House of Commons

Committee of Public Accounts

Financial sustainability of local authorities

Twenty-sixth Report of Session 2016–17

Report, together with formal minutes relating to the report

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The Committee of Public Accounts

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Summary

While local authority revenue spending power has decreased significantly over recent years, authorities have, taken as a whole, maintained capital spending levels. However, revenue pressures have led to changes in the nature of capital spending with authorities focussing more on schemes intended to generate future revenues. Many are investing less in physical assets, such as libraries, museums and parks, and spending more on commercial investments, often involving investing in property. The Department for Communities and Local Government (the Department) has overall responsibility in government for the local government finance system. The Department expects authorities to become more 'entrepreneurial' as it encourages local government to become largely self-financing. But we are concerned that the Department appears complacent about the risks to local authority finances, council tax payers and local service users arising from the increasing scale and changing character of commercial activities across the sector. The Department does not have good enough information to understand the scale and nature of authorities' commercial activities or which authorities are placing themselves at greatest risk and it does not use the information it does have to give it a cumulative picture of risks and pressures across the sector. Unless the Department strengthens its understanding of the capital issues faced by local authorities, it will not be well placed to anticipate risks to financial and service sustainability.

Introduction

The Department for Communities and Local Government (the Department) has responsibility in government for the local government finance system. Accountability for capital is more devolved than for revenue, but the Department still has responsibility for ensuring that local authorities are financially sustainable. The Department recognises that this includes both revenue and capital. The Department also maintains the accountability system for local government to enable assurance to Parliament about local authority use of resources. In 2014–15, local authorities spent £38.1 billion on revenue to deliver services and £12.3 billion on capital (excluding education). Capital spending pays for local assets like leisure centres, libraries and roads. Revenue spending on services has fallen since 2010–11, while capital spend has increased in real terms for local authorities as a whole. However this overall increase masks changes in the purpose of capital spending as authorities now focus increasingly on using their capital programmes to generate revenue returns rather than solely to provide services.

Conclusions and recommendations

1. **We are concerned that the Department for Communities and Local Government (the Department) appears complacent about the risks to local authority finances, council tax payers and local service users resulting from local authorities increasingly acting as property developers and commercial landlords with the primary aim of generating income.** There is growing activity among local authorities aimed at generating revenue income from capital investment in properties and businesses. For example, developing houses and commercial units for rent or sale at market rates. Local authorities can finance these investments through borrowing and can invest outside the authority's own area. The Department does not have a good understanding of the scale and nature of these activities. It suggests that they are predominantly an extension of long-standing council activities and not necessarily more risky. However new and additional risks come from authorities purchasing properties to lease to businesses or developing houses for market rent, as authorities themselves recognise. Some authorities are also adopting these strategies in order to provide significant elements of their future revenue income. We do not share the Department's confidence that the increased commercial acitivity in the sector adds no particular risk to the Department's own work. We are also concerned that some authorities might lack the necessary commercial skills and experience amongst both members and officers. If commercial decisions go wrong, council tax payers will end up footing the bill and other services will be under threat.

   Recommendations:

   By summer 2017 the Department should send an update to the Committee setting out how it is strengthening its understanding of the scale and nature of authorities' commercial activities, focussing in particular on the scale of risk across the sector and the types of authorities placing themselves at greatest risk.

   Working with partners in the sector, the Department should review the level of commercial skills across both officers and members in different types of authorities.

2. **Neither the Department nor HM Treasury understand why local authority investments on deposit are now at record levels.** Local authority investments on deposit grew to £26.1 billion in 2015–16, compared to £18.5 billion in 2010–11. Deposits with commercial banks and most other institutions are not risk-free. However, the Department was not able to explain to us the factors underlying the growth in these deposits. HM Treasury's understanding was equally limited and appeared to be based on supposition rather than evidence collected from authorities. In particular, HM Treasury's views that the changes in early repayment terms to Public Works Loan Board loans have not played a role in the build up of deposits is at odds with evidence from the Local Government Association that the changes made had a clear effect on the choices open to local authorities.

   Recommendation: ***In its update to us in summer 2017, the Department and HM Treasury should explain clearly the causes of, and risks associated with, the build-up of investment cash held on deposit by local authorities based on both analysis of data and direct engagement with local authorities.***

3. **The Department does not have a good enough understanding of the extent to which revenue pressures are affecting local authorities' capital spending and resourcing activities.** Local authorities are under sustained revenue pressure, with reductions in government funding leading to a 13.8% real terms reduction in revenue service spend from 2010–11 to 2014–15. A significant number of local authorities have to use more than 10% of their revenue spending to service debt incurred to finance capital spending. Authorities cite revenue pressures as the main factor that shapes their capital programmes; for example by making them reluctant to increase external borrowing and causing them to prioritise capital spending that reduces revenue costs or generates additional income. Accordingly, capital spending on a commercial property portfolio could replace some capital spending on libraries or youth centres. The Department accepts that local authority capital programmes are being shaped by decisions made in the light of tight revenue budgets. However, the Department's work for the last Spending Review was focused on revenue pressures and did not include a full analysis of the capital side. While the Department's policy, through 100% localisation of business rates, is that authorities should become more self-sufficient and entrepreneurial, it has not yet considered the implications for capital expenditure and resourcing.

   Recommendation: ***The Department should ensure that the interactions between revenue spending, capital spending and borrowing and the resulting pressures on local authority capital programmes are considered fully in future spending reviews and in the design for the 100% business rates retention scheme. The Department needs to set out plans to do this in its summer 2017 update to us.***

4. **The Department lacks a cumulative picture of capital risks and pressures across the sector.** Local authorities have a great deal of freedom to decide on borrowing and capital spending without central control. The Department relies on a devolved framework that gives it assurance about the short-term sustainability of individual authorities, but the framework does not identify issues across the sector. Despite this, the Department does not use the data it collects effectively to build its own system-wide picture of trends across the sector and carries out limited analysis related to capital. The Department's current understanding of risks across the sector, such as the deteriorating condition of capital assets, is not sufficient. The Department accepts that in future it needs to monitor trends and developments in the sector more actively and to be more intelligent in the way that it identifies trends in the sector.

   Recommendation: ***The Department's update note should set out how it intends to strengthen its use of quantitative data and other information to ensure it has a clear understanding of trends and risks across the sector relating to capital spending and resourcing.***

5. **The Department's figures for capital spending in the sector do not provide sufficient detail to identify significant changes in its purpose and objectives.** In the Department's statistics, three-quarters of capital spending is grouped into a single category called 'new construction, conversion and renovation'. This is broad enough to hide the marked changes in investment strategy ongoing in the sector including a switch to invest to save and commercial schemes away from long-term asset management. The Department agreed to look at how it could improve the usefulness

and quality of such data. The rest of government relies on the Department's data and analysis to understand local government and HM Treasury supported the need for more detail. Furthermore, significant levels of funding are now being granted to Local Enterprise Partnerships and there has been some double counting when the funding is transferred from accountable authorities to other authorities.

Recommendation: ***In the update note for summer 2017 the Department should set out what measures it has introduced to ensure that the purpose and geographical location of capital spending can be ascertained and what specific steps it has taken to remove double counting from its figures.***

6. **There is a risk that the local capital finance framework might not be able to cope with the current, rapidly changing and uncertain institutional and economic environment.** The nature and purpose of local authority capital spending is changing in response to continued revenue funding reductions. The Department is also considering further significant changes to the funding of local authorities, such as to the New Homes Bonus and business rates retention. The Department is still gathering and analysing evidence about implications of Brexit for local authorities. New questions about transparency and accountability are being raised by progress with devolution deals and the developing role of combined authorities. The Chartered Institute of Public Finance and Accountancy (CIPFA), which the Department relies on for information and expertise, has accepted the need for the capital framework to be reviewed. However, we are not convinced that the Department is being sufficiently pro-active in reviewing the capital framework itself; seemingly content to take assurance from the framework's existence rather than from evidence that it is working properly or that it is robust enough for the current turbulent times.

Recommendation: ***Working with CIPFA, the Department should ensure that the local government capital finance framework remains current and continues to reflect developments in the sector, alongside wider institutional and economic changes.***

1 Local authority risks and impacts

1. On the basis of a report by the Comptroller and Auditor General, we took evidence from the Department for Communities and Local Government (the Department) and HM Treasury. Our evidence session was also informed by an update memorandum from the National Audit Office.[1]

2. There are 353 local authorities in England, which use capital spending to invest in assets such as roads, leisure centres, libraries and the offices that they use in delivering services. In 2013–14, local authorities collectively held assets worth £168.5 billion (excluding education). In 2014–15, local authority capital spending was £12.3 billion (excluding education).[2]

3. Between 2010–11 and 2015–16, local authority capital spending increased by 13.6% in real terms. This is in contrast to day-to-day spending on services, such as meeting staff costs, which is classed as revenue spending and fell by 13.8% over the same period.[3] Understanding the ways that revenue and capital interact is necessary to get a full picture of the financial challenges facing local authorities and the ways in which they can respond. For example, authorities can borrow to finance capital spending but then interest costs and repayments will represent a fixed cost to revenue, reducing their room for manoeuvre.[4]

4. The Department is responsible for the local government finance system within government. This responsibility covers both revenue and capital spending. The Department operates a devolved accountability framework for capital; more so than for revenue. However, the Department remains responsible to Parliament for assurance about the financial sustainability of local authorities and the way in which local authorities use their resources.[5]

5. HM Treasury approves decisions taken by the Department that could have an impact on the national finances. It also sets the framework under which local authorities can borrow from the Public Works Loan Board.[6]

Commercial capital investments

6. Local authorities are increasingly making commercial capital investments aimed at generating revenue income, for example by purchasing properties to lease to businesses, developing houses for market rent, and developing commercial units. South Norfolk Council told us that its capital programme includes making "new property investments to generate income above the returns being earned on cash investments to ensure we can

1 C&AG's Report, Financial sustainability of local authorities: capital expenditure and resourcing, Session 2016–17, HC 234, 15 June 2016; and National Audit Office memorandum for the House of Commons Committee of Public Accounts, Update to Financial sustainability of local authorities: capital expenditure and resourcing, October 2016

2 C&AG's Report, paragraphs 1.2 to 1.4, figure 2 and Appendix 1. For this report local authorities include London borough councils, metropolitan district councils, unitary authorities and district councils

3 Update memorandum, paragraphs 2.1 and 2.2. C&AG's report, paragraph 1.2 and figure 2

4 C&AG's Report, summary paragraph 3 and paragraphs 1.12 and 1.17

5 C&AG's report, paragraphs 3.1, 3.3, 3.4 and 3.20

6 C&AG's Report, paragraphs 1.34, 3.21 and figure 16

deliver those services that residents value the most" and "to help our aim of moving closer to financial independence". This type of activity is growing: the National Audit Office found that many councils are in the early stages of setting up such schemes.[7]

7. For some authorities, these investments are specifically intended to replace income from reducing government grants. Government policy is for "the sector to be largely self-financing" and the Department told us that "a degree of entrepreneurialism is part of the picture".[8] Despite this recognition, the Department's data does not capture this change and the Department has not fully engaged with the changes taking place in the sector or the potential for increased risks for council tax payers and local service users. When we asked the Department about its awareness of the risks involved, it told us that "a lot of the time, the commercial structures that local authorities are putting in place are new ways of operating existing services" and that out-of-area activity involved selling council services to other authorities and so "are not necessarily more risky". The Department also argued that commercial investments did not add risk to council finances since they were no more risky than managing social care demand pressures.[9]

8. However, local authorities are increasingly acting as property developers and commercial landlords with the primary aim of generating income. These investments can be outside their own authority and they can be financed by borrowing. Furthermore, in some cases these activities have been designed to replace lost government funding and can represent significant elements of authorities' income. These developments are substantially different to the types of smaller scale commercial ventures undertaken previously. Authorities themselves recognise that such activities bring new risks to their finances.[10]

9. Oversight of these new commercial activities will require skills of elected members that may be in short supply in some authorities. Already some authorities are less confident than others about members' ability to provide strategic oversight of the sustainability of capital programmes. Members receive support from officers but these new ventures may require specialist skills and experience that have not been needed by officers in the past. The market value of the commercial skills and experience required is not a good fit with local authority pay scales. Authorities in straitened circumstances could struggle to fill these gaps.[11]

Local authority "investments on deposit"

10. The amount of local authority money deposited with banks and other financial institutions (investments on deposit) has grown by £7.6 billion since 2010–11, reaching £26.1 billion at the end of the 2015–16 financial year. This level is higher than the previous peak of £25.0 billion in 2007–08.[12]

11. Deposits with commercial banks and most other institutions are exposed to 'counterparty' risk as it is possible for the institution to fail and the money to be lost. For this reason, the Department issues statutory guidance on local authority investments

7 C&AG's Report, paragraphs 2.20 and 2.21; South Norfolk Council, (FLA0002)
8 Q 15; C&AG's Report, paragraph 2.20
9 Qq 9, 11, 33, 37; C&AG's Report, paragraphs 2.27 and 2.28
10 Q 4; C&AG's Report, paragraphs 2.14 and 2.20 to 2.22; South Norfolk Council, (FLA0002)
11 Qq 7, 38; C&AG's Report, paragraph 3.26
12 C&AG's Report, figure 9 and update memorandum, paragraph 1.7

that requires them to manage such risks. It told us that this guidance requires authorities to prioritise security and was strengthened in April 2010; this followed the report of an inquiry prompted by the local authority investments on deposit put at risk following the collapse of Icelandic financial institutions in 2008.[13]

12. When asked to give more detail on the cause of the recent increase in deposits, the Department's response did not lead us to believe that it had a strong grasp of the issues.[14] The only explanation the Department gave us for the increase in the level of deposits was the need for local authorities to "make minimum revenue provisions in order to repay their debts primarily to the Public Works Loan Board". Local authorities repay money borrowed from the Public Works Loan Board in a lump sum at the end of the loan.[15] However, local authority borrowing, requiring such provisions, has steadily risen during a period while the level of deposits has risen, fallen and risen again.[16] This suggests that there are likely to be other factors in addition to minimum revenue provision charges.

13. The National Audit Office reported that some local authorities felt that changes to the early repayment terms of Public Works Loan Board debt meant that early repayment was no longer seen as value for money. In the past, local authorities have repaid loans to the Public Works Loan Board early using money that might otherwise be held on deposit but early repayment has fallen significantly in recent years.[17] When we asked HM Treasury about the impact of changes they made to Public Works Loan Board early repayment terms, we were told that the change in interest rates is "the major driver of that behaviour" rather than the Treasury changes. But HM Treasury told us this without referring to any detailed analysis of the issue or to the views of local authorities.[18] In contrast, local authorities told the National Audit Office that the changes were a significant factor irrespective of the change in interest rates, while the Local Government Association said that the early repayment route for local authorities has "effectively been closed" by the changes to Public Works Loan Board terms.[19]

Impact of revenue pressures

14. The Local Government Association told us that "local government remains under significant financial strain".[20] The Department told us that, where they have had concerns about the financial risks to individual local authorities, these concerns have arisen from "the overall budgetary pressures on the revenue side".[21] Revenue spending power (income from government grants and council tax) fell by 25.2% from 2010–11 to 2015–16 and is expected to fall by a further 7.8% in real terms by 2019–20.[22]

15. Local authorities can finance capital spending by borrowing but must then bear the cost of interest and repayments from their revenue resources. With falling revenue income, the impact of debt servicing costs has become substantial for many authorities.

13 Q 42; C&AG's Report, paragraph 1.54 and figure 16; House of Commons Communities and Local Government Committee, *Local authority investments*, seventh report of 2008–09, HC 164, 11 June 2009
14 Qq 70–74
15 Q 42
16 C&AG's Report, figures 8 and 9
17 C&AG's Report, paragraphs 1.32 to 1.35
18 Qq 17–19
19 C&AG's Report, paragraph 1.35 and Local Government Association, (FLA0001), p. 3
20 Local Government Association, (FLA0001), p. 1
21 Q 32
22 C&AG's Report, paragraph 1.52

For example, more than a quarter of metropolitan district councils spent more than 10% of their revenue spending on debt servicing in 2015–16.[23] Debt servicing costs are effectively fixed costs for an authority, competing for the revenue resources needed to meet its statutory service obligations in areas such as children's and adult social care.[24]

16. The National Audit Office reported that the main issue facing authorities was making sure their capital programmes put less pressure on revenue spending. Some capital spending can reduce revenue costs, for example if a new office costs less to heat than the space it is replacing, while other capital investments can generate income.[25] The Department said that authorities are making sensible decisions about capital investments in the light of tight budgets.[26] Authorities have prioritised capital spending that reduces revenue costs, generates additional income or supports local growth. However, along with an understandable general reluctance to increase debt servicing costs any further, this has left less room for spending on services like youth centres and libraries.[27] It also leads to risks that the condition of important capital assets will deteriorate. For instance, the National Audit Office reported that authorities have reduced or are delaying long-term capital investment in capital works and asset management as this was becoming increasingly difficult to resource. Authorities are increasingly reluctant to borrow to resource this type of investment as it is not able to generate savings or income to cover the costs of borrowing.[28]

17. The Department focused its efforts in the most recent spending review on revenue pressures. It did, however, recognise that it needed "to pay more attention to the capital side in future".[29] It also recognised that the position of capital needed to be considered as the sector moves to financial self-sufficiency by 2020 with the introduction of 100% business rates retention. But the Department still expects that the core revenue budget will be where the "big debate needs to be".[30] However, the National Audit Office report has demonstrated the significant and growing interactions between both capital and revenue; servicing debt represents a significant element of revenue expenditure and capital programmes are now increasingly shaped by a desire to reduce revenue pressures or generate revenue incomes.[31] Capital and revenue cannot be seen as separate and distinct elements of authorities' financial and service sustainability and need to be considered side-by-side by the Department on a consistent basis.[32]

23 C&AG's Report, paragraphs 1.12 and 1.17; *update memorandum*, paragraphs 1.9 and 1.10, and figure 2
24 C&AG's Report, paragraphs 5 and 2.11
25 C&AG's Report, paragraphs 1.15 and 2.16 to 2.22
26 Q 1
27 Q 1; C&AG's Report, paragraphs 1.20, 1.21, 2.11 and 2.26
28 C&AG's Report, paragraphs 2.13 to 2.15 and 2.26, and South Norfolk Council, (FLA0002), p. 3
29 Qq 4, 62
30 Q15, Q62
31 C&AG's Report, paragraph 5 and figure 1
32 C&AG's Report, paragraphs 6 to 8

2 Departmental oversight

The Department's approach to oversight

18. The Department for Communities and Local Government (the Department) described the way it oversaw local authority capital spending as "a principles-based approach", as opposed to one that was overly rigid and prescriptive.[33] This devolves accountability, giving authorities a great deal of freedom to make their own decisions about capital spending and borrowing. The National Audit Office reported that this local accountability system for capital, centred around the prudential code for capital finance in local authorities overseen by the Chartered Institute of Public Finance and Accountancy, provided assurance at the level of individual authorities but did not identify issues across the sector.[34]

19. The Department takes a high degree of assurance from the intelligence it derives from "speaking to local authorities and being out there with the sector, and doing that with the LGA".[35] It told us that it uses this intelligence to guide its analysis and help it understand potential systemic risks. However, this approach had not resulted in the Department monitoring several significant trends identified by the National Audit Office.[36] The Department did not monitor the risks of capital assets being allowed to deteriorate due to revenue pressures, despite evidence provided to the National Audit Office and to us of the risks.[37] Similarly, the Department does not monitor "internal borrowing" despite this being a significant source of finance for capital spending in recent years and potentially exposing authorities to re-financing risk were interest rates to rise.[38] Overall we were not reassured that the Department had a sufficient level of independent understanding of the issues and risks it is responsible for.

20. The Department accepts that it needs "to be monitoring the trends and ensuring that over time [it is] aware of the developments in the sector so that [its] risk analysis is as full as it can be" and recognises that there are "a number of points where [it] can and will improve [its] monitoring".[39] The Department also accepts that it does not use data "as actively as [it] could. All of the analysis in the NAO Report used DCLG data, but not all of it was put together in ways that [it has] done before. [Its] challenge is to make better use of the data and to be more intelligent in the way [it is] pulling out the trends".[40]

Departmental data

21. The Department collects data on local government finance, including on capital spending and borrowing.[41] The Department analyses this data to inform its work with the rest of the Government as part of Spending Reviews, and to inform its ongoing monitoring of the risk of failure in individual local authorities.[42]

33 Qq 12, 29
34 C&AG's report, paragraphs 3.7, 3.20 and 3.21, and figure 16
35 Q28
36 Q31; C&AG's report, paragraph 3.6
37 Q 44; C&AG's report, paragraphs 2.13–2.15 and 2.26–2.27; South Norfolk Council, (FLA0002)
38 C&AG's report, paragraph 3.6; The Chartered Institute of Public Finance and Accountancy (CIPFA), (FLA0006)
39 Qq 3, 4
40 Q50
41 Q 50; C&AG's report, paragraph 3.5 and figure 16
42 C&AG's report, paragraphs 3.11 and 3.12; Qq 60, 61

22. However the Department uses a single category called "New construction, conversion and renovation" that covers three-quarters of local authority capital spending. This category is so broad that it captures revenue generating activities, other invest to save schemes and long-term asset management. Accordingly, users of the data are not able to identify the important changes in capital spending made by authorities, which the National Audit Office identified.[43] Also, the National Audit Office identified some double-counting of capital spending within the Department's data. This related to Local Enterprise Partnership (LEP) funding that was recorded twice by different local authorities: once by the LEP accountable authority and once by the authority that ultimately spent the money.[44]

23. HM Treasury supported the need for data improvements, saying that the category containing three-quarters of capital spending appears to represent "a block of continuity […] in how local government is operating. Getting under the skin of that would be very helpful for us to understand." The Department stated that it was happy to review the way it categorises capital spending within its data and was willing "to look at how [it] can improve that and improve both the usefulness and quality of [its] data for the sector itself to use and for it, the NAO and others to use in analysis". The Department also committed to examining the issues raised by the National Audit Office in relation to double counting of LEP expenditure.[45]

The Department's capital framework for local authorities

24. The Department is responsible for the statutory and policy framework governing local authority capital. This responsibility includes ensuring that the framework is fit for purpose in the current environment.[46]

25. There have been significant shifts in the nature and purpose of local authority capital spending in response to continued revenue funding reductions. We received written evidence highlighting the potential impact of changes to the New Homes Bonus that are under consideration.[47] The Department is currently developing policy arrangements for the 100% localisation of business rates, which it accepts will require consideration of capital issues.[48] The Department told us that it was currently discussing with local authorities "their concerns, their questions and their priorities around Brexit" and will ensure that analysis is available to feed into Government decision making.[49] The Government has yet to make some key decisions that will influence borrowing and capital spending by Combined Authorities and the transparency and accountability issues that arise have yet to be dealt with to our satisfaction.[50]

26. The Department has confidence in the devolved framework for capital and argued that National Audit Office report provides evidence that the framework is robust. The report did indeed indicate that there was no evidence of widespread problems with the prudential framework. However, it also highlighted a range of areas where improvements could be made, for instance in relation to the clarity and value of certain prudential indicators,

43 C&AG's report, paragraph 2.28
44 Update memorandum, paragraphs 2.5 to 2.7
45 Qq 48, 49, 51
46 C&AG's report, paragraphs 3.21 and 3.33
47 C&AG's report, paragraphs 2.25 and 2.27; South Norfolk Council, (FLA0002)
48 Qq 39–40, 62; C&AG's report, paragraph 3.18
49 Qq 70, 81
50 Qq 63–69; CIPFA, (FLA0006)

the level of departmental expectation placed on external audit, and the availability and value of Departmental data to support local decision making. The report also indicated that, given the range of financial pressures acting on local authorities, there were grounds for reviewing the capital framework to ensure that it appropriately considers the various financial pressures facing local authorities.[51]

27. The Department acknowledges that the Chartered Institute for Public Finance and Accountancy (CIPFA) is a key partner in relation to capital, as both a source of information and as the author of two Codes that the Department has chosen to designate as statutory guidance.[52] CIPFA recognises the need to ensure that the Prudential Code, a significant part of the overall capital framework, remains current and has committed to reviewing it.[53]

51 Q 3; C&AG's report, recommendation e and paragraph 3.26
52 Qq 4, 31; C&AG's report, paragraph 3.23
53 C&AG's report, paragraph 3.23; CIPFA, (FLA0006)

Formal Minutes

Monday 14 November 2016

Members present:

Meg Hillier, in the Chair

Mr Richard Bacon
Philip Boswell
Charlie Elphicke
Chris Evans
Kevin Foster
Nigel Mills
Bridget Phillipson
Karin Smyth

Draft Report (*Financial sustainability of local authorities*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 27 read and agreed to.

Introduction agreed to.

Conclusions and recommendations agreed to.

Summary agreed to.

Resolved, That the Report be the Twenty-sixth of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Monday 21 November 2016 at 3.30pm

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Monday 10 October 2016

Question number

Melanie Dawes, Permanent Secretary, **Matthew Style**, Director, Local Government Finance, Department for Communities and Local Government, and **Catherine Frances**, Director, Public Services, HM Treasury — Q1–82

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

FLA numbers are generated by the evidence processing system and so may not be complete.

1 Charity Finance Group (FLA0008)

2 CIPFA (FLA0006)

3 Debt Resistance UK (FLA0003)

4 Dr Laurence Ferry (FLA0010)

5 Local Government Association (FLA0001)

6 National Audit Office (FLA0009)

7 Professor Colin Copus (FLA0007)

8 South Norfolk Council (FLA0002)

List of Reports from the Committee during the current session

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

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Fourth Report	Entitlement to free early education and childcare	HC 224 (Cm 9351)
Fifth Report	Capital investment in science projects	HC 126 (Cm 9351)
Sixth Report	Cities and local growth	HC 296 (Cm 9351)
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Eighth Report	BBC critical projects	HC 75 (Cm 9351)
Ninth Report	Service Family Accommodation	HC 77 (Cm 9351)
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HOUSE OF COMMONS

Public Accounts Committee

Oral evidence: The Financial Sustainability of Local Government, HC 708

Monday 10 October 2016

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Watch the meeting

Members present: Meg Hillier (Chair); Mr Richard Bacon; Philip Boswell; Kevin Foster; Nigel Mills; Mrs Anne-Marie Trevelyan.

Sir Amyas Morse, Comptroller and Auditor General, Adrian Jenner, Director of Parliamentary Relations, National Audit Office, Aileen Murphie, Director, NAO, and Marius Gallaher, Alternate Treasury Officer of Accounts, HM Treasury, were in attendance.

Questions 1-82

Witnesses

I: Melanie Dawes, Permanent Secretary, Department for Communities and Local Government, Matthew Style, Director, Local Government Finance, DCLG, and Catherine Frances, Director, Public Services, HM Treasury.

HOUSE OF COMMONS

Report by the Comptroller and Auditor General

Financial sustainability of local authorities: capital expenditure and resourcing (HC 234)

Examination of witnesses

Witnesses: Melanie Dawes, Matthew Style and Catherine Frances.

Q1 **Chair:** I was waiting for the normal "standing room only" crowds, but it seems like it is a quiet one for you today, Ms Dawes.

Welcome to today's Public Accounts Committee on Monday 10 October 2016. We are here today to look at the financial sustainability of local authorities, which, while that is the bread and butter of our work, is also pertinent when we look at issues around devolution and generally a number of other public services that are funded by or run by local authorities. We have seen, as the Report shows, an increase in capital spending by local authorities, which on paper could be seen as positive for local taxpayers, but the Report highlights that the figures mask wide variation in local authorities' ability to invest in capital projects and the long-term improvements to local assets.

Of course, there are risks involved in the stretch that some local authorities are making in some interesting areas of work. A lot of the capital investment is to create revenue streams to backfill some of the loss of revenue that they have had. Let us not forget there has been a 25% reduction in revenue for local authorities over the last Parliament or thereabouts, and there is an onus on local authorities to repay their debts of £58 billion, just to give some context to the figures.

Our witnesses today are, from my left to right: Catherine Frances, who is the director of public services at the Treasury; Melanie Dawes, the permanent secretary at the Department for Communities and Local Government—we haven't got such a large audience today, Ms Dawes; perhaps there is something they know that we don't—and Matthew Style, who is the director of local government finance at the Department for Communities and Local Government. Our hashtag for today is #localgov for anyone who is following that.

Ms Dawes, I mentioned that revenue power has fallen significantly over the last five years or so, and that is affecting the decisions that a lot of local authorities are making around their capital programme. Do you think that indicates that the revenue reductions forced on local government have caused some perverse behaviour in their capital spend?

Melanie Dawes: Thank you; we are very glad to be here today. As I think you said at the beginning, overall capital spending has risen across the sector as a whole over the last Parliament, despite the squeeze on revenue budgets that you described. So I think one of the things going on here is, as you say, local government is investing. Yes, it is partly investing to save, and I think you see very sensible investments that are things that I do not think any of us could argue about—consolidating buildings, investing in refurbishing assets so that they will not have such high maintenance costs in future—but you are also seeing quite a lot of investment going on in local growth, in housing, in unlocking sites and so on.

So I do not think we feel that the sector as a whole, either in the past, which is where you referred to in the figures, or in the future, when we think about this new spending review period, is leading to a perverse set of behaviours in the mix of capital and revenue. Clearly budgets are tight, but we are seeing some sensible decision making from the sector.

Q2 **Chair:** We are also seeing a range of decisions where capital investment is on the basis of trying to create a revenue stream. A lot of local authorities seem to be buying car parks—colleagues will be raising other examples of that. Don't you think when one of the key pressures on capital spending is to create a revenue stream, that skews capital spending in a particular direction? Don't you recognise that that is an issue?

Melanie Dawes: Well, again I would not want to judge that that was necessarily a problem. In the end, local authorities set their overall investment strategies with full council approving those. So big investment decisions, whether they are to save or to invest in growth or some other service provision, or whether they are to develop a commercial revenue stream, are things that local councils, in accordance with our strategy framework, decide after care and consideration and with clear governance.

I would also say that local government has been investing in commercial activities for many decades, so there are lots of examples of where this has been going on since the 1960s and 1970s. Kent County Council, for example, has a procurement arm that developed, I think, in the 1970s around common procurement for the county's schools. It has now got a much wider array of commercial activities, which has been successful for a number of years. So that is not new for local government. I think it has taken that type of decision making seriously in accordance with the statutory framework.

Q3 **Chair:** The capital freedoms have been welcomed and, as I highlighted, they can be seen as good news. But, if it is being used to create a revenue stream, it does lay open a series of risks, because if that revenue stream then does not come in, that has an extra impact on local government services. They have already had the reduction in revenues funding, which is one of the reasons why some of them are going down the capital spend route: to get a revenue stream.

If there is an issue about the performance of some of those assets or they have made their projections wrong, there is a big risk to the revenue stream they are assuming they will get from that. How do you keep an eye on that from the centre? Because that can have a very big impact on things like social services, which are obviously funded entirely locally, through the local authority.

Melanie Dawes: What we try to do—we did this for the last spending review last autumn—is to have a comprehensive look at all the different pressures and the statutory responsibilities that local authorities are required to carry out. As you say, social care for children and adults is an increasingly large share of their budgets. We do look in the round at all of those pressures and we did do that in the last spending review.

I think you are right to raise some of these activities—the things that local government is now doing. They are taking more commercial judgments, more risk-based judgments, as I said, in the context of quite a strong statutory framework. The NAO Report highlights this, which we were glad to see, and we can take quite a lot of comfort from that framework, but you are also right: we need to be monitoring the trends and ensuring that over time we are aware of the developments in the sector so that our risk analysis is as full as it can be.

Q4 **Mr Bacon:** On this point, my own local district council—without my knowledge until today—sent in some evidence on their own commercial activities. Some of the things you say you do not see as a problem are precisely the things they are doing. They are getting £400,000 of income from renting out commercial space, which is a 6% return. They are building houses and then renting them out, and for the ones done so far, once complete, that will produce a rental income of £120,000 a year. These are relatively low-risk activities.

The neighbouring council has bought a golf and country club in my constituency, which I think is giving a 6% or 7% return. There are a variety of things like that that might be seen as perfectly commercially sensible and reasonably within the capacity of a local authority to make a sensible decision and manage.

However, there are two issues. One is DCLG’s capacity to monitor, in the way that you described, growing in the way that it needs to be commensurate with this broader level of activity. Secondly, we all know plenty of examples of local authorities that could not run a bath or organise their way out of a paper bag; one does not have to go back as far as Hammersmith and Fulham’s swaps fiasco 20 years ago. Are you sure that you have the right scale of monitoring activity to cope with this level of activity across the piece? And is it growing?

Melanie Dawes: Is what growing?

Mr Bacon: Your monitoring capacity. This is all growing, but are you growing your capacity to monitor it?

Melanie Dawes: That is a fair question. Are we growing our capacity? Yes, we are. Partly in response to NAO and Public Accounts Committee recommendations over the past 18 months to two years, we have invested significantly more in monitoring the sector. I have prioritised that since becoming permanent secretary.

We have focused our efforts for the spending review particularly looking at revenue pressures because councils told us that that was the priority. But it is a fair challenge as to whether we are able to ensure that we are monitoring some of the commercial issues that you mentioned.

We work quite closely in partnership with CIPFA and with the Local Government Association. We also talk to authorities. Our local growth teams and our conversations with LEPs about the growth fund mean that we have quite a lot of intelligence and understanding of what is going on with local growth and local housing and development in areas. As accounting officer, I feel that we have to make every effort to invest in and keep on top of monitoring. I should have said earlier that I find the Report very helpful in that respect, as it raises a number of points where we can and will improve our monitoring.

Chair: And what would you do? Take Mr Bacon's example of south Norfolk, and some of the things that were just a stretch too far for a local authority of that size.

Mr Bacon: I didn't say that I thought it was a stretch too far; my local council is unusually commercially savvy. We have a council leader who cannot inhale without thinking about the commercial consequences. But my point is that not every council is commercially well run.

Q5 **Chair:** If you think a council is well run, how do you assess that? If you are concerned—and given you have given the freedoms to local government, which those of us who are devolutionists support—how do you ensure that they are not stretching themselves too far or putting themselves too much at risk?

Melanie Dawes: In the end, we rely—particularly on the investment and capital side—on a devolved framework. It is a strategy framework, so it requires the right skills to be in place. We rely on audit and on council decision making.

You are right that councils vary in their commercial capacity. When I go out and talk to councils, generally speaking I find that those who are the most commercially savvy are doing the most. The challenge is whether some smaller councils in particular are truly doing enough to manage their assets, make value from those assets, and think about which they want to realise and which they want to keep, grow and so on.

We rely on the framework and we rely on audit a great deal. I did not read into the NAO Report a big concern that we should worry about that framework, but we accompany it with increasing sophistication in the analysis we do inside the Department.

Q6 **Chair:** And what about the Treasury, Catherine Frances? Are you content with the assurance policies and strategies in place to ensure that there is no risk to local council taxpayers from some of these activities?

Catherine Frances: Yes. As Melanie said, to some extent councils have been doing a lot of this for a long time, although its scale and ambition in some areas is changing. We draw a great deal of reassurance from a combination of the prudential framework and the guidance that DCLG has issued over time. That guidance recommends that local government prioritises stability in where it puts its money and in the framework that follows through behind that—the auditors' framework and the democratically locally-elected people making decisions about the structure of their council's budget and where they are prepared to put their funding.

Q7 **Chair:** That is an interesting point because the Report highlights the challenge for members. I am a former councillor and a lot of us here have been councillors. I am passionate about local elected representatives, but there is often a skills shortage among those people, who are very good at their jobs, when it comes to that level of audit and watching financial issues in this way. Are you confident, Melanie Dawes, that elected members have the support they need to do this job properly?

Melanie Dawes: We rely on a number of things here. We rely first on the statutory framework, which requires certainly the officers to have the right capability. That is something every council is supposed to ensure. Then when it comes to councillor capability, we have, as you know, a contract with the Local Government Association for peer support, and that includes some of these more commercial areas. We have over the past year put a lot of effort with the LGA into making sure that the contract with them is good enough and clear enough about outcomes. That is part of the way we have refreshed our overall approach to risk and the sustainability of the sector in the past year. That is the capability support we have in place, through that contract.

Q8 **Chair:** I remember when we were looking jointly with the Communities and Local Government Committee a few years ago at issues around accountability and the changes with the Audit Commission going and so on, the then chief executive of Oxfordshire County Council said that when they advertised for someone external to sit on their audit committee—they had two places to fill—they could only find one. That was Oxfordshire, where you would think there might be quite a lot of people with the right kind of qualifications. There are local authority officers and members, but there is also that external view. Do you think there is a deficit in local government in terms of that sort of audit?

Melanie Dawes: That is not something we have any evidence of—that there is a deficit. I should say that in my own experience, both in the civil service and as a non-executive in a number of organisations over the years, it is always a challenge to find really good people who will serve on audit. They are worth their weight in gold. It is not something where it is easy, even in areas where you have a pretty vibrant labour market, to find people. I always think that is a challenge, and they are such important roles, but I do not feel and I do not have any evidence that this is a particular concern for local government.

Matthew Style: It is worth saying that the CIPFA treasury management code also highlights the need for officers to consider whether members have the necessary training and skills to perform the scrutiny that the code suggests they should over treasury management, and particularly issues around risk and so on. That is in the framework.

Chair: Thank you for highlighting that.

Q9 **Nigel Mills:** I suppose the question on this comes back to how far we are happy for councils to go before we are engaging in lots of risky investments around the country that perhaps in central Government we would shy away from. We had a recent hearing on selling the Northern Rock assets because we did not want to be involved in quite safe mortgage lending of quite mature mortgages, and yet we are going to ask them to start developing houses for rent elsewhere in the country. There could be a bit of an opposite strategy going on there. What sort of activities would you want to see before you started to say, "No, you can't do that. We must change the rules here and stop buying hotels and country clubs, which sounds a little risky."

Melanie Dawes: I don't think it is easy to give an answer to a specific limit. I would observe—my colleagues may want to add to this—that a lot of the time, the commercial structures that local authorities are putting in place are new ways of operating existing services. They are not necessarily more risky; they are actually just more professional, and one could argue that they are therefore less risky because they are finally recognising the game that local authorities have been in for quite some time. For example, in Worcestershire, there is now in place a new commercial vehicle for managing the county's and some of the district's property. That is just putting existing activities on a more professional and commercial footing, and recognising, in a way, what already has been going on. Quite a lot of the time, that is the activity going on in this sector. As I say, I think it reduces risk rather than increasing risk.

Q10 **Nigel Mills:** That makes sense, but if what is happening is, "I've got a bit of capital but my revenue budget is under pressure. What I'm going to do is find something I can invest my capital in that gets me some revenue income, so I can prop up my revenue budget," that is not quite what we intended the capital budget to be there for. I am sure my constituents want to have a new library, a new school building and a new bypass—all manner of things that they would see as the reasons for there being capital funding separate from revenue. Are we not in danger of allowing the two to merge? Perhaps we should just scrap the distinction and let people spend the money on what they want to spend it on in their situation.

Melanie Dawes: Matthew might want to come in on this, but when we look at the data—the NAO Report was helpful in this—I am not sure we do see that local authorities are spending money on activities completely unrelated to their statutory functions, certainly not in exchange for spending on those statutory functions. So what we see is investment in planning and development, investment in culture and so on, and we see increases in loans. Sometimes that's around unlocking housing developments or other regeneration projects. We see investment in intangible assets, which is often about investing in new IT systems, so that they can realise savings in the future.

In the end, local authorities' first requirement is to deliver their statutory responsibilities. When they are given capital grants by Government Departments, it is for a purpose, for which they have to account. So I do not think that we should be concerned that this is somehow completely displacing the normal range of council activities. I agree that we need to make sure that we understand that and that we are monitoring it, so that we know that there isn't an excessive shift in that direction.

Q11 **Nigel Mills:** But we do see examples of councils making commercial investments in areas quite distant from their own council area, don't we? It would be a little hard to explain that as rationalising or improving services. That is just effectively speculation, isn't it? It might be a good return, it might be a pretty good investment, but you'd be a bit surprised to see a council in the north-east having a really good reason for investing in the south-west, wouldn't you? It would seem slightly strange.

Melanie Dawes: I am not sure whether you have an example in mind there. We do see some of the commercial services firms; I mentioned the Kent example earlier. We do see some other local authorities—in fact, I am thinking of Norfolk now, which provides those services to a range of other local authorities, including, I believe in the case of Norfolk, to authorities in Wales. But that is about using their existing commercial activities—

Mr Bacon: Norse.

Melanie Dawes: Norse, indeed. It is about using their existing commercial activities within a clear commercial framework that is wholly owned by the council, but delivering services outside that council's boundary, but in a way that is actually quite tried and tested over the years. It is providing services to other councils, as well.

Q12 **Mr Bacon:** I am looking at the Localism Act 2011, part 1, chapter 1, paragraph 1, which is headed, "Local authority's general power of competence" and which says: "A local authority has power to do anything that individuals generally may do." Wasn't the whole point of that Act—to liberate local authorities? Quite a few have been rather slow in waking up to what that meant.

I have to tell you that the leader of my local council spotted it and thought, "Phwoarr, I'm going to grow the business! There's lots of opportunities to do stuff and therefore do a better job of looking after my local electors", and that is sort of what they've done. Is that not the whole idea of that Act: that local authorities can be more enterprising and more forward-thinking, knowing that they're not going to get caught out for being ultra vires?

Melanie Dawes: Indeed, it is, yes. That is the Localism Act and that was the intent, I believe.

Matthew Style: It is true that in the past we have operated a much more rigid, prescriptive regime of regulation around capital, and that wasn't seen to serve either the sector or the needs of the taxpayer necessarily very well. In fact, moving to a principles-based approach, as we have now, backed by the very best of professional good practice and strong statutory codes, I think is generally seen to strike a better balance between the need for innovation and security, and it's stood the test of the time.

Q13 **Nigel Mills:** I am just trying to nudge you around the edges, I guess. If what I want is to spend money on social care but what I have is a load of capital budget that I don't have an immediate, pressing need to spend, I could do something non-core with that capital budget to try to create some revenue, so that I can do what I want to do with my social care.

Are we not really merging the revenue and capital budgets in a horribly complicated way? Perhaps we should just say, "Okay, you've got the money, you've got no real need for it, spread it over 15 years and spend it on social care", and isn't that a better use for the money rather than going round an expensive circle of investments that I didn't really want to have to make?

Melanie Dawes: Local authorities can borrow and overall borrowing requirements are set by full council. Actually, grants from central Government for specific purposes only make up between around a quarter and perhaps 40% of overall local authority capital spending in any one year—it varies a little bit, because sometimes the figures are a bit lumpy from year to year. Local authorities have more discretion than that suggests because they can borrow, which is intrinsic to the system. They have to set those overall borrowing limits in a prudent way and in accordance with the overall framework, but if they feel that they have an opportunity or a need that they need to invest in, they have quite a lot of discretion to do that, and Public Works Loan Board finance is available to them on quite good terms.

Q14 **Nigel Mills:** My question was: can we give them the discretion to move their capital money into their revenue budget over a period of years for what they think their priorities are, so they do not have to engage in some complex mechanism to try to convert the capital into a revenue stream, which takes up time, risk and effort, and which they didn't really want to do but they think it is the only way of propping up their revenue budget? Isn't it easier to say, "Just spend it over 15 years," or something?

Catherine Frances: From the Treasury vantage point, we would be concerned if you started using capital assets that are there and available for use for long-term investment just to cover existing, normal running costs. From our vantage point, we want local government, like any other part of the public sector, to think about its capital receipts and how it reinvests them for the long term. At the spending review, we allowed a flexibility of three years for local authorities to use capital receipts exceptionally to fund certain revenue activities, where they are transformative and where they can see that they will get a benefit from so doing in the long term, which is an unusual freedom and flexibility for us to have granted. In the usual course of business, though, I'm afraid I slightly disagree with you. I wouldn't necessarily be happy with a public body using its capital stock to fund normal revenue and business as usual.

Melanie Dawes: I don't think that would meet the test of being a sustainable financial strategy for the local authority either. Again, that is at the core of the overall control framework for local government.

Nigel Mills: No, although I suspect that many local councils would suggest that their current funding streams aren't a great strategy for sustainable financial conditions either. They would probably say, "Times are desperate and we can't afford to do all the things we want to do. Isn't there a way we could use some of the money we have?" You can see why many councils would be attracted by that as a way through what they hope is a short-term funding problem, rather than a long-term one.

Q15 **Mr Bacon:** I was talking to a local authority leader last week in the Netherlands, where we were looking at housing. He is from the south-west, and he said, "I have got £200 million—£100 million goes on old people, £50 million goes on young people and I have got £50 million for everything else. In one year's time it's going to be £40 million, and the year after that it's going to be £30 million." That's not sustainable, is it? You are encouraging them to find other sources of revenue, so you can't be surprised when they do so.

It is a little unfair for Catherine Frances of the Treasury to say, "Well, we don't think that is sustainable." If they have enough rental income from enough properties, presumably it could be sustainable. Wouldn't it? To give a very simple example to make the point, what's wrong with having enough assets to produce enough income to sustain yourself locally? The entire thrust of policy, as far as I understand it, is, "If you want any extra business rates, you're going to have to grow the local economy and get the revenue from doing that, because you ain't getting it from us. In fact, the graph from us is looking downwards." You can't be surprised if they then do that. You can't say, "Well, we don't think it would be sustainable if they do that," because that is actually what you are encouraging them to do, aren't you?

Melanie Dawes: Over the spending review now ahead of us, the budget is a flatter one for local government. It is broadly flat in cash terms, and as you know it is slightly lower in the short term and then it rises towards the end of the period once you take into account the additional precept for social care and the Better Care Fund money, which goes in in the final year. It is a flatter trajectory than it was over the last spending review period. We analysed the pressures on local government over that period as part of our spending review preparations. Each year, local authorities go through a process of setting their budget for the year ahead and looking again at their medium-term plans. We work very closely with the sector to make sure we know if anyone is coming close to not being able to set a budget or a longer-term financial strategy.

I do not agree with the characterisation that the sector is at a level of strain and stress that is causing authorities to have to find completely alternative means of finance to carry out their statutory responsibilities, but I do agree with you in one sense. Do we want them to become more entrepreneurial? Yes. Do we want them to become more independent? Yes. We have set out—this is a policy question—the aim of moving to 100% business rates retention and, ultimately, for the sector to be largely self-financing. As we have discussed in this room before, there were questions then about whether individual authorities will be sustainable and the system of tariffs and top-ups and so on we will need to make individual level calculations stack up as well as the overview stack up for the sector. A degree of entrepreneurialism is part of the picture, yes, within the context of a prudential framework.

Q16 **Chair:** I am tempted to ask about the garden bridge, but I think I will leave that for next week or whenever we are talking about it in terms of entrepreneurialism.

May I touch on debt because it is interesting to note how local authorities are tending to lend internally rather than tie themselves into the market? I wonder whether you have any concerns about the level of debt costs in local authorities and the way they are using their own day-to-day cash to support things rather than go to the market.

Melanie Dawes: We were pleased to see the CIPFA view in its evidence to you. It does not see any systemic risk from internal borrowing as it is called, and that is our view as well. "Internal borrowing" is a slightly odd phrase. It is not really borrowing; it is good cash management. It is simply using your cash reserves first before going out to the market. This is largely about temporary use of your cash in a way that is effective and keeps interest costs low. It is very useful that the NAO has done an analysis, but we weren't surprised to see that overall pattern because with the yield curve as it is at the moment, it is sensible.

Q17 **Chair:** But there has been a different pattern because of the change to the Public Works Loan Board money—perhaps Catherine Frances can touch on this—which was a decision made in 2008-09 to penalise early payment.

Catherine Frances: Perhaps I can explain. In 2007, we introduced a very small charge to cover the potential cost to the Exchequer of intra-day volatility, which was essentially a question of meeting our costs effectively. If a local authority chooses to repay a loan early, it pays a premium and there are basically three sub-elements in that premium.

The first and most critical element at the moment for local authorities wishing to repay is to compensate for the fact that when central Government issue the loan, we have to issue a gilt. If we issue that gilt at a time when interest rates are higher and the local authority subsequently wants to exit the loan, we need it to compensate the PWLB; otherwise, the National Loans Fund runs at a loss. That will be the major element of any repayment premium at the moment.

In 2007, we added an extra level of a very small 11 basis points to cover intra-day volatility, again to prevent the National Loans Fund running at a loss. In 2010, we took a policy decision to introduce a margin above gilts and the intra-day volatility cost. That was a wider decision on what rates the PWLB would lend at. That had the knock-on effect on local government wanting to repay a loan early of having to compensate the PWLB for the interest it had effectively forgone because of the early exit.

We think that in the current interest rate environment the major effect that local authorities will be feeling will simply be that they took out loans at a point when rates were higher; rates are now lower and it is entirely rational for them to choose not to repay their loan given the current environment they are in.

Q18 **Chair:** Absolutely, but obviously the fluctuation in interest rates and the recent drop may encourage them now to go external rather than doing it internally. On the Public Works Loan Board changes and the history of the pattern you described, has that been rethought or will it be rethought by the Treasury at any point soon? Is that something you are now fixed on doing, or is there a chance that you will revisit that?

Catherine Frances: We do look at the rates. For example, in 2012 we introduced a slightly lower rate—a certainty rate—which is now the rate that most local authorities borrow at and is available particularly for larger authorities, but not small parish councils.

Essentially, when we introduced those rates in 2010, we asked ourselves whether they would best reflect the rates available in the market. We also asked ourselves about the fiscal position and whether we wanted to charge local authorities in a way that would prevent them from just borrowing to the max. The fact that the PWLB has ended up being a fairly constant provider of debt at about three quarters of the debt for local authorities at that stage and throughout to now suggests to us that the rate is pitched about right, but we keep it under review when we look at it.

Q19 **Chair:** So you don't think that, because of those changes, there is any desire to do more internal funding of debt?

Catherine Frances: One of the things the Report picks up is that, in this environment, it may be less attractive for local authorities to repay PWLB, but I think the major driver of that behaviour will be the underlying shift in rates, for most authorities, rather than the margin above the rates.

Q20 **Mr Bacon:** There is a whole swirl of activity in local government, including the devolution agenda and the call for more coherent structures that can do more to invest in local infrastructure. The chairman of the Prime Minister's policy board, George Freeman, who happens to be my parliamentary neighbour, has for a long time been calling for the ability for the east of England, for example, to be able to go into the marketplace and issue bonds to connect up transport infrastructure properly in a way that is commensurate with go-to-work patterns and so on. I should declare an interest: the parish that I live in is hoping to go to the loans board at some point to get some money to buy our local pub, if we get the opportunity to buy it from the vendor, because it has been closed for nine years. Obviously I am very concerned about our local pub, but aside from that, do you think this area of local government debt is going to grow and become more important?

Catherine Frances: The evidence suggests that, over time, borrowing as a percentage of local government capital expenditure is relatively stable, and that the use of the PWLB is relatively stable, too.

Q21 **Mr Bacon:** What I mean is that, given the changes we see coming in local government, which are policy, as far as I understand it—the Government would like to see those changes happen if they have local support—do you then see a change and a growth in this area?

Catherine Frances: It is perfectly possible that new combined authorities, for example, could choose to try to borrow more for transport policies than they might otherwise have done, as their governance develops and their level of ambition develops. They are not prevented from doing so under the existing framework. It is perfectly possible that they will take decisions in that area.

Melanie Dawes: We are already seeing some authorities issuing bonds in the way you described. Most—in fact, all but one—are in the large areas; in fact, they are all TfL and the Greater London Authority, with Warrington the one exception. They have issued a bond to finance regeneration in the town centre. That will generate a return for them and will also invest in jobs in the area. It fits with their economic development activities, and also with their housing activities.

Q22 **Chair:** In the past, Melanie Dawes—actually, perhaps Matthew Style will want to answer this. You used to publish an overview of capital grants to local authorities for the year ahead, but you don’t do that anymore. Why is that?

Matthew Style: For the last spending review, the approach the Treasury took to allocating capital investment was very different—it was a kind of bottom-up process—

Q23 **Chair:** Is it a reflection of the freedoms that local authorities have?

Matthew Style: It is a reflection of the freedoms, but also a more rigorous zero-based approach in the Treasury, which looked at each individual capital programme and allocated capital on the basis of where the greatest returns were, rather than looking at capital investment trends in the past and simply increasing or decreasing existing capital budgets. That meant that in the spending review decisions that individual Departments were making about allocation to local government took longer than they have done in the past. We have looked at areas where there was a big knock-on consequence in some detail. For example, we looked at the social care area in some detail.

Q24 **Chair:** So you do some overview. I was wondering how you manage the risk if you cannot have the overview of where the capital loans are.

Matthew Style: The Treasury publishes a retrospective allocation of capital grants to local government in PESA, and we publish an analysis of local authority spending financed by capital grant, so we publish backward-looking data. On a forward-looking basis, where the impacts on local authority finances overall are most significant, we work closely with Departments to get a handle on what their forward allocations will be.

Q25 **Chair:** But that is not public information.

Matthew Style: We no longer publish a systematic analysis, that's true.

Q26 **Chair:** I will bring in Aileen Murphie from the National Audit Office.

Aileen Murphie: To go back to the point about the PWLB, the evidence from our case-study authorities was clear: they all said, "We are not paying back early to PWLB because it is costing us too much." I just wanted to make that point clear.

Catherine Frances: To be entirely clear, I think that is absolutely consistent with what I said. I do not think it is at all inconsistent for local government to say that they don't want to repay early because the charges that they are being charged make it not a good value-for-money decision for them at the moment, in the current environment. That is totally consistent with how I have tried to explain the early repayment regime.

Q27 **Kevin Foster:** What has been interesting in the discussion so far is where borrowing or capital spending is about facilitating delivering the services versus doing something a bit different to try to generate revenue. The point you made earlier in response to Mr Mills, who has sadly now gone, was that it is not about capital being used directly to fund revenue; it is the idea that if you have a pot of capital, you invest it and you get money purely to fund revenue. You are not doing it because it's a good thing; it is a facilitating act in itself. Where we are seeing councils going into this line of borrowing to fund interesting capital investments—not direct services—how confident are we that they are using that to facilitate their wider objectives rather than just doing it as a commercial investment?

Melanie Dawes: They are not required only to do things that are about their statutory objectives. As Mr Bacon was saying earlier, the general power of competence has given them a broader potential remit. Our sense, from all the data we have and from the conversations we have with local authorities, is that the vast majority of these investments have quite a strong synergy with the activities that local authorities engage in. You can see that in the data.

Q28 **Kevin Foster:** I would agree with that, having been a deputy leader of a council where we had a large commercial property portfolio, which came from the history of having been heavily bombed in world war two, and a service delivery portfolio. How satisfied are we that it is about facilitating? I have no issue where councillors are looking to facilitate growth in their areas and invest, but if the vast majority are okay, how are we monitoring to make sure there are not one or two quite bad commercial investments that could affect a local authority's overall balance sheet?

Melanie Dawes: I don't know if Matthew wants to comment on this. This comes back to our overview of the system. We do monitor overall trends in the sector. We look in particular at a broad set of financial indicators for local authorities, and then we complement that with information about different service pressures—things like Ofsted reports, CQC inspections and so on.

Kevin Foster: That is very interesting, but often a report won't tell you if, let's say, building a massive football stadium is a great investment or a complete disaster.

Melanie Dawes: What that gives us is a sense of an overview for each local authority. Then we complement that with the intelligence and analysis we get by speaking to local authorities and being out there with the sector, and doing that with the LGA. We think we have a pretty good network of information. Is there a data point that says, "Are you investing in activities that have nothing to do with your service responsibilities?" No, not specifically. A lot of the time, investments that local authorities make will, these days, be a more sophisticated mix of services and activities.

Kevin Foster: Mr Style seems to be itching to talk. Perhaps he would like to add something.

Matthew Style: We would also expect auditors to be looking at material capital transactions on the scale that you just suggested. Where those were not properly evidenced and where the statutory processes have not been followed to ensure that those were sensible investments, we would expect that to be flagged in audit, and we would pick that up in the usual way.

Q29 **Kevin Foster:** I can think of the good, the bad and the ugly of investments. I think of places like the NEC, which 50 years back was a phenomenal investment, and I think of a more relevant and recent experience of a football stadium, where the financial structure turned out to be almost disastrous. Do you think there should be any threshold for the percentage of commercial exposure, or would we just be happy to allow it, as long as each system stacks up? Is there a level of commercial risk that would raise your concerns more than if it was building a new leisure centre, a new depot or a new council building?

Matthew Style: My instinct is that local circumstances are different from council to council. As I said a moment ago, in the past we have had very prescriptive regulatory regimes around capital that did not stand the test of time and did not, in fact, provide the right level of oversight. A principles-based regime backed up with a strong statutory framework and the very best professional practice probably is our best approach for avoiding some of those issues.

Q30 **Chair:** May I just chip in? Mr Style, you talked about audit. Local government audit may stack up individually, but it is about the overall picture—not only that in the local authority, but the bigger picture for local government as a whole. Given the accumulation of risk, a change in interest rates, a crash in the pound or a property devaluation nationally could have a massive impact across local government as a whole. It's all very well to say, "We're letting 1,000 flowers bloom"—if I can borrow from my party's leadership—"and everything's going to be fine because they are making good decisions", but overall that cumulative risk is there. How do you watch what is going on there with the data that you have, which is not great?

Matthew Style: As Melanie said, we are increasingly looking to mine that data in more sophisticated and detailed ways to pull out trends, in the way that the National Audit Office have done in this Report. We would expect to pick up common issues coming out of audit if auditors were picking up repeated instances of misplaced investments.

Q31 **Chair:** Before I go back to Mr Foster, if the NAO had not done this Report, how would you have had the overall picture? Melanie Dawes, you have already said that you think it is useful. We think it is, too. It has thrown up some very interesting examples. Without this work, how would DCLG and the Government know what is going on, in terms of capital and investment?

Matthew Style: We are in regular discussion with CIPFA, the LGA and others about where our analysis is best focused. On one of the examples drawn out in the Report—minimum revenue provision—as the team began their field work we were already aware that there were changes in practice that were worth analysing and we had set about commissioning that work because it had come up in our liaison with CIPFA and others as something worth looking at. Our liaison with the NAO's financial audit side had also thrown that up. We have intelligence sources that guide our analytical work into the places where we think there might be systemic risk potential that is worth looking at in more detail.

Q32 **Chair:** Have you ever had an example of a local authority you think has stretched a bit too far? We might hear some more examples of interesting models. What do you do? Do you go and have a chat with them? It may not be an audit issue; you have got lots of things going on here and a lot of investments in different areas. Do you go and talk to the leader? Do you talk to the chief finance officer? What power does DCLG have to safeguard local taxpayers?

Melanie Dawes: Where we have concerns that an authority is at risk on the financial side, that has normally come out of the systematic analysis we have done. That is why I referred to it earlier. A lot of the time, it tends in the end to come down to leadership. It is sometimes because there is a plan that we don't think will be deliverable—perhaps because it requires a contribution from the local NHS partners, which is unlikely to be realised, or perhaps because we think the timescale is very short. Normally, we would then talk to the Local Government Association about that, and we would often have an open conversation with the council concerned—in fact, we would always seek to do that.

A lot of the time, the answer is peer support—support at a political level or an officer level. The LGA has a good track record of helping councils to get their budget plans on a more sustainable footing and keep the responsibility where it lies, which is with the individual council concerned. If we felt as a Department that that was not good enough and we had concerns that a council was still not solving its problems, again the primary responsibility there is with the system and the section 151 officer, who must flag that and go through the normal processes. We have to be very careful as a Department not to assume responsibility—I'm sure you agree—and start to confuse accountability. Our experience is that that peer support combination of political and officer conversations gets you quite a long way in these situations.

On your specific question about an authority that has been in that situation because it has been taking on too much commercial risk, I can't think of a recent example like that. It's more about pressures that come from managing the overall budgetary pressures on the revenue side and plans that are too quick or difficult.

Q33 **Chair:** So you are saying it is more about the reduction in budgets and the pressures on revenue than the commercial side.

Melanie Dawes: Yes. We don't see the commercial side adding risk in the work that we do, for the most part. I agree that we need to keep an eye on that.

Q34 **Kevin Foster:** I think you would struggle to find many recent examples because of course things go wrong over a period of time and it has only been in the last five years that these sorts of things have happened. Normally capital investment goes wrong over a period of time, not within two or three years of the expenditure happening.

Melanie Dawes: That is a fair comment.

Q35 **Kevin Foster:** On a point of principle, are we happy that the financial viability—the success or otherwise—of a local authority will depend on its success as a property investor?

Melanie Dawes: In analysing the situation for the spending review, I do not think we felt we were leaving the sector reliant on its activities in property investment or any other commercial activity. Some authorities are choosing to add that to their plans—

Q36 **Kevin Foster:** Not totally reliant, of course, but fundamentally if they lost money badly or took on a bad investment, that would clearly hit their revenue requirements.

Melanie Dawes: But we have not got a set of assumptions here in the Department that rely on some gap being filled by commercial activity. That is not the basis on which we did our spending review activity.

Q37 **Kevin Foster:** I accept that you might not have a gap that you rely on filling in your own accounts, but if something went wrong in a commercial investment that could create a gap, couldn't it? A debt that needs to be repaid.

Melanie Dawes: I think what you are saying is that there are risks there. I am not sure that the risks are greater for commercial activities than they are for non-commercial activities. If you are an authority with upper-tier responsibilities, managing demographic pressures on social care and children's services is in itself risky, so whether or not it is more risky to be investing in property is I think a moot point.

Q38 **Kevin Foster:** I suggest the difference is that it is going outside the area of public service into, bluntly, an area of commercial property acquisition. Most authorities—certainly upper-tier authorities, and I think of my own—would have decades of experience of managing the risk you have just talked about, but, bluntly, given that the private-sector market for people is well above any local authority pay scale, they would not necessarily have those people with decades of experience of commercial structured investment. Would most local authorities have that?

Melanie Dawes: A lot of the time they are going into joint ventures precisely for that reason. They do have significant experience of housing, for example—those authorities for whom that is one of their responsibilities—and of development and regeneration. So I do not think this is a blank sheet of paper for the most part. It is building on existing capability. But are they having to invest more in that? Yes, in some places they are. But as Matthew was saying earlier there are requirements for them to look at the skills issues, which gives me some assurance that that factor will be taken into account—it is a very important one.

Q39 **Mrs Trevelyan:** On that point, Ms Dawes, Northumberland, my council, is concerned about its sustainability because we have a relatively low council tax base. It relies on my voters in north Northumberland who are reliable council tax payers, but we cannot really rely in the medium term on an increasing council tax base coming from some of the poorer parts of Northumberland. It has been borrowing heavily, doing as Mr Foster suggests to try to broaden the business base with a view to the business rates filling what it can see will be a substantial gap in the balance of payments. That concerns my taxpayers particularly, because if one of the business decisions goes wrong, they feel they will be the ones who will have to pick up the tab. There is the question of whether simply servicing the debt, which is increasing by the hundreds of millions, is acceptable when the rural service provision is already very poorly sustained. How are you able to see that from the DCLG point of view to ensure that my taxpayers will not suffer if something goes wrong in a business decision?

Melanie Dawes: Overall the capital financing costs for the sector have been broadly stable over the last few years. They went up slightly and they have come down a little bit in 2015-16. The NAO have mapped the range and there are some councils who have increased their overall financing requirements but the median has stayed broadly stable. So I think it is important that we look at these trends, that we understand them and that we are factoring in any burdens on revenue budgets that are coming from borrowing increasing or from the capital financing costs increasing through some other way.

Q40 **Mrs Trevelyan:** So how can north Northumberland residents feel any confidence that the Department will be there with oversight in case the council is making risky decisions with the view of trying to fill what they consider will be a black hole in ongoing funding streams?

Melanie Dawes: Fundamentally, the decisions on how to make those decisions are with the local council, and with the ability to vote for that council. The Department's role, in the first instance, is about understanding the sector and ensuring that Ministers have the right advice on overall funding for local government. That brings us to the business rates retention reforms, and how those will work. The consultation closed just a few weeks ago, and we will look at that issue actively in the coming months and years. Need, distribution and the system of tariffs and top-ups will be included in an important set of policy discussions.

Q41 **Mrs Trevelyan:** Will it be for the council chiefs to present their case honestly to you in order to ensure that, in Northumberland's case, we do not get forgotten? Across the north-east, the balance is all right but in rural Northumberland, there are serious risks to service provision, which is more costly to do across rural parts of the country.

Melanie Dawes: Yes. We are doing the work in partnership with the Local Government Association. So far, councils have not been slow in coming forward with their concerns. In fact, it is not just by region, but by different types of authority. The point you made about rural areas has been made to us previously.

Ministers will be faced with big decisions about the overall package, but we are doing the work with one of the most consultative approaches possible, recognising the complexity and the pressures on the system. The sector welcomes the set of reforms, but an important set of decisions will be made and we simply cannot do the work without having all the views on the table.

Q42 **Philip Boswell:** Local authority cash holdings are at their highest level since 2004-05. That would typically mean that there is higher cash allocation or virement, and it typically equates to higher risk recognition by the local authority or a poorer definition on spend. Have you looked at why the cash holdings are at that level? Has virement been considered? The situation suggests that more risk is being identified by local authorities, and that they are looking to mitigate that.

Melanie Dawes: Overall, the increase in balances reflects, in part, the need for local authorities to make minimum revenue provisions in order to repay their debts primarily to the Public Works Loan Board. That is how the system works. It is effectively an interest-only loan, but one where local authorities are required to keep a provision for the repayment at the end of the loan. That is one of the reasons that the balances have risen, but we do not feel that that reflects an increase in risk-taking or a judgment about risk across the sector.

Matthew Style: The only thing that I would add is that we have a strong statutory framework for how that cash is invested, which, as Catherine mentioned earlier, requires local authorities to put security and liquidity before yield in making decisions about how that cash is invested. Again, we strengthened that framework in April 2010 following feedback from the Select Committee at that time.

Q43 **Chair:** As Mr Boswell hit on, authorities are using their reserves as an asset to borrow against, or to lend—indeed, they are lending themselves—rather than as something to be used as a liquid rescue boat if something goes wrong. Reserves are there for a reason and they are rather tying them up, aren't they? Does not that worry you? Isn't that a sign that they are struggling financially?

Melanie Dawes: There is a distinction between reserves and cash. They are using their cash to delay external borrowing; that is the internal borrowing point. That is slightly different from how they account for their reserves. Decisions are made on a council-by-council basis on projects that authorities think they need to invest in, the provision that they need to put aside, and the unallocated amounts that they need to have available.

As you know, reserves have increased over the past few years, which is partly because of risk and because of the investments that local authorities have been planning for. We are not particularly concerned about the pattern on reserves for the sector as a whole. There was some debate in the spending review as to whether, in fact, it gave the authority more capacity. We had quite long conversations about that at the time.

Matthew Style: This is also where the arrangements for borrowing from the PWLB come in, because the local authorities have of course established terms of trade with the PWLB that allow them to access external borrowing with a turnaround of two business days. That helps to enable local authorities to engage in internal borrowing without running up against the sort of liquidity risks that were just mentioned.

Q44 **Chair:** One of the things we have touched on a number of times is the delaying of essential maintenance and so on. There is spend to save, but there is also delaying expenditure and causing bigger costs down the line. It has been only—only—five years. Local government has had financial trouble for longer than that, but it has been particularly hit in the past five years. What do you do centrally to assure yourselves that future council tax payers are not going to be paying the costs of these delays? Good local authorities, with rigour and rules around how they spend money and operate, which you have highlighted, will obviously have done what they can in the current climate, but they could be shifting—some of them are—big spending to the right, as we would put it. How do you analyse the impact of that on future council tax payers?

Melanie Dawes: In essence, we rely on the requirement to set a sustainable budget. A local authority that is knowingly delaying necessary expenditure that will have to take place at some point, with no plan for that in their projections, is not going to be meeting the requirement to set a sustainable budget. In the end, that is the bedrock of the system. In some places, local authorities say that they are delaying maintenance expenditure because they have another plan for that asset. They may be planning to sell it or to renovate it as part of a longer-term savings and investment programme. In other places, maintenance costs have significantly reduced because of investment that has already taken place. For example, heating bills have been significantly reduced in many places because of activity like that. It is quite a complicated picture, but in the end our main assurance comes from the need to set a sustainable budget, which just isn't going to happen if you are ignoring pressures that are just around the corner.

Q45 **Chair:** There is evidence out there that many local authorities will be—indeed, are—putting off spending on maintenance because that is a revenue cost and they have a squeeze on revenue. You sound very complacent about it, if I may say so, Ms Dawes, sitting in Whitehall, compared with the council tax payer locally who is seeing services run down and facilities deteriorating.

Melanie Dawes: As you know, we in DCLG are constantly trying to strike the balance between relying on the local democratic accountability and the framework we have in place and the need to monitor and understand risk at a system level and at the level of individual local authorities. That is our constant balancing act. I would not want us to be complacent about this, but do we actually hear from the sector that they are delaying essential maintenance as a result of their service pressures? To be honest, no, not really. We hear pressures around social care and concerns about the longer-term budgets, which we have discussed and which we work very closely to understand. Do we hear that roads are not being maintained in a systematic way that gives councils concern at the system level? It isn't something that we hear as a very big issue. We hear a lot of activity to defray those costs through investment over time.

Q46 **Chair:** Okay. I want to touch on an area that is slightly outside your purview—forgive me—but that relates to what many local authorities will still be spending on. The Education Funding Agency is now funding a certain number of schools because they are not under local authority control. There is some evidence—I have heard some quite good evidence that I will be presenting to the EFA separately—about overpayment for some sites. I have had evidence from local authorities saying that if they had had that money they would have spent it better and provided, yes, the school, but also some other local benefits with the same money. They are concerned that there are seemingly no constraints on that central Government funding. It goes straight to the school management of free schools or academies, compared with going through a local authority.

This is not an argument about policy on free schools and so on; I am simply asking about the cash. Do you have any oversight or input into how the Education Funding Agency spends that money? Have you had any of those sort of conversations with local authorities about "If you gave us the money, we could do it better", which is what they say to me?

Melanie Dawes: We do not have an explicit role in those decisions from DCLG. No.

Q47 **Chair:** But hopefully you have influence in Whitehall on behalf of local government.

Melanie Dawes: You raise an interesting point. Some of this is about the balance of different policy objectives. It is quite common in my experience for local authorities to be champing at the bit to do more things, quite rightly. As you know, we certainly experienced that in the devolution discussions. Local authorities are often very clear that money that is spent centrally by the Government on skills, work programmes and so on could be spent better locally. Sometimes they are right and sometimes they are not right. Sometimes it is about a wider value-for-money judgment across the Government as a whole. The Public Works Loan Board changes are a good example of that.

Can we be confident that in every single case the local authority could not have spent the money in a different way? I am not sure that is a test we can and should apply to every decision. I think that as a system issue, you raise a good point and it is something we can take up with the Department for Education.

Chair: We will raise it elsewhere.

Q48 **Kevin Foster:** Briefly, coming back to the point about the balance of how capital is spent, most of you have read paragraph 2.28 on page 38 of the report: "National data is not sufficiently detailed to allow the shift in the patterns of spending to be identified. For instance, 75% of total capital expenditure falls within the single category of new construction, conversion and renovation." For me, that probably sums up what capital spending should actually be about: building things, renovating things and one-off expenditure. Is it really appropriate to have a category that covers 75% and do you feel that gives enough data to the Department in terms of looking forward?

Matthew Style: One of the things we do is run a governance group with experts from the sector which helps us to decide what questions to ask, what data to collect, what categories to use and so on. We do that as well as drawing on best professional practice that accountants normally use for categorising their capital spending and so on, but we are very happy to look at how we can improve that and improve both the usefulness and quality of our data for the sector itself to use and for us, the NAO and others to use in analysis.

Kevin Foster: But for me, Mr Style, it makes sense of things like separating out invest to save from long-term asset management and particularly some commercial investing that is going on. It makes eminent sense. Thank you for that answer.

Q49 **Chair:** I want to touch on some issues around data. First, one thing the NAO highlighted was the issue of double counting when an LEP spends its money through a designated local authority and it seems, according to the NAO, that there is clear evidence of double counting going on. There has been growth in LEP capital funding of roughly 300% over the period of the Report, whereas it has gone up 36% typically for individual local authorities. Are you aware of that and what are you going to do about it?

Melanie Dawes: We were already aware of that and indeed we have put in place a lot of safeguards to make sure that local authorities don't double count and that expenditure that comes into one local authority on behalf of the LEP is not counted when what should be counted is the expenditure later on. We are very happy to look again at the NAO's figures. We are fairly confident that the risk of substantive double counting is quite small—

Chair: We don't like double counting.

Melanie Dawes: We don't either.

Chair: Good. I am glad to hear that from an accounting officer.

Melanie Dawes: We are looking again at the guidance to make sure we have got it right, but it is something that we were aware of and we want to make sure we have understood the NAO's concerns, which came through in the update report only a week or so ago.

Q50 **Chair:** Okay, so we may well want to make a recommendation in that direction, but I am glad to know that you are open to it; that always helps.

The other issue is around the data that you generally are collecting. Ms Dawes, you mentioned that it was important to monitor the trends, but—this is a constant refrain on the Committee—without good data, how can you monitor the trends? We have gone around the houses a bit on the risks involved, the type of lending, the internal debt and so on, but you do not have clear data, according to the National Audit Office. What are you doing to improve that?

Melanie Dawes: I don't think we lack data, but I don't think we use it as actively as we could. All the analysis in the NAO Report used DCLG data, but not all of it was put together in ways that we have done before. Our challenge is to make better use of the data and to be more intelligent in the way that we are pulling out the trends. That is my personal view. Actually, I would say that that is often the issue across Government as a whole—we don't lack the numbers, but we do lack sometimes the really good analysis of them.

Q51 **Chair:** So it is not a shortage of data being dumped; it is just a question of how it is being used, perhaps. Catherine Frances, from the Treasury's point of view, do you feel there could be improvements in how the data is presented or collected?

Catherine Frances: The points that Matthew made earlier around disaggregating some of the capital data—some of that large block of data that looks like a block of continuity, as you described it, in how local government is operating. Getting under the skin of that would be very helpful for us to understand. We support what Melanie has said about generally improving how we use the data that the Department has. In the Treasury, we rely on CLG's expertise and intelligence on what is going on in the sector. We think that broadly speaking, we know quite a lot about what goes on in the sector, but some of the issues that have been highlighted in today's discussion are areas where we want to find out more.

Chair: I would have thought that from the Treasury's point of view, if you find out more, you can apply lessons learned to other areas.

Catherine Frances: Absolutely.

Q52 **Chair:** It seems there are quite big gaps in sight here. We will look into that more. I want to touch on a couple of other issues. LOBO loans—I don't know who wants to talk about them—were very much a trend, peaking around five or six years ago. We have had some interesting evidence on their impact.

For anyone listening or watching who is not an expert, my analysis is that these loans are a bit like a zero per cent credit card, where you pay a higher interest rate if you don't manage to pay off the loan in time. It seems to me, from the outside—I wasn't aware of these until I was preparing for this hearing—that these loans are quite a risk for local authorities to take on. I have not got to the bottom of why they all went in for this, but are you concerned about LOBO loans? Perhaps Catherine Frances can answer this, secondly: is it not something to do with the way the Public Works Loan Board was working?

Melanie Dawes: Perhaps I can give an overview. Are we concerned about LOBOs? No, in the sense that they are no longer part of the offer that the banks make to local authorities. There is not, as far as we are aware, any lender offering those.

Q53 **Chair:** Is that simply a bank decision, or was there any pressure from Government to reduce them?

Melanie Dawes: I suspect it is a bit of both. One bank—Barclays—has in fact converted all their LOBOs into more straightforward fixed-rate loans, so they have taken away their own option to increase interest rates.

Q54 **Chair:** That is interesting. Do you know what drove that? Was it pressure from Government, or did they just decide it?

Melanie Dawes: When you look at the LOBO story over a number of years, as far as I am aware, there have not been any lender options exercised. The banks have not actually exercised the ability to raise the interest rates, and it may be that that product simply did not work for them in the way they expected it would. I have not spoken to Barclays, but that is a decision they took fairly recently.

Q55 **Chair:** I did not have a chance to get back to others about this, but can you tell us why local government went for this a few years ago? Why was it flavour of the month then, rather than going for a straightforward fixed-rate loan? Interest rates, I suppose, will have been a factor. Public Works was possibly a factor.

Matthew Style: A reflection of the interest rate environment at the time, their own assessments of the future path of likely interest rates and so on. A certain amount of marketing went around the products also, I think it is fair to say.

Q56 **Chair:** Seen from the outside, it seems like a lot of freedom. For an ordinary person looking at it from the outside it does not seem a very sensible approach. Is that a fair summary, or am I being a bit harsh on hard-pressed local authorities?

Melanie Dawes: When you look at it dispassionately now, it looks like a slightly odd arrangement, particularly given the availability of public works loan board finance on quite favourable terms, despite the issues around repayment that we discussed earlier. Local authorities view this—rightly, I believe—as a pretty good source of finance for them. It does not look like a great deal, but, as Matthew said, it is partly a product of the interest rate environment at the time and a slightly different context.

Q57 **Chair:** I have one question for you before I go to Catherine Frances on the same issue. That was an interesting trend, as we both acknowledged. A slightly puzzling one, perhaps, and potentially risky. Is that the sort of thing that you see the Department with its oversight going in and saying, "We're worried about this; we're seeing a trend", and then trying to put pressure on banks or local authorities or both to look at a different way of financing themselves?

Melanie Dawes: I think it is the sort of trend that we ought to be aware of, yes.

Q58 **Chair:** Have you got the expertise in your Department? I should hope the Treasury has.

Melanie Dawes: It is a joint effort between ourselves and the Treasury. The investment strategy, the Treasury guidance, is a partnership between ourselves, the Treasury and CIPFA in the first instance, and also with the Local Government Association.

Catherine Frances: In addition, the rate of take-up of these things has generally been, in the past, from the 2004 to 2010 period, at a point where interest rates were higher and reflecting that point—interestingly, before we made the changes to the rates, which we discussed earlier. They predate that point. I agree with what Melanie and Matt have said. I am not sure there is much more to add in the sense that what we see in the sector now is a sort of preference to continue to come to the PWLB for their borrowing in a remarkably stable fashion. But I back everything that Melanie and Matt have said.

Q59 **Chair:** So you don't think they were driven to it, because most of it arose before PWLB changed.

Catherine Frances: Before—exactly. I think they were simply in a different interest rate environment at the time, and it's a set of decisions that they took in the past. We are not seeing it so much now.

Q60 **Chair:** Do you look at the percentage of interest payments that councils are paying as a percentage of their council tax revenues? Is that a factor in your data that you look at, either at the Treasury or DCLG?

Melanie Dawes: We look at the overall capital financing, both the mandatory and the non-mandatory, in the way that the NAO has set out in its Report, as a percentage of overall revenue budget, and also as a percentage of debt.

Q61 **Chair:** Is there a warning point where you think, "Hang on. They are a bit heavily geared there"?

Melanie Dawes: What we have observed is relative stability in those ratios in the recent past. We have observed some rise in the range—that is in the NAO Report—and we have observed some authorities increasingly with higher financing rates as a percentage of their revenue budgets. That is an example of how the data flags up certain authorities to us.

We would always look at those outliers and try to understand what was going on to see whether it was a planned and sensible and clear result or whether it was something that maybe gave us cause for concern. So we look at the data. I don't think we have a clear view of particular thresholds. I think it is probably quite important that we are not too prescriptive and that we are ready to respond to the data rather than to steer ourselves too firmly in any one direction.

Matthew Style: It is also why local authorities are required not only to balance their budget in a given year, but to produce a medium-term financial strategy. We should look at exactly those sorts of exposures over a longer time period.

Q62 **Chair:** We have touched on this; I just want to try and nail it down. It concerns what you are looking at when you do a spending review. You have some authorities exposed to potential risk and something could go wrong. I remember when Hackney Council was bailed out by the Government by about £25 million, so it does happen. I should say Hackney is now extremely well managed, including by the new Mayor, Phil Glanville, but those things happen. So when you are looking at the spending review and you look at the exposure of local authorities, are you looking closely at their capital exposure? Does that make a difference to the decisions?

Melanie Dawes: As the NAO Report says, we focused our effort in the last spending review on the revenue side. I think it is a fair point that we need to pay more attention to the capital side in future. We focused in that way because the sector told us that that was its concern and that was the big discussion we needed to have with the Treasury, particularly around social care. I think it is important that when we next do a full analysis—we will need to do some of that as part of the business rates reforms—we look in the round at the capital side as well, but my guess is that the core revenue budget will still be the one where the big debate needs to be had.

Q63 **Chair:** With further cuts coming down the line, I am sure it will be.

I also want to ask about combined authorities. We touched on mayors with both of you earlier; they can borrow—the combined authorities—for transport investment but, Melanie Dawes, you sat in front of us in a previous hearing saying that when the manifestos were published there would be another look at what mayors and combined authorities can do. Are there any plans to allow further borrowing for those combined authorities with executive mayors?

Melanie Dawes: There are no plans yet.

Q64 **Chair:** Any discussions going on?

Melanie Dawes: It was interesting to see that CIPFA raised that in its evidence to you. I think that is an interesting question. It is a policy discussion that I expect we will have with the Treasury.

Q65 **Chair:** It is not just policy for the Treasury, of course; it is watching the bottom line as well. Is that something you are contemplating?

Catherine Frances: That is absolutely right. They currently have powers to borrow for transport. I can't remember whether we discussed this in our previous discussion about devolution deals, but most of the devolution deals feature a commitment to continue to discuss with them their wider borrowing powers. Beyond that, it is a policy decision; as you rightly say, from our perspective it is a financial decision as well.

Q66 **Chair:** There is also a transparency issue if the executive mayors have overall responsibility but there is also a combined authority and the money is borrowed by the combined authority's constituent parts. When Karin Smyth and I went on a representative visit of this Committee to Bristol, the LEP was responsible for making decisions but it was the five constituent boroughs that had to bear the risk. Some of them, of course, were not going to gain any of the benefits from some of the projects being proposed. How is the average local council tax payer in somewhere like Manchester or West Midlands to know what is going on with that opacity of approach?

Catherine Frances: As we have discussed before, we are very clear that at each stage of devolution we move through we have to clearly describe the accountability frameworks exactly so that local taxpayers and local voters can understand precisely what is going on. We have committed to laying those out before each devolution process gets to the next point. On the issue of combined authority borrowing, we have heard the message that CIPFA has raised in its evidence today and we will carry on looking at it.

Q67 **Chair:** Time is running out: it is October, the Bill is going to be laid very soon—some of my Conservative colleagues might know more than me—to allow the mayors to be elected in May, but it is not being nailed down yet.

Catherine Frances: Indeed. The powers to switch on additional mayoral borrowing powers and combined authority borrowing powers are contained in the legislation that was passed earlier this year. What has not been switched on, in a sense, is any power relating to any individual city region. That could be switched on according to a policy choice, if that choice was made, but the underlying legislation is there; it needs secondary legislation.

Q68 **Chair:** So there is a space there for mayors to come in and bid for what they would like to do. Is that an open door?

Catherine Frances: Many of them are discussing those kinds of question with us in many of the areas.

Q69 **Chair:** I am sure they are. This Committee has a very strong concern, whatever our views on devolution—

Catherine Frances: Clarity of accountability is absolutely key.

Chair: Accountability not just from Whitehall down, but from the ordinary taxpayer in those areas up. There are concerns there.

Catherine Frances: Yes.

Chair: Before I make my final point, I will hand over to Phil Boswell, who is going to touch on Brexit.

Q70 **Philip Boswell:** I want to understand more about why local authorities are holding on to more and more cash. Are we monitoring the degree, if any, to which the virement percentage in budgets is increasing? First, is all the cash used exclusively for MRP—minimum revenue provision? Or is it, along with virement, simply introducing greater contingency in a higher risk environment?

Secondly, the budgets were clearly prepared before the Brexit decision, but given the environment of increasing risk—that is certainly the case post the Brexit decision—are there any indicators that local authorities intend to or are actually holding on to or maximising holding on to contingency? Or are they actually investing more to mitigate, so that is why there is an increase in MRP?

Melanie Dawes: Again, I may ask Matthew to come in on this, but as I was saying earlier, I think reserves have increased for a number of different reasons. Sometimes, it is because local authorities feel they need more contingency, given the tighter financial environment for them, and sometimes it is because they are, quite simply, making contingencies for specific projects.

We don't see the overall reserves position as a concern, either as an indicator of overall risk or as something that in itself adds risk. It is not something that, from that system-wide perspective, gives us a concern. Matthew may want to comment more on that.

However, I will just say something about Brexit, since you raise it. We are discussing with the sector their concerns, their questions and their priorities around Brexit, and that feeds into the overall work that the Government is doing. We don't have a lot to say about that right now, but I can say that local government does have a seat at the table and that in DCLG we are very clear that we are co-ordinating that, to make sure that any issues they have are raised. Those include, for example, questions of European funding, some issues around the labour market and so on.

Matthew Style: The only thing I would add is that when I talk to finance directors and chief executives about the patterns of their reserves, I think that the two most common explanations they give for significant increases in their reserves are, first, putting money aside to fund infrastructure developments, which is obviously something that local authorities are increasingly engaging in in this day and age; the other thing is putting aside reserves to fund investment in systems and their own infrastructure that will reduce their future operating costs. So actually this is putting money aside to modernise and transform their services, to get better value for their taxpayers in the future. Those are the two things that are most commonly raised with me as drivers.

Q71 **Philip Boswell:** Understood. Well, I must say, Matt, that I do have concerns that in any situation like this risk mitigation is down to lack of definition or the perception of higher risk, and because these numbers are on the increase in terms of cash being held on to and potentially increasing contingency, it usually means one or the other: either there is higher risk or the definition of what the actual spend is isn't nailed down enough. I am still concerned about that.

Melanie Dawes: We wouldn't say that the system is without risk; clearly, there is risk—local authorities have a lot of responsibilities they need to juggle. They are on tighter budgets than they were before, so there is risk, and that is one of the reasons why some of them have increased reserves; it is to be ready for that. So I do not disagree that, at a system-wide level and for certain authorities, putting money aside over the last few years to be ready for the tighter budgets ahead was part of what is going on. At the same time, some of this is a technical issue around MRPs. That is more about the overall cash and the balance of their investments and what they hold at any one time, which is a slightly different point, although it's related to the question of reserves.

Q72 **Philip Boswell:** And is all the cash MRP?

Matthew Style: Authorities could be holding cash that has come in from an asset disposal, or there would be other sources of income that would generate cash—

Q73 **Philip Boswell:** "Could be"?

Melanie Dawes: Could it all be MRPs? I think that would be surprising, because the cash position at any point in time, as Matthew said, is going to reflect a lot of change—

Q74 **Chair:** Maybe Aileen from the NAO can shed some light on this.

Aileen Murphie: Well, if we're talking about figure 9, which is looking at local authority investments held on deposit, that is all the cash that they would have. So it will be money they have drawn down through the Public Works Loan Board, asset disposal money, money due to go out to somewhere else for LEP spending, grants already drawn but not yet spent—it is all of it together.

I think the point we are making about the upward curve is the fact that none of us is entirely sure why it is happening. Our point is: is there a systemic risk here—we are not saying there is, but is there?—and do a bit more analysis of what the causes are.

Q75 **Chair:** Can I just be clear on Brexit? I heard somewhere else but I wanted to hear from you about EU funding for regeneration that has gone into local authorities, and any other EU funding for skills and so on. Is it right that the Government have now guaranteed for local authorities that that will continue?

Melanie Dawes: Yes. Last week there was an announcement that, in addition to the guarantee that had been given before for projects agreed before the autumn statement, there is now also a guarantee for projects agreed after the autumn statement. We are working through that.

Q76 **Chair:** So the hole will be filled by the Exchequer rather than by local taxpayers when we lose that EU funding.

Catherine Frances: The commitment is to continue to pay out on those funding streams. We are working with Departments to work out a way to best maximise value for money.

Q77 **Chair:** So that is one thing they can be sure of. What was the other issue I was going to ask about Brexit? I can't remember now. Can I go on to right to buy, which is obviously still a worry for local authorities? There is no news yet on how that will work and how that capital contribution will be made to pay for the sale of housing association homes. When is that announcement likely to be made? When is that decision going to be made?

Melanie Dawes: On the sale of high-value assets, I do not have anything further I can say about that at the moment. It is something that is under discussion.

Q78 **Chair:** With Ministers?

Melanie Dawes: Yes.

Q79 **Chair:** Do you have any idea, in rough civil service timescales—spring being from February to about October—when that might be forthcoming? Obviously, local authorities are very concerned about the impact on their asset bases.

Melanie Dawes: I don't think I can give you any firm timescales today.

Q80 **Chair:** Fine. I will take it up with the Minister and spare you the trouble on that one. The other thing I was going to ask about Brexit is, are you trying to find out from local authorities how many European nationals are employed in local authorities?

Melanie Dawes: No, we are not specifically asking that question. What we are working with them on is where they think they are reliant on particular groups of EU nationals to deliver services. There are questions for local government that are similar to some of those faced by the NHS, but we are not asking them for any kind of information on the nationality of their employees.

Q81 **Chair:** What are you going to do with that information when/if you get it? How will you feed that into the Brexit discussions as a Department to ensure that local government services do not fall over?

Melanie Dawes: It will be one of the things that the Government needs to take into account. We are making sure that the analysis is there so the overall decision making reflects the issues for local government that they have raised with us. But, as you can imagine, it is a sensitive area and I do not want to say anything more at this stage.

Q82 **Chair:** So you have some handle on it but more detail to follow. Is that a fair summary?

Melanie Dawes: Yes. We are playing our part in the Government work here by bringing to bear the local authority issues—and indeed the housing issues, I might add, which are also important for DCLG.

Chair: Thank you very much indeed for your time this afternoon. Our transcript will be up on the website, as ever, in a couple of days' time uncorrected; we will send you a copy as well. Our Report will be published some time before Christmas—I cannot give you a date at this point. Thank you very much.