

# CIPFA BRIEFING

June 2015

## English local authority reserves

According to survey data collected by CIPFA into the level of reserves they hold, at 31 March 2014 local authorities held £3.7bn in general reserves and balances, representing about 4% of local government revenue expenditure. In addition they held £2.3bn in schools reserves and £13.8bn in earmarked reserves<sup>1</sup>.

Reserves are important to local authorities as, unlike central government, they cannot borrow money over the medium-term, other than for investment in assets, and they are required to balance their budgets on an annual basis. They generally hold reserves for three purposes:

- working balance to help cushion the impact of uneven cash flows
- contingency to cushion the impact of unexpected events or emergencies
- building up funds to meet known or predicted requirements – often referred to as earmarked reserves.

In addition to their useable reserves, local authorities have unusable reserves on their balance sheets. These reserves, such as the Pension Reserve and Capital Adjustment Account, hold costs that the authority has accrued but not yet financed and cannot be spent on council services.

Some local authorities also hold reserves on behalf of their schools and for public health and these reserves can only be spent on the services they are assigned for.

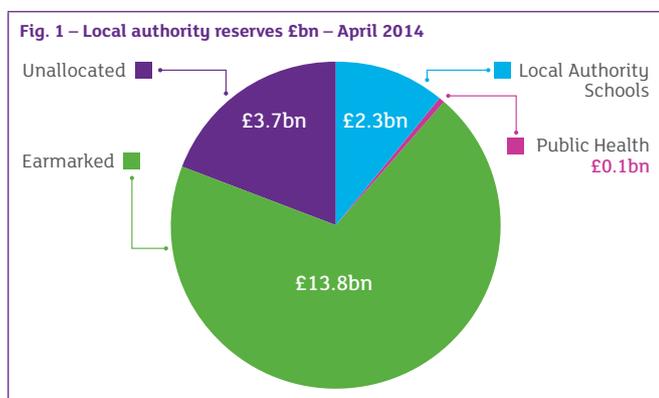
Given increasing service demands and other continuing pressure on resources, CIPFA has surveyed local authority chief financial officers to gain an up to date insight into their plans for projected reserves at the end of 2014-15, in advance of audited figures being available, and their plans for these reserves over the medium-term. This CIPFA Briefing summarises the results of our work, including comments from survey respondents<sup>2</sup>.

## Level of reserves

To better understand the reasons local authorities hold reserves, what is driving changes in reserves levels and what authorities intend to use their reserves for, CIPFA undertook a survey of local authority finance officials and combined this with existing data on council reserves levels.

In response to CIPFA's survey, 40% of local authorities reported increasing reserves in order to meet the increased uncertainty around funding due to the introduction of local Council Tax support and localisation of business rates.

The chart below (Fig. 1) shows the make-up of reserves held by English local authorities as at the 1 April 2014. Unallocated reserves of £3.7bn for local authorities compare to a cash balance of £4.3bn held by NHS Foundation Trusts and £2.5bn held by Academy Trusts.



## Why local authorities hold reserves

Local authorities take a number of factors into account when working out the level of reserves they need:

- External risks such as resource levels, interest rates risks, demand pressures and likelihood of incidents such as flooding.
- Internal risks such as the ability to deliver savings, the overall financial standing of the authority and the financial risks inherent in any significant new funding partnerships, major outsourcing arrangements or major capital developments.
- Future investment needs, for example, in major transformation projects.

## Managing higher level of risk

Recent changes to local authority funding have significantly increased the level of risk being managed by local authorities. Local authorities are now exposed to changes in the overall yield from business rates as well as the costs associated with successful business rate appeals.

In addition to the business rate risk, the change from Council Tax Benefit to local Council Tax Support moved the risk from central to local government at the same time as reducing resources available.

Previously Council Tax Benefit formed part of Annually Managed Expenditure with no fixed annual budget. Following the transfer to local government, authorities are now required to manage within budgeted resources after making the required cut.

Local authorities' views of risk are heavily influenced by their perceptions of the stability in the funding system and the way in which it operates. Previous mid-year changes to funding through specific grants, the Business Rate Review, uncertainty over the future of the New Homes Bonus and the difficulty in identifying Council Tax Freeze Grant once it is built into Revenue Support Grant have all created a climate of uncertainty over future funding levels.

As a result there is considerable variation in the distribution of reserves in different classes of authority, geographical location and individual authorities. For example at 31 March 2014 there were significant variations in the levels of general reserves compared with Revenue Expenditure:

- Non-metropolitan counties 2.3% compared with 22.9% for non-metropolitan districts.
- Greater London area 3.1% compared with 4.6% for East of England authorities.
- For outer London boroughs the range was from 1.9% to 6.0%.

The survey comments reveal the impact of the changes in funding and perceptions of future risks in practice at the individual local authority level:

### Risks councils are providing for

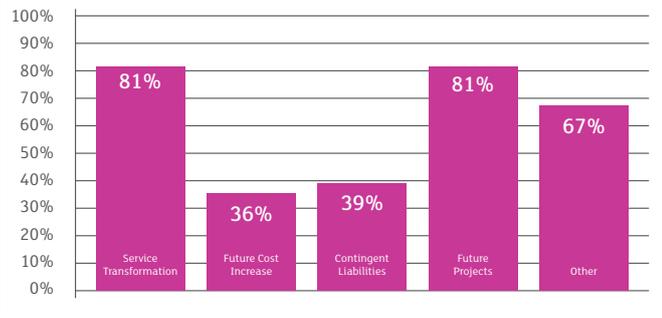
**District council – East of England:** £1.5m to cope with additional risk from the business rates regime including uncertainty over appeals.

**District council – South-West:** £1.9m of New Homes Bonus allocations added to reserves to be used to offset potential loss of Council Tax Freeze Grants in future years.

**District council – Midlands:** Minimum general fund revenue balance increased from £2.2m to £2.9m to allow for variations in the cost of the Council Tax Support Scheme.

**District council – Midlands:** £1.7m reserve against reduction of new homes bonus funding in the future.

**Fig. 2 – How local authorities plan to use reserves by area of spending**



## Investing for transformation

Given the complexity and size of service transformation needed to balance future budgets, local authority reserves are vital in meeting the one-off costs of service transformation, including redundancy costs. As councils are increasingly exhausting simple efficiency savings, the complexity and scale of service transformation and the associated risks can only increase.

81% of authorities plan to use their reserves to fund service transformation in the medium-term (Fig. 2), and on average these authorities are planning to spend 8.4% of their reserves on this purpose (Fig. 3).

### Reserves for transformation in councils

**Unitary – South East:** £3.2m reserve to support move to outcome based commissioning in social care.

**Police and Crime Commissioner – North West:** £1.7m for management of change and termination costs.

**Fire authority – North West:** £1.9m capital investment reserve to fund major fire station building projects and to allow for mergers.

**District council – Midlands:** Reserves increased with specific aim of providing capital funding for schemes which will ultimately have a positive impact on the annual revenue budget either through generation of additional income (a museum and new leisure centre) or increased efficiencies (new energy efficient HQ shared with other public and third sector services).

## Reserves for capital and other investment

Capital investment by its very nature is ‘lumpy’. Many local authorities are unwilling to take on additional borrowing to fund capital schemes when the ongoing financing costs would need to be met from increasingly tight budgets. They are therefore increasingly building up revenue reserves to fund or part fund capital expenditure.

In response to our survey, 81% of authorities said they plan to use their reserves to fund future projects in the medium-term (Fig. 2), planning to spend on average 23.4% of their reserves on this purpose (Fig. 3).

Realising capital receipts remains difficult, so revenue funding is also an increasingly common source of investment for spend to save schemes and capital schemes provided in collaboration with partners.

### Reserves for future council projects

**District council – South East:** £2m held in reserves to support a new build housing project within its HRA.

**Integrated transport authority – North West:** £2.2m in reserves to fund an investment in new rolling stock.

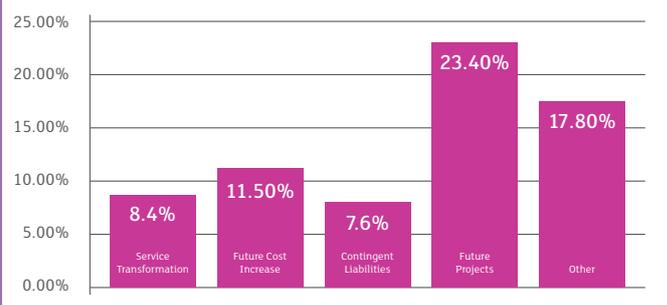
**District council – South East:** £3.7m reserve for leisure centre refurbishments.

**District council – South East:** £2.8m equalisation reserve to support a self-build development project.

**Unitary – South East:** New Homes Bonus held in a reserve to support infrastructure investment to bring forward future development schemes for economic regeneration and additional housing supply.

**Unitary – North West:** Authority has delivered savings in advance of budget reductions and is now using the reserves to support debt-free capital investment programme. This programme includes a number of key investments – new economic investment (circa £40m - £50m) and support for social care integration programme (circa £10m).

**Fig. 3 – Proportion of reserves local authorities are planning to spend by area of spending**



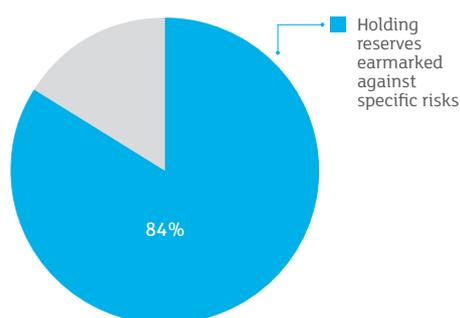
## Earmarked reserves

84% of authorities are holding reserves against specific risks in their budgets (Fig. 4). The average drawdown of earmarked reserves was 6.7% in 2014-15 and is planned to be 17% in 2015-16.

Earmarked reserves are used for a number of purposes by councils, commonly including:

- insurance reserves to cover both insurance excesses and self-insurance in a bid to smooth out and reduce ongoing expenditure
- reserves to hold funding for specific projects, often including income received from third parties
- reserves used to smooth payments due under PFI or other contracts
- reserves to 'equalise' expenditure or revenue that is subject to annual fluctuation
- reserves used to deal with mismatches between funding and expenditure.

Fig. 4 – Local authorities holding earmarked reserves



### Earmarked reserves councils are providing for

**County – South:** £8.0m self-insurance reserve to cover future claims and allow savings in ongoing cost of insurance.

**Unitary – South:** £11.7m added to reserves over two years up to March 2015 in respect of PFI contract funding excess occurring in early years of contract period with further planned contribution of £6.5m in 2015-16.

**Metropolitan – North East:** £6.0m reserve against the cost of equal pay claims.

**County – East:** £1.0m earmarked reserve for winter gritting as a result of sustained adverse weather.

**Police and Crime Commissioner – South West:** £2.4m held to cover variations in major incident costs.

## Balancing the budget

The need to hold reserves is to some extent cumulative; the total level of reserves being built up from the interaction of a number of different risks.

With continuing funding reductions, the ability of local authorities to manage unexpected expenditure in-year has reduced substantially and the need for adequate levels of reserves has increased.

Overall, 94% of local authorities responding said they have plans in place to use their reserves (Fig. 5).

Of which:

- 36% of authorities plan to use their reserves to cover likely future cost increases over the medium term (Fig. 2)
- While 39% plan to provide cover in the medium term for contingent liabilities (Fig. 2).

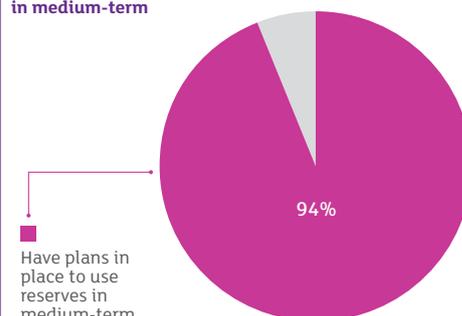
In addition the average increase in unallocated reserves during 2014-15 was 2.5%, whilst the average use of earmarked reserves was 6.9%. However going forward local authorities are planning to use on average 9.2% of their unallocated reserves in 2015-16 and 17% of their earmarked reserves, significantly increasing the use of these types of reserves.

Local authorities have already entered into a large number of partnership and outsourcing arrangements in order to protect front line services and drive efficiencies. Increased use of contracting out can reduce the local authority's ability to manage input costs in the short-term and leave them open to committed price variation. In addition, local authorities are increasingly subject to litigation with issues such as equal pay creating significant potential liabilities.

Local authorities may sometimes use reserves to help them balance their budgets but need to do so with care as they can only be used once. Using reserves purely to support ongoing expenditure merely postpones the need for cuts and makes those cuts more difficult to deliver when needed as there is less ability to manage delivery costs and risks and there is a cumulative impact with additional cuts needed at that point in time.

A number of CFOs have reported the need to use reserves whilst savings are implemented and increasing pressure from members to use reserves rather than make difficult savings.

Fig. 5 – Proportion of local authorities with plans in place to use reserves in medium-term



## CIPFA's position on local authority reserves

- 1 Local authorities build up reserves for a number of reasons based upon the risks that they face and their plans for the medium-term, examples of current risks include equal pay and the recent court ruling on holiday pay.
- 2 Reserves are a vital part of prudential financial management in local authorities, including their ongoing ability of local authorities to meet the balanced budget requirement.
- 3 Reserves are built up over the longer term and their level and their use is a key part of effective medium-term financial planning
- 4 Reserves are crucial to local authorities delivering the progressive reductions in public expenditure required over the coming years.
- 5 Current reserves levels reflect the success of local authorities in planning beyond single year budget horizons.
- 6 The level of reserves is not uniform across the country or the tiers of local government.
- 7 Central Government behaviour has a strong influence on reserves as it impacts on the uncertainty local authorities face around medium-term resource forecasts.
- 8 Recent transfers of business rates and council tax support into locally financed expenditure have increased local uncertainty.
- 9 Local authorities are building up capacity to fund the one-off costs of transformation needed to allow future savings and for future capital investment supporting the economic growth agenda.

1 Figures taken from CIPFA Finance and General Purposes Statistics, 2014-15 Estimates.

2 CIPFA achieved a 51.9% response rate from all local authorities including Police and Fire, Key response rate were 69.7% of London boroughs, 66.7% of metropolitan districts, 48.2% of Unitaries, 85.2% of counties and 36.8% of metropolitan districts.



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