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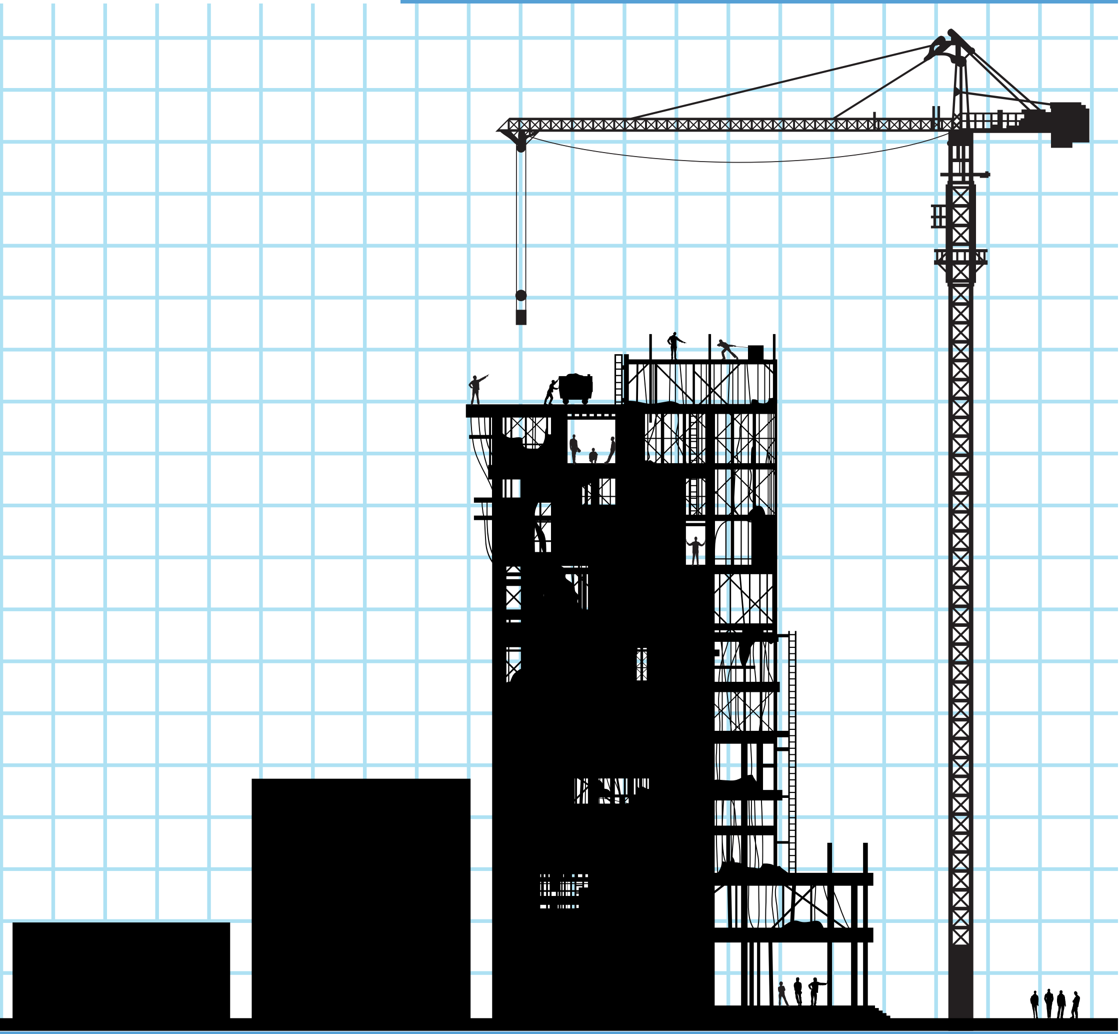
NEW LOCAL GOVERNMENT NETWORK

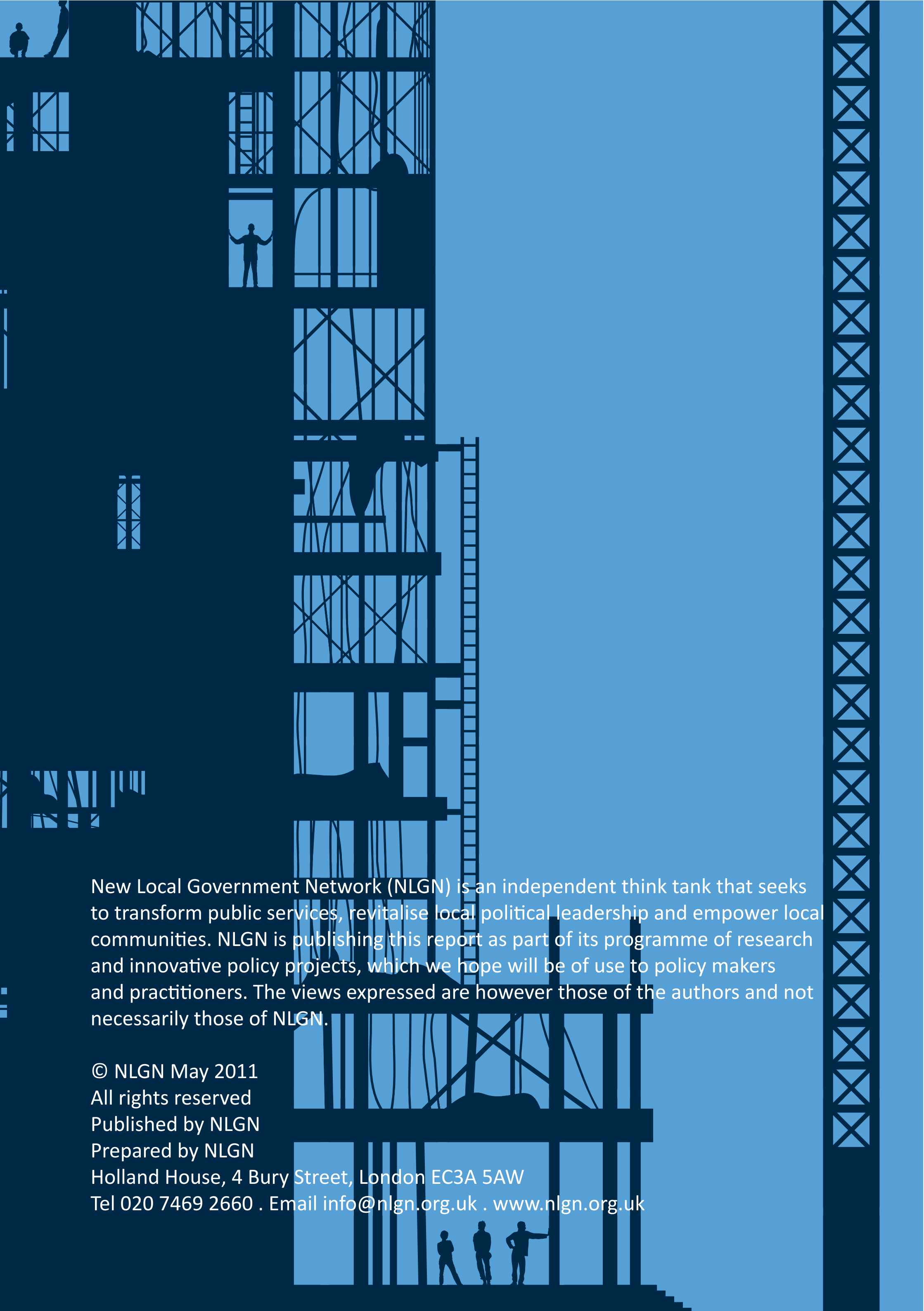


Localist Capital Finance

The challenges ahead

Tom Symons

www.nlgn.org.uk



New Local Government Network (NLGN) is an independent think tank that seeks to transform public services, revitalise local political leadership and empower local communities. NLGN is publishing this report as part of its programme of research and innovative policy projects, which we hope will be of use to policy makers and practitioners. The views expressed are however those of the authors and not necessarily those of NLGN.

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Summary

The economic revival of the British economy has been pinned to the prospects for increasing local growth and a rebalancing of employment and output towards the private sector. This places a new emphasis on the role of local authorities to provide the underlying infrastructure and development needed to facilitate private sector growth, as well as continuing the work of regenerating areas and investing in the social infrastructure needed to make communities prosperous and economically viable. Councils now have the important task of having to lead, co-ordinate and deliver a significant proportion of the new development needed to build a resilient and sustainable economy.

As the context and profile of local capital investment has changed, so to has the funding landscape within which it must be delivered. A combination of pressures has created new tensions and dynamics which will alter the way councils approach capital investment. A broad political shift towards localism will present councils with greater control and new governance frameworks at a local and sub-regional level, crucially without the regional tier present as a co-ordinating force. This shift also brings with it the prospect of more localised revenue streams. At the same time, economic pressures mean that development which was predicated on market growth are no longer applicable. But in their place new financing techniques and models, such as Tax Increment Financing and land auctions, have been given greater hope through the promise of devolution of financial powers and freedoms to local authorities.

Development in an era of low growth will present significant challenges. It is essential that at this moment of transition attention is focussed on how the capital finance landscape can be re-designed for local authorities to best facilitate sustainable and growth generating investment.

A major trend is likely to be that decreases in capital grants and PFI credits will shift the onus towards prudential borrowing as the main artery for development. Following the decision in the CSR 2010 to increase the rate of borrowing at the Public Works Loans Board by 1 percentage point above

the price of gilts – an effective 25% increase in the costs of borrowing for local authorities – the sources of prudential borrowing are set to change. A fundamental question for the local government sector is now to ask how councils can access borrowing from new sources .

An equally important trend will be the redefinition of the local capital finance toolbox. This will entail the creation of new models of investment, and improvements to existing techniques, that can help councils adapt to a new funding climate.

NLGN's major new research project Capital Futures will aim to answer the fundamental questions facing the local government sector and a build a new vision of the mechanics of local capital investment. The research will re-draw the local capital finance landscape, detailing the features of a localist settlement capable of promoting investment in an era of low-growth. It will outline a range of mechanisms for local authorities to use to access investment capital, and the suite of powers local authorities will need to utilise these most effectively. To do this NLGN has launched a task-force, comprised of senior figures from across the local government sector, to consider the range of options available and test the applicability of these.

1 *The challenges ahead: investing to rebalance the economy and promote private sector growth*

"The Government's economic ambition is to create a fairer and more balanced economy, one that is not so dependent on a narrow range of economic sectors, is driven by private sector growth and has new business opportunities that are more evenly balanced across the country and between industries. We will connect people to jobs, help them get the skills they need and equip local areas with the tools they need to create and shape dynamic and entrepreneurial local economies"[1]

Though there has been over a decade of increasing levels of capital spend, it remains a vital task for local authorities, albeit in different ways and for different reasons. The previous decade's major capital programmes all focussed heavily on social infrastructure, addressing historic backlogs in capital works through programmes such as Building Schools for the Future and Decent Homes. Taking aside whether a continuation of such expenditure is needed, the onus has now shifted towards investment that will promote local growth and a rebalancing of the economy towards the private sector.

The 2010 Local Growth white paper and Budget 2011 both made clear the coalition government's intentions for Britain's economic revival.[2] Both argued that to be more sustainable, internationally competitive and resilient there must be a rebalancing of the economy towards the private sector. In line with the coalition's commitment to localism, a significant emphasis has been placed on bottom-up measures that will lead to this local growth, with major national infrastructure schemes implemented to complement these. A number of reforms, such as the planned localisation of business rate growth, local enterprise partnerships, enterprise zones and tax increment financing, are all designed to encourage councils to nurture local growth. The profile of local capital expenditure will inevitable change to reflect this. For instance, the Regional Growth Fund, a partial replacement for Regional Development

1 *BIS Local Growth: realising every place's potential* 2010
2 HMT *The Budget 2011* (2011) p.1

Agencies, has been launched with the primary purpose of creating jobs in the private sector to cushion those lost in the public sector as a result of the government's austerity measures.[3]

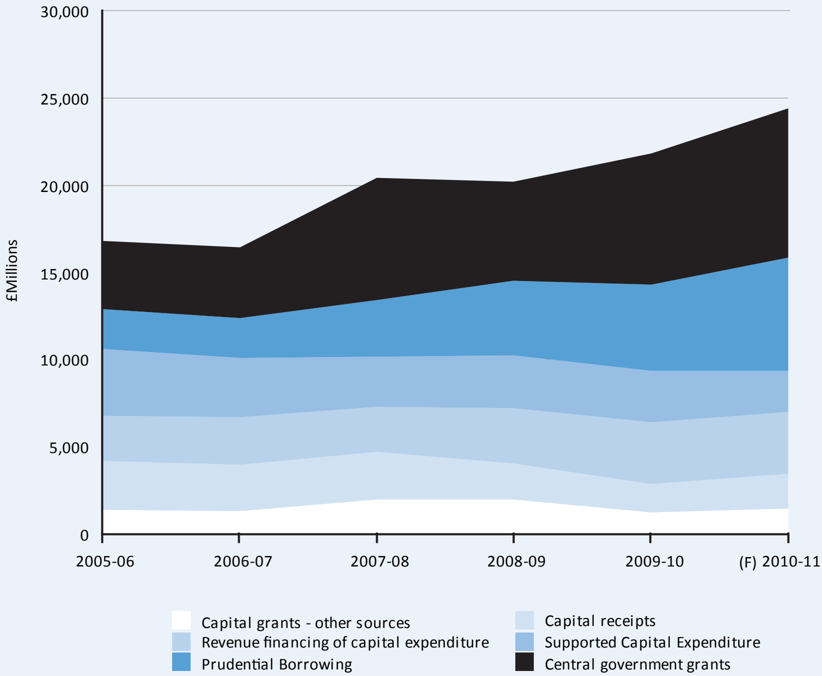
There is now an urgent need for local authorities to invest in capital infrastructure that will support business growth. Succesfully doing so, however, will require the sector to overcome a number of substantial challenges.

Changing sources of local capital finance

The 15 years up until 2010 will be considered a high-water mark for local capital investment. Economic and market growth provided clement conditions for investment, with central government grant, PFI credits, capital receipts and development contributions all at healthy and increasing levels. However, in the past few years substantial political and economic changes have cast doubt on the viability of many of the prevailing sources of capital finance. As a result we are now at a point of transition, between a largely centralised, top-down system predicated on high levels of growth, towards a more localist framework designed to promote growth and which is capable of operating within a much more austere economic period. The table below demonstrates the sources of capital finance up to 2011. It is expected that spending cuts, a period of low growth and adoption of new financing techniques will see the profile of financing sources change markedly.

3 http://www.bis.gov.uk/RGF

Figure 1 Sources of local authority capital expenditure



Challenge 1 *Continuing investment in an era of decreasing funding*

By 2014-15 the Communities and Local Government capital budget is due to reduce by 74% cumulatively in real terms from 2010-11 levels.[4] This represents a reduction from £6.8bn to £2bn. However, the vast majority of capital grant for local authorities in year 2010-11 was from the Department of Education – 71.12% - which is scheduled for a 60% cumulative real terms decrease in capital expenditure. The second biggest source of capital grant for councils was the Department for Transport, scheduled for an 11% reduction in capital expenditure. CLG was the third biggest contributor of capital grant to local government, contributing 10.7% of councils' capital grant. It is not yet clear how the profile of grant allocation from the various central departments that contribute to local authorities will change.

4 HM Treasury Comprehensive Spending Review (2010)

Figure 2 Departmental sources of local government capital grant 2010-11

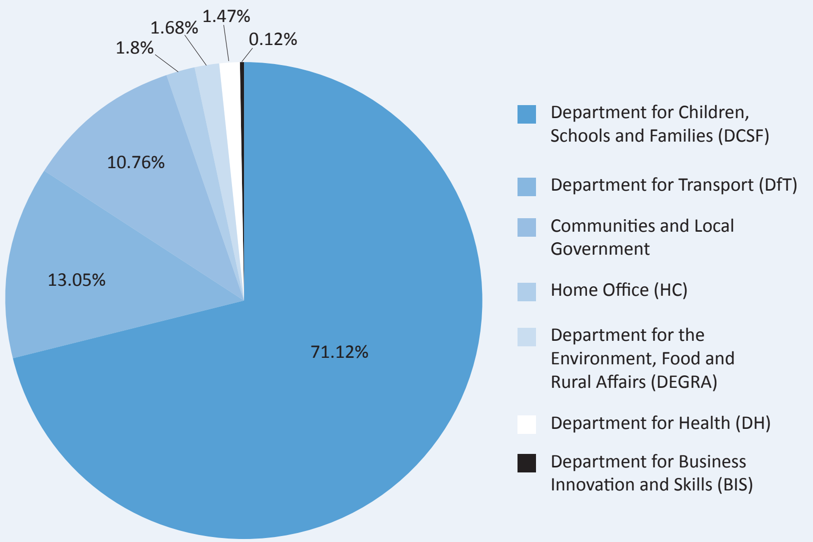
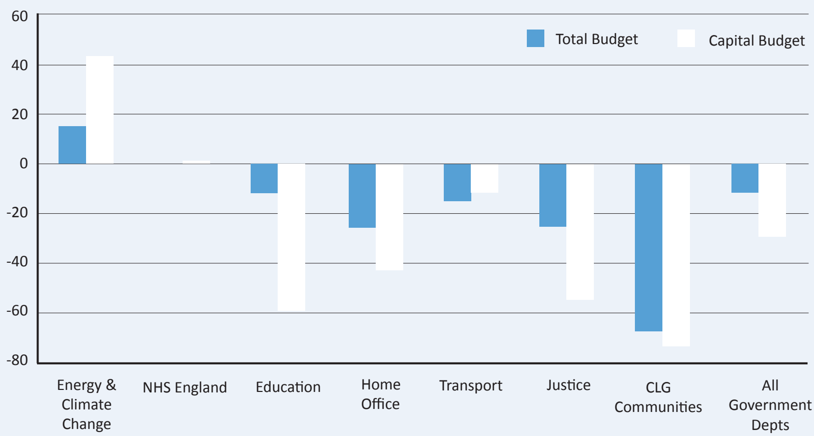


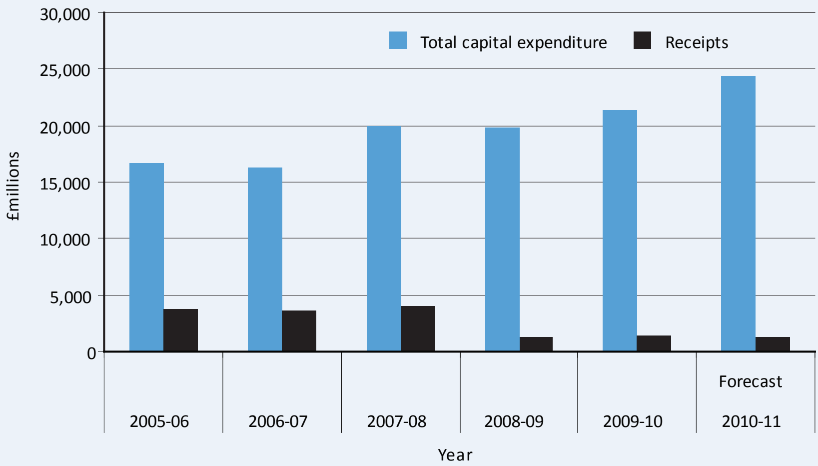
Figure 3 Capital investment 2010-15 by government department - cumulative real world changes



Other sources of capital fianance

Other previously dominant funding streams are also shrinking. When the property market was strong, capital receipts provided local authorities with substantial contributions towards their capital programmes. With low growth forecast over the next 3-4 years it is unlikely that asset sales will play a primary role in financing investment. Currently capital receipts are approximately one third of the level they were in 2007-08.

Figure 4 Declining capital receipts



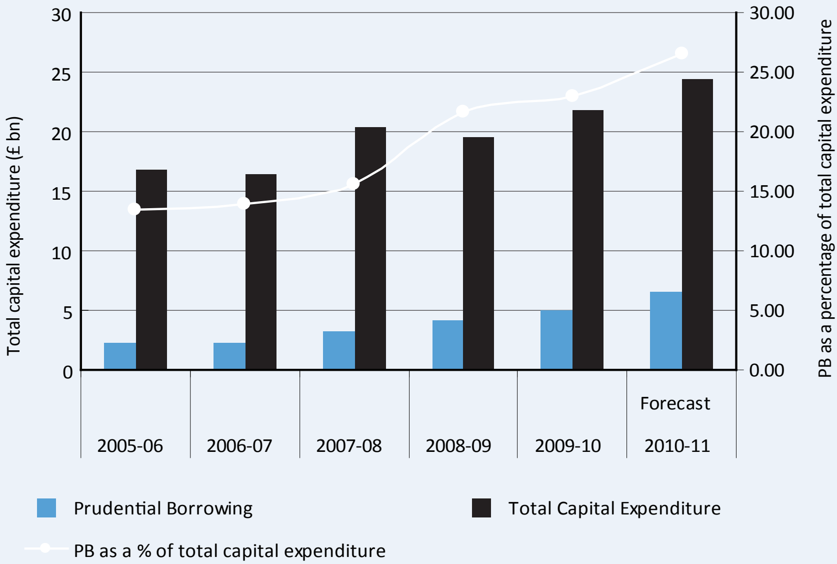
The Coalition has also publicly distanced itself from the PFI and has called for a Treasury Inquiry into the future of the model. Once the schemes currently in the PFI pipeline have been closed, it is not clear what level of PPP-related supported finance there will be from central government, and in which format. It certainly seems unlikely that the model will be used as extensively as before, or will be responsible for such a large proportion of investment.

The broad trend is clear, however. What were previously the largest sources of finance for capital investment are drying up, and local authorities will have to find a means of replacing it if they are to assist in promoting a private sector recovery and meeting the investment demands of their communities.

Challenge 2 *finding new sources of affordable prudential borrowing*

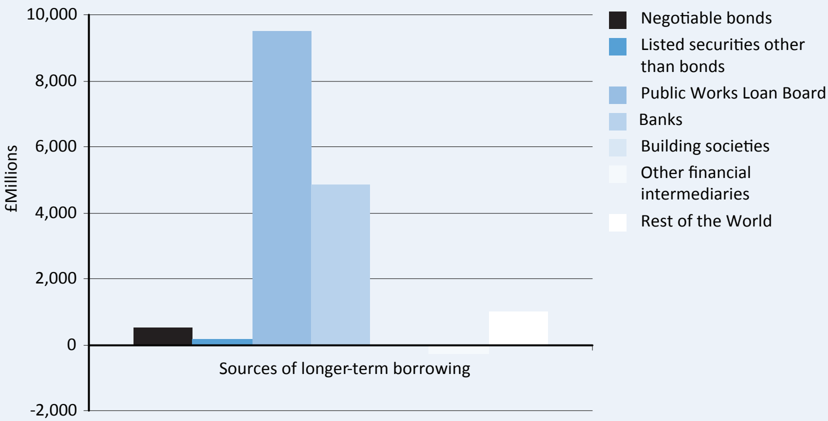
Prudential borrowing powers, introduced by the 2003 Local Government Act, have seen the proportion of local government capital expenditure that is carried out through self-financed borrowing rise from 13.4% in 2005-06 to 26.5% in 2010-11 (forecast).

Figure 5 Prudential borrowing and total capital expenditure



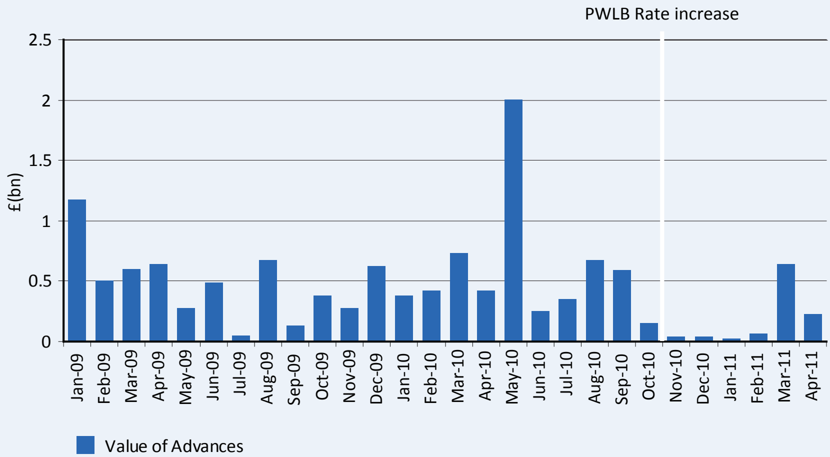
The majority of self-financed borrowing historically has been from the PWLB. Prior to October 2011 the PWLB would on-lend from government gilts at a rate of gilts + 20 basis points.

Figure 6 Sources of local authority long-term borrowing for capital expenditure 2004/5-2008/9



The CSR 2010 increased the rate of borrowing from the PWLB to gilts + 100 basis points, increasing the costs of borrowing for local authorities by approximately 25%. There has been a subsequent reduction in the amount borrowed from the PWLB. Though other factors should not be discounted, this is an indication that local authorities are now borrowing less, and by implication undertaking less capital works, as a result of the interest rate increase.

Figure 7 Borrowing from the PWLB 2009 -2011



With other sources of finance drying up, and new measures introduced to give local authorities access to more revenue streams (business rate growth localisation, TIF), borrowing will be a fundamental part of future local government financing. There will be huge appetite within the sector for this to be done as cheaply as possible, making it vital that local authorities have access to borrowing from a range of new sources and a range of new ways.

Challenge 3 *redesigning the local capital finance landscape*

It is likely that even with sustainable economic growth achieved by 2015, and less straitened times for local authority finances, the governmental approach and sources of local capital finance experienced in the past decade will not return. Returning to the levels of government expenditure witnessed over the past decade would be treated with great scepticism by governments and financial markets alike.

Now is a pivotal moment for the sector to reflect not only on how vital capital investment can be maintained over the next 5 years, but also about how it should be carried out after this Parliament. A strong commitment to localism from central Government provides to the best chance in decades for capital finance to become more locally autonomous. The conditions are right for a permanent and fundamental shift in the ways and means of local capital investment. Local government must begin to define on its own terms how local capital investment should be carried out.

2 *The moment for change in local government finance*

The local government sector must use this moment of opportunity to define its own solutions to these challenges. With a coalition government committed to decentralisation, councils have the freedom to design a new capital finance landscape through a localist lens, arguing for reforms that will lock-in legislatively the powers and techniques that will enable a sustainable and locally autonomous approach to capital investment for generations to come. Particular focus must be paid to the key challenges outlined in the previous section, with pressing questions to answer including:

- new sources of borrowing and the different mechanisms that can be used to obtain this
- building a localist capital finance tool-kit that can embed a sustainable approach to development
- the suite of powers and freedoms local government will need in order to effectively deliver the investment needed to promote growth

Recent developments indicate that the major change in local capital finance will be that the main vector for investment will shift from grant to prudential borrowing. The amount prudentially borrowed has risen steadily since the introduction of the freedom to do so. In addition, ways to enable councils access to new revenue streams are planned through the Local Government Resource Review and the local growth strategy. Such revenue streams will enable further borrowing, albeit necessarily predicated on development that will lead directly to new business growth.

Assess the range of options new borrowing options available to councils

The CSR PWLB interest-rate change means that sources of local government borrowing are now likely to be a lot more varied. A major area of work for the sector will be to understand the various ways in which councils could borrow money at competitive rates for capital investment. England is unusual internationally in its use of the PWLB. It is more common in developed economies for local or municipal authorities to utilise bonds as a way of bringing in new finance for development. Borrowing through a bond issue entails an initial sum being loaned, to be returned at a specified date, and with interest payments made at specified intervals in between. Within the sphere of capital market operations there are three main options for councils to borrow: bond issues, private placements (a bond issued without an initial public offering, typically to a group of private investors) and 'bond clubs' or syndicated bond issuing arrangements (whereby a bond is issued by an intermediary organisation on behalf of one or more member organisations). All are used widely throughout the rest of the world and offer much potential for English local authorities looking for new competitive borrowing rates.

The large variations in size, profile and financial status of England's local authorities, however, suggests that we require a range of viable options for new debt raising mechanisms. We therefore need to have a better understanding of the variety of options there are available for local authorities who wish to find new ways of borrowing for capital investment, or to re-finance existing debt. The largest of local authorities may find most benefit in independent bond issues. For smaller authorities, the scale of their capital investment would preclude this and they would therefore be more suited to a club arrangement, such as the Kommuninvest model that operates in Sweden.

In addition to understanding the variety of approaches that may be needed, we need to examine what the structures of the debt vehicles that can enable this will look like. How could a Kommuninvest-style vehicle be developed in England and how would it relate to councils and capital debt markets? Similarly, how best can individual local authorities access capital markets independently?

Such considerations also require attention to be paid to the capacity of the sector to be accessing capital debt markets and the under-developed relationship that exists between councils and financial institutions. In addition, to get the best deals and manage risk effectively it is possible that councils would benefit from the ability to use derivatives. At present councils are not able to securitise their borrowing by using their assets to underpin debt. However, without the ability to fully develop a capital finance tool-kit the benefits of accessing new sources of debt could be limited. We therefore need to understand what instruments need to be in a local capital finance tool-kit and recommend any legislative changes that are required to facilitate this.

More generally, this is a moment for the sector to redefine the way it approaches capital investment. Though adjusting to lower levels of central government support will be challenging, there is an opportunity to move beyond historic top-down arrangements. A dependence on central government for capital finance can be constraining even in times of increasing grant, through for instance ring-fencing, and can lead to a boom-and-bust scenario, with capital investment only happening when there is economic growth and stopping abruptly during times of austerity.

The reform agenda of the coalition has already paved the way for councils to have much sought-after freedoms to borrow against hypothecated increases in future business rate income through the introduction of tax increment financing. Land auctions, a method for councils to better capture planning gain and produce new revenue streams to finance supporting infrastructure, have also been promised. These represent two ambitious new additions to the local capital finance tool-kit, which will change the way councils approach development. There is scope for local authorities to build on these new techniques, and using the new opportunities presented by more local revenue streams, to develop new financing techniques.

Public-private partnerships have levered in significant amounts of private capital in recent years. As previously noted, there are now fundamental questions about the viability of the favoured incarnation of PPPs – the Private Finance Initiative. Losing the access to such significant amounts of private finance would be negative for hopes to continue investment in an already challenging financial climate. Attention therefore needs to be paid to how the public and private sector can continue to work together in different arrangements that can retain the benefits of partnership in a more flexible and bespoke way. Local asset-backed vehicles and strategic partnering arrangements are examples arrangements councils can enter into with greater freedom than they may have enjoyed with PFI. More work is needed to look into the ways in which the public and private sector can engage in mutually beneficial ways.

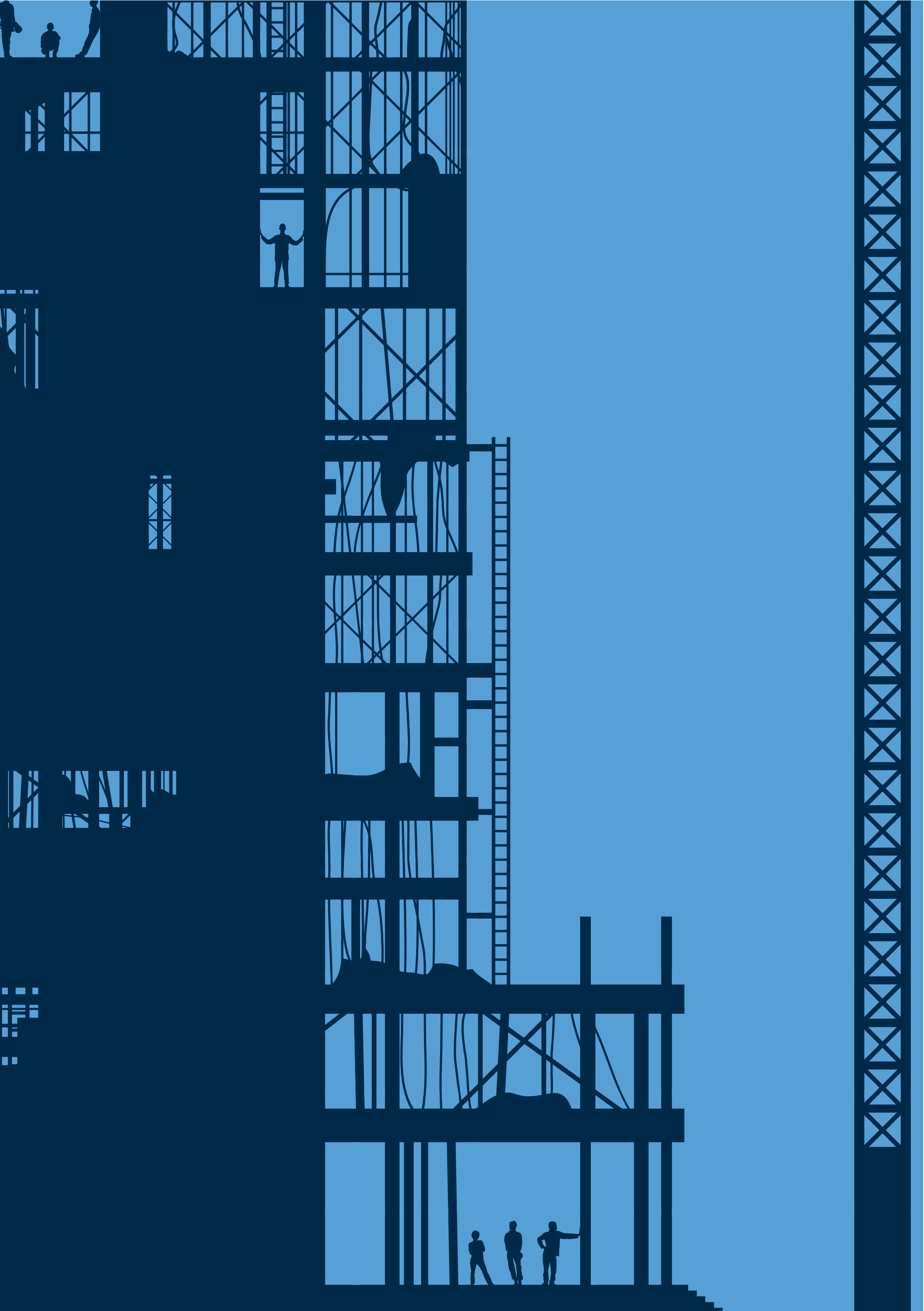
Capital Futures

NLGN's forthcoming research – Capital Futures – seeks to address these pressing issues in local capital finance. The research will be supported by a special task-force assembled to shape the focus of the work, develop the concepts involved and test the rigour of its recommendations. The task-force has representation from a range of key individuals from the local capital finance sector, combining significant experience and expertise in addition to a range of perspectives.[5]

Chair: Paul Woods, Director of Finance, *Newcastle City Council*
Helen Bailey, Chief Executive, *Local Partnerships*
Euan Blair, *Morgan Stanley*
Matt Bowmer, Director of Finance, *Northamptonshire*
Elizabeth Cooper, *Nabarro*
Ged Fitzgerald, Chief Executive, *Liverpool City Council*
Jonathan Hunt, Director of Finance, *Westminster City Council*
Paul Mahony, *Morgan Stanley*
John Mothersole, Chief Executive, *Sheffield City Council*
Alison Scott, Assistant Director of Local Government, *CIPFA*
James Snape, *Nabarro*
Dave Swarbrick, *Balfour Beatty*
Tom Symons, Senior Researcher, NLGN
Nigel Keohane, Head of Research, NLGN

The research is scheduled to be launched in late 2011

5 For details of task-force members see appendix 1



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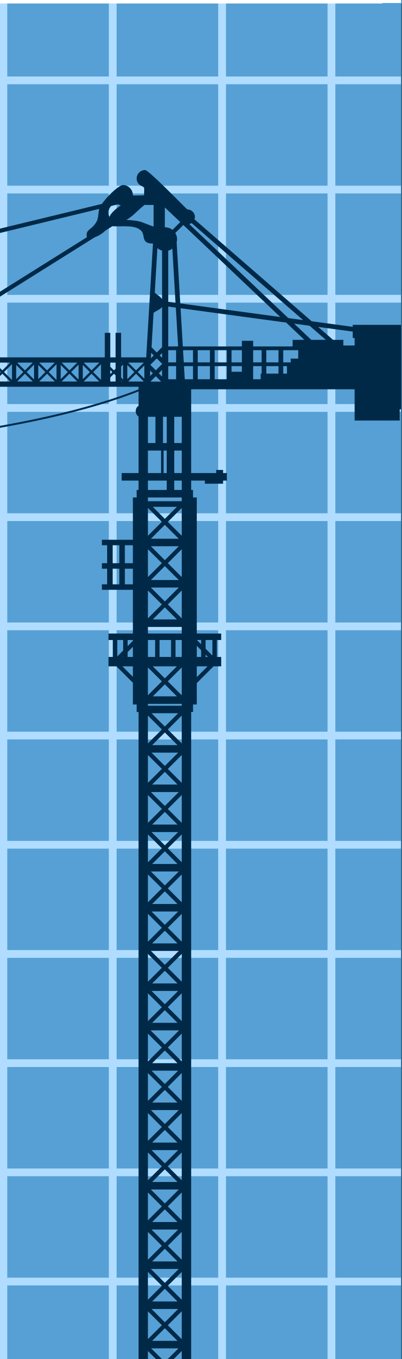

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