The Scottish Government

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# FUNDING LOCAL AUTHORITY CAPITAL INVESTMENT

## Purpose of paper

1. To describe the financial framework within which the Scottish Government finances local authority capital expenditure and describe the different treatment of this expenditure in the national accounts and local authority accounts.

2. The following table provides a summary of the detailed information set out in the rest of the paper.

## SUMMARY FOR SCOTLAND

3. The Scottish Government has separate **budgets** for Resource (revenue) and Capital (resource DEL and capital DEL).

4. The Scottish Government is free to allocate its capital and resource budgets determined in spending reviews to reflect its own priorities.

5. The Scottish Government may switch provision from resource DEL to capital DEL. They may consider with the Treasury in year a switch from capital DEL to resource DEL, but only in exceptional circumstances. This has to be done at the level of the Scottish Block in total and the nature of the resource costs would almost certainly have to be 'one-off' for Treasury to consider giving their approval. There is no instance of this having happened.

6. **The capital budget is for capital investment**. The Scottish Government may use it's capital budget for the acquisition of capital assets (land, buildings, machinery etc.), to buy capital stocks (such as large machinery parts) or to pay capital grants to an individual or enterprise in the private sector or to a public corporation, including voluntary bodies and local authority arms length bodies.

7. **Budgets differ from accounts**. Resource accounts are based on International Financial Reporting Standards. Many transactions are treated in the same way in resource accounts and national accounts: pay is a current expense in any system of accounts. But there are a number of differences between the two systems of accounts. These differences in accounting treatment explain some of the cases where resource accounts and budgets treat transactions differently, since

budgets are trying to achieve objectives expressed in terms of the national accounts rather than IFRS accounts.

8. Scottish Government support for capital investment to local authorities takes two forms:

- **Capital grants** – General Capital Grant and Ring-fenced capital grants.

- **Supported borrowing** – is the Scottish term for the amount of new borrowing which the Scottish Government is prepared to support each financial year. A stream of current support to cover local authority borrowing to this level is provided as part of the General Revenue Grant. This provision is known as Loan Charge Support. For 2011-12 supported borrowing has been replaced directly with grant and included as part of the General Capital Grant paid to local authorities.

9. The Capital Budget includes Capital Grants to local authorities and scores in the Departmental Resource Accounts (DRAs) (as revenue expenditure).

10. The Capital Budget includes Supported Borrowing, which although it does not feature in DRAs, does count towards the Public Sector Net Cash Requirement (PSNCR) and hence, is included as a real charge within the Scottish Governments total budget each year as a control mechanism (Supported borrowing).

11. The Resource (revenue) Budget includes the General Revenue Grant (which includes loan charge support) and scores in the Departmental Resource Accounts (DRAs) (as revenue expenditure).

12. The Capital Budget is for capital investment. The General Capital Grant is paid from the Scottish Government capital budget. The terms and conditions of the GCG reflects the requirement for capital investment – whether directly by the local authority or through the provision of grant to a third party for capital investment. In accounting terms (IFRS) it is revenue expenditure. It is the objective of the grant that is important and not its accounting designation.

13. Increases in supported local authority borrowing continue to be classified as DEL. Increases in self financed (unsupported borrowing) are classified as AME. Appropriate borrowing limits for increases in unsupported borrowing may be introduced if necessary in the light of the overall fiscal position.

## DETAILED INFORMATION

### Legislative Background

14. The Scotland Act 1998 is essentially the Scottish Constitution and the financial aspects are covered in sections 64 to 72. Section 119 translates the references in legacy legislation to the Consolidated Fund to the Scottish Consolidated Fund (SCF). Section 53 provided for all the statutory, prerogative or other executive powers and duties of Ministers in the UK Government (Ministers of

the Crown) in devolved areas to be transferred to the Scottish Ministers. Section 126 states that "Minister of the Crown" includes Treasury. References in legacy legislation to Treasury are therefore translated to the Scottish Ministers and guidance issued by Treasury has no direct application to devolved functions unless explicitly adopted by the Scottish Ministers.

15. Section 64 (1) of the Scotland Act makes provision for the SCF. The Westminster Parliament provides the Secretary of State for Scotland with the resources to pay into the SCF. The management of those resources falls thereafter to the Parliament and to the Scottish Ministers - including their officials. The Secretary of State operates within the procedural framework which applies to the Westminster Parliament. The financial relationships between the UK Government and the Scottish Ministers are set out in the Statement of Funding Policy, the Memorandum of Understanding and Supplementary Agreements between the devolved administrations and the UK Government and the Concordat between HM Treasury and the SG.

**General**

16. Government funding for the devolved administrations' budgets is normally determined within spending reviews alongside departments of the United Kingdom and in accordance with the policies set out in the 'Statement of Funding Policy'. The United Kingdom Parliament votes the necessary provision to the Secretaries of State; they make payments to the devolved administrations.

17. The total budget of each devolved administration is composed of a number of separate categories of public expenditure. These are defined as Departmental Expenditure Limits (DEL) set over three years and Annually Managed Expenditure (AME) set yearly.

18. The Scottish and Northern Ireland Executives and Welsh Assembly are free to allocate their capital and resource budgets determined in spending reviews to reflect their own priorities. They may also switch provision from resource DEL to capital DEL and in exceptional circumstances they may consider with the Treasury in year a switch from capital DEL to resource DEL. (paragraph 2.12 of the Statement of Funding Policy).

**Public Spending and Reporting**

19. The UK Government uses the budgeting system to plan and control public expenditure. The system has two main objectives:

- To support the achievement of macro-economic stability by ensuring that public expenditure is controlled in support of the Government's fiscal framework; and
- To provide good incentives for departments to manage spending well so as to provide high quality public services that offer value for money for the taxpayer.

### *Total Managed Expenditure*

20. Total Managed Expenditure (TME) is a measure drawn from national accounts representing the current and capital spending of the public sector. The public sector is made up of central government, local government and public corporations.

### *Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME)*

21. The framework for public expenditure is divided between

- Departmental Expenditure Limit (DEL) spending, which is planned and set at Spending Reviews; and
- Annually Managed Expenditure (AME), which is more volatile, demand-led expenditure and therefore not subject to multi-year limits in the same way as DEL. AME includes social security benefits, local authority self-financed expenditure, debt interest, and payments to EU institutions.

### *Departmental Expenditure Limits (DEL)*

22. Within the over DEL budget, Departments are set separate control totals for resource (current) and capital budgets.

23. The amount of their Resource Budget DEL that departments may spend on running themselves (e.g. paying most civil servants' salaries, accommodation costs, etc) is limited by Administration Budgets, which are set in Spending Reviews. Administration Budgets are used to ensure that as much money as practicable is available for front line services and programmes. Administration Budgets exclude the costs of frontline services delivered directly by departments.

### *Annually Managed Expenditure (AME)*

24. AME typically consists of programmes which are volatile and demand-led, and which are therefore not subject to firm multi-year limits in the same way as DEL. The biggest single element is social security spending. Other items include tax credits, Local Authority Self Financed Expenditure and spending financed from the proceeds of the National Lottery.

## HM TREASURY CONSOLIDATED BUDGETING GUIDANCE

25. HM Treasury issue Guidance for government departments on the budgeting framework that applies for expenditure control. This guidance is updated annually.

26. The following extracts have been taken from the 2011-12 guidance. To assist interpretation for Scotland additional information has been added in [ ] brackets.

### Overview - Introduction to budgeting (Chapter 1)

27. Departments have separate budgets for

- Capital – for new investment and net policy lending

- Resource – current expenditure such as pay or procurement and including depreciation, which is the current cost associated with the ownership of assets. Within the Resource Budget DEL there are separate administration controls set in Spending Reviews. Administration budgets cover expenditure on running central government departments but excluding their frontline activities.

28. Departments may not switch provision from Capital Budgets to Resource Budgets. Such switches would mean that money that had been earmarked for investment was used for current spending. Such switches would impact upon Surplus on the Current Budget. Departments may switch provision from Resource Budget DEL to the Capital Budget DEL but not from ring fenced elements.

29. There are restrictions on switching into and out of support for local authorities.

30. Budgets differ from accounts.

**Differences between budgets and accounts (Chapter 1 and Annex A)**

31. Departmental Accounts (DAs) are based on International Financial Reporting Standards as interpreted by the Financial Reporting Manual. Many transactions are treated in the same way in DAs and national accounts: pay is a current expense in any system of accounts. But there are a number of differences between the two systems of accounts. These differences in accounting treatment explain some of the cases where DAs and budgets treat transactions differently, since budgets are trying to achieve objectives expressed in terms of the national accounts rather than IFRS accounts.

32. Annex A lists the main differences between budgets and DAs:

The main differences between the Statement of Comprehensive Net Expenditure (SoCNE) and Resource Budgets:

| | |
|---|---|
| Departments' own spending | The SoCNE includes capital grants; these score in Capital Budgets.<br>Income that is classified as a capital grant, such as a donation that is to be used to finance acquisition of a capital asset, scores in the Capital Budget. |
| Support for local authorities | Capital grants to LAs score in the SoCNE and in Capital Budgets |
| Public Corporations | Capital grants to PCs score in the SoCNE and in Capital Budgets for PCs on the external finance basis |

The main differences between the Capital Budget and the Departmental Account entries for total net additions to fixed assets and investments

| | |
|---|---|
| Departments' own spending | Capital Budgets include capital grants; these score in the DA SoCNE |

| | |
|---|---|
| Support for Local authorities | Capital grants to LAs score in the SoCNE and in Capital Budgets<br>Capital Budgets include Supported Capital Expenditure (Revenue) which does not feature in DAs [in Scotland known as Supported Borrowing] |
| Public Corporations | Capital grants to PCs score in the SoCNE and in Capital Budgets |

**Resource budget (Chapter 2)**

33. The Resource budget scores most of the department's current expenditure. Items of Central Government's own expenditure score in the resource budget at the same value and with the same timing as in the Statement of Comprehensive Net Expenditure (SoCNE) in the Departmental Accounts. Care should be taken however as there are a couple of exceptions to this rule.

34. DAs do not distinguish between current grants and subsidies and capital grants. However, the national accounts do, with current grants and subsidies affecting the current balance and capital grants not. Therefore departments have to distinguish between current and capital grants according to national accounts principles. Current grants and subsidies score in the Resource Budget; capital grants score in the Capital Budget.

35. Current grants are paid to individuals and to not for profit bodies serving households. Subsidies are current payments paid to profit making bodies designed to influence levels of production, prices or wages.

36. Capital grants are unrequited transfer payments, which the recipient has to use to:

- Buy capital assets (land, buildings, machinery etc.); or
- Buy stocks (machinery parts etc if significant) ;
- Repay debt (but not to pay early repayment debt interest premia); or
- Acquire long-term financial assets, or financial assets used to generate a long-term return.

Chapter 5 of the budgeting guidance sets out further details for stocks and financial assets:

**Financial assets**

5.4 In addition capital budgets include net acquisitions of financial assets (e.g. movements in loans to the private sector) that score as movements in fixed assets on the balance sheet. In exceptional cases movements in debtors or other current assets (stocks / prepayments) may be included in the capital budget.

**When Stocks are treated as Capital in Budgets**

5.16 DAs do not treat purchases of stocks as investment in fixed assets. Rather, stock movements are treated as changes in current assets. Normally, budgets follow accounts in their treatment of stocks, and stocks are excluded from budgets until they are used, disposed of or written off.

5. 17 The net acquisition of stocks is an item of capital spending in national accounts and increases TME. Therefore it would be appropriate to score all net acquisitions of stocks in

capital budgets. However in the interest of keeping down compliance costs we normally ask departments to follow the treatment in DRAs.

5.18 Different budgeting rules are however appropriate where the item being acquired for stock would be the acquisition of a fixed asset if it were not being acquired for stock. For example, land acquired by English Partnerships for reclamation and development scores as capital expenditure in capital budgets.

5.19 Similarly, if stock acquisitions are large, or set to increase significantly, it may be appropriate to score them in capital budgets.

5.20 Where departments are aware of stock acquisitions that might fall into the categories above, they should consult the Treasury on whether treatment in capital budgets would be appropriate.

37. Where grants are paid that may be used at the recipient's discretion either on capital or on current expenditure they should be treated as current grants or subsidies.

**Capital budget - central government's own expenditure (chapter 5)**

38. New capital spending by departments and NDPBs scores in the capital budget at the same value and with the same timing as in accounts.

39. Capital budgets include capital grants.

**Support for Local Authorities (Chapter 9)**

40. Departmental budgets include Government support for local authorities. They do not include self-financed local authority spending.

***Resource budget***

41. The resource budget includes current grants to local authorities. DAs do not distinguish between current and capital grants. Both go through the SoCNE. National accounts do distinguish between current and capital grants, and the budgeting treatment follows the National Accounts distinction, with capital grants going through the capital budget.

***Capital budget***

42. Capital budgets include:
- Supported Capital Expenditure (Capital) [Scotland: Capital grant]
- Supported Capital Expenditure (Revenue) [Scotland: Supported Borrowing]

***Supported Capital Expenditure (Capital)***

43. Supported Capital Expenditure (Capital) is the local government finance term for capital grants. Capital grants may be distinguished from current grants in that capital grants have to be used by local authorities to:
- Buy capital assets (land, buildings, machinery etc.); or
- Buy stocks (machinery parts etc if significant); or

- Pay capital grants to an individual or enterprise in the private sector or to a public corporation. [By definition this includes voluntary bodies and local authority arms length bodies]

44. Where grants are paid that may be used at the recipient's discretion either on capital or on current expenditure they should be treated as current grants.

45. Payments of compensation to Local Authorities for capital goods destroyed or damaged by natural disasters count as capital grants.

***Supported Capital Expenditure (Revenue)***

46. Supported Capital Expenditure (Revenue) (SCE(R)) is the Local Government finance term for the amount of borrowing which government is prepared to support. A stream of current support to cover local authority borrowing to this level is provided as non-ringfenced revenue as part of the Formula Grant Settlement [Scotland: General Revenue Grant].

47. Departmental budgets score the capital value of SCE(R). The current support is paid by CLG (Local Government) [Scotland: Local Government Division] as part of the Formula Grant.

48. Self-financed borrowing by Local Authorities under the prudential borrowing regime that is not supported by Government does not score in departmental budgets.

***Debt repayment grants***

49. Grants to enable local authorities to repay debt principal score in capital AME budgets. Any payment of such a grant requires specific Treasury approval. Normally, approval of such a grant will be associated with offsetting budgetary adjustments.

***NDPBs***

50. NDPBs support to Local Authorities is treated in the same way as support for Local Authorities provided by departments.

***Capitalisation directions***

51. CLG (Local Government) and the devolved administrations have the power to issue directions to local authorities to capitalise certain expenditure. Such directions do not change the nature of the expenditure from current to capital. Rather, broadly, they allow local authorities to borrow or use capital receipts in order to finance current spending.

52. There may be arguments for allowing Local Authorities to spread the incidence of certain lumpy current expenditure payments such as large redundancy payments in order to smooth the path of Council Tax. However, capitalisation directions run contrary to Treasury's position to protect Surplus On Current Budget (SOCB).

53. To protect SOCB and manage the threat from capitalisation, a ceiling of £100 million per annum was placed on the level of Local Authority capitalisation in England from 2008-09 onwards. A similar proportionate level may be agreed with the devolved administrations. Separate arrangements exist to manage equal pay settlements.

**STATEMENT OF FUNDING POLICY**

**Expenditure financed from borrowing (Chapter 7) - extract**

54. Borrowing counts towards the Public Sector Net Cash Requirement (PSNCR) and hence, is included within the devolved administrations' total budgets each year as a control mechanism, so that any increases in borrowing must be offset by reductions in other spending. The effect is to reduce the level of grant from the United Kingdom Government and hence to restore the United Kingdom borrowing position.

55. Generally the financing costs of borrowing are met locally – either from the assigned budget itself, from local taxation or through higher charges for services. Local authority capital is funded through a balance of borrowing, where financing costs must be met by local authorities, and capital grants, where financing costs are met by the United Kingdom Exchequer. In cases of a significant shift in the balance between borrowing and capital grants, the Treasury reserves the right to adjust the assigned budget for the financing costs of this shift.

56. Prudential borrowing regimes for Local Authorities in England, Scotland and Wales (and for the Northern Ireland Executive in the case of Northern Ireland) have been introduced in 2004-05. Following the 2004 Spending Review, increases in supported local authority borrowing (which replace credit approvals) will continue to be classified as DEL. Increases in self financed unsupported borrowing are classified as AME. Appropriate borrowing limits for increases in unsupported borrowing may be introduced if necessary in the light of the overall fiscal position. There is no local authority prudential borrowing regime in Northern Ireland.

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**Annex A**

Extract from Treasury Consolidated Budgeting Guidance 2011-12

## Appendix 1 to chapter 1: Summary content of budgets

This table summarises the main standard contents of resource and capital budgets. Budgets are divided into DEL and AME. The Resource Budget DEL is divided into Administration and Programme.

**Table 1.A: Content of budgets**

| | **Resource Budget** | **Capital Budget** |
|---|---|---|
| Department's own transactions with the private sector | Expenditure on an accruals basis, including administration costs, pay, accruing superannuation liability charges and other pensions contributions or current service pensions costs, grants to individuals, subsidies to private sector companies.<br><br>Take-up of provisions movement in value of provisions, and release of provisions (as well as the expenditure offset by the release of the provision except provisions related to capital expenditure).<br><br>Profit/ loss on disposal of assets.<br><br>Depreciation and impairments on the department's assets.<br><br>*Less* income treated as negative DEL/ AME, for example sale of services.<br><br>Note: Excludes revaluations charged to revaluation reserve. | Expenditure on new fixed assets on an accruals basis. Includes assets bought under finance leases and transactions that are in substance borrowing (i.e. on-balance sheet PFI deals)<br><br>*Less* Net book value of sales of fixed assets.<br><br>Net policy lending to the private sector.<br><br>Capital grants to the private sector. |
| NDPB transactions with the private sector | As the department.<br><br>Note: the department's grant in aid to the NDPB is excluded from budgets | As the department. |
| NHS Trusts (England) | As the department. | As the department. |
| Support for Local Authorities | Current grants to local authorities. | Capital grants to local authorities.<br><br>Supported capital expenditure (revenue). |
| Public Corporations | Subsidies paid to public corporations *Less* Interest and dividends received from public corporations. | Investment grants paid to public corporations.<br><br>Net lending to public corporations (Voted and NLF).<br><br>Public corporations' market and overseas borrowing (including on balance sheet PFI).<br><br>*Less* Equity withdrawals from Public Corporations. |