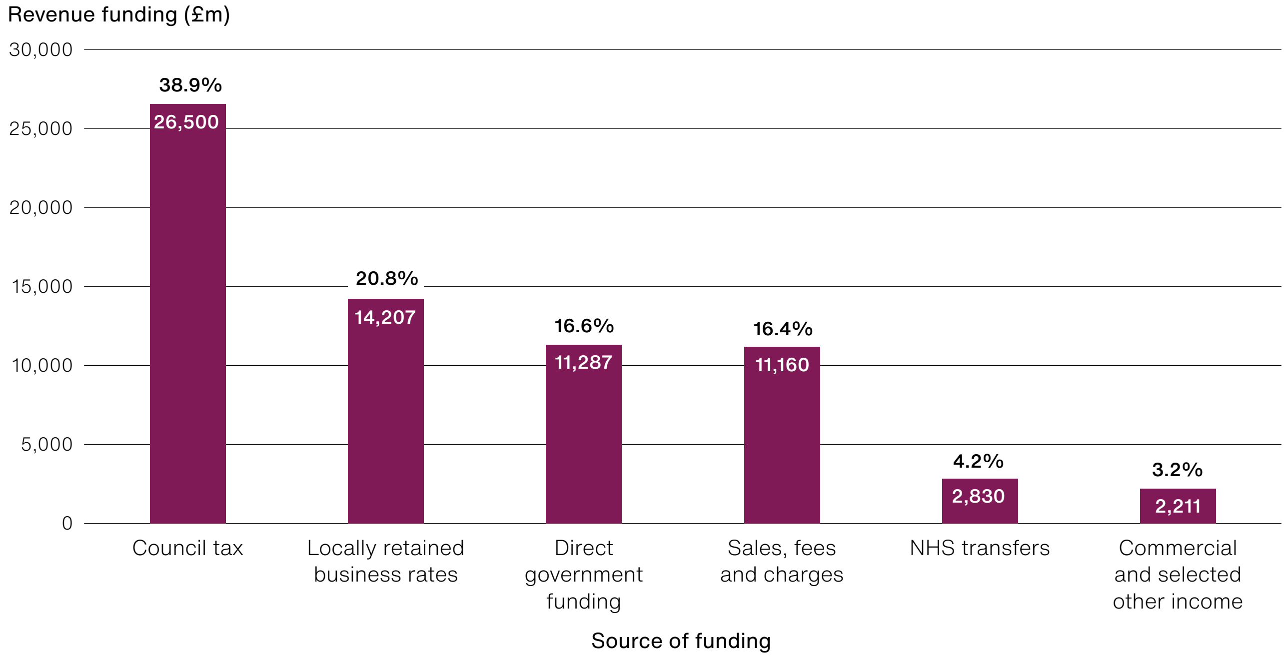
Local authorities are legally required to set council tax to produce a balanced budget that funds their service and non-service costs each year, allowing for other income. Council tax levels remain subject to centrally set referendum requirements and cannot be increased in-year to maintain the balance if circumstances change. The requirement for a balanced budget, which persists throughout the year, is in contrast to other public sector bodies, such as NHS bodies, which are able to operate deficits. Local authorities may also choose to use their reserves to fund any shortfall between income and expenditure to balance their budgets, making reserves an important element of local authority financial management. However, money drawn down from reserves is not included in Figure 2.

1 Un-competed grants are targeted at specific local authorities without applying criteria or requiring a competitive process, for example where only one authority has the capacity to deliver the objectives.

Figure 2

Sources of revenue funding for English local authorities, 2019-20

Council tax accounted for almost 40% of revenue funding in year



Notes

1 Our analysis of revenue income excludes:

- front-line schools funding, such as Dedicated Schools Grant, which passes through local authorities to be spent by schools themselves; and
- revenue income from council-owned housing stock. Where local authorities have such stock, they account separately for them in a ringfenced housing revenue account.

2 The level of business rates income depends on changes in the income collected by each local authority, in addition to the government formula; accordingly it is shown separately from other government funding in the chart.

3 Unlike charts looking at change over time, public health is included here. This affects both government funding and sales, fees and charges.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Local authority capital spending, 2019-20

Local authorities incurred £18.7 billion of capital spending in 2019-20. Capital expenditure relates to investments in long-lived assets such as buildings, roads, bridges, vehicles, IT equipment and waste processing plants.

The pattern of capital spending across service areas differs from that of revenue expenditure. Around half of all capital spending in 2019-20 was on housing or highways and transport services (**Figure 3** overleaf). Only 2% of capital spending was on social care, in large part because local authorities have outsourced this provision and no longer own significant social care assets. Environmental services also have relatively low levels of capital spending compared with revenue expenditure levels.

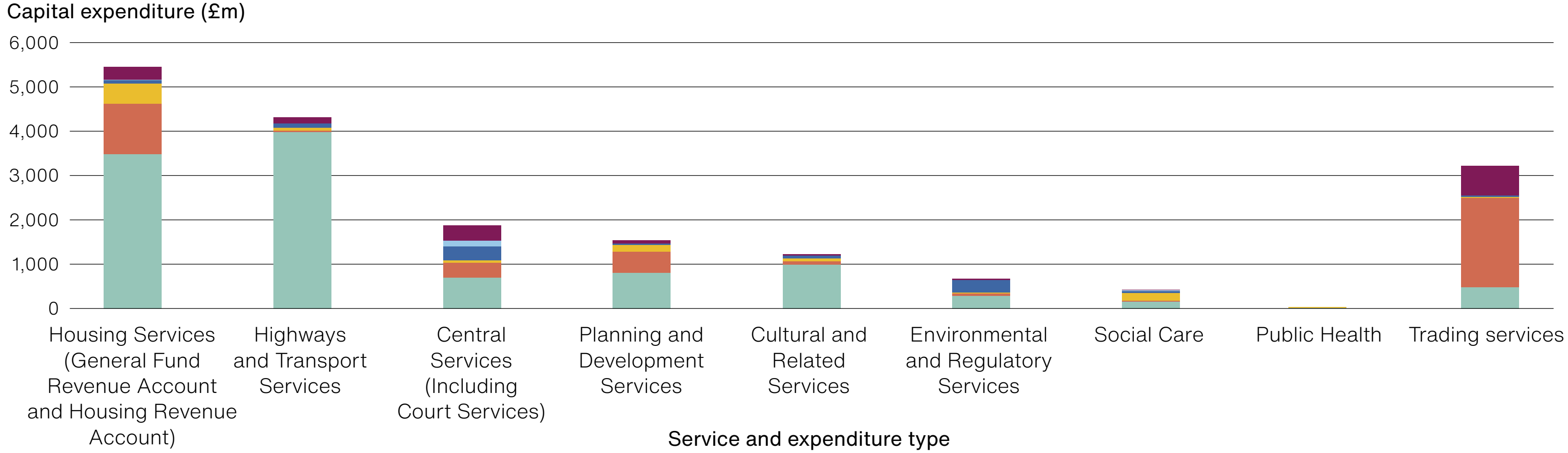
Spending on buildings, land and infrastructure makes up 80% of capital spending. Much of this is either construction of new assets or the renovation of existing ones. However, local authorities also spent £4.1 billion on the purchase of land or existing buildings. Purchasing land or existing buildings by local authorities within trading services accounted for half of this £4.1 billion, and was 11% of all capital spending.

Despite their general separation, the capital and revenue sides of local authorities' expenditure and resources do interact. At a strategic level such capital investment can be used to deliver revenue savings, for example through investment in information technology to change the way services are delivered. Capital investment in commercial schemes can also be used to generate revenue income.

Figure 3

Capital expenditure by English local authorities, by service and type, 2019-20

Most capital spending (around 58%) goes on new construction, conversion and renovation of buildings and infrastructure



	Housing Services (General Fund Revenue Account and Housing Revenue Account)	Highways and Transport Services	Central Services (Including Court Services)	Planning and Development Services	Cultural and Related Services	Environmental and Regulatory Services	Social Care	Public Health	Trading services
Acquisition of share/loan capital; and spend on loans and other financial support	287	138	341	70	27	26	4	0	662
Intangible fixed assets	6	2	133	2	2	2	14	0	1
Plant, furniture, equipment and vehicles	79	88	316	37	71	273	54	0	30
Expenditure on grants	458	74	47	142	63	27	169	16	24
Acquisition of land and existing buildings	1,130	34	336	481	78	49	22	0	2,010
New construction, conversion and renovation	3,483	3,975	706	813	991	296	161	4	485
Total	**5,442**	**4,309**	**1,879**	**1,545**	**1,231**	**673**	**424**	**21**	**3,213**

Notes

1 Unlike revenue spending, it is not possible to split capital spending between schools and non-schools education spend. This chart excludes all education capital spend and some other service areas. We include financial expenditures but exclude 'other transactions'.

2 Our analysis of revenue spending and income on the preceding pages excludes the ringfenced Housing Revenue Account. In contrast we cannot isolate capital spending on council-owned housing stock. All capital spending on housing is included here as we believe excluding it would remove substantial relevant capital spend.

3 Trading services include the maintenance of direct labour and service organisations, such as civic halls, retail markets and industrial estates, and commercial activity.

4 Figures are rounded. As a result, adding up sub-totals may not give the same number as shown for totals.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Local authority capital resources, 2019-20

Local authorities can resource in-year capital spending in two ways: funding it upfront or financing it over time using borrowing. This is in contrast to revenue spending, where local authorities cannot borrow to balance their budgets.

Upfront funding of capital spend can come from a variety of sources including government grants, funds from the sale of their own capital assets (capital receipts), and contributions from revenue income. These resources may have been received in-year or set aside in earlier years. The Housing Revenue Account and Major Repairs Reserve are funding sources purely for capital investment in social housing.

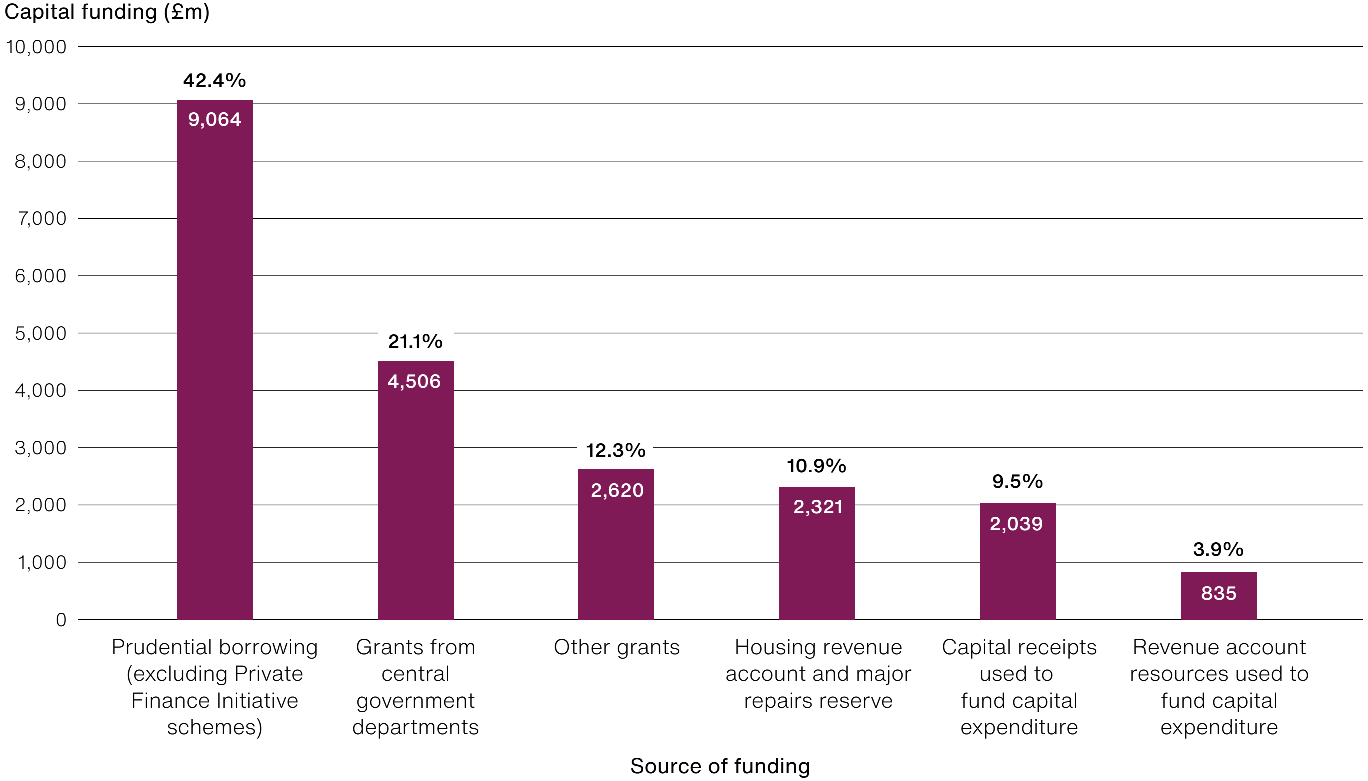
In 2019-20, borrowing made the largest contribution to resourcing in-year capital spending (Figure 4). Forty-two per cent of capital expenditure in 2019-20 was financed by borrowing. External borrowing sources include the government's Public Works Loan Board, commercial banks and other local authorities. Local authorities may also borrow internally if they have temporary surplus cash holdings available. Interest payments on borrowing need to be met from revenue resources, and local authorities make provision from revenue to repay outstanding debt (this is called minimum revenue provision).

Local authority borrowing is largely self-regulated within the prudential framework of underlying legislation and four statutory codes, and thus is known as 'prudential borrowing'. Within the parameters of this framework, authorities are responsible for their own borrowing and investment decisions. In particular, the CIPFA Prudential Code (available at www.cipfa.org) sets out guidelines for local authorities to make sure their capital programmes and borrowing are prudent, affordable and sustainable, given the impact on revenue.

Figure 4

Sources of capital funding for English local authorities, 2019-20

Most capital spending in year (around 64%) was resourced by borrowing and central government grants



Notes

1 Capital expenditure is resourced collectively and it is not possible to identify and fully exclude individual elements from the data. Accordingly, this chart includes the resourcing of education and housing capital spend. For this reason, this chart covers a wider range of services than the revenue spending charts, and the total spending covered in this chart does not match the total spending on pages 9 and 10.

2 Figures are rounded. As a result, adding up sub-totals may not give the same number as shown for totals.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Developments in local government finance policy since 2010

Since 2010 successive governments have reduced funding for local government in England as part of their efforts to reduce the fiscal deficit, while making a range of changes to provide local authorities with greater flexibility and local accountability over their income.

This part of the overview sets out:

- the extent of government funding reductions since 2010;
- policy developments intended to provide flexibility and local accountability;
- actions government has taken to support funding challenges including COVID-19; and
- key intended reforms to the local government finance system that have been delayed and remain undelivered.

Government has reduced funding for local authorities since 2010, while council tax has risen

The Department for Levelling Up, Housing & Communities (the Department) measures the income it makes available for local authorities through 'spending power'. This indicator captures the main streams of government funding to local authorities, in addition to council tax. Accordingly it does not include various other forms of local income, such as sales, fees and charges, or commercial income. The Department includes in its spending power measure of government funding an assumed amount for locally retained business rates that is uprated for inflation each year. However, this does not include pilots for retaining higher levels of business rates, and will not capture above-inflation growth in locally retained business rates income.

If council tax is removed, spending power funded by government fell in real terms by more than 50% on a like-for-like basis between 2010-11 and 2020-21.

After an initial fall, council tax has grown substantially in real terms since 2016-17. These increases are likely to be related to:

- the end of the council tax freeze schemes which operated from 2011-12 to 2015-16. The removal of these schemes, which came with grants, means there is no financial incentive from government for local authorities to freeze or reduce council tax; and
- the council tax referendum limits set by government, including the flexibility granted from 2016-17 which allows local authorities with social care responsibilities to increase council tax rates specifically to pay for adult social care (the social care precept).

Within this context, local authorities take decisions on the setting of council tax on the basis of their own priorities.

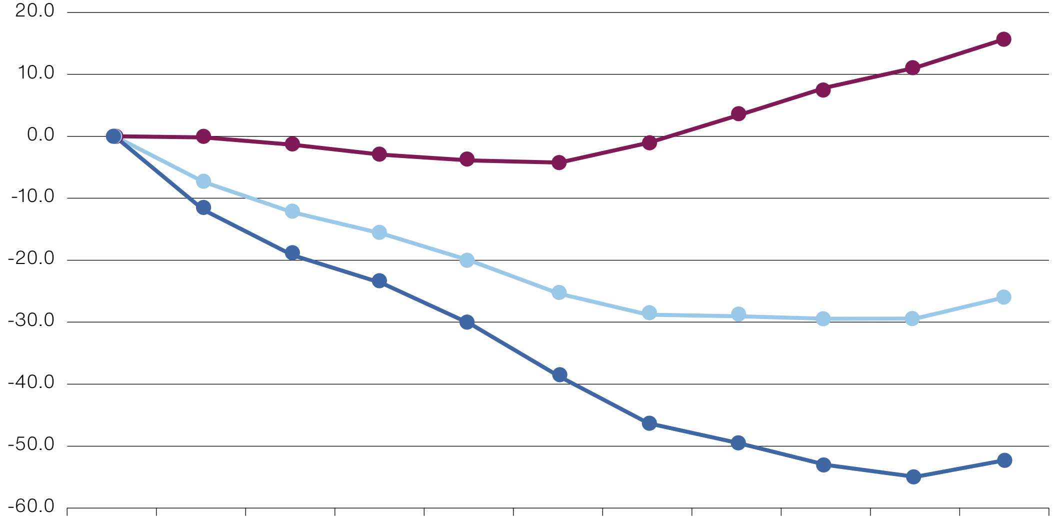
The recent council tax growth has led to a real-terms stabilisation in overall local authority spending power. While overall spending power is 26% lower on a real terms, like-for-like basis than in 2010-11, the growth in council tax since 2015-16 has helped stabilise overall spending power in that period.

Figure 5

Change in components of spending power in English local authorities 2010-11 to 2020-21

Government-funded spending power has reduced by more than 50% since 2010-11

Change in spending power and its components (indexed: 2010-11 = 0%; real-terms in 2019-20 prices) (%)



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Council tax	0.0	-0.2	-1.4	-3.0	-3.9	-4.2	-1.0	3.3	7.9	11.1	15.6
Spending power	0.0	-7.4	-12.3	-15.7	-20.1	-25.4	-28.8	-29.0	-29.5	-29.4	-26.0
Government funded spending power	0.0	-11.9	-19.2	-23.7	-30.3	-38.8	-46.3	-49.5	-53.0	-55.0	-52.3

Note

1 Spending power is a government measure of the revenue resources made available to local authorities (from 2015-16 government refers to 'core spending power'). We exclude funding for public health grant, the original Better Care Fund and NHS funding for spend on social care that also benefits health. This funding was removed from the Department's definition of spending power from 2016-17 onwards and we remove this funding from the time series as a whole to improve consistency. Similarly, we use a weighted index to enable a like-for-like comparison despite significant changes in the duties placed on local authorities and the way financial data were reported in the period 2010-11 to 2015-16. Accordingly, the index cannot be used to estimate absolute changes in funding.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Funding reductions have coincided with growing service demand and other cost pressures

Government reduced funding for local government while social and demographic changes have increased demand on many key services local authorities provide. Government decisions at spending reviews are informed by the estimates of future spending demand on services, based primarily on projections of changes in population-related variables. The government also carries out work to understand changes in demand and other cost pressures between spending reviews, where necessary.

The population as a whole has grown 7% since 2010-11. Our recent work has highlighted particular pressures in services including adult social care, children's social care and homelessness services:

- **The number of adults over 65 has increased since 2010, while adult social care spending has remained broadly static in real terms (Figure 6).** Between 2010-11 and 2019-20, the number of adults aged 65 to 84 has increased by 21%, and those over 85 have increased by 20%. Following decreases between 2010 and 2014, adult social care spending gross of sales, fees and charges recovered to a level in 2019-20 which was 5% higher than in 2010-11. Levels of unpaid care remain high, and too many adults have unmet needs.

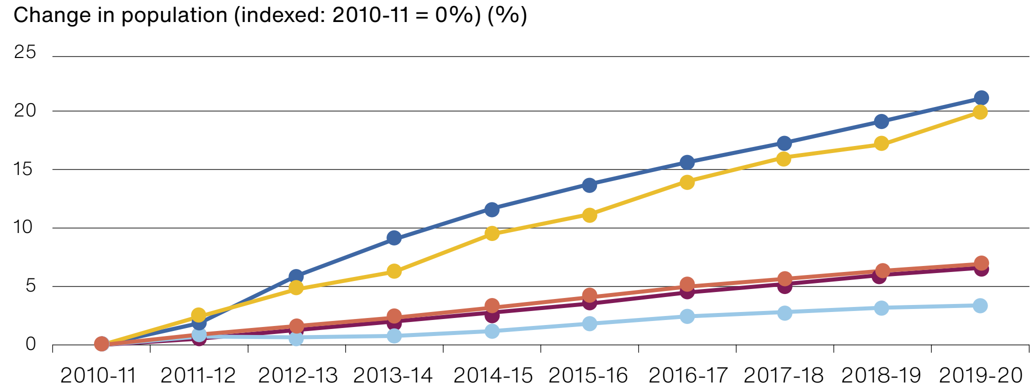
- **Spending on children's social care has increased, although demand for certain services has outstripped capacity.** Overall spending gross of sales, fees and charges increased 17% between 2010-11 and 2019-20. In 2019 we reported that the most expensive cases, where children are taken into care, have risen at almost triple the rate of population growth. Demand for residential placements and staff has outstripped capacity.

- **The number of homeless households has increased, driving a three-fold increase in spending on temporary accommodation.** The numbers of homeless households in temporary accommodation increased from around 48,000 in 2010-11 to 92,000 by the final quarter in 2019-20. Local authority net spending on temporary accommodation increased in real terms from £110 million in 2010-11 to £330 million in 2019-20.

Figure 6

Change in population of England by age group, 2010-11 to 2019-20

The number of adults over 65 has increased faster than the overall population



Change by year and age group (%)

	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
0-17	0.0%	0.5%	1.3%	2.0%	2.8%	3.5%	4.5%	5.2%	6.0%	6.6%
18-64	0.0%	0.7%	0.7%	0.8%	1.2%	1.8%	2.4%	2.8%	3.2%	3.4%
65-84	0.0%	1.9%	5.9%	9.0%	11.7%	13.8%	15.6%	17.3%	19.1%	21.1%
85+	0.0%	2.4%	4.8%	6.3%	9.5%	11.2%	14.0%	16.1%	17.2%	19.9%
All ages	0.0%	0.9%	1.6%	2.3%	3.2%	4.1%	5.0%	5.7%	6.3%	6.9%

Number of people in each group (millions)

	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
0-17 (millions)	11.3	11.3	11.4	11.5	11.6	11.7	11.8	11.9	12.0	12.0
18-64 (millions)	32.8	33.0	33.0	33.1	33.2	33.4	33.6	33.7	33.8	33.9
65-84 (millions)	7.4	7.5	7.8	8.1	8.3	8.4	8.6	8.7	8.8	9.0
85+ (millions)	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.4	1.4	1.4
All ages (millions)	52.6	53.1	53.5	53.9	54.3	54.8	55.3	55.6	56.0	56.3

Source: National Audit Office analysis of Office for National Statistics local authority-based population estimates

Government has taken some steps to help local authorities manage their finances and to assure itself about the impact of funding reductions on services

In 2010, alongside plans to reduce local authority funding, the government set out its intentions to give local authorities greater freedom and flexibility. The government wanted to give local authorities freedom to be innovative and efficient in the face of financial challenges, and to respond to local priorities, rather than being directed by conditions that central government places on spending, restricted by caps on council tax rises, or steered by central oversight of performance.

Government initially took steps to reduce central control over both council tax and the grant funding it provided to local authorities. Approaches to increase flexibility or local accountability included:

- **replacement of council tax capping** – the Localism Act 2011 abolished central government capping of council tax increases, setting instead a limit for increases beyond which local authorities need democratic approval via a local referendum;
- **reduced ring-fencing of grants** – ringfenced grants must be spent on the purpose for which they are given. By 2013-14 91% of government funding to local authorities was unringfenced. The Public Health Grant accounted for the majority of the remaining ringfenced grant; and
- **reduction in number of specific grants** – by 2013-14 21 revenue grants worth £3.2 billion had been rolled into general unringfenced funding. Any new grant streams needed to be approved by the Department, and by HM Treasury in certain circumstances.

The government also ended some of the detailed frameworks for monitoring local authority spending and performance, such as the set of National Indicators and the inspections carried out by the Audit Commission. Instead, departments secure assurance from the local system of accountability. The Local Government Association has a systematic approach to identifying those local authorities that could benefit from sector support and is a source of information to the Department.

Government later took steps to increase funding certainty through longer-term funding. For each of 2011-12, 2013-14 and 2014-15, the Department announced a provisional or illustrative settlement for the following year alongside that year's local government finance settlement. Then, from 2016-17 the Department offered an optional four-year funding settlement to all local authorities to enable better financial planning. Running to 2019-20, the multi-year settlement gave a degree of certainty over levels of revenue support grant, rural services delivery grant, transition grant, and redistributive elements of the business rates retention system. It was open to local authorities to continue to work on a year-by-year basis; however, government said they could not guarantee future levels of funding to those who prefer not to have a four-year settlement. Almost all local authorities accepted the four-year settlement.

The Department has monitored funding challenges for priority services. The Department's monitoring of financial impacts on services is highly concentrated on a small number of high-priority services. The Department primarily relies on other government departments to oversee the impact of funding challenges on the statutory services that fall under their remit. This oversight may be more or less robust depending on the level of information available to central government. The Department prioritises its attention and its engagement with other departments on areas that are particularly high-spending or under particular pressure; this has always included adult social care.

The components of government funding for local authorities have changed

Introduction of local retention of business rates

From 2013-14, the local government sector has retained 50% of business rates income. The objectives of the change were to incentivise local authorities to develop their local economies; and enable local authorities to become more financially self-sufficient. However, the system has a complex design and requires substantial redistribution of retained business rates between local authorities in line with a formula that also determines the remaining Revenue Support Grant. Since the 2015 Spending Review the government has intended to increase the proportion of business rates retained by local authorities. The government has used pilots to develop the approach to increased retention. Six areas currently retain increased growth in excess of the 50% scheme by exchanging grant funding for retained business rate income. However, errors in payments in 2017-18 and guidance in 2018-19 led to some pilot authorities receiving overpayments or being compensated for mistakes. The Department created an independent review in response to the first errors and is taking action in response to the review's recommendations.

New Homes Bonus

From April 2011 the Department has paid New Homes Bonus to local authorities in relation to the number of new homes built. There have been a number of changes to the design of the scheme and the scale of New Homes Bonus is currently decreasing. The amounts allocated to authorities by the Department in the years 2011-12 to 2019-20 add up to £7.9 billion, primarily funded by top-slices from Revenue Support Grant or its predecessor formula grant. The intention was to incentivise local authorities to facilitate building of more homes in their areas.

Replacing council tax for those unable to pay

Prior to April 2013, central government set the rules for how residents' council tax bills were reduced by council tax benefit. Central government provided funding to replace the precise level of the income reduction for local authorities. Since then local authorities decide on their own council tax support schemes. Funding related to this is included in revenue support grant or locally retained business rates. However, the funding level is connected to historic spending rather than current spending or caseloads. The Department expected that localising responsibility for council tax support will give local authorities a greater stake in promoting local economic growth.

Additional funding streams for adult social care

In response to funding pressures on adult social care services, central government introduced a series of measures to provide additional funding for adult social care. This included NHS transfers, a winter pressures package and the flexibility granted from 2016-17, which allows local authorities with social care responsibilities to increase council tax rates specifically to pay for adult social care – the social care precept – the terms of which have changed over time. However, local authorities with social care responsibilities vary in their ability to raise money through the use of the precept, so additional social care grants, such as an improved Better Care Fund, were created and assigned using formulas that compensate for the different amounts that can be raised from the precept.

Funding for specific purposes

Specific general grants are distributed outside of the local government finance settlement. These grants are designed to help deliver specific government policy objectives such as net zero. They may be competed, un-competed or based on criteria. Our report *Local authority financial sustainability 2018*, (available at: www.nao.org.uk/report/financial-sustainability-of-local-authorities-2018) found the funding landscape was characterised by one-off and short-term funding initiatives. This position has remained unchanged. We reported in *Local government and net zero 2021*, (available at: www.nao.org.uk/report/local-government-and-net-zero-in-england) that while funding for local authority delivery of net zero had increased significantly in 2020-21, it remained fragmented. Similarly, the Chartered Institute of Public Finance and Accountancy (CIPFA) reported in May 2021 that while local government receives more grants now than in the past, the total amount of funding has decreased, with a large variation in grant size. CIPFA found smaller, shorter duration and less flexible grants challenge the limited resources of many local authorities, particularly when they are competed.

The Department has improved its delivery of key aspects of its financial oversight role

We have reported how the Department's overall responsibility for government funding of local authorities is complex in the context of the localism agenda. Localism gives local authorities greater control over spending decisions but, consequently, the Department has less oversight of their financial sustainability.

Our work has shown the Department has improved key aspects of its oversight of local government finance since 2010-11. In particular:

- **the Department has improved its oversight of financial risk in the local government sector.** We have seen the Department systematically collecting and using data and other forms of information. It has robust internal reporting mechanisms and engagement from the highest level of management;
- **the Department has improved the information it collects and the analysis undertaken on local government finance.** The Department has adopted a more strategic approach to data and analysis, moving from producing bespoke analysis for each fiscal event – such as each Spending Review – to having a range of tools that can be re-used on an ongoing basis. It has developed a local authority sustainability tool which models local authorities' financial resilience. This informs the Department's assessment of the risk of widespread financial failure;
- **the Department has improved its engagement with other government departments during Spending Review processes.** In 2018 we reported how the Department's advice to ministers for the 2015 Spending Review drew on a more comprehensive evidence base than in 2013, including data returns from 12 departments. This supported a cross-government view on the level of funding for local government; and
- **during the pandemic, Departmental officials engaged intensively with the sector about impacts on its finances and took actions to facilitate engagement between the sector and other government departments.** These efforts and the Department's understanding of local government finance received very positive feedback from the sector. This engagement built on established relationships, such as extensive collaboration with the sector about potential changes to the local government finance system.

Our work continues to show there is more to do, including across government.

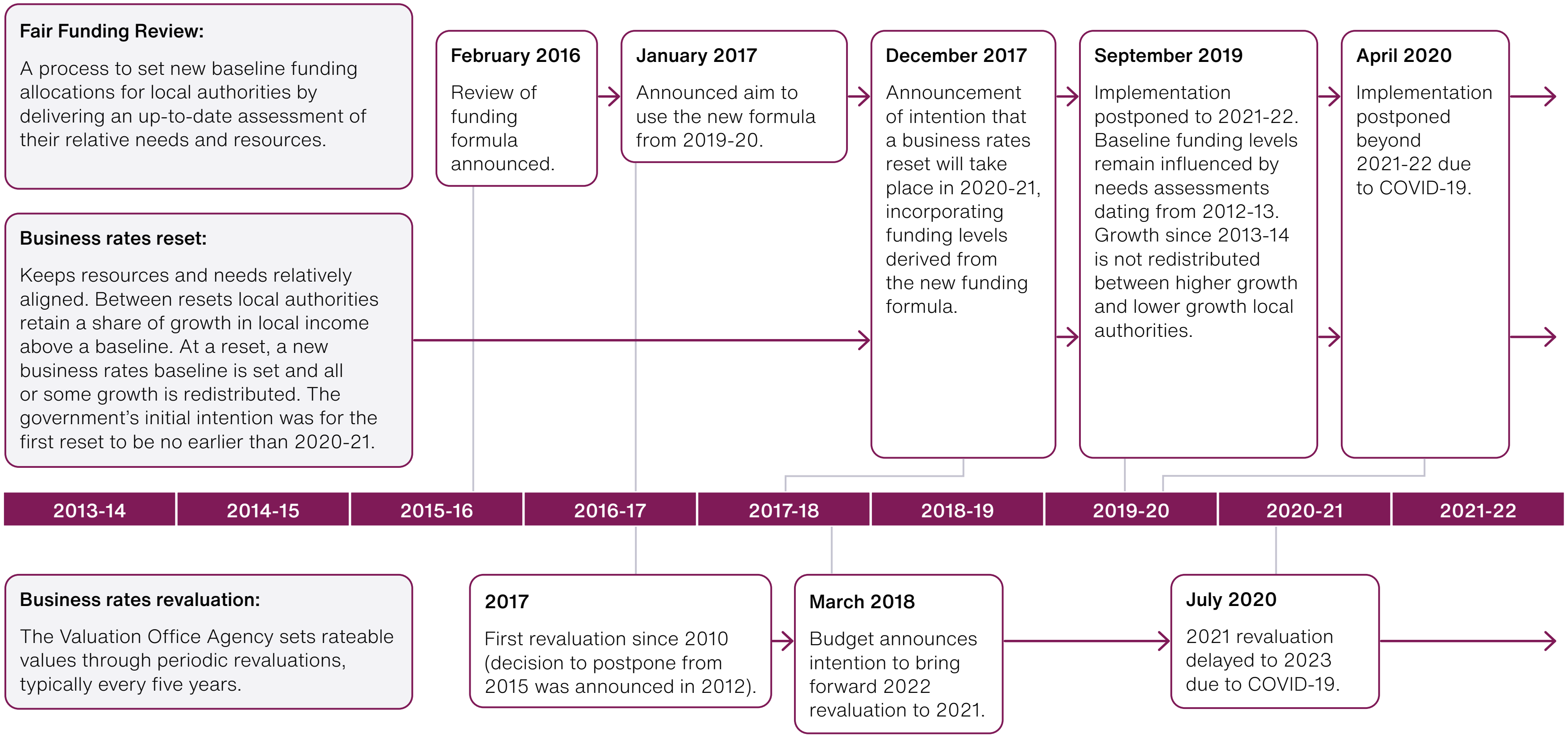
- **In 2018 we concluded that the Department must continue to strengthen its oversight and assurance mechanisms** to protect against risks to value for money from financial failure in the sector. It must also set out at the earliest opportunity a long-term financial plan for the sector that includes sufficient funding to address specific service pressures and secure the sector's future financial sustainability. We said the government, led by the Department, should develop a clear understanding of the role and significance of local authorities as a whole in the context of the current funding climate.
- **In 2021, in relation to net zero we found there are serious weaknesses in central government's approach to working with local authorities on decarbonisation,** stemming from a lack of clarity over local authorities' overall roles, piecemeal funding and diffuse accountabilities. We said this hampers local authorities' ability to plan effectively for the long-term, build skills and capacity and prioritise effort. It creates significant risks to value for money as spending is likely to increase quickly.
- **In 2021, we recommended that the Department should assess, in light of the pandemic, the information it needs to manage financial risk in the sector,** bearing in mind the problems the pandemic exposed with data such as on local authorities' reserves.

Updates related to the existing local government finance system have been delayed

Figure 7

Updates relating to the existing local government finance system have been delayed

Government's plans to update the relative funding levels of local authorities and the business rates baselines above which growth is retained have been delayed several times. Updates to business rates through the revaluation process have also been delayed. These changes would help keep the system, and elements underpinning it, current



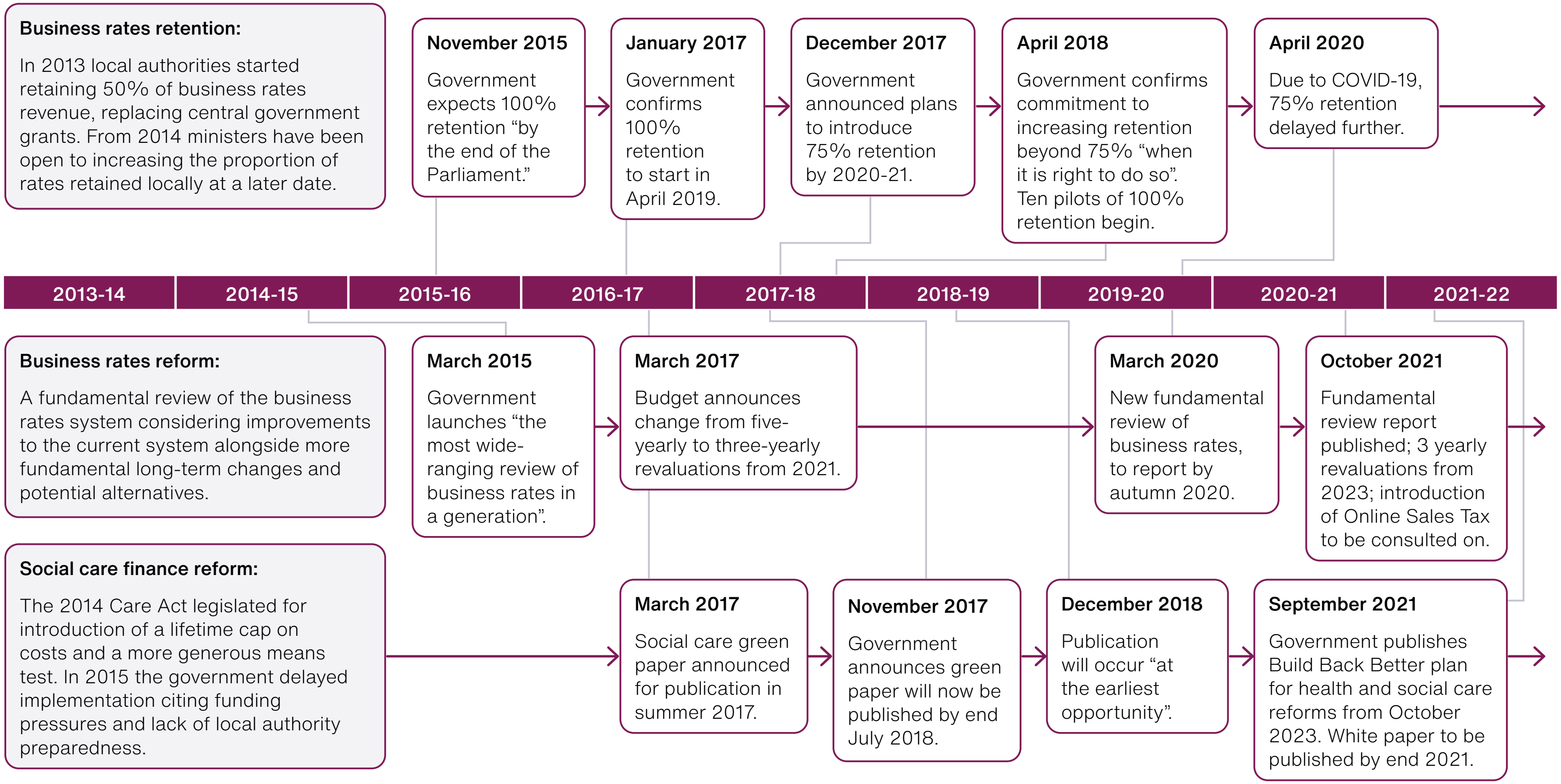
Source: National Audit Office analysis of government announcements

Key planned reforms relevant to the local government finance system have been delayed

Figure 7 *continued*

Key planned reforms relevant to the local government finance system have been delayed

Intended reforms to business rates retention have been delayed, and a more fundamental review has since been announced. Details of social care reform have also been repeatedly delayed



Source: National Audit Office analysis of government announcements

The Department reacted quickly to the funding challenges from the COVID-19 pandemic

The unprecedented challenge of the COVID-19 pandemic placed significant pressure on local authorities' finances. For March 2020, at the very start of the pandemic, local authorities estimated combined cost and non-tax income pressures at £0.2 billion. In April 2021 local authorities estimated that these pressures across 2020-21 were £9.7 billion.

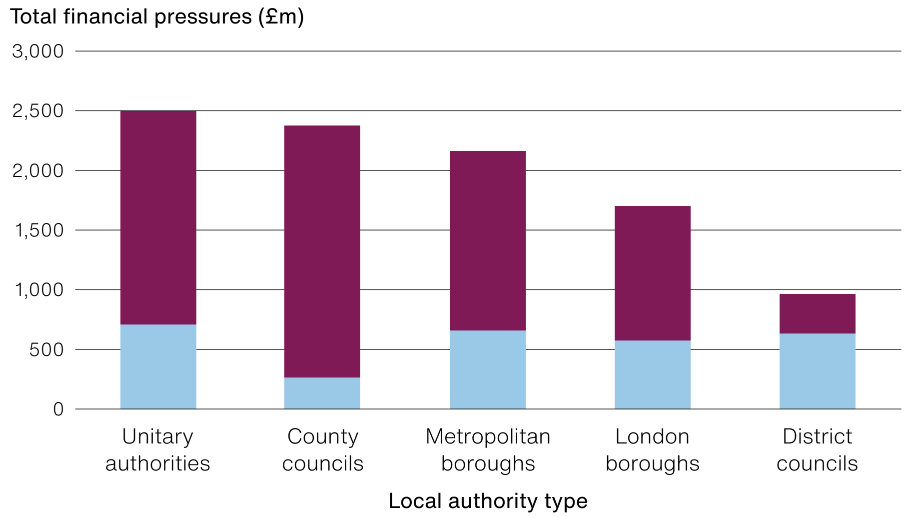
Cost pressures as a proportion of revenue expenditure were highest for district councils. In particular, district councils have greater exposure to income losses relative to their revenue spend (**Figure 8**). Overall, the pressures represented 18% of revenue expenditure across the sector in 2020-21.

Continued overleaf.

Figure 8

Financial pressures (non-tax income losses and cost pressures) for English local authorities in 2020-21 due to COVID-19

The pattern of financial pressures caused by the COVID-19 pandemic varied across different types of local authority



	Unitary authorities	County councils	Metropolitan boroughs	London boroughs	District councils
Cost pressures (2020-21)	1,791	2,111	1,504	1,127	330
Non-tax income losses (2020-21)	702	259	655	573	632
Total financial pressure (2020-21) as a percentage of revenue expenditure (2019-20)	18.1%	15.4%	18.4%	17.7%	20.8%

Note

1 Tax losses during 2020-21 do not have a direct in-year impact and will only hit local authority budgets the following year. Accordingly the chart only includes non-tax income losses.

2 The estimates of cost pressures and income losses are taken from local authority returns to the Department in April 2021.

3 For comparability we use 2019-20 revenue expenditure as a benchmark in the same way as in *Local government finance in the pandemic*, March 2021. The definition of this measure is set out in that study. Buckinghamshire is included as a unitary authority, which it became on 1 April 2020. This required combining the 2019-20 revenue expenditure of its predecessor authorities.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

In October 2021 the Department estimated government COVID-19 funding for the sector for 2020-21 at £10.8 billion.[2] This is made up of £9.5 billion of grants and £1.3 billion in compensation for sales, fees and charges income losses delivered through a number of government departments.

Fifty-four per cent of the estimated £10.8 billion was unringfenced, and 46% was ringfenced. The Department was the lead department for 57% of the funding, including all the unringfenced funding.

Of the grant funding received during 2020-21, some was required to be spent in-year but, where grant conditions allow, local authorities can carry forward unspent funding to 2021-22. For example, local authorities received £518 million in March 2021 from the Contain Outbreak Management Fund, which can be carried forward.

The Department's approach was to provide timely, targeted and temporary support rather than open-ended guarantees. Action by the Department to support the sector averted system-wide financial failure at a very challenging time, although its incremental approach did not support good financial planning. We received very positive feedback from the sector about Departmental engagement, its understanding of local government finance issues and its response to sector feedback. However, the approach of keeping the need for future funding under review created uncertainty around how long tranches of unringfenced funding were supposed to last, or whether there would be further ones.

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, local authorities will need to replenish reserves where necessary, deliver delayed savings programmes and address tax deficits from 2020-21.

2 Including the National Leisure Recovery Fund of £0.1 billion.

Impact on local government finance

The changes implemented by government have impacted on local authorities and caused behaviour change with greater reliance on local sources of income.

This part of the overview sets out:

- the impact of funding reductions on patterns of local government spending;
- the impact of increased reliance on locally generated funding, including commercial investment and borrowing;
- the impact on local authority finance of delays to reform; and
- evidence of strain on the financial resilience of local authorities and the mechanisms established to protect them.

Rising social care spending has squeezed funds available for non-social care services

Across all services, local authority service spending was 10% lower in real terms by 2019-20 than in 2010-11.

Local authorities have sought to protect spending on adult and children's social care services, where they have well-defined statutory responsibilities that are crucial for the well-being of service users. Despite an initial fall, social care spending has ultimately risen over this period. This has been helped by additional funding dedicated to adult social care.

In contrast, spending on non-social care services in 2019-20 was 25% lower in real terms than in 2010-11 (Figure 9).

Local authorities have found it most difficult to constrain spending on children's social care. The additional social care spend in 2019-20 relative to 2010-11 was relatively evenly split between adult and children's social care. However, as less is spent on children's social care, a similar level of additional spending represented a much larger percentage increase than for adult social care (see pages 26 and 27).

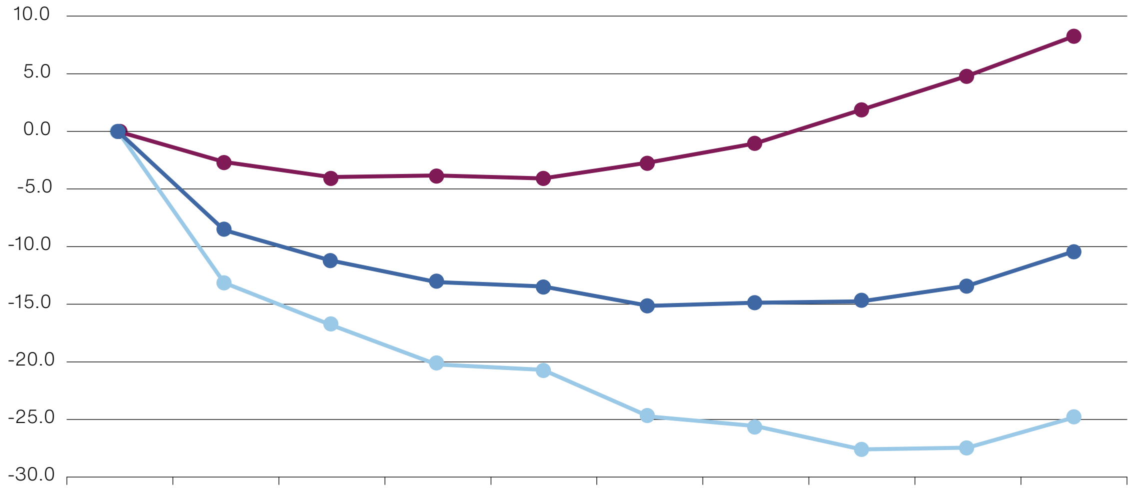
Real-terms social care spend now makes up a greater share of relevant local authority spending. Social care spending is not incurred by all types of local authorities: district councils do not have social care responsibilities. In local authorities with social care responsibilities, their spend on social care has risen from 52% to 80% of their spending power; see Figure 20 data table on page 41. (There has been a similar rise as a proportion of net revenue expenditure, which is the measure used in the Chartered Institute of Public Finance and Accountancy's (CIPFA's) financial resilience index.) This means these local authorities have less 'financial space' to make further spending reductions without affecting social care.

Figure 9

Change in service spend, gross of sales, fees and charges, by English local authorities, 2010-11 to 2019-20

Spending on non-social care services has fallen nearly 25% since 2010-11

Change in service expenditure (indexed: 2010-11 = 0%, real-terms in 2019-20 prices) (%)



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
● Social care	0.0%	-2.6%	-4.0%	-3.8%	-4.1%	-2.7%	-1.0%	1.9%	4.8%	8.3%
● Non-social care	0.0%	-13.1%	-16.8%	-20.1%	-20.5%	-24.6%	-25.6%	-27.6%	-27.5%	-24.8%
● All services	0.0%	-8.6%	-11.2%	-13.0%	-13.4%	-15.1%	-14.9%	-14.7%	-13.4%	-10.4%
Social care (£m)	29,747	28,960	28,570	28,609	28,532	28,946	29,439	30,306	31,180	32,204
Non-social care (£m)	38,508	33,449	32,045	30,768	30,599	29,026	28,663	27,883	27,936	28,944
All services (£m)	68,256	62,409	60,615	59,377	59,131	57,972	58,102	58,188	59,117	61,148

Note

1 Figures are rounded. As a result, adding up sub-totals may not match the numbers given for all service spend.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Yet rising spend has not prevented concerns about social care, and projections suggest continued cost and demand pressures

Adults

Our report on *The adult social care market in England* (available at: www.nao.org.uk/report/adult-social-care-markets) concluded that levels of unpaid care remain high, too many adults have unmet needs, and a lack of long-term vision for care and short-term funding had hampered local authorities' ability to innovate and plan for the long term. COVID-19 could have short- to medium-term consequences for the market's financial sustainability.

Based on long-term forecasts there will be large increases in future demand for care and therefore cost. Government projects that if current patterns of care continue, around 29% more adults aged 18 to 64, and 57% more adults aged 65 and over, will require care in 2038 compared with 2018. The publicly funded costs of care for all adults were projected to rise from £17.9 billion to £34.7 billion between 2018 and 2038 (**Figure 10** overleaf).

These pressures may increase further following government's *Build Back Better* plan for health and social care, and its aim to invest £5.4 billion in adult social care over three years to cap care costs and invest in the workforce; it includes a UK-wide 1.25% Health and Social Care Levy based on national insurance contribution rates. Ongoing demographic and unit cost pressures are to be met through council tax, the social care precept and efficiencies, however. Government has committed to bringing forward proposals on adult social care reform by the end of 2021.

Children

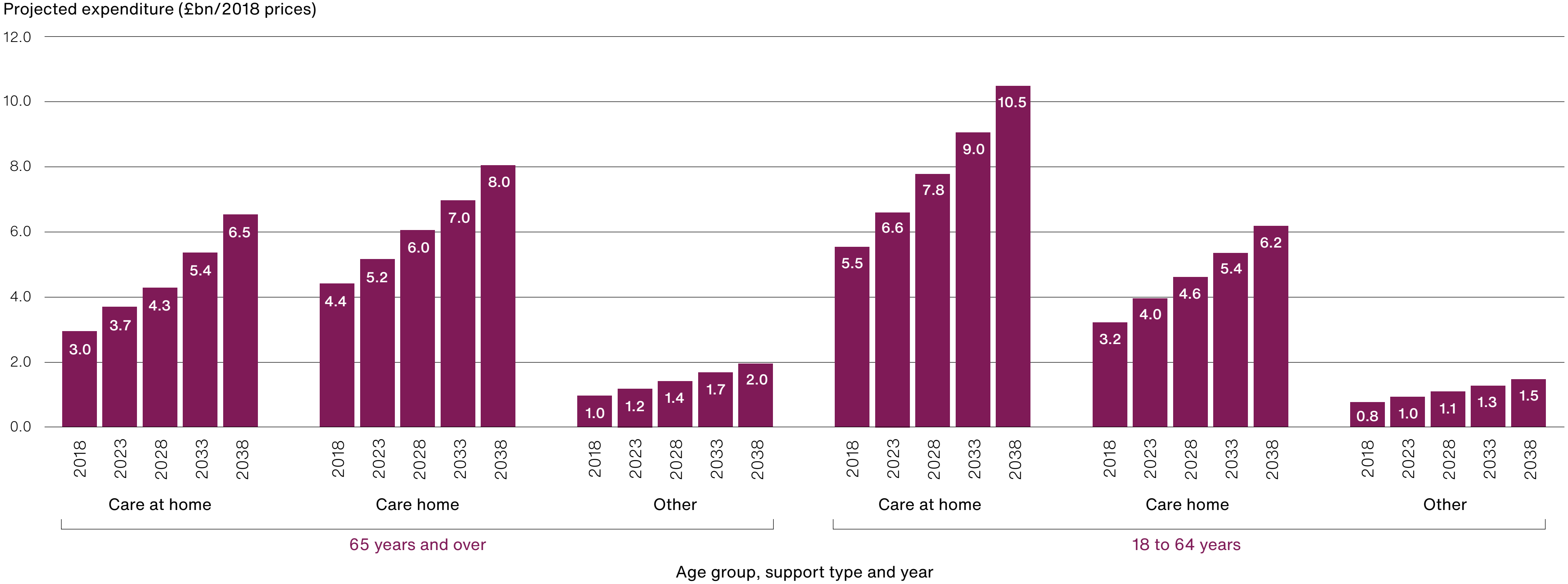
The Committee of Public Accounts (the Committee) said in 2019 that the government had "not done enough to make the quality or finances of children's social care sustainable". The Committee noted that 91% of local authorities exceeded their budgets for spending on children's services in 2017-18, and highlighted the proportion of local authorities with Ofsted ratings below 'Good' (58%). The proportion of authorities with Ofsted ratings below 'Good' had fallen to 50% by March 2020.

Understanding the drivers of demand and cost for children's social care is crucial to being able to fund it properly. We have found that local authorities have responded to financial pressures by prioritising child protection work and reducing spending on non-statutory children's services. We and the Committee have been critical of the Department for Education's limited understanding of what is causing increases in demand and activity within children's social care. The Department for Education has since reported a range of work it has under way to improve information and knowledge on demand, costs and effectiveness.

Figure 10

Projected cost of publicly funded care for adults in England, 2018 to 2038

Government projections indicated large increases in publicly funded costs of care between 2018 and 2038



Note

1 These projections predate the September 2021 policy announcements about extending eligibility for publicly funded support. 'Care at home' is the provision of social care in a person's own home; a 'care home' is a dedicated facility for the provision of care to a resident population.

Source: National Audit Office analysis of Care Policy and Evaluation Centre, *Projections of Demand and Expenditure on Adult Social Care 2018 to 2038*

Local authorities have made substantial spending reductions in some services

Some services have seen greater spending reductions than others (Figure 11 overleaf). The overall real-terms decrease of 25% in non-social care spending includes falls of 37% in cultural and related services, and 36% in planning and development services. Other services have seen smaller reductions, such as an 11% fall in spending on environment and regulatory services.

The implications of these spending reductions for the services people are receiving may not be apparent from national data. We have previously said that there are a variety of service areas where there have been substantial reductions in spending, but national data shed little light on the implications of this for service users, for example, reduced outcomes or, alternatively, increased efficiency.

Where there are data, some indicate substantial changes in activity supported by local authority general revenue funding. For example, the number of food standards and hygiene samples taken by local authorities fell by 49% from 2010-11 to 2019-20. Local authority-supported bus service mileage in England outside London reduced by 57% over the same period.

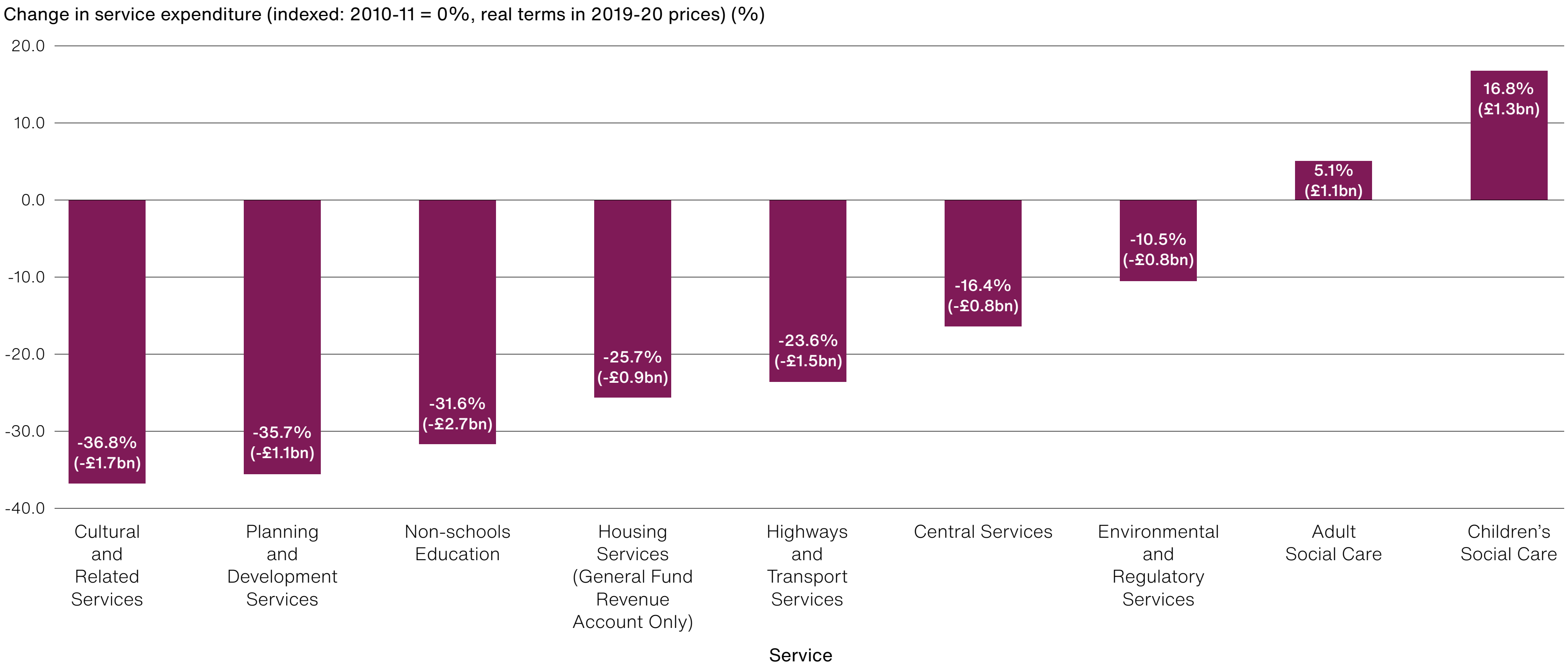
It is often difficult to assess how changes in activity relate to desired outcomes, as there can be improvements in efficiency or productivity. **However, a range of concerns have been expressed about some of these service areas:**

- In June 2021 we reported that staffing and capacity challenges in Trading Standards services present risks to the sustainability of the regulatory system. The Department for Business, Energy & Industrial Strategy had previously told us in 2018 that it was concerned about local reductions going too far.
- The Food Standards Agency has previously said that local authorities are "... under increasing financial pressure, such that some are struggling to fully discharge their functions".
- Shifting more journeys to public transport is essential to achieving the government's aims for decarbonising transport. The Department for Transport believes that diminished capability and capacity in local authorities' transport planning teams is an inhibiting factor in improving bus services, and the March 2021 National Bus Strategy for England announces some steps to support local authority capacity.

Figure 11

Change in service spend by English local authorities, gross of sales, fees, and charges, 2010-11 to 2019-20

Cultural and planning services have both seen spending reductions of more than 35% since 2010-11



Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Local authorities have sought to maximise revenue funding from other sources

Local authorities have increasingly sought to offset funding reductions by generating new income. At the sector level, local authorities have chosen to increase local income from sales, fees and charges, trading and investments.

Strategies have included providing trading services, establishing trading companies, providing loans to third parties at commercial rates and undertaking joint ventures with private developers. Local authorities have also increased the money raised from service users.

Without this income, local authorities would have needed to take other actions to balance budgets, but we cannot say what these would have been or what impact they would have had on services.

Local authorities increased the money raised from sales, fees and charges, through trading accounts, or from investment income by £1.6 billion between 2010-11 and 2019-20 (Figure 12 overleaf). Some of this increase has come from capital spending intended to generate financial returns.

Some local authorities have exercised specific discretions related to capital spending to increase the revenue resources available to them. Local authorities set aside £0.7 billion less revenue income for the eventual repayment of loans in 2019-20 than they did in 2012-13 (Figure 13, data table).

Normally, money received from the sale of capital assets (capital receipts) can only be used to pay off debt or make further capital investments. Since 2016-17, local authorities have been free to use capital receipts to support the revenue costs of transformation projects. Of capital receipts, £600 million have been spent on revenue under this special flexibility since it started.

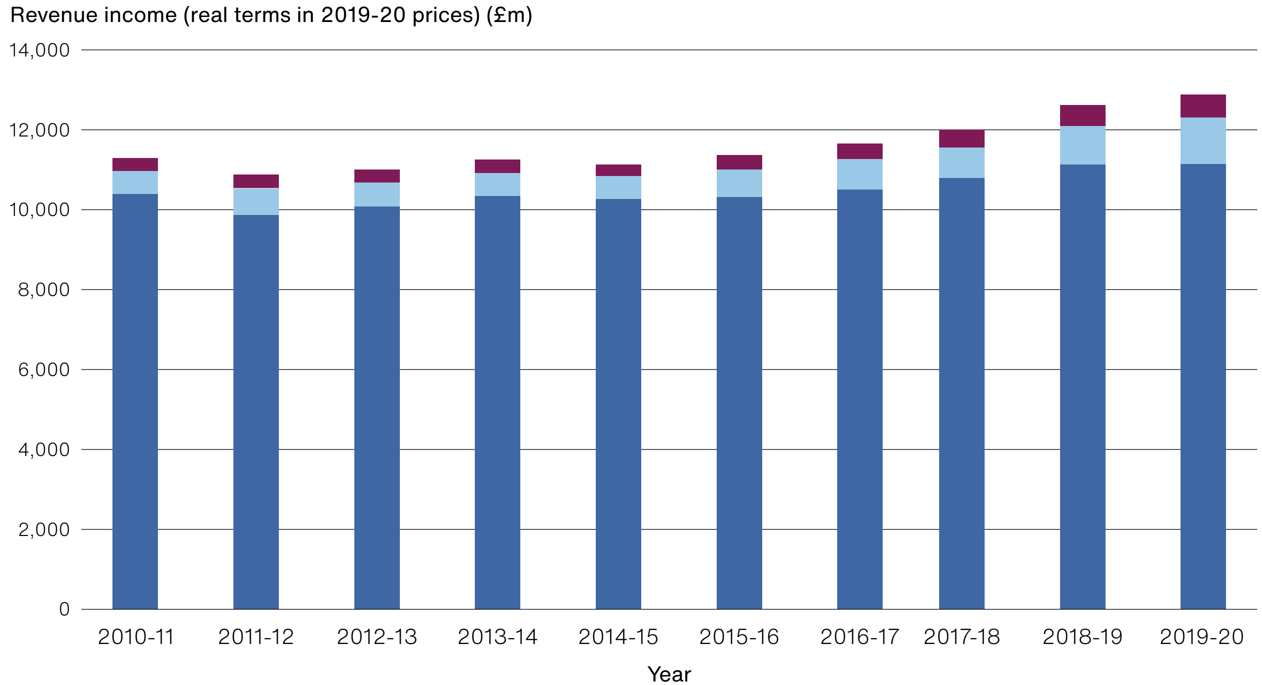
Service users are now paying directly for more of what local authorities spend on those services, by paying fees or charges or making purchases. Service users now directly fund almost half the cost of planning and development services, and highways and transport services, up from 25% and 31% respectively. If spend supported by sales, fees and charges is excluded, overall spend on non-social care services has fallen by 33% rather than by 25%.

Although income from trading accounts has increased overall, this does not capture the full impact of the use of companies by local authorities. The Department intends to collect additional data on local authority investment properties (including income, costs and location) and also on other investments (including performance and changes in the value of subsidiaries and joint ventures), from 2022-23. In addition, not every company delivers the returns planned. If a local authority budgets for a great deal of trading income and it is not delivered, then this could have a significant effect on that authority's financial resilience.

Figure 12

Commercial and service user income for English local authorities, 2010-11 to 2019-20

Income from these sources has increased since 2010-11, with investment income doubling in this time



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Surplus on external trading accounts	312	335	320	331	288	347	382	423	516	572
Interest and investment income	565	662	594	574	563	709	752	773	973	1,172
Sales, fees and charges	10,408	9,888	10,091	10,355	10,285	10,313	10,516	10,790	11,133	11,139
Total	**11,285**	**10,884**	**11,006**	**11,260**	**11,136**	**11,369**	**11,650**	**11,986**	**12,622**	**12,883**

Note

1 Figures are rounded. As a result, adding up sub-totals may not give the same number given as the total.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Some local authorities have sought to maximise revenue available for services in ways that may reduce financial resilience

Local authorities are required to set aside money over time to repay a loan, rather than simply paying the interest and leaving the whole of the principal to be repaid at the end; this is known as minimum revenue provision (MRP).

Although gross borrowing has risen over this period, the level of MRP being made peaked in 2012-13, and by 2019-20 had fallen by around 30% in real terms (Figure 13). In 2016 we reported that some local authorities were recalculating their approach to MRP, including by spreading future charges over a longer period or taking a temporary break from payments. In 2020 we reported that some local authorities were not making MRP in relation to borrowing associated with acquisition of commercial property, despite statutory guidance having changed to state explicitly that this approach is not prudent. The government is now proposing to change secondary legislation relating to MRP.

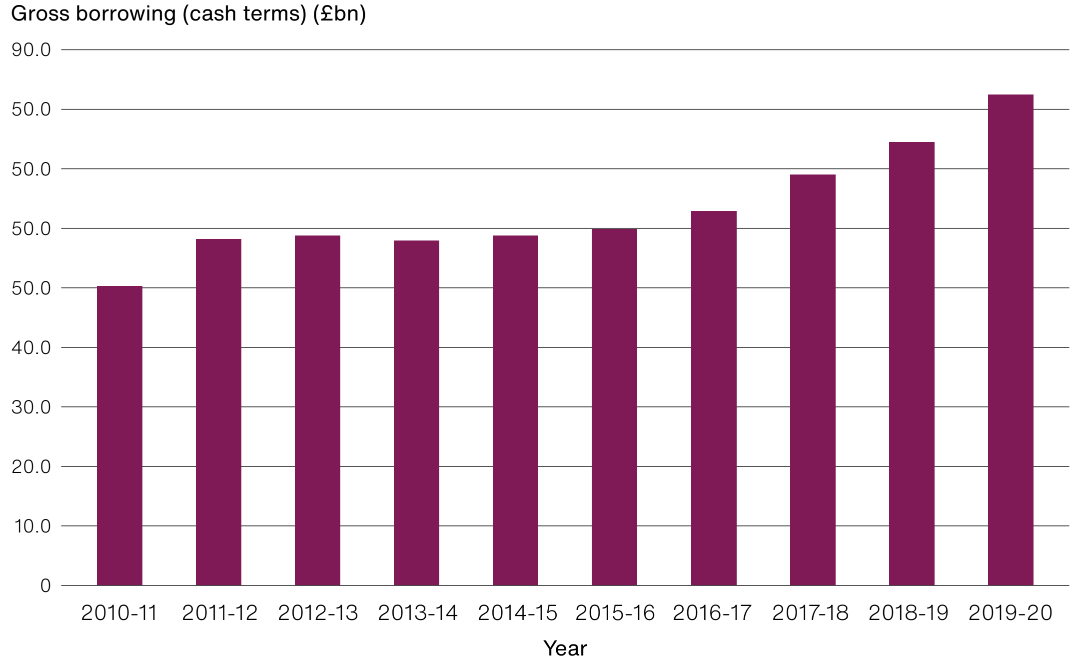
Local authorities are currently free to use capital receipts for the revenue costs of transformation projects, such as funding the cost of service reconfiguration, restructuring or rationalisation in line with departmental guidance. Accountability arrangements for this special flexibility operate at the local level and include local audit. The Department requires local authorities to return data annually on the level of receipts they have used flexibly, to inform its sector monitoring. **In 2016 we highlighted some possible risks, including that local authorities may invest in transformation schemes in which planned revenue savings are not delivered.**

Reductions in MRP or use of capital receipts for revenue purposes primarily impact on long-term financial standing. **However, if large-scale use of these discretions are subsequently determined to be inappropriate and need to be reversed,** the short-term impact could potentially affect the local authority's financial resilience.

Figure 13

Gross borrowing and minimum revenue provision across English local authorities, 2010-11 to 2019-20

While borrowing has increased since 2010-11, levels of minimum revenue provision are lower



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
■ Gross borrowing at 31 March (£bn)	50.2	58.1	58.8	57.9	58.7	59.8	62.9	69.0	74.5	82.4
Minimum revenue provision (£bn)	2.0	2.1	2.2	2.1	2.0	1.7	1.4	1.2	1.4	1.5

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Commercial property investment strategies have increased some local authorities' exposure to risk

A rapid expansion in local authority investment in commercial property has been a key part of this growth in income generation. The period 2016-17 to 2018-19 saw a step-change in scale, with local authorities spending over 14 times more on commercial property than in the preceding three-year period (**Figure 14**). This activity is concentrated in a relatively small number of local authorities. Nonetheless, there were 107 local authorities making commercial property acquisitions in 2018-19.

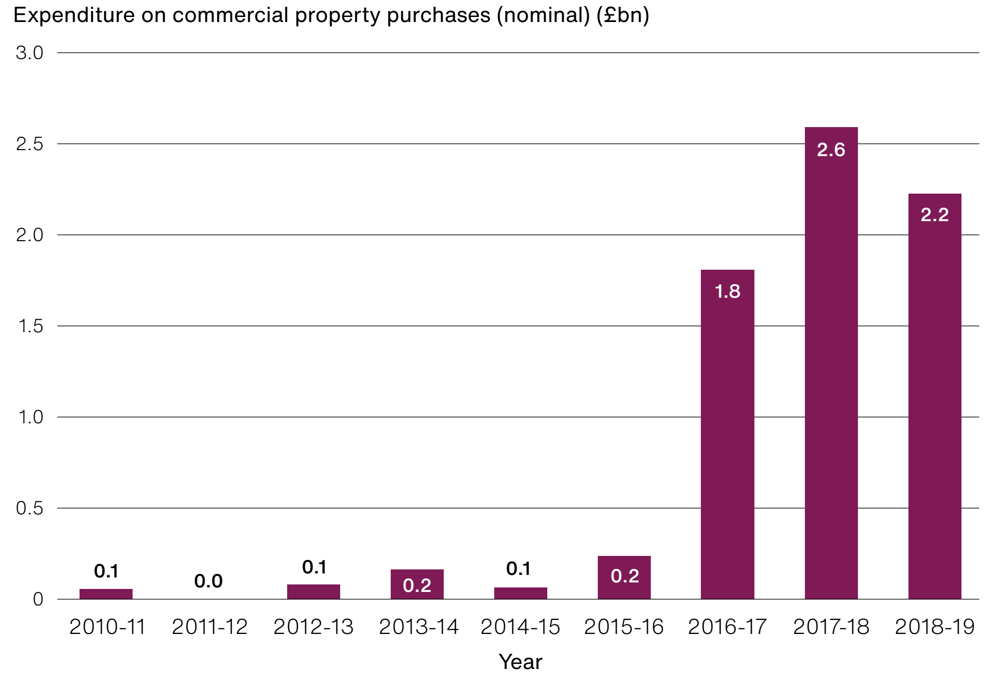
Borrowing has played an important role in supporting the acquisition of commercial property, and has likely accounted for a proportion of growth in the stock of local authority external borrowing in recent years. A small group of local authorities have seen significant increases in their external borrowing and debt servicing costs, with some having borrowing that is many times bigger than their annual core spending power. The risk exposure of individual local authorities can only be assessed by taking into account their contingency arrangements and how much their budgets rely on commercial income.

The government has taken action to discourage borrowing to fund purchases of commercial property. The Department has expressed concern about disproportionate levels of borrowing and the risks from services becoming reliant on commercial income. It has taken steps to require greater local transparency and local accountability about these points. Departmental work to strengthen the capital system is ongoing and a policy paper on planned improvements to the capital finance framework was published in July 2021 (available at: www.gov.uk/government/publications/local-authority-capital-finance-framework-planned-improvements/local-authority-capital-finance-framework-planned-improvements). HM Treasury has recently stopped local authorities from accessing the Public Works Loan Board, the main source of local authority borrowing, if they make commercial property purchases. These measures are likely to have a significant impact on the level of new borrowing and purchasing activity, but local authorities will continue to need to manage the risks associated with the existing stock of property and associated borrowing. CIPFA is also strengthening the Prudential Code, which it expects to publish by the end of 2021.

Figure 14

Commercial property purchases by English local authorities, 2010-11 to 2018-19

There was a step-change in the scale of commercial property investment from 2016-17



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Local authorities active in year (count)	11	14	18	28	30	41	83	107	107

Notes

1 The chart draws on NAO analysis of proprietary data, carried out for our report *Local authority investment in commercial property*, February 2020. Accordingly, analysis for 2019-20 is not available.

2 The Department has since carried out a pilot data collection covering this and other topics. However, the results have not been published, and we have not assessed the level of comparability with our analysis. Numbers are rounded. Bars in the chart use unrounded data.

Source: National Audit Office analysis of CoStar data

A lack of short-term funding certainty hampers local authorities' ability to plan

Departmental monitoring supported a range of government funding changes during the four-year funding settlement period (2016-17 to 2019-20), which had not been anticipated at the start. Existing measures were increased or extended, and new measures were introduced. Most initiatives had specified end points. Local authorities highlighted the short-term nature of, for example, the Improved Better Care Fund, viewing it as temporary funding rather than built into budget baselines. While they were in response to pressures, these changes to funding streams outside the core four-year settlement contributed to a funding landscape characterised by one-off and short-term funding initiatives.

The four-year settlement has been followed by two single-year settlements. These have been provisionally announced later in the financial year. While these decisions were driven by the overall government response to particular circumstances, this does not change the impact on local government funding certainty. Also in these two years, public health grant allocations were announced after the settlement rather than before it, giving local authorities less time to plan.

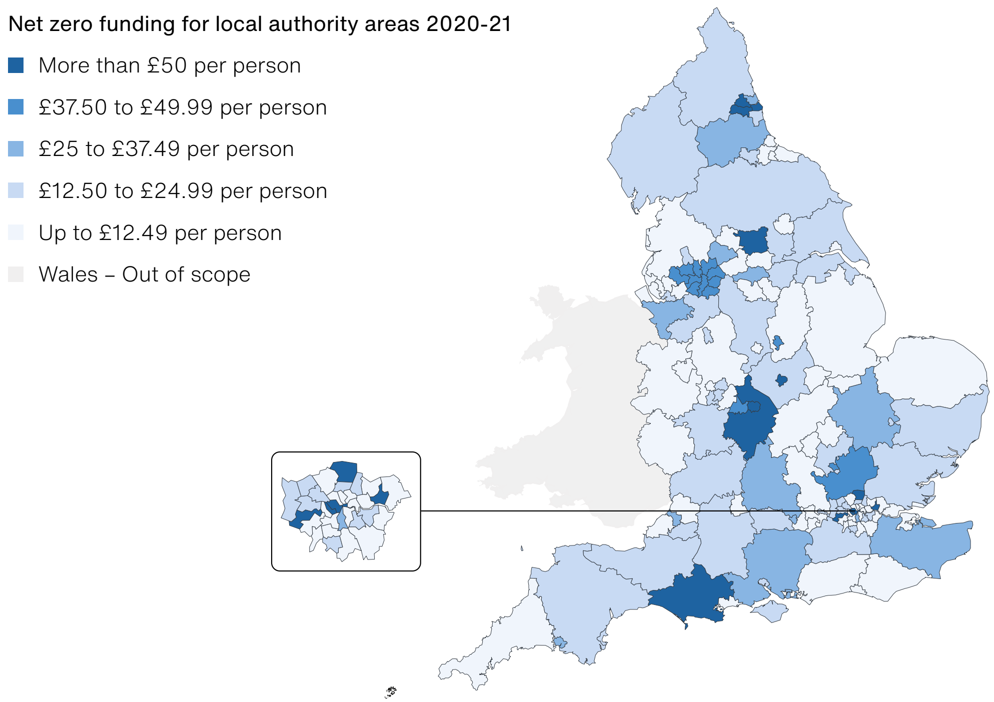
Fragmented funding and use of competitive bidding creates uncertainty in both established and newer policy areas. In relation to transport funding, the National Infrastructure Commission has recently commented that: "One of the biggest problems caused by the current system is that with grants allocated through multiple decision making processes, and with much capital funding for transport projects dependent on competitive bidding, local authorities have no certainty over the amount of funding available to them." This makes it difficult to develop effective local infrastructure strategies, plan recruitment and retain skilled staff.

Local authorities will have a critical role to play in meeting government's net zero targets but funding for this long-term challenge remains fragmented and short-term (Figure 15). National Audit Office analysis shows that while grant funding for work in this area increased significantly in 2020-21 it remains fragmented. Twenty-two grant funds were available for net zero work, many of which were competitive funds with limited delivery timescales, which can make it difficult for local authorities to plan for the long term.

Figure 15

Estimated dedicated grant funding per person for net zero activities consolidated to upper tier local authority areas (including funding for combined authorities and district councils) 2020-21

There was a wide variation in 2020-21 in funding received by different local authority areas



Note

1 This map was first published in our 2021 report *Local government and net zero in England*. For full information on the data and caveats to our analysis please see the original figure on pages 40 and 41 of that report.

Source: National Audit Office analysis of funding information from the Department for Business, Energy & Industrial Strategy, Department for Transport and Department for Environment, Food & Rural Affairs. Office for National Statistics licensed under the Open Government Licence v.3.0. Contains OS data © Crown copyright and database 2021

Local authorities are also planning and delivering services amid medium-term financial uncertainty

Repeated delays to the updates and reforms of local government finance have led to uncertainty about when these will take place. Delays also mean the changes may be larger when they do take place. Over time, the distribution of needs and resources moves away from the distribution used to set funding formulas. Without implementation of the fair funding review, the underlying distribution of business rates and revenue support grant is based on data sets chosen in 2012-13. Most commonly, elements of the funding formula use three-year averages from 2009-10 to 2011-12, but in some instances older data are used, including the 2001 census.

Significant financial pressures create their own budget uncertainty. Local authorities cannot guarantee that their responses to financial pressures (such as generating new income, holding down budgets in the face of demographic pressure, or making major service changes to save money) will be successful. In 2018 we found that initially at a sector level local authorities were able to deliver underspends on their service budgets, but since 2014-15 there had been overspends against service budgets overall (**Figure 16**).

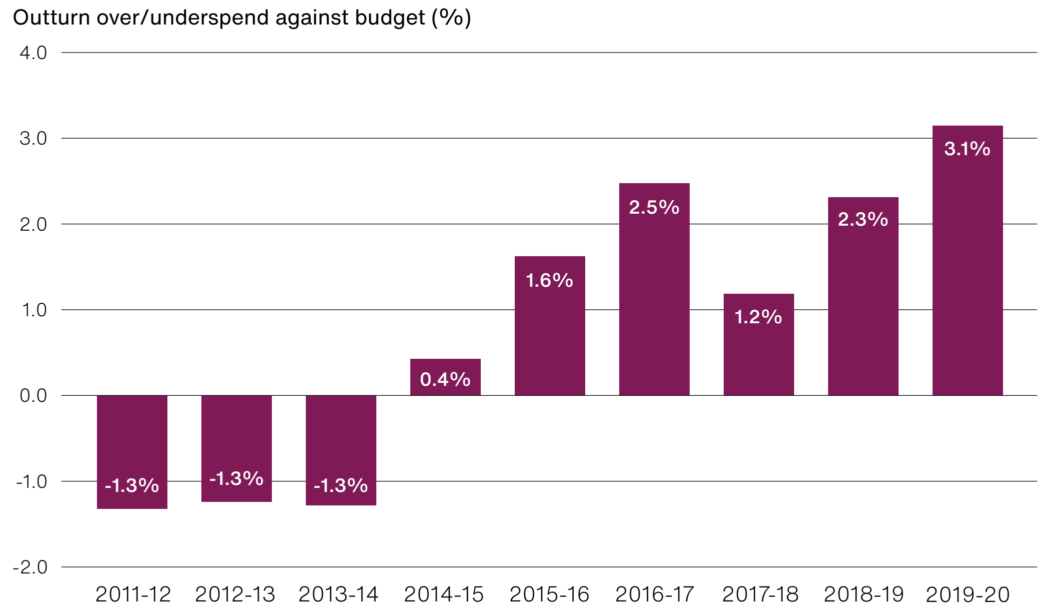
Reserves represent the most fundamental buffer against uncertainty for local authorities and it is not surprising when local authority reserves increase as uncertainty rises. However, adding money to reserves competes with service spending and could potentially add to the impact of funding reductions. At the sector level, despite a dip in the level of reserves at the start of the four-year settlement, reserves were £5.6 billion higher in 2019-20 than in 2010-11. This figure adjusts for COVID-19-related funds in reserves at March 2020. Local authorities hold reserves for a number of reasons but often increase reserves as a response to uncertainty and risk, given that they must balance their budgets each year.

The Department is considering its approach to data collection on reserves following a Committee of Public Accounts hearing in March 2021.

Figure 16

Over/underspend as a share of revenue budget across all services by English local authorities, 2011-12 to 2019-20

Since 2014-15 there have been overspends against service budgets overall



	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
■ Outturn vs budget									
Budget (real terms in 2019-20 prices) (£m)	45,728	44,304	43,495	41,743	40,293	39,265	39,636	39,699	40,364
Outturn (real terms in 2019-20 prices) (£m)	45,118	43,749	42,933	41,915	40,941	40,233	40,105	40,613	41,628

Note

1 Percentages are rounded. Bars in the chart use unrounded data.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Financial uncertainty does not support value-for-money decision-making

The importance of certainty for financial planning is clear. We have previously said that to deliver value for money, central government needs a planning and spending framework which includes long-term clarity on funding. Long-term commitments provide stability and a longer horizon within which departments and local government can set goals for improvement. Otherwise there is less time available to review options and make well-evidenced and considered decisions. The Department recognises these points, which is why it previously sought to provide earlier financial settlements for local government and a multi-year settlement.

During our study *Local government finance in the pandemic*, local authorities we spoke to told us that uncertainty does not support value-for-money decision-making. Examples of the impact of uncertainty provided by chief finance officers included:

- elected members holding off making difficult decisions in the hope that the settlement would be more positive than expected;
- a lack of time to review savings options to make good rather than quick decisions;
- a tendency to be overly cautious and cut services rather than to plan for efficiencies over the medium term; and
- the tendency to build up reserves in-year in the expectation that they will be needed to balance the next budget.

These examples were collected during the pandemic, which was an unprecedented economic emergency when uncertainty was particularly high, but we believe they are applicable to uncertainty more widely.

The National Infrastructure Commission's report on *Infrastructure, Towns and Regeneration* said that **the current approach to funding** "leads to funding uncertainty, short term outcomes over long term priorities, and ultimately burns rather than builds local capacity".

Local authorities now rely more on sources of income that are dependent on local economic conditions

Locally retained business rates have been a prominent and growing part of local authorities' income since 2013-14. However, funding local services through the local retention of business rates required fundamental design issues to be addressed, which resulted in a complex system. This provided a starting point but over time an area's capacity to generate business rates growth does not necessarily match change in demand for services.

Locally retained business rates are a source of volatility in local authorities' income. Local authorities benefit from rises but are exposed to falls also. Business rates income can fall due to valuation appeals. By 2015-16, local authorities had set aside £2.8 billion against the possibility of successful appeals. The system contains safety net arrangements set in 2013-14 that have risen with inflation since then. Without a reset, above-inflation growth in business rates income takes local authorities further above their safety net. Therefore, high growth local authorities are exposed to greater falls in their business rates income before being protected.

As anticipated within local government finance settlements, local authorities have generally made use of higher council tax referendum limits. Accordingly, **council tax has become more prominent as a share of local government funding**. However, local authorities vary in their ability to raise money through council tax increases. And the ability of local people to pay council tax fluctuates with local economic circumstances. Council tax support localisation means that government funding no longer changes in response to mitigate the impact of this fluctuation. (The adult social care precept after 2016-17 has also contributed to the rise in council tax, although the government has provided additional grant to equalise the overall funding raised from these sources.)

At the sector level, local authorities have decided to increase income from **sales, fees and charges, trading and investments.** This income is also influenced by local economic conditions.

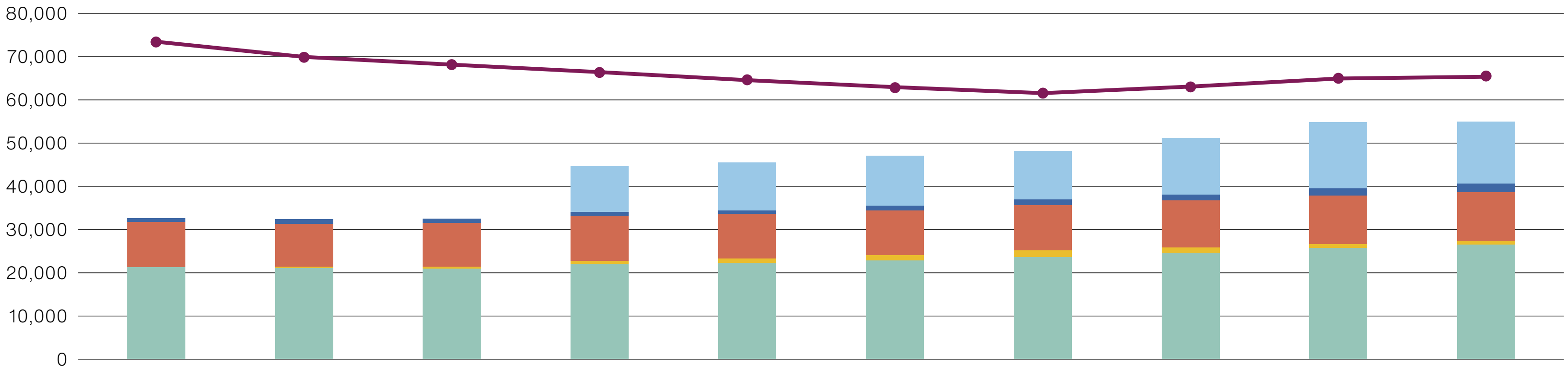
The **Community Infrastructure Levy** is a charge on new developments in a local authority's area. The levy rate per square metre in a local authority must take account of the potential effect on the viability of developments, and so is clearly related to the strength of local property markets, as is the level of development taken forward in the area. We have previously found that the regional distribution of **New Homes Bonus** broadly reflects local economic circumstances and the strength of local housing markets, that in turn affect the level of housing development.

These changes have left authorities' finances more reliant on their local economies and residents. By 2019-20 like-for-like revenue funding for local authorities was £65,243 million, of which we estimate £54,764 million was dependent to some extent on local economic conditions (see **Figure 17** overleaf). This component has grown by 68% in real terms compared with 2010-11. (If locally retained business rates are excluded, then locally dependent funding had grown by 25% by 2019-20.)

Figure 17

Change in selected sources of revenue funding for English local authorities, 2010-11 to 2019-20

Income linked to local economies, such as council tax and business rates, has become more prominent as a share of funding since 2010-11



Income sources that change with local economic circumstances	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Locally retained business rates	0	0	0	10,530	11,015	11,440	11,106	13,050	15,259	14,207
Commercial income and Community Infrastructure Levy	877	996	915	906	875	1,100	1,299	1,370	1,691	2,014
Sales, fees and charges	10,048	9,888	10,091	10,355	10,285	10,313	10,516	10,790	11,133	11,139
New Homes Bonus	0	228	448	740	967	1,209	1,528	1,267	962	905
Council tax	21,278	21,130	20,954	22,043	22,288	22,819	23,590	24,645	25,727	26,500
Overall change in these income sources since 2010-11	0.0%	-1.0%	-0.5%	36.9%	39.5%	44.0%	47.5%	57.0%	68.2%	68.2%
Overall change in these income sources since 2010-11 (excluding locally retained business rates)	0.0%	-1.0%	-0.5%	4.5%	5.7%	8.8%	13.4%	16.9%	21.3%	24.5%
Total of these income sources, NHS transfers and direct government funding (excluding public health)	**73,650**	**69,983**	**68,151**	**66,354**	**64,422**	**62,760**	**61,327**	**62,918**	**64,846**	**65,243**

Note

1 Figures are rounded. As a result, adding up sub-totals may not give the same number as shown for totals.

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

The governance mechanisms that support decision-making about financial sustainability are under strain

The challenges local authorities are facing have tested their governance arrangements, while resources to support this work have fallen. Governance arrangements need to be robust in the context of reducing funding and growing demand, as this increases the risk that local authorities will not be able to deliver their objectives. However, resources to support governance fell by 37% in real terms between 2010-11 and 2019-20. New delivery arrangements adopted to secure savings or generate commercial income have added greater complexity to governance arrangements, and have contributed to risk profiles in many local authorities increasing between 2016-17 and 2017-18 (**Figure 18** overleaf).

Our 2018 survey of external auditors raised concerns about the effectiveness of a range of internal checks and balances including risk management, internal audit and whistleblowing procedures. Local authorities with higher levels of governance issues also tended to have higher risk profiles. There is therefore a substantial body of local authorities where governance arrangements are showing signs of stress in the context of the financial pressures acting on the sector.

There are long-standing problems with local government audit. Local authorities need accurate and reliable financial information to plan and manage their services and finances effectively. The audit process provides a key element of assurance for financial planning and budgeting. In addition, the Department continues to rely on information from external auditors' work on local authorities' accounts and on local authority arrangements to secure value for money. Our work has identified several long-standing problems with local audit, including insufficient staff with relevant qualifications and experience, and increased regulatory expectations on audit work following high-profile corporate failures. Fifty-seven per cent of local government body[3] audits met the required deadline for reporting in 2018-19, down from 97% in 2014-15.

The COVID-19 pandemic exacerbated many of these problems. Despite the Department easing the deadline for the completion of 2019-20 local government body audits due to the effect of the pandemic, 55% of audit opinions were not issued by the extended deadline of 30 November 2020. In 2021, we concluded that the system of local audit in England had worsened. The increase in late audit opinions, concerns about audit quality and doubts over audit firms' willingness to continue to audit local authorities all highlight a situation that needs urgent attention. And as reported by Public Sector Audit Appointments at the target date of 30 September 2021 only 9% of local government bodies' 2020-21 audits had been completed.

Since 2010 the government has made a range of changes to the arrangements for local external audit, reducing the cost to local authorities. These reductions have been greater than anticipated. In 2014 the Department estimated that local audit fees for 2018-19 would be £54 million. In reality, scale fees for 2018-19 were £28 million alongside variations (additional fees) amounting to at least 8.5% of the total scale fees.

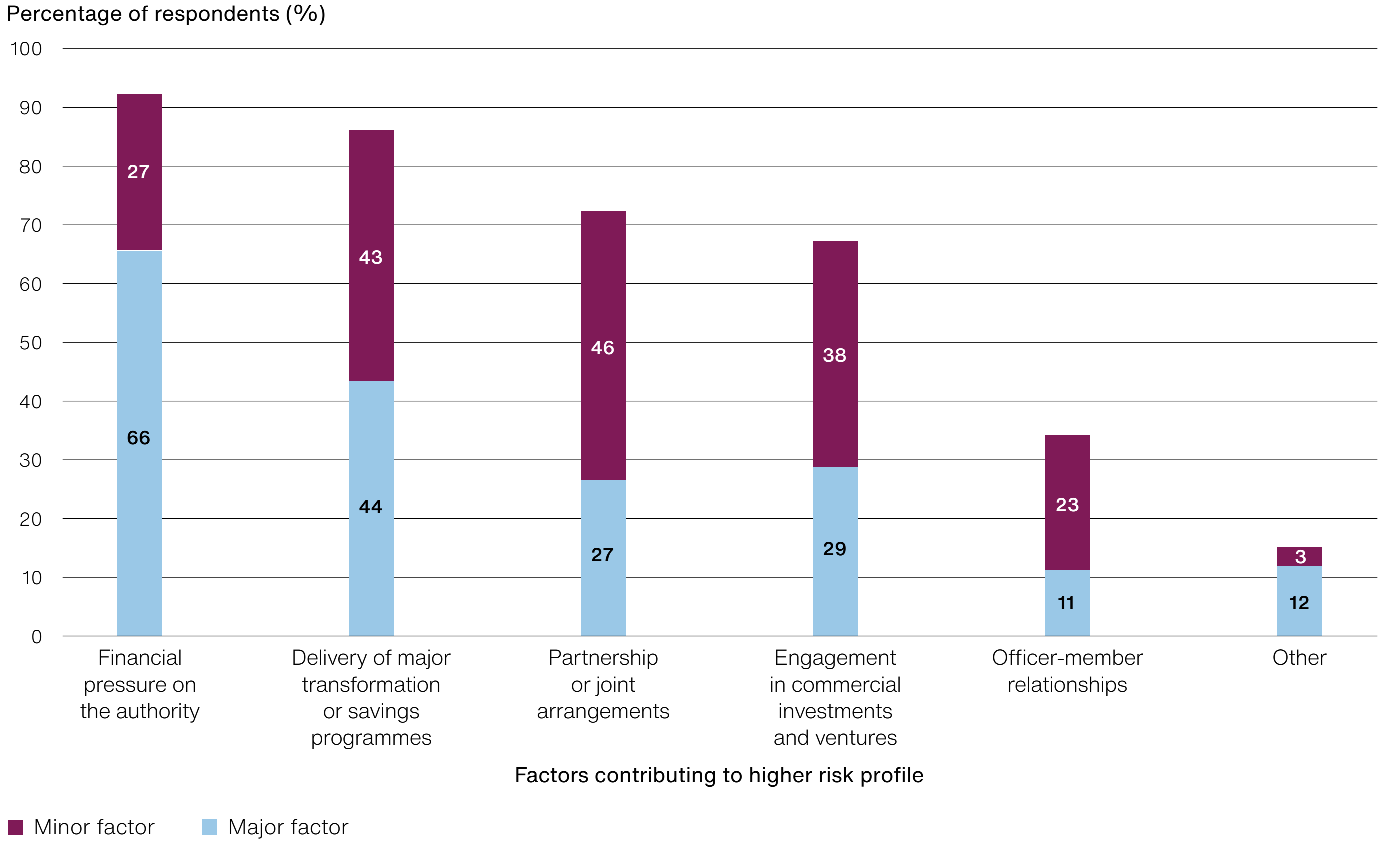
The government commissioned an independent review of external audit arrangements in local government, and is now implementing its response to the review's recommendations. The review set out a concern that the current fee structure did not enable auditors to fulfil the role in an entirely satisfactory way. The government's response includes providing £15 million to support local bodies with the costs of audit in 2021-22. The government recently consulted on proposals to establish a new body, the Audit Reporting and Governance Authority, as the statutory leader for local audit.

3 The figures compiled by Public Sector Audit Appointments Ltd (PSAA) for timeliness of local auditor reporting cover all types of local authorities, local police, and local fire bodies in England. These are the bodies subject to audit under the Code of Audit Practice.

Figure 18

Factors contributing to high and medium risk profiles in local authorities in 2017-18

External auditors have identified a range of factors contributing to higher risk profiles, with financial pressures identified as the most significant risk factor currently facing local authorities



Source: National Audit Office analysis of external auditor survey data. This figure was first published in our 2019 report on *Local authority governance*

The financial resilience of the local government sector was being tested, even before the COVID-19 pandemic

High levels of inflexible spend increasingly limit the financial resilience of local authorities. Spending areas where savings can be made relatively quickly or easily provide another way to respond to financial shocks. Social care spending has increased further as a share of spending power in local authorities with social care responsibilities (single tier and county councils), meaning their flexibility to spend on areas that are more discretionary has fallen significantly. In contrast, district councils generally have much lower levels of inflexible spend. However, there has been a concentrated change in a proportion of district councils where debt costs (generally linked to commercial property purchases) have risen sharply (**Figure 20** on page 41).

At any one time there is a small number of local authorities with relatively low reserves. Local authority reserves can give them the headroom needed to respond to financial shocks. While reserve levels are a local choice and need to suit individual circumstances, low reserves can make local authorities vulnerable to shocks or mismanagement. Between 2012-13 and 2019-20, there has been £1.5 billion growth in reserves (unallocated and COVID-19 adjusted earmarked) among local authorities with social care responsibilities. However, the proportion of these authorities with reserves of less than 15% of spending power has stayed relatively stable (**Figure 19** overleaf).

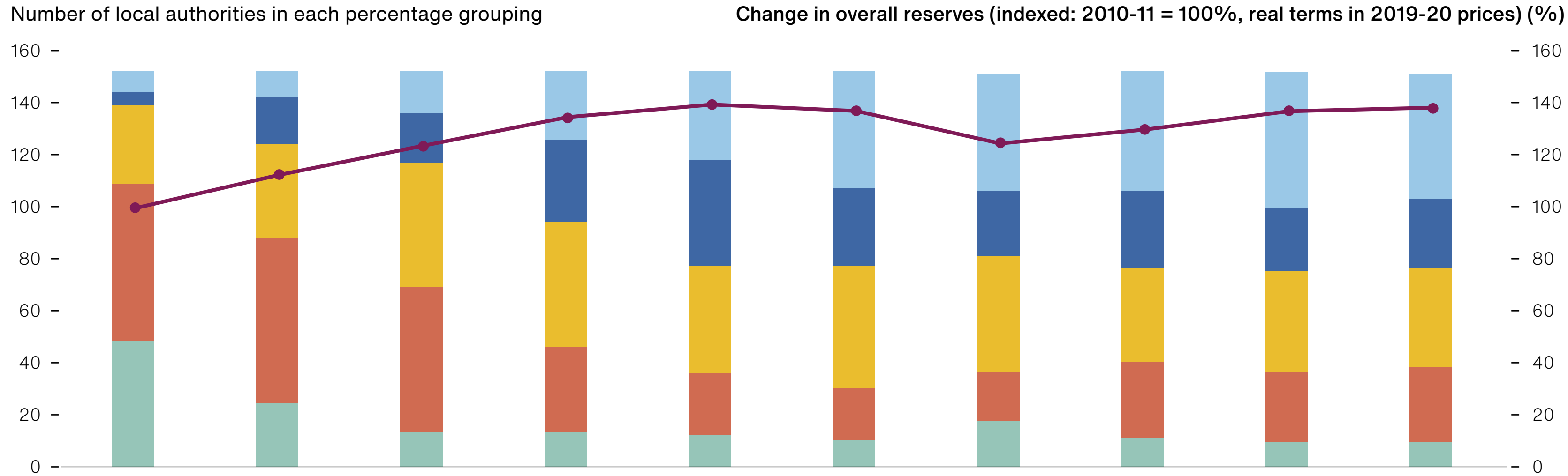
There have been financial failures in a number of local authorities. Three local authorities with social care responsibilities have issued Section 114 notices (a public declaration that a local authority's budget cannot be balanced, which also results in a suspension of additional spending) since 2018, indicating risks of spending more in a financial year than the resources a local authority has available. Prior to this, the last Section 114 notice had been issued in 2000. In each case it is clear from the Section 114 notice or a subsequent independent review that the issues at the local authority wholly or primarily predated the COVID-19 pandemic.

The COVID-19 pandemic created acute and unmanageable financial pressures for some local authorities and the longer-term impacts are not yet clear. Nine local authorities have either received exceptional financial support for 2020-21 or had support agreed in principle for 2021-22 in relation to issues caused or exposed by the COVID-19 pandemic. There is evidence the pandemic will have a medium- to long-term scarring impact on the sector's finances. Many local authorities do not know when their finances will recover, while more than half of local authorities indicated to us in late 2020 that their finances would not recover until at least 2023-24.

Figure 19

Change in earmarked (COVID adjusted) and unallocated reserves as a proportion of spending power across English single tier and county councils, 2010-11 to 2019-20

While reserve levels have tended to rise since 2010-11, at any one time there remain a small number of single tier and county councils with relatively low reserves



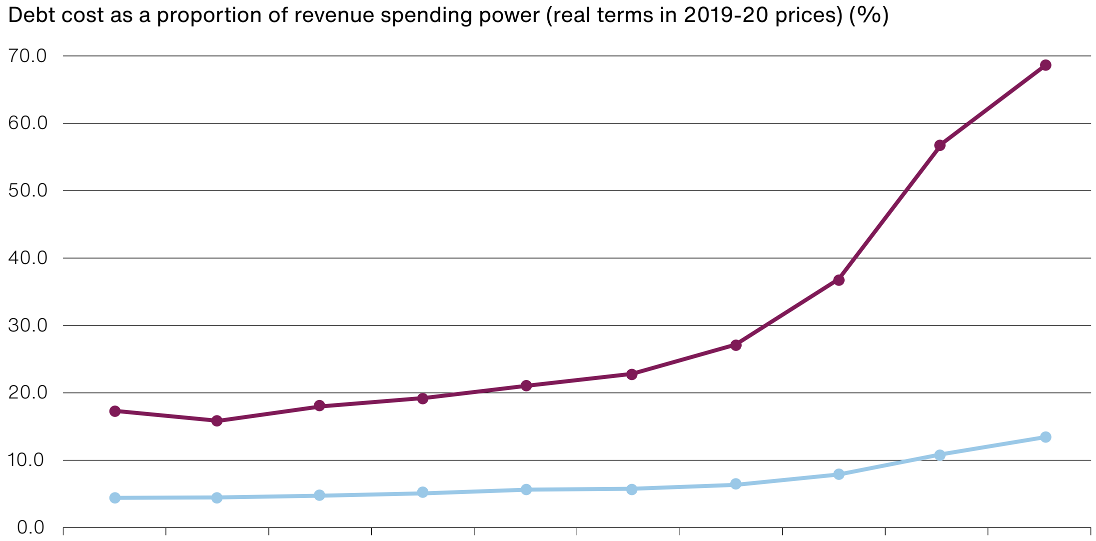
Reserves as a proportion of spending power	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
At least 45%	8	10	16	26	34	45	45	46	52	48
At least 35%, but less than 45%	5	18	19	32	41	30	25	30	25	27
At least 25%, but less than 35%	30	36	48	48	41	47	45	36	39	38
At least 15%, but less than 25%	61	64	56	33	24	20	19	29	27	29
Less than 15%	48	24	13	13	12	10	17	11	9	9
Total councils	**152**	**152**	**152**	**152**	**152**	**152**	**151**	**152**	**152**	**151**
Change in total earmarked (COVID adjusted) and unallocated reserves	100%	112%	123%	134%	139%	136%	124%	129%	136%	137%

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Figure 20

Debt costs in English district councils as a percentage of net revenue expenditure, 2010-11 to 2019-20

Overall district debt costs as a proportion of spending power rose by nine percentage points between 2010-11 and 2019-20. However, the increase for the most indebted 20 districts was much steeper (51.4 percentage points)



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Top 20 districts in each year as a percentage of spending power (%)	17.3	15.8	17.9	19.2	21.0	22.8	27.1	36.9	57.0	68.7
All districts debt cost as a percentage of spending power (%)	4.4	4.4	4.7	5.0	5.6	5.7	6.3	7.8	10.9	13.4
Single tier county council social care spend as a percentage of spending power (%)	52.3	54.9	57.1	59.5	62.7	68.3	72.8	74.9	77.3	79.7

Source: National Audit Office analysis of Department for Levelling Up, Housing & Communities data

Further reading

NAO

Comptroller and Auditor General, *Local government funding: Assurance to Parliament*, Session 2014-15, HC 174, National Audit Office, June 2014. Available at: www.nao.org.uk/report/local-government-funding-assurance-to-parliament

Comptroller and Auditor General, *Financial sustainability of local authorities 2014*, Session 2014-15, HC 783, National Audit Office, November 2014. Available at: www.nao.org.uk/report/financial-sustainability-of-local-authorities-2014

Comptroller and Auditor General, *Local government new burdens*, Session 2015-16, HC 83, National Audit Office, June 2015 Available at: www.nao.org.uk/report/local-government-new-burdens

Comptroller and Auditor General, *Financial sustainability of local authorities: capital expenditure and resourcing*, Session 2016-17, HC 234, National Audit Office, June 2016. Available at: www.nao.org.uk/report/financial-sustainability-of-local-authorities-capital-expenditure-and-resourcing

Comptroller and Auditor General, *Housing in England: overview*, Session 2016-17, HC 917, National Audit Office, January 2017. Available at: www.nao.org.uk/report/housing-in-england-overview

Comptroller and Auditor General, *Planning for 100% local retention of business rates*, Session 2016-17, HC 1058, National Audit Office, March 2017. Available at: www.nao.org.uk/report/planning-for-100-local-retention-of-business-rates

Comptroller and Auditor General, *Financial sustainability of local authorities 2018*, Session 2017–2019, HC 834, National Audit Office, March 2018. Available at: www.nao.org.uk/report/financial-sustainability-of-local-authorities-2018

Comptroller and Auditor General, *Improving government's planning and spending framework*, Session 2017–2019, HC 1679, National Audit Office, November 2018. Available at: www.nao.org.uk/report/improving-governments-planning-and-spending-framework

Comptroller and Auditor General, *Local authority governance*, Session 2017–2019, HC 1865, National Audit Office, January 2019. Available at: www.nao.org.uk/report/local-authority-governance-2

Comptroller and Auditor General, *Pressures on children's social care*, Session 2017–2019, HC 1868, National Audit Office, January 2019. Available at: www.nao.org.uk/report/pressures-on-childrens-social-care

Comptroller and Auditor General, *Support for pupils with special educational needs and disabilities in England*, Session 2017–2019, HC 2636, National Audit Office, September 2019. Available at: www.nao.org.uk/wp-content/uploads/2019/09/Support-for-pupils-with-special-education-needs.pdf

Comptroller and Auditor General, *Local authority investment in commercial property*, Session 2019-20, HC 45, National Audit Office, February 2020. Available at: www.nao.org.uk/report/local-authority-investment-in-commercial-property

National Audit Office, *Departmental Overview 2019: Local authorities*, March 2020. Available at: www.nao.org.uk/report/departmental-overview-local-authorities-2019

Comptroller and Auditor General, *Local government finance in the pandemic*, Session 2019–2021, HC 1240, National Audit Office, March 2021. Available at: www.nao.org.uk/report/local-government-finance-in-the-pandemic

Comptroller and Auditor General, *Timeliness of local auditor reporting on local government in England, 2020*, Session 2019–2021, HC 1243, National Audit Office, March 2021. Available at: www.nao.org.uk/report/timeliness-of-local-auditor-reporting-on-local-government-in-england-2020

Comptroller and Auditor General, *The adult social care market in England*, Session 2019–2021, HC 1244, National Audit Office, March 2021. Available at: www.nao.org.uk/report/adult-social-care-markets

Comptroller and Auditor General, *Protecting consumers from unsafe products*, Session 2021-22, HC 294, National Audit Office, June 2021. Available at: www.nao.org.uk/report/protecting-consumers-from-unsafe-products

Comptroller and Auditor General, *Local government and net zero in England*, Session 2021-22, HC 304, National Audit Office, July 2021. Available at: www.nao.org.uk/report/local-government-and-net-zero-in-england

National Audit Office, *Financial sustainability of local authorities visualisation: update*, July 2021. Available at: www.nao.org.uk/other/financial-sustainability-of-local-authorities-visualisation-update

Other

HC Committee of Public Accounts, *Transforming children's services*, Eighty-Eighth Report of Session 2017–2019, HC 1741, March 2019. Available at: www.parliament.uk/globalassets/documents/commons-committees/public-accounts/1741.pdf

Local Government Association, *Guidance for new councillors: 2019/20*, April 2019. Available at: www.local.gov.uk/sites/default/files/documents/11.166%20Councillors%20Guide%202019_08_0.pdf

Sir Tony Redmond, *Independent review into the oversight of local audit and the transparency of local authority financial reporting*, Ministry of Housing, Communities & Local Government, September 2020. Available at: www.gov.uk/government/publications/local-authority-financial-reporting-and-external-audit-independent-review

Ministry of Housing, Communities & Local Government, *Accounting Officer System Statement*, November 2020. Available at: www.gov.uk/government/publications/mhclg-accounting-officer-system-statement-2020

Chartered Institute of Public Finance and Accountancy, *Local government grants: how effectively do they support communities?*, May 2021. Available at: www.cipfa.org/cipfa-thinks/insight/local-government-grants-support-communities

National Infrastructure Commission, *Infrastructure, Towns and Regeneration*, September 2021. Available at: https://nic.org.uk/studies-reports/infrastructure-towns-and-regeneration

Appendix One

Sources and methods

Analysis in this briefing primarily draws on the data underlying our *Financial sustainability of local authorities visualisation: update*, available at: www.nao.org.uk/other/financial-sustainability-of-local-authorities-visualisation-update/. Links to the raw data for the data visualisation are available on the data visualisation page.

Extensive methodology notes can be also found on the data visualisation page, setting out how it treats the underlying Departmental data. These notes explain the approach to dealing with changes in prices over time, exclusions or adjustments to increase comparability over time, and the treatment of local government reorganisation, for example. (Exceptionally, our Figure 19 takes a different approach to local government reorganisation and presents authorities in existence in each year. There is one instance of missing data in this Figure: Isles of Scilly in 2016-17.)

While we generally follow the data visualisation's approaches, at times we categorise the raw data in different ways to the data visualisation. For example we classify council tax benefit funding (for the years where it existed) as income from government rather than as part of council tax income. This is to increase comparability over time, given the change to local council tax support. Similarly the categorisation of income sources dependent to some extent on local economic conditions, explained on pages 35 and 36, does not exist within the data visualisation.

The data visualisation draws primarily from the Department's revenue and capital data collections. Guidance on these collections, indicating what is included in the Department's categories, is available here: www.gov.uk/government/publications/general-fund-revenue-account-outturn (revenue) and here: www.gov.uk/government/publications/capital-outturn-return/cor-capital-outturn-return-guidance-notes-version-1 (capital).

Information on COVID-19 pressures on pages 20 and 21 use data from round 12 of the Department's collection of COVID-19 financial impact monitoring information (available at: www.gov.uk/government/publications/local-authority-covid-19-financial-impact-monitoring-information), using an approach set out in Local government finance in the pandemic. Pages 20 and 21 also draw on unpublished Departmental data on funding provided to local authorities.

Some Figures (10, 14, 15 and 18) have been published in previous National Audit Office (NAO) reports and more detailed descriptions of the methodology and sources are available in those. The same is true for individual numbers from past reports.

Details for these reports are on the further reading page, which also lists previous NAO reports we have drawn on for qualitative information and conclusions.

This report has been printed on Pro Digital Silk and contains material sourced from responsibly managed and sustainable forests certified in accordance with the FSC (Forest Stewardship Council).

The wood pulp is totally recyclable and acid-free. Our printers also have full ISO 14001 environmental accreditation, which ensures that they have effective procedures in place to manage waste and practices that may affect the environment.

National Audit Office

Design and Production by NAO Communications Team
DP Ref: 010744-001

£10.00

ISBN 978-1-78604-394-8

9 781786 043948