



# The impact of the economic downturn on local government finances

This briefing provides details of Audit Commission report 'Crunch time? The impact of the economic downturn on local government finances'.

## Key Issues:

- The UK economy has deteriorated since the comprehensive spending review 2007 set in October last year
- Pressure on council services will increase as a result of the economic downturn
- Councils are often a major source of local economic spending through procurement of supplies and services and can have a significant impact on the local economy.

## 1. Introduction

In October 2007 the Comprehensive Spending Review (CSR 07) set out the economic framework for public spending in the UK and determined the level of settlement for local authority finances.

Since CSR 07 Inflation measured by the Consumer Prices Index (CPI) has risen by more than inflation and in particular the price of fuel, energy and food has increased.

Much of the local authority income is fixed through settlements and the level of council tax raised locally is also fixed through the budget setting processes. Therefore it is generally difficult for councils to make up any shortfall in income or increase in expenditure.

Councils also have a local role in the economy through their purchasing powers with local and regional suppliers and spend some £140 billion on goods and services and in some areas is the largest local employer<sup>i</sup> and further more councils have been encouraged by central government to use means available to them to promote economic development within the local area and to promote local 'well being'.

## 2. Economic challenges

**Higher inflation:** The Government target for inflation was 2% but has risen on average by 1.8% per month to a peak of 5.2% in September 2008. Energy has also risen but more recently prices have started to reduce again. The Audit Commission report recognises that whilst councils do not purchase a normal 'consumer basket of goods' there have been pressures in certain areas. Most notably APSE member authorities have reported rising fuel costs for local authority fleet vehicles and food cost for education caterers (school meals).

Waste services are also referenced in the Audit Commission report. This again reflects concerns raised by APSE member authorities in relation to increased cost of landfill taxes, a fall in the prices achieved for the sale of recyclates and cost inflation on fleet and fuel used in the service.

**Interest rates and credit:** Local authorities tend to pay higher levels of interest rates than in the general economy and pay more in interest than they earn on deposits. Therefore the increase in interest rates has had an adverse effect on the local economy. However it is recognised that some council have made windfall gains on investment.

Borrowing from the Public Works Loans Board (PWLB) has not been affected in the same way as the shortage of available credit. PWLB interest rates have fallen sharply from 5.5% in January 2008 to less than 2% in December 2008.

**Falls in property values:** Falls in housing market activity and land values have reduced income from planning fees, S.106 agreement income, and asset values.

**Downturn in economic growth and local services:** There has been consistent economic growth from 1992 to 2008 however falls in growth are now predicted with a likely contraction in the UK economy of over 1% in 2009. In times of economic slowdown councils tend to see higher levels of demand for certain services including benefits claimants, demand for social care and demand for social housing.

## 3. Comprehensive spending review '07

The level of local authority spending set out in CSR 07 was less generous than previous settlements at around 1.4% above the assumed level of inflation which was forecast at 2.25% for 2007/08 and for 2% thereafter. The current estimate for 2008/09 is 3.75% whilst economic growth has dropped from 2.5% to -0.25%. However the Audit Commission points out that during the past ten years the settlement levels for central funding to local councils have risen by 39% in real terms.

Due to the way in which grant distribution operates some 270 local authorities received formula grant increases below the Governments assumed rate of inflation. With nine out of ten London authorities receiving increases below the rate of inflation.

Once the GDP deflator is applied at the rate of 3.35% - compared to the forecast figure of 2.75%, 77% of local authorities have received settlements below the assumed level of inflation. Additional income via council tax is constrained by the increases of no more than 5%. However the lower levels of inflation predicted for 2009-2011 could see an increase in the real value of the grant settlement.

#### **4. Impact on local authority finances;**

**Reductions in income and fees:** The Audit Commission has surveyed chief finance officers to understand where if any reductions in capital and revenue income would come from.

The main areas identified were in planning and building control fees and section 106 income where reductions were described as 'substantial' representing a decrease of above 5%. Within parking, treasury management, rental and leisure fee income reductions were between 'substantial' (at above 5%) and 'moderate' (representing reductions of 3-5%). Some chief finance officer's reported neither an increase nor decrease in these areas.

Over 80% of councils have reported falls in development activity including private development which has affected S.106 income. Notably around half of affordable housing supply has been provided under S. 106 agreements and this could have an impact on the supply of affordable housing. One south west authority has reported an 80% reduction in S. 106 income with an estimated loss of £4 million. Planning fees alone provided local authorities with £243 million in 2007 therefore reductions in these income streams will create significant difficulties.

**Increases in expenditure:** Increased costs of gas, electricity, and fuel which represent around 2% of total expenditure have increased by around 1-3% overall. Though between April and October 2008 gas, electricity and food rose by between 7% and 31%.

Based on responses from chief finance officers the impact of the shortfall in income and the increases in expenditure would translate into a shortfall for local government of some £2.5 billion representing around £7.5 million for each local authority. Around 45% of councils report that they need to 'take significant steps' to deal with financial pressures whilst 55% say they are coping with the changes.

The Audit Commission do highlight that the impact of economic turbulence is different dependent upon local factors. For example rural councils being disproportionately affected by increases in fuel charges.

#### **5. Local authority responses**

**Short to medium term responses:** Local authorities are planning a number of responses. Reductions in fuel and energy use to create efficiencies are the most common options alongside use of council reserves. Many have opted for a recruitment freeze

within specific areas of staffing or across the authority as a whole and 21% plan for voluntary redundancies with 7% planning for compulsory redundancies. 42% suggest they will make compensatory savings elsewhere.

The vast majority of chief finance officers were unable to identify specific areas for service cuts however leisure and cultural services, including art galleries tourism and sports development, were identified alongside other community services.

Use of non school reserves to make up budget shortfalls was considered to be one favourable way of making up shortfalls. Average reserves stand at 13% compared to 8% in 2002/2003.

87% of authorities have reported that as a result of the economy heading for recession and almost certainly higher levels of unemployment there will be an increase in demand for council services, in response to which they have revised their medium term financial plans.

**Longer term challenges:** Over 90% of authorities forecast higher numbers of benefits claimants with 92% predicting further reductions in development – some have reported having to renegotiate agreements with developments with a subsequent reduction in income. Less development also means a reduction in capital receipts incomes; 'right to buy' revenue and less available affordable housing. Around 70% have reported they anticipate an increase in statutory homelessness levels as a result of increased mortgage arrears and repossessions. Near to 75% also report an increase is likely in council tax and rent areas. As a result of the economic downturn there is also likely to be an increase in demand for social care services through family breakdown and a demand for more residential care places for older people.

## **6. Risks as a result of outsourced contracts and private finance.**

Local authorities are reliant to a greater or lesser extent on certain contracts that are delivered by the private sector to provide services to the public, provide back office functions or to act as suppliers. Areas such as school meals or contracts for care of the elderly may be provided by private firms under contract to the local authority and may be put at risk, as going concerns, as a result of the economic downturn including increased fuel and food costs which have risen well above inflation levels. The sharp fall in recycle values will also have had a detrimental impact upon waste contractors.

With increased prices or reductions in income for such contractors margins have been reduced and the financial viability of such contractors is then called into question.

Shortage of credit has also put at risk some private finance initiatives deals with developers seeking to renegotiate or pulling out of contracts with councils. This could present a major risk to capital schemes reliant upon PFI.

The Audit Commission report suggests that councils affected by outsourced contracts or PFI schemes need to risk assess such services and take steps to mitigate risks.

## 7. APSE comment

The Audit Commission highlights a number of medium to long term changes facing councils.

However some of the major challenges that councils face is the increased pressure to deliver on efficiency targets. In 2007 the efficiency targets were stretched to become 3% cashable efficiencies rather than the 2.5% efficiency gains from the previous spending review, only half of which (1.25%) were cashable. The new efficiency target is therefore extremely tough and in addition the Pre-Budget Report 2008 added a further £5 billion of efficiencies to the existing targets for the public sector.

Whilst inflation has now fallen and therefore the value of the overall settlements from CSR 2007, set when inflation was much higher, will increase in real value this will not offset all of the increased financial pressures on councils through reductions in income and increases in expenditure.

Undoubtedly tough financial times are ahead with one in seven councils planning compulsory redundancies and one in six councils planning for service cuts or having already implemented service cuts.

Whilst the Audit Commission study identifies overall little disturbance within over-arching council budgets, in terms of APSE members, many of whom operate under trading account arrangements, the loss of income could create 'clusters' within local authorities, whereby specific services are hardest hit by a reduction in fee income and / or increases in expenditure. This is particularly true of areas such as environmental services, such as refuse and recycling, which will potentially see a loss of income as well as increased expenditure on fuel. So too in education, civic and welfare catering whereby the increase in food and fuel costs has had an impact across public sector providers. Social housing providers and building maintenance service may also see an increase in demand in dealing with homelessness and making good void homes for rent will increase pressure on ensuring rapid turnaround times for social housing.

In areas such as leisure services, which are dependent upon income from fees in order to minimize council funds being used to subsidise the service, there is likely to be financial pressure created through loss of income from fees and charges as well as overall pressure from the local authority budget to generate greater efficiencies.

Council services have worked hard in recent years to deliver efficiencies and to continue to develop more effective local services. This work will continue but there is a real danger that at the point when the public become more reliant than ever upon public services the economic situation will require certain services to be cut.

Councils will need to develop rapid solutions to the current economic downturn and need to collaborate fully with in-house service providers to develop new and innovative ways to support local services. Addressing efficiencies, including looking at better ways to stream line business processes and minimise waste from service delivery will be a major area of work. This course of action will include utilizing the 'well being' powers under S.2 of the Local Government Act 2000 and maximizing income opportunities through the charging powers within Section 93 of the Local Government Act 2003.

APSE has recently conducted a major piece of timely research on developing the economic footprint of the local authority. This research includes an exploration of the value of the public pound on the local economic, particularly to small to medium businesses. A key finding was that for every £1 spent by the local authority £1.64 is returned to the local economy.

In addition local authorities are well placed to develop training and apprenticeship responses. Many local authority direct labour or service organisation have successfully implemented local training schools which as well as developing skills which will help with gaining the required skills to deliver better local public services, also help to address sub-regional economic development issues such as worklessness and education attainment levels. Such schemes can also provide an effective response to ameliorate the impact of unemployment at a local level.

APSE will be exploring examples of best practice in achieving more efficient and streamlined ways of delivering in-house services, dealing with workforce changes and developing better ways of working at a major policy seminar on the 22 January 2009 entitled 'Economy efficiency and effectiveness; How councils are responding to economic turbulence' on the 22 January 2009. For more details please click [here](#).

An executive summary of 'Creating resilient local economies; exploring the economic footprint of the public sector' can be downloaded from the APSE website by clicking [here](#) or to order a full copy please click [here](#).

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<sup>i</sup> Source; 'APSE research Creating resilient local economies: Exploring the economic footprint of public services'