National Audit Office

Report
by the Comptroller
and Auditor General

Department for Communities and Local Government

Financial sustainability of local authorities: capital expenditure and resourcing

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Key facts

£12.3bn

local authority capital spending, 2014-15 (excluding education)

5.3%

real-terms increase in capital spending (excluding education), 2010-11 to 2014-15

£148

average cost per dwelling of servicing debt for single tier and county councils, 2014-15

0.2%	real-terms increase in the value of departmental capital grants to local authorities (excluding education), 2010-11 to 2014-15
£58.7 billion	local authority gross external debt, 2014-15
£25.4 billion	local authority investments on deposit, 2014-15
9.9%	or more of revenue spend taken up by debt costs in 2014-15 exceeded this level in a quarter of single tier and county councils
21%	increase in capital spending via grants and loans from local authorities to other bodies
49%	proportion of local authorities where real-terms capital spending fell, 2010-11 to 2014-15

Summary

1 Local authorities meet the costs of their statutory and discretionary services through a combination of revenue and capital expenditure. Revenue spending covers day-to-day costs such as wages. Capital expenditure relates to investments in assets such as buildings and transport infrastructure. In 2014-15, authorities spent £38.1 billion on revenue to support services and £12.3 billion on capital (excluding education).

2 Since 2010, the government has reduced funding for local government as part of its plan to address the fiscal deficit. Our previous work has shown that local authority revenue income, including council tax, fell by 25.2% in real terms from 2010-11 to 2015-16.[1] This current study focuses on changes in capital resourcing and spending over this period.[2] It examines the implications of these changes for authorities' financial and service sustainability.

3 Local authority capital spending and resourcing operate within a different set of rules from revenue. But there are important interactions between the two. To identify the full range of financial challenges and opportunities faced by local authorities it is important to understand how the two sides of the system interact.

4 A key difference between capital and revenue is that authorities can use long-term borrowing to support capital spending. This gives them freedom to invest in their asset bases and also to pursue 'invest to save' schemes which can deliver revenue savings. However, authorities must ensure that borrowing is affordable and must meet debt servicing costs from revenue. These processes are largely self-regulated within the framework of the prudential code for capital finance.

1 Comptroller and Auditor General, *Financial sustainability of local authorities 2014*, Session 2014-15, HC 783, National Audit Office, November 2014.
2 Capital resourcing refers to the combination of up-front funding and longer-term financing that is used to support capital spending.

5 This system creates both opportunities and risks for local authority financial and service sustainability (**Figure 1**) and these form the focus of this study:

- **Servicing debt costs from revenue** – Local authorities have to meet debt costs from revenue which ensures borrowing remains affordable, but also means that when revenue is falling, the 'fixed cost' of servicing historic debt can exert increasing pressure on authorities' dwindling revenue resources.
- **Ensuring adequate investment in local authority assets** – In the current context of falling revenue incomes, authorities' ability to borrow to support long-term investment that does not deliver a direct revenue saving is restricted, even if it is needed to maintain key assets.
- **Balancing local autonomy and national oversight** – The devolved accountability system for capital provides authorities with substantial autonomy to develop investment strategies in line with local priorities and circumstances. However, this may also mean that there is less understanding in central government of capital issues, trends and challenges across the local authority sector.

The Department for Communities and Local Government

6 The Department for Communities and Local Government (the Department) has responsibility in government for the local government finance system. But accountability for capital is more devolved to authorities, with the Department taking a lighter-touch approach to assurance.

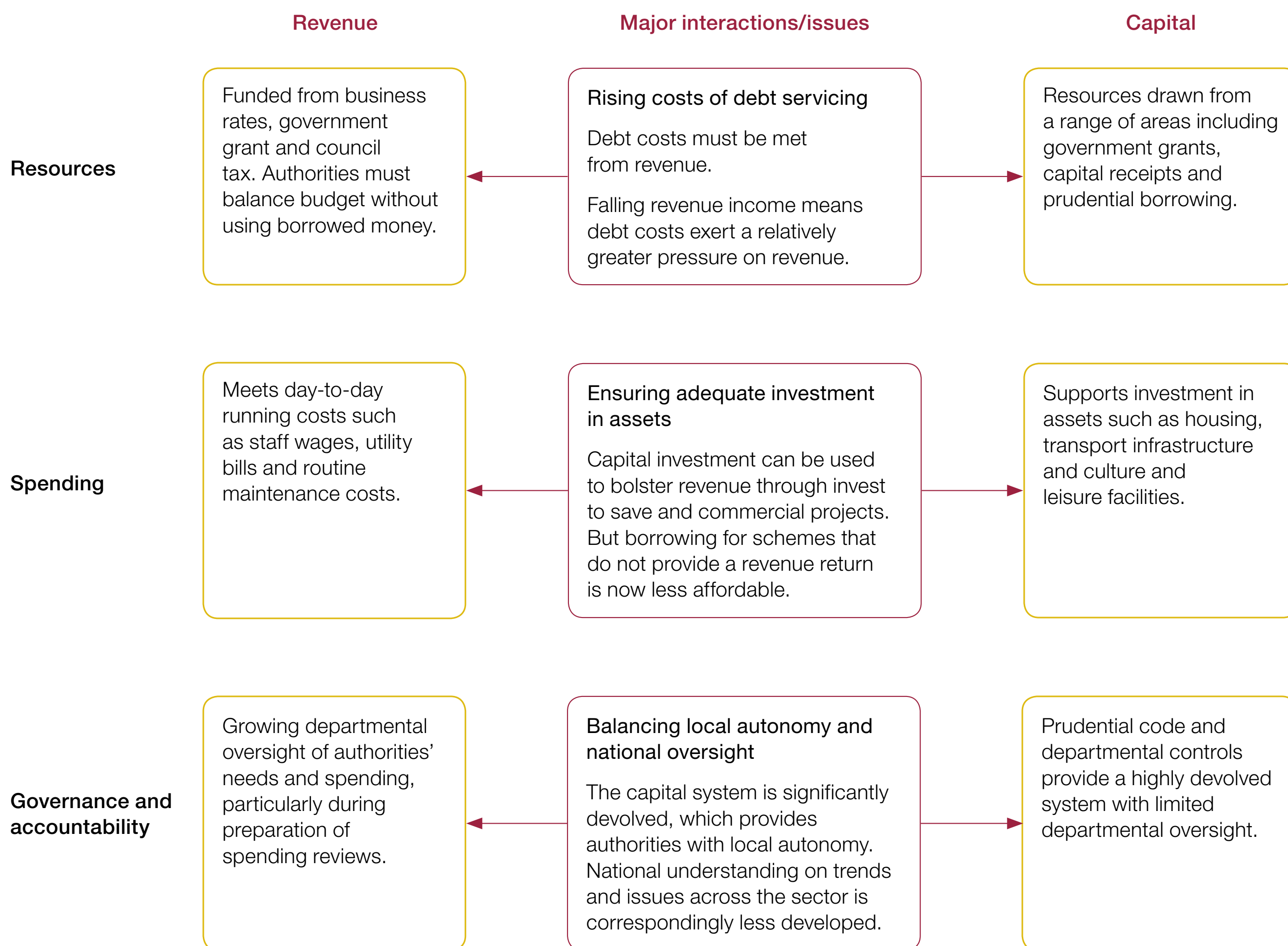
7 The Department does still retain some responsibilities for local authority capital spending and resourcing, however. In particular it:

- oversees a system to support authorities to remain financially sustainable – this involves providing funding for authorities to support their core services, including revenue funding that could be used to service debt; and
- maintains the system of local accountability, which enables the government to assure Parliament that authorities spend their resources, including capital, with regularity, propriety and value for money and that mechanisms are in place in the event of failure.

8 The Department therefore has a more limited role in relation to capital. However, the significance of capital within the local authority financial system, and the pressures it places on revenue income, means that it should still be part of the Department's understanding of authorities' financial and service sustainability. The Department should understand when authorities risk being unable to discharge their statutory duties. This includes understanding potentially significant changes in capital expenditure and resourcing.

Figure 1

Revenue and capital – core components, issues and interactions



Source: National Audit Office

Our report

9 This report examines the implications of changes in capital expenditure and resourcing for local authority financial and service sustainability since 2010-11. It also examines the Department's oversight role in relation to local authority financial and service sustainability. The report has three parts:

- Part One examines the challenges facing local authorities in resourcing their capital programmes and servicing debt;
- Part Two explores changes in authorities' capital spending and the implications for services; and
- Part Three examines the Department's role in overseeing a system to ensure that authorities remain financially sustainable.

A separate *Methodology* is available on the National Audit Office website: www.nao.org.uk/report/financial-sustainability-of-local-authorities-capital-expenditure-and-resourcing/.

10 In 2014-15, authorities incurred £3.5 billion of capital spending on education. Arrangements for local authority capital spending on education have been radically restructured since 2010-11. The Department for Education provides funding to local authorities to enable them to provide sufficient local school places and to maintain school buildings. However, aggregate funding which local authorities receive direct from the Department for Education has fallen since 2010-11 as many schools are no longer the responsibility of local authorities to maintain. Furthermore, the Building Schools for the Future programme – where funding was routed through local authorities – was cancelled and the new Priority Schools Building Programme is being centrally delivered by the Department for Education rather than through local authorities. The scale and significance of these changes is such that we will publish a separate report on this issue in 2016-17. Consequently, we have not focused on capital spending on education in this report. We have excluded it from our analysis where possible.

Key findings

Challenges to capital resourcing

11 Since 2010-11, local authorities have faced less pressure on their resources to support capital expenditure relative to revenue. Local authorities' revenue spending power (government grant and council tax) fell by 25.2% in real terms from 2010-11 to 2015-16. In contrast, we estimate that capital grants to authorities (excluding education) increased by 0.2% from 2010-11 to 2014-15. The use of other forms of capital resource, such as capital receipts, also increased. Authorities have also had the option to borrow to support capital spending (paragraphs 1.8 to 1.12 and Figure 4).

12 **The primary challenge facing authorities in managing their capital spending and resourcing has been to minimise the revenue cost of their capital programmes**. Authorities meet debt servicing costs from revenue spending. In 2014-15, these costs accounted for £3.6 billion of revenue, equivalent to 7.8% of revenue spend (excluding education). Authorities' key priorities are reducing these and ensuring that they do not go up as a result of new borrowing. They have adopted a range of prudent treasury management strategies including minimising external borrowing, and recalculating the minimum revenue provisions (MRP) they must set aside to cover debt repayments. They have also increased 'internal borrowing', where authorities fund capital spending from temporarily surplus cash. This avoids interest payments by deferring the need to borrow externally (paragraphs 1.15, 1.18 to 1.31, and 1.37 to 1.39, and Figures 5, 6, 7 and 8).

13 **Authorities' debt servicing costs have grown as a proportion of revenue spending**. Mandatory capital costs to revenue fell by 4.3% in real terms between 2010-11 and 2014-15. However, revenue expenditure fell by 14.7%, making capital costs to revenue a relatively larger element of revenue expenditure. A quarter of single tier and county councils now spend the equivalent of 9.9% or more of their revenue expenditure on debt servicing. Metropolitan district councils are particularly exposed, with a quarter spending over 11.2% of their revenue spend on debt servicing. However, across the sector as a whole debt servicing costs as a share of revenue spend fell slightly in 2014-15, as a number of local authorities reduced their MRPs (paragraphs 1.41 to 1.45, and Figures 10 and 11).

14 **If interest rates start to rise, new borrowing will become more expensive, and authorities may also take on more external debt in order to lock in relatively low interest rates**. Authorities have used internal borrowing to keep the cost of debt servicing down. However, they may switch to external borrowing if an interest rate rise looks imminent in order to lock in borrowing at a relatively low rate. This will push up the cost of debt servicing. At the same time, authorities' revenue incomes will be constrained by cuts in government funding. If authorities cannot reduce their debt servicing costs, this will place further pressure on revenue spending. Authorities may also decide that borrowing for new capital spending is unaffordable, reducing the scale of future capital programmes (paragraphs 1.46 to 1.47 and 1.52 to 1.53).

15 **Counterparty risk has increased as levels of investments on deposit have grown**. Local authorities in general are more exposed to counterparty risk – the possibility that an institution holding an investment fails – as levels of early repayment of debt have fallen and investments on deposit with third parties have grown. Early repayment of Public Works Loan Board (PWLB) debt fell from an annual average of £3.4 billion in the three years to 2010-11, to £186 million per year in the three years to 2015-16. Investments on deposit grew by £6.9 billion (37%) from 2010-11 to 2014-15. These changes may have been partly driven by the fall in interest rates in recent years which has increased the premium payable on early repayments by local authorities. However, authorities we spoke to said that changes to PWLB's early repayment terms in 2007-08 (to protect the National Loans Fund) and to new loan terms in 2010-11 mean early repayment was now no longer value for money (paragraphs 1.32 to 1.36, and 1.54 and Figure 9).

Capital expenditure in local authorities

16 Capital spending by authorities increased slightly from 2010-11 to 2014-15, but this is not even across authorities or service areas. Overall spending increased by 5.3% in real terms. However, 49% of authorities reduced their capital expenditure during this period, with nearly three quarters (72%) of metropolitan district councils reducing their capital spending. These authorities have also seen the greatest reduction in average revenue income since 2010-11. Most service areas saw an increase in capital spend, but culture and related services was an exception: capital spending fell by 22% in this service area, including reductions of 33% on open spaces and 60% on libraries (paragraphs 2.2 to 2.3 and 2.7 to 2.10, and Figures 12, 14 and 15).

17 Authorities have focused capital spending on meeting their statutory responsibilities, engaging in 'invest to save' activities and promoting local growth. Authorities have prioritised investment in their assets to ensure that they meet their statutory obligations, such as ensuring that their assets comply with road safety or disability discrimination legislation. However, some have reduced revenue expenditure on routine maintenance, and others have reduced investment in more major capital works on their existing assets. All authorities we spoke to are engaged in invest to save schemes, frequently focused on rationalising their estate. Some authorities are developing capital investment strategies to secure revenue income. Authorities have also been prepared to invest in schemes to support local growth (paragraphs 2.11 to 2.24).

18 Authorities face a growing challenge to continue long-term investment in their existing assets. Capital strategies have begun to shift from focusing on managing assets, to generating revenue savings and commercial income. Total spending has remained stable, but increasingly capital activities are focused on invest to save and growth schemes that cover their costs or have potential to deliver a revenue return. However, many areas of authorities' asset management programmes do not meet these criteria and are now seen as a lower priority. In particular, authorities told us they are delaying long-term investment in capital works on existing assets. This raises concerns about the possible degradation of authorities' assets and pushes the costs of the maintenance backlog into the future (paragraphs 2.13 to 2.15 and 2.25 to 2.27).

The role of the Department

19 The Department takes assurance from its devolved framework for capital which is robust, but it needs to combine this with a deeper understanding of sector-wide issues. The devolved framework for capital, centred on the Chartered Institute for Public Finance and Accountancy's (CIPFA) prudential code for capital finance, provides assurance on financial sustainability at the authority level. However, it does not provide a mechanism for identifying trends and issues across the sector. Consequently, the Department has limited insight into broad changes in authorities' capital resourcing and spending, and associated risks. We have identified several trends, such as the use of internal borrowing, that the Department has not monitored. The Department needs to use data to improve its understanding of risks at the system level, and use this information to support future decision-making (paragraphs 3.5 to 3.8, and 3.20 to 3.24).

20 The Department rightly focused on revenue issues in the 2015 spending review but it will need to focus more on capital in future reviews. The Department is confident from its engagement with authorities that revenue pressures are their main concern. However, our analysis demonstrates that capital costs exert a significant pressure on authorities' revenue resources. The Department told us it recognises that there is room for improvement in future spending reviews in relation to its understanding and inclusion of capital. We would support this, particularly in relation to understanding other departments' plans for capital grants (paragraphs 3.10, and 3.13 to 3.18).

21 The Department made a significant change within the capital control framework in 2016-17 without assuring itself sufficiently on the likely outcomes. The Department allowed authorities to use capital receipts to support the revenue start-up costs of transformation projects for a three-year period from 2016-17 in what it described as "a radical shake-up of spending rules". Before, receipts could only be used to pay off debt or invest in capital programmes. This represents a major shift within a system that has been effective in securing authorities' financial sustainability and in ensuring that public resources invested in their asset bases are used to secure value for money. While there are challenges in estimating the level of take-up of this new flexibility, the Department could have done more modelling and consultation work to assure itself on potential outcomes given the significance of the change (paragraphs 1.16, and 3.27 to 3.32).

22 Authorities and the Department need to strike an appropriate balance between short-term and long-term considerations with regard to capital arrangements. A variety of decisions by authorities, including changing minimum revenue provision charges and reducing long-term maintenance spending, have prioritised the short term over the long term in their judgement of what is prudent. The Department has increased the scope for such decisions with the new capital receipts flexibility. As financial pressures continue and intensify, such choices may increase. While we recognise the importance of short-term requirements, local authorities and the Department must consider the long-term value-for-money impacts of decisions relating to capital investment and debt servicing (paragraphs 1.29 to 1.31, 2.13 to 2.15 and 3.31 to 3.32).

Conclusion on value for money

23 Local authorities' capital programmes since 2010-11 have not been under the same pressure as their revenue income. Authorities have maintained their overall capital spending levels and have acted prudently, seeking to minimise or reduce the cost of debt servicing wherever possible. Despite authorities' best efforts, debt servicing costs account for a significant share of revenue spending, and this is likely to increase further. This means further borrowing by some authorities may not be affordable, calling into question their capacity to invest in and maintain their core assets.

24 The Department needs to strengthen its understanding of the capital issues faced by local authorities. The Department is right to take confidence from the devolved capital control framework built around the prudential code, but this is not enough by itself. It should be complemented with an understanding of system-wide issues and risks that the Department does not currently have. This includes an understanding of the drivers behind, and implications of, local authorities pushing debt servicing costs into the future and delaying investment in capital works. Without this understanding of broader trends the Department will not be well placed to anticipate risks to value for money from changes in authorities' capital programmes as they come under greater financial pressure.

Recommendations

a **The Department should improve its understanding of capital expenditure and resourcing issues and risks across the sector.** Working with CIPFA, the Department should analyse these issues based on its existing data.

b **The Department should examine the variety of approaches to recalculating minimum revenue provisions currently used by local authorities, and consider whether it needs to review its existing guidance to the sector.**

c **The Department and HM Treasury should engage with local authorities to investigate the causes of and any possible systemic risks resulting from the build-up of investment cash held on deposit by local authorities.**

d **The Department needs to investigate the extent to which authorities are reducing their asset management programmes and assess the potential long-term implications.**

e **There should be a review of the current capital framework to ensure that it is likely to lead to decision-making that appropriately considers the long term given expected financial pressures:**

- **CIPFA should consider the long-term implications of decision-making in its planned review of the prudential code.**
- **In conjunction with this work the Department should review the other elements of the framework to ensure that the system as a whole will continue to be sufficiently robust.**
- **The Department must ensure that any future significant changes to the capital control framework are accompanied by meaningful and proportionate risk assessment.**

f **The Department should investigate whether the data it publishes on capital spending and resourcing could be made more relevant to local authorities.**