LGHP Committee Pre-budget scrutiny 2025/26

Accounts Commission response

Background

1. The Local Government, Housing and Planning Committee is undertaking pre-budget scrutiny for 2025-26. The Committee is focusing on the sustainability of local government finances, particularly around the funding of council infrastructure through debt, reserves and capital investment.

2. The Committee will be taking oral evidence from key stakeholders during September and October 2024 but has also written to stakeholders inviting responses, by 23rd August 2024, to a set of questions in three areas:

   - Financial sustainability of Scotland's local authorities
   - Capital funding
   - Impacts of capital spending decisions on communities.

3. Financial sustainability has been the focus of several recent outputs from the local government programme of work within Audit Scotland on behalf of the Accounts Commission. While we have yet to focus in detail on capital funding, this has been highlighted as a theme to explore in more depth in the forthcoming 2023/24 Financial Bulletin, due to be published in January 2025.

Financial sustainability of Scotland's local authorities

What are the main challenges facing local government finance over the next five years?

4. The financial outlook for councils is extremely challenging, as they face unprecedented financial and service demand pressures which present real risks for the future. Despite councils receiving more funding and income in cash terms, due to high inflation in 2022/23 total revenue funding from all sources fell by £619 million (2.8 per cent) in real terms to £21.3 billion compared to 2021/22.

5. Councils identified at least £585 million between their anticipated expenditure and the funding and income they expect to receive (the budget gap), estimated to increase to £780 million by 2026/27. Councils will have to make increasingly difficult decisions about how they are run, how they deliver services and what services may have to stop, if they are to deliver balanced budgets, as required by law.

6. Councils' total net debt (total debt less cash and investments) is rising. In 2022/23, total net debt was £17.4 billion. Between 2018/19 and 2022/23 net debt in councils rose by £1.7 billion. While net debt levels dropped in 2020/21, they have continued to rise since then, increasing by £1 billion between 2021/22 and 2022/23. During that time, net debt increased in 24 councils. However, there is significant variation between councils, with changes in net debt ranging from a seven percent decrease to a 29 per cent increase.

7. Councils' medium- and longer-term financial plans provide a clear picture of the challenging and volatile financial landscape that they face. Significant pressures result from increased demand for services (due to an ageing population and cost of living crisis, for example), inflation, increasing cost of supplies and services, pay pressures, new commitments and legislative reform.

8. Some service areas are at risk. We have published several outputs recently highlighting some areas facing financial sustainability challenges, including:

   - Early Learning and childcare - in June 2023, the Accounts Commission and Auditor General's follow up joint performance audit reported that, although Scottish Government and partners had done well to increase the hours provided to each child, the sector was fragile.

   - Social care services – an Accounts Commission blog highlighted the crisis in social care services, caused by growing demand, both in terms of numbers and complexity, and workforce and resourcing challenges.

9. A blog published by the Chair of the Accounts Commission in July 2024 highlighted the importance of an effective corporate finance function to the overall stability of each of Scotland's 32 councils, particularly against a backdrop of unprecedented financial challenge and uncertainty. The blog makes clear that the Chief Financial Officer (CFO) for each council has a critical role to play in addressing these challenges. The CFO must take an active leadership role, not just within the finance function, but across their organisation, sector and public services as a whole.

10. In recent years we have been reporting that councils, individually and as a sector, urgently need to transform how they deliver services to become financially sustainable. Several sector-led approaches to transformation are underway, including the Transformation Programme led by the Society of Local Authority Chief Executives (Solace) and the Improvement Service. Sector-led transformation work has potential to help, alongside other local approaches, to councils achieving financial sustainability in the medium to long-term.

11. Financial sustainability will become more difficult to achieve if not addressed urgently, and councils need the support of the wider public sector to address this. The Accounts Commission is due to publish a report in this area in early October 2024.

Have councils assessed how much revenue funding they need from the Scottish Government in 2025-26 to deliver their statutory and discretionary services to an adequate standard?

12. Our audit work carried out to date has not considered any assessment made by councils as to how much revenue funding is needed to deliver statutory and discretionary services.

13. However, our analysis does show that councils face significant financial sustainability challenges, placing vital public services at risk. There is a gap between anticipated expenditure and the funding and income they expect to receive.

14. An increasing proportion of funding is to support the delivery of specific national policies, for example the expansion of early learning and childcare, rather than provision of flexible funding for councils to use at their discretion. The proportion of funding where councils have discretion on how to spend has fallen.

15. Our Local government in Scotland: Financial Bulletin 2022/23 sets out that an increasing proportion of Scottish Government funding is formally ring-fenced or provided with the

expectation it will be spent on specific services. We calculated that ring-fenced and directed funding increased to 25.7 per cent (from 23.7 per cent) in 2022/23.

16. Spending on children's services (education and looked after children) and adult social care has been protected and increased because of increased demand and national policy directives. This means that the remaining 'unprotected' services (such as roads, environmental services, culture and leisure and planning) have experienced a disproportionate level of spending reductions.

17. Some councils use indicators to assess their financial resilience but the extent to which they are used, and their effectiveness, varies. In some councils, financial resilience is instead built into day-to-day financial processes and strategies. The Accounts Commission has recommended financial resilience indicators should be a component of councils' medium- and longer-term financial plans to provide assurance they are balancing short-term pressures with robust planning for long-term financial sustainability.

18. Our blog benchmarking and good public performance reporting highlighted how data in the latest Local Government Benchmarking Framework annual report showed the pace of improvement in council services is slowing, with 2022/23 the first year that the rate of decline in indicators has overtaken the rate of improvement. Using data on how services are performing is crucial as councils must make increasingly difficult spending decisions, alongside decisions about allocating limited resources. The Accounts Commission will continue to follow this data.

19. We recommend that councils prioritise the achievement of recurring savings and avoid reliance on non-recurring savings to enhance longer-term financial sustainability.

The Verity House Agreement impacted on the financial sustainability of local government since it was signed last June and if so, how?

20. The Verity House Agreement, which has been in place for over a year now, includes a commitment to offer councils longer-term funding and greater local financial flexibility. These changes should provide greater financial certainty to help support better long-term planning within councils and more flexible direction of resources to meet local need. However, progress on the implementation of the Verity House agreement has been slow.

21. The Accounts Commission's Local Government in Scotland: Financial Bulletin 2022/23 highlighted how, at December 20023, three key milestones below had not been met:

- From June 2023 the default position was to be no ring-fencing of direction of funding unless mutually agreed. However, this commitment was broken when the Scottish Government announced a council tax freeze without consulting the Convention of Scottish Local Authorities (COSLA) (see below).
- a joint review of specific grants and in-year transfers to local government had not been undertaken (due end of October 2023)
- a new fiscal framework to govern the allocation of funding for local authorities and provide councils with increased control over their budget-setting processes (for example, though including multi-year settlements wherever possible to support strategic planning and investment) had not been agreed (due end of September 2023).

22. The Scottish Government's freezing of council for 2024/25 tax significantly reduced discretion and flexibility at individual council level. The impact this will have on financial sustainability is not yet known, but councils have placed an increased reliance on raising council tax to help deliver a balanced budget over the past two years.

23. The Accounts Commission's briefing on Local government budgets 2024/25 welcomed the Verity House Agreement's commitment to move towards reducing ring-fenced funding but noted that funding remains constrained as the increase in the general revenue grant is largely directed towards the delivery of Scottish Government policies or to support previous pay awards, rather than an increase in available funding for councils to use at their discretion.

What would you like to see in the forthcoming fiscal framework to help improve financial sustainability?

24. At the LGHP Committee evidence session on June 13 2023, Andrew Burns, Deputy Chair of the Accounts Commission, called for a fiscal framework that provides a three-year budget framework for local authorities, to allow planning on three horizons and to enable a shift to prevention and early intervention; to reduce fragmentation in the approach to funding and improve efficiency; and to enable focus on longer term outcomes.

25. Our Local Government in Scotland: Financial Bulletin 2022/23 recommended that councils and the Scottish Government work together to build momentum and accelerate progress in the development of a fiscal framework for local government to enhance the clarity and certainty of budgets for councils in future years.

Is there a risk that Scottish local authorities might face similar financial difficulties to those faced by some English councils such as Nottingham, Croydon, Thurrock and Slough? If so, how can this risk best be mitigated?

26. Although councils in Scotland are facing financial pressures, there are important differences between Scottish and English local government finance.

- Section 114 notices used in England, which effectively declare councils 'bankrupt', do not apply in Scotland.
- Scottish councils have not entered into high-risk investment in commercial ventures in the same way as councils south of the border can.
- The Controller of Audit and the Accounts Commission provide consistent audit oversight and assurance around the financial management within Scottish local government. This type of oversight no longer exists in England due to the Audit Commission being disbanded in 2015.

27. Councils have their own Chief Financial Officers, sometimes referred to as Section 95 Officers, who are responsible for the financial affairs of their council (see the Accounts Commission Chair's blog on the important role of the CFO). There are procedures in place for them to follow if they have concerns, for example, they can give a formal indication to the council's Chief Executive about potential financial difficulties, and attempt to secure immediate remedial action, or they could prohibit any new agreements incurring expenditure. If a council doesn't take appropriate action in response to their Section 95 officer, auditors should advise Audit Scotland so the Controller of Audit can take appropriate action, such as undertaking a Section 102 report.

28. There are financial pressures on councils and the outlook is challenging, with an increasing budget gap. Despite this, in 2022/23, local appointed auditors did not identify any councils in Scotland as being financially unsustainable in the short term.

29. Councils' levels of reserves have increased overall, albeit driven by a growth in committed reserves. Most councils plan to maintain uncommitted reserves at around 2 to 4 per cent of net budgeted expenditure as a contingency to respond to unforeseen events and associated cost pressures. Where the uncommitted reserves are lower than this, they are the result of planned decisions with additional specific reserve funds earmarked for contingency.

Capital funding

Do councils have enough capital funding to provide and maintain the infrastructure communities expect?

30. There is pressure on all public sector capital budgets, and this presents risks to the viability of local government capital programmes, many of which impact on key services (e.g., the construction and maintenance of schools, libraries, roads). There are now higher costs associated with capital programmes (resulting from inflationary pressures and shortages in construction materials for example) and these are affecting councils' ability to fund capital transformation programmes, which are a necessary component of modernising services to deliver improved outcomes for local communities.

31. Councils receive capital funding from the Scottish Government in the form of the capital grant, distributed by means of a funding formula based largely on population and road-length. The initial capital funding settlement for local government in 2023/24 was £747 million but at the autumn revision it was increased to £767 million. This represents a 2.6 per cent fall in cash terms and an 8.2 per cent fall in real terms compared to the same position in 2022/23.

32. Councils' capital expenditure in 2022/23 was £3.6 billion. This is a 16 per cent (£0.5 billion) increase in cash terms compared to 2021/22. Most councils (22) reported higher capital expenditure in 2022/23 than in the previous year. The rise in expenditure has mainly been driven by a 52 per cent increase in borrowing.

33. Analysis of councils' Annual Audit Reports for 2022/23 highlighted slippage against capital projects across Scotland. Contributory factors included higher costs for goods and services (including utilities, fuel and labour); and wider economic circumstances including inflation, war, Covid-19, interest rates and pay awards.

What level of capital grants do local authorities need in 2025-26 to ensure their capital priorities and pre-existing commitments are met?

34. Despite large increases in capital reserves (see below), the Local Government in Scotland: Financial Bulletin 2022/23 notes that the capital funding outlook for the whole Scottish public sector is challenging and the Scottish Government is currently undertaking a programme of reprioritisation of capital projects. The continued pressure on capital budgets presents risks to local government capital programmes, many of which impact on key services (e.g., schools, libraries, roads, etc).

How have local authority debt and reserves levels changed over the past ten years?

Debt

35. Councils' total net debt (total debt less cash and investments) increased by £1 billion between 2021/22 and 2022/23, from £16.4 billion to £17.4 billion. Net debt increased in 24 out of the 32 councils but there is significant variation between councils. Changes in net debt ranged from a seven percent decrease to a 29 per cent increase.

Reserves

36. Reserves play an important role in good financial management of councils. They may be used to invest in a major project, transform services or respond to unexpected events. Capital reserves are used for future capital expenditure or to repay borrowing. Reserves are a one-off resource, so councils need to plan carefully for their use. In doing so, they should consider the strategic, operational, and financial risks facing the council.

37. The Local Government in Scotland: Financial Bulletin 2022/23 highlights how councils increased their total usable reserves from the previous year by £0.31 billion to £4.46 billion. While revenue reserves increased by 2.2 per cent (£80 million), the increase in capital reserves was much larger, rising by 40 per cent (£232 million), to £0.81 billion. The increase in capital reserves may be linked to slippage against capital projects (see above).

38. Looking at the level of reserves as a proportion of total net revenue expenditure is one way of assessing financial sustainability, with a low figure suggesting a council may struggle financially if it experiences a financial shock or is unable to deliver a balanced budget. In 2022/23, the total usable reserves across all councils as a proportion of total net revenue expenditure was 27.3 per cent compared to 20.4 per cent in 2019/20 before the pandemic. In 2022/23, no council had usable reserves that were less than ten per cent of net revenue expenditure compared to four councils in 2019/20. Twenty councils had reserves that were over 20 per cent of net revenue expenditure, compared to nine in 2019/20.

Why are councils borrowing more now and how will this impact resource budgets in future years?

39. In 2022/23, councils in Scotland borrowed £1.41 billion, a 52 per cent increase on the previous year. This was the largest single source of capital financing (followed by Government grants accounting for £1.35 billion). Additional borrowing places further pressure on revenue budgets over the longer term.

40. Capital funding from the Scottish Government rose in 2022/23 but remains lower than before the pandemic. Our work in 2022/23 did not include analysis of the relationship between capital funding and borrowing levels.

41. Although there has been an increase in borrowing, borrowing costs have reduced in recent years as many councils have used permitted financial flexibilities to reprofile debt payments. However, while helping with immediate budget pressures, the decision to reschedule debt repayments risks adding pressure on future budgets, as it defers costs to later years, and it does not tackle the underlying challenges to financial sustainability.

42. This will be explored again in our financial bulletin 20223/24, due to be published in January 2025.

Why have reserve levels changed over recent years?

43. The most significant increase in reserve levels held by councils over recent years occurred in 2020/21. As reported in Local government in Scotland: Financial Overview 2020/21, all councils increased their total usable reserves at 31 March 2021 to £3.8 billion. This represented an increase of £1.2 billion (46 per cent) on the previous year and included revenue and capital reserves.

44. Most of the increase in 2020/21 related to general fund reserves (including Housing Revenue Account) of £1.1 billion. This was predominantly due to a significant element of

Covid-19 funding that was issued to councils very late in the financial year. This contributed to about a 70 per cent increase in reserves held by councils at the end of 2020/21.

45. Our Local Government in Scotland: Financial Bulletin 2022/23 focused on the overall levels of reserves within councils, and the extent to which these are committed or uncommitted, rather than the reasons for significant year on year movements. Furthermore, our high-level bulletin did not explore how councils are planning to use their reserves.

46. However, the continued lack of consistent transparency and detail in annual accounts around what and when reserves are committed for, and their associated spending plans, makes conclusions in this area difficult to draw. Our report recommends councils should provide clear statements about reserves policy and the purpose of committed reserves within their annual accounts. This will enhance the level of assurance that councils can provide regarding their ongoing financial sustainability.

What criteria and definitions are used to determine whether reserves are "committed" of "uncommitted"?

47. Councils have reserves policies in place that set out the rationale for the minimum reserves levels set by the council. Most councils plan to maintain uncommitted reserves at around 2 to 4 per cent of net budgeted expenditure as a contingency to respond to unforeseen events and associated cost pressures. In 2022/23, five councils had an uncommitted reserve balance below two per cent of net budgeted expenditure. Low levels of uncommitted reserves present a risk as it limits a council's ability to cushion the impact of uneven cash flows, unexpected events or emergencies.

48. Some councils are committing reserves to financial sustainability funds or budget support funds to cushion the impact of known financial challenges in the years ahead or committing reserves to help fund transformation, potential workforce reconfiguration or pay settlements.

Impacts of capital spending decisions on communities

In a time of restricted capital resources, how do councils prioritise their capital spending?

49. We have not carried out any work in relation to councils' prioritisation of capital spending.

What impacts have recent capital spending decisions had on various service users and communities?

50. Our most recent Local Government Financial Bulletin did not consider the impacts of capital spending decisions on service users and communities. However, our work did consider the implications of revenue spending decisions and savings proposals.

51. Some councils have experienced significant resistance when seeking to make service reductions to balance revenue budgets. Some have already taken difficult decisions to address budget gaps through implementation of recurring savings options.

52. We know that some councils have experienced significant public opposition to some of their proposed savings measures, including in the case of threats of judicial review of Aberdeen City's proposed closure of a number of local swimming pools and libraries. Further examples include the postponement of cuts to library and leisure services in Clackmannanshire and a reversal of plans to close 39 community facilities in North Lanarkshire in response to public opposition. This highlights the need for effective and timely consultation and engagement with communities over budget proposals.

53. The extent of savings across different service areas, and their impact on service delivery and service users is an area of interest for the Accounts Commission and we will continue to develop our monitoring and reporting on this in future outputs.

How do councils involve service users in their capital spending decisions?

54. Our Local government budgets 2024/25 explored how councils consult communities as part of their budget setting processes, although not specifically in relation to capital spending decisions. Although councils are trying hard to engage with local citizens in a variety of ways (for example, through consultations, online surveys, targeted community group engagement etc) not all have informed or consulted residents about the financial pressures faced.

55. Councils publish their annual budgets and accounts however these are not always easily accessible and understandable to the public.

How do councils communicate the likely impacts of capital spending decisions to their communities?

56. Our recent work has not considered the type and extent of communication around capital spending decisions made by councils.