Capital Gains

Improving the Local Government Capital Expenditure System
The Audit Commission

... promotes proper stewardship

of public finances and helps those

responsible for public services

to achieve economy, efficiency

and effectiveness.
1 An Introduction to Local Authority Capital Expenditure

2 How Well Has the Capital Expenditure System Been Working?

3 Government Attempts to Improve the System 1991–97

4 An Agenda for Change
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© Audit Commission 1997
First published in July 1997 by the Audit Commission for Local Authorities and the National Health Service in England and Wales, 1 Vincent Square, London SW1P 2PN
Printed in the UK for the Audit Commission by Belmont Press Ltd, Northampton.
ISBN 1 86240 031 8
Photography: Sally and Richard Greenhill (p17); Pictor International (cover, p65); Hilary Shedel (p5); Tony Stone Images (cover, p43); and with thanks to Nottingham City Council.
Preface

In February 1995 the Audit Commission for England and Wales began a value-for-money study on local authority capital expenditure. The study was carried out in two phases. The Phase 1 report, *Just Capital...* (Ref. 1), was published in September 1996 and examined the performance of councils in planning and managing capital projects. A management handbook, *Rome Wasn’t Built in a Day* (Ref. 2), published in February 1997, complemented the report and provided examples and checklists to help local authority managers improve programme and project performance. And auditors have had an Audit Guide to assist them during 1996 and 1997 as they have reviewed the performance of individual authorities, identifying opportunities for improvement and preparing reports for councils.

This report, on Phase 2 of the Commission’s study, examines the broader issues concerned with the capital expenditure system. What are the respective roles of central and local government in the capital expenditure process? How well is the capital system working? Which services use most capital expenditure? Is enough capital available? Are resources allocated and used efficiently? How can the system be improved? This is not the first time that the Commission has examined these issues. But since the previous report in 1985 (Ref. 3), the statutory basis for capital spending has changed radically. In addition, the outgoing government set up the National Lottery, developed competitive bidding as a way of allocating a growing proportion of capital resources and sought to attract increased finance (principally from the private sector, but also from the EC) into the public sector. These changes make it timely for the Commission to return to the subject.

This study is based on an investigation that preceded the 1997 General Election. The new Government inherits the problems described in this report. The Commission hopes that its analysis and conclusions will stimulate a review of central government policies and procedures, in order to tackle the underlying issues and problems.

In addition to surveying 60 authorities and visiting 10 for Phase 1 of the study, additional evidence has been collected from:

- visits to a further 14 authorities (listed in Appendix 1);
- a questionnaire completed by 248 authorities in England and Wales (60 per cent of those surveyed);
- data on capital expenditure published or supplied by government departments;
- interviews with civil servants from the government departments with an interest in local government capital expenditure in England, from the Welsh Office and from three Government Offices of the Regions;
discussions with other interested parties such as the local authority associations and the Chartered Institute of Public Finance and Accountancy; and

consultancy studies undertaken at the Commission's request by Warwick University Business School and Ecotec Research and Consulting Limited on the impact of European Union funding on capital programmes (Ref. 4), by Price Waterhouse on the private finance initiative (PFI) and by the London Research Centre on the capital control system in France.

The Commission would like to thank all those who contributed to the study team's research and to the advice and assistance provided by an advisory group (the membership of which is detailed in Appendix 2). As always, responsibility for the conclusions and recommendations remains with the Commission.

The study team was led by Robert Hill and comprised Matthew Allen, Max Peacock on secondment from Department of the Environment and Carmel Zammit on secondment from District Audit, under the direction of Bob Chilton and Greg Wilkinson. Sarah Wallace and Tina Eberstein undertook valuable work on data analysis and exhibit preparation.

This report is published in two volumes. The main findings are to be found in this volume; the second volume – the Technical Supplement – includes a technical explanation of the capital systems in England and Wales, further details on the demand for capital expenditure and an examination of the capital control system in France.

The system of capital expenditure is exceptionally complex. It has spawned a shoal of abbreviations which are unique to itself. These tend to limit discussion to a few specialists who have mastered the terminology. To overcome such 'jargon', each chapter of this report is preceded by a glossary of abbreviations to be found in the subsequent text.
Local authorities are responsible for a wide range of services, and have an extensive portfolio of assets (with an estimated worth of over £120 billion) to help deliver these services. Spending on these assets counts as capital expenditure, and in 1996/97 totalled about £7 billion in English and Welsh authorities. Central and local government both play a part in taking and funding capital expenditure decisions - but they pursue different objectives, with those of central government dominating.

Since the mid-1970s, the restraint of public expenditure has been a priority for central government. The 1980 Planning and Land Act - the first major legislative attempt to control local authorities' capital spending - was unsuccessful. It was replaced by the 1989 Local Government and Housing Act, which brought capital expenditure far more closely into line with government forecasts. But the control of expenditure is not the only criterion against which the system should be judged.
Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACG</td>
<td>Annual Capital Guidelines - a guide issued by central government for individual authorities, representing the government department’s assessment of each authority’s relative need for capital expenditure on a service. They are issued for five major service areas: education, housing, personal social services, transport and other services.</td>
</tr>
<tr>
<td>BCA</td>
<td>Basic Credit Approval - the ‘permission to borrow’ issued to each authority for each financial year as a block credit approval to cover all types of capital expenditure.</td>
</tr>
<tr>
<td>DoE</td>
<td>Department of the Environment.</td>
</tr>
<tr>
<td>MRP</td>
<td>Minimum Revenue Provision - the amount that councils have to set aside each year to repay debt.</td>
</tr>
<tr>
<td>RTB</td>
<td>Right to Buy - describes the right of council tenants to purchase their home from their local authority landlord.</td>
</tr>
<tr>
<td>RTIA</td>
<td>Receipt taken into account - the Government’s assessment of local government’s ability to finance capital expenditure from usable capital receipts. Each authority’s share of the national RTIA total is calculated by the Department of the Environment. An authority’s BCA is the sum of its ACGs for each service less its share of the RTIA total.</td>
</tr>
<tr>
<td>SCA</td>
<td>Supplementary Credit Approval - a credit approval above and beyond an authority’s basic credit approval, issued for a specific project or programme that fits in with government policy.</td>
</tr>
</tbody>
</table>
Local authorities in England and Wales are responsible for a wide range of important local services. For example, over seven out of ten children attend schools maintained by local education authorities, and over three million households rent their home from their local council. Local authorities also organise care and support for children, young people, families and elderly people; assess and pay important welfare benefits; run libraries and leisure services; collect and dispose of rubbish; maintain and clean most of the nation’s roads; check food hygiene and provide fire cover. To help deliver these services authorities have, over the years, invested in buildings, equipment and other expensive items. Schools, fire stations, blocks of flats, town halls, maintenance depots, swimming pools, leisure centres, old people’s homes and mainframe computers illustrate the varied nature of authorities’ asset portfolios.

Spending on these costly items counts as capital expenditure, and councils fund this expenditure in a variety of ways (Exhibit 1 and Box A). In 1996/97 councils in England and Wales spent around £7 billion on capital projects, with most money being spent on housing, followed by transport and education (Exhibit 2, overleaf).

Current and capital expenditure are identified separately in company accounts, in order to recognise the increased capital value of a company and its productive potential. But there is no statutory framework that earmarks a company’s resources as revenue or capital. Private companies can choose whether to invest in a capital- or revenue-intensive scheme on the basis of which option offers better value for money. This is not the case with local authorities – they face separate statutory capital and revenue expenditure controls that limit their freedom to take investment decisions.

Capital assets are an expensive commitment. It can take many years to pay off a loan, and the assets themselves may have to last up to 100 years. So decisions on how much to spend on capital schemes, and which projects to fund, are important: they have long-term implications. Central and local government both play a part in taking and funding capital decisions, but they approach the issue from different perspectives.

### Box A
**Defining and paying for capital expenditure**

Capital expenditure is, at its simplest, spending on large items that are expected to provide benefit for several years. Spending may take the form of purchasing, building, replacing or improving an asset. Local authorities finance their capital expenditure in one of five main ways:

- by government-approved borrowing. Each year the Government issues councils with credit approvals, permissions to borrow up to a specified amount to fund either general capital schemes or specific projects;
- by grants from government departments;
- by grants from other bodies, such as the Arts and Sports Councils, English Heritage and the Millennium Commission;
- by selling land and property to generate capital receipts; and
- by using their revenue budgets.
Most money is spent on housing, followed by transport, education and a range of other services.

Notes: Around two-thirds of the ‘housing’ total is spent on council housing; the other third is allocated by local authorities to housing associations (to support new housing) and to low-income owners and disabled people (to support improvements). ‘Other Services’ includes arts and libraries; coastal and flood protection and smallholdings; fire service; sport and recreation; and general services - including waste collection and disposal, administrative buildings, planning and development and industrial and commercial estates.

Four main principles have historically been evident in central government’s policies for local capital expenditure:

- the capital system must ensure financial prudence. Have local authorities made proper provision for repaying the sums they have borrowed? Will the total of a council’s capital spending place too high a burden on local taxpayers - both currently and in future? To ensure that councils act prudently, governments have, over the years, required councils to limit debt levels and to set periods for repaying loans;

- local authority capital expenditure must be controlled, as it forms part of overall public spending on which the Government has imposed cash limits;

- the distribution of capital resources among local authorities and between services should reflect government policy objectives (as well as national and local assessments of need); and

- within these controls local authorities should be responsible for deciding how to spend capital budgets and for managing capital assets, but the capital system should encourage efficiency.
Local government’s interests have not been the highest priority for central government. But local authorities have as strong a focus on local needs, as central government has had on national needs. Councils have seen it as their role to:

◆ assess which of the many statutory services and other community needs in their area have the highest priority, so that they can prepare capital programmes and bid for resources from government departments and other external agencies;

◆ balance the demands on their revenue and capital budgets and decide, within the Government’s capital framework, on the overall level of capital funding for a financial year and which projects should go ahead; and

◆ manage their existing capital assets, including deciding whether and when to dispose of assets, to reinvest the proceeds and to renovate or replace buildings and other facilities.

Inevitably, tensions have arisen between central and local government as they have developed their roles - although it would be wrong to characterise the history of local government as one of central government always attempting to restrain local expenditure and activity (Box B, overleaf). In the latter half of the last century, and in the period after 1945, central government used local authorities to expand services and encouraged capital spending. Councils have also had powers over the years to respond imaginatively to local needs by piloting new roles, such as gas supply, support for local industry and sheltered housing. However, it has always been central government that has set the financial and statutory terms of the relationship with local government.

This became particularly apparent in the late 1970s when government policies of spending restraint replaced those of expansion. The 1980 Local Government, Planning and Land Act abolished loan sanctions and for the first time defined most types of capital expenditure in law. Local authorities made provision to repay debt over the life of the assets. Capital spending - whether it was funded by borrowing, grant, capital receipts or revenue - was subject to an annual government-imposed allocation. This Act also prevented councils from spending all of the proceeds gained from selling assets.
**Box B**

**Key developments in local authority capital spending and borrowing**

<table>
<thead>
<tr>
<th>Period</th>
<th>Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>1550 – 1600</td>
<td>First examples of local authorities borrowing to finance capital projects. Bristol City Council borrowed money to entertain Queen Elizabeth I and lay new water pipes.</td>
</tr>
<tr>
<td>1600 – 1700</td>
<td>Poor Law relief, including almshouses and workhouses, and road maintenance financed by parish rates.</td>
</tr>
<tr>
<td>1700 – 1830</td>
<td>Turnpike trusts given borrowing powers to build roads and bridges, with tolls levied on users providing earmarked income to pay the interest and repay the loans.</td>
</tr>
<tr>
<td>1830 – 1880</td>
<td>County boroughs set up for the major towns and cities. Individual Acts of Parliament allow local authorities and service-specific boards access to borrowing, through a Public Works Loans Commission, to provide hospitals, schools, roads, prisons, libraries and sanitation. The first district auditors appointed to inspect the accounts of authorities administering the Poor Law.</td>
</tr>
<tr>
<td>1880 – 1920</td>
<td>County councils established and, subject to the approval of a Local Government Board, allowed to borrow. A prudential framework of borrowing limits, sinking funds and consolidated loan funds developed.</td>
</tr>
<tr>
<td>1920 – 1945</td>
<td>Half of local government spending now financed by central government through a block grant and specific grants, and half through a general rate. Government ministers take over from the Local Government Board the role of approving loans for specific capital projects.</td>
</tr>
<tr>
<td>1945 – 1975</td>
<td>Some local authority functions, such as health, transferred to central government, but spending on housing and education grows rapidly. Borrowing for capital projects still subject to ministerial loan sanctions and prudential rules.</td>
</tr>
<tr>
<td>1975 – 1990</td>
<td>Central government decides to reduce levels of public spending. Loan sanctions are abolished and replaced by an annual cash-limit on councils' capital spending. Audit Commission set up. Council homes sold. Rate-capping introduced.</td>
</tr>
<tr>
<td>1990 – 1997</td>
<td>The Government tightens the controls on borrowing and capital receipts. Revenue budgets of all councils capped. Increasing use of competitive bidding for capital resources. Government seeks to attract funding from the private sector.</td>
</tr>
</tbody>
</table>

*Sources: Local Authority Borrowing: Past, Present and Future (Ref. 5) and Audit Commission*
The 1980 Act did not work as planned. The Audit Commission’s 1985 report on capital expenditure (Ref. 3) showed how capital spending was ballooning out of control and identified a number of reasons for this problem (Exhibit 3):

◆ lack of control. Defective drafting of the legislation resulted in local authorities being able to re-use far more of the receipts from the right-to-buy (RTB) sale of council homes than had been intended by central government. This problem was made worse by the fact that such sales ran at higher than expected levels; at one stage RTB receipts were yielding £4 billion a year. Furthermore these receipts were not distributed evenly. They were generally concentrated in those areas with the most desirable housing, not necessarily those with the greatest housing need;

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Exhibit 3
Key problems associated with capital control systems in the 1980s

The Audit Commission’s 1985 report showed how capital spending was ballooning out of control and identified a number of reasons for this problem.

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Capital finance during the 1980s

9. The 1980 Act did not work as planned. The Audit Commission’s 1985 report on capital expenditure (Ref. 3) showed how capital spending was ballooning out of control and identified a number of reasons for this problem (Exhibit 3):

◆ lack of control. Defective drafting of the legislation resulted in local authorities being able to re-use far more of the receipts from the right-to-buy (RTB) sale of council homes than had been intended by central government. This problem was made worse by the fact that such sales ran at higher than expected levels; at one stage RTB receipts were yielding £4 billion a year. Furthermore these receipts were not distributed evenly. They were generally concentrated in those areas with the most desirable housing, not necessarily those with the greatest housing need;
poor information. Central government’s information on spending levels was not accurate. By 1989/90 local government capital spending in England had reached a peak of £10 billion – some two and a half times the amount forecast in government spending plans; and

creative accounting. Local authorities had started to develop innovative ways of sidestepping the borrowing regulations and the central government annual capital cash-limit. They were, for example, agreeing deals to use facilities provided by a third party but postponing payment to future years or linking payments to a future redevelopment. They were effectively adopting a ‘buy now, pay later’ approach that was at odds with central government concerns for financial prudence. Although the 1980 Act did contain measures to control these schemes, the Commission’s report showed how government attempts to regulate them were beginning to fail.

Local Government and Housing Act 1989

10. Against this background, the government of the day rewrote the capital control regime (it had already overhauled local government revenue-raising in 1988, by replacing domestic rates and locally set business rates with the Community Charge and a uniform business rate). At that time ministers argued that the nation’s wider economic interests required fairer and more effective control of local government borrowing (Box C). The resulting Local Government and Housing Act 1989 used a fourfold strategy to bring capital-spending levels back down to earth (Box D and Exhibit 4, overleaf).

Box C

Reasons for the capital finance provisions of the Local Government and Housing Act 1989

‘The present capital control system has few friends. It has not delivered the Government’s spending plans and it has led to the wrong distribution of spending between authorities. The new system changes the system from the control of capital expenditure to control of the sources of finance ... we will issue credit approvals to control the amount of credit that an authority can borrow ... It is right for the Government to control that as part of their management of the national economy.’

Rt Hon. Nicholas Ridley MP, speaking in the House of Commons on 14 February 1989 (Hansard col. 169).
Box D
Key aspects of the Local Government and Housing Act 1989

The 1989 Act was built around four principles:

1. **It established a baseline** - all local authority spending has to be treated as revenue unless it falls within the definition of capital expenditure. This means that unless an item can be considered as capital, authorities have to pay for it in the year in which they incur the cost of it.

2. **It defined permitted capital spending** - expenditure coming within the definition of capital may be charged to a local authority’s revenue budget, but need not be so charged if it is:
   - funded by a capital grant paid by a government department or another agency, such as the Sports Council, the National Lottery or a private company; or
   - funded from usable capital receipts: that is, the proportion of a capital receipt received by a council that is left after a proportion has been set aside to repay outstanding debt. The set-aside part of the receipt is normally 75 per cent for council housing and 50 per cent for most other assets, with the remainder constituting the usable receipt; or
   - covered by a credit approval – a permission to borrow – issued by a government department. There are two types of credit approvals. A basic credit approval (BCA) is issued to each authority each financial year as a block credit approval to cover all types of capital expenditure. Supplementary credit approvals (SCAs) are issued for specific projects and programmes that fit in with government policy.

3. **It enabled the Government to limit the overall level of local government’s capital expenditure** - not by setting an annual capital cash-limit for individual councils, but by controlling allocations of capital grants and credit approvals and by restricting the use of capital receipts.

4. **It provided a supporting framework that reinforced the aims of the Act by**:
   - regulating local authority companies (partly to prevent them being used as a way to avoid capital controls), although this section of the Act was not implemented until 1995;
   - obliging authorities to make a Minimum Revenue Provision (MRP), as a way of ensuring that proper provision was made to repay debt and of avoiding too much of the debt burden falling on future taxpayers. The MRP was set at two per cent of housing debt and four per cent of other debt; and
   - controlling creative accounting. To remove any incentive for authorities to defer expenditure or postpone payments, the Act required the full value of finance leases and other credit arrangements to count against an authority’s credit approvals, usable capital receipts or revenue in the year that a contract begins.
The 1989 Act has largely delivered its objectives:

◆ It has enabled central government to control local authority capital expenditure. Levels of spending and capital receipts since 1990 have turned out much closer to government forecasts than they did in the 1980s (Exhibit 5) – although the reduction in capital receipts has also helped.

◆ The Act has removed the attractiveness of creative accounting. Although local authority external auditors are still reporting problems arising from schemes entered into in the 1980s, the post-1990 regime does not appear to be throwing up similar difficulties.

◆ The MRP requirement ensures that councils have to make the traditional prudential provision for repaying borrowing, and ministers’ control of the allocation of grants and credit approvals means that they can distribute capital resources by service to reflect national priorities.

◆ And the system has also enabled central government to take account of authorities’ relative resources in making new capital allocations (Box E, overleaf).
The rewriting of the capital system can, therefore, be considered a success from the perspective of Whitehall. It has addressed many of the problems inherent in the 1980s arrangements. But has the system worked as well when judged against other objectives? Is it enabling local authorities to meet their statutory and other community requirements? How far is it helping them to plan an effective capital programme? Is it providing incentives for authorities to maintain and manage their assets efficiently? Chapter 2 examines these issues. Chapter 3 of this report goes on to explore the range of initiatives that central government has introduced to tackle perceived problems within the system and provides an evaluation of these initiatives. Finally, Chapter 4 outlines a series of options for improvements to the capital expenditure system.

Exhibit 5
Variance in local authority capital expenditure and capital receipts from government forecasts

Levels of spending and capital receipts since 1990 have turned out much closer to government forecasts than in the 1980s.

Source: Audit Commission analysis of DoE data
The process for equalising capital resources

Box E
Process for equalising capital resources

The spending allocation for each government department is decided in late November as part of the Budget process. Shortly after this, departments notify authorities of an annual capital guideline (ACG) for each main service, based on their appraisal of councils' bids for capital schemes. But before the service ACGs are converted into a BCA for each authority, a proportion of an authority's usable capital receipts are taken into account (RTIA) and deducted from its ACG. The Government does this to redistribute resources from those authorities that are cash-rich, through selling council homes or other assets, to those councils with lower receipts. Expressing this mechanism as an equation:

\[
\text{an authority's BCA} = \text{the total of its ACGs} - \text{its RTIA assessment}
\]

If the amount of an authority's usable receipts taken into account is higher than the total of its ACGs, then the authority receives a BCA of zero. In 1997/98, 101 non-metropolitan districts (of 267), five London authorities, one metropolitan district and one new unitary authority fell into this category.

In 1997/98, £325 million - 31 per cent - of councils' usable capital receipts in England were taken into account to achieve a partial redistribution of resources. A full equalisation of resources would require a 100 per cent-rated RTIA. The RTIA system does not apply in Wales - although the capital framework in Wales is based on the 1989 Act (see the Technical Supplement to this report).
The capital expenditure system causes serious problems for local authorities. Firstly, the procedures for allocating resources do not provide them with sufficient security and flexibility to allow effective forward planning. Secondly, technical aspects of the system cause confusion and inhibit value for money. And thirdly, the demand for capital expenditure outstrips the resources available. Estimates vary, but up to £15 billion might be required over the next five years to bridge the gap.

These problems are compounded by the failure of many authorities to manage their portfolio of assets properly. Many councils are short-termist in their planning and programming; others lack the mechanisms for effective corporate control over their capital expenditure; and only a minority of authorities collect comprehensive data on the condition of their assets.
## Glossary

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<td>BCA</td>
<td>Basic credit approval - the ‘permission to borrow’ issued to each authority for each financial year as a block credit approval to cover all types of capital expenditure.</td>
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<tr>
<td>CCT</td>
<td>Compulsory competitive tendering - the process whereby local authorities must invite external companies to submit bids for many ‘manual’ and some ‘white-collar’ services and, if they wish to continue providing these services using their own staff, show that it is better value for money to do so.</td>
</tr>
<tr>
<td>CIPFA</td>
<td>Chartered Institute of Public Finance and Accountancy.</td>
</tr>
<tr>
<td>DfEE</td>
<td>Department for Education and Employment.</td>
</tr>
<tr>
<td>DLO/DSO</td>
<td>Direct labour organisation or direct service organisation - internal local authority trading units staffed by the authority’s own employees, set up to compete with external companies to provide services for the council.</td>
</tr>
<tr>
<td>DoE</td>
<td>Department of the Environment.</td>
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<td>DoH</td>
<td>Department of Health.</td>
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<tr>
<td>DoT</td>
<td>Department of Transport.</td>
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<tr>
<td>ERDF</td>
<td>European Regional Development Fund.</td>
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<td>EU</td>
<td>European Union.</td>
</tr>
<tr>
<td>FOLACL</td>
<td>Federation of Local Authority Chief Librarians.</td>
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<tr>
<td>IT</td>
<td>Information technology.</td>
</tr>
<tr>
<td>LEA</td>
<td>Local education authority.</td>
</tr>
<tr>
<td>RSG</td>
<td>Revenue support grant - the financial support made available to local authorities by central government to help pay for the cost of local services.</td>
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<td>SRB</td>
<td>Single regeneration budget.</td>
</tr>
<tr>
<td>SSA</td>
<td>Standard spending assessment - the Government’s view of what a local authority needs to spend to provide a standard level of service consistent with overall public spending targets, taking into account the social, demographic and geographical characteristics of the authority’s area. SSAs are used to distribute Revenue Support Grant and as part of the capping regime.</td>
</tr>
<tr>
<td>TPP</td>
<td>Transport Policies and Programmes - the principal system by which the Department of Transport distributes capital resources to authorities for local transport schemes.</td>
</tr>
<tr>
<td>TSG</td>
<td>Transport supplementary grant.</td>
</tr>
<tr>
<td>WLGA</td>
<td>Welsh Local Government Association.</td>
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</tbody>
</table>
While the current capital system may meet central government’s objectives, it does not necessarily meet those of local government. Four key questions can be asked of the system:

- How well is the allocation system working – does it provide certainty and flexibility to allow effective forward planning?
- What impact do technical regulations have on council decisions regarding the use of capital resources?
- Is the level of capital resources sufficient for authorities’ investment needs?
- Is local authorities’ management of capital resources at the highest levels of efficiency and effectiveness?

This chapter assesses performance against these key questions.

The last government intended the 1990 system not only to strengthen its control over councils’ capital spending but also to bring greater certainty to the process, while still allowing authorities flexibility to respond to unforeseen developments. Certainty would be achieved by giving authorities a firm capital allocation for each financial year and ‘provisional limits for three years ahead’ (Ref. 6). A block allocation (Basic Credit Approval, or BCA) and freedom for councils ‘to supplement their capital spending by spending from usable capital receipts and also revenue’ (Ref. 6) would provide flexibility. But local authorities say the system has failed to deliver these objectives. Their five most-desired changes in the capital finance system all relate to increased certainty and flexibility (Exhibit 6). Although capital allocations are effectively guaranteed over several years (once funding for an individual road, school or regeneration project is underway), new allocations are highly uncertain, and authorities have very limited flexibility over how and when they can use them. Councils highlight five reasons for this:

14. The last government intended the 1990 system not only to strengthen its control over councils’ capital spending but also to bring greater certainty to the process, while still allowing authorities flexibility to respond to unforeseen developments. Certainty would be achieved by giving authorities a firm capital allocation for each financial year and ‘provisional limits for three years ahead’ (Ref. 6). A block allocation (Basic Credit Approval, or BCA) and freedom for councils ‘to supplement their capital spending by spending from usable capital receipts and also revenue’ (Ref. 6) would provide flexibility. But local authorities say the system has failed to deliver these objectives. Their five most-desired changes in the capital finance system all relate to increased certainty and flexibility (Exhibit 6). Although capital allocations are effectively guaranteed over several years (once funding for an individual road, school or regeneration project is underway), new allocations are highly uncertain, and authorities have very limited flexibility over how and when they can use them. Councils highlight five reasons for this:

Exhibit 6
Changes to the capital finance system desired by local authorities

The five highest priorities for change all relate to increased certainty and flexibility.
‘Recent practice has been for central government to notify authorities of their BCA just three months before the start of the financial year.’

- the Government gives them too little advance notice of their capital allocations;
- the rules on having to use capital allocations within a financial year are too rigid;
- indications of forward funding do not form a reliable basis for medium-term planning;
- too many capital allocations are earmarked for specific projects; and
- frequent changes to the capital system undermine longer-term planning.

Each of these criticisms warrants consideration to assess its validity.

**Short and late notice**

15. Recent practice has been for central government to notify authorities of their BCA just three months before the start of the financial year. Capital projects take a long time to plan, and short notice means that authorities have to risk time and money on planning projects that may not proceed once an authority’s BCA is known. Moreover, authorities simply do not have enough time after the BCA announcement to adjust capital programmes and budgets, finalise project plans and let tenders, in order to make sure that they can use the whole allocation in the following financial year. It is no accident that April and May are the months when the fewest new projects start on site.

16. The position with supplementary credit approvals (SCAs) is even more acute. These may be announced at the same time as BCAs, but in England they are often notified later. These may only be confirmed up to six months after the end of the financial year to which they relate. The Department of the Environment (DoE) says that this is to enable SCA cover to correspond with the actual amount spent (Ref. 6). But the arrangements make it difficult to plan SCA-related projects (Case Study 1).

**Case Study 1**

**A social services project in a county council**

Rushing to use an SCA that is notified after the financial year starts can result in inadequate preparation, and poor value for money.

A county council bid for SCA cover of £650,000 for building two new drop-in centres for the mentally ill. In June 1994 – three months into the financial year – it was awarded an SCA of £300,000. The money had to be spent by 31 March 1995.

Awarded less than half its bid, the council had to rethink the entire project. It decided to go for just one centre, based on buying and converting a building. Design and tendering were rushed. Problems were then discovered on site that, had a longer planning period been possible, would have been found earlier; as a result, the contract for the work had to be extended from 9 to 17 weeks. This took the completion of the project well past the end of the financial year, which meant that the authority risked losing some £70,000 of its SCA allocation. In the event, the Department of Health issued a further SCA in 1995/96 for £40,000, but the authority had to make up the shortfall from its own revenue reserves.
Lack of flexibility between years

17. BCAs and nearly all SCAs have to be used within the year to which they relate. Section 54 of the Local Government and Housing Act 1989 theoretically allows ministers to issue an SCA that lasts more than 12 months and (or) that spans more than one financial year, but this provision has rarely been used. This rigid time-frame can lead to a ‘spend-up syndrome’, as authorities rush to complete projects and use their credit approvals before the end of the financial year. This often results in poor value for money and may act as a disincentive for authorities to scrutinise contractors’ accounts rigorously. The Association of London Government has argued that these problems could be reduced if the Government used the facility in the 1989 legislation, either introducing two-year SCAs or allowing a ‘limited carry over of unused SCA into the following financial year’ (Ref. 7). But, so far, the proposal has foundered on the Treasury’s annual cash-limit system, with the DoE arguing that ‘issuing SCAs for a period covering more than one financial year would create difficulties for forecasting and controlling public expenditure’ (Ref. 6). The significance of these difficulties would depend on the value of SCAs issued in this way.

Breakdown in forward indications

18. When the new capital system began in 1990 central government provided ‘forward indications’ of an authority’s annual capital guideline (ACG) for one or two years ahead at the same time as it announced its capital allocations for the next financial year. It still does so for some services. But the process has not committed ministers to particular levels of funding. Increasingly, forecasts and forward indications vary significantly from actual allocations – both nationally (Table 1) and locally.

Table 1
Variations in predicted credit approvals and grants for 1997/98

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Challenge</td>
<td>-</td>
<td>-</td>
<td>150</td>
<td>-</td>
</tr>
<tr>
<td>Education and Employment</td>
<td>435</td>
<td>419</td>
<td>413</td>
<td>-5</td>
</tr>
<tr>
<td>Housing</td>
<td>1,242</td>
<td>1,056</td>
<td>811</td>
<td>-35</td>
</tr>
<tr>
<td>Other Services 1</td>
<td>268</td>
<td>262</td>
<td>397</td>
<td>48</td>
</tr>
<tr>
<td>Personal Social Services 2</td>
<td>145</td>
<td>150</td>
<td>81</td>
<td>-44</td>
</tr>
<tr>
<td>Protective Services</td>
<td>304</td>
<td>212</td>
<td>202</td>
<td>-34</td>
</tr>
<tr>
<td>Single Regeneration Budget</td>
<td>616</td>
<td>560</td>
<td>480</td>
<td>-22</td>
</tr>
<tr>
<td>Transport</td>
<td>861</td>
<td>756</td>
<td>712</td>
<td>-17</td>
</tr>
<tr>
<td>Total</td>
<td>3,871</td>
<td>3,415</td>
<td>3,246</td>
<td>-16</td>
</tr>
</tbody>
</table>

Note 1: Other Services includes EU projects, sport and recreation, coastal protection, land drainage, fire service, and for 1996, £150 million for local government reorganisation.

Note 2: £33 million of Social Services funding transferred from capital to revenue.

Sources: HMT Cm. 2821 and Cm. 3201; and DoE CPWP (96)21.
Table 2

<table>
<thead>
<tr>
<th>Service</th>
<th>Date of forward indicator</th>
<th>Forward indicator (£m)</th>
<th>Actual ACG (£m)</th>
<th>Variation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>January 1995</td>
<td>5.802</td>
<td>8.166</td>
<td>41</td>
</tr>
<tr>
<td>Other Services</td>
<td>October 1995</td>
<td>0.542</td>
<td>0.996</td>
<td>84</td>
</tr>
<tr>
<td>Social Services</td>
<td>December 1994</td>
<td>2.538</td>
<td>2.809</td>
<td>11</td>
</tr>
</tbody>
</table>

Note: Further additions to the forward indicator for education were made during the year.

Source: Lancashire County Council

(Table 2) – and provide an unreliable basis for medium-term planning. The Government itself seems to have recognised the decreasing value of low and unreliable forward indications, and (with effect from the 1996 Budget) has abandoned issuing them for the Other Services block.

19. The problem of forward indications appears to be less acute for authorities in Wales, largely because BCAs and most of the Strategic Development Grant – the Welsh equivalent of the Single Regeneration Budget (SRB) – are distributed on a formula basis. This enables individual local authorities to project their future capital resources by applying the formula to estimates of total spending. In addition, the Welsh Office issues most SCAs at the start of the financial year.

Increased earmarking of credit approvals

20. Nearly three out of five authorities told the Commission that the arrangements for allocating education and transport capital resources were inflexible. One of the main reasons is that block allocations – BCAs – designed to give councils a flexible corporate capital spending power, have increasingly been supplanted by SCAs, whose use is tied to specific schemes. BCAs are falling in real terms and accounting for a smaller proportion of overall credit approvals, thus reducing flexibility (Exhibit 7). The DoE’s justification for this has been that it enables ‘capital spending power to be targeted in accordance with specific Government policies’ (Ref. 8). But earmarking funds restricts authorities’ ability to switch between funds and manage schemes within time limits. The growth in SCAs is a particular problem for non-metropolitan district councils: over 100 of them received no BCA for 1997/98, and those that did received BCAs largely just for council housing. Education and transport authorities claim that they, too, have a further problem. The system effectively requires them to treat a substantial proportion of their BCA as earmarked for particular schemes, since their allocations are based on project-specific bidding.
BCAs are falling in real terms and accounting for a smaller proportion of overall credit approvals, thus reducing flexibility.

Note: SCAs issued as credit cover for schemes funded by the European Union’s Regional Development Fund (ERDF) partly account for the rise in SCAs. In 1993/94 they accounted for £149 million, and in 1997/98 they are projected to account for £94.6 million.

Source: DoE

Changing regulations

Over the period 1990–97, the then government repeatedly adjusted the capital system. The Local Government and Housing Act 1989 was followed by 18 separate sets of regulations. While the early regulations were needed to establish the detailed framework of the legislation, the scope of subsequent changes has created problems. Amendments to the rules on capital receipts provide one example (Box F, overleaf). But other changes – including amendments to the so-called ‘in-and-out’ regulations on recycling capital receipts within a service area, the rules on large-scale voluntary housing transfers and the treatment of property leases – have created an unstable and shifting framework. Far-sighted authorities have not been able to plan long-term capital strategies with confidence or certainty, while others have an alibi for their short-term approach.

Summary

The current capital system is, therefore, unpredictable. The short notice, unreliable forward indications and changing regulations make it difficult for authorities to plan ahead, and give them little incentive to take the long view. The system also lacks flexibility and imposes challenging expectations on project management. Authorities are having to become more and more adept at planning their capital schemes and managing their cash-flow if they are to get round the rigidity of earmarked credit approvals and the requirement to use them within a financial year. The 1990 system was not intended to operate in this way. And it need not do so.
### Box F

**Amendments to the regulations since 1990 requiring local authorities to set aside a proportion of their capital receipts to repay debt**

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1990</td>
<td>Receipts set-aside fixed at 75 per cent for right-to-buy (RTB) sales and 50 per cent for most other disposals.</td>
</tr>
<tr>
<td>November 1992</td>
<td>Set-aside for most capital receipts reduced to zero from 13 November 1992 to 31 December 1993. For disposal of police, probation, magistrates' courts or civil defence assets, set-aside proportion reduced from 75 per cent to 50 per cent.</td>
</tr>
<tr>
<td>September 1993</td>
<td>Restrictions removed on the rate at which debt-free authorities can spend receipts arising from large-scale voluntary housing transfers.</td>
</tr>
<tr>
<td>January 1994</td>
<td>Calculation of set-aside rule changed to discount from the sale price money spent on bringing derelict land back into use.</td>
</tr>
<tr>
<td>April 1995</td>
<td>For disposal of airport companies and bus companies, set-aside proportion reduced from 50 per cent to 25 per cent for two years from 1 April 1995.</td>
</tr>
<tr>
<td></td>
<td>Set-aside proportion reduced from 75 per cent to 50 per cent for disposal of shares acquired before 10 March 1988 in economic development, entertainment and waste-disposal companies.</td>
</tr>
<tr>
<td>September 1995</td>
<td>For disposal of retail property and car parks, set-aside proportion reduced from 50 per cent to 10 per cent for one year from 1 September 1995.</td>
</tr>
<tr>
<td>January 1996</td>
<td>For disposal of crematoria, set-aside proportion reduced from 50 per cent to 10 per cent for 18 months from 1 January 1996.</td>
</tr>
<tr>
<td>April 1996</td>
<td>For disposal of local authority farms, set-aside proportion reduced from 50 per cent to 10 per cent for two years from 1 April 1996.</td>
</tr>
<tr>
<td></td>
<td>For disposal of education assets, set-aside proportion reduced from 50 per cent to 25 per cent for two years from 1 April 1996.</td>
</tr>
<tr>
<td>April 1997</td>
<td>Set-aside proportion reduced from 50 per cent to 25 per cent for disposal of unoccupied council dwellings, occupied industrial estates, docks and harbours, leisure facilities, shops and offices and land for development, provided</td>
</tr>
<tr>
<td></td>
<td>(i) the receipts are used on regeneration projects in specified deprived area and (ii) the private sector meets more than half of the projects' costs.</td>
</tr>
<tr>
<td></td>
<td>The reduced set-aside rates applying to the disposal of bus and airport companies extended for a further year.</td>
</tr>
</tbody>
</table>
What impact do the technical aspects of the regulations have?

23. As well as failing to deliver certainty and flexibility, the capital system has other flaws. Apparently small technical changes can have a big impact on both the amount and cost of capital finance available to local authorities. The technicalities of the system cause particular problems for authorities in three areas (Exhibit 8):

- the methods of funding capital expenditure;
- the definition of capital expenditure; and
- the existence of separate capital and revenue expenditure controls.

Methods of funding capital expenditure

24. Overall, around 40 per cent of government support for capital comes through capital grants, which are normally paid in full once approved expenditure has been undertaken and audited. An authority may have to borrow in the short term until the grant is paid, but apart from this, the capital is, in effect, free to the authority. The other 60 per cent of government support comes through credit approvals. All the costs of an authority’s permitted borrowing (other than for council housing), are meant to be met by Revenue Support Grant (RSG) with no long-term effect on its revenue budget – ‘the capital financing standard spending assessment (SSA)... is intended to cover the interest charges and capital repayments associated with an authority’s approved borrowing’ (Ref. 9). In theory, it should make little difference whether an authority’s capital support is in the form of a grant or credit approval. But in practice it does. In 1996/97 and 1997/98 the SSA system supported only 90 and 85 per cent respectively of borrowing costs. The main reason for this is that SSA support is based on a notional measure of debt, rather than on actual debt (see the Technical Supplement for a more detailed discussion of these issues). This difference between notional and actual debt is largest for London and metropolitan local authorities because of their past capital financing strategies.
Authorities that have reached the cap on their revenue budgets may face another problem. Although they receive SSA and RSG support related to their credit approvals, they may find that they cannot increase their budget to pay for the extra revenue costs of capital expenditure, because their overall revenue spending is capped. If such an authority wants to use its credit approvals, it will have to make revenue savings to pay for its increased debt charges in order to stay within its budget cap. If the same authority received a grant instead of a credit approval, there would be no revenue consequences at all. There appears to be no underlying rationale why some projects are funded through capital grants and some by credit approvals. For example, approved Transport Policies and Programmes (TPP) bids are half grant-aided and half financed by credit approvals; and a school renovated as part of an SRB project is funded by capital grant, but government support for new schools comes through ACGs and BCAs.

Definitions of capital expenditure

Capital expenditure is defined in the Local Government and Housing Act 1989 (see the Technical Supplement). But that definition still leaves a number of ‘grey areas’. For example, the distinction between capital and revenue is notably vague in areas such as road maintenance and housing maintenance. An independent report for the DoE on spending on housing maintenance, published in 1996, concluded that ‘historically there has been a wide difference of interpretation between different local authorities of the capital/revenue split’ (Ref. 10). Do such differences between authorities matter? In some respects the extra flexibility is beneficial – it allows authorities at the margin to ‘swap’ expenditure between revenue and capital in order to maximise their use of available resources – and the Commission’s auditors have reported few major problems in this area. However, in other respects, it is less helpful. Lack of clarity over the definitions makes comparisons between authorities difficult and may also cloud central analysis of spending, resulting in poor allocation of resources.

Choosing when to use capital

As explained in Chapter 1, local authorities face separate capital and revenue expenditure controls that limit their freedom to take investment decisions. So a scheme that may lead to revenue savings may be thwarted because of insufficient capital resources (Case Study 2). To get round this problem, some authorities resort to stretching the regulations to the limit – even if it results in outcomes that represent poor value for money in the longer-term (Box G). Towards the end of its life, the last government took steps to address this problem by easing some of the rules on credit arrangements. It also reduced the credit cover that authorities require if they have a scheme that has a good payback period and they get the private sector to carry out the work and maintain the facility in the future (see Box M in Chapter 3).
Case Study 2
Problems with replacing a school heating system
Lack of capital can block revenue-saving schemes.

Two schools on adjoining sites shared the same heating system to maximise economy. As a result of a reorganisation, one school was closed, and the site was eventually taken over by a further-education college. The college received a grant from its funding body to replace the heating system in its building. This left the remaining school and the education authority to cope with the original, old-fashioned and inefficient, boiler. The education authority reports that – because of more significant problems in other schools – it lacks sufficient capital resources to invest in a new boiler, despite the obvious long-term revenue benefits it would bring.

Box G
Stretching the capital regulations

Short-term leases of buildings originally fell outside the capital controls if they were for under three years, but this was relaxed to 10 years in 1995. This means that an authority entering a 25-year lease for office accommodation, or extending an existing lease beyond 10 years, has to find credit cover for the whole cost of the lease. Many authorities regard this rule as harsh, since they treat the office rent as an annual revenue charge and find it difficult to equate a renegotiation of the lease with other capital spending. To get round the capital controls, some councils have expanded the number of short-term leases they use, even if this approach results in higher rent payments and poorer value for money.

Are there sufficient capital resources?

28. The problems which local authorities face are not related only to the allocation mechanisms. There are other problems that relate to the level of resources available, and in particular about whether these are sufficient to meet local authorities’ service needs. Since 1990 central government has largely determined the overall level of local government capital expenditure by limiting how much councils may borrow and how much they may use from their own resources. Local authorities claim that the system is no longer effective because overall capital expenditure has declined during the 1990s (Exhibit 9, overleaf) to the point where it is insufficient to meet service needs. They also say that the system is inefficient because routine maintenance is being underfunded, increasing the need for expensive long-term refurbishment (Case Study 3, overleaf). An aggregation of available estimates suggests an apparent substantial shortfall in the level of resources required if local authorities are to maintain their current asset base and cope with future pressures. The position varies from service to service (Box H and Table 3, overleaf); the full results of the analysis are set out in the Technical Supplement. To meet the shortfall an increase of nearly 50 per cent on current levels of capital expenditure would be needed for the next five years. However, this cannot be regarded as a reliable conclusion, as there are significant weaknesses in the way that estimates of the demand for capital are built up. These are discussed below.
Exhibit 9
Capital expenditure by source of funding (at 1995/96 prices)

Overall capital expenditure levels have declined in real terms during the 1990s.

Note: Deflated using GDP deflator at December 1996 prices. ‘Other’ includes grants from the private sector and non-departmental public bodies and set-aside capital receipts used by debt-free authorities.

Source: DoE

Case Study 3
Lancashire County Council’s planned maintenance programme

Lack of capital resources can undermine a planned approach to maintenance.

Lancashire County Council’s portfolio of properties is valued at over £1.6 billion. Forty per cent of the properties were built between 1960 and 1974, and almost a quarter before 1902. The stock of 700 schools includes over 200 Victorian primaries. The council’s property services department carries out a five-yearly review to identify a planned maintenance programme for each property and undertakes a rolling condition survey of one-third of its stock each year, at a cost of £150,000.

Despite this good practice, lack of resources has made the maintenance programme very ‘hand-to-mouth’. A £20-million maintenance backlog in 1990 (of work identified in the review but not included in the five-year programme through lack of resources) more than trebled to some £75 million in 1995. A peak in maintenance demand – arising from system-built stock – and cuts in the authority’s BCA and property budget (as revenue capping forced difficult decisions on councillors) have been the main causes. Capital spending during this period was halved; from £96 million in 1990/91 to £46 million in 1995/96. The Education Department complains that some temporary classrooms have to be evacuated during high winds, and that the current replacement rate for primary schools is over 200 years.

Table 3
Aggregation of estimates of the funding shortfall

Note: These estimates have been produced by the local authority associations, government departments and other bodies.

Source: Capital Gains Technical Supplement
Box H
Summary of demand for capital expenditure on a service-by-service basis

The overall ACG for schools maintained by local education authorities (LEAs) in England has averaged around £425 million during the 1990s. Funding for schemes, agreed in previous years, accounts for about two-thirds of this amount; the other third is for new schemes. In 1992/93 most of the money available for new schemes went towards repairing and replacing schools. But during the past few years capital allocations for pupil growth and changes in pupil distribution have squeezed out new capital allocations for school maintenance (Exhibit 10). The only explicit capital allowance for maintaining school buildings is now the Schools Renewal Challenge Fund.

Exhibit 10

Allocations for pupil growth and changes in pupil distribution have squeezed out capital allocations for school maintenance.

£ million

- Schools Renewal Challenge Fund
- New allocations mostly for improving and replacing school buildings
- New allocations for removing surplus places
- New allocations for basic and exceptional basic need (mostly for pupil growth)

Source: DfEE

cont./
The Department for Education and Employment says that it is for LEAs and school governors to ‘assess the need for maintenance work in respect of school premises’ which they own and maintain (ref. 11). It does not make any national estimate itself. However, a local authority association survey of school buildings in England, carried out in 1995, indicated that an additional £3.2 billion over five years was required to keep existing buildings in use (ref. 12). The Welsh Local Government Association (WLGA) has identified a maintenance backlog in schools of £250 million, of which the capital element is around £150 million phased over three or four years’ (ref. 13). A more recent survey by the Society of Chief Architects in Local Authorities (SCALA) (ref. 14) reports that in the last three years the gap between the spending need to renovate schools and actual spending has grown by 40 per cent for primary schools and 25 per cent for secondary schools. School maintenance spending is unlikely to peak until the end of the first decade of the next century, because of the number of schools built between 1960 and 1975.

The local authority associations have estimated that gross capital expenditure requirements for the fire service have been about £100 million per year and will rise to £130 million at the end of the century. In contrast, net capital spending reached a peak of £74 million in 1994/95. This would suggest a shortfall that is currently in the broad order of magnitude of £25 million per annum and which is likely to rise. This shortfall mainly affects buildings and vehicles, but there is also an element for IT and communications equipment. The fire service argues that underfunding prevents it from improving efficiency by investing in a programme for rationalising fire stations.

Libraries account only for a small amount of local authority capital spending: around £35 million per year. In 1994 the Federation of Local Authority Chief Librarians (POLACL) carried out a capital-needs audit of all public libraries in England and Wales to assist the Department of National Heritage to make a case for adequate funding (ref. 15). Disregarding the costs of buying books and library equipment, the survey estimates a ‘need’ for nearly £550 million of capital expenditure – £27 million of it relating to Wales. This equates to an extra £360 million over the next five years to maintain adequate library buildings and services.

Most public indoor sports centres are less than 25 years old. The Sports Council has carried out a survey of half of these centres and developed a methodology for calculating how much is needed to bring them up to an acceptable standard and maintain them in this state (ref. 16). Although the stock is in a relatively good condition, the Sports Council calculates that an extra £250 million of capital expenditure is needed over five years to fund this programme.
Most local authorities survey the condition of their housing stock, but not on a standard basis. Given this, the best overall estimate of any local authority housing maintenance backlog is the DoE’s 1991 English House Condition Survey (Ref. 17). This identified a backlog amounting to around £8 billion at current prices (the equivalent sum for Wales was around £250 million). It is unlikely that there has been any significant improvement in the position since then. Local authority investment on renovation has remained fairly constant in cash terms since 1991/92 (Exhibit 11). However, it is likely that the figures for 1996/97 and 1997/98, when they are available, will show a reduction, as the Government cut overall capital allocations for housing for these years. The amount spent on maintenance from revenue budgets has increased in real terms, but it is not clear whether the increase is going on improved programme maintenance or on immediate repairs in response to the backlog problems. Moreover, the ageing of the local authority housing stock in general (and of that part of it that was built during the post-war construction boom in particular) is increasing maintenance pressures on local authorities.

Exhibit 11

Local authority housing direct capital investment, 1990–95

Local authority investment in renovation has remained fairly constant since 1991/92.

<table>
<thead>
<tr>
<th>Year</th>
<th>£ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990/91</td>
<td>3,000</td>
</tr>
<tr>
<td>1991/92</td>
<td>2,500</td>
</tr>
<tr>
<td>1992/93</td>
<td>2,000</td>
</tr>
<tr>
<td>1993/94</td>
<td>1,500</td>
</tr>
<tr>
<td>1994/95</td>
<td>1,000</td>
</tr>
<tr>
<td>1995/96</td>
<td>500</td>
</tr>
</tbody>
</table>

- **Other direct investment in local authority housing (excluding grants to housing associations and homeowners)**
- **Renovation**

Note: Deflated using GDP deflator at April 1996 prices. ‘Renovation’ includes expenditure on leasing and Estate Action.

Source: DoE

cont./
Government support for transport capital spending has fallen during the 1990s, while local authority TPP bids have risen (Exhibit 12). However, actual spending in cash terms has remained fairly constant, as authorities have used capital receipts and revenue to make up the reduction. Although there are doubts over the reliability of the data, the National Road Maintenance Conditions Survey (Ref. 21) indicates that the condition of the roads for which local authorities are responsible is broadly stable. There are, however, particular problems with urban classified roads and rural unclassified roads, and a fifth of principal roads have a residual life of four years or less. The local authority associations estimate that an additional £457 million per year of capital expenditure is needed if authorities are to ‘meet statutory requirements, to provide new roads and public transport to ease traffic growth and congestion and to maintain roads, highways and bridges’ (Ref. 22).

Exhibit 12

Transport capital bids, spending and resources 1992/93–1996/97

The gap between central government support and actual expenditure has increased.

Sources: DoT, DoE and HM Treasury (‘actual spending’ figures for 1995/96 and 1996/97 are provisional estimates)
Variable evidence base
29. The strength of evidence for an increased demand for capital resources is variable. Estimates – particularly for education, libraries and social services – are based largely on surveys, many of which are incomplete. Moreover, it is not certain that requests for data have been interpreted in a standard fashion. For example, local authority estimates of the need for spending on school buildings vary from £200 per pupil in one LEA to over £1,700 per pupil in another. Even in housing, where more systematic stock-condition surveys are carried out locally, independent research carried out for the DoE reported that ‘Government offices see little consistency in the methodology used, either for conducting the surveys or converting the data into repairs and maintenance programmes’ (Ref. 10). In other areas, such as transport, definitions are in dispute or are subject to change, making time-series comparisons difficult. Housing and sports centres are the service areas where evidence for increased capital has been most systematically assembled. The housing estimates gain their credibility not from the local but the national house-condition surveys. And the figures for sports centres use a computerised cost model to link stock-condition data on nearly half the sports centres in England to the projected life-cycles of the main building components and the cost of maintaining and replacing them.

Uncertain future demand
30. Government departments forecast the impact of demographic and social change on, for example, pupil numbers, households and traffic levels. However, central and local government do not have any joint mechanisms for evaluating the cost and impact of these changes. Neither do the arrangements for assessing the cost to local authorities of implementing new legislative burdens (Ref. 23) seem to result in agreed estimates. For example, the last government calculated that it would cost the public sector between £30 and £80 million to implement the rights-of-access provisions of the Disability Discrimination Act 1995 (Ref. 24). But the local authority associations estimate the cost to local authorities alone at £200 million a year for the next ten years (Ref. 25).

Bidding and inflated estimates
31. Many of the figures prepared by the local authority associations and professional bodies have been prepared for a purpose – to maximise resources. The FOLACL survey on libraries is a case in point. This does not necessarily mean that the results and costings are invalid, but it does raise the possibility that figures may, consciously or unconsciously, have been inflated to strengthen the case for more cash. This is not a criticism just of local authorities or professional bodies; it is a comment on the effect of the current capital system. It is clear from fieldwork interviews that a number of government departments see local authorities, and the estimates they provide, as allies in the annual public expenditure ‘battle’ to gain more resources for their department.
Changing role of local authorities

32. A number of the estimates assume that local government continues to fulfil a function in the same way that it has hitherto. But in services as diverse as education, housing and social services the local authority role has changed and is continuing to change. The trend in recent years has been for local authorities to adopt an enabling role with the private and independent sectors resulting in reduced levels of direct provision. The rapid growth of private and independent residential care homes, for example, calls into question the number of homes local authorities will continue to manage directly. In housing, the last government’s policy was to view housing associations as the main vehicle for providing new social housing units. Another policy was to put pressure on local authorities to raise funds to renovate their existing homes by transferring their housing stock to housing associations or forming local housing companies. Therefore, to project the need for future capital resources based on present patterns of service delivery is not necessarily a reliable guide.

Summary

33. An aggregation of the estimates collected from local authority associations and government departments suggests that the principal areas of local authority responsibility may require up to £15 billion of extra spending over the next five years, to clear the maintenance backlogs and bring existing assets up to acceptable standards, and to provide new assets to meet future demands. Although undoubtedly exaggerated, this total suggests a substantial level of unmet need – there is an order of magnitude difference between what local authorities think is needed and what central government has been prepared to allow. The problem is that neither central or local government has a truly accurate picture of what the level of unmet need is.

34. It is sometimes argued that, although the estimates are weak, there is little point in gathering detailed information or forecasting more accurately, because finance to close the funding gap is not available. The shortfall is so large, it is said, that building up more robust estimates is a pointless waste of time and money. This is not persuasive: it is not acceptable that so much of the nation’s infrastructure depends upon ‘back-of-the-envelope’ calculations. Until and unless there is an accurate and reliable understanding of the scale of the problem:

◆ decisions on the overall level of capital expenditure – and policies on the use of capital receipts – will be taken, at least partly, in ignorance;

◆ priorities cannot be properly assessed and agreed; and

◆ options for addressing the areas for which funds are not available will not be considered seriously.
How well are local authorities managing their assets?

35. The problems do not fall entirely within the remit of central government. The case for additional resources for local government would be strengthened if it could be shown that local authorities used their existing resources and assets as efficiently as possible. But authority performance is patchy. Just Capital... (Ref. 1) found many examples of good practice but it also identified serious weaknesses in managing capital projects. The issue is not simply one of effective project management. There is scope for improving the way that capital programmes are planned and managed, and cause for concern over whether recent government policies have encouraged or discouraged improved performance. There are three main problems with local authority performance (Exhibit 13).

**Short planning horizons**

36. This chapter has already highlighted the problems caused by the annual nature of central government capital allocations and the uncertainty and inflexibility inherent in the process. Some local authority managers argue that this makes it impractical to plan more than one year ahead; they say that forward plans lead to dashed expectations and confusion. But the most effective programme managers are not restricted to an annual cycle. They operate as ringmasters, establishing longer-term goals but operating flexibly to achieve them as current projects draw on committed resources, as potential projects develop and as funding opportunities arise. In such circumstances the annual cycle has two main functions: it establishes and revises the longer-term goals, and it holds the programme manager to account for delivering projects that will meet them.
The most effective programme managers are not restricted to an annual cycle – just over half of authorities plan their capital programmes on a longer-term basis.

Source: Audit Commission survey

Exhibit 14
Percentage of local authorities having a three- to five-year corporate statement of capital investment priorities, by service

The longer-term approach not only provides a framework for allocating resources rationally – it also gives authorities a good basis for:

◆ developing partnerships with other local agencies, the private sector and community interests, thus maximising the chance of obtaining other sources of funding; and

◆ deciding where to apply for funding and which projects to pursue through competitive bidding.

Just over half of authorities say that they plan their capital programmes on a longer-term basis (Exhibit 14). The evidence from the first part of the Commission’s study complements this finding. It showed that, of those authorities that do not use a three- to five-year timescale, about one-quarter plan just one year at a time and a further 20 per cent use a two-year planning horizon. Such authorities need to develop a longer-term approach.

Corporate co-ordination

As well as planning within a sensible time frame, authorities also need agreed corporate processes at member and officer level. The adopted approach will depend on the size and structure of the authority, but a clear corporate focus should be at the heart of arrangements. But a number of authorities seem to have not one but two, three or four capital programmes. For example, housing capital resources are sometimes managed completely independently from those for other services. And it is often the same with transport and roads programmes. Additionally, one-third of authorities overall – and two-thirds of metropolitan authorities – said that bids for new projects were not submitted to a corporate group of officers to audit and assess before the projects entered the authority’s capital programme (Exhibit 15). Of those authorities that do appraise capital bids corporately, most apply a standard process. This provides a useful discipline for making sure that projects support corporate priorities, take account of risks and assess costs, and for evaluating value for money (Case Study 4).
Exhibit 15
Percentage of authorities with a group of officers to assess and audit bids which use a standard format for doing this

One-third of authorities overall – and two-thirds of metropolitan authorities – do not submit bids for new projects to a corporate review group of officers.

Source: Audit Commission survey

Case Study 4
Essex County Council’s criteria for evaluating capital projects

A standard process provides a useful discipline for ensuring that projects support corporate priorities, and for taking account of risks, assessing costs and evaluating value for money.

Essex County Council requires all capital projects to be appraised before members are asked to approve the overall capital programme. Appraisals are first made at departmental level, and then reviewed by a cross-departmental Capital Programme Management Team chaired by the Deputy County Treasurer. The appraisal process is based on criteria that have been endorsed by elected members:

- the purpose and ‘need’ for the project, including whether there is a statutory requirement for it;
- the relevance of the project to committee, service and corporate objectives;
- whether other options were considered, including the results of any feasibility study (or, if such a study was not carried out, why it was not necessary);
- the health and safety implications if the project does not go ahead;
- the achievability/practicality of the project, including an analysis of constraints, such as whether a new site or planning permission is required (and, if so, whether it is available);
- the service implications arising from the project;
- a financial appraisal of the project, examining the capital costs and revenue consequences both of carrying out the project and of not carrying it out; and
- whether the project is to be carried out in partnership with other agencies such as another local authority or health authority.
Corporate working is more evident at member and officer level when it comes to monitoring the delivery of capital programmes. Nearly four out of five authorities had an identified group of officers, and around three out of five have a corporate sub-committee, dedicated to capital programme monitoring. Good corporate monitoring arrangements of this type are vital if authorities are to improve their performance in completing projects on time and within budget. At present two-thirds of local government capital projects finish behind schedule, and half of them end up outside their contract cost by more than five per cent.

In its final year, the last government began to move away from targeting investment at specific services or objectives and provided an incentive for authorities to plan their capital programmes more strategically and corporately. In the 1996 Capital Challenge pilot scheme, councils wishing to bid were required to outline their ‘strategy for local capital investment to demonstrate that the authority have in place a clear, coherent approach to capital spending’ (Ref. 26). An independent review of the pilot scheme sponsored by the DoE showed how rare such corporate capital strategies are in local government. Although two-thirds of authorities claimed that they either had or were developing a written strategy document, an in-depth analysis of 30 councils concluded that only 6 of them had ‘anything like a “genuine” capital strategy’ (Ref. 27). And, while the pilot scheme provided ‘added impetus to existing corporate/strategic developments’, it ‘alone did not provide a sufficient incentive for principal authorities to develop a capital investment strategy if they did not already possess one’ (Ref. 27).

One of the reasons why authorities have not gone further in developing a cross-service perspective is that central government policies have not encouraged such a perspective. For example, in England the annual round of bidding to individual government departments – each with their separate bidding guidance – encourages officers and members and government offices to adopt a compartmentalised, service-based approach to capital planning. The ‘in-and-out’ rules – on re-using capital receipts in the service area that generated them – have the same effect. There is a tension between the Government’s objectives. On the one hand, there have been attempts to foster effective strategic planning of capital resources; on the other hand, the last government tried to ensure that specific funds were spent on specific services. As one civil servant in a government regional office told the study team: ‘We are asking local authorities to be more corporate and strategic, when departmental structures in Whitehall make it difficult for authorities to respond corporately’. The compartmentalism of Whitehall departments is a recurrent problem that has yet to be solved satisfactorily.
Poor asset management

42. Good asset management is essential if local authorities are to plan and use their capital resources efficiently. The opportunity costs of holding assets may be significant, and authorities need to ensure that the assets required for service delivery are kept in the best order, given financial limits. There have been improvements over the past few years, but many authorities still have much to do. The introduction of capital accounting in April 1994 should be one factor that stimulates improvement: local authorities now have to value their assets, include operational assets on their balance sheets, and charge each service a sum for depreciation and the loss of interest on the capital tied up in each asset. The aim is for budgets to reflect the true cost of the services they deliver and the facilities they use. The Audit Commission’s auditors have reported that by the end of the financial year 1994/95 all but two local authorities in England and Wales were complying with the new system (Ref. 28). But three factors are blunting the impact of capital accounting:

◆ first, capital accounting is essentially a paper exercise. For a local authority, unlike a private-sector company, the value of its assets is incidental to its financial standing. And the provision that a council has to make in its budget for capital liabilities – which in turn affects the level of council tax – is driven by the rules in the 1989 legislation on repaying debt, rather than by the cost of the rentals on its capital assets;

◆ second, capital charges are applied only at a broad service level. They do not have to be broken down to individual cost centres. For example, capital charges apply to sports centres in general rather than to specific sports centres. The new system of capital accounting has the most impact when it is related to an identifiable service or trading unit. For example, the regulations on compulsory competitive tendering (CCT) require direct labour and direct service organisations (DLOs and DSOs) to count capital or asset charges as part of their trading costs. This has resulted in many authorities reviewing and rationalising depot facilities, so that their DLOs and DSOs remained competitive;

◆ third, authorities have to strip out all capital charges when they report the cost of their services to the Government. The current analyses of expenditure used by central government focus on ‘current costs’, which exclude the cost of asset usage. If there is a government objective of trying to encourage the more efficient use of assets, then this approach is, at the very least, sending authorities a mixed message. However, as central government moves towards a system of budgeting and accounting similar to that of local authorities, there may be a timely opportunity to review how local authority expenditure on services is monitored.

The Chartered Institute of Public Finance Accountancy (CIPFA) has published practical guidance on how authorities can use capital accounting to improve asset management and service performance (Ref. 29).
Even though capital accounting has not yet had its full impact on local authorities’ behaviour, many have taken steps to make better use of their property. Over half of authorities told the Commission that they had reviewed their land and property needs over the past three years. And nine out of ten authorities say that they have a computerised property register. But there is still scope for improvement. For instance, the Commission’s survey shows that only a minority of councils offer incentives to service committees (such as allowing them to retain all or part of any revenue savings that accrue from rationalising their assets) to encourage good property management. And, although many authorities use their property databases to identify under-used or surplus assets and to plan maintenance and capital programmes, few have full stock-condition data (Exhibit 16) – and lack of stock-condition information limits the usefulness of property databases as a management tool to help with capital programming. Significantly, housing – the service area in which most authorities include stock condition on their property register – is also the service that scores highest for using condition data to plan maintenance and capital programmes.

Authorities point to a number of factors that prevent them from making better use of property. The obstacle most regularly cited by authorities is the ‘set-aside’ rules (Ref. 30) for capital receipts (Exhibit 17). From the Treasury’s point of view, ‘set-aside’ has proved to be an important and effective method of limiting public spending. For authorities, it is a disincentive to maximising capital receipts, because they cannot reinvest all of the receipts that they generate, and this contradicts another explicitly stated aim of central government: to ‘encourage asset sales and efficient asset management’ (Ref. 8).

Exhibit 16
Percentage of authorities including stock-condition information on their computerised property database

Few authorities have full stock-condition data.

Source: Audit Commission survey
The obstacle to effective property management most regularly cited by authorities was the ‘set-aside’ rules for capital receipts. The last government acknowledged this tension and, from time to time, provided temporary incentives to dispose of assets by introducing various receipts holidays and relaxations (see Box F, p24). Between 30 and 40 per cent of authorities said that they were expecting to take advantage of the set-aside relaxations in force during 1996/97. Some authorities were expecting to raise large sums – up to £10 million from the sale of shops in one case. On average, the sums generated appear to be more modest – ranging from £90,000 per authority for smallholdings to £450,000 for education buildings, £550,000 for car parks and £2.5 million for shops. Some authorities told the Commission that the receipts holidays were not so much making them identify new assets to sell, as determining their asset-disposal timetable. The apparent unpredictability and arbitrary nature of the relaxations last for variable periods and they apply to assets as unconnected as bus companies and crematoria (though only one authority reported an expectation of receipts from the sale of crematoria). The opportunity to gain from them may be fortuitous, depending on whether a council already has a scheme in the pipeline. Authorities stress that it takes time to put together deals. They prefer changes to the system that are more certain, longer-lasting and enable them to plan ahead.

45. The last government acknowledged this tension and, from time to time, provided temporary incentives to dispose of assets by introducing various receipts holidays and relaxations (see Box F, p24). Between 30 and 40 per cent of authorities said that they were expecting to take advantage of the set-aside relaxations in force during 1996/97. Some authorities were expecting to raise large sums – up to £10 million from the sale of shops in one case. On average, the sums generated appear to be more modest – ranging from £90,000 per authority for smallholdings to £450,000 for education buildings, £550,000 for car parks and £2.5 million for shops. Some authorities told the Commission that the receipts holidays were not so much making them identify new assets to sell, as determining their asset-disposal timetable. The apparent unpredictability and arbitrary nature of the relaxations last for variable periods and they apply to assets as unconnected as bus companies and crematoria (though only one authority reported an expectation of receipts from the sale of crematoria). The opportunity to gain from them may be fortuitous, depending on whether a council already has a scheme in the pipeline. Authorities stress that it takes time to put together deals. They prefer changes to the system that are more certain, longer-lasting and enable them to plan ahead.
In summary, local authorities face a number of problems under the current approach to capital expenditure, some of them inherent in the system, but some self-inflicted. The result is that local government finds itself pulled from two sides (Exhibit 18). On the one hand, local communities expect authorities to maintain their existing local infrastructure of schools, houses, roads and offices and to meet new service needs. On the other, the limits on resources, the obstacles to forward planning and the impact of technical anomalies, as well authorities’ own weaknesses, are holding back their capacity to respond to capital needs. Chapter 3 examines recent attempts by central government to provide new ways for local authorities to square the circle of limited resources and rising demand.

Exhibit 18
Forces affecting local authorities

Local government finds itself pulled from two sides.

Local forces
- Maintain existing infrastructure
- Meet new service and community needs

National forces
- Government controls on capital spending
- Uncertainty over allocations
- Technical anomalies

Source: Audit Commission
A series of initiatives has been introduced over recent years to improve the operation of the capital expenditure system. Substantial use is being made of new ways of distributing finance, such as Challenge funding, where resources are allocated following competitive bids. The National Lottery has provided £400 million of new money to local authorities. And the Private Finance Initiative (PFI) offers scope for greater private sector involvement in the funding and operation of public services.

But these new initiatives have drawbacks as well as benefits. Challenge funding directs money towards central government’s priorities. Lottery funding, while relatively limited, creates the need to find matched funding and encourages authorities to instigate projects that meet external funding criteria rather than their own priorities. And the PFI has spawned not only a range of practical problems but also worries about unsustainable long-term revenue commitments arising from ‘design, build, finance and operate’ (DBFO) deals.
### Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>4Ps</td>
<td>Public Private Partnerships Programme - the company set up by the local authority associations to develop PFI specifically within local government.</td>
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<td>CCT</td>
<td>compulsory competitive tendering.</td>
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<td>DBFO</td>
<td>design, build, finance and operate - the name given to schemes where the private sector designs, constructs, pays for and runs a facility needed by an authority, with the authority paying an annual service fee for the service.</td>
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<td>DoE</td>
<td>Department of the Environment.</td>
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<td>ERDF</td>
<td>European Regional Development Fund.</td>
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<td>EU</td>
<td>European Union.</td>
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<tr>
<td>HIP</td>
<td>housing investment programme.</td>
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<tr>
<td>IT</td>
<td>information technology.</td>
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<tr>
<td>NCV</td>
<td>notional credit value.</td>
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<td>NSCA</td>
<td>non-scoring credit approval.</td>
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<tr>
<td>PFI</td>
<td>private finance initiative - the name given by central government to the initiatives aimed at encouraging the private sector - working within a specification drawn up and monitored by a public authority - to take over the risk of providing and funding public services and assets (see Box K, p57).</td>
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<tr>
<td>SRB</td>
<td>single regeneration budget.</td>
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<tr>
<td>TPP</td>
<td>Transport Policies and Programmes.</td>
</tr>
<tr>
<td>VFM</td>
<td>value for money.</td>
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Introduction

47. If central government wants to ease the capital pressures on local authorities and find the resources to pursue its own objectives, it needs to find techniques that do not undermine its wider economic policies. Over the 1990s three new initiatives were introduced to help ease the difficulties:

◆ It has provided incentives for authorities to make better use of scarce capital resources by allocating an increasing proportion of government support on a competitive basis, in particular through the use of Challenge funding.

◆ It has sought to provide new sources of capital finance from the National Lottery.

◆ It has sought to lever in new finance that does not count as public expenditure – primarily through the operation of the Private Finance Initiative (PFI).

This chapter evaluates the effectiveness of these initiatives.

Challenge funding

48. Bidding for capital is not new for local authorities. It was inherent in the loan sanction regime, operational until 1980, where authorities applied to ministers for loans for specific projects. But during the 1980s central government introduced a more overtly competitive element. Bids for Urban Programme allocations were judged on how well councils' plans met ministerial objectives. Since 1990 the Housing Investment Programme (HIP) has based authorities' capital allocations for housing largely on need, but has allowed the DoE to vary allocations according to the relative strength or weakness of local housing strategies. In 1991 central government introduced City Challenge: selected councils were invited to form partnerships with other local groups to bid competitively for regeneration funds. Thirty-one bids were approved over two years and two rounds of bidding. The Single Regeneration Budget (SRB) Challenge Fund extended the competitive process to all regeneration funding. In 1996 Challenge funding was further extended to capital allocations for mainstream service needs. By 2000 Challenge funding is projected to exceed £1 billion (Exhibit 19, overleaf) – around one-third of all government capital support. There is now a wide range of competitive funds (Box I, overleaf).

The case for Challenge funding

49. The last government argued that Challenge funding has 'proved its value' (Ref. 31), asserting that it:

◆ 'attracts ... private sector investment';

◆ drives up standards of local services by fostering 'innovation' and ensuring that 'taxpayers' money is directed where it can achieve most';

◆ 'builds up local partnerships' and 'stimulates genuine community and private sector involvement'; and

◆ encourages local authorities to decide 'strategic priorities' and develop plans for 'spending on local investment and development, without the normal constraints dictated by central government-led programmes' (Ref. 31).
Exhibit 19
The growth in competitive funding

By 2000 challenge funding is projected to exceed £1 billion.

Note: Around 50 per cent of Challenge funding goes on revenue expenditure.

Source: Audit Commission analysis of DoE data

Private-sector investment

50. Independent research has revealed that during the first three years of City Challenge £546 million of Challenge funding levered in nearly £1.3 billion of private-sector support (Ref. 32). The DoE has also highlighted how each of the three rounds of SRB bidding is projected to attract £2.5 billion of private-sector funding over a seven-year period, providing £2.50 for every pound of SRB Challenge Fund support (Ref. 33). Between half and two-thirds of the Estate Action schemes have attracted private finance (Ref. 34). And the pilot round of Capital Challenge is expected to involve £700 million from private-sector partners (Ref. 35). Moreover, the involvement of the private sector makes it more likely that projects will achieve their total targeted spending level, as increased private investment tends to compensate for shortfalls in public funding (Ref. 32). In short, private-sector investment (motivated by the expected revenue stream) will help schemes happen that otherwise would not get off the ground because of the lack of capital finance.
## Box I
Projected competitive funds for local authorities in England, 1997/98

<table>
<thead>
<tr>
<th>Challenge Funds</th>
<th>Estimated funding in 1997/98</th>
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<tr>
<td><strong>City Challenge:</strong> the original competition for major urban regeneration. Aimed at ‘imaginative, ambitious and realistic plans to revitalise key areas of urban deprivation’ (Ref. 36). Eleven partnerships were established in 1992 and 20 in 1993, each receiving grant of £37.5 million over five years. Absorbed into SRB in 1994.</td>
<td>£140m</td>
</tr>
<tr>
<td><strong>Estate Action:</strong> provided capital resources to housing authorities in priority areas to ‘transform unpopular estates into places where people want to live’ (Ref. 36). Funding peaked at £370 million in 1994/95. Absorbed into SRB in 1994.</td>
<td>£150m</td>
</tr>
<tr>
<td><strong>SRB Challenge Fund:</strong> the main annual competition for regeneration resources for all areas in England. Over 450 winning partnerships have been created since 1995. Partnerships last from one to seven years and awards have varied from £30,000 up to £60 million. Funding is predominantly linked to the achievement of outputs - for example, jobs created, houses improved - rather than specific projects. Resources can be used for both revenue and capital projects.</td>
<td>£480m</td>
</tr>
<tr>
<td><strong>Estates Renewal Challenge:</strong> £500 million of funding between 1996/97 and 1999/2000 to help facilitate the transfer of poor quality housing estates to new social landlords. The funding covers both capital and revenue costs.</td>
<td>£110m</td>
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<td><strong>Schools Renewal Challenge:</strong> schemes to improve school building stock.</td>
<td>£30m</td>
</tr>
<tr>
<td><strong>Rural Challenge:</strong> economic and social development projects in rural areas.</td>
<td>£6m</td>
</tr>
<tr>
<td><strong>Capital Challenge:</strong> introduced as a pilot in 1996. Local authorities competed for £600 million of capital funding over the three years from 1997/98 to 1999/2000. The emphasis is on establishing a corporate cross-service capital strategy and identifying an authority's highest investment priorities.</td>
<td>£150m</td>
</tr>
<tr>
<td><strong>European Union funding:</strong> project-linked funding is distributed to local partners, including eligible local authorities, mainly by the Regional Challenge process. Capital funding for infrastructure, transport, tourism, or environmental improvement projects comes chiefly from the European Regional Development Fund (ERDF). EU funding forms a relatively small proportion of authorities' capital programmes. Further details are out in the paper specially prepared for the Commission (Ref. 4).</td>
<td>£150m</td>
</tr>
</tbody>
</table>

The Government also provides resources competently for various specific initiatives, such as the technology in schools initiative, CCTV (security measures), recycling projects, and various housing schemes. Local authorities may also be engaged in bidding for funds from English Partnerships, the National Lottery and a variety of other sources. In Wales, Welsh Capital Challenge is broadly the equivalent of the SRB Challenge Fund (see the Technical Supplement). The Welsh Development Agency and the Development Board for Rural Wales are also potential sources of capital funding for Welsh authorities.

Source: Audit Commission
Innovation and improved standards

51. Local authorities responding to the Commission’s survey agreed, by a margin of three to one, that Challenge funding encouraged innovation. Independent research on City Challenge confirmed that ‘competition ... produces more positive and imaginative proposals’ (Ref. 32). And a study on the SRB undertaken by Birmingham University concluded that bidding partnerships had ‘tackled a wider range of housing-related issues in a more flexible and innovative manner than before’ (Ref. 37).

52. However, it is more difficult to judge whether Challenge bidding has resulted in improved management of capital schemes and programmes. A report by the House of Commons Environment Committee into the first SRB round concluded that the ‘SRB Challenge Fund has already demonstrated its potential to achieve excellent value for taxpayers’ money’ (Ref. 38). City Challenge has more than met its output targets and has ‘speeded up developments which would otherwise be slower and more piecemeal’ (Ref. 32). And the DoE believes that – by incorporating delivery plans, quantified outputs, milestones, key indicators and monitoring into the Challenge Fund process – it is ‘encouraging efficiency and effectiveness from local authorities’ (Ref. 31). But not all City Challenge partnerships perform to the same standard: ‘they vary ... in their success in meeting their targets’ (Ref. 32). A recent audit of SRB partnerships by the DoE suggested ‘substantial shortcomings in financial management, project appraisal and monitoring systems’ in a number of authorities (Ref. 39). However, the Challenge funding discipline is prompting authorities to improve their management of regeneration projects (Case Study 5). Three-quarters of authorities told the Commission that Challenge bidding had required them to develop new management skills.

Case Study 5
Using a company to manage SRB projects

The spur of Challenge funding can make authorities explore new ways of working.

One major metropolitan council has set up a company limited by guarantee to manage its three successful SRB bids. Managing the schemes ‘at arm’s-length’ from the council has brought more focused management and has resulted in:

- **quicker project approval.** Projects can now get underway in two weeks – under the previous arrangements it could take up to three months to get schemes through the system;
- **greater independence.** This in turn has increased confidence among other SRB partners, who had previously seen SRB management as a council operation; and
- **improved management** based on a computerised monthly management information plan.

The company is now starting to develop value-for-money (VFM) indicators in order to benchmark its performance and compare its results with other SRB partnerships.
Local partnerships
53. As partnership is a precondition of most of the Challenge competitions, it is not surprising that most bids involve a number of partners. In the first round of bidding for the SRB Challenge Fund local authorities were involved in 85 per cent of bids, Training and Enterprise Councils in three-quarters, the private sector in four-fifths and the voluntary sector in nearly half (Ref. 40). Tenants are participating in the management of their estates in between a third and half of Estate Action projects (Ref. 34). Partnership between authorities is also being fostered (Case Study 6). Twenty of the 189 successful pilot Capital Challenge bids involved more than one authority.

Spending on local strategic priorities
54. As well as encouraging partnership with external bodies, Challenge funding has stimulated more partnership working within authorities. It has provided an incentive for councils to think and work across traditional service and departmental boundaries. For example, SRB ‘has stimulated a corporate approach to regeneration ... including interdepartmental and interauthority working’ (Ref. 36). City Challenge has stimulated ‘more corporate working within local authorities’ (Ref. 36). Although each competition has its own distinctive purpose, theme and criteria, Challenge funding provides authorities with the opportunity to come forward with local solutions to local problems. One London borough told the Commission’s study team that Capital Challenge had given it the opportunity to bid for a cross-service project – developing housing in one part of the borough and providing a road link to another part with jobs and entertainment – that under existing capital programmes, would have been unlikely to be funded.

Case Study 6
Cross-river partnership
Bidding for Challenge funding has encouraged local authorities to work together.

The London boroughs of Lambeth and Southwark, the City of Westminster and the City of London differ significantly in size, nature and political control. But they have joined together in a cross-river partnership to develop and promote tourism, employment and social facilities along the Thames in central London. The partnership, which has been successful in all three rounds of SRB bidding and won over £25 million, also involves other local public agencies and community organisations.

Southwark acted as the lead authority in all three bidding rounds, but the City of Westminster provides the secretariat to the partnership board that oversees the implementation of the local SRB programme. However, each borough acts as the accountable body for the projects on which it has lead responsibility.
The case against Challenge funding

Despite the evidence of benefits claimed for Challenge funding, not all local authorities are convinced of its value. They are divided, for example, over whether competitive bidding is to be preferred to the previous arrangements (Exhibit 20). Many of them accept that there are benefits, but they also highlight a number of significant disadvantages. They say that it:

◆ contributes to uncertainty, and that the number of competitions makes planning capital programmes more difficult;
◆ neglects basic need in favour of ‘glamour’ projects;
◆ gives central government too much control in allocating capital resources and favours national rather than local priorities;
◆ overstretches authorities’ capacity to provide matched funding; and
◆ increases the cost of acquiring capital resources.

Uncertainty and too many competitions

If and when authorities win Challenge competitions, they know that in all probability they will receive funding for projects for several years ahead. But they have the uncertainty of not knowing whether they will win or how much they will win. As the House of Commons Environment Committee concluded, ‘the main disadvantage of the competitive system is the uncertainty which is an inherent part of it’ (Ref. 38). Some authorities have suggested that further uncertainty is created by apparent variations between the approaches of different government offices. The last government attempted to reduce uncertainty by getting authorities to make outline bids – on which government offices formally or informally advise – before full bids were submitted. In most competitions authorities have also been required to include in their bids a scaled-down but viable version of their proposal, in case funding for the whole of a scheme is not available. Despite these initiatives, more than four out of five authorities told the Commission that Challenge funding made medium-term planning more uncertain.

The number of separate competitions – which include those run by government agencies, as well as those by central government itself – also make capital planning more difficult. In 1989 the Audit Commission criticised government support for urban regeneration as ‘a patchwork quilt of complexity and idiosyncrasy’ (Ref. 41), and in 1994 the Government merged over 20 separate programmes into one fund – the SRB Challenge Fund – to enhance ‘good government’ (Ref. 34). Nonetheless, the growth in the number of competitions for which authorities can bid has created the danger of a new patchwork effect. During the study authorities were preparing or bidding for: SRB round three; the pilot round of Capital Challenge; Schools Renewal Challenge; TPP, HIP and education capital submissions; National Lottery awards; EU funds; and PFI projects. If anything, this list understates the problem: one director of housing itemised ten competitions that his department was bidding for or managing. Nearly three-quarters of authorities say that the number of competitions is creating a fragmented approach to local planning.
Neglect of basic need

Authorities argue that competitive bidding distracts from meeting basic needs. Capital Challenge is resourced by ‘top-slicing’ existing credit approvals. Authorities say that this diverts valuable resources to glamorous schemes at the expense of schemes that meet the most pressing local needs. This is not an isolated view: four out of five authorities in the Commission’s survey said that Challenge funding favoured ‘glamour projects’. It is not that authorities are bidding for projects they do not want to carry out. Rather, to conform with the bidding guidance and maximise their chances of a winning bid, they are putting ‘bread-and-butter’ maintenance and renovation projects on one side, and selecting schemes that are not necessarily their highest priority, or repackaging priority schemes to meet the criteria of a competition (Case Studies 7 and 8).

Case Study 7
Sheffield City Council

Authorities are having to select bids to meet the requirements of competitions.

Sheffield City Council prepared a £14-million Capital Challenge bid – with an £11-million fallback plan, the size of the bid being determined by the level of resources available nationally. While the Council was keen to target Capital Challenge resources at its traditional renovation, maintenance and service priorities, these had to be packaged in such a way as to meet the objectives of the competition.

Accordingly, the Council focused its submission around the theme of the social regeneration of a 1930s housing estate. Under this approach, traditional priority work on Housing and Education was linked with themes of economic regeneration, crime prevention, environmental improvement and community development. The limited level of resources available restricted the type and size of the area that was suitable for inclusion in a Capital Challenge funding submission, and as a result the scheme was not considered appropriate for tackling areas of highest need or a wide geographical area. It was considered that these areas – which needed revenue as well as capital support and required work over a longer period than Capital Challenge allowed for – would be more suitable for an SRB bid. While the capital schemes included in the successful submission included high-priority work which the Council would have sought to tackle within a five-year period, the decision to focus on a geographical area meant that the submitted scheme was not the highest priority.

The Council’s bid was successful and £11 million was awarded.
Dealing with ‘bread-and-butter’ bids in Capital Challenge

It is more difficult to fit bids focused on repairs and renovations into competitions.

Too much central control

59. Although they are asked to make bids on the basis of local priorities, local authorities do not accept that they control the bidding process. They argue that increased central control is inevitable if central government decides both the bidding criteria and, on the advice of government offices, which bids win. Most government offices also accept this as the reality: as an official in one office put it, ‘although bids are submitted on the basis of local priorities they are judged according to central government’s priorities’. Four out of five authorities responding to the Commission’s survey said that Challenge funding favoured national over local priorities.

60. Bids for the pilot Capital Challenge scheme illustrate the tensions between national and local priorities. The Commission reviewed the outline bids in two regions. Despite the fact that both the Commission’s survey and fieldwork showed that education in general – and education maintenance in particular – was the highest capital-spending priority of those authorities with education responsibilities, most such authorities did not put forward ‘bread-and-butter’ schemes, such as repairs to schools. In the event, transport bids accounted for three times as much Capital Challenge funding as education, and economic development twice as much (Exhibit 21). This may reflect some authorities’ failure to build their priorities into a coherent capital strategy, but it also suggests that bids were skewed away from local priorities to meet other national criteria – particularly the innovation objective (Ref. 27).

61. Authorities are also concerned about central control of the bidding process and whether government offices act consistently. Most recognise that the guidance provided by government offices during a bidding process is helpful, but believe that some aspects of the offices’ involvement are distorting the competitive process. For example, not all government offices interpret ministers’ priorities and the bidding criteria in the same way, and authorities do not always receive consistent advice (Box J).
Exhibit 21
Capital Challenge bids and allocation by service

Transport projects accounted for three times as much Capital Challenge funding as education – despite the high priority that authorities with education responsibilities attached to education maintenance.

Percentage of proposed expenditure

Note: ‘Other’ includes the careers service, coastal protection, consumer protection, fire and civil defence, environmental health, general administration, magistrates’ courts committees, parks and open spaces, probation committees, sheltered employment, smallholdings and trading standards.

Source: DoE

Box J
Department of the Environment comments on regional consistency in dealing with Challenge bids

‘There have been significant variations between regions in the management of bidders’ expectations, particularly in terms of encouraging/discouraging bids ... Furthermore, the process has not been consistent throughout the country.’

Source: Department of the Environment, Examination of Ten Case Studies of Unsuccessful Bids by the Department of Land Economy in the University of Cambridge, October 1996.

‘There was some variation in the messages from government offices, or their interpretation by authorities, especially in relation to the importance of capital strategy, the importance of the innovation objective and the likely success of “basic” projects.’

Insufficient matched funding

62. Authorities say that another major disadvantage of Challenge competitions is that too much funding is expected from council resources to match allocations by central government. Eighty per cent of councils claimed that the demand for matched funding has increased over the last three years, and that a lack of matched funding is the biggest single problem that prevents them from making full use of government and other funding sources, such as the National Lottery and English Partnerships (Exhibit 22). Funds won in one competition can be used as matched funding against a government allocation in another. One of the main benefits of EU funding is that, although a relatively small component of most authorities’ capital budgets, it is an important source of matched funding (Ref. 4). But even this is not as helpful as it seems; competitions often have different information requirements, timescales, eligibility and appraisal criteria, and in the case of the EU, they operate to a different financial year (Case Study 9). One local authority officer described it as like ‘trying to win three or four different races at once and ensuring that you cross the finishing line for each one at the same time’.

Exhibit 22

Factors inhibiting local authorities’ use of funding sources

Lack of matched funding is the single biggest problem.

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Case Study 9

Wolverhampton Metropolitan Borough Council

Co-ordinating sources of matched funding is difficult and can delay projects.

In 1995 Wolverhampton was awarded £3 million from the National Lottery to refurbish a sports stadium in the borough. The scheme was delayed for more than 12 months because of problems in obtaining approval for matching EU funding, which was being bid for separately. When approval eventually arrived, the Council found that it had received only two-thirds of the amount that it had bid for. This meant that the scheme had to be redesigned and, further discussions with the Lottery awarding body – the Sports Council – were needed. The project is still not complete.
Table 4
The costs of bidding for Challenge funds

<table>
<thead>
<tr>
<th>Challenge fund</th>
<th>Average cost per bid £000</th>
<th>Estimated total costs £000</th>
<th>Estimated total bidding costs as a percentage of total Challenge funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>SRB Round 1</td>
<td>30</td>
<td>14,000</td>
<td>1.3</td>
</tr>
<tr>
<td>SRB Round 2</td>
<td>40</td>
<td>13,160</td>
<td>1.2</td>
</tr>
<tr>
<td>Capital Challenge</td>
<td>14</td>
<td>4,564</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Sources: Birmingham University review of SRB, Audit Commission survey and York Consulting evaluation of Capital Challenge

Increasing the costs of capital acquisition

Another local authority concern is the cost of bidding – particularly for those authorities whose bids fail. However, unlike other local authority concerns there is less evidence to justify this claim. Average bidding costs for Challenge fund competitions are small, especially when compared with the overall sums awarded (Table 4). The averages do, however, disguise a wide range. For example, over half of the authorities bidding for Capital Challenge funds had costs below £10,000, but 3 per cent had costs over £50,000. The range becomes even wider when bidding costs are matched against the size of bids (Exhibit 23). There are three broad trends:

- very cheap bids (in SRB terms, this means bids costing less than £10,000) are unlikely to be successful. The low cost may be indicative of an ill-conceived or low-quality bid;

Exhibit 23
Cost of bid matched against size of bid for round two of the SRB

The average cost disguises a wide range of bidding costs.

Source: Audit Commission survey
bids on which authorities spend a substantial sum (in the case of SRB over £100,000, and that of Capital Challenge over £50,000) tend to succeed – although most such bids are likely to be for very substantial projects, for which clear government office support has been signalled. Authorities may consider it unwise to spend such large sums without encouragement from the government office; and

most bids fall in a middle range where the cost does not appear to be a significant factor in whether the bid succeeds or not. This would indicate that investing resources in preparing a bid is a necessary, but not a sufficient, condition for a successful bid.

Despite the range of bidding costs, the sums involved are not significant for those who ‘win’ – particularly as such costs would have been incurred in any event if projects had been funded through a non-competitive route. But those who lose say that they waste a lot of time and energy developing abortive proposals. However, resources invested in failed bids are not necessarily lost. A study, commissioned by the DoE, of ten partnerships that failed to win SRB funding showed that most of them not only survived but were ‘reinforced and more effective as a consequence of failure’ (Ref. 42). For example, two unsuccessful bidders from round one re-grouped to work on successful bids in round two and another two partnerships even survived a second failed bid. Identified ongoing benefits include better relations with government offices, improved inter-agency working, and an ‘enhanced understanding of the economic development process’.

Weighing the advantages and disadvantages of competitive and Challenge funding

Both central and local government can legitimately say that their claims about competitive bidding in general, and Challenge funding in particular, are justified. In line with central government claims, it has levered in private finance, stimulated partnership and promoted innovation. But it has also neglected basic need, cut across strategic planning, exacerbated uncertainty and stretched authorities’ capacity to provide matched funding. Therefore, the challenge is to find ways of reforming the system so that the advantages are retained and the problems addressed.
The National Lottery

66. The National Lottery is another relatively new competition that is providing extra capital resources for local authorities. Projects have to be accompanied by partnership funding; are primarily for capital schemes; and must supplement, rather than replace, services or projects funded by public expenditure (Ref. 43). Between its launch in November 1994 and December 1996 the Lottery raised £2.8 billion for good causes, and local authorities have been successful in bidding for projects worth over £400 million (Table 5). This has enabled councils to implement schemes which they would otherwise not have been able to finance (Box K); three out of five authorities told the Commission that the Lottery had introduced new projects into their capital programme. Three-quarters of local authorities have an officer whose remit includes the National Lottery and one-third have a dedicated Lottery Officer.

67. The Lottery has brought clear benefits to local authorities. But it has also given rise to a number of concerns. As with Challenge funding, resources are tending to support projects that attract external funding, rather than those that reflect authorities’ priorities. It has exacerbated authorities’ problems with matched funding – over a third of authorities say they would be unable to fund every Lottery project they have applied for. And the costs of running and maintaining Lottery projects are likely to put more pressure on authorities’ revenue budgets. Lottery funding may also override sound VFM judgements. For example, in one authority a Lottery-funded project – of which the council had contributed one-quarter of the costs

### Table 5

<table>
<thead>
<tr>
<th>Distributing body</th>
<th>Awards to local authorities in England £m</th>
<th>Awards to local authorities in Wales £m</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arts Councils</td>
<td>118.9</td>
<td>3.4</td>
<td>122.3</td>
</tr>
<tr>
<td>Sports Councils</td>
<td>136.9</td>
<td>9.6</td>
<td>146.5</td>
</tr>
<tr>
<td>Heritage Lottery Fund</td>
<td>26.6</td>
<td>2.1</td>
<td>28.7</td>
</tr>
<tr>
<td>Millennium Commission</td>
<td>91.7</td>
<td>20.1</td>
<td>111.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>374.1</strong></td>
<td><strong>35.2</strong></td>
<td><strong>409.3</strong></td>
</tr>
</tbody>
</table>

Source: Department of National Heritage

### Box K

Examples of local authority projects part-funded by the National Lottery

The Metropolitan Borough of Tameside has combined awards from the Heritage Lottery Fund, the European Union and English Heritage to renovate and extend the facilities at a Victorian public library. The library had dry-rot and a range of other problems, but until the arrival of the Lottery it had not been possible to find the £2 million needed to restore the building.

The London Borough of Southwark was keen to make good a long-standing leisure deficiency: the lack of a modern swimming pool in an area of high population density and great social need. The Council teamed up with the local health authority and the private sector and used Lottery funding to develop a combined leisure and community-health facility.
provided a new floodlit all-weather football pitch. Although the resulting facility was excellent, people in the area could not afford to pay the charges levied to use it. And, in the 50 per cent of authorities which are not proactive in monitoring Lottery applications, bids are much more likely to overlap or duplicate each other. For example, one authority told the Commission of two neighbouring schools in its area; both had submitted bids for sports halls, but the council was unable to provide matched funding for both schemes. If the bids had been better co-ordinated, the chance of getting funding for one properly planned scheme would have been greater.

The Private Finance Initiative

68. Both Challenge funding and the Lottery provide incentives for local authorities to work in partnership with other agencies - including the private sector - to attract external capital finance. But there have been further attempts by central government to involve the private sector more directly in the delivery of public services. The main vehicle has been the Private Finance Initiative (PFI). Long-term contracts with private-sector suppliers have been developed to deliver in a single package the public sector's requirement for ongoing services and the associated capital assets - apparently placing financial burdens outside the Public Sector Borrowing Requirement (PSBR). What effect is PFI having? Is it a better way of attracting private capital for local government services? And is it helping to close local government's capital funding gap?

Background

69. Local authorities have a long history of working with the private sector. For example, they are accustomed to using their landholdings and planning powers to work with developers to rebuild town centres and provide roads and leisure facilities. Many have outsourced the management of council functions such as IT and revenue collection to private-sector suppliers. Others have formed partnerships to promote economic regeneration. But the last government considered PFI, introduced in 1992, to represent a real change of emphasis. PFI is not primarily about the public sector getting the private sector to fund new or refurbished assets - though it normally involves this. Nor is it simply a matter of identifying and seeking to transfer individual risks. To appreciate the six principles that underpin the operation of PFI (Box L) 'requires a total shift in mind-set to see it as an opportunity to procure services, leaving the risks of ownership and operation of the asset with the private sector' (Ref. 44). But applying PFI to the highly regulated local government capital system has not been easy. The government ended up making a series of changes to the rules on capital expenditure to encourage local authorities to develop PFI deals. Initial incentives were provided in April and September 1995 and March 1996, but interest was very limited. Accordingly, in October 1996 it implemented a more radical package (Box M, overleaf). And the present government is likely to make further adjustments following the review by Malcolm Bates commissioned by the Paymaster General.
Box L
Key elements of the Private Finance Initiative

PFI is based on six principles and assumptions:

1. Private funders and contractors design, build, finance and operate (DBFO) new or refurbished public facilities – such as roads, prisons, hospitals and offices – and operate them for a period of between 20 and 50 years.

2. The public sector specifies the nature of the service it requires; tenders and selects an operator or consortium to develop the facility required and run the scheme; negotiates the contract and the charging mechanism that provides the private sector with its return on the money it has invested; and monitors and regulates the service provided.

3. Charging mechanisms are based on: actual income (charges to the public for using a facility – for example, a toll for crossing a bridge); shadow tolls (notional charges – for example, payments based on the number of cars using a stretch of road per week or month); payments for service outputs (for example, paying for access to a school building with a certain number of places and maintained, cleaned and catered for to a required standard); or a combination of the above.

4. The private sector can offset its inability to borrow money as cheaply as public authorities – and hence the potentially greater long-term cost of the services provided – by using staff more flexibly, building and running facilities more efficiently and exploiting the potential for income generation more effectively.

5. Transferring significant construction and operational risks to the private sector frees the public sector to concentrate on its strategic role. It also transfers effective ownership of capital assets to the private sector, and so places the capital investment outside public-spending limits and the Public Sector Borrowing Requirement (PSBR).

6. PFI solutions must show value for money, usually calculated in relation to a public-sector comparator.

70. As a result of this package there is increased interest in PFI, with a range of projects being developed (Box N, overleaf). In 1996, one in ten of authorities said that they were negotiating DBFO schemes, and nearly one-third were seeking potential partners and projects (Exhibit 24, overleaf). The Public Private Partnerships Programme (4Ps), set up by the local authority associations to help councils develop PFI projects, is tracking around 200 potential schemes. It is offering special support to 29 ‘pathfinder’ projects – 23 in its own right and a further 6 in partnership with the Private Finance Panel Executive. The Home Office and the Lord Chancellor’s Department also have a number of pathfinder projects for the police, fire, probation and magistrates courts services.
From 31 October 1996 local authorities can pursue DBFO contracts through one of three routes so that they have “flexibility to develop schemes with varying degrees of risk transfer” (Ref. 45). In all cases, if the contract involves transferring an asset from an authority to the private sector there will be no requirement to set aside part of the notional receipt.

### Route 1 - full DBFO meeting statutory contract structure test*  
A DBFO scheme that meets the full requirements of the contract structure test will not need credit cover (i.e. it will be outside the capital controls). But the Government will issue a notional credit approval (NCA) as a way of providing authorities with revenue funding support for the scheme.

### Route 2 - full DBFO not meeting the contract structure test*  
A DBFO scheme that does not quite meet the full contract structure test, but in the Government’s view meets other PFI criteria and offers good value for money, can be allocated a non-scoring credit approval (NSCA). This will provide the necessary credit cover (which will be additional to authorities’ other credit approvals) and enable the scheme to attract revenue support for the capital element in the scheme.

### Route 3 - partial DBFO ('spend-to-save') measure  
A DBFO scheme that involves creating a new asset or replacing or upgrading an existing one, but does not transfer enough risk to the private sector to pass the contract structure test either fully or nearly, can qualify for reduced credit cover. The reduction will equate to the efficiency saving achieved by the new facility compared with the average annual running cost of the existing facility over the previous five years, or a notional 30 per cent – whichever is the higher.

*The contract structure test for DBFO schemes consists of eight main conditions:

- A local authority must enter into a contract with a private operator for the operator to provide all the assets and services associated with the scheme.
- Standards or outputs of service must be specified.
- The contract must provide for a minimum level of service below which the authority may unilaterally terminate the contract.
- At least 20 per cent of the payments under the contract must relate to usage or performance.
- No payments should be made until the service becomes available.
- Variations in payments must relate only to changed performance standards or inflation (that is, they cannot be made because of increases in contractors’ costs or income shortfalls).
- Councils must not guarantee contractors’ liabilities.
- Contracts must demonstrate good value for money.
Box N
Examples of PFI schemes being developed in local government

Devon County Council is inviting private contractors to design, build and manage a £50-million bypass. A private consortium would recoup its investment over 30 years through a combination of ‘shadow’ tolls and availability payments – ie, no charge will be levied on motorists but the number of cars using the road will determine the payment to the contractor.

Derbyshire Police Authority is close to finalising a DBFO and management scheme for a replacement police station worth £2.7 million. As well as provision of the new building, the contract will cover such matters as buildings and grounds maintenance, cleaning and caretaking and the management of energy and waste.

Dorset County Council appointed a preferred bidder in February 1997 to build a replacement school. The original school was built in 1959 to accommodate 650 children, but there are now around 1,000 on roll. Like many schools it lacks space; despite additional accommodation provided over the years, it still has to use temporary buildings, which are in a poor state, and the hall and catering facilities are inadequate. The council estimates the cost of a new school at around £11.5 million. Although the council is debt-free, and therefore has considerably more freedom in relation to capital controls than most other authorities, it decided to go for a PFI deal because it faced a reduction in its resources after local government reorganisation. The final contract will last about 35 years and is likely to include arrangements for some commercial use of the new premises, including community use of the sports facilities.

Exhibit 24
Local authority involvement with PFI schemes, 1996

One in ten authorities were negotiating DBFO schemes, and nearly one-third were seeking partners and projects.

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage of Authorities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actively pursuing joint ventures</td>
<td></td>
</tr>
<tr>
<td>Involved in joint-venture companies for years</td>
<td></td>
</tr>
<tr>
<td>In negotiation on DBFO-type specific package</td>
<td></td>
</tr>
<tr>
<td>Currently seeking potential partners and projects</td>
<td></td>
</tr>
<tr>
<td>Will consider how others fare before pursuing</td>
<td></td>
</tr>
<tr>
<td>Not currently an option</td>
<td></td>
</tr>
</tbody>
</table>

Source: Audit Commission survey
Short-term problems

71. A range of practical problems is holding back the development of PFI:

◆ the arrangements for DBFO schemes are too complex. ‘We would prefer a simpler framework’ and ‘the rules are too complicated’ were typical of the comments voiced by private operators. And the 4Ps has questioned how the private sector is meant to cope with the complex regulations, definitions, exclusions and prohibitions when these are ‘difficult enough for experienced public-sector lawyers and accountants to pick their way through’;

◆ the size of deals in local government is a drawback. Developers and funders told the Commission that they are looking for PFI schemes to be worth at least £8 to £10 million in order to recoup their costs on setting up deals and to make a return on their capital outlay. But only around one in ten of local authority capital projects has a value of more than £500,000;

◆ the cost of setting up PFI deals is high. Experience with the NHS shows it is not unusual for the feasibility, legal and consultancy costs incurred by the public sector in developing PFI projects to run to several hundred thousand pounds. Developers say that local authorities are reluctant to commit expenditure of this scale to deals that may not materialise when, for the same amount, they could finance a number of smaller-scale projects;

◆ many authorities do not yet have sufficient expertise to negotiate PFI deals. ‘There is a serious lack of knowledge of what can be achieved’ was a comment from one major contractor. Although the 4Ps has held roadshows and is providing training, it will take time for all authorities to be able to make the most of PFI and judge when and where to use it;

◆ recent legal judgments have created doubts about the extent of local authorities’ powers to enter into PFI deals. Funders are worried that a council will sign a contract, only for it to be discovered later that it did not have the power to do so. If this happened the service contract, on which the funder would be relying to make a return on the capital investment, would become null and void. Funders are prepared to take the credit risk (that is, normal commercial risks) but not the legal risk that the contract will be declared invalid;

◆ developing auditing procedures for allocating risk, negotiating charges and payments and assessing value for money is difficult – particularly for complex and innovative PFI projects. Until tried and tested methodologies are in place, there remains a risk that financially disadvantageous projects may proceed simply because they are fundable; and

◆ experience of writing public-service contracts for long periods is limited. Authorities know that they have to define outcomes sufficiently clearly to pass the contract structure test, hold contractors to account for their performance and provide a fallback if things go wrong. But they also want flexible contracts, so that they can alter a specification as their service needs change during the contract period.
Other problems

72. As well as practical problems there are longer-term worries. PFI frees councils from most capital constraints, but schemes continue to need resources. Controls for allocating revenue support replace capital controls. Therefore, the only net benefit that PFI brings to local government is the increased efficiency and flexibility which the private sector might provide; PFI does not offer a route to free additional resources. This factor, along with the long duration of DBFO deals, makes some funders question whether authorities will be able to afford PFI deals in the long-term. What is to stop authorities building up too high a future revenue commitment to PFI schemes? Authorities, too, are concerned about the future. They know that funding of assets in the traditional way commits them to debt charges for a fixed number of years. But, unlike a DBFO scheme, the traditional route enables them to change the use of an asset, or dispose of it, if their service needs or budget priorities change radically.

73. A further worry is that – like Challenge funding – PFI will skew priorities and lead to projects being developed because they are suitable for a DBFO scheme, rather than because they address the greatest need. And at national level the allocation of revenue support is apparently not being linked to any assessment of need. The £200 million of credit approvals available for English PFI projects in 1997/98 has been divided between government departments, but within departments these allocations will apparently go to authorities on a first-come-first-served basis.

74. Another concern is that, although PFI schemes are meant to be about private-sector provision of services, the arrangements in local government have been so constructed that they create a perverse disincentive for authorities to outsource services or negotiate partnerships with the private sector. DBFO schemes are based round a capital package, on to which a service contract is ‘piggy-backed’; the capital element of the scheme may generate extra revenue support for the service contract. But if an authority approached the issue from the other direction – negotiating a long-term service contract with a supplier, including an injection of capital support as part of that package – it would not qualify for extra revenue assistance. For example, a social services authority could get revenue support if it negotiated a DBFO deal to bring its houses for the elderly up to registration standards linked to a 20- to 30-year contract for maintenance and care services. But, under the existing DBFO arrangements, an authority that outsourced its residential services for elderly people for five or ten years would not be eligible for additional revenue help, even if the private-sector supplier was investing capital in the service as part of the deal. Service-led deals – a more natural starting point for a partnership between local authorities and the private sector – are perversely disadvantaged.

Summary

75. PFI has the potential to meet some of local government’s capital demands by increasing the repertoire of funding techniques. But it has been slow to get going. Central and local government need to remove the obstacles that are
preventing it making a more substantial contribution to the capital funding shortfall. Projects should be related to clearly defined priorities. Value for money must be demonstrated clearly. The long-term revenue implications should be fully taken into account before deals are signed and should be made separate, explicit and visible in council accounts. And deals based primarily on service delivery should be treated on the same basis as deals based on providing assets - reflecting the original intention behind PFI.

**Conclusion**

76. Where, then, do recent initiatives on Challenge funding, the National Lottery and PFI leave local authorities? The case for the initiatives is primarily that they can give access to substantial funds – particularly from the private sector. The bidding process has also given local authorities incentives to use capital assets and resources more efficiently and effectively. The case against these initiatives is that they do not address the problems in the capital system, and in some respects make them worse. Competitive bidding, PFI and the Lottery are all skewing local priorities and favouring more ‘glamorous’ projects at the expense of ‘bread-and-butter’ schemes. The number of different competitions is fragmenting the capital process and making the planning of capital programmes more demanding. And authorities’ use of central government initiatives is being constrained by a lack of resources for matched funding. Overall, these initiatives have helped to ease some local capital pressures, but in other respects they have not been so beneficial (Exhibit 25). In short, the new initiatives contain no panaceas. There remains a case for reform to address the underlying problems in the system. Chapter 4 of this report considers what needs to change.

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**Exhibit 25**

**Impact of Challenge funding, PFI and the National Lottery on the capital system**

The policies have helped to ease some of the capital pressures on councils, but in other respects they have been less beneficial.

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**Source:** Audit Commission
Steps can be taken to improve the value for money generated by the capital system. Collecting standardised data on the condition of existing assets and authorities’ needs would provide a more accurate picture of the demand for capital. Central and local government should allocate resources and plan programmes on the basis of longer-term local capital strategies. The allocation process should strike a better balance between needs-based and competitive funding. The PFI scheme should be overhauled and authorities, supported by central government, should improve their management of capital assets and resources.

But even with these improvements, the capital regime is unlikely to meet all legitimate needs. To make the best use of limited resources, authorities should shed unproductive and unwanted assets. They may also need to review their local activities to identify whether there are services that they should cease to provide, or provide in a different way.
## Glossary

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>4Ps</td>
<td>Public Private Partnerships Programme - the company set up by the local authority associations to develop PFI specifically within local government.</td>
</tr>
<tr>
<td>CCA</td>
<td>cost-compliance assessment.</td>
</tr>
<tr>
<td>DLO/DSO</td>
<td>direct labour organisation or direct service organisation - internal local authority trading units staffed by the authority's own employees, set up to compete with external companies to provide services for the council.</td>
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<tr>
<td>EU</td>
<td>European Union.</td>
</tr>
<tr>
<td>HIP</td>
<td>housing investment programme.</td>
</tr>
<tr>
<td>IT</td>
<td>information technology.</td>
</tr>
<tr>
<td>RTIA</td>
<td>receipts taken into account - the Government’s assessment of local government’s ability to finance capital expenditure from usable capital receipts. Each authority’s share of the national RTIA total is calculated by the Department of the Environment. An authority’s BCA is the sum of its ACGs for each service less its share of the RTIA total.</td>
</tr>
<tr>
<td>SCA</td>
<td>supplementary credit approval - a credit approval above and beyond an authority’s basic credit approval, issued for a specific project or programme that fits in with government policy.</td>
</tr>
<tr>
<td>SRB</td>
<td>single regeneration budget.</td>
</tr>
<tr>
<td>VFM</td>
<td>value for money.</td>
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Chapter 1 showed that the capital system is soundly based. It is built on the prudential standards that have traditionally characterised local government finance; it supports the wider economic aims of central government by controlling levels of capital spending; and it enables central government to allocate resources to reflect its service and policy objectives. Despite these strengths, the system has weaknesses. Chapter 2 highlighted the significant problems it causes for local authorities. Chapter 3 described how recent government initiatives were attempting to lever in additional finance (particularly from the private sector) and create incentives for greater efficiency, but had not addressed underlying flaws in the capital system - and had made some problems worse. How, then, can the weaknesses of the capital system be addressed without discarding or undermining its strengths? Can the circle of central and local government’s differing interests be squared? This chapter describes six areas where central government and local authorities can act to improve the efficiency, economy and effectiveness of the capital finance system (Exhibit 26).

**Areas for improving the capital finance system**

There are six areas in which central government and local authorities can improve the efficiency, economy and effectiveness of the capital finance system.

---

**Exhibit 26**

**Areas for improving the capital finance system**

There are six areas in which central government and local authorities can improve the efficiency, economy and effectiveness of the capital finance system.

---

**Form a more accurate picture of the demand for capital**

**Develop a longer-term capital strategy**

**Use a capital allocation process that is ‘fit for purpose’**

**Maximise external capital resources**

**Manage capital assets and resources more efficiently**

**Consider other options**

---

*Source: Audit Commission*
Exhibit 27
Forming a more accurate picture of the demand for capital

It is vital that local and central government have accurate information with which to decide priorities and allocate resources.

For many services it may also be sensible to apply the Sports Council’s approach of calculating the life expectancy of key building components and to estimate when major expenditure will be needed in an asset’s lifecycle. Collating stock-condition data more systematically will not in itself generate increased resources. However, it will enable reliable and consistent comparisons to be made between local authorities and regions; help councils to decide which properties to retain and maintain and which to dispose of; and give central government a clear overall picture of the condition of public assets. Such benefits will outweigh the inevitable costs associated with such a rigorous data-collection exercise.

79. Disagreements between central and local government over the capital cost of implementing new legislation might be reduced by making the process for assessing increased costs more transparent. The arrangements for publishing business cost-compliance assessments (CCAs) provide an example. For each piece of legislation, the Government carries out a CCA. The CCA is a matter of public record for which the Government can be held to account. If the CCA identifies a disproportionate financial burden on local authorities the appropriate department is responsible for consulting
the local authority associations and securing the additional resources required; normally, however, only the headline figure is published. On the other hand, when dealing with the impact of new legislation on businesses, the details as well as the headline figure are published, alternative approaches are considered and representatives of business are consulted on the results. This approach could provide a better and more open framework for assessing the costs to local government of implementing new duties.

A longer-term capital strategy

80. A local authority's capital programme should be more than an amalgam of worthwhile schemes, pet projects and hand-to-mouth maintenance. Having accurate stock-condition data is a good starting point for developing a longer-term perspective. As is now required in New Zealand (Box O), authorities' annual capital plans should be rooted in a long-term corporate strategy (Exhibit 28, overleaf). The Capital Challenge pilot scheme provided the first formal incentive for councils to adopt such a strategy. However, Capital Challenge provided only sketchy guidance on what constituted a capital strategy and how it should be drawn up. One option would be for the Government and the Local Government Association to draw up an agreed guidance. But the Commission envisages that a capital strategy would incorporate an authority's assessment of:

- the value and condition of its assets;
- the priorities set out in a strategic plan for its area, agreed with other partners;
- the capital implications of its service development and delivery plans;
- community needs and service priorities;
- key government policy objectives;
- potential funding opportunities – including PFI initiatives;

Box O

Long-term strategic planning in New Zealand

Recent legislation in New Zealand requires councils to produce ten-year financial strategic plans and review them on at least a three-yearly basis. As part of this process, authorities have to adopt formal funding, investment and borrowing policies. The plans must encompass all of a council's activities and intended projects. They must explain how services and projects will be funded; set out a council's intentions for distributing costs between rates, user charges and loans; and include an assessment of the benefits and costs of different policy and service-delivery options. The plans must be subject to public consultation, and specific procedures entitle local people to comment on the proposals.

Provided that councils comply with this strategic process and take account of other prudential considerations – such as a requirement for operating reserves in any financial year to be set at a level adequate enough to cover all operating expenses – authorities are free to raise loans to implement their strategy.

Source: Audit Commission (Ref. 46)
Exhibit 28
Developing a longer-term capital strategy

An authority’s annual capital plans should be rooted in a long-term strategy.

- the revenue implications of its capital plans; and
- the needs of, and contributions from, private-sector and community partners.

81. The resulting strategy would give authorities a platform from which to develop partnerships, prepare and make bids, plan a medium-term revenue budget, rationalise and manage its assets and agree a rolling annual capital programme. Strategies can be effective only if they take a long-term view. The Government can help by agreeing that strategies should be drawn up and reviewed with government offices on a three-yearly basis – as has already been recommended for housing investment programme (HIP) strategies (Ref. 46) – and making resource allocations more certain over the three years. If this change is to take root, the Government’s involvement will need to focus less on assessing specific projects and more on the content of the strategy: in particular, whether it is consistent with ministerial guidelines and whether it is based on a thorough and prioritised survey of the needs of the area. This is consistent with the way in which the HIP and SRB processes have developed for housing and regeneration work and reflects the way that central government recently reformed the administration of EU funded projects (Box P).
The present system for allocating capital resources is fragmented and short-term. Some of the allocations are project-specific, while others are based on an authority’s strategy; some are service-specific, while others are corporate; some are awarded as a result of a competition, while others are not; and some are supported by a capital grant and others by credit approvals. In short, there is no discernible rationale to the current arrangements. The allocation system should be shaped to fit as many of central and local government’s objectives for the capital process as possible. These objectives include:

◆ delivering the Government’s key policy priorities;
◆ taking account of local authorities’ relative needs, priorities and resources;
◆ providing a long-term planning perspective;
◆ encouraging a corporate cross-service approach to capital planning;
◆ using the strengths and benefits of competitive Challenge bidding;
◆ facilitating the funding of large one-off projects;
◆ providing flexibility for authorities to manage their capital resources in a way which maximises value for money; and
◆ providing a logical basis for revenue support.

Devising a system that meets all of these objectives is difficult. It is possible to identify four broad options for a national allocation mechanism – and of these, one scores better against the system objectives than the others (Exhibit 29, overleaf).

Option 1: allocation by formula

The formula could be based on a needs index or, as happens in Wales, agreed by local authorities among themselves. This approach would reflect local needs – and, if it were linked to an RTIA-type mechanism, could also take account of local authorities’ resource bases. Formulae would have to use indicators of stock condition with care so as to avoid rewarding past or future neglect. Councils would be able to project the application of the formula to future years, which would help with forward planning. This option would not, however, enable central government to be sure that its...
Policy priorities would be delivered – and nor would it, by its nature, build in the benefits of competitive bidding. It would not provide an incentive to plan capital programmes corporately, nor would it facilitate the funding of large one-off projects.

Option 2: allocation by competitive bidding

Either by strategy or project, Challenge-style funding does deliver government policy objectives, lever in private finance, promote partnership and provide a means of funding large schemes. But its relationship to local needs and resources is weak, it provides an uncertain base for long-term planning and does not necessarily encourage a corporate approach. The evaluation of the Capital Challenge pilot scheme revealed no evidence that those authorities with the best corporate capital investment strategies attracted the most resources.

Option 3: allocation by evaluation of bids to government departments

This approach, which is at the heart of the current system, can make sure that government policy priorities are secured and that expensive projects are funded. If the bidding process includes a needs element, it may take account of local needs and resources and, depending on how the bidding is constructed, may also incorporate some of the advantages of competition.
But it undermines moves towards a corporate approach to capital planning, and its annual basis does not encourage a long-term approach.

Option 4: allocation by formula combined with competitive allocation based on an authority’s capital strategy

Under this option, part of an authority’s capital allocation would be related to a formula and part would be dependent on the quality and content of an authority’s corporate capital strategy. This was the approach before 1997/98 for HIP allocations: a proportion of these housing resources was allocated by needs indicators and the remainder according to a competitive evaluation of housing authorities’ HIP strategies. Since 1997/98, the evaluation of housing strategies has been used to adjust allocations up or down from benchmarks determined by needs indicators. This option also has similarities with the allocation systems for education and transport. The proportions allocated by formula and by evaluation would need to be discussed between central and local government, as would the nature of any needs-related formula and the balance between local priorities and government policy in any evaluation process. This option still leaves a place for potential judgement and discretion – with all of the advantages and drawbacks that these entail. However, it has the potential to meet most of the core objectives of an allocation system. The formula element takes direct account of agreed measures of need. The competitive element allows the Government to specify and assess how far its policy priorities are being adopted and to encourage corporate working, partnership and private-sector finance. Providing the competitive evaluations follow the model of Capital Challenge in making allocations for three-year periods, this approach would encourage long-term planning. Having a corporate strategy would be fundamental to the process and would enable the advantages of competition to be retained but within a strategic framework.

The ability of any of the options to deliver local flexibility and to provide a logical basis for revenue support depends on factors other than the nature of the allocation system. Increased flexibility argues that central government should go back to the 1990 position: rely less on SCAs, reduce the number of competitions and channel the majority of capital through a block allocation. The one area that would justify being an exception to this approach, by continuing to be a separate allocation outside the main block allocation, is the SRB Challenge Fund. It is a significant fund in its own right, has proved effective in forming partnerships to target regeneration resources, and involves revenue as well as capital resources. In terms of providing revenue support for capital schemes the Government needs to review its arrangements, in consultation with local government, for deciding which areas can most appropriately be supported by capital grant, and which by credit approvals.
Exhibit 30
Maximising external sources of capital finance

Both local and central government have a part to play.

Local authorities have benefited from considerable injections of capital finance from the private sector, Europe, the National Lottery and other agencies. But there is more that can be done to increase the flow of such funds and to ensure that they are directed towards authorities’ highest priorities. Both local and central government have a part to play (Exhibit 30).

At a local level, councils need to check that external bids and potential deals arise out of their capital strategy, rather than being parachuted into it by the demands of an external funder. It may also be advisable – particularly for those authorities involved in several competitions – to set aside some capital resources for matched funding, in order to be able to launch bids quickly and flexibly (Case Study 10).

There is much that authorities can learn from each other to improve internal co-ordination of the bidding process (Ref. 2) and to negotiate PFI deals. Those authorities that are not yet monitoring and co-ordinating all Lottery bids in their area should follow the example of those that do. And as PFI develops, standard forms of contract, experience of VFM assessments and examples of risk-sharing should emerge. The 4Ps will have a key role to play in networking this experience among local authorities.
Setting up a matched funding pool

and providing appropriate training and guidance. Several authorities are working on ‘bundling’ a group of projects – such as renovating and maintaining a cluster of schools – into one deal, to make it more viable. This may be a way of meeting private-sector concerns about schemes that are not big enough to justify the set-up costs or to provide a return on the investment. Finally, there are a number of options for tackling the problem of PFI schemes creating unsustainably high financial burdens on authorities in the long-term. There may be a case for changing financial reporting arrangements to ensure that the full consequences of PFI schemes are made more visible within local authority accounts. And it would be possible to establish rules that limited the percentage of local authorities’ revenue budgets allocated to the revenue consequences of PFI schemes.

87. The Government can play its part in helping authorities to attract more external capital finance by:

- making grants to cover part of the cost of commissioning DBFO deals. The Home Office is providing financial assistance of up to £70,000 per scheme for six or seven pathfinder projects, while the Welsh Office has made £0.5 million available; and the approach has been adopted by DfEE for schools projects. This could be extended to other areas;

- introducing regulations or primary legislation to clarify local authorities’ powers if doubts in this area should prove to be a major stumbling block to reaching PFI deals;

- providing incentives for local authorities to develop joint ventures, which may be a more flexible way to attract private-sector investment into local government than DBFO deals;

- considering ways of simplifying and streamlining the DBFO process, so that it is more comprehensible to both local authorities and the private sector;

- integrating revenue support for PFI deals with the proposed competitive evaluation of capital strategies. This would help to ensure that private-sector investment was targeted at services and areas of need; and

- advising National Lottery distributing bodies to provide incentives and give priority to applications that are consistent with a council’s capital strategy.

Wirral and Sefton Metropolitan Borough Councils both sold stakes in local shopping centres to generate funds for European-financed economic development. Wirral established a ‘Europa pool’ in its budget headings, while Sefton ring-fenced £1.8 million of the realised receipts. Both authorities have recognised that this approach is not without its drawbacks, because realising equity implies the loss of future revenue streams, and ring-fencing receipts reduces funding for other policy areas.
Exhibit 31
Managing capital assets and resources more efficiently

There is a range of policy issues around asset management that central and local government need to consider.

Source: Audit Commission

More efficient management of capital assets and resources

88. Making long-term capital plans is important. So is allocating and maximising resources to support plans. But it is also vital that authorities make the most of the funds and assets they have. There are many practical steps that they can take to improve their property management and deliver capital projects to time and within budget (Refs 1 and 2). But, in addition, there is a range of policy issues around asset management that central and local government need to consider (Exhibit 31).

Local authority action

89. There are two initiatives that authorities could consider. First, instead of applying capital rentals to services for the use of assets in general, they could apply them to individual cost centres, such as schools, libraries, offices and leisure centres. This would give capital accounting more bite, since authorities and service committees could not ‘hide’ capital costs in general service budgets but would have to show and respond to the cost of running particular facilities. Second, authorities could set up an identified budget for long-term maintenance. This builds on an approach already used...
in other sectors. For example, The Higher Education Funding Council’s Financial Memorandum with higher education institutions requires them to maintain their estate in accordance with a maintenance plan. The Statement of Recommended Practice (SORP) for higher education institutions requires them to provide for the costs associated with the maintenance plan. The Council is developing the sector’s good practice guidance on the character of maintenance plans. And the Housing Corporation advises housing associations each year to set aside 0.8 per cent (1 per cent for renovations) of the capital cost of all schemes built since 1988 for long-term repairs.

**Government action**

90. There are two areas where the Government could change the capital framework to help authorities manage resources more efficiently. First, it could reduce the rush to ‘spend up’ capital allocations at the end of a financial year, which often results in poor value for money. This could be done by allowing authorities to carry over 10 per cent or more of their total capital allocations from one financial year to the next – which would put them more on a par with grant-maintained schools (which can carry one year’s formula capital allocation over to the next). Such a change would mean that the Government could not be certain whether up to £300 million of public expenditure was going to be spent in one year or the next, but this sum represents only 0.11 per cent of total public expenditure. In terms of its impact on overall spending forecasts, this level of uncertainty is unlikely to undermine the Government’s macro-economic objectives or destabilise its public-spending plans. Another helpful step would be to issue more SCAs at the start of the financial year, as happens in Wales, or to allocate them for a two-year period if they are notified after the start of the financial year.

91. The capital receipts mini-holidays (which enable authorities to use more of the sale proceeds from particular types of assets than the regulations would normally allow) are uncertain in timing and duration (Box F, p24). Since housing capital receipts – which account for a significant proportion of total receipts – are now broadly stable (Exhibit 32, overleaf), the second way in which the Government could promote increased efficiency would be by deciding on a longer-term policy for the use of capital receipts. This would help to deliver the objective of providing incentives for local authorities to dispose of unproductive or unwanted assets – something that should be at the heart of authorities’ efforts to manage their asset portfolio more efficiently – and giving them ‘additional spending power to invest in new partnership projects’ (Ref. 47).
Housing capital receipts are now broadly stable.

Note: The table shows the total local authority housing capital receipts received in each financial year deflated to 1996/97 prices using the GDP deflator at market prices.

Source: DOE Housing statistics 1996 and CPWP(96)18

More radical options

92. The changes to the capital system outlined above would help to address many of the problems identified in Chapters 2 and 3. They would provide a more stable forward-planning framework for allocating and managing capital resources and give authorities more flexibility in using them. They would enable authorities to get more from existing resources and assets and increase levels of funding from external sources. But these measures by themselves are unlikely to be sufficient to address all of local government’s capital problems – particularly the backlog of maintenance. Central and local government may therefore also need to consider some more radical options (Exhibit 33).

93. Some in local government, noting the approaches adopted in other countries, argue for a more radical approach that gives local authorities greater freedom. This might include the freedom for authorities to borrow against the value of their assets, independent of national capital controls. It might also incorporate the argument that, if controls on revenue expenditure are properly devised and implemented, there is no need for additional controls on capital expenditure.

94. Another more radical approach – though one that keeps within the current control regime – involves reviewing authorities’ approaches to service provision. An increasing number of local authorities deliver local services in partnership with a private-sector supplier or through ‘arm’s-length’ companies or trusts. Sometimes such arrangements have been made because they generate revenue savings, and sometimes because they provide a vehicle for attracting capital that does not count against an authority’s credit approvals. For example, some councils have transferred the management of their leisure centres and civic theatres to independent charitable trusts to give them – within agreed limits – more commercial
Central and local government may need to consider some more radical options. Freedom and the opportunity to raise capital finance for renovation and new facilities that the council cannot afford. As they survey their capital needs, more authorities may need to evaluate and pursue options along these lines. They may even need to consider ceasing to be involved in some areas of activity altogether, so that those services they continue to provide can be properly funded and maintained.

The Government also has big issues to consider. The last government encouraged the development of arm’s-length service provision outside normal public-sector controls as a way of raising private finance. The examples of housing associations, grant-maintained schools, universities, local authority housing companies and joint-venture companies illustrate how bodies can be regulated and financially assisted by the Government while remaining outside the mainstream of the public sector. If capital-finance allocations from the Government continue to fall in real terms, the Government may have to consider whether there are other areas where this approach should be applied. However, it will need to make sure that long-standing prudential standards are not compromised, and that local authority financial guarantees of these enterprises are reflected in councils’ accounts.
Another area that may need further examination is the operation of the National Lottery. Chapter 3 showed how capital support going to sports, leisure, arts and heritage ‘good causes’ compares with the amount of capital available for statutory local authority services. There is an outstanding government commitment to ‘a continuing review of the operation of the Lottery and of policies for the use of funds’ (Ref. 43). The new Government may wish to consider whether the scope of National Lottery funding should be reviewed, in order to improve the effectiveness with which services are delivered to the local community as a whole. One possibility would be to reduce the level of matched funding that local authorities have to provide, and so minimise the risk of an authority’s priorities being skewed. Another option – though one of considerable political sensitivity – would be to review the implications of awards having to be ‘additional’, so that an increased range of local authority services could potentially benefit from awards.

Conclusion

This report started by highlighting the differing perspectives of central and local government. Sound finance and achieving particular policy objectives are the prime considerations for central government. These are shared by councils, but responding to community needs and delivering statutory services are their main concerns. The capital system does not balance both sets of objectives. Central government calls most of the shots; the capital controls are designed to deliver on ministers’ agenda. As a result, authorities say that it is increasingly difficult for them to deliver what local communities expect and want – although the inadequacy of estimates of the demand for capital and councils’ less than efficient use of existing resources weaken their case. The response of central government has been to maintain a firm grip on the level of public resources but to provide the means and the incentives for authorities to use other sources of capital – in particular private finance. This strategy has, in part, been successful (though the potential of PFI has yet to be realised), but it has also brought into sharp focus the flaws in the operation of the capital system. These problems – uncertainty, inflexibility, fragmentation, a lack of corporate approach and other technical problems – need to be addressed.

Many of the problems can be resolved. There are options for developing a longer-term approach. Demand can be measured and assessed more accurately. Improvements can be made in the management of capital resources. Competitive bidding can be made to work more effectively. There is the opportunity to draw in more private finance. But the basic tension – between controlling public expenditure and meeting local demand – will remain. There will continue to be a gap between what local government says is needed and what central government says can be afforded. Central and local government will need to consider their priorities. Some facilities and services may have to go – or at least be provided in a new form. But by building a strategic approach into the heart of the capital-allocation system government and authorities will have a coherent base for the tough decisions they may need to take.
Recommendations

To local authorities

1. Improve asset management. In particular:
   - ensure a fully corporate approach to the management and control of capital resources (paragraph 81);
   - extend the use of asset rentals to individual service cost centres (paragraph 89);
   - set and keep planned maintenance budgets at a level appropriate to the size and condition of the asset portfolio (paragraph 89); and
   - dispose of assets that are unproductive or unwanted (paragraph 91).

2. Improve efforts to secure finance from other sources. In particular:
   - consider the introduction of matched funding pools, in order to be able to launch successful bids quickly and flexibly (paragraph 85);
   - establish arrangements for co-ordinating Lottery bids in an authority’s area (paragraph 86); and
   - share PFI-related lessons between authorities and develop standard documents and techniques, using the 4Ps where appropriate (paragraph 86).

To central government

3. Review allocation systems to secure a better balance between needs-based and competitive funding techniques and reduce the number of competitions (paragraphs 82–84).

4. Consider changes to the control regime that would increase flexibility and efficiency. In particular:
   - decide which areas are most appropriately supported by capital grant and which by credit approvals (paragraph 84);
   - review the rules governing the carry-over of credit allocations from one financial year to the next and the procedures for issuing SCAs (paragraph 90); and
   - develop longer-term arrangements for decisions on capital funding and the use of local authority capital receipts (paragraphs 81 and 91).
5 Consider changes to the regulations governing the PFI to allow better use of private sector resources and expertise. In particular:

- make grants to cover part of the cost of commissioning PFI deals;
- clarify local authority powers to enter into PFI deals;
- simplify and streamline the DBFO process; and
- provide incentives for authorities to develop joint ventures as an alternative to DBFO deals (paragraph 87).

6 Consider changes to the regulations governing the use of National Lottery money to improve funding arrangements for local authority services (paragraph 96).

To both central government and local authorities

7 Develop systems for gathering and reporting consistent information on the condition of each local authority’s assets and anticipated future service needs (paragraphs 78–80).

8 Move to a system of local authority capital strategies, which reflect authorities’ priorities for capital expenditure and which, after consideration by central government, would form the basis for longer-term resource allocation and project programming (paragraphs 80–81).

9 Revise the PFI scheme rules to prevent authorities from incurring unsustainably high burdens. In particular:

- explore options for changing financial reporting arrangements so that the full consequences of PFI schemes are made more visible within authorities’ accounts; and
- consider the case for rules that limit the percentage of authorities’ revenue budgets allocated to the consequences of PFI schemes (paragraph 86).

10 Review the range of local authority service responsibilities in the light of judgements about the levels of available resources for capital expenditure (paragraphs 92–96).
Appendix 1 - local authorities visited by the study team

Blackburn Borough Council
Chester City Council
Coventry City Council
The London Borough of Croydon
Harrogate Borough Council
Lancashire County Council
Lancaster City Council
North Lincolnshire Council
North Yorkshire County Council
Sheffield City Council
The London Borough of Southwark
St Edmundsbury Borough Council
Swansea City Council
Tameside Metropolitan Borough Council
Appendix 2 - members of the study advisory group

Brian Aldred, Lancashire County Council
William Bradshaw, Stockport Metropolitan Borough Council
Paul Bryans, Private Public Partnerships Programme
Tim Day, Stafford Borough Council
Paul Durham, Chester City Council
Leisha Fullick, London Borough of Islington
Gabrielle Griesbach, London Borough of Greenwich
Doug Hale, Doncaster Metropolitan Borough Council
Chris Jeffrey, Gateshead Metropolitan Council
Peter Leeming, London Borough of Croydon
Barry Simons, London Borough of Hammersmith & Fulham
Guy Spencer, Dorset County Council
Huw Vaughan Thomas, Denbighshire County Council
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