

Norman Flynn¹THE FINANCE OF LOCAL GOVERNMENT IN GREAT BRITAIN:
BUDGET STRUCTURE AND PROCESS IN LOCAL GOVERNMENTIntroduction

Local authorities in Britain produce annual budgets. Some also produce forecasts of income and expenditure for a longer period but land tax charges are adjusted annually at the start of each financial year.

There is not a standard form of accounts in local government and therefore no standard budget format. Some elements, however, are standardised by the Chartered Institute of Public Finance and Accountancy. The subjective headings of expenditure (employees, premises etc.) are standard but the grouping of services within the budget is left to the discretion of individual authorities. Most budgets are arranged according to the committee structure, which is itself discretionary.

Most budgets consist of statements of income and expenditure under the subjective headings, grouped into activities, committees or programme area and by individual establishments. There are a few authorities which also produce budget statements of units of activity (number of old people in residential homes, numbers of children aged 5-11 years at school) and estimates of unit costs of those activities in the coming year.

Capital and Revenue Budgets

Budgets are produced for each of the capital and revenue expenditures and incomes. The revenue budgets contain recurrent

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expenditure and income and the capital budget shows the purchase of assets lasting more than one year and the method of funding those purchases.

Both budgets must balance over the year. However, the capital budget is balanced through borrowing, while the revenue budget must, by law, balance the year's income with the year's expenditure. Borrowing is not permitted to finance the revenue budget, taking the year as a whole.

The three main accounts

Naturally, the accounts kept by the authority reflect the functions carried out. Housing authorities keep a Housing Revenue Account for the municipal housing service. Income into this account consists of rents, government subsidies and contributions from the general rate fund if the expenditure exceeds other income. Expenditure is the cost of administering the service, maintaining the housing stock, and debt charges. The Housing Revenue Account may not balance but there are incentives applied by central government to ensure that it is not in deficit. There are Housing Revenue Accounts in some authorities which are in surplus and make a contribution to the general rate fund.

The General Rate Fund is the account for the majority of services provided. Income consists mainly of the rates (a tax on land and buildings), government grants, fees and charges, interest on balances, rents on buildings other than housing. The expenditure is on everything to run the services, plus contributions to capital expenditure and contributions to compensate for any deficit on the housing revenue account.

In addition; authorities keep Trading Accounts for any activities of a commercial nature. This may include public transport undertakings, airports, markets building and civil engineering work, restaurants, theatres. In these trading accounts the income consists of the payments received for the services provided, and expenditure consists of the costs of providing the services. If expenditure exceeds income, there has to be a contribution to the account to compensate for the deficit.

Since both Housing Revenue and Trading Accounts may go into deficit and the General Rate Fund will have to cover the deficit the budget process has to take into account these deficits as well as activities financed through the General Rate Fund.

The Budget Process: Revenue Budgets

The starting point of the production of the budgets is the issuing of overall budget guidelines by the Finance Committee which is in effect acting on behalf of the political leadership of the authority. These guidelines will indicate the target level of expenditure, taking into account the central government's guidelines and grant payments and the political judgement about the desirable and feasible level of local taxation. The guidelines are issued to the committees responsible for areas of the budget in September. Work then starts on the detailed budget charges necessary to meet the guidelines or to challenge them in order to have them changed.

Draft budgets are then produced by committees (more correctly, produced by officials and approved by committees) and submitted to the Finance Committee for approval. These draft budgets have to be consistent with the amount of central government grants. The amount of grant to be received depends on the total amount of grant available and the level of expenditure of individual authorities. Generally, if the amount of expenditure exceeds the central government's guidelines the amount of grant is severely reduced. Detailed budgets, then, cannot be finalised until the grant announcement is made, normally in November.

When the grant settlement is made, then firm predictions of grant income can be made and the fundamental choice of the overall level of expenditure can be made. All that remains is the bargaining process which takes place between committees and service areas, with each set of officers and politicians advocating their service and bidding for expansion or resisting contraction of their service.

The detailed budget considerations take account of the following matters:

a) The base budget

The starting point of the process is normally the budget which was produced the year before. The final, actual figures for the year's expenditure are not available until some months after the start of the process. This base budget will have been produced at prices prevalent at November of the previous year. The prices therefore have to be inflated to a new price base.

b) Commitments

Since the previous budget was produced, the authority will have entered commitments which will continue into the forthcoming year. These commitments will include debt charges on borrowing made during the year, new activities started during the year because of legislation or policy changes. These commitments need to be added to the base budget.

c) Policy Changes

Some politicians have argued that the major policy choices have already been made and that the budget process is merely a ratification of those political choices. In fact many important policy choices are made during the budget discussions. The choices involve decisions to increase activities or to do new things and to decrease other activities or cease to do them.

These decisions arise from two main sources: a change in politics as a new party or a new faction of a party takes control of the authority; changes in the environment of the authority such as a fall in the number of school children and an increase in the number of old people. The budget will have to take account of these political and environmental changes.

Clearly a budget which is produced only with the subjective headings and no estimates of the units of services provided is difficult for politicians to use in expressing their political wishes. In many cases it is difficult to translate statements of political intentions into budget allocations.

d) Efficiency changes

If the same service can be provided at less cost in the forthcoming year, then the budgetted expenditure can be reduced without

effect on the services. Recent reductions in overall levels of expenditure in some authorities in Britain have led to significant efficiency savings, mainly by reductions in the numbers of employees or reductions in wages paid.

e) Inflation

The new budget will have to take account of the level of pay and price changes in the forthcoming year. This prediction will be difficult, especially in a period of unstable prices.

f) Fees and Charges

Although all fees and charges do not have to be decided at the time of the production of the budget, there needs to be an estimate of the level of income to be produced from rents and fees and charges. In some cases rent and fee level decisions will be left until after the local government elections, which are held in May.

These decisions will produce the net committee expenditure. In addition to the budget procedures of individual decisions, there are certain decisions which need to be made centrally, by the Finance Committee:

g) Revenue Contributions to Capital Outlay

Capital expenditure may be funded by the current year's income. This contribution to capital expenditure will be decided by the authority as a whole and not by individual committees.

h) Contingency Reserves and Balances

The budget calculation contains several unknown quantities. The level of inflation in the forthcoming year is only guessed. If inflation in prices and wages and salaries is higher than the estimate, then the budget could fail to balance. Emergencies could occur during the year (floods, severe frosts, excessive snow, major accidents) which will require funds to deal with them. For these reasons authorities usually budget for a contingency reserve.

In addition, most authorities have substantial cash balances. These are kept for various reasons; to safeguard services against sudden changes in the amount of grant paid by central government;

to enable smaller tax changes to be made in election years; to enable the authority to earn interest on the funds invested.

The use of balances has become a politically sensitive matter, since the availability of reserves of cash can give great flexibility and power to the ruling party. In the new legislation the present government is proposing to take account of the level of balances when setting the tax levels of "highspending" authorities.

Once all these decisions and judgements have been made, the authority can fix its rate level. The amount of central government grant payable at each level of net expenditure is known by this stage, so the final decision on the overall budget level is a matter of judgement of the acceptable level of rate increase compared with the level of services to be provided. With severe grant loss for exceeding central government's expenditure guidelines, the marginal benefit/cost ratio of expenditure over guidelines will be very low. Judgements will therefore tend to conform with central government's wishes.

Lessons to be learned from the British revenue budget process

1. The recent turmoil introduced by changes to the grant system to enhance central government's control over individual authorities expenditures has reduced the predictability of income. Since a budget has as its main objective a balance of income and expenditure, this has brought great annual uncertainty. If authorities are to be able to respond strategically to changes in the environment, the income should be more predictable, not just year to year but also over a medium term to enable medium term planning to take place.

2. The use of subjective headings makes genuine policy choices difficult. The politicians are forced to choose between collections of alternative inputs, rather than alternative outputs whose merits could be judged against each other. Budgets which include estimates of outputs or even intermediate outputs would be preferable: for example, a budget which expressed the number of elderly people who would receive a particular form of care, rather than a budget which says "£X will be spent on this form of care for the elderly".

3. Budgets are generally produced after making a prediction of inflation. The amounts contained in the budget may then be cash-limited (i.e. the amount of cash available is fixed, whatever the actual inflation rate turns out to be) or an inflation contingency can be established, whereby extra cash is made available as the actual levels of inflation become apparent. The choice of method is at the discretion of the individual authority which in some cases adopt a mixture of the two approaches. However, central government grant is cash limited and no extra is made available if inflation turns out to be higher than predicted.

4. The use of last year's budget as the base for this year's decisions tends to produce inertia. The pattern of expenditure persists from year to year with marginal adjustments only. This is especially true when expenditure is static or reducing year to year.

5. Although the consequences of capital expenditure in previous years, the future consequences of capital expenditures are given too little attention in the budget process. The capital and revenue budgets tend to be done in relative isolation.

The Budget Process: Capital Budgets

Local authority capital expenditure is controlled by central government: all capital spending must, since 1981, be approved by the relevant central government department. Permission to spend is given under five headings: housing, social services, education, transport and "other". After permission has been obtained, expenditure may be switched between headings, and 10% may be carried over to the subsequent year or brought forward from the next year. In addition to the amounts authorised by central government, authorities may include an amount equivalent to half the amount raised from the sale of capital assets.

Within this strict control, the capital budgeting process still leaves scope for choice: the overall level of expenditure may be less than that approved by the centre; there is choice of projects; the method of funding will have to be decided.