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To all Local Authority Leaders
cc Baroness Eaton, LGA

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Dear Colleague,

We are aware that authorities are now in the process of setting their budgets for 2011-12, and, following points made to us in the consultation on the Local Government Finance Settlement, we thought it would be helpful to provide an early indication of the capitalisation framework for 2011-12.

Capitalisation is a relaxation of accounting convention and permits authorities to borrow or use capital receipts for revenue purposes. Whether it is through borrowing or the use of capital receipts (eg from asset sales), capitalisation scores as public spending, and has national implications for the wider economy and deficit reduction programme. It is therefore important that capitalisation is strictly controlled.

Initial Questions and Answers on capitalisation for 2011-12 are available on the Department's website, and we intend to issue full guidance on the policy and application procedure in February.

This guidance will be issued to authorities earlier than in previous years, so that you are clear ahead of the financial year how this process will work, and in order to support local authorities who wish to deliver efficiency savings early through organisational restructuring.

Clearly, in setting its budget, an authority should not make assumptions about whether it will receive a capitalisation direction in 2011-12. However, without pre-empting the detailed guidance – and the precise criteria - it can be expected that the Government will take account of the level of reserves, as well as authorities' overall financial position.

As has been the case in previous years, the Government will look at the total reserves for each authority, including both "earmarked" and unallocated reserves, since the extent to which earmarked reserves are firmly committed will vary considerably from case to case.

While capitalisation will provide important support to authorities next year to help them to manage organisational restructuring, the directions cannot meet all of these costs, and it will be for authorities to assess how they best manage costs overall from their own resources, including, as appropriate, from reserves.

Within the statutory and regulatory framework, it is the responsibility of the chief finance officer to advise the local authority on the level of reserves. Clearly, there will be many factors to be considered in determining what the appropriate level should be, and, as CIPFA emphasises in its most recent guidance note on reserves (LAAP Bulletin 77, November 2008), these factors are best assessed at the local level, and in the context of both the budget for a particular year, and medium term financial planning.

There is no prescriptive national guidance on the minimum or maximum level of reserves, either as an absolute amount or as a percentage of the budget; it is for the local authority to assess what the appropriate level should be, taking into account all of the relevant factors.

As the Secretary of State said in his statement in November, Ministers believe that it is sensible - as part of wider financial planning - for authorities to consider drawing on their reserves to address short term costs and pressures, and to help them manage transformational change, where it is appropriate to do so. That will include managing the costs of internal restructuring.

We would also like to clarify one further point. It has been suggested that the Treasury requires authorities which pursue PFI projects to maintain a particular level of reserves. This is not the case. The Treasury does not require reserves to be earmarked for PFI purposes, nor that any such arrangement be retained over the life of the contract. Local authorities are certainly required to demonstrate that PFI projects are affordable. But it is for them to determine the preferred and prudent approach of meeting project costs in future years, including any decisions in relation to reserves.

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