

# Chapter 12

## Capital Financing

### *The Current System*

224. There are currently three sub-blocks within the capital financing block. These are:

1. debt charges;
2. interest on reserved receipts; and
3. other interest receipts.

225. The current formula for each of these sub-blocks is given below:

### ***Debt charges***

226. The *debt charges* component of the FSS element for Capital Financing for a particular authority is calculated as follows:

<b>Debt charges</b>	
(a)	<b>DEBT I</b> ; plus <b>SUPPORTED CAPITAL EXPENDITURE (REVENUE)</b> multiplied by 0.5; minus <b>DEBT I</b> multiplied by 0.02;
(b)	The result of (a) is then multiplied by <b>INTEREST RATE</b> ;
(c)	The result of (b) is then added to <b>DEBT I</b> multiplied by 0.04;
(d)	The result of (c) is then multiplied by the scaling factor for <i>Debt charges</i> .

### ***Interest on reserved receipts***

227. Reserved capital receipts which have to be set aside as provision to meet credit liabilities ('reserved receipts') are assumed to be distributed in proportion to an adjusted figure for assumed outstanding debt at 1 April 1997. The adjusted debt figure takes into account the additional debt which an authority would have incurred if it had had to borrow to finance the assets which are assumed to have been financed out of past capital receipts. Set proportions of the total of reserved receipts are assumed to lie with the following groups of authorities:

- (i) non-metropolitan district councils which do not have functions of county councils;

- (ii) county councils which do not have the functions of district councils, and shire county police authorities;
- (iii) county councils which have the functions of district councils and non-metropolitan district councils which have functions of county councils; and
- (iv) London borough councils, the Common Council of the City of London, the Greater London Authority, metropolitan district councils, metropolitan county fire and civil defence authorities, the Council of the Isles of Scilly, and police authorities other than the Common Council of the City of London, the Metropolitan Police Authority and shire county police authorities.

228. The *interest on reserved receipts* component of the FSS element for Capital Financing for a particular authority is calculated as follows:

<b>Interest on reserved receipts</b>	
(a)	<b>DEBT II</b> is <i>divided by</i> the sum of <b>DEBT II</b> for the group of authorities within which the authority falls;
(b)	The result of (a) is <i>multiplied by</i> x as set out in paragraph 223 below;
(c)	The result of (b) is then <i>multiplied by</i> the control total for <i>Interest on reserved receipts</i> given in Annex E.

229. For the purpose of (a) in paragraph 221, the groups of authorities are set out in paragraph 220 above.

230. For the purpose of (b) in paragraph 221, for the groups of authorities set out in paragraph 220 above:

- for (i)  $x = 0.28555$ ;
- for (ii)  $x = 0.11227$ ;
- for (iii)  $x = 0.20218$ ; and
- for (iv)  $x = 0.4$ .

231. The calculation set out above is equivalent to multiplying **DEBT II** by the scaling factor for *Interest on reserved receipts* for the group of authorities to which the authority belongs.

### ***Other interest receipts***

232. Other interest receipts are assumed to be distributed in proportion to non-capital FSS shares. Set proportions of the total of other interest receipts are assumed to lie with the following groups of authorities:

- (i) non-metropolitan district councils which do not have functions of county councils;

- (ii) county councils which do not have the functions of district councils, shire county police authorities, and combined fire authorities;
- (iii) county councils which have the functions of district councils;
- (iv) non-metropolitan district councils which have functions of county councils; and
- (v) all remaining authorities.

233. The *Other interest receipts* component of the FSS element for *Capital Financing* for a particular authority is calculated as follows:

<b>Other interest receipts</b>	
(a)	The total of all FSS elements for the authority is <i>divided by</i> the total of all FSS elements for the group of authorities within which the authority falls;
(b)	The result of (a) is <i>multiplied by</i> x as set out in paragraph 228 below;
(c)	The result of (b) is then <i>multiplied by</i> the control total for <i>Other interest receipts</i> .

234. For the purpose of (a) in paragraph 226, the FSS elements are all those excluding Capital Finance and the groups of authorities are set out in paragraph 225 above.

235. For the purpose of (b) in paragraph 226, for the groups of authorities set out in paragraph 225 above:

- for (i)  $x = 0.14468$ ;
- for (ii)  $x = 0.33730$ ;
- for (iii)  $x = 0.00275$ ;
- for (iv)  $x = 0.16567$ ; and
- for (v)  $x = 0.34960$ .

236. The calculation set out above is equivalent to multiplying the total of all FSS elements excluding Capital Finance for the authority by the scaling factor for *Other interest receipts* for the group of authorities to which the authority belongs.

237. The result of (d) in paragraph 219 is added to the results of (c) in paragraph 221, if any, and (c) in paragraph 226 to give the FSS for the Capital Financing service block.

238. No changes are proposed for the debt charges formula. The two elements on interest receipts, which are deducted from the debt charges element to give the overall Capital Financing FSS, have arguably outlived their usefulness, giving an opportunity to focus this FSS element solely on the financing of capital. The Government no longer prescribes that certain capital receipts have to be set aside to meet credit liabilities ('reserved receipts'). The element on other interest receipts is distributed within classes of authorities pro rata to the totals of their FSS; the only potential distributional value added

by this element is in the way in which it is split among the classes of authorities. Some kinds of authorities have greater balances in proportion to their size or budget, than others. If we give those classes of authorities a proportionately larger share of this (negative) FSS element, then their formula grant will be reduced compared to other classes in a way that can be argued to reflect their greater ability to earn interest. But, now that we have moved to a prudential regime for capital management, such micro management by the formula grant system seems unwarranted; it could also act over time as a disincentive to retain prudent balances.

239. Given that these FSS elements are negative, however, any reduction or abolition would need to be accompanied by a proposal on handling the consequences of that. Within a formula whose purpose is to distribute grant (and where, therefore, the totals are not related to spending), the simplest option is to abolish the negative elements without any corresponding reduction in FSS elsewhere. But other options are possible.

***Summary of options:***

*Option CF1*

Abolish both interest receipts elements from the capital finance FSS

*Option CF2*

Abolish both interest receipt elements and reduce the capital finance FSS total by the equivalent amount

*Option CF3*

Abolish both interest receipt elements and reduce the non-capital FSS totals by the equivalent amount

***Questions***

**Question 25: Do you think we should remove the Interest Receipt elements?**

**Question 26: If not, and we retained one or both of them, do you have any views on how they should be distributed?**

**Question 27: If so, should we reduce other FSS totals to compensate, or not? If we reduce other FSS elements, where should we make the reductions?**