Policy briefing: Addressing the local authority financial crises

Lyons, Matthew; Kratena, Kurt

Citation for published version (Harvard):
Lyons, M & Kratena, K 2024, *Policy briefing: Addressing the local authority financial crises*. University of Birmingham.

UNIVERSITY OF BIRMINGHAM | CITY REDI

Policy briefing: Addressing the local authority financial crises

September 2024

Dr Matt Lyons

Prof Kurt Kratena

We advance
We activate

birmingham.ac.uk

Summary and policy recommendations

There is increasing concern about the financial viability of some local authorities with estimates by the LGA suggesting that councils in England are facing a funding gap of £4 billion (1, 2). English councils are under increasing financial pressures with 1 in 9 fearing a section 114 notice (effective bankruptcy). Councils have limited levers to pull to respond the address the funding shortfall. The main levers are to rise council tax, to cut spending on goods and services or to cut transfers to households. This policy briefing analyses the distributional impact of the actions proposed by the Birmingham City Council in 2024/25 and 2025/26 to address its £300m budget deficit.

The policy briefing considers how different household groups are likely to be impacted by the potential policy responses to address the deficit using an economic model - the SEIM-UK (3). The briefing seeks to provide local governments with the evidence to make better policy decisions.

The analysis finds that all actions tend to hit households on lowest incomes the hardest. However, the impact of council tax rises are found to be the least regressive option.

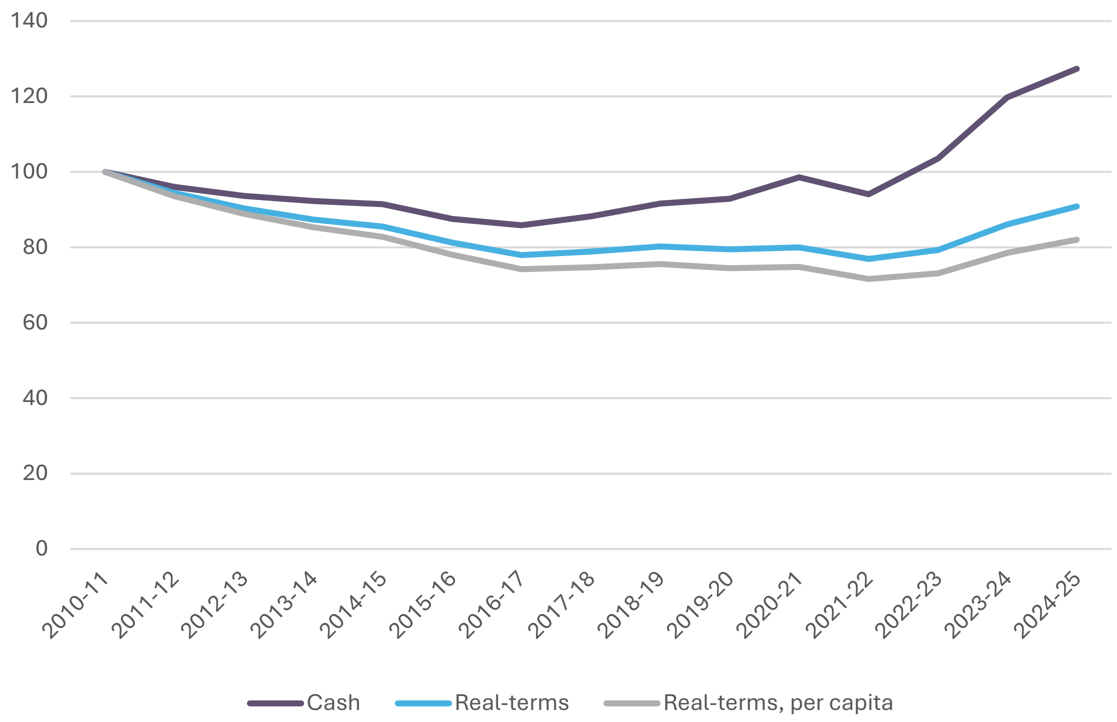
Policy recommendation: Local Government should consider the distributional effect of their actions to address funding crises. Our analysis suggests that council tax rises may be the least regressive option.

Policy context: Local government budgets under pressure.

Local government budgets have been under pressure since 2010 with real terms and real terms per capital funding in 2024-25 9% and 18% below 2010 levels respectively (**Figure 1**). At the same time councils have seen cost increases outpacing inflation. The IFS (9) report that the number of homeless households in B&Bs doubled from 2019 to 2023, the cost for children's home places increased by 20% (2019-20 to 2022-23) and, the cost of care home places for over 65s increased by 35% (2019-20 to 2023-24). These cost increases and some specific local issues have led 6 councils to issue section 114 notices (effective bankruptcy) and a further 29 councils to use 'capitalisation directions' to bolster poor finances.

The financial pressures will mean councils will have to consider the levers they have to reduce budget deficits. The two main levers councils have are to raise income through council tax rises or to reduce outgoings through spending cuts. Both options will have negative consequences for different groups in society, this policy briefings seeks to understand what these harms might be and what options might be the least regressive.

Figure 1. Cash and real-terms core council funding and funding per person (2010–11 = 100)



Source: Institute for Fiscal Studies (9)

Regional context: the financial crisis in Birmingham city council

The Birmingham City Council is the largest lower level council in Europe and one of the most high profile examples of the financial crisis impacting English councils. In 2023, Birmingham City Council (BCC) was served a section 114 notice. This means that effectively the council ran out of money. In short, BCC needs to raise £300m to fulfil is budget deficit over 2 years. The ways in which this 'financial hole' is addressed will impact some households more than others.

The BCC have announced council tax rises and a collection of spending cuts to different areas to address the £300m shortfall. Council tax rises have been announced and take the form of a 9.99% rise (4) in 2024-25 and again in 2025-26. Those households on low incomes – around 75,000 households (5) out of the 461,000 households in Birmingham - will be exempt from the council tax rises.

Spending cuts (6) are not fully detailed yet but early announcements include:

- Dimming of street lights (saving £1m per year)
- 600 job cuts in local government
- Reduced frequency of waste collection
- Spending cuts on highways (saving £12m annually)
- Adult social care to be cut £23.7m from a total budget of £471m
- Children's Young People and Families department will be forced to find £51.5m in savings
- Renegotiating children's travel contracts could also save £13m a year

Analysis: Modelling the BCC Crisis

The SEIM-UK a model developed by City-REDI allows for the simulation of changes to the regional economy. By simulating different policies or shocks (positive or negative) we can gain an understanding of how regions and households can be impacted.

We estimate the BCC will have to raise £300m over two years and based on what has been published so far (above), we estimate the money will be raised through three avenues"

- £130m will be raised through council tax rises.
- £81m will be saved through reductions in council spending.
- £88m will be saved through reductions in social care spending.

We input these changes into the SEIM-UK in three ways@

i) We incorporate the council tax raises through altering the effective tax rate for different household groups.
ii) We incorporate the cuts in council spending that relate to goods and services as reductions in public consumption.

iii) We incorporate the cuts to social care through reduced government transfers.

What is the potential impact on household groups?

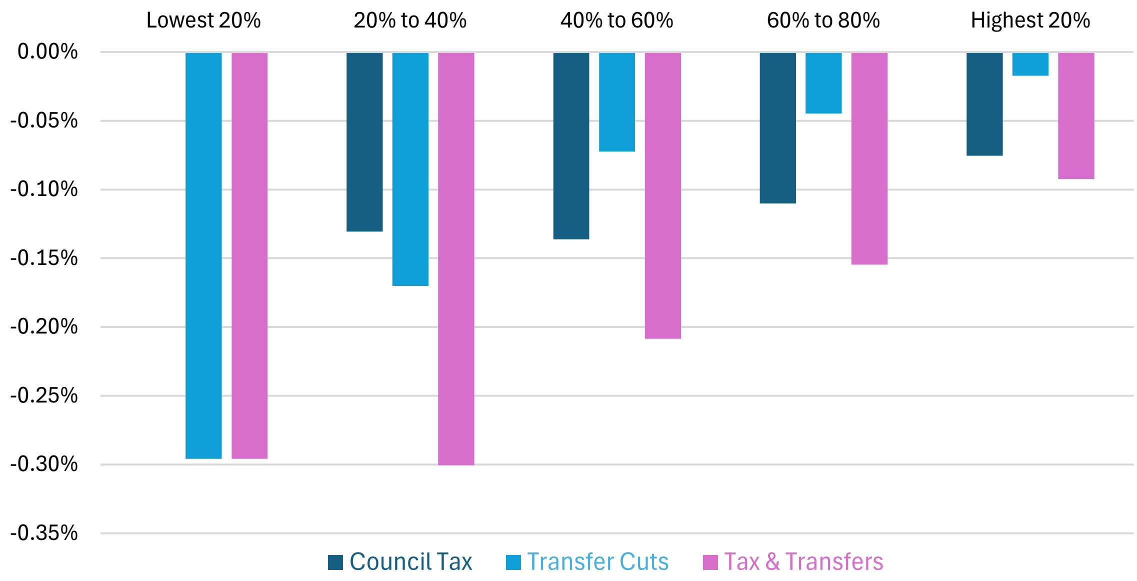
Using the SEIM-UK economic model we estimate the impact of these cuts and tax rises on household groups by income quintile.

Figure 2 shows the impacts on real incomes. What we observe is council tax rises most impact those with incomes in the 40% to 60% quintile, representing those who earn between £32,300 and £43,500. The impact is closely followed by those in the 20-40% quintile. The analysis shows that those on the lowest incomes (below £14,000) are effectively protected from this rise while, at the same time, those on highest incomes (earning over £43,500) are least impacted.

Transfer cuts refer to reductions in government social welfare payments, in this case cuts to social care spending. The modelling shows the impact of transfer cuts is disproportionately felt by those in the lowest two income groups, especially those with incomes below £14,000.

Taken together the analysis indicates the BCC crisis is likely to be most heavily felt by those on lower incomes. With those on lowest incomes observing a small but significant drop in incomes -0.30% against those on highest incomes who observe just a -0.09% fall.

Figure 2. Direct real income impact, council tax & transfer cuts by household income group



Source: SEIM-UK

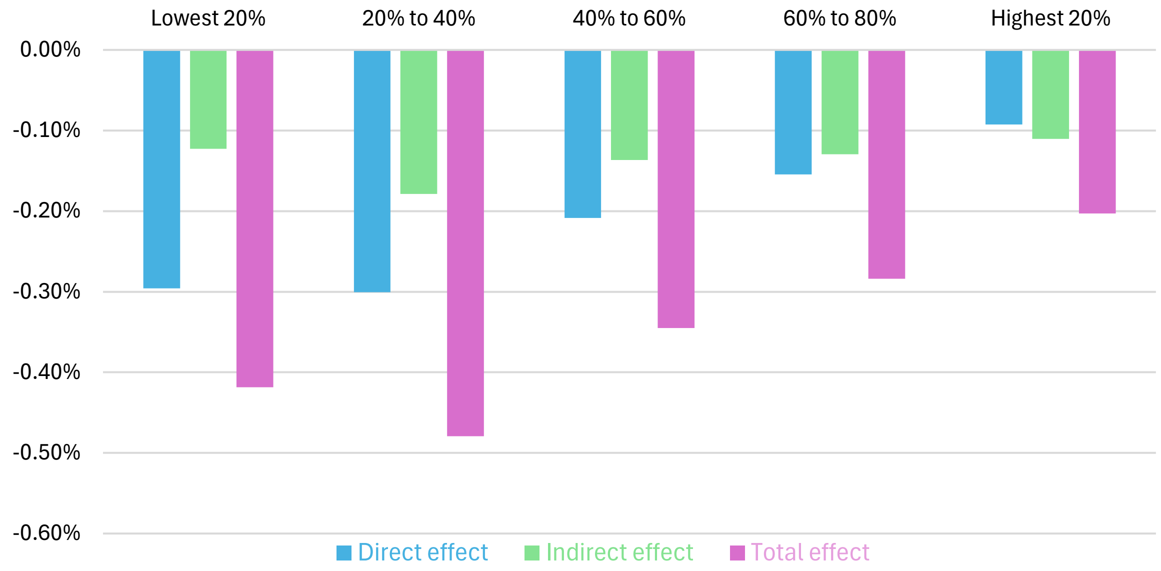
Figure 3 separates out the impact of these changes into direct, indirect, and total (direct + indirect). Unlike figure 1, figure 2 also includes the impact of public consumption cuts i.e. a reduction in government spending on goods and services for public use.

When we consider the additional impacts of public consumption cuts and the indirect impacts unsurprisingly, we see all income groups see further falls in incomes. Perhaps more surprisingly, we find that the lowest income group is no longer the biggest loser.

Figure 3 shows that those in the lowest income group see incomes fall -0.42% but the second lowest quintile (20% to 40%), representing those with incomes between £14,500 to £23,500 see incomes fall further still, by-0.48%. This is due to the relatively greater exposure to indirect impacts generated by other quintiles.

As we go up the income quintiles, we observe the indirect impact makes up a relatively higher share of the overall impact until in the highest 20% the indirect impact is greater than the direct impact. This reflects well established findings that the spending of low income-households generates a significant income increase for higher income households, who – in turn – spend proportionally less of this income increase, thereby generating only a small income feedback for low income-households. This mechanism also works for income decreases and is responsible for the relatively high indirect impact on the top earners.

Figure 3. Direct, indirect and total real income impact of tax rises, transfer and public consumption cuts*



*Note: Unlike Figure 1, Figure 2 includes the impact of public consumption cuts

Source: SEIM-UK

Modelling results indicate that the BCC crisis will have significant and negative impacts for households across income groups.

One might assume that the poorest will be hit hardest by tax and fiscal shocks. The results show more nuance than this – indicating that while lower income households are hit harder than higher income households it is those with incomes of £14,500 to £23,500 that will be the most impacted seeing their real incomes fall -0.48%.

The cuts to public consumption and transfers are likely to have further compounding negative effects not captured by the modelling. The impact of cuts to Children's Young People and Families department will mean less money for services such as parental education, children's mental health, nutrition, and other important services. Birmingham is also in a homelessness crisis (7) – the financial crisis in the BCC will mean the council has less resources to respond, potentially further worsening outcomes for those most vulnerable in the city.

After years of austerity and cuts to council budgets what is clear is this is not just an issue for the BCC. According to a survey by the Local Government and Information Unit 9% of councils surveyed were likely to declare effective bankruptcy in the next 12 months (8).

As more councils come under financial pressure increasingly councils will have to decide how to deal with their deficits. What our analysis shows is that both spending cuts and tax rises will negatively impact households especially those on lower incomes. However, it also shows that council tax rises are a *less* regressive way of addressing the budget deficit than transfer cuts.

Financial crises in local government are likely to be an on-going challenge for the new Labour Government who may see council tax rises as the least worst option.

Policy recommendations

Policy recommendation: Local Government should consider the distributional effect of their actions to address funding crises. Our analysis suggests that council tax rises may be the least regressive option.

Sources

1. Local Government Association. Local government finances and impact on local communities. *Local Government Association* [Internet]. Available from: https://www.local.gov.uk/parliament/briefings-and-responses/local-government-finances-and-impact-local-communities
2. Levelling Up, Housing and Communities Committee. Government must tackle £4bn council funding gap or risk severe impact to services and council finances, say MPs. *UK Parliament* [Internet]. Available from: https://committees.parliament.uk/committee/17/levelling-up-housing-and-communities-committee/news/199671/government-must-tackle-4bn-council-funding-gap-or-risk-severe-impact-to-services-and-council-finances-say-mps/
3. Birmingham Business School. Socio-economic impact model for the UK. *University of Birmingham* [Internet]. Available from: https://www.birmingham.ac.uk/schools/business/research/research-projects/city-redi/socio-economic-impact-model-for-the-uk
4. Calnan S. Birmingham £1.2bn support and 10% tax rises to balance budget. *LGC* [Internet]. 2024 Feb 20. Available from: https://www.lgcplus.com/finance/birmingham-1-2bn-support-and-10-tax-rises-to-balance-budget-20-02-2024/
5. BBC News. UK councils struggle with funding as cuts deepen. *BBC News* [Internet]. Available from: https://www.bbc.co.uk/news/uk-68476173
6. City-REDI. West Midlands Economic Impact Monitor 23 Feb 2024. *University of Birmingham* [Internet]. Available from: https://blog.bham.ac.uk/cityredi/wp-content/uploads/sites/15/2024/02/West-Midlands-Economic-Impact-Monitor-23-Feb-24.pdf
7. Birmingham Business School. Britain the world's worst on homelessness: What about the West Midlands? *City-REDI Blog* [Internet]. Available from: https://blog.bham.ac.uk/cityredi/britain-the-worlds-worst-on-homelessness-what-about-the-west-midlands/
8. Butler P. Nearly one in 10 English councils expect to go bust in next year, survey finds. *The Guardian* [Internet]. 2024 Feb 28. Available from: https://www.theguardian.com/society/2024/feb/28/nearly-one-in-10-english-councils-expect-to-go-bust-in-next-year-survey-finds#:~:text=Eight%20English%20councils%20have%20declared,attempt%20to%20stave%20off%20insolvency
9. Institute for Fiscal Studies. How Have English Councils' Funding and Spending Changed? [Internet]. 2024 Jun [cited 2024 Aug 20]. Available from: https://ifs.org.uk/sites/default/files/2024-06/How%20have%20English%20council%27s%20funding%20and%20spending%20changed.pdf

Details of authors

Dr Matt Lyons, City-REDI, University of Birmingham
m.lyons@bham.ac.uk

Prof Kurt Kratena, CESAR Institute, Vienna