Government response to the Housing, Communities and Local Government Select Committee report on Local Authority financial sustainability and the section 114 regime

CP 543

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Introduction

The Government welcomes the Housing, Communities and Local Government Select Committee's Local authority financial sustainability and the section 114 regime report following their inquiry that was published on 19 July 2021. We are grateful to the Committee and all those that provided evidence.

We recognise the value of local government and the vital role the sector plays in delivering key public services as well as the challenges the sector are currently facing. This is why, to address increasing costs and increasingly insecure funding, spending reviews in 2019 and 2020 offered real terms budget increases, maintaining sector stability after a decade of reductions. Additionally, to offset costs incurred and losses in income as a result of COVID-19, the sector has received a package of funding worth over £12 billion. By not implementing reforms to the Local Government Finance System this year, councils have had the stability they needed to focus on meeting challenges posed by COVID-19.

Moving forward, we will work to provide the sector with a sustainable financial footing, enabling it to deliver vital frontline service and support other government priorities. We will also take stock, including of the impact of the pandemic on local authority resources and service pressures, to determine any future reforms.

Recommendations and Responses

Social Care

Recommendation One:

The failure to properly fund children's and adult social care, especially adult social care, is the single biggest threat facing local government financial resilience. Given that the cost of providing social care consumes between 60% and 70% of the budgets of top-tier councils, a solution to this funding crisis alone could largely restore local government finances. The Government's current policy of effectively forcing local councils to impose successive above-inflation council tax rises is imposing additional burdens on council taxpayers. It is disappointing that the recent Queen's Speech made so little mention of plans to reform social care funding. We are also concerned about the cuts to more discretionary services arising from councils' need to prioritise social care provision. **We recommend that the Government urgently reform the funding of social care in England.**

Government response:

Since the start of the pandemic, we have committed over £12 billion in financial support to councils to tackle the impacts of COVID-19, including over £6 billion of un-ringfenced grants (£4.6 billion for 2020/21 and £1.55 billion for 2021/22) which can be used on social care. At a national level, 32% of the additional £6 billion has been allocated to adult social care, equivalent to £1.9 billion and 8.9% has been allocated to children's social care, equivalent to £521 million.

Throughout the pandemic, we have also made available over £2 billion in specific funding for adult social care. This is made up of the £1.49 billion Infection Control Fund, £396 million Rapid Testing Fund and £120 million Workforce Capacity Fund. In addition, in 2021/22 we are providing councils with access to over £1 billion of additional funding for social care, through a £300 million increase to the social care grant, and enabling up to a further £790 million of new funding though a 3 per cent adult social care precept.

We are committed to the delivery of world-leading health and social care across the whole of the UK, and our 7 September 2021 announcement marked an important step on the journey to reforming adult social care. We have committed to investing an additional £5.4 billion over three years, which will allow us to begin a comprehensive programme of reform for adult social care. This includes protecting individuals from unpredictable costs and major improvements to the wider social care system in England. We will work with care users, providers, and other partners to co-develop more detail on these plans and publish further detail in a White Paper for reform later this year.

Funding

Recommendation Two:

We recommend that the Government implement the Fair Funding Review and business rates reset as soon as possible, as the quickest way of partly restoring the link between funding and need. *The Government should also allow councils to retain 75% of business rates from 2022, but so that this represents a net increase in funding, we urge it not to impose commensurate cuts to grant funding. The additional funding should then be put towards equalisation in a separate grant designed for this purpose. We also urge the Government to clarify what level of funding equalisation it considers to be appropriate for local government.*

Government response:

The Government announced last year that it would not proceed with the implementation of the Review of Relative Needs and Resources (formerly the Fair Funding Review) and 75% Business Rates Retention in 2021/22. We also decided not to reset accumulated business rates growth in 2021/22. These decisions have allowed both the Government and councils to focus on meeting the immediate public health challenges posed by the COVID-19 pandemic, driving forward recovery and maintaining critical services. This decision was broadly welcomed across the sector. We now need to take stock of the impact the pandemic has had on both local authority resources and service pressures to determine the direction of local government finance reform. Decisions on the way forward will be taken at the ongoing Spending Review.

Recommendation Three:

The Government should reform council tax by undertaking a revaluation of properties and introducing additional council tax bands, in line with the recommendations of our predecessor Committee. *In the longer term, the Government should consider options for wider reform of council tax and business rates, including possibly replacing them with a proportional property tax.*

Government response:

Council tax provides stable income for local authorities to deliver a range of vital local services, and predictable bills for taxpayers. This certainty is particularly important as the country recovers and builds back from the pandemic. To ensure fairness, each council has its own local council tax support scheme to provide reductions in council tax for residents in financial need. The Government has provided councils with £670 million of new funding for these schemes in 2021/22. The Government has no plans to replace or fundamentally reform council tax. A revaluation would be expensive to undertake and could result in increases to bills for many households. The creation of higher council tax bands, which in itself would require a revaluation, may penalise people on fixed incomes, including pensioners, who could face a substantial tax rise without having the income to pay the higher bill. Given that council tax is retained locally, a revaluation would not address the disparity between strength of council tax base and need. The Government recognises that councils have differing abilities to generate income from council tax and ensures that the Local Government Finance Settlement takes these into account when the distribution of funding is determined each year. It has also equalised against the adult social care precept since its introduction, ensuring that funding - including that raised through the precept - is distributed in line with its assessment of relative need.

Recommendation four:

We recommend that the Government widen the funding base of local government to make it less vulnerable to shocks such as the COVID-19 pandemic, including by giving councils more flexibility over local taxes and other revenue-raising powers. *This would also align with giving local authorities more powers over spending, which we will consider in our future report on devolution in England. Giving local government more powers to raise and spend money is a position supported by our predecessor Committee.*

Government response:

The Government considers that the current charging regime for individual services strikes the right balance between allowing councils to raise revenue to cover the cost of providing services and ensuring that service users are treated fairly and fully informed of costs incurred. For statutory services, the power to charge is prescribed by service specific legislation, which may specify the charging framework. For discretionary services, local authorities have the power to charge up to full cost recovery provided the user has agreed to be charged and there is no pre-existing legislation governing the charging regime. If local authorities wish to charge above cost recovery for services, they are able to do this commercially via a trading company.

It has always been the case that council tax decisions are taken by local authorities. In line with its manifesto commitment, the Government continues to maintain a referendum threshold to ensure that local residents can have the final say over excessive increases. The Government has set varied referendum thresholds from year to year and for different types of local authority to reflect differing circumstances, following annual consultation with the sector. The principles – which are approved by the House of Commons each year – are not a cap and it is open to an authority to set a larger increase and make the case for it to voters.

The Government has also responded to requests for local flexibility through providing councils with greater discretion over a number of council tax discounts, levels of empty homes premium and the design of local council tax support schemes.

Through the Chancellor's Fundamental Review of Business Rates, the Government is considering options for reforming the business rates system. The Review's Call for Evidence, published in July 2020, sought views on a range of potential reforms, including options for alternative taxes to either replace of complement the business rate system. Within the existing system, the Review also explored whether business rates reliefs and exemptions should be set locally, and options for greater local flexibility to adjust the multipliers. The Review will conclude in the Autumn.

In addition, following the Prime Minister's statement on 7 September, revenue from a new Health and Social Care Levy will go to local authorities.

Recommendation Five:

We also recommend that the Government reform business rates, in particular by finding a mechanism by which to level the playing field between bricks-and-mortar and online retailers. *This is an issue we will return to in our upcoming report on supporting high streets after COVID-19.*

Government response:

In response to the pandemic, the Government provided eligible retail, hospitality, and leisure properties with a business rates relief worth a total of £16 billion across 2020/21 and 2021/22. This comes on top of a range of business rates measures introduced since 2016 which are worth around £15 billion over the next five years.

The Government is continuing to consider options for reforming the business rates system and the Chancellor is currently carrying out a Fundamental Review of Business Rates. This Fundamental Review is looking at how the system currently works, issues to be addressed, and ideas for change. Stakeholders were invited to provide their views on the tax as part of the Review's call for evidence and these responses were summarised in the Interim Report published on 23 March. Amongst other options for reform, the Government continues to consider whether there is a case for introducing an online sales tax as part of the Fundamental Review of Business Rates. The Review will conclude in the autumn.

Recommendation Six:

The next financial settlement for local government must be a multi-year settlement. *The Government should also consolidate the number of small and ring-fenced grants, which can limit local authorities' ability to provide services flexibly, and should reduce the number of bidding processes, which can be burdensome and time consuming.*

Government response:

Government agrees that a stable funding environment ensures local authorities can plan effectively and recognises that multi-year settlements provide certainty. The approach to the next settlement will be informed by the ongoing Spending Review, which will be an opportunity to consider local government's funding needs in the round.

We appreciate that multiple, competitive funds bring challenges to local councils. We are exploring opportunities to simplify the system, while recognising that there will be cases where competitions or ringfences are helpful in ensuring value for money.

COVID-19

Recommendation Seven:

We urge the Government to consider ways of mitigating the uneven financial support across local authorities and provide greater certainty to councils over what future costs incurred as a result of the pandemic it intends to cover.

Government response:

Providing certainty and stability to the sector throughout the pandemic has been a priority for the Government. The Government has demonstrated this by committing over £12 billion to councils in England to tackle the impacts of COVID-19, over £6 billion of which was unringfenced.

Tranches 3 and 4 of our support through the pandemic alongside the additional £1.55 billion of unringfenced funding for 2021/22 distributed expenditure grant based on need through the COVID-19 Relative Needs Formula (RNF). This new formula was designed to account for population, deprivation and the varying costs of delivering services across the country.

The Government has always ensured that funding is distributed according to need to local authorities, with each funding allocation informed by the latest assessment of pressures reported by councils. We have continued to work with local government, including through tailored financial monitoring. The Government is continuing to use monitoring information and engagement with the sector to inform its work on the ongoing Spending Review.

The Government recognises that there will be individual authorities with either unique circumstances or residual issues resulting in significant pressures. We will continue to work with them and keep the situation under review.

Local Authority Commercial Investment

Recommendation Eight:

We recommend that the Government legislate to make compliance with the prudential code by local authorities a statutory duty.

Government response:

Under the current system, primary legislation sets out that local authorities must have regard to the four statutory codes produced by Government and CIPFA, which includes the Prudential Code. Local authorities must appropriately comply with the codes unless there are clear reasons for departure.

In response to PAC's recommendations on LA commercial investments, CIPFA is making changes to its statutory codes to make clearer that authorities must not invest principally for yield. Government has worked closely with CIPFA in developing the amendments. The new codes are in consultation with planned implementation from April 2022.

Government's programme of work will strengthen the capital system and compliance with the Prudential Framework. This reinforces the Government's message to the sector and sets out clearly the actions Government is taking. The actions take a holistic approach to strengthening the system at multiple points using 'three lines of control':

1) detection of risks through scrutiny and transparency, including improving Government's data for monitoring sector risk;

2) supporting processes at local level over decisions making and risk management by working with partners to improve local capability; and

3) strengthening the Prudential Framework itself. Including tightening legislation on the Minimum Revenue Provision duty and application of the statutory borrowing capping powers.

Recommendation Nine:

The Government should also make good on its commitment to improving the data it collects on local authority commercial investment.

Government response:

In reviewing the capital system, Government has drawn on the evidence from its continued monitoring of sector data and sector engagement, and evidence that has come to light from those authorities that have approached Government for emergency financial support. The most recent data already demonstrates that both new borrowing and commercial investment decreased significantly in 2020/21 relative to 2019/20.

Government is improving its monitoring of the sector through improved data collection and intelligence gathering. Government has now completed the voluntary data survey to gather additional information on sector behaviour and is now using the findings to implement permanent changes to its regular data collection from February 2022.

Government is also improving its early identification of risk, by developing additional metrics to use our data and qualitative information in a tool for the earlier identification of risky capital practices. This will be used alongside targeted engagement to address risk and non-compliance in a more timely way.

Lastly, local authorities are now required to submit three-year capital spending and borrowing plans in order to access the Public Works Loan Board (PWLB). Government is reviewing all submitted plans to assess the capital plans submitted to determine whether the information provided is compatible with the PWLB's lending terms, including that the local authority is not borrowing for yield. The information in the plans will be used alongside other data to improve Government's monitoring of the sector.

Audit and Control

Recommendation Ten:

We recommend the Government remove the ability of local authorities to choose their own auditors. *The risk is that auditors will be reluctant to flag up potential problems for fear of losing their contract. The Government should consider who will be best placed to appoint local authority auditors, given that it should not be local authorities themselves, and ARGA doing so could lead to a conflict of interest.*

Government response:

In September 2020, Sir Tony Redmond published his review of local authority financial reporting and external audit. Since then, the Government has undertaken a range of activities in response to all 23 of Sir Tony's recommendations. This includes extending audit deadlines from July to September for two years, amending regulations to increase flexibilities to ensure that audit firms can more easily claim for the full costs of audit and providing £15 million to local bodies to help with the costs of audit. Also, strengthening local audit arrangements, and confirming our intention to establish the Audit, Reporting and Governance Authority (ARGA), as the new system leader for local audit.

The Government has also reiterated its view that there should be independence between the procurement of audit services and audit quality oversight and monitoring functions. Additionally, the Public Sector Auditor Appointments Ltd (PSAA) is the organisation best placed to act as the appointing body. This includes overseeing the next opt-in bulk procurement, due to their technical expertise and the proactive work they have done to help identify improvements that can be made to the process[1].

While local bodies have the power to appoint their own auditors, the large majority of principal bodies to date (all bar nine) have chosen not to, with 98% of such bodies choosing to opt-in to the appointing person arrangements overseen by PSAA from 2018/19 to 2022/23, whereby PSAA appoint auditors on their behalf. While opting-in to PSAA's procurement arrangements is optional, local bodies may determine that the scheme continues to offer a valuable alternative to making their own arrangements, particularly given ongoing issues of market fragility and the limited supply of qualified public auditors.

The Government is confident that the broader checks and balances in the system, including the FRC's audit quality review framework, help to ensure that auditors will be confident to flag up issues that emerge. Local auditors provide an independent assessment and are required to report their findings, regardless of how they are appointed.

Maintaining around the appointment of local auditors will also help to provide continuity, given the proximity of PSAA's next procurement exercise, which is due to launch shortly, for completion by June 2022. However, the Government will be taking the views of stakeholders into consideration through its recent local audit framework: technical consultation and will keep all existing arrangements under review.

1 See https://www.gov.uk/government/consultations/local-audit-framework-technical-consultation/local-audit-framework-technical-consultation paragraphs 77-88.

Recommendation Eleven:

We also ask the Government to confirm that the new system leader will be able to join up individual auditor findings with a view to identifying systemic issues across local government. *Without a central body responsible for oversight of the sector, we see no way of ensuring a robust and transparent regime of local audit.*

Government response:

We agree that it is important that the new system leader will be able to join up individual auditor findings with a view to identifying systemic issues across local government. In the recent local audit framework: technical consultation, the Government strongly agreed with Sir Tony Redmond's recommendation that the system leader for local audit should have responsibility for producing annual reports summarising the state of local audit[2].

The consultation proposes that ARGA's statutory function as local audit system leader will form a distinct, standing element of ARGA's annual reporting, potentially as a separate annex to the main annual report which ARGA produces. And that, in addition to reporting against its own system leader objective, this would be an important mechanism for ARGA to report to the Department for Levelling Up, Housing and Communities on the state of the local audit market, as well as to inform the Department for Levelling Up, Housing and Communities' stewardship of the local government accountability framework. This could include detail summarising the results of audits, similarly to Public Sector Auditor Appointments (PSAA) previous reporting, as well as identifying emerging themes and issues facing local bodies.

The consultation seeking views on this closed on 22 September, and the Government is now analysing the responses to this as it develops its thinking further.

Recommendation Twelve:

We recommend that the Government consider changing the section 114 regime to provide Chief Finance Officers with intermediary measures that can be applied at a much earlier stage to highlight concerns before a council's finances deteriorate so far as to require a section 114 notice.

Government response:

Section 114 notices are an important and effective part of the local government finance system as both a legal mechanism and as a spending control for councils that have particular issues in setting or maintaining a balanced budget. However, Section 114 notices exist within a wider system of checks and balances, such as the statutory requirement for Section 151 Officers to report on the robustness of budget estimates and adequacy of reserves as part of the annual budget setting process; or the additional powers and duties afforded to external auditors under the Local Audit and Accountability Act 2014, for example to issue statutory recommendations or

2 See https://www.gov.uk/government/consultations/local-audit-framework-technical-consultation/local-audit-framework-technical-consultation paragraphs 58-62

reports in the public interest, to highlight concerns about an authority's finances. This means we would expect councils to take a number of steps to address financial challenges before reaching a point where issuing a notice is necessary.

Recommendation Thirteen:

We also recommend that Chief Finance Officers report to both the Executive and appropriate scrutiny committees on a quarterly basis on the state of local authority finances and, in particular, draw attention to potential serious financial problems.

Government response:

The Government agrees that it is essential that Section 151 Officers are afforded appropriate input into decision making processes, and there are clear existing duties for them to report on serious financial problems through the Section 114 framework and Section 25 requirement for reporting on the adequacy of reserves. Effective financial governance is essential to the proper functioning of local government and a core part of a council's meeting the 'best value' duty set out in the Local Govt Act 1999.

Alongside this, we are also taking steps to strengthen local government audit committee arrangements. In the local audit framework: technical consultation published on 28 July, the Government set out proposals for updated guidance relating to audit committee arrangements, including the appointment of independent members, and that Accounts and Audit regulations are amended so that Full Council should receive the Auditor's Annual Report, accompanied by a report from the Audit Committee with responses to the Auditor's Annual Report. This consultation also reaffirmed the expectation that auditors must have appropriate powers and opportunities to meet with the appropriate statutory officers, including Chief Finance Officers.

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