Local Authority Finance

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Overview

A period of rising interest rates and economic shocks often expose financially vulnerable institutions. With a growing number of local authorities declaring bankruptcy since rates began to increase, an evaluation of local government finances is needed to understand whether these were exceptional cases, or the start of a worrying trend of insolvency in one of the most important providers of public services; the analysis provided in this briefing note suggests more evidence for the latter than the former.

This briefing note explores how local authorities financial pressures started building from a fall in funding and increase in service demand over the 2010s, and how some invested in infrastructure projects in the hope that they would replace falling central government funding through the 2010s. We then evaluate the consequences of the debt needed to finance these projects and to whether this will be made worse by higher interest rates.

Key findings

- **Local authorities have seen £80 billion fall in net worth since interest rates started to rise in late 2021**: this is the largest fall in net worth since records began and is driven by a growing cost of debt.

- **Local authority debt has nearly doubled since 2010:** the use of loans has been building substantially since 2010 as many invested in capital to meet future financial shortfalls by taking out loans with comparatively low rates.

- **Rising interest rates will be pushing many local authorities into a debt crisis**: the average interest on this debt has broadly doubled since the Bank started raising interest rates.

- **On average 15 per cent of all Local Authority budgets is being spent on debt interest payments**: worth £3.2 billion a year.

- **Local authorities lost 60 per cent of government funding between 2010 and 2020**: this has driven a 40 per cent fall in overall spending power.[1]

[1] As we explore below, some of this has been replaced by other sources of funding

Summary: A decade of debt is catching up

Local Authorities throughout the 2010s adapted to the era of austerity by cutting staff and services (Hoddinott, 2022). In addition to this, they took advantage of historically low interest rates to finance large scale investments in residential and commercial property as one tool to combat funding challenges by generating future revenue.

At the time of writing, local government loans stand at over £100 billion (ONS, 2023).

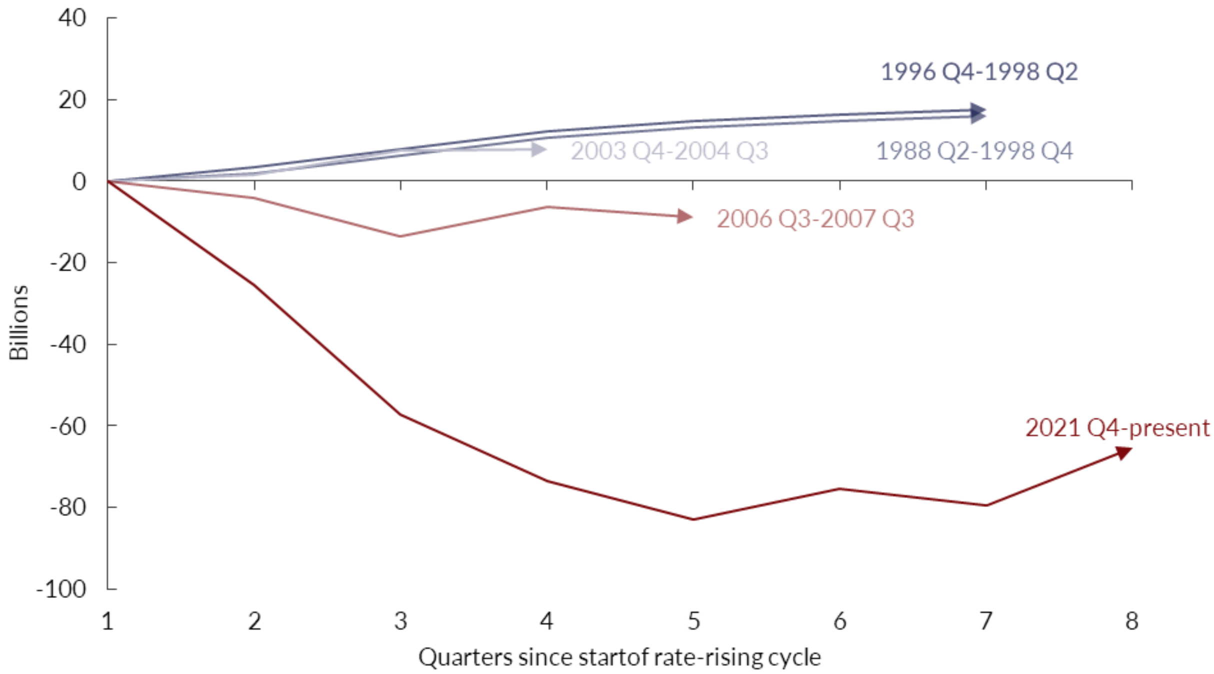
Local authority funding was brought to national attention in 2018 when Northamptonshire County Council issued a section 114 notice (declaration of insolvency/bankruptcy), becoming the first council to do so in 18 years. This would be the ‘canary in the coalmine’ moment: since then ten section 114 notices have been issued (Atkins &Hoddinott,2020). Comparatively low-cost loans enabled local authorities to finance a switch to a self-sustained funding model during the era of austerity, however for many it was not enough.

As the Bank of England (BoE) began raising interest rates in the fourth quarter of 2021, those local authorities who had taken on debt as one of a number of tools to adapt to falling funding levels faced a new financial challenge. Those authorities who need to renew their debt (in a similar way to households refinancing mortgages) are seeing their interest payments doubling on average.

We find that this interest rate rise cycle is hitting local authorities harder than any other since records began. The financial net worth of local government (Figure 1) has fallen by around £80 billion since the BoE started raising interest rates.

Figure 1: Change in Local Authority Net Worth (Assets minus Liabilities)

Local authorities have seen the largest fall in net-worth during this rate-rising cycle. 1988-2024



Notes: rate rising cycles is defined as consecutive quarters of increases in interest rates.
Source: Author’s analysis of ONS, National Accounts

Key term: Net Worth
Local authority Net worth is the value of all the non-financial and financial assets owned (such as new capital projects) minus the value of all its outstanding liabilities (such as the debt taken on to finance the capital projects).

Debt as a tool to combat the funding pressures of the 2010s may now be the very source of funding pressures for the 2020s. We further find that authorities are spending a record amount of their budgets (core spending power) just servicing this debt, at around 15 per cent (£3.2 billion in total per year).

Falling funding and increasing service demand

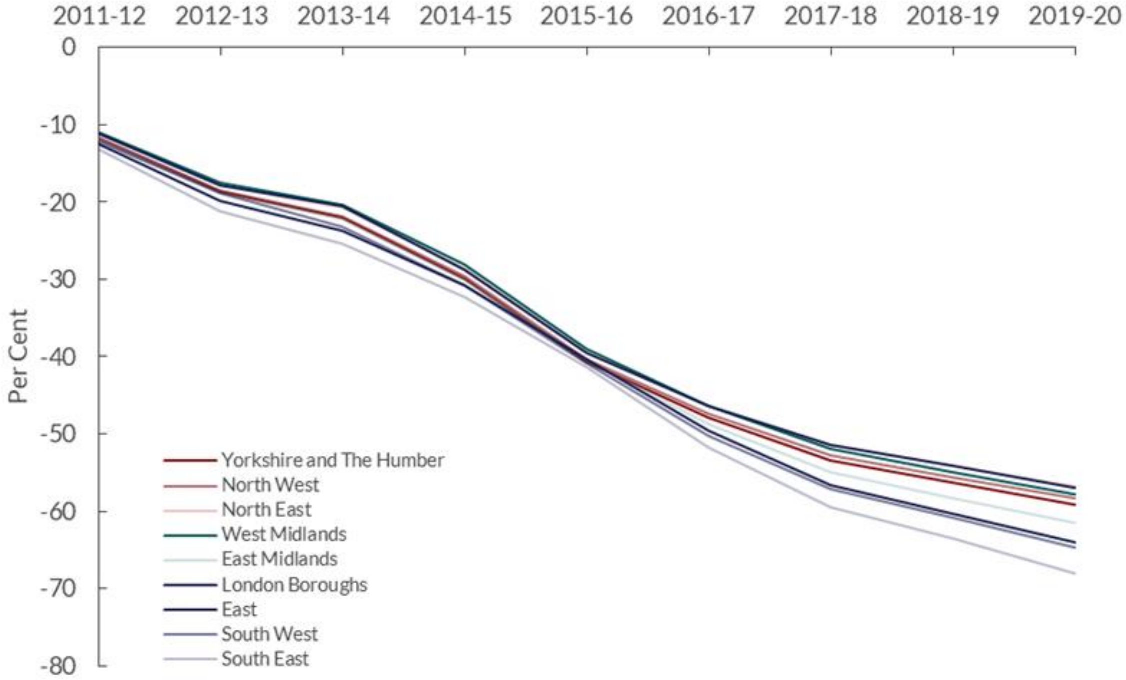
Local authorities receive their funding from central government (known as formula grants or 'core funding'), specific grants and/or through council tax. Government grants (or formula grants) include a Revenue Support Grant and redistributed business rates.

Key term: Core Funding
Local authority core funding is the total amount of funding received from central government. Local authorities receive further funding raised through council tax or from ring-fenced grants from central government, but core funding refers to unrestricted funding provided to local authorities.

As of the 2012 Local Government Finance Act, local authorities keep 50 per cent of their business rates, with the other half going to central government which is then redistributed back to local authorities through government grants. These are adjusted based on the financial position of the local authority, where a tariff is applied to councils deemed to need less than more financially challenged local authorities who receive a top-up. These grants are not ring-fenced so can be spent on day-to-day council business and as of 2019-20 represented around 40 per cent of local authorities' total funding. Government grants were cut by 60 per cent real terms on average for local authorities from 2010 to 2019 (Figure 2).

Figure 2: Regional Change in Local Authority Core Funding 2010 to 2020

All regions have seen some fall in core funding since 2010



Notes: Core funding defined as formula grant (including Revenue Support Grant, redistrubuted rates and police grants), figures do not include council tax or other specific grants. All figures are real using 2016-17 prices.
Source: London Councils, Core Funding and Spending Power Change (2020)

In addition to core funding, councils receive specific grants (ring-fenced money) and council tax receipts. Specific grants are dedicated to 'national priorities', such as education. These grants on average represent around 20 per cent of local authority funding, however these funds are passported through local government who don't realise this cash in reality.

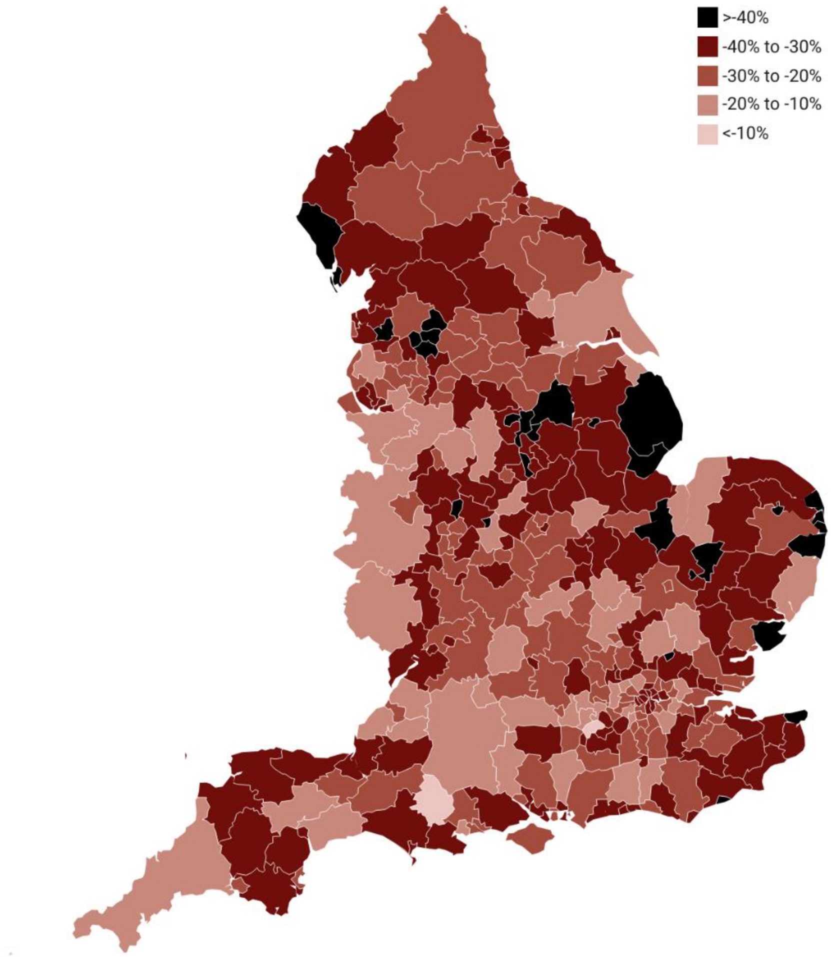
As two of the three main funding sources are determined by central government grants, this leaves council tax as the main mechanism by which local authorities can affect their spending power. However, since 2010 a number of reforms have been implemented which have placed new limits on the amount by which local authorities can raise council tax. Under the new policy, council tax can only rise beyond a certain threshold if the local authority holds a referendum. This threshold was initially 2 per cent but rose over the years to 4.99 per cent as of 2024 for local authorities responsible for social care (for district councils without this responsibility their limit is 3 per cent).

Key term: Spending Power
Local authority spending power is a combination of formula grants, specific grants, and council tax.

With constraints on raising council tax and falling formula and specific grants, overall local authority spending power has fallen sharply since 2010 (Figure 3). The largest driver behind this is the fall in formula grants.

Figure 3: Changes in Local Authority Spending Power, 2010 to 2020

All local authorities have seen some fall in spending power since 2010

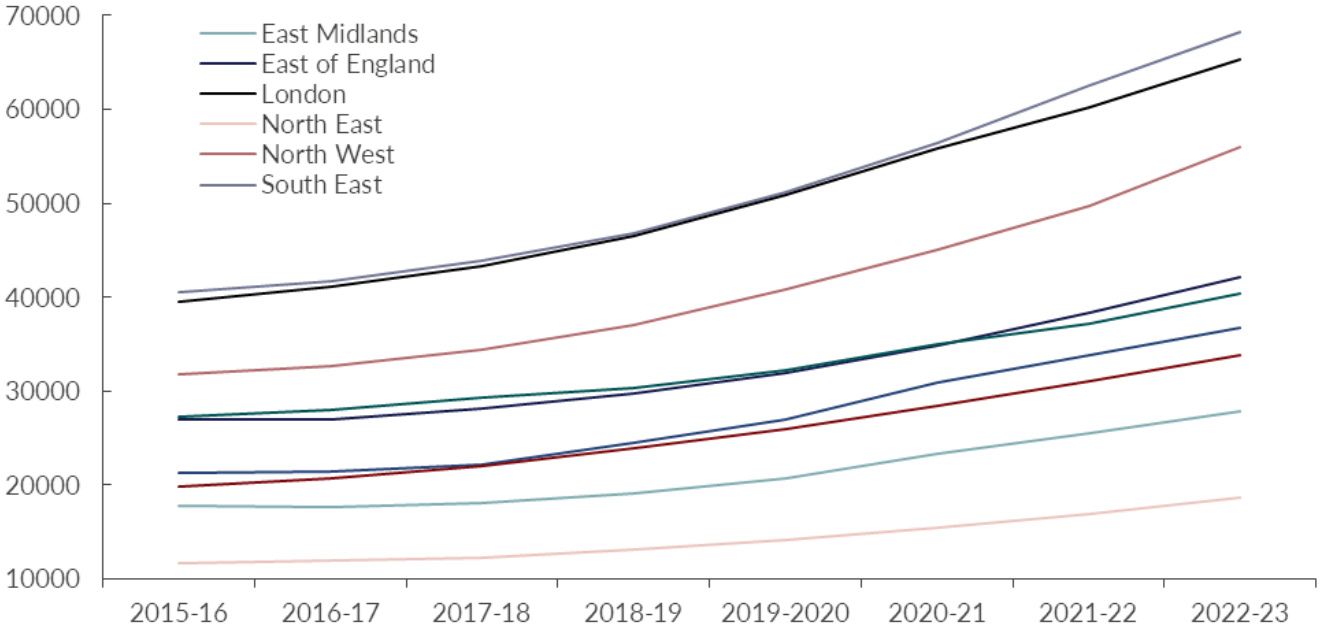


Source: Author's analysis of London Councils, Core Funding and Spending Power Change (2020)

While funding has been falling, local authority service demand has kept growing with changes in demographics. As the population naturally grows, so does the demand for local authority services. As an illustration, local authorities are financially responsible for financing support for children with Special Educational Needs and Disabilities (SEND). Though central government provides specific education grants that are intended to cover the costs of SEN support through high needs block allocations. However, the number of SEND children needing support has risen dramatically. Between 2015 and 2023, the number of SEND children on an Education and Health and Care plan (EHC) – which is a legally recognised document identifying specialist needs – rose by 64 per cent across the UK (shown by region in Figure 4)

Figure 4: Children with an EHC Plan 2015-16 to 2022-23

All local authorities have seen an increase in children with special educational needs



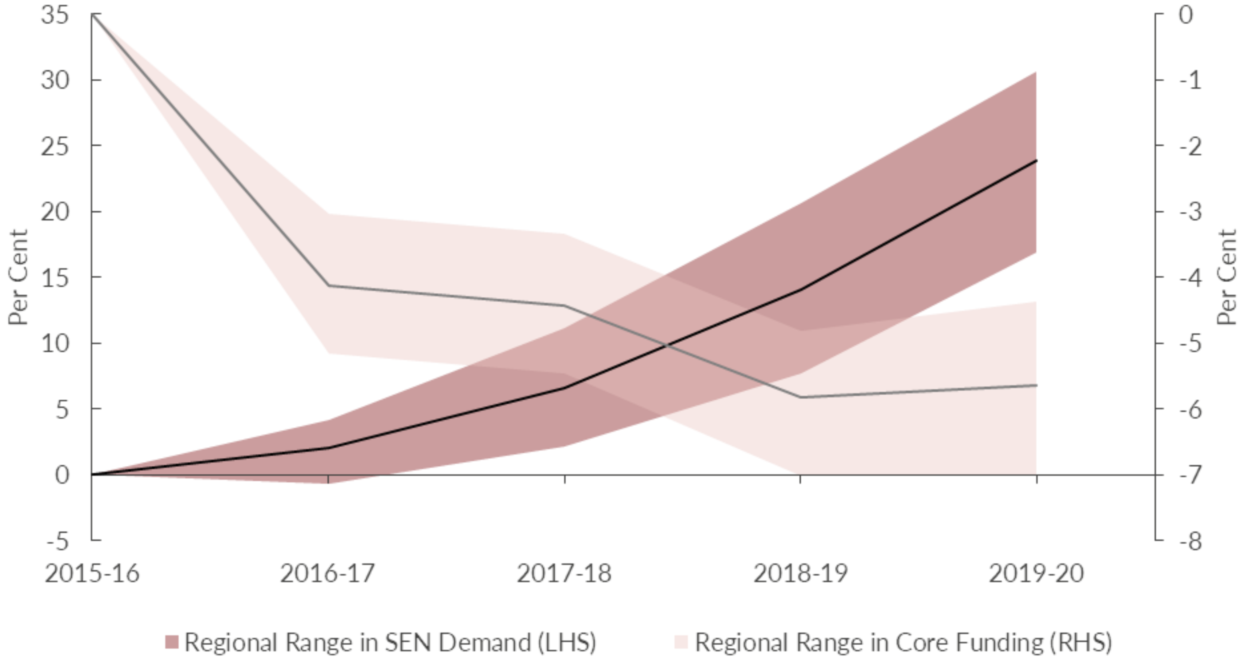
Notes: Data includes state-funded nursery, primary, secondary and special schools, non-maintained special schools, state-funded alternative provision schools and independent schools. EHC plans also include statements of SEN which were phased out from 2014 to 2018. Figures include independent schools and general hospital schools.
Source: Author's analysis of DfE, Special educational needs in England

Many local authorities have, however, identified that the funding allocated is not sufficient to cover the increase in service demand. A study by the Local Government Association (LGA) found that many local authorities supplement high needs block allocations with other funding sources, such as Dedicated Schools Grant (DSG) reserves, local authority reserves or general core funding; they found that £547 million additional funding had been transferred into to support the high needs block between 2015-16 and 2018-19 (Parish et al, 2018).

Should a local authority not transfer other funds to cover the gap between block allocation and SEND demand and instead enter into an overspend on their education funding, then they face being placed under a 'safety valve agreement' with the Department of Education. This agreement provides those local authorities with an overspend with additional funding. In exchange for this financial assistance, the local authority must agree to reduce their spending on provision for children and with SEND to prove deficits will not increase again.

Figure 5: Changes in SEN Demand and Core Funding Since 2015-15

As core funding has fallen, demand for services has increased



Notes: Data includes state-funded nursery, primary, secondary and special schools, non-maintained special schools, state-funded alternative provision schools and independent schools. EHC plans also include statements of SEN which were phased out from 2014 to 2018. Figures include independent schools and general hospital schools.
Source: Author's analysis of DfE, Special educational needs in England and London Councils, Core Funding and Spending Power Change (2020)

As of March 2024, the Department of Education lists 38 local authorities with a safety valve agreement (DfE, 2024), with many describing the scheme as effectively 'rationing' the provision of EHC agreements. We summarise this trend in increasing demand and falling funding in Figure 5, which shows the rise in EHC plans next to fall in core funding, which is frequently used to fill funding shortfalls for such SEN support schemes.

Debt

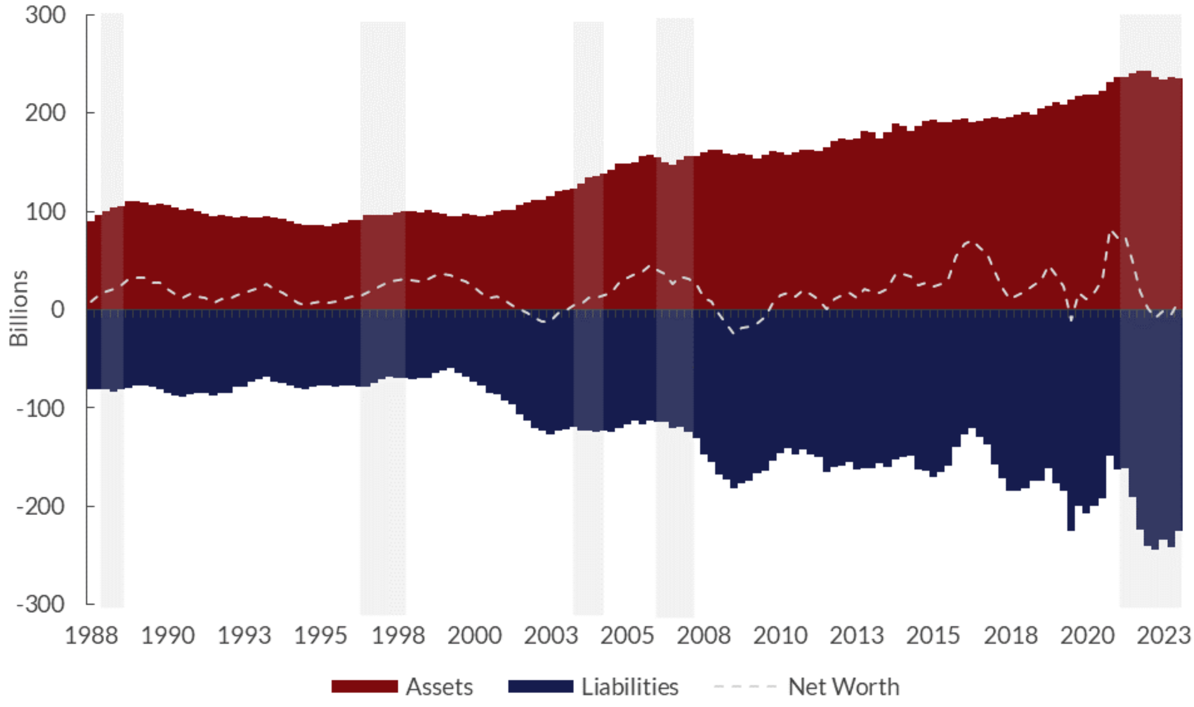
By taking a longer view at local government net worth (Figure 6), we can see that both assets and liabilities have been growing steadily since the introduction of the 2003 Local Government Act and the accompanying 2003 Capital Accounting regulations (commonly referred to as 'the code'). This gave local authorities a framework whereby they could borrow to invest in capital projects, which typically has been commercial and residential property developments. The prudential regime has given local authorities responsibility for their own financial decisions; however it stipulates that borrowing should not only be for financial return. Prudential borrowing steadily grew as a percentage of local government borrowing, from 15 per cent in 2005 to 43 per cent by 2020-21 (Standford, 2023).

Naturally, liabilities grew which drove a short dip in net worth. As this debt was paid off and the associated investments began to return income, the value of assets rose, bringing the total net worth back to positive. While funding became more limited after 2010, little to no impact on net-worth can be observed.

The reason for this is likely because of the returns generated from these developments by the previous spur in local government investment following the introduction of the 2003 local government act. Put simply, the effect of future funding challenges was likely dampened by previous capital investments.

Figure 6: Local Authority Net Worth (Assets minus Liabilities), 1987 to 2023

The latest fall in net worth is driven by a substantial increase in liabilities since 2010.



Notes: Data is quaterly, shaded areas represent interest rate rising cycles
Source: Author's analysis of ONS, National Accounts

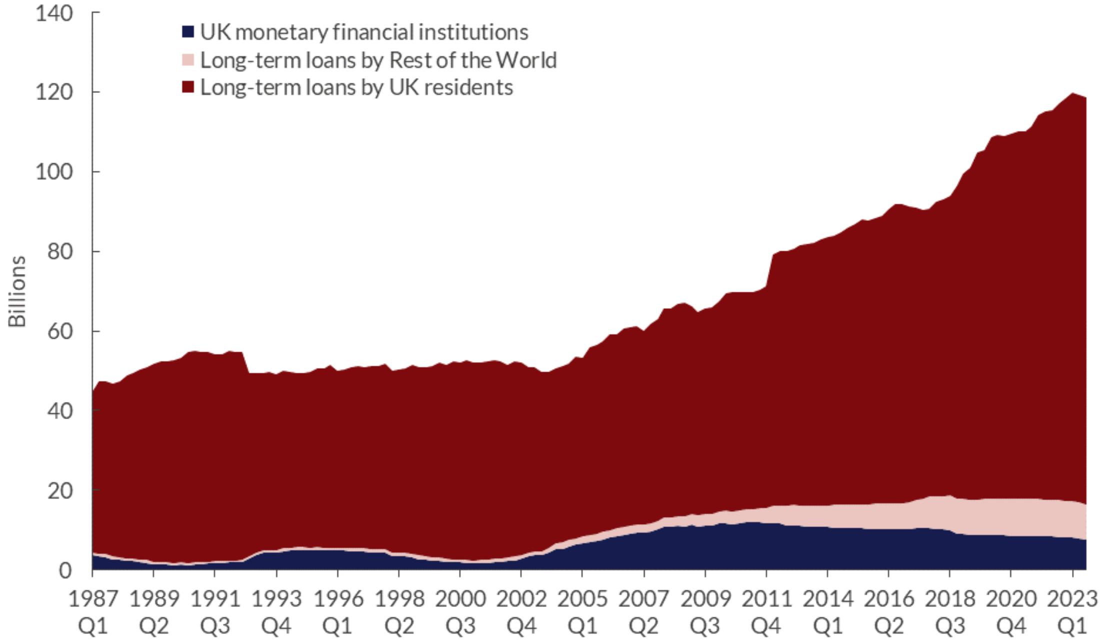
Once those funding challenges took hold, we can observe a steady rise in long-term loans (Figure 7). Given the success of the previous formula of capital expenditure today equals returns/savings tomorrow and with the creation of more formalised structure for loans, it is likely that local authorities chose to further increase investments as a strategy to adapt to ever diminishing core spending power in order to create a more self-sustaining structure.

We know this strategy was central to Croydon Council, who would later be heavily criticised by auditors for attempting to *"invest its way out of financial challenge rather than pay attention to controlling expenditure on core services"* (Grant Thornton, 2020) as it eventually issued a section 114 notice. A report by the National Audit Office in 2020 identified 49 out of 352 local authorities as spending 80 per cent of all commercial spending in local government (NAO, 2020), which would imply this strategy is localised. To what extent others have taken this approach since remains unclear at this stage.

Overall, this switch to a more self-sustained financial model by financing property developments can be observed clearly in the growth in home building after 2010-11 (Figure 8). Before 2010, just 0.1 per cent of all homes built were built by local authorities. This number jumps to 1.5 per cent between 2010 and 2023.

Figure 7: Local Authority Liabilities by Type ,1987-2023

The rise in liabilities is driven most by an increase in loans from 'UK Residents' (PWLB)

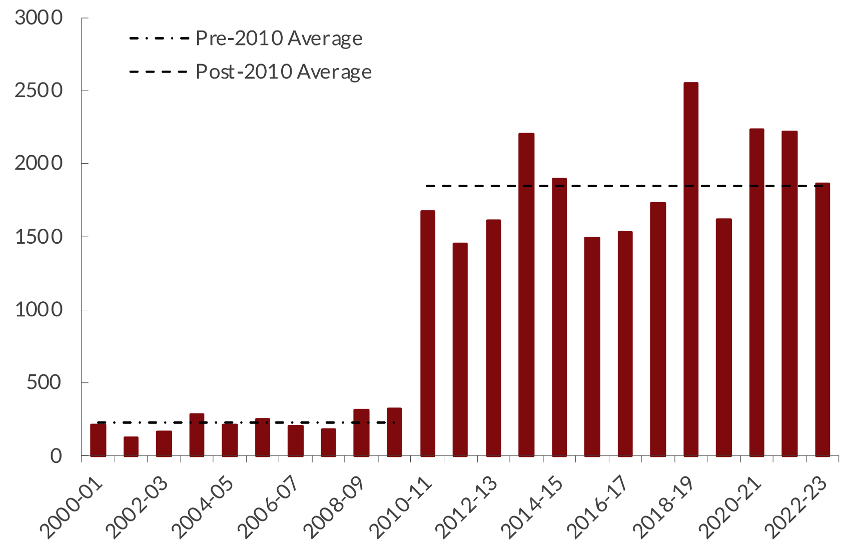


Notes: other liabilities omitted due to insignificance
Source: Author's analysis of ONS, National Accounts

Prior to the 2008-09 financial crisis, loans from UK monetary financial institutions were the most popular source of debt. This switched to loans from the Public Works Loan Board (PWLB) after 2010[2].

Figure 8: Homes Built by Local Authorities, 2000-01 to 2022-23

Local authorities began building more homes after 2010.



Source: Author's analysis of ONS, permanent dwellings started and completed by country

Throughout 2010, new forms of debt were created and/or formalised into a new framework for local authorities. Examples include municipal bonds that are provided through the UK Municipal Bonds

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[2] This is described in the National Accounts as 'long-term loans from UK residents'. Given this stands at around £96 billion, and total PWLB loans stands at £96.2 billion, it is therefore the government that is financing these loans rather than municipal bonds (also known as a community municipal investment), contrary to what the label would suggest.

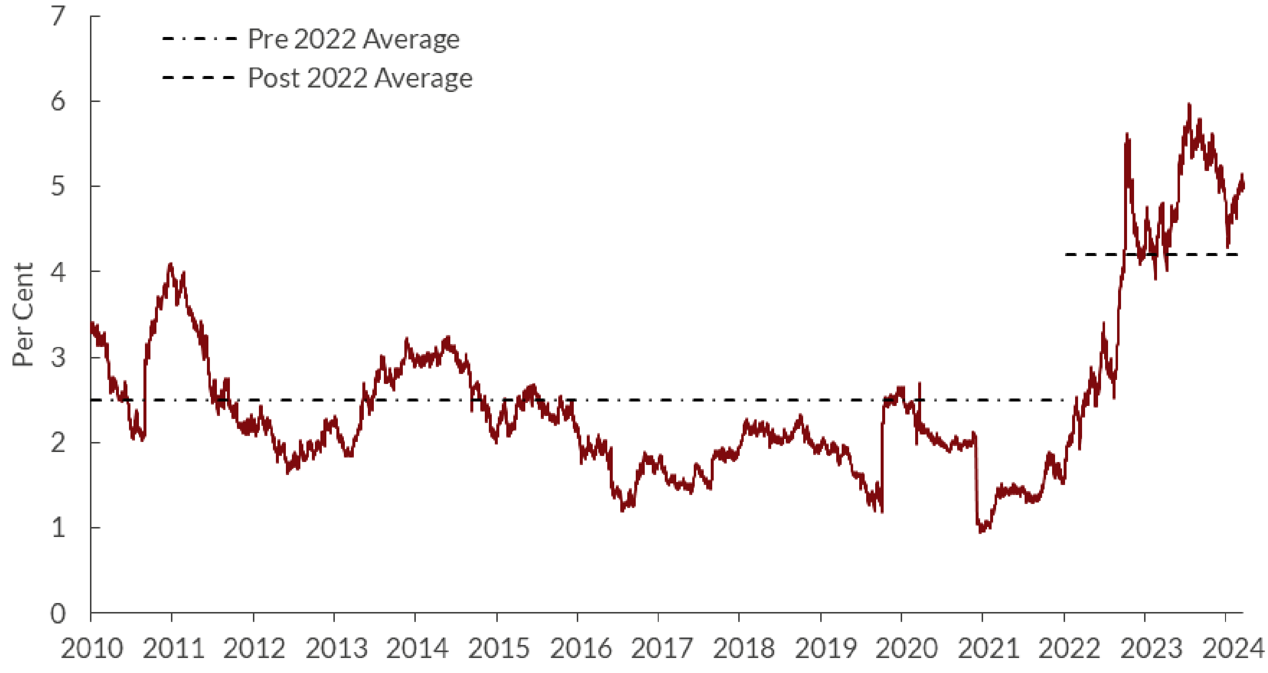
Agency (UKMBA), which was created in 2014 and is now subsumed into the UK Debt Management Office as part of the HM Treasury. These loans have broadly similar rates to the PWLB but can be cheaper should the applying local authority have a favourable credit score.

Community Municipal Bonds (CMB) are a new funding source, which involves crowdsourcing funds from residents who contribute modest amounts and receive regular returns from the project for (often green) investments. Debt is then issued based on this structure at a more favourable rate than would be charged by the PWLB. At the time of writing, no CMB worth more than £1 million has been attempted yet.

The overall cost of debt through the 2010 period was historically low, as interest rates remained constrained at the zero-lower bound. Naturally, the interest charged by the PWLB to local authorities (Figure 9) was similarly low. The average interest charged for a 10-year loan was around 2.5 per cent between 2010 and 2022. From 2022 onwards, this rose to an average of just over 4 per cent as a result of rising interest rates.

Figure 9: Average Interest Rate Charged to Local Authorities, 2010 to 2024

The PWLB have increased the rate charged to local authorities since the Bank of England started raising rates.



Notes: Figures based on an average 10 year loan from the Public Works Loan Board
Source: PWLB

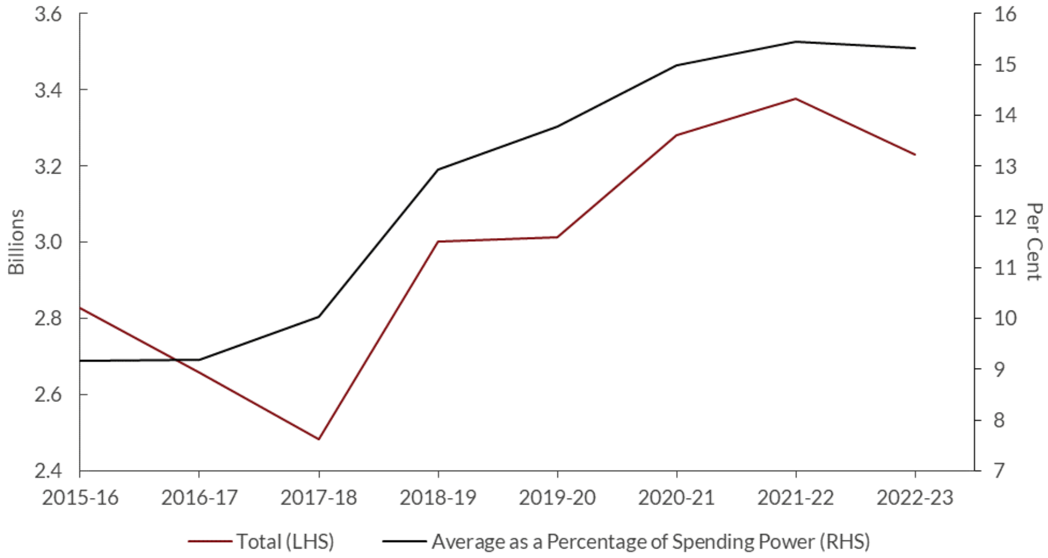
The latest data takes this level to over 5 per cent, which is double what local authorities were spending just a few years ago. The consequences of rising interest charged on loans are that future projects become more expensive and local authorities have to pay more for their existing debt.

We can see by comparing reported debt servicing costs in revenue outturn data and estimates of Core Spending Power that local authorities are spending more of their budgets on debt interest costs, which stand at around 15 per cent of their budget on average (Figure 10).

It is important to note though that this has been rising for some time and is not exclusively driven by the rising cost of debt. However, this trend will continue to worsen as debt becomes more expensive.

Figure 10: Change in Debt Servicing as a Percentage of Core Funding between 2015-16 and 2022-23

Local authorities have steadily increased the proportion of their budget spent on debt interest costs since 2015-16.



Notes: debt servicing costs defined as payments for both 'provision for repayment of principal' and 'interest payable and similar charges' found in Revenue Outturn Summary data. This is in line with Office for Local Government (Oflog) definition found in their local authoirity corporate and finance dashboard.
Source: Author's analysis of ONS, Revenue Outturn Summary and DLUHC, Core Spending Power, various years

Conclusion

It is clear that the debt crisis developing in local government will be slowly pushing many local authorities to the brink of bankruptcy, and that the few who have already done so are not exceptions to the rule that local authorities always find a way to survive difficult financial periods, but proof that this rule may not survive into the 2020s.

A trend of local authorities declaring bankruptcy just as a new government is sworn in will be an unenvious image for any government in any country. A considerable amount of reform and money will be needed to make sure that it is not this one.

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