CIPFA
The Chartered Institute of
Public Finance & Accountancy

balancing local authority budgets

Written by Sean Nolan and Joanne Pitt

INSIGHTS
for public financial management

About the authors:

Sean Nolan, CIPFA, Senior Local Government Advisor

Sean has 30 years' experience in various finance roles including the role of treasurer in two county councils and is currently Chief Finance Officer (CFO) for the Kent Police and Crime Commissioner. He is a former President of both the Association of Local Authority Treasurer Societies and the Society of County Treasurers, and is the current President of the Police and Crime Commissioners Treasurers Society.

Joanne Pitt, CIPFA, Policy Advisor

Joanne has over 25 years' experience working in the public sector at both operational and advisory level. Her experience spans business rates, housing, welfare and devolution.

To complement this insight CIPFA held a round table to discuss the challenges CFOs face around balancing the budget. The round table was attended by finance directors, lawyers and policy makers working across the public sector who helped to shape the discussion by sharing their thoughts and comments. Their views have been incorporated into this paper and CIPFA appreciates the input.

foreword
Rob Whiteman

The Government's priority is to reduce the current budget deficit, rebalance the economy and in the long-term to achieve a current budget surplus. It plans to do this by cutting spending and increasing tax revenues while reforming local government funding to devolve power and financial autonomy. While cuts, efficiencies and spending limits have long been part of the public sector the current cuts are adding to the pressures faced by local government.

By 2020 the Government claims funding for local government services will be marginally higher in cash terms, mainly as a result of council tax growth and the retention of local business rate income by authorities. Against this financial background, the Government will reduce its Revenue Support Grant (RSG) to local councils by £7.8bn or 78% over the next four years. This comes on top of the last five years of grant cuts since 2011.

For the medium-term, good councils are growing their income streams and tax bases, building resilience through reserves, managing demand, integrating services, moving to new delivery models, sharing and digitising services and reducing what the council provides. And for the medium-term the government is helping with space for 3.99% council tax rises, business rate retention, the Better Care Fund, four year settlements, devolution deals and scope to capitalise transformation costs.

Good councils will agree that a good medium-term strategy is no substitute for short-term grip. Councils are permitted to draw on reserves to support the revenue position, and can effectively run a deficit on current spending in a year if they have the means to fund it. However it is illegal for planned expenditure in the current or a future year to exceed budgeted resources and available reserves. In such cases the CFO must statutorily enforce an expenditure freeze and the council respond and adjust its plans for the year in question.

Effective councils will see the pressures in advance and manage the risks before they can materialise. The importance of a medium-term financial planning approach will be all the more important as rate retention means that authorities need to manage the risks for the downturn by having greater financial resilience.

This insight is aimed at CFOs faced with the possibility of an unbalanced budget and will help members of the leadership team to understand the context behind any actions the CFO takes. It will stress the importance of everyone working together to keep finances on track and consider the dynamics between the CFO, monitoring officer and chief executive.

Rob Whiteman
Chief Executive
CIPFA

\ introduction

It is little wonder that many CFOs in local government are worried about unbalanced budgets.

Concerns about unbalanced budgets are seated in the realisation that local government has faced significant funding cuts in recent years and this, combined with rising demand, means councils are under unparalleled financial pressure.

The RSG will drop by £7.8bn or 78% by 2020 and for many that cut is front loaded. While there is possible income to be generated in the future through changes such as 100% business rate retention, balancing the 2016-17 budget is the immediate issue.

Balancing the books will simply be much harder through to 2020. The level of financial risk will vary but it will be tough for all, and for some especially so. We could well have an unprecedented number of councils effectively considered to be in financial crisis.

Crisis in this sense is a council being unable or unwilling to take the actions needed to live within its resources. A voluntary spending freeze is commonly used as the means of avoiding financial crisis and introduced in a measured way shows sound financial practices are in place and the organisation is working together to rectify the budget. However beyond this voluntary approach the CFO has additional powers to force a balanced budget.

For local government, it is the CFO or Section 151 officer who has the role under law of being the most senior financial advisor to the wider council's leadership on its financial plans. Uniquely across the public sector however, the CFO also has the power and responsibility to legally suspend spending for a period of time if they judge the council does not have a balanced budget or the imminent prospect of one. This is known as a Section 114 report and is outlined in the Local Government Finance Act 1988.

The financial management challenges facing councils are currently more complex than ever and constantly shifting. Reflecting on these pressures the round table unanimously agreed that the combination of uncertainty over revenue funding and demographic pressures resulted in high risk for councils regardless of how they are managed.

Adding to this mixture of financial challenges are the new devolution deals to local government. New partnerships, new governance and new commitments all impact on financial sustainability and as none of these new arrangements have been stress tested for resilience it is easy to see why balancing a budget is full of risk.

We could well have an unprecedented number of councils effectively considered to be in financial crisis.

budgeting in an unpredictable world

In practice the nature and scale of all the financial risk facing local government will not be uniform. Despite the differences we can say that the best local budget plans are those owned and articulated by the whole council and its senior leadership not simply the CFO.

Cost drivers and income sources will be well understood, risks and delivery plans will be clear. Delivering a robust budget is an organisational responsibility and failure to do so points to wider failures within the organisation.

CIPFA has always maintained that it is important for the CFO to be at the leadership table[1] as this increases awareness of the importance of financial planning and closely aligns budgets and strategy. Organisations where this is not the case would do well to consider the implications and risk attached to their structure.

Every council will face sudden shocks to their budget plans and will need to respond accordingly. One such in-year tactic is a self-imposed spending freeze to avoid or minimise an otherwise unmanageable overspend at the year-end. That is good financial management.

Even in setting the budget at the beginning of the year, some financial challenges can be sudden and significant, requiring an urgent resetting of budget plans. The recent example of the Government unexpectedly changing the RSG distribution formula on the cusp of the budget setting process for 2016-17 was a case in point for a number of shire councils.

Participants at the round table agreed that financial crises don't appear overnight. What may start as a small problem, can worsen as a result of a combination of factors including:

- denial
- overly short-term tactics
- overly optimistic longer-term solutions
- insufficient monitoring.

When the budget for the year ahead is before Council to approve, legislation requires the CFO to provide members with a statutory statement dealing with two questions:

- whether the budget estimates for the year ahead have been formulated in a sound way
- whether the reserves are adequate for the risks being faced.

In nearly all cases in the current environment the CFO statement will give a qualified yes to both questions but would note any particularly significant risk events and emphasise the importance of risk management, active monitoring and strategies for delivering savings.

The best local budget plans are those owned and articulated by the whole council and its senior leadership not simply the CFO.

1 The role of the CFO in local government 2015, CIPFA

However if this is not the case the CFO will have to take further action. In those highly challenged situations, the CFO saying 'no', when no is the right answer, is probably one of the best services they can perform for the longer-term sake of the local taxpayer and service users.

What is a balanced budget?

Not being able to balance the budget has more serious consequences for local authorities than the public may realise because for a local authority avoiding a deficit is a legal requirement under the Local Government Finance Act.

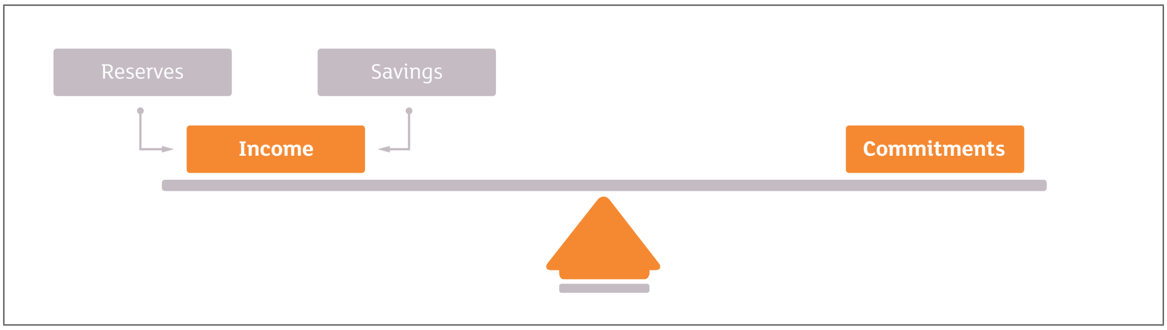
However what is meant by 'balanced' requires the CFOs to use their professional judgement and interpretation. At the round table the definition of a balanced budget was debated and it was generally agreed that a wider definition would be more appropriate.

CIPFA's suggestion was that a prudent definition of a sustainable balanced budget for local government would be:

A financial plan based on sound assumptions which shows how income will equal spend over the short- and medium-term.

Plans would take into account deliverable cost savings and/or local income growth strategies as well as useable reserves. Normal preference is that day-to-day income covers day-to-day costs and at year-end there is no variance. If there is a variance, it is an underspend.

For local government, at its very simplest, a balanced budget means that the council is content that the combination of income, the sensible use of reserves and having robust savings plans in place means that underlying income will cover on-going costs and future commitments in a sustainable and manageable way.



The context of 'medium-term' is crucial. It is entirely possible that abrupt financial shocks, such as sudden losses in funding or unplanned increases in cost, may mean year-end overspend is inevitable even with an emergency savings plan. If that overspend can be covered by the use of reserves in the current year and the CFO is confident other measures being taken will bring the position into balance in the following year, the CFO still has a balanced budget.

CIPFA has always been clear that local authorities must be very measured in their use of reserves and the advice provided in CIPFA's English Local Authority Reserves briefing (June 2015) still holds true.[2] CIPFA recognises that reserves offer very useful options for balancing the budget in the short-term. Reserves can be called upon to manage fluctuations between financial years to ensure that an overall balanced budget is maintained. However, it is important that they are replaced when the short-term need has passed.

Allocated reserve spends can be used for:

- planned investment
- capital projects
- change programmes
- unexpected events such as natural disasters.

Getting back on track through a 'voluntary' freeze

A spending freeze is an approach to help balance the books in-year. It sits alongside all the planned approaches and strategies set out in the budget when it was first approved. The need for a spending freeze in year may be because of an unplanned event or unexpected set of circumstances which mean the council is heading for an unmanageable overspend at year-end or in future years.

An unplanned event could be a sudden loss of funding and an unexpected set of circumstances could be transformational savings plans not being delivering as hoped.

Implementing the freeze is a sign of good financial management. It shows that although the finances are not on target, monitoring has identified the problems at an early stage and the leadership team is working collaboratively to realign income and expenditure. By default, it will be implemented with the support of the chief executive and leader if not the wider leadership.

Participants in the round table discussion identified a variety of attitudes and approaches to implementing a spending freeze. It was seen as useful for introducing behavioural change and focusing discussions around expenditure activity. But its ability to generate sufficient income was questioned. All those present confirmed that the CFO should work closely with the chief executive and produce a measured response that balanced the need to reduce expenditure with the duties to deliver services. It was evident in this discussion that this response would in part reflect local approaches to risk but also the health of local reserves.

2 www.cipfa.org/cipfa-thinks/briefings

An exercise in communication

In the summer of 2015 Buckinghamshire County Council identified financial difficulties and implemented an organisation-wide spending freeze. Key to its implementation was good communication.

Led by the CEO and supported by the senior leadership team it recognised that the best way forward was to act early and in a measured way after close monitoring by the finance team had identified a shortfall in income.

'This was not a panic knee jerk reaction but a controlled and measured introduction of spending controls designed to realign income and expenditure.'

The spending freeze did not mean there was a crisis but its introduction was seen as a sensible way to avoid one. The spending freeze introduced measures such as the need to have additional director authority on expenditure. If this was over £100K then further authority was needed from the director of finance. This gateway approach resulted in a mind-set where expenditure required a sound and well thought through business case but was not automatically refused.

Throughout the organisation and beyond it was necessary to ensure that the same consistent message was communicated. This was about the need to think carefully about expenditure but to recognise the temporary nature of the freeze. Working closely with the communication team the finance department used various approaches including a visual spend metre to engage staff in the process. This communication was especially important when dealing with external partners. Contracts still need to be fulfilled but with careful negotiation and again the focus on the temporary nature of the freeze contracts were renegotiated in the short-term.

The organisation was keen to show that expenditure cuts included council members who accelerated their move to a paperless environment and relinquished community budgets where plans were not developed. Although the freeze is a temporary measure the authority is learning from the experience and is using it to address underlying issues as part of the financial planning process.

'It is all about working in collaboration and that means you have to have a clear and consistent message for everyone – that includes staff, members and your external partners.'

Richard Schmitt, Head of Strategic Finance, Buckinghamshire County Council

Strategies for achieving a balanced budget

In the current world of local government, it may be the robustness of the cost savings plan that will ultimately determine a balanced budget. That plan may be crude because of the emergency being faced and involve simple cost cutting or it could be more sophisticated and, for example, linked to reduced demand. Either way it has to deliver in a realistic and predictable timeframe.

The contributors to the round table discussed the financial strategies around cost cutting and there was a recognition that for some there would come a point when no amount of cost cutting would balance the budget. The group were clearly divided between those that were able to make substantial savings and those where income generation played a more important role.

There are several areas of activity that create income for local authorities in England including off-street parking, sports and leisure facilities and trade waste, although the amount of income that is generated can vary.[3] CIPFA's publication The Practical Guide for Local Authorities on Income Generation outlines a number of ways that revenue can be brought in via fees and charges, services and trading opportunities.[4]

Medium-term planning

The emphasis and importance on medium-term planning was a key message for the participants at the round table and one supported by Rob Whiteman, CIPFA's chief executive:

> 'The role of the chief financial officer is vital to medium-term financial planning. It should never be narrowed to producing monthly monitoring tabs and closing the accounts.'[5]

The council's medium-term plan has to accurately forecast the changes in costs or income going forward and adjusting its savings plans accordingly. Combining this data with demand management information the leadership team must identify sustainable financial plans. The failure of the leadership team to appreciate how this information works together may have significant consequences.

3 The Practical Guide for Local Authorities on Income Generation (2015), CIPFA, **cipfa.org**
4 CIPFA income generation statistics, CIPFAstats, **cipfa.org**
5 'CFOs should be less tolerant of overspending in the NHS', Rob Whiteman – Public Finance July 2015

statutory and non-statutory

The dividing line between statutory and non-statutory is not as simple as one might think. Deciding what spending costs are allocated to what services is critical to managing a budget especially in a time of a spending freeze.

The first area of grey is around the delivery of statutory duties themselves. There are over 1,000 statutory duties for a local authority to carry out and this ranges from duties around homeless provision to elections. Some of these duties are purely administrative and would have very little impact on the lives of their rate payers but provide important functions around governance accountability and transparency. Others such as the provision of care for children are high risk, cover the cornerstones of a civilized society and form the basis of citizens' expectations of the state.

What is less commonly known is that very few of these statutory duties are prescribed in detail in the legislation and this is where there is flexibility for local authorities to consider how services are delivered.

Looking at it through the eyes of a rate payer the scenario below explains the dilemma.

The statutory requirement is for the council to provide transport from home to school for certain children. In council A the children are picked up in a new mini bus with Wi-Fi and air conditioning and in Council B they are transported in six-year-old taxi. Both options meet the statutory requirement but the level of the service is at the discretion of the authority.

A possible over simplification of the challenge presenting itself but for illustrative purposes this is the grey area of spending choice facing the CFO and the organisations for all the statutory provision. No council wants to be the one that offers its ratepayers the minimum services for everything required but where there is a financial imperative this may be the stark choice facing many types of council over the next few years.

The round table deliberations over statutory duties included a discussion around the large number of responsibilities local authorities had to deliver but the degree to which councillors were willing to reduce spend was liable to vary: the ceiling would be at a different height from one authority to the next.

A lower cost service does not always equate to the minimum level of provision for statutory services. The innovation shown around the delivery of library services over the last five years has showcased the many and varied ways statutory services can be delivered.

New ways of borrowing

In 2015, Peterborough City Council introduced a new delivery model in their 10 libraries that resulted in longer opening hours and no library closures but a saving to the authority of £305,000 a year.[6] This has been achieved through the use of technology, volunteers and the refocussing of staff hours. The new model means:

- the mobile library service and at home service is run by volunteers
- registered library users can access a library, borrow material and use library computers even when the library is unstaffed using card and PIN technology
- staffing hours have been cut from 261 to 149
- staffing hours have been matched to library activities such as reading groups to ensure continuity of service.

Changes are further complicated due to the intricate web of contracts and other commitments that any authority will have. Many services will be provided by contractors and therefore there is a legally binding commitment to a certain level of service relating to a previously specified level of financial commitment. Good procurement and contract negotiation will mitigate the worst excesses around contract change but there is still often a financial penalty around any process of renegotiation.

The CFO's dilemma does not stop when reviewing the nature of statutory services. There is also the hidden cost that has to be taken into account when considering stopping duties that are not statutory. At this point the skills around demand management, forecasting and medium-term financial planning are heightened as it is necessary to question what future impact the removal of certain non-statutory services might have for the long-term sustainability of the organisation.

This moves into the territory of preventative spend where the provision of a service at the current time leads to the reduction in requirement for a more expensive service is a challenging one in the face of budget cuts. The long-term is at great risk however during a time of spending freeze.

Any type of preventative activity not protected by statute is at risk of being removed at a time of austerity. The long-term consequences of stopping the delivery of a service has yet to be identified.

A Section 114 report

When the CFO considers the council is unable to set or maintain a balanced budget it is likely that there will be a discussion within the leadership team concerning a Section 114 report. Such a report is only issued in the gravest of circumstances and is the most serious possible action open to the CFO.

It involves the CFO making a report under Section 114 of the local Government Finance Act 1988. The authority has 21 days to meet and consider the report. During the 21 days the authority must not incur any new expenditure unless the CFO has specifically authorised the spend.

6 https://librariestaskforce.blog.gov.uk/2015/12/21/a-new-way-of-delivering-library-services-in-peterborough

This suspension of spending also triggers external scrutiny from the authority's auditors. However, failure to act when necessary would ultimately result in the council losing its financial independence with its powers transferred to commissioners appointed by government.

The seriousness of the sanction is evident in that no Section 114 report has been issued since 2000. Other strategies and options have been reviewed and compromise and cooperation have avoided the sanction. But these are different times and if it becomes necessary, the CFO must act. By definition, the council concerned will be at a self-evident point of financial crisis and all alternative routes would have been explored.

The issuing of the Section 114 report would be an act of serious and proper financial management for the ultimate benefit of local taxpayers and service users. Government and the sector more broadly need to be encouraged to see it in that context

In an ideal world no Section 114 report would need to be issued. Its deterrent value alone is recognised as very powerful in encouraging certain behaviours as the reputational impact to a council is significant. However, that deterrent is worthless if no one believes the CFO would act.

These are onerous responsibilities that go with the role and status of the CFO in local government and the Institute recognises it has a role in supporting its members through this most difficult of times.

Tipping point

To be at the point where a Section 114 report is a real possibility would suggest that the organisation has failed to heed or act effectively on the warnings of the CFO about the seriousness of the budgetary position. Warnings and conversations that CIPFA would expect to have been taking place at the highest level of the organisation. Facing a difficult financial outlook is not a reason in itself to expect a rush of Section 114 reports.

However, councils facing growing demand for high cost statutory services, such as social care, are recognised to be more exposed than other organisations at the current time. But the financial challenge is real for every council. There are a cocktail of warning signs that could point to some councils not being able to cope. They would typically but not exclusively include:

- a recent history of significant overspends over several years, being covered either by dwindling reserves or a series of short-term measures
- a recent history of failing to deliver savings plans and other cost control measures planned
- late identification of emerging in-year overspend and an understating of its financial impact
- tension and a breakdown of trust amongst the senior leadership of the council.

The role of the CFO

The CFO's role is extensive, and critical in ensuring the local authority as a whole ensures the budget being set is met in practice. They also need to consider how to manage the risks and underlying pressure associated with the proposed budget and any contingency plans required. CFOs also need to provide clear commentary on spending cuts and their implication of future planned delivery.

The CFO needs to be at the centre of the organisation's strategic vision as well as having the technical ability to manage the organisation's finances. CIPFA would argue a broader crucial point about the role of the CFO, recognising that:

> 'No organisation can achieve its goals effectively without proper structures for allocating and optimising the use of resources. The centrality of finance means the CFO must play the lead role in advising and supporting the leadership team in turning policy aspirations into reality by aligning financial planning with the vision and strategic objectives for the authority.'[7]

The CFO would clearly need to understand the consequences of a Section 114 for the organisation. Not only in the short-term with the initial 21 day spending freeze but also the other implications such as the possible intervention from auditors, the media attention and the longer-term effects such as financial and reputational risks. In the past, the issuing of a Section 114 report may have been seen as severely career limiting but the consequences of not when the circumstances demand, is definitely career limiting.

The Hackney experience

When Hackney instigated a Section 114 report in October 2000 the council was heading for a deficit of £15m. In an inspection the Audit Commission, amongst others, concluded they would not be able to balance the budget by the end of the financial year. Despite attempts to balance the budget the council had reached a point whereby it was unable to go any further without additional support. Following the report being issued the Government used its power to intervene under the Local Government Act 1999 and stepped in to address the issues. At the time there was criticism of the councils political leadership and lack of strong management.

A three year recovery plan was agreed with the authority which included such things as cutting back on the use of agency or temporary staff, changing the terms and conditions for a number of key workers, losing 250 jobs, increasing fees and charges in the early years' service and a major restructuring of several service delivery areas. Savings in the first year were due to be in the region of £4.5m which would lead to £18m in year two.

With the recovery plan agreed the Section 114 report was lifted. Progress was to be monitored by the Audit Commission and would happen in three stages. Improvement would include:

- having better political accountability and good financial management
- appointing an effective top management team
- reviewing all services to ensure cost-effective delivery.

7 Role of the CFO (CIPFA) 2015

the new world order but still balanced budgets

We need to consider the legal framework surround the Section 114 in a world where partnerships and shared working dominate the agenda. The framework was written for a very different type of local government with different risks and challenges.

The myth to be dispelled is that high profile and high risk areas like social care, make Section 114 reports obsolete as no one would impose such stringent spending restrictions. It must be recognised that a temporary suspension of spending can still accommodate the need for emergency release of funding which might become relevant for certain services. Participants at the round table discussed the reality that additional spending may be required during this period using the example of vulnerable children. It was recognised that at these critical times the relationship between the CFO and the director of children's services or the director of adult social care will be especially important.

Combined authorities are not new in local government. They operate under the same laws that apply to an individual council including in respect of Section 151 and Section 114. Whilst the combined authority can choose to employ their own, or share a CFO, the legislation surrounding the responsibilities are the same. This includes the requirement around Section 114. It is irrelevant which organisation is the main employer the CFO should issue a Section 114 report if one was required. In the future the operation and action needed within combined authorities will also require close scrutiny.

The new world order does not however change the established wisdom on reserves. Reserves can play a valid but limited part in helping the council steer towards a balanced budget over time. Organisations should use reserves for likely and significant risks and should not lightly waste those reserves propping up their day-to-day budgets. Organisations would also need to consider how they would be able to replenish reserves that had been used – a task that becomes increasingly challenging in the current financial landscape.

'The current budget for 2015-16 envisages reductions of £117m – a figure that would have been higher but for debt rescheduling and dipping into reserves.'[8]

Sir Albert Bore, Birmingham City Council

8 Ft.com/UK December 14, 2014,12.14pm Birmingham council reels amid scathing management report

\ in conclusion

It is unsurprising that CIPFA has identified an increasing number of CFOs concerned about the ability to fund services in the coming year. The reduction in income has not included any significant reduction in the requirement to deliver statutory services. This means that funds are stretched to pay for even the minimum of requirements meaning services either have to be cut, income rises or councils find better ways of managing funding strategies in the future. Commonly a combination of all three of these activities needs to be in place to balance the budget.

Even these may not be sufficient to balance some of the budgets where statutory demand outstrips income. At this point we should at all cost avoid blame and recrimination and act in a collaborative way to tackle the challenges. Everyone has a role to play. This message must be communicated clearly throughout the organisation and to all relevant stakeholders. The CFO will be at the centre of this activity but it needs to be remembered that they have that unique statutory duty in respect of the local authority budget. Local authorities must be prepared to scrutinise behaviours and actions in light of the advice received and consider the most appropriate response.

Acting on their statutory duty should not lead to demonising the CFO, the consequence of not fulfilling that duty will be even worse for all concerned. However, the highest sanction of a Section 114 report should be the last option but one definitely applied against defensible professional judgement if all other tactics have failed.

The Chartered Institute of Public Finance & Accountancy

Registered office:
77 Mansell Street, London E1 8AN
T: +44 (0)20 7543 5600 F: +44 (0)20 7543 5700
www.cipfa.org

INVESTORS IN PEOPLE

04/2016