

# LOCAL GOVERNMENT ACT 2003

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## EXPLANATORY NOTES

### COMMENTARY ON SECTIONS

#### **Part 1: Capital Finance Etc and Accounts**

##### **Summary**

7. The new capital finance system (like the one it replaces) sets the legal framework within which local government may undertake capital expenditure and central Government may regulate that activity.
8. The innovative feature of the new system, however, is that local authorities will be free to raise finance for capital expenditure - without Government consent - where they can afford to service the debt without Government support. There will be reserve powers for Government to set limits on borrowing and credit, but it is envisaged that these would be used only in exceptional circumstances.

##### **Section 1: Power to borrow**

9. The present wide-ranging power of an authority to borrow for purposes relevant to its functions is preserved. But the new legislation goes further and clarifies that there is power to borrow for normal treasury management purposes – for example, to refinance existing debt.

##### **Sections 2, 6 and 13: Control of borrowing**

10. The main borrowing control section 2(1) will be the duty not to breach the prudential and national limits set under sections 3 and 4.
11. Authorities will be free to seek loans from any source, but will, as now, be prohibited from borrowing in foreign currencies without the consent of Treasury, since adverse exchange rate movements could leave them owing more than they had borrowed. Various provisions in the present legislation protecting lenders to authorities will be preserved. These include the long established ‘safe harbour’ (section 6): this ensures that debts can still be enforced even if it turns out that the authority borrowed unlawfully and means that potential lenders do not need to make detailed enquiries about authorities’ borrowing powers. Section 13(3) maintains the vital principle that all of a local authority’s revenues serve as security for its borrowing.
12. The mortgaging of property will continue to be prohibited: section 13(1). It will also remain unlawful to ‘securitise’, that is, to sell future revenue streams such as housing rents for immediate lump-sums (this is implicit in section 13(1)).

##### **Section 3: Duty to determine affordable borrowing limit**

13. This provision forms the heart of the new ‘prudential’ borrowing system. It first imposes a broad duty for authorities to determine and keep under review the amount they can afford to borrow. The section then empowers the Secretary of State or the National

Assembly for Wales to define that duty in more detail in regulations, which may in turn require authorities to have regard to specified codes of practice. The latter power will be used primarily to specify the Prudential Code being produced by the Chartered Institute of Public Finance and Accountancy (CIPFA), which will lay down the practical rules for deciding whether borrowing is affordable.

14. It will be for each authority to set its own 'prudential' limit in accordance with these rules, subject only to the scrutiny of its external auditor (special arrangements apply to the Greater London Authority and its functional bodies). The authority will then be free to borrow up to that limit without Government consent. The authority will be free to vary the limit during the year, if there is good reason. Subsection (8) ensures that the consent of the full Council is needed for the setting of the limit and any subsequent variation. Breach of the limit is prohibited by section 2(1)(a).
15. Requirements in existing legislation for authorities to balance their revenue budgets prevent the long-term financing of revenue expenditure by borrowing. However, the new system, like the present one, will confer limited capacity to borrow short-term for revenue needs in the interests of cash-flow management (see note on section 5 below).

#### ***Section 4: Imposition of borrowing limits***

16. The Government, or the National Assembly for Wales will have reserve power to impose 'longstop' limits for national economic reasons on all authorities' borrowing and these would override authorities' self-determined prudential limits (set under section 3). Such limits (implemented by regulations) would only be imposed if authorities' total borrowing, albeit locally prudent, was increasing to a level which threatened the country's overall economic interests.
17. If an individual authority did not wish to undertake the full amount of borrowing permitted to it under a national limit, it would have power to transfer the spare 'headroom' to another authority, which would thereby have its borrowing capacity increased (subject to still complying with its own prudential limit).
18. There would be a similar power to impose a borrowing limit (by direction in this case) on an individual authority, to prevent it acting imprudently and borrowing more than it could afford.
19. Breach of the limits set under this section is prohibited by section 2(1)(b).

#### ***Section 5: Temporary borrowing***

20. The present system allows authorities also to borrow temporarily to meet their revenue costs, pending the receipt of income due to them (for example, while waiting for council tax payments). Under the new system, foreseeable requirements for temporary revenue borrowing will be allowed for when borrowing limits are set by the authority under section 3 (or by the Government or National Assembly for Wales under section 4). Section 5 then allows extra flexibility in the event of unforeseen needs, by providing for the borrowing limits to increase by the amounts of any payments which are due to the authority in the year but have not yet been received.

#### ***Sections 7 and 8: Credit arrangements***

21. A main aim of the present capital finance system was to regulate the innovative property leasing and hire purchase deals which some authorities used before 1990 to evade the controls on borrowing then in force. Such transactions, known collectively as 'credit arrangements', have the same crucial effects as borrowing – they both increase public expenditure and create significant long-term revenue commitments at the local level.
22. Credit arrangements (as defined in section 7) will continue to be treated like borrowing under the new system. Section 8 ensures that the affordability assessment under section 3 must take account not only of borrowing but also of credit arrangements. In

addition, any national limit imposed under the reserve powers in section 4 would apply to both borrowing and credit.

23. The definition of credit arrangements is much simpler than under the present system, relying on the accounting concept of long-term liabilities. The power to vary that definition by regulations would be used to provide that certain liabilities (such as those relating to pensions) are excluded from the definition.

### **Sections 9 to 11: Capital receipts**

24. Capital receipts are defined in section 9 broadly as now – i.e. as the proceeds of property sales. However, such sums will be treated as received when they become payable to the authority, rather than, as now, when actually paid. This change is simply part of the general approach of bringing definitions in line with accounting practice (see note below on sections 21 and 22) and will have no practical implications. There is power to vary this definition by regulations (section 9(3)) and it is likely that the repayment of certain loans made for capital expenditure will be, as now, defined as capital receipts.
25. The present rules requiring part of housing capital receipts to be ‘set aside’ for debt redemption will disappear. These will be replaced by new arrangements, including ‘pooling’ of a proportion of housing receipts (section 11(2)(b)), so that spending power can be redistributed to those authorities in areas with a greater need for new housing investment. This will apply to all sales proceeds obtained in cash; and to most non-money proceeds (section 10) (but disposals in return for housing nomination rights will be exempted). The pooling power will apply only to *housing* receipts and only to those which are obtained after the legislation comes into force.
26. **Section 11** provides power to make regulations about the use of other capital receipts – that is, all non-housing receipts and any housing receipts which are not pooled. The intention is to ensure that such receipts will, as now, be usable only for new *capital* spending or for the repayment of debt.
27. The treatment of amounts already ‘set-aside’ under the present system will be specified in regulations made under section 21. The repeal of the current set-aside regime will not in itself create access to any additional resources for authorities. However, the set-aside rules were relaxed for *debt-free* authorities, giving them extra scope for capital expenditure; and a debt-free authority with unused spending capacity of that kind will still be permitted to spend those sums when the new system starts.

### **Section 12: Power to invest**

28. For the avoidance of doubt, section 12 makes clear that authorities have power to invest, not only for any purpose relevant to their functions but also for the purpose of the prudential management of their financial affairs.
29. The power of the Secretary of State or National Assembly for Wales to issue guidance (section 15) is likely to be used to encourage authorities to invest prudently, thus preserving the safeguards of the present system but allowing greater flexibility and more local discretion.

### **Section 14: Information**

30. This requirement to provide information is simpler than the one in the present capital finance legislation. In practice, it will mainly mean, as now, that authorities have to complete regular statistical returns to the Secretary of State or National Assembly for Wales.

### **Section 15: Guidance**

31. Authorities will have to have regard to any guidance either issued specifically by the Secretary of State or National Assembly for Wales or identified in regulations.

Guidance is likely to be needed, for example, on investments, enabling Government or the Assembly to steer authorities towards prudent options, while avoiding the rigidities of the present controls embodied in regulations (see note on section 12 above).

### **Section 17: External funds**

32. The main effect here is to ensure that transactions by local government pension funds will, as now, be outside the capital controls. Separate regulatory systems apply.

### **Section 18: Local authority companies**

33. The present system ensures that authorities cannot evade the capital controls by operating through companies they own or influence. That broad principle will be preserved under the new system, both for the purposes of the prudential limit and any limit imposed under reserve powers (sections 3 and 4). This section confers the powers necessary to achieve that end and relies upon concepts used in the present system in Part 5 of the *Local Government and Housing Act 1989*.

### **Section 19 and Schedule 1: Application to parish and community councils**

34. The borrowing of parish and town councils in England (plus charter trustees and, in Wales, community councils) is still controlled under the system in the *Local Government Act 1972* which was repealed for principal authorities in 1990. This relies upon case-by-case appraisal of applications for borrowing consent. The effect of this section is to replace the old provisions with new ones which appear in Schedule 1 to the present Act. There is some tidying up but the broad arrangements are unchanged.

### **Sections 21, 22 and 16: Accounting practices, “Revenue Account”, “Capital Expenditure”**

35. The new system will as far as possible take standard local authority accounting practices and concepts as its starting point, thereby avoiding the need for special definitions in the legislation.
36. The legislation will provide a framework for identifying the accounting codes which are to constitute ‘proper practices’ (section 21(2)). The codes so identified will have that status for the purposes of the capital finance system and other existing legislation.
37. Some special accounting treatments may be needed for the purposes of the capital system and there will be power for the Secretary of State or National Assembly for Wales to specify accounting practices by regulation (section 21(1)).
38. **Section 16** deals specifically with the definition of ‘capital expenditure’. Again, the normal accounting definition will apply, but there is power to amend this, for individual authorities (by direction) or more generally (by regulations). That power to widen the definition will be used very sparingly, but regulations are likely, as now, to classify computer software development costs as capital expenditure. Directions will again be given only in exceptional circumstances, which could, as now, include cases where authorities are faced with significant redundancy costs.

### **Section 23: ‘Local authority’**

39. The list of bodies to be covered by the new system (section 23(1)) will be largely the same as under the present system. As now, there will be power to bring levying and precepting bodies into the system later by regulations (section 23(2)).

### **Section 24: Wales**

40. **Part 1** of the Act refers only to the Secretary of State and not also to the National Assembly for Wales. The effect of this section is that functions conferred under Part 1 on the Secretary of State are, in Wales, to be functions of the Assembly (and not

*These notes refer to the Local Government Act 2003 (c.26)  
which received Royal Assent on 18th September 2003*

functions of the Secretary of State). In section 19 and Schedule 1 this result is achieved by reliance on the concept of “the appropriate person” (defined in section 124).