Local government call for views on capital measures to improve sector stability and efficiency

Summary

1. On 18 December, the Secretary of State for the Department for Levelling Up, Housing and Communities (DLUHC) announced that Government would engage with councils to identify and develop options for the use of capital resources and borrowing to support and encourage invest-to-save activity and more flexibilities to use capitalisation without the requirement to approach Government.
2. The Government is therefore inviting local authorities, sector representatives and other stakeholders to provide views on a set of options with respect to capital flexibilities and borrowing, to be managed locally, that could be used to encourage and enable local authorities to invest in ways that reduce the cost of service delivery and provide more local levers to manage financial resources. Our intention is to also invite other ideas to be put forward, to ensure we have adequately considered all viable options.
3. It is not the intent to replace the EFS process: this process will remain and the Government will take action where there is local failure. The Government does, however, recognise where local authorities face cost pressures that are not a consequence of local failure, then further freedoms to use capital resources could allow local management of budget pressures, and facilitate investment that reduces future costs and supports continued sustainability over the long-term.
4. The options are set out in detail in this document. At high level these can be categorised as:
    a. **Supporting invest-to-save activity.** Increasing the flexibilities to use capital receipts and borrowing to finance the costs of transformation and efficiency projects.
    b. **Local management of budget pressures.** Providing greater flexibilities on the use of capital receipts, including the scope to meet general budget pressures, and potential additional flexibilities where the proceeds relate to the sale of investment properties.
5. The options are not intended to be mutually exclusive, and local authorities that use any new flexibilities provided by the Government will be expected to put in place plans to reduce costs and improve efficiency in a way that reduces future risk. The Government is considering these flexibilities as a means to help local authorities help themselves so local authorities must play their role in making this work effectively.
6. There is a clear balance between providing greater freedoms to use capital resources to alleviate local revenue pressures and incentivise efficiency, while avoiding creating unsustainable financial practices through misuse of flexibilities. The Government is mindful that any additional flexibilities must have safeguards that are proportionate and effective at preventing misuse, while still placing decision-making at local level. This document sets out a range of options to mitigate risk while still devolving decision-making locally and respondents are invited to provide views on these and put forward any other risk mitigation measures that may be appropriate.
7. The Government does not commit to any of the options set out in this document. To be taken forward, the measures must have material benefit to the sector; not significantly increase risk

to the sector or public finances; and be consistent with the Best Value duty and the Prudential Framework. The evidence collected through this call for views will inform Government policy.

Background

8. Central to the local government finance system is the concept of capital expenditure. The term is defined in section 16(1) of the Local Government Act 2003 ("the 2003 Act") as expenditure of the authority which falls to be capitalised in accordance with proper practices. Normally, only capital expenditure may be funded out of capital resources or financed by borrowing, whereas revenue expenditure must be charged to the revenue account and forms part of the 'balanced budget' requirement, whereby council tax must be set each year to balance net expenditure plus or minus movements in reserves.

9. Under normal practices, local authorities cannot use capital resources or borrowing to finance revenue costs. The Government, however, can by regulations or directions allow local authorities to treat revenue costs as capital, allowing the costs to be met through the proceeds of asset sales (capital receipts) or through borrowing. Referred to as 'capitalisation', this mechanism is used by the Government as the principal means to support local authorities that require financial support. There is also a general direction, which has been in place since 2016, that allows local authorities to use certain capital receipts to fund the revenue costs of activity that reduces ongoing revenue costs or improves efficiency. This '*flexible use of capital receipts*' may be used by local authorities without approval from the Government and is intended to allow authorities to take forward transformation and cost-saving projects that are otherwise unaffordable.

10. It is not generally considered prudent or sustainable for local authorities to rely on capital or borrowing for revenue costs. This is because capital receipts are one-off and unpredictable, while borrowing creates a liability. However, there are circumstances where using capital or borrowing to meet revenue pressures is necessary and appropriate and the ability to use capital resources and borrowing for revenue costs is a powerful additional flexibility. It can be used to address financial pressures or remove affordability barriers to projects that may increase costs in the short-term but lead to savings overall.

11. Capital flexibilities are used to support investment that produces ongoing revenue savings. Local authorities have considerable flexibility in being able to finance capital expenditure using borrowing. This includes any investment needed for projects that improve efficiency of service delivery, reduce costs, or increase income. Generally, the bigger constraint is the associated revenue costs, due to the statutory requirement to set a balanced budget each year. Where revenue budgets are constrained, it may not be affordable for authorities to proceed with projects where the return on investment is not seen for a number of years. The *flexible use of capital receipts* offers the means to use capital receipts to support projects that produce ongoing revenue savings, but has limitations.

12. Capitalisation is the most common form of support offered by the Government to local authorities. The *Exceptional financial support* (EFS) framework can use capitalisation directions to allow authorities to address revenue pressures. It is not limited to capital receipts but can also be applied to capital from borrowing, and may be used for costs other than invest-to-save. As such, the EFS process is rigorous and generally requires an external review of the council, and may have conditions such as increased interest rates on any borrowing for capitalisation

purposes. Given that it is a departure from normal accounting practice, we generally take the view that capitalisation is only appropriate as a means to address time-limited or one-off costs rather than ongoing pressures.

Purpose of engagement

Proposed new capital flexibilities and measures

13. The purpose of the engagement is to seek views on the options set out and invite additional suggestions. The Government is not committing to any of these options at this point. To be considered viable, an option must meet at least one of the following objectives:
    - encourage and enable local authorities to take forward projects, programmes and initiatives that produce ongoing revenue savings and improve efficiency;
    - provide additional local levers such that authorities are able to manage pressures without approaching the Government as part of a plan to move back to financial sustainability;

    and all of the following principles:

    - provides demonstrable benefit to the sector or sufficient number of individual authorities that justifies the increased flexibility and outweighs any accepted risk;
    - the risks of implementing the option must be manageable to an acceptable level while still permitting local decision making; and,
    - is consistent with an authority's Best Value duty and the objectives of the Prudential Framework such that all borrowing and investment is prudent, sustainable and affordable.

14. The proposed options are as follows.

    Option 1: extend capitalisation flexibilities to include a wider set of eligible costs. That is, to allow authorities to capitalise *general cost pressures* and meet these with capital receipts. As a condition, the authority must put in place and commit to delivering an efficiency plan to reduce costs, with a defined payback period on any capitalised spend. The intent is that any use of the flexibility must be part of an overall plan to move back to financial sustainability within the Medium Term Financial Plan.

    With this option, the capitalised costs are not necessarily related to invest-to-save measures but represent a broader agreement to allow a local authority to deal with immediate pressures on the condition that it will take forward cost reduction and efficiency plans to bring itself back into sustainability. This will support authorities with immediate financial pressures and provide a period in which the authority can put in place measures to reduce costs. It also has the longer-term effect of promoting efficiency. It also provides an additional route other than EFS, which is currently the only way for local authorities to seek permission to capitalise any non-transformation costs.

    This option could be constrained to only allow capitalisation of specific types of expenditure – for example, common areas of spend that contribute to financial pressures.

Q1: Does this option meet the objectives and principles as set in this document? Please provide detailed comments.

Q2: If you are a local authority, would you use the flexibility in the foreseeable future if available?

Q3: If you are a local authority and you think you would use the flexibility, please provide an approximate value of capital receipts you would potentially use in 2024/25 (£'m).

Q4: Should this flexibility be constrained to a specific area or type of expenditure? Or certain types of expenditure be excluded? Please provide detailed comments.

Q5: In your view, are there any risks or unintended consequences that the Government should consider?

Option 2: extend the *flexible use of capital receipts* to allow authorities to borrow for the revenue costs of invest-to-save projects. This would be a simple extension of the current direction to allow authorities to borrow to finance the revenue costs of eligible projects, as well as use capital receipts. The parameters of the direction could otherwise be kept the same (with the same definition of eligible costs and restrictions).

This would have the benefit of allowing authorities that do not have access to capital receipts to also progress eligible projects where they otherwise may not be able to afford to do so. We are mindful, however, that borrowing comes with additional costs in the form of interest costs and Minimum Revenue Provision, which may mean that some authorities are still not able to take forward projects if borrowing is unaffordable.

Q6: Does this option meet the objectives and principles as set in this document? Please provide detailed comments.

Q7: If you are a local authority, do you have projects ready to take forward that this flexibility would support/enable? If yes, please provide detail on the number, type and cost of the projects.

Q8: If you are a local authority and you think you would use the flexibility if available, please provide an approximate value of borrowing you would use in 2024/25 (£'m).

Q9: In your view, are there any risks or unintended consequences the Government should consider?

Option 3: Allow additional flexibilities for the use of the proceeds of selling investment assets. The sector has an estimated £23.2bn in value of investment properties (as at 31 March 2021). This figure is taken from the Whole of Government Accounts (WGA) data and values may have changed subsequently, however, it is undoubtedly the case that the sector holds a significant amount of value in investment properties. Investment properties in this case refers to property held under accounting standard "IAS 40" – any properties classified as an 'investment property' under this standard can only be held for rental income or capital appreciation.

The proposal is effectively an extension of Option 2, whereby local authorities may use the investment asset proceeds to fund financial pressures, but to also have access to additional flexibilities which may include: increasing reserves where they are demonstrably low; repaying Public Works Loan Board Borrowing without a premium (where one would otherwise be charged).

The intent is to encourage divestment of assets held only for revenue and not for the delivering the objectives of the local authority, and providing additional incentives to recognise that local authorities selling such assets will likely be foregoing future revenue income.

Q10: Does this option meet the objectives and principles as set in this document? Please provide detailed comments.

Q11: If you are a local authority, do you have investment properties (as per the IAS 40 definition)? Please provide the fair value as at 31 March 2023 or the latest valuation (please specify the date of the valuation). Please provide the total forecast net return for 2024/25 (£'m).

Q12: If you are a local authority would this option provide incentive to divest of some or all of your investments assets? Are there alternative or additional incentives that, in your view, would be effective?

Q13: In your view, are there any risks or unintended consequences the Government should consider?

15. The Government is also interested in understanding whether **a reduced interest rate for borrowing from the Public Works Loan Board for invest-to-save projects** would further enable invest-to-save projects. The proposal is that this would be to finance the capital costs of expenditure of projects that meet the definitions set out in the *flexible use of capital receipts direction*.
16. Further details would be subject to development of the proposal, however, it is likely the following would apply: local authorities would not be required to apply to the Government to use the rate, but would need to include planned borrowing with the discounted rate in their capital plans provided to DLUHC; local authorities would need to submit additional details to DLUHC for transparency; and, local authorities would not be able to borrow in advance of need.
17. The discount offered would not be more than 40 basis points on prevailing rates. This is the discount currently offered for HRA borrowing. The Government is aware that the majority of the cost of interest rates is driven by gilt rates, however, we are looking to understand whether such a discount would support the affordability of invest-to-save projects.

Q14: If you are a local authority, if this discount rate were offered, would you use it in 2024/25? Please indicate approximately how much your authority would seek to borrow.

Q15: Would a discount of 40 basis points help make invest-to-save projects more affordable? Please provide details. Examples and case studies are particularly useful, but all views are welcome.

RISKS AND MITIGATIONS

18. The Government is mindful that introducing any further flexibility on the use of capital resources and borrowing inherently increases risk. The key concerns are that authorities could use capital receipts or borrowing to meeting their revenue costs under one of these flexibilities in a way that is ineffective, increases risk or defers it to the future or masks indicators of financial failure against a council's relevant statutory duties. These risks may arise from local authorities applying the flexibilities incorrectly, such as using capital receipts for ineligible costs or using the flexibilities for projects which ultimately do not produce any long-term savings.
19. The Government is not proposing a centrally managed system whereby authorities have to apply. The premise of these flexibilities is to enable local actions to take action locally and build in enduring improvements to efficiency. It is therefore important that any risk associated with additional flexibilities must be mitigated to an acceptable level commensurate to the benefits to the sector and achieving the Government's objectives while being consistent with local control and local accountability..
20. The following are a list of additional controls that are intended to reduce risk to an acceptable level without the need for a centrally controlled process. These options are not mutually exclusive and can be taken in any combination or in total. The proposal at this time is that, subject to refining the details further through sector engagement, all of these would be introduced and any authority seeking to use the flexibilities would be required to comply.
21. The proposed controls are:

- **Full transparency.** A condition that using any additional flexibilities with respect to borrowing for revenue costs must be supported by an efficiency plan detailing how the council will use the capitalisation flexibility, how it will reduce costs and the payback period on this. The plan should be presented to Full Council or equivalent, and submitted to the Government – not for approval, but for review. The plan should also be published on the local authority's website. Updates on the efficiency plans must be published at least quarterly. The premise is that the flexibilities are used 'in plain sight'.
- **Mandate a payback period.** Efficiency/invest-to-save plans must have a payback period of no more than a fixed number of years e.g. 10 years. This should include the capitalised cost of revenue as part of the investment.
- **Independent review.** Local authorities must commission an independent review of their efficiency plans, share these with the Government and publish on their website if they want access to additional capital flexibilities.
- **Limit flexibilities to specific types of expenditure.** Specifically for Options 1 and 3 (paragraph 14). Where capital receipts may be applied to general cost pressures, this could be limited to certain categories of service spend and/or exclude categories of cost spend.
- **Assurance engagement.** The Government can commission an independent review of the use of the flexibilities at its discretion.

Q16: Do you agree with these additional controls to apply to any local authority that uses the capital flexibilities or PWLB discount rate? Please provide details.

Q17: Are there additional controls that the Government should require with respect to all or some of the options set out? Please provide details.