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Local government in England: capital finance

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Summary

Local authorities are required to distinguish between capital and revenue finance in their accounting. They can access capital finance for infrastructure investment from a number of sources, but borrowing is the most common of these.

In England, local authorities have normally borrowed from the Public Works Loan Board in recent decades, at favourable rates of interest. There has been recent exploration of alternative sources of borrowing. Following interest from a number of authorities in issuing municipal bonds, the Local Government Association is pressing forward with establishing a joint agency to issue bonds.

The Government has also introduced tax increment financing schemes, founded on the Business Rates Retention Scheme introduced in 2013-14. Under these schemes, local authorities may borrow for infrastructure projects, against the future growth in business rate receipts which will result from the projects.

The note also covers recent debates on the possibility of local authority pension funds investing in local authority infrastructure projects; and on the restrictions on investment using funds from local authorities' Housing Revenue Accounts.

This note covers England only. However, the Public Works Loan Board lends to authorities in England, Scotland and Wales, and the Prudential Code covers England, Scotland and Wales.

1. Capital expenditure

1.1 Local authority capital expenditure: how it works

Local authorities must distinguish between capital expenditure and revenue expenditure in their accounting. 'Capital expenditure' for this purpose is defined, in the *Local Government Act 2003*, as "expenditure of the authority which falls to be capitalised in accordance with proper practices".[1]

The aim of the current capital expenditure regime, introduced in the 2003 Act, was to bring local authority practice into line with 'generally accepted accounting practice' (GAAP). Tony Byrne's guide *Local Government in Britain* states:

> Expenditure for new roads, school buildings, libraries or residential homes is an example of what is called 'capital' expenditure. Such expenditure implies that the object of expenditure has a long life: it is an asset. Such items are usually very expensive: they involve a heavy outlay, and for that reason they tend to be financed largely from borrowed money (and so repaid over a long period).[2]

Central government provides an annual allocation of capital funding alongside the annual distribution of revenue funding in the Local Government Finance Settlement. Alongside this, when local authorities sell capital assets they must place the proceeds in their capital account.

The quantity of expenditure that is required for capital projects means that most local authority capital finance is obtained through borrowing. Authorities may also choose to finance capital projects via their reserves, or through various forms of joint venture with private sector bodies.

1.2 Borrowing under the Prudential Code

Under part 1 chapter 1 of the Local Government Act 2003, a local authority may borrow for any purpose relevant to its functions or for "the prudent management of its financial affairs".[3] The total amount that a local authority may borrow is governed by the requirements of CIPFA's *Prudential Code for Capital Finance in Local Authorities*, and by the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI 2003/3146), as amended. Each authority must set a total borrowing limit for itself in accordance with the principles of the *Prudential Code*. The borrowing limit will be related to the revenue streams available to the local authority, with which it can repay the debt. Authorities are prevented by law from using their property as collateral for loans.[4]

There is some flexibility in exactly how individual local authorities set these limits. The Prudential Code does not prescribe formulae allowing

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1 *Local Government Act 2003* section 16; see also the *Local Government in Scotland Act 2003*
2 Tony Byrne, *Local Government in Britain*, Penguin, 2000, p.336
3 *Local Government Act 2003*, s.1
4 *Local Government Act 2003*, s.13

the exact calculation of prudential limits, relying instead on the judgement of the local authority chief finance officer, and on 'generally accepted accounting practices'.

The Code requires all local authorities to draw up rolling three-year plans for capital expenditure. It covers all capital spending apart from that on housing. This contrasts with the system it replaced, under which individual consents for borrowing were granted by central government, under specific policy heads (e.g. education, housing).[5] Following the introduction of the Code in 2003, prudential borrowing by English local authorities grew as a percentage of total borrowing, from some 13% of local government capital spending in 2005-6 to some 23% in 2009-10.[6] In 2015-16 it was 21%, before rising sharply to 40% in 2017-18.[7]

Local authorities may borrow money from a number of different sources. These include borrowing on the markets; using the Public Works Loan Board; or municipal bonds. However, they cannot breach the overall limits on their borrowing set by the Prudential Code regime. The use of alternative or unfamiliar sources of capital finance, such as Tax Increment Financing (TIF - see section 2.1), or the new Municipal Bonds Agency (see section 3.2), is not a means to increase the total amount that a local authority can borrow. The rationales for choosing between these different sources of borrowing would include the interest rates offered by the lender(s) and the repayment period sought by the local authority.

1.3 Borrowing statistics

Statistics for annual allocations, and for local authority capital receipts, are available on the DCLG website.[8] The DCLG's 2019 statistical release states:

> Capital expenditure for local authorities in England totalled £24.7 billion in 2018-19, £573 million (2%) less than in 2017-18. This is the first time in the last five years that capital expenditure has fallen.
>
> …
>
> Acquisition of land & existing buildings rose for the fifth year. However, at £181 million, the increase in expenditure from 2017-18 to 2018-19 on the acquisition of land & existing buildings was smaller than the increases from 2015-16 to 2016-17 (£1.6 billion) and 2016-17 to 2017-18 (£1.2 billion).[9]

Actual debt held by local authorities is recorded at £104.46 billion at the end of June 2019.[10]

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5 For more detail on this, and a brief history of capital controls over UK local authorities, see Stephen Bailey, Darinka Asenova and John Hood, "The UK's Prudential Borrowing Framework: Professional Discipline and Control", *Local Government Studies 38:2*, 2012, 211-229

6 Richard Carr, *Credit where credit's due*, Localis, 2012, p. 17

7 MHCLG, *Local Government Financial Statistics 2019*, 2019, p.28

8 See the website *Local authority capital expenditure, receipts and financing*.

9 MHCLG, *Local authority capital expenditure and receipts, England: provisional outturn, April 2018 to March 2019 & forecast, April 2019 to March 2020*, 2019, p4

10 MHCLG, *Capital estimates return 2018 to 2019: prudential system information*, June 2019

Statistical releases also record debt held by local authorities; the total of local authorities' operational boundaries; and the total of local authorities' authorised limits, which must be set by the full council:

> At the beginning of 2017/18, local authority external debt stood at £110.1 billion. At the end of 2017/18, local authority external debt stood at £118.3 billion, an increase of 7.4%.
>
> At the beginning of 2017/18, the England total for operational boundaries was £119.1 billion, and that for authorised limits was £134.0 billion. At the end of 2017/18 the England totals for operational boundaries and authorised limits stood at nearly £124.7 billion and £139.0 billion respectively.[11]

1.4 Credit agency ratings

A small number of authorities have obtained credit agency ratings, which would allow them to borrow on the open market:[12]

London Borough of Wandsworth	AA1	Fitch
Guildford Borough Council	AA2	Moody's
Cornwall Council	AA2	Moody's
Lancashire County Council	AA3	Moody's
Woking Borough Council	AA-	Standard & Poor's
Greater London Authority	AA+	Standard & Poor's
Warrington Borough Council	A1	Moody's
Aberdeen City Council	AA2	Moody's

Moody's announced that it had downgraded its four assessments following the UK's vote to leave the European Union on 23 June 2016.[13] Warrington's was subsequently revised upwards.[14]

Additionally, Transport for London has an AA1 rating from Moody's. The Municipal Bonds Agency (see below) will also obtain a credit rating when it begins to issue bonds.

1.5 Capitalisation

In generally accepted accounting practice, capital resources can only be spent on capital expenditure. Local authorities may transfer money earmarked for revenue expenditure into their capital account, but may not transfer money from their capital account into their revenue account without permission from central government. Transferring money from the capital to the revenue account is known as 'capitalisation'.

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11 MHCLG, Local authority capital expenditure and receipts in England: 2017 to 2018 final outturn, Table 6.

12 Richard Carr, *Credit where credit's due*, Localis, 2012, p. 46. Updates have been provided to the ratings based on media reports since 2012.

13 Dan Peters, "Councils have credit rating downgraded after Brexit", *LocalGov*, 1 July 2016

14 See Gavin Hinks, "Outlook for Warrington upgraded by Moody's", *Room 151*, 27 June 2018

Guidance on capitalisation was issued alongside the 2016-20 local government finance settlement. From 2016 to 2019, local authorities will be permitted to use capital receipts for a range of specified revenue spending purposes. Details are available in the March 2016 paper Guidance on the flexible use of capital receipts, which defines 'qualifying expenditure' as:

> expenditure on any project that is designed to generate ongoing revenue savings in the delivery of public services and/or transform service delivery to reduce costs and/or transform service delivery in a way that reduces costs or demand for services in future years for any of the public sector delivery partners. Within this definition, it is for individual local authorities to decide whether or not a project qualifies for the flexibility.[15]

The paper gives examples, including sharing of staff, joint procurement arrangements, joint arrangements regarding the management of public sector land, and establishing alternative models of service delivery. This guidance applies to the end of the 2021-22 financial year.[16]

This guidance replaces earlier guidance issued in 2013.[17] The 2013 guidance made a total of £100 million of capitalisation available in 2013-14. Local authorities in England would have to apply for a share of this capitalisation 'fund', and can then transfer the amount they are 'awarded' into their revenue account from their capital account. Scenarios in which capitalisation has been permitted in recent years include:

- lost interest on investments made in Icelandic Banks;
- consultancy fees;
- publicity and public consultation costs;
- costs of tenants' ballots on proposed large-scale voluntary transfers of housing;
- legal costs arising from contractual disputes;
- development and procurement costs of capital projects and Private Finance Initiative schemes;
- costs of re-engineering administrative processes;
- workforce efficiency training;
- concessionary fares.[18]

1.6 Local authority reserves

Under section 32 of the *Local Government Finance Act 1992,* local authorities are required to maintain an appropriate level of reserve funding. As with prudential borrowing, the judgement as to an appropriate level of reserves lies with local authorities: there is no

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15 DCLG, *Guidance on the flexible use of capital receipts*, 2016, p.7

16 MHCLG, *Guidance on the flexible use of capital receipts*, 2018 (see 'Flexible use of capital receipts direction: local authorities').

17 DCLG, *Capitalisation Returns 2013-14: Policy and Procedures*, July 2013, p. 3-4

18 Ibid., p. 7

formula to arrive at the 'correct' level. The rationales for maintaining reserves can be threefold:

> A working balance to help cushion the impact of uneven cash flows and avoid unnecessary temporary borrowing – this forms part of general reserves;
>
> A contingency to cushion the impact of unexpected events or emergencies – this also forms part of general reserves;
>
> A means of building up funds, often referred to as earmarked reserves, to meet known or predicted requirements, but where the requirements or amounts are not certain enough to create a provision.[19]

In recent years, authorities have increased the quantities of reserves they hold considerably. DCLG statistical releases indicate that overall levels of non-school reserves held have risen from £12,386 million on 1 April 2008 to £22.165 billion on 1 April 2018, having peaked in the interim at £25,188 million on 1 April 2015.[20] The former Secretary of State, Eric Pickles, attacked the levels of reserves held by local authorities during his tenure:

> There are no rules on what councils should hold in reserve and taxpayers will be amazed that while councils are amassing billions in secret stockpiles some are pleading poverty and raising Council Tax bills for hard working families.
>
> Everyone appreciates the need for a financial umbrella for those rainy days but keeping reserves at levels unprecedented in recent years should give local residents pause for thought.[21]

More recent Government statements have been more neutral in tone.[22] The Government publishes statutory guidance on local government investments under powers in the *Local Government Act 2003*, which applies to England only.[23] The latest version, published in 2018, does not address the issue of appropriate levels of reserves.

Reserves are not necessarily large additional sums of money which are freely available to councils. Some 70% of non-schools reserves take the form of 'earmarked reserves': these are held in respect of future commitments, such as repaying loans which have already been taken out, self-insurance, or costs which may arise from legal action. The Audit Commission report *Striking a balance* found that, in a sample of 20 local authorities at 31 March 2012, an average of 83% of reserves held were earmarked.[24] Councillor Claire Kober, on behalf of the LGA, said in September 2015:

> Reserves are designed to help councils manage growing financial risks to local services. Most of this money is essentially a growth fund which councils are using to build new roads and regenerate

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19 CIPFA, *An introductory guide to local government finance*, 2013 edition, pp. 41-2
20 DCLG, *Local Authority Revenue Expenditure and Financing: 2014-15 Final Outturn, England*, 2015, p.12
21 DCLG, "Councils amassing secret stockpiles of taxpayer money says Local Government Secretary", 28 November 2013
22 See DCLG, "Councils have over £22 billion in reserves", 19 November 2015
23 See DCLG, *Guidance on local government investments*, 2018
24 Audit Commission, *Striking a balance: improving councils' decision-making on reserves*, 2012, p. 19

> areas or pay for school places and superfast broadband. What's left would only cover less than a month's spending. The size of cuts councils are having to make are simply too big to be plugged by reserves. Spending them in this way would be a gamble with the future of people who rely on council services and would put local areas on the fast-track to financial failure.[25]

Councils must also include 'unusable reserves' in their accounts: these include entries in respect of depreciation, or future changes to pensions. These are not cash sums and are not available for spending. They are not included in the figures quoted above.

1.7 The Public Works Loan Board

In recent years the majority of loans taken out by local authorities have been supplied by the Public Works Loan Board (PWLB). Since the introduction of prudential borrowing, the PWLB has normally offered the lowest rate of interest available to local authorities. The PWLB is located within the Debt Management Office. It lends to local authorities and other public bodies. Parish councils may borrow from it with DCLG approval.[26]

The Government published a consultation paper in May 2016 proposing the abolition of the Public Works Loan Board and the transfer of its powers to the Commissioners of the Treasury. A motion to approve this change was laid before Parliament in late October 2019. Section 54 of the *Infrastructure Act 2015* confers on the Government the power to abolish the Public Works Loan Commissioners.

During the 2000s, the PWLB tended to offer interest rates only 0.15-0.20% above the Government's borrowing costs, but in October 2010 this differential was raised to 1%.[27] As a result, a number of larger local authorities began to investigate whether a bond issue could achieve a more favourable interest rate (see section 3.2). However, in the 2012 Budget, the Government introduced a discount for borrowing from the PWLB for local authorities which provided information requested on long-term borrowing and capital spending. This took the form of a new 'certainty rate', a discount from 1% to 0.80% over gilts, available from 1 November 2012.[28] A further discount to 0.60% over gilts for borrowing regarding an infrastructure project nominated by a Local Enterprise Partnership was introduced in November 2013.[29] A further discounted rate of 0.40% was introduced in April 2018 for "nominated infrastructure projects that are high value for money".[30] A total of £1 billion of lending will be available at this rate, via a bid-based process.[31]

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25 Claire Kober, quoted in LGA, "'Fast track to financial failure' – Councils warn against using reserves to plug funding gaps", 11 September 2015

26 Further information can be found on the PWLB's website.

27 See James Illman, "Council borrow costs rise 25%" [sic], *Local Government Chronicle*, 22 October 2010

28 See http://www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Concessionary_Rates for further details

29 See details on the PWLB website.

30 Public Works Loan Board, *Concessionary rates*, n.d.

31 See HM Treasury's letter to eligible authorities, published 11 April 2018.

However, on 9 October 2019 the Government announced a decision to *raise* the interest rate on new loans from the PWLB by 1% over gilts over and above existing interest rates. Thus the standard rate is 1.8% above gilts at the time of writing.

The Government's announcement explicitly linked the decision to recent substantial borrowing for commercial investments: "Some local authorities have substantially increased their use of the PWLB in recent months, as the cost of borrowing has fallen to record lows". 2019 had seen a substantial increase in new loans from the PWLB to local authorities.[32] At the same time, the Government increased the cap on the total amount that may be borrowed from the PWLB from £85 billion to £95 billion.

Many local authorities reported that the rate rise would make large-scale regeneration schemes costlier, potentially making them unviable or lengthening the time before they obtained a return on investment. A considerable number are likely to seek alternative sources of finance, with options including private sector lenders and the nascent Municipal Bonds Agency one option (see section 3.2 below).[33] The credit rating agency Moody's said that, whilst the change would drive up costs, it may benefit local authority financial management in the long term:

> The majority of capital expenditure in the sector is on infrastructure which fulfils traditional statutory service requirements, such as housing, highways, street lighting and waste facilities.
>
> We do not expect the sector to cancel or postpone the majority of these projects as they fulfil important statutory duties.
>
> The rate hike will therefore negatively affect the operating performance of local authorities, as interest costs will increase.
>
> We consider commercial property projects to be risky for local authorities, since they are predominantly 100% debt funded and increase their exposure to economic volatility.
>
> However, the increase in the cost of capital may deter the rapid take-up of commercial risk in the sector by reducing their financial viability.[34]

In March 2020, the Government published a consultation document on the PWLB's future lending terms.[35] This consultation proposed a framework to limit access to PWLB lending for local authorities that borrowed funds purely for revenue-raising purposes. It also said that "the Government intends to cut the interest on all new loans from the PWLB, subject to market conditions",[36] once that framework has been established.

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[32] Sarah Calkin, "Scale of 2019 borrowing from PWLB revealed", *Local Government Chronicle*, 11 October 2019

[33] Colin Marrs, "Councils to seek PWLB alternatives to maintain capital programmes", Room 151, 24 October 2019

[34] Colin Marrs, "Moody's: PWLB rate rise 'credit negative' for local authorities", Room 151, 16 October 2019

[35] HM Treasury, *Public Works Loan Board: future lending terms consultation*, 11 March 2020

[36] Ibid., p3

2. New forms of borrowing against local revenue

In recent years a number of alternative borrowing mechanisms have been trialled in the UK, using local revenue streams as a basis for long-term lending. Take-up of each of these mechanisms has been limited. Furthermore, not all of these forms of borrowing are suitable for all capital projects. For instance, the Centre for Cities' 2011 report, *A Taxing Journey*, notes that tax increment financing (TIF) is only likely to be suitable where substantial business rate growth is a realistic prospect.[37] They also note that lack of infrastructure is not a problem faced by some areas with struggling economies, and that TIF therefore may not be an appropriate policy tool in this instance. Similarly, Bailey, Asenova and Hood (2012) note that bond finance is suited to long-term, low risk projects:

> Some project types are better suited for the application of bonds compared to other mechanisms…Projects with long duration, low performance and low technology risks such as hospitals and accommodations attract the bond market. Other more dynamic sections like IT are thought to be less suitable for bond financing. Large capital projects can be financed by a mixture of bank loans, fixed rate or index-linked corporate bonds, sometimes provided with the participation of international project finance banks.[38]

2.1 Tax increment financing

Tax increment financing (TIF) permits local authorities to borrow money for infrastructure projects against the anticipated increase in tax receipts resulting from the infrastructure. Following the 2010 General Election, the Government confirmed its commitment to introducing tax increment financing schemes, in the White Paper *Local growth: realising every place's potential*:

> 3.40 Depending on responses to the proposals outlined above, in particular the retention of locally raised business rates, we anticipate that TIF would, at least initially, be introduced through a bid-based process. Lessons from a set of initial projects will inform future use of the power.[39]

Tax increment financing schemes in England have so far been based on business rate revenues, as this is the only local authority tax the revenues of which are directly affected by infrastructure projects. The DCLG consultation paper, *Local government resource review: proposals for business rates retention*, published on 18 July 2011, included information on the Government's plans for TIF. The Plain English guide to the proposals noted that TIF:

> …will allow councils to pay for future infrastructure developments by allowing them to borrow against projected rate growth. Councils are not currently permitted to retain their rates so cannot

[37] Centre for Cities, *A Taxing Journey*, 2011, p. 4-5

[38] Stephen Bailey, Darinka Asenova and John Hood, "Making widespread use of municipal bonds in Scotland?", *Public Money and Management*, January 2009, p.12

[39] BIS, *Local growth: realising every place's potential*, Cm 7961, October 2010, p. 29

> borrow against them. Rate retention would remove this barrier. The consultation sets out two options. An open structure that lets councils invest and take on the risks alone or one with stronger Government controls that guarantees revenue and disregards the levy or reset processes.[40]

The consultation suggested two options for the implementation of TIF. Both options were based upon borrowing against business rates income, and were linked to the Business Rates Retention Scheme (BRRS): this was introduced as of the 2013-14 financial year.[41]

Under the first TIF option, local authorities would borrow against their income within the Business Rate Retention Scheme. Under the second option, local authorities would be able to borrow against the business rates revenue in specific geographical areas (such as Enterprise Zones) in which they would retain 100% of the growth in revenue. These areas would not be subject to the levy or reset for a defined period of time. The two options involve borrowing against different elements of retained business rate revenue.[42]

2.2 New Development Deals

The second option noted above was initially referred to as 'TIF2' at its announcement in the 2012 Budget; it was rebranded as 'New Development Deals' in July 2012.

The Secretary of State may designate a geographical area which would not be subject to future levies and resets, thereby creating an area (and a stream of revenue) which is outside the Business Rate Retention Scheme.[43] The *Non-Domestic Rating (Designated Areas) Regulations 2013* (SI 2013/107) lists several dozen areas, many of which are Enterprise Zones, in which the local authority will retain 100% of business rates growth for the next 25 years.[44]

Newcastle, Nottingham and Sheffield benefited from New Development Deals within the city deals which they negotiated in 2012:

> Newcastle and Gateshead will benefit from new tax increment financing powers, with all growth in business rate income generated within the four key development sites retained by the two Councils for 25 years. This will allow Newcastle and Gateshead Councils to immediately initiate a £92m investment

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40 DCLG, *Local Government Resource Review: Proposals for Business Rates Retention, A Plain English Guide*, July 2011

41 For details of the Business Rates Retention Scheme, see the Library briefing paper *Reviewing and reforming business rates*.

42 The legislation under which both forms of TIF are implemented is schedule 1, paragraphs 39-41 of the Local Government Finance Act 2012.

43 See Schedule 1 paragraph 39 of the *Local Government Finance Act 2012*.

44 See the Library standard note *Enterprise Zones* (SN/EP/05942) for further details. Further areas were designated in subsequent years: see *Non-Domestic Rating (Designated Areas) Regulations 2014* (SI 2014/98), the *Non-Domestic Rating (Designated Area) Regulations 2015*, (SI 2015/353), the *Non-Domestic Rating (Designated Areas etc.) Regulations 2016* (SI 2016/317), the *Non-Domestic Rating (Designated Areas etc.) Regulations 2017* (SI 2017/318), the *Non-Domestic Rating (Designated Areas etc.) (Amendment) Regulations 2017* (SI 2017/471), the *Non-Domestic Rating (Designated Areas etc.) Regulations 2018* (SI 2018/213),

> programme, creating 2,000 permanent jobs within five years, and 13,000 within 25 years.
>
> Sheffield will receive new powers to fund a £33m city centre regeneration scheme through tax increment financing – a New Development Deal.
>
> The deal will also transform the infrastructure and transport links across the Creative Quarter through a £8m New Development Deal scheme.[45]

The 2012 Budget set a limit of £150 million which could be borrowed via New Development Deals: the funding would only be available to core cities.[46] The Local Government Association suggested that all areas with good business cases should be able to take schemes forward.[47]

The justification for a limit lies in the fact that this approach requires funds to be removed from the Business Rate Retention Scheme. Revenue is redistributed within the scheme to ensure that local authorities with lower revenues can continue to provide services: the more money is removed, the less capacity exists for redistribution within the Scheme. Funds borrowed under TIF would also fall within the overall Public Sector Borrowing Requirement, justifying central government taking an interest in the sums at stake. Nevertheless, some commentators believed the limit could have been higher:

> For example, Edinburgh's TIF plans envisage an £84 million loan serviced by annual revenues of around £7.8 million per annum. If each of England's 56 cities were to launch a TIF project of a similar size – an unrealistic prospect – it would imply a total liability of £4.7 billion, serviced by an annual revenue commitment of £440 million. This would increase public sector debt by less than 0.5 percent and represent just two percent of England's current annual business rates revenues (£20 billion).[48]

2.3 Earn back, gain share and investment funds

The Manchester City Deal, agreed in 2012, included an 'earn-back scheme'. Under this scheme, £1.2 billion would be invested up-front in transport improvements:

> The Earn Back Model uses a formula, linked to changes in rateable values over time at the Greater Manchester level, to provide a revenue stream to Greater Manchester over 30 years if additional GVA is created relative to a baseline. Earn Back provides an additional incentive for Greater Manchester to prioritise local government spending to maximise GVA growth. If successful in driving economic growth, under Earn Back Manchester will receive a larger proportion of resultant tax take generated from this growth than would otherwise be the case under business rate retention.[49]

This was not a tax increment financing scheme: it was a grant scheme that sought to mimic the effect of tax increment financing. Greater

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45 HM Treasury, *Unlocking growth in cities: city deals wave 1*, 2012, pp. 15-19
46 HM Treasury, Budget 2012 announcements, 21 March 2012
47 LGA, *Budget 2012: LGA briefing*, 21 March 2012
48 Centre for Cities, *A Taxing Journey*, 2011, p. 13
49 Greater Manchester Combined Authority, *Greater Manchester City Deal*, 2011, p. 8

Manchester would have received additional grant funding, reflecting local policy contributions to increased revenues across a range of taxes. This approach avoids dependence on a single tax (business rates), but also avoids the need to create complex formal mechanisms to assign revenues between central and local governments.

In 2014, the Manchester 'earn back' scheme was replaced by the investment fund in the first Greater Manchester devolution deal. This followed substantial difficulties in agreeing on the formula to be used to determine revenues for Greater Manchester under the 'earn back' scheme.[50] The operation of the 'earn back' scheme is now set out in the Government's *National Local Growth Assurance Framework*.

[50] See National Audit Office, *Devolving responsibilities to cities in England: Wave 1 City Deals*, HC266 2015-16, 2015, p. 33

3. Local authority bonds

UK local authorities have always had the power to issue bonds. Municipal bonds were used regularly throughout the early and mid-20th century, but fell into disuse during the 1970s and 1980s, as central government introduced controls over capital finance. The Public Works Loan Board became the main source of borrowing during this period.

Bonds allow local authorities to raise substantial sums of capital immediately, to repay it at a specified point in the future. Any authority wishing to issue bonds would need to obtain a credit rating, and would be likely to need to work with a professional agency to handle the sale of the bonds. Cox and Schmuecker, writing in 2013, suggested that a bond issue by a local authority would cost around £50,000.[51]

It would be possible for a local authority to issue bonds as part of a TIF process. Money would be obtained up-front by selling the bonds, and they could be repaid by the additional tax revenues resulting from the public investment. TIF takes this form in many cities in the USA. If the future tax revenues do not materialise and the local authority is thus unable to repay the bonds, this will of course cause financial problems for the local authority. Inability to repay bonds was one of the (many) causes of the high-profile bankruptcy of Detroit City Council in the USA in 2013.

3.1 Recent use of bonds

The Municipal Bonds Agency issued a bond to Lancashire County Council in February 2020 (see below). Prior to this, the following bond issues have taken place in recent years:

- Warrington Council (2015, £150 million, with a 40-year repayment period. The majority of the funding is to be used to redevelop Warrington town centre);[52]
- Aberdeen City Council (2016, £370 million, the funds from which will support redevelopment in the city centre);[53]
- The GLA (2015, £200 million related to the planned extension of the Northern Line; 2011, £600 million for Crossrail). This is the first bond of any kind to be linked to the Consumer Prices Index (CPI);[54]
- Birmingham City Council in 2005 (some £200 million, as part of a refinancing related to the National Exhibition Centre);
- Salford City Council (1994, £100 million);

51 Ed Cox and Katie Schmuecker, *Beyond Banks and Big Government*, IPPR, 2013, p. 7
52 Luke Cross, "Warrington council issues first direct local authority bond in 10 years with CPI-linked deal", *Social Housing*, 26 August 2015
53 Neil Stewart, "Aberdeen's £370m bond journey", *Room 151,* 18 January 2017
54 See "Government bonds: are they about to make a comeback?", *Mindful Money*, 1 September 2011; Richard Johnstone, "CPI-linked bond 'could provide model for local government borrowing'", *Public Finance*, 20 May 2015

- Leicester City Council (1994, £80 million).[55]

3.2 The Municipal Bonds Agency

A UK Municipal Bonds Agency was established in 2016. It is owned by some 56 shareholding local authorities. The LGA had first produced a report proposing to create a collective bond issuing agency in mid-2012.[56] A number of councils expressed interest in joining. This was followed by an outline business case, published in March 2014.

The purpose of the agency is to facilitate the issuing of bonds by smaller local authorities, and to obtain a competitive price for their bonds within the conventional bond market. In particular, it is intended that the agency will offer a lower rate of interest than the Public Works Loan Board in the long term.

56 councils have invested in part ownership of the Agency. The local government finance website *Room 151* reported in August 2019 that the Agency had issued "a tender for a "managed service provider" to develop a new operating model and corporate structure for the agency".[57] The *Municipal Journal* has also reported that the LGA had committed to offering ongoing financial and operational support until 2028.[58]

The Municipal Bonds Agency is open both to shareholder authorities and other authorities. Councils wishing to participate in a bond issue will have to supply sufficient financial information for investors to be able to judge the agency's collective creditworthiness (a 'credit process'). The services of the bonds agency will be paid for via a levy on any bonds issued, of 10 basis points for members and 15 basis points for non-members.[59]

The Municipal Bond Agency issued its first bond in February 2020, a £350 million issuance to Lancashire County Council. Three further pooled bond issues were announced in April 2020, with Westminster City Council and Barnsley Borough Council announced as participants.[60]

Earlier, a report in April 2019 had suggested that a sticking point for councils was the requirement that all councils with an ownership stake in the Agency would be required to be jointly and severally liable for any bonds issued. In other words, if a borrowing council defaulted on its bonds, they could all be held financially liable. This requirement was revised in 2019 so that liability would be proportional rather than joint and several.

[55] Peter Rodgers, "Municipal bond market reopens", *Independent*, 11 January 1994
[56] See LGA, *Establishing a municipal bonds agency*, December 2013. During its development, the Agency was also referred to at times as the 'Local Capital Finance Company'.
[57] Colin Marrs, "Bonds agency seeks outsourced solution to achieve first bond launch", *Room 151*, 8 August 2019
[58] Ibid.
[59] One basis point is equal to 0.01%.
[60] Municipal Bonds Agency, *UKMBA announces participants in pooled bond, plans for short-term lending product*, 30 April 2020

4. Housing finance

Local authorities with retained housing stock became 'self-financing' from April 2012. Within the new system, they could borrow against rental income to finance investment in their existing stock and new housebuilding up to a centrally set limit. Income and expenditure must be recorded in a separate ring-fenced Housing Revenue Account (HRA). This account receives income in the form of rent and service charges; the key item of expenditure is day-to-day management and maintenance of the housing stock.

Up to the end of October 2018 there was a total national cap on HRA borrowing which was initially set at £29.8 billion, representing a tighter limit than would apply if the Prudential Code was applied to councils' borrowing against their Housing Revenue Accounts. This cap restricted the level of housing investment which local authorities could undertake. Authorities argued that they were already subject to the Prudential Code for Capital Finance and could demonstrate a good track record which should be viewed as a sufficient safeguard against imprudent borrowing.[61] Housing commentators estimated that lifting the borrowing cap had potential to release additional investment of £7bn over five years which, in turn, could produce 60,000 homes (12,000 extra per year).[62]

In 2012, the Communities and Local Government Committee concluded that the Government should "consult on proposals to enable local authorities to 'trade', swap and pool borrowing headroom. This should be subject to councils' agreeing that any borrowing under these arrangements will still be in accordance with the Prudential Code".[63] The Government rejected this proposition:

> The Government does not think it is the right time to make changes that would enable individual councils to borrow more for housing than currently allowed under the caps.[64]

A limited increase in local authorities' borrowing caps was announced during the 2013 Autumn Statement (December):

> **The government will increase the funding available for new affordable homes, by increasing local authority Housing Revenue Account borrowing limits by £150 million in 2015-16 and £150 million in 2016-17, allocated on a competitive basis, and from the sale of vacant high-value social housing.** This funding will support around 10,000 new affordable homes and will form part of the Local Growth Fund, available to local authorities who have a proposal agreed by their Local Enterprise Partnership (LEP). This will strengthen the role of the Local Growth Fund in transforming local economies, by providing much-needed

[61] DCLG, summary of responses to the prospectus, *Council housing: a real future,* November 2010, p7

[62] Innovation and Ambition: the impact of self-financing on council housing, ARCH, June 2013,

[63] *Ibid.*, para 96

[64] DCLG, *Government Response to the Communities and Local Government Committee's Report on Financing of New Housing Supply,* Cm 8401, July 2012, para 17

> housing to support growth. The government will prioritise bids on the basis of their value for money, and would expect partnership working with Housing Associations or through Joint Ventures. The government also expects bids to contribute public sector land, and disposal of high-value vacant stock to drive competitive bids. To support this, the government will ensure all councils are transparent in the value and size of their housing assets.[65]

Budget 2017 announced that HRA borrowing caps would be lifted for councils in "areas of high affordability pressure":

> **…the Budget will lift Housing Revenue Account borrowing caps** for councils in areas of high affordability pressure, so they can build more council homes. Local authorities will be invited to bid for increases in their caps from 2019-20, up to a total of £1 billion by the end of 2021-22. The government will monitor how authorities respond to this opportunity, and consider whether any further action is needed.[66]

This was followed by the then Prime Minister announcing, during her speech to the Conservative Party Conference on 3 October 2018, **that borrowing caps would be lifted to support more housebuilding.[67]** The then Chancellor announced the lifting of borrowing caps with effect from 29 October 2018 during the Budget:

> …the Housing Revenue Account cap that controls local authority borrowing for house building will be abolished from 29 October 2018 in England, enabling councils to increase house building to around 10,000 homes per year. The Welsh Government is taking immediate steps to lift the cap in Wales.[68]

The announcement was warmly greeted within the sector. The Resolution Foundation commented on the potential impact:

> The Office for Budget Responsibility (OBR) estimates that councils could complete an additional 20,000 new units by 2023-24 (and we estimate a further 7,000-plus units could be started by this point). Construction on this scale would represent a significant step-change for local authorities: in England and Wales they built a mere 1,900 new homes in 2017-18.[69]

The 2019 UK Housing Review highlighted several unknown factors which may influence the degree to which councils will take advantage of the removal of the borrowing caps, including how much additional capital grant will be required; and councils' appetite for reopening HRAs where they no longer have one.[70]

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65 Cm 8747, 2013 Autumn Statement, December 2013, para 1.228
66 Budget 2017, November 2017, para 5.23
67 Prime Minister's Conference Speech, 3 October 2018
68 HMT, HC 1629, 2018 Budget, para 4.56
69 Resolution Foundation blog, Lifting the lid on the borrowing cap, 31 October 2108
70 Stephens M; Perry J; Williams P; Young G: 2019 UK Housing Review, Chartered Institute of Housing and Heriot Watt University, p62

5. Local authority pension funds

Pension funds invest large quantities of money across the economy. Suggestions have been made in recent years that local government pension funds could assist the progress of local and regional infrastructure projects by being more ready to invest in them directly.

Although the rules of the Local Government Pension Scheme (LGPS) are set nationally, it is administered at local level by administering authorities, whose responsibilities include managing fund investments within the statutory framework. As with the trustees of pension funds in the private sector, the primary responsibilities of administering authorities are to deliver the returns needed to pay scheme members' pensions, and to protect local taxpayers and employers from high pension costs.[71]

In recent years, the Ministry of Housing, Communities and Local Government (MHCLG) has been looking at ways to achieve economies of scale in LGPS funds – with the primary aim of improving returns and reducing deficits, but also to enable greater capacity for investment in infrastructure.[72]

In the summer 2015 Budget, the Government said it would invite local authorities to come forward with proposals to pool investments to reduce costs. It would consult on detailed criteria and backstop legislation to ensure that authorities that did not come forward with "sufficiently ambitious proposals" could be required to pool investments.[73]

In October 2015, MHCLG launched consultation on proposals to revoke and replace the LGPS Investment Regulations for England and Wales. Proposals included the introduction of:

- Safeguards to ensure that guidance on pooling of assets is adhered to;
- Statutory guidance to assist administering authorities prepare for the new Investment Strategy Statements, including guidance on the extent to which non-financial factors should be taken into account when making investment decisions and how these should reflect UK foreign policy.[74]

Criteria published alongside the consultation, made clear the Government's expectation for ambitious proposals for pooling. In addition, it proposed issuing guidance to authorities to the effect that investment policies should not "be used to give effect to municipal foreign or munitions policies that run contrary to Government policy." The Government proposed giving the Secretary of State power to intervene where authorities did not take advantage of benefits of scale or adhere to guidance. Intervention could include: directing an authority

[71] MHCLG consultation, November 2012, para 1.1
[72] MHCLG June 2013 and CLG, May 2014
[73] HM Treasury, Summer Budget 2015, HC 264, para 2.19
[74] MHCLG, Revoking and Replacing the LGPS Management and Investment of Funds Regulations 2009: consultation, September 2015

to develop some or all of its assets in a particular way or requiring the investment functions to be exercised by the Secretary of State.[75]

In Budget 2016, the Government said it had received "ambitious proposals" from LGPS authorities to establish a "small number of British Wealth Funds" by combining assets into larger investment pools. It would work with them to establish a new LGPS infrastructure investment platform.[76]

On 22 January 2018, the Government said it had received proposals from LGPS administering authorities in England and Wales to "consolidate their assets into a small number of pools to take advantage of their scale." It would work with administering authorities to establish a new LGPS infrastructure investment platform to "boost their capacity and capability to invest in infrastructure."[77]

Guidance on preparing and maintaining an investment strategy statement published in September 2016 said that administering authorities "must commit to a suitable pool to achieve benefits of scale."[78] The LGPS Advisory Board issued an updated statement on pool governance in November 2018.

The issues are discussed in more detail in the Library briefing paper Local Government Pension Scheme investments (May 2019).

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75 November 2015 consultation, para 4.7
76 HM Treasury, Budget 2016, HC 901, March 2016, para 1.284
77 PQ 123038, 22 January 2018
78 MHCLG, LGPS: guidance on preparing and maintaining and investment policy statement, September 2016

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