Written evidence submitted by the National Audit Office [FSR 112]

Introduction

1. The National Audit Office (NAO) welcomes the opportunity to submit evidence to the Committee’s inquiry on Local Government Finance and the 2019 Spending Review.

2. The NAO has produced a number of relevant reports on local government finance in recent years (see list of Reports referenced). Our response uses our reports to address the inquiry’s four questions. Key points from NAO work that speak to the Committee’s questions are summarised in italics, followed by detailed supporting material from past published work. Where the supporting material refers to "the Department" we mean the Ministry of Housing, Communities & Local Government (previously known as the Department for Communities and Local Government).

3. The NAO’s work focuses on the value for money of the decisions made, and actions taken, by government departments in implementing policy set by ministers. The NAO does not comment or make recommendations on policy. Our response reflects these principles.

Key messages and material from NAO reports

Question 1: What lessons can be learned from past changes to local government funding in England, the current financial situation of councils, and how this has affected their ability to deliver services.

1a. A reduction in government grant for local authorities since 2010-11 has been perhaps the most significant change in local government funding in England in recent years.

"Government funding for local authorities has fallen by an estimated 49.1% in real terms from 2010-11 to 2017-18. This equates to a 28.6% real-terms reduction in ‘spending power’ (government funding and council tax)". NAO 2018, Financial sustainability of local authorities 2018, paragraph 9.

1b. The initial mechanism used for calculating government funding reductions led to significant differences in overall spending power reductions faced by different local authorities

"Between 2010-11 and 2017-18 the range of reductions in government funding by local authority type was narrow, from a 48.2% median reduction for London boroughs to 51.1% for shire districts. However, these reductions have a proportionately greater impact on the spending power of authorities that depend more on government funding as opposed to council tax. As a consequence, authorities that are relatively more grant-dependent, such as metropolitan district councils, have had greater reductions in their overall spending power". NAO 2018, Financial sustainability of local authorities 2018, paragraph 1.8.

1c. A change in the method for calculating reductions in government funding had a marked impact on the distribution of funding cuts from 2016-17 onwards.

"From 2016-17, the Department introduced a new method of allocating revenue support grant, the main government funding stream for authorities. This took account of the main resources available to an authority (including revenue support grant, baseline funding from retained business rates and council tax), rather than focusing only on revenue support grant. This new method was beneficial to authorities that were more grant-dependent but led to relatively larger
reductions for less grant-dependent authorities”. NAO 2018, Financial sustainability of local authorities 2018, paragraph 1.9.

1d. A recent switch from declining to stable spending power nationally relies to a large extent on the willingness of local politicians to raise council tax rates to their maximum allowed levels, and the ability of local residents to pay.

"The slower rate at which spending power has reduced from 2016-17 reflects a slight slowing in the rate of reductions in government funding. This is partly due to the introduction of the Improved Better Care Fund after the 2015 Spending Review. Council tax income is also likely to rise following the introduction of the new flexibility that enables social care authorities to increase their council tax rate specifically to pay for adult social care. The ending of council tax freeze grants, which operated from 2011-12 to 2015-16, may also lead to increases in council tax. These compensated local authorities that froze or reduced council tax. Their removal means that there is no financial incentive from government for local authorities to freeze or reduce council tax". NAO, Financial sustainability of local authorities 2018, paragraph 1.12.

1e. Funding reductions have had a substantial impact on both the quantum and focus of local authority service spending; overall service spending has reduced and become more concentrated on social care.

"Local authorities have protected spending on service areas such as adult and children’s social care where they have significant statutory responsibilities, but the amount they spend on areas that are more discretionary has fallen sharply. Adult and children’s social care services have seen a reduction of 3.3% and an increase of 3.2% in real terms, respectively. In contrast, spending on planning and development fell by 52.8% in real terms, with spending on housing services and highways and transport falling by 45.6% and 37.1% respectively. Spending on cultural and related services fell by 34.9%.

Local authorities now spend less on services, and their spending is more concentrated on social care. Since 2010-11, spending on services has fallen by 19.2% in real terms. This is the net outcome of a 3.0% fall in spending on social care and 32.6% fall in spending on non-social-care services. Consequently, social care now accounts for 54.4% of service spend, compared with 45.3% in 2010-11". NAO 2018, Financial sustainability of local authorities 2018, paragraphs 12-13.

1f. The growing focus of spend on adult social care has been driven to a degree by new funding for this service since 2016-17. Funding available for other service areas continues to fall.

"While the overall rate of reduction in spending power slowed following the 2015 Spending Review, much of the new funding that underpins this latest phase of austerity is in principle available only for adult social care. The adult social care council tax flexibility and the Improved Better Care Fund come with conditions.

The rate of reduction in spending power from 2016-17 to 2019-20 is 8.2% in real terms, excluding new funding for adult social care. Services other than adult social care are continuing to face reducing funding". NAO 18, Financial sustainability of local authorities 2018, paragraphs 1.13-1.14.

1g. Our 2018 report found that the overall financial position of the sector had worsened markedly in recent years.

"Compared with the situation described in our 2014 report, the financial position of the sector has worsened markedly, particularly for authorities with social care responsibilities. We noted in 2014 that the sector had coped well financially with funding reductions, but our current work has identified signs of real financial pressure. A combination of reduced funding and higher demand
has meant that a growing number of single-tier and county authorities have not managed within their service budgets and have relied on reserves to balance their books. These trends are not financially sustainable over the medium term”. NAO 2018, Financial sustainability of local authorities 2018, paragraph 15.

1h. In response to ongoing funding reductions and growing service demand, local authorities have begun to shift their financial strategies from purely reducing service spending, to a mix of service and non-service spending reductions alongside efforts to generate new income.

"Local authorities have changed their approach to managing reductions in income, shifting away from reducing spending on services to looking for other savings and sources of income. Local authorities have faced funding reductions for six years. For the first three years, authorities as a whole reduced spending on services at a rate in excess of their income reductions, allowing them to build up reserves. In the second three-year period, net reductions in service spending accounted for less than half of the required savings. Instead, in aggregate, local authorities have increasingly offset funding reductions by reducing other spending – including reducing the cost of servicing debt – reducing their net contributions to reserves or drawing them down, and increasing alternative income such as commercial trading profits or external interest”. NAO, Financial sustainability of local authorities 2018, paragraph 11.

1i. Pressures on local authorities’ revenue income and spending have passed through into their capital programmes, with a growing focus on capital spending that generates revenue income or savings in the short-term.

"Authorities have focused capital spending on meeting their statutory responsibilities, engaging in ‘invest to save’ activities and promoting local growth. Authorities have prioritised investment in their assets to ensure that they meet their statutory obligations, such as ensuring that their assets comply with road safety or disability discrimination legislation. However, some have reduced revenue expenditure on routine maintenance, and others have reduced investment in more major capital works on their existing assets. All authorities we spoke to are engaged in invest to save schemes, frequently focused on rationalising their estate. Some authorities are developing capital investment strategies to secure revenue income. Authorities have also been prepared to invest in schemes to support local growth.

Authorities face a growing challenge to continue long-term investment in their existing assets. Capital strategies have begun to shift from focusing on managing assets, to generating revenue savings and commercial income. Total spending has remained stable, but increasingly capital activities are focused on invest to save and growth schemes that cover their costs or have potential to deliver a revenue return. However, many areas of authorities’ asset management programmes do not meet these criteria and are now seen as a lower priority. In particular, authorities told us they are delaying long-term investment in capital works on existing assets. This raises concerns about the possible degradation of authorities’ assets and pushes the costs of the maintenance backlog into the future”. NAO 2016, Financial sustainability of local authorities: capital expenditure and resourcing, paragraphs 17-18.

1j. In both our 2014 and 2018 reports we raised concerns over the lack of a co-ordinated understanding across different departments with local service responsibilities over the implications of spending reductions for local authority services.

"The Department does not monitor the impact of funding reductions on services in a co-ordinated way. The Department is reliant on other departments and inspectorates to alert it to individual service failures. It prioritises its interest in service delivery on services where local authorities spend the most money, engaging more closely with relevant departments. However, its reliance on other departments, and selective focus on services, means it risks only becoming aware of serious problems with the financial sustainability of local authorities after they have occurred.
The Department is the single point within government that should monitor the impact of funding reductions across the full range of local authority services on an ongoing basis, but does not do so robustly enough*. NAO 2014a, *Financial sustainability of local authorities 2014*, paragraph 21.

"There is a lack of ongoing coordinated monitoring of the impact of funding reductions across the full range of local authority services. The interdependent and connected nature of service delivery in local authorities is not reflected at the level of government departments. Individual government departments have an understanding of the service areas for which they are accountable, but not necessarily of the potential implications of pressures in other service areas locally. The Department has a role in developing an overview of the overall service cost pressures faced by local government. However, to date it has focussed its attention on priority areas such as social care rather than on understanding the impact of funding reductions across local authority services as a whole*. NAO 2018, *Financial sustainability of local authorities 2018*, paragraph 22.

**Question 2:** The efficiency, fitness for purpose and sustainability of the current system for funding local government (central government funding, council tax, business rates retention and other income); how it could be improved, including options for widening the available sources of funding; and what lessons can be learned from other jurisdictions.

2a. In order to support local financial planning government gave local authorities greater clarity over their funding via a four-year settlement published in 2016-17. However, there has been significant changes to funding streams outside the core settlement.

"The government has announced multiple short-term funding initiatives in recent years and does not have a long-term funding plan for local authorities. In 2016-17, the Department offered a four-year settlement to all authorities to enable better financial planning. However, there have been many changes to funding streams outside this core offer, such as the adult social care support grant and a second tranche of funding within the Improved Better Care Fund. The Department’s view is that these are responses to new pressures and risks that have been identified by their monitoring. Ultimately, however, the funding landscape following the 2015 Spending Review has been characterised by one-off and short-term funding initiatives". NAO 2018, *Financial sustainability of local authorities 2018*, paragraph 20.

2b. At the current time government is simultaneously pursuing a series of significant changes in the local government finance framework. As a result, local authorities have no clarity on the funding landscape for 2020-21 and beyond.

"There is also uncertainty over the long-term financial plan for the sector. The absolute scale of future funding is unknown until the completion of the next Spending Review. The government has confirmed its intention to implement the results of the Fair Funding Review in 2020-21 and to allow local authorities to retain 75% of business rates. However, the implications of these changes are not yet clear. Financial uncertainty, both short term and long term, creates risks for value for money as it encourages short-term decision-making and undermines strategic planning*. NAO 2018, *Financial sustainability of local authorities 2018*, paragraph 20.

2c. The use of locally retained business rates to fund local services almost inevitably leads to complexity in the system due to mismatches between areas’ tax bases and their spending needs.

"Funding local services through the local retention of business rates requires fundamental design issues to be addressed, which will result in a complex system. A key problem for locally retained business rates is that an area’s capacity to generate business rates does not necessarily match demand for services. The 50% scheme addressed this through a
redistribution mechanism based on ‘tariffs’ and ‘top-ups’. Secondly, some areas have the capacity to grow their tax bases while others may see theirs shrink. The 50% scheme managed this divergence through periodic resets in which all areas’ incomes were returned to a baseline. Other mechanisms such as safety nets and pools further helped to limit risk and smooth volatility". NAO 2017, Planning for 100% local retention of business rates, paragraph 8.

2d. The move to greater local retention of business rates is driven by the twin objectives of giving local authorities greater control over the money they raise and incentivising them to support local economic growth, but the link between business rates retention and local economic growth remains opaque and has not been fully assessed.

"The link between business rates and economic growth is not direct. By allowing local authorities to retain tax base growth, the government expects that this will incentivise them to adopt pro-development planning and investment policies. This is expected to deliver economic growth in the long term. However, the scheme incentivises local authorities to increase their tax base, and tax base growth does not necessarily generate economic growth: new developments might lead to the relocation of existing economic activities rather than the creation of new ones. Equally, not all areas have the same capacity to grow their tax base. The challenge for the Department is to design the 100% system to maximise the scheme's potential to deliver economic growth rather than just tax base growth, and to ensure that the benefits of the scheme are widely spread. The Department will also need to understand the propensity and capacity for different types of authorities to use other elements of the scheme designed to support economic growth including multiplier reductions and the infrastructure supplement". NAO 2017, Planning for 100% local retention of business rates, paragraph 7.

"The Department has not made any formal assessment of whether the 50% scheme has promoted economic growth. The Department has not examined systematically whether the incentive in the scheme has driven different types of local authority behaviour that might promote economic growth. In the Department's view, it is too early in the life of the 50% scheme to assess its impact on economic growth and it is methodologically difficult to isolate the impact on the 50% scheme from other factors that impact local economic growth. Ultimately, however, it is not yet clear whether the 50% scheme has incentivised authorities to adopt pro-economic growth policies, and whether any behaviour change has actually supported economic growth". NAO 2017, Planning for 100% local retention of business rates, paragraph 14.

2e. The removal of ring-fences on the great majority of government funding has created a tension within departments as they try both to promote localism while also seeking to ensure that their policy objectives are delivered.

"There is a tension between departments using unringfenced targeted grants and relying on the local accountability system. Whilst these grants lack formal conditions, departments seek to exert influence over local authorities’ use of the funding by establishing spending expectations for the grant, rather than leaving the decision solely for local consideration. In the Department’s view, these types of grants allow national priorities to be pursued locally while also providing a degree of local financial flexibility. For example, local authorities can reallocate unspent grant funding to other activities rather than repaying it to departments. However, the primacy of local priorities within the accountability system could mean that the departments’ expectations for these grants are overridden locally. Overall, departments wanting to achieve specific objectives through their funding to local authorities is not fully consistent with an assurance and accountability framework designed to promote local priorities, and where there is limited reporting on local spending". NAO 2014b, Local government funding: Assurance to Parliament, paragraph 22.
Question 3: How funding needs of local government are assessed. The current and forecast funding needs of local government and how these needs can be better understood at both a national and local level.

3a. We were critical of government’s assessment of local authorities’ funding needs in the 2010 and 2013 Spending Reviews.

"While individual government departments assessed the impact of the changes being made, their approach was not comprehensive. We looked at the information three departments provided for the 2010 spending review. One, the Department for Education, could not estimate the scope for savings across the entirety of their service area (children’s services), but it did consider the pressures and scope for efficiencies in a number of major areas of spend, such as caring for ‘looked after’ children. In addition, all three departments did not identify regional or other variations in the demand for, or cost of, services". NAO 2013, Financial sustainability of local authorities, paragraph 12.

"The Department used partial information to comment to HM Treasury on a proposed 10% reduction in the main component of government funding to local authorities in 2015-16. At the 2013 spending round the government agreed to implement a 10% reduction in 2015-16 in the local government departmental expenditure limit, the main government budget for local authority revenue funding. This decision was supported by a cross-government assessment of how local authorities would find the required savings, and of the potential impact on services. This exercise was coordinated by the Department. While the submissions it obtained from other departments were better overall than at the 2010 spending review, they still varied in quality and completeness. Service areas such as libraries, youth services and trading standards were not covered. None of the submissions assessed the capacity of different types of authority to manage further reductions". NAO 2014a, Financial sustainability of local authorities 2014, paragraph 16.

3b. The government’s assessment of local authority funding needs at the 2015 Spending Review was better than previous reviews, but there is still room for further improvement.

"The primary assessments of funding needs take place at spending reviews. The most recent one took place in 2015. The Department coordinates a cross-government process that provides information to HM Treasury on spending requirements in the sector; this supports ministers in deciding on funding allocations.

The Department requested information from 13 government departments on:

• services delivered by local authorities where the department has policy responsibility;
• the cost of delivering services and cost pressures;
• the scope for efficiencies and savings; and • funding expected to be available to local authorities from all sources.

All but one department provided a return.

The Department drew together all information, including sector submissions, to inform its overall estimates and modelling. Creating the overall estimates involved some judgement and estimates in relation to remaining gaps, particularly on potential savings within different service areas. The Department identified adult social care, children’s social care and homelessness for closer monitoring over the Spending Review period.

At the conclusion of the Spending Review ministers took a cross-government view on the level of funding for local government, taking into account the other calls on government resources and the evidence provided by departments about potential risks of financial and service failure.
Overall, the exercise the Department undertook for the Spending Review in 2015 was better than in 2013, and advice to ministers drew on a stronger and more comprehensive evidence base. However, as in 2013, the information from other departments was highly variable in quality. Their analysis also tended to be at a high level, with little evidence that the departments had analysed distributional issues and understood how pressures differed across authorities with the same duties, for example geographically or by type”. NAO 2018, Financial sustainability of local authorities 2018, paragraphs 4.5-4.8.

**Question 4: The approach the Government should take to local government funding as part of the 2019 Spending Review, what the key features of that settlement should be, and what the potential merits are of new or alternative approaches to the provision of funding within the review.**

4a. Our 2016 study on capital expenditure and resourcing identified the need for government to consider both revenue and capital elements in its assessments of local authority funding needs. Given the growing inter-relationships between these two parts of the local finance system this fuller assessment of local spending appears to be increasingly relevant.

"The Department rightly focused on revenue issues in the 2015 spending review but it will need to focus more on capital in future reviews. The Department is confident from its engagement with authorities that revenue pressures are their main concern. However, our analysis demonstrates that capital costs exert a significant pressure on authorities’ revenue resources. The Department told us it recognises that there is room for improvement in future spending reviews in relation to its understanding and inclusion of capital. We would support this, particularly in relation to understanding other departments’ plans for capital grants”. NAO 2016, Financial sustainability of local authorities - capital expenditure and resourcing, paragraph 20.

4b. Our 2018 study made specific recommendations on areas where government should improve its work in future spending reviews.

"The Department should continue to strengthen its processes for assessing local authority funding requirements at future spending reviews. It should:

• work with other departments to develop more robust methods for assessing savings and efficiency options available for local authorities; and
• ensure that other departments are informed of the outcomes of the Department’s final analysis and are aware of the possible implications for their service areas, to assist them in discharging their responsibilities for those service areas”. NAO 2018, Financial sustainability of local authorities 2018, recommendation a.

4c. In our 2018 study we stressed the need for departments to build a consensus about the role and significance of local government as a whole rather than engaging with local authorities solely to deliver their individual policy objectives. This principle of ensuring the viability of the local government sector as a whole, rather than just a focus on individual policy streams delivered by authorities, should inform the 2019 Spending Review.

"The Department’s capacity to secure the sector’s financial sustainability in the context of limited resources is shaped by the priorities and agendas of other departments. The Department’s improvements in understanding and oversight are necessary but not enough. Equally, because responsibility for services is dispersed across departments, each department has its own narrow view of performance within its own service responsibilities. There is no single central understanding of service delivery as a whole or of the interactions between service areas. To date, the current spending review period has been characterised by one-off and short-term funding fixes. Where these fixes come with restrictions and conditions, this poses a risk of
slowly centralising decision-making. This increasingly crisis-driven approach to managing local authority finances also risks value for money.

The current trajectory for local government is towards a narrow core offer increasingly centred on social care. This is the default outcome of sustained increases in demand for social care and of tightening resources. The implications for value for money to government from the resulting re-shaping of local government need to be considered alongside purely departmental interests. Departments need to build a consensus about the role and significance of local government as a whole in the context of the current funding climate, rather than engaging with authorities solely to deliver their individual service responsibilities”. NAO 2018, Financial sustainability of local authorities 2018, paragraphs 26-27.

"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; and

• create an understanding of how funding pressures and increased demand for services are interacting locally and impacting on different services, improving the availability of service outcome data as necessary, and establish a coordinated approach to cross-government engagement with local authorities”. NAO 2018, Financial sustainability of local authorities 2018, recommendation e.

April 2019

Reports referenced


NAO (2017), Planning for 100% local retention of business rates, HC 1058, session 2016-17, March 2017.