Finance Committee

FIN(4) 07-12 - Paper 2

Devolved Funding: Borrowing Powers and Capital

Evidence from the Local Government Association

Introduction

The Local Government Association (LGA) was formed in 1997 to be the voice of local government on the national stage. Over the past 15 years we have lobbied and campaigned on behalf of local authorities in England and Wales, both in Westminster and in Brussels.

The LGA's mission is to support, promote and improve local government. We work with councils to achieve our shared vision for local government by focusing our efforts where we can have real impact, being bold and ambitious, and supporting councils to make a difference, deliver and be trusted.

Almost all English Local Authorities are members of the LGA and all Welsh Local Authorities are in membership through the Welsh Local Government Association, which has corporate membership of the LGA.

1. Local authorities and prudential borrowing

Prudential Borrowing - overview

On 1 April 2004 the provisions of the Local Government Act 2003 came into force, introducing a new regulatory framework (the Prudential Code) which enabled councils to borrow in sterling for capital expenditure from any source so long as the borrowing is prudent, affordable and sustainable. This replaced a more prescriptive system of credit approvals and borrowing limits specified by central government.

Local Authority use of prudential borrowing

Local authorities have managed the prudential borrowing system with care. Table 1 shows how borrowing by UK local authorities has increased over the past six years.

Table 1: Total UK local authority borrowing 2005-06 to 2010-11[1]							
						£ million	**% Change**
As at 31st March:	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2010-11**
Total borrowing	**58,117**	**61,415**	**65,886**	**66,775**	**67,862**	**70,563**	**4%**

[1] Source: Department for Communities & Local Government http://www.communities.gov.uk/documents/statistics/pdf/2041385.pdf

(£m)							

The level of borrowing can be compared with the value of local authorities' capital assets. As at 31 March 2011, the value of English local authorities' capital assets was £232,776m[2]. Assets held include council houses (£66,928m), schools (£60,240m) and infrastructure assets (£30,779m).

As at 31 March 2011, the overwhelming majority of UK local authorities' borrowing (£69,782m) was long term. £52,701m of outstanding borrowing (76%) was owed to the Public Works Loans Board, with £11,802m owed to banks[3]. The proportion of borrowing owed to the Public Works Loans Board has remained in the 75% - 80% range over the last five years. There has been almost no use of bonds as a source of finance until a recent issue by Transport for London.

The use of prudential borrowing has been both cautious and gradual. While councils have increased the amount of borrowing undertaken since the introduction of the Prudential Code in 2004, this should be seen in the context of a general increase in total levels of capital expenditure and a period of rising budgets. The trend in England is now for reducing capital expenditure. This is partly because funding from central government is set to reduce (both in terms of capital grant and in terms of revenue support for borrowing) and partly because local authorities are themselves reducing funding of capital expenditure. Chart 1 overleaf shows the sources of financing of English local authorities' capital expenditure expressed in real terms at 2010-11 prices.

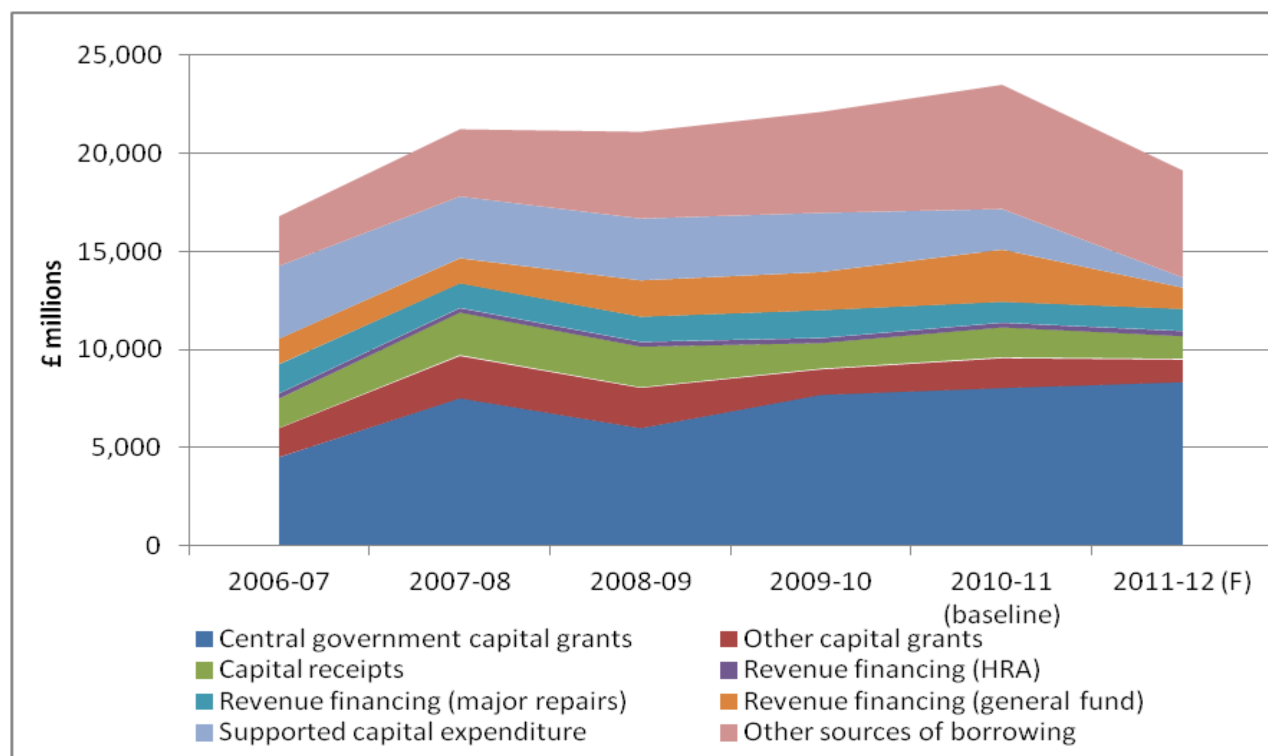
For English local authorities, the use of prudential borrowing increased in real terms between 2006 and 2011. In 2006-07, prudential borrowing was £5,655m, but borrowing rose to £8,399m by 2010-11. However, the proportion of capital expenditure financed by borrowing remained relatively constant at just over one-third[4]. 2011-12 forecasts indicate that borrowing has fallen back sharply in 2011-12.

[2] Source: Department for Communities & Local Government, http://www.communities.gov.uk/documents/statistics/pdf/20132511.pdf Annex E(2)

[3] Source: Department for Communities & Local Government, http://www.communities.gov.uk/documents/statistics/pdf/2041385.pdf, Table 4

[4] Source: Department for Communities & Local Government, http://www.communities.gov.uk/documents/statistics/pdf/20132511.pdf, Table 5

Chart 1: Financing of English local authority capital expenditure, 2006-07 to 2011-12[5]



2. Benefits of the prudential borrowing code

The Code provides a framework enabling authorities to determine their own programmes for capital investment in fixed assets that are central to the delivery of quality public services. The Code supports local strategic planning, local asset management planning and proper option appraisal.

The key benefits of the Code are as follows:

Integration into the corporate planning process – The Code integrates revenue and capital budgeting which were previously driven by separate processes, with the capital elements mainly driven by the government constrained limits on borrowing.

More effective asset management – The enhanced links to the corporate planning process are designed to ensure that a local authority's assets are managed in accordance with their strategic objectives. The Code also allows flexibility in capital financing, for example a local authority may initially finance their capital expenditure from internal resources rather than taking out external borrowing, as demonstrated by external

[5] Source: LGA analysis of DCLG, *Local authority capital expenditure and receipts, England: 2011-12 forecast revision* (Oct 2011), Table 5

borrowings being less than the underlying need to borrow. This enables resources to be used effectively in line with local circumstances.

Prudent medium term financial planning – the Code promotes effective financial planning which considers the range of options for revenue funding and capital investment by:

- Establishing whether the local authority considers it affordable and prudent to bear additional future revenue costs associated with additional investment, ie financing and running costs
- Establishing whether the use of existing or new revenue resources to finance capital investment should have precedent over other competing needs for revenue expenditure
- Establishing the scope for capital investment to generate future revenue savings or income, taking into account the risks associated with such proposals.

More rigorous option appraisal – Given the pressures on revenue resources many local authorities appraise schemes on an "invest to save" basis which allows individual schemes to be appraised.

Governance Arrangements

Local authorities in England and Wales are required to have regard to the Code under Section 3(5) of the Local Government Act 2003.

The Local Government Act 2003 also requires local authorities in England and Wales to determine and keep under review the amount of money that they can afford to borrow for capital investment. In addition the Local Government Finance Act 1992 requires local authorities to set council tax at a level sufficient to meet planned revenue expenditure after taking into account other sources of income. This is known as the "balanced budget requirement". These statutory requirements further ensure that local authorities act prudently and can afford to repay any borrowing undertaken.

The governance arrangements within the Code ensure that decision making is open and transparent, decisions are taken at key times and that there are early warning signs to indicate potential problems. The Code includes a range of Prudential Indicators which are designed to ensure that capital investment plans are prudent, affordable and sustainable. These are monitored and reported on a regular basis and procedures should be put in place for instances where there are likely to be potential breaches in the Indicators.

The Code places specific responsibilities on the Chief Finance Officer (CFO) within a local authority who is responsible for ensuring that all matters that must be taken into account are reported to the budget decision making body for consideration and for establishing procedures to monitor performance.

If a CFO forms the view that the authorised limit on borrowing is about to be exceeded a report must be made to the decision making body that originally set the limit. It will then be for the decision making body, taking into account the advice of the CFO, to determine if it would be prudent to raise the current limit or instigate procedures to ensure that the limit is

not breached. In order to be able to respond to unforeseen and extraordinary events, local authorities in England and Wales may make use of the provision in Section 5 of the Local Government Act, which permits temporary borrowing, but reliance on this section to borrow above the authorised limit should be reported to the next meeting of the body that set the budget for the local authority.

The government has the power to intervene and set an individual borrowing limit for a local authority if, for example, it was considered that the Code was not being followed and that expenditure was being incurred which was unaffordable, imprudent and unsustainable. It is indicative of the success of the Code that these powers have not been used.

The prudential indicators are approved by the same body that approves the budget, reflecting the inherent link between the two processes.

3. Recent Developments

Spending Review 2010 PWLB Increase

The 2010 Spending Review included a decision to increase the rate of interest charged to local authorities by the Public Works Loans Board (PWLB). Historically, rates had been set at gilts +13-20 basis points (1 basis point = 0.01%). The new arrangements are that rates are set at gilts + 100 basis points. The government's stated rationale for this decision was that it wished to impose both a degree of downward pressure on local authority borrowing and tougher discipline, in the context of the difficult spending decisions being made in other parts of the public sector. The result of this decision, and the spending reductions imposed by the Spending Review, has been to reduce significantly the amount of borrowing local authorities are undertaking from the PWLB. Between January 2009 and September 2010 (the month before the rate increase), local authorities across the UK borrowed on average £554m a month from the PWLB. Since October 2010 local authorities across the UK have borrowed on average £228m a month from the PWLB[6]. However, the PWLB remains the main source of borrowing and has continued to fund some 76-77% of total borrowing.

Chart 2 overleaf shows changes in the levels of quarterly loan advances by the PWLB in periods before and after the announcement of the 2010 Spending Review decisions. These figures exclude the exceptional borrowing in March 2012 undertaken to finance the buyout of the Housing Revenue Account.

The Spending Review decision pushed PWLB rates higher than likely market rates for lending to local authorities. In consequence, the LGA has explored the possibility of establishing arrangements that would facilitate its member authorities drawing finance from the bond markets.

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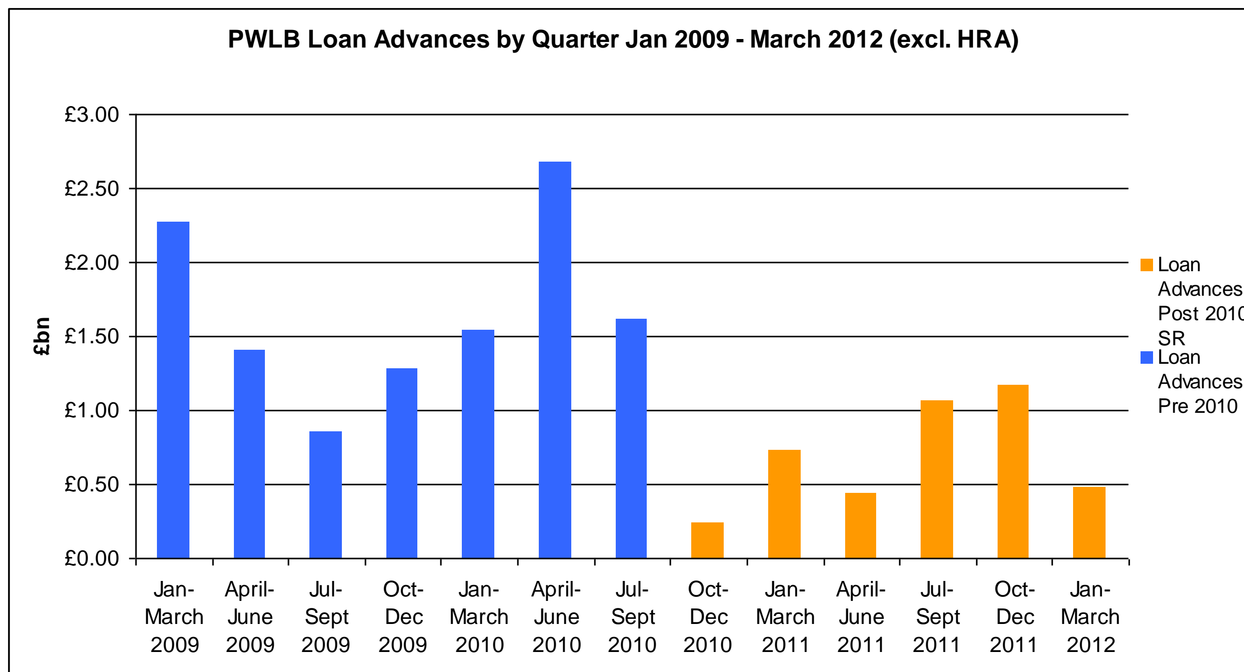
[6] Source: PWLB monthly lending data published at http://www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Monthly_Loans_Report

In its 2012 Budget, the government indicated that it would introduce new arrangements to reduce PWLB rates by 20 basis points in return for increased provision of information by local authorities about their borrowing, and that it would consider possible arrangements for further reductions in rates.

Chart 2 – Quarterly loan advances by the PWLB



The Housing Revenue Account Buy-out

In March 2012 the Housing Revenue Account Subsidy System was reformed, with local authorities taking on the historic debt that was previously financed by central government through national pooling of housing rents. This reform applies in England, but not in Wales. The reform was significant for prudential borrowing for two reasons. Firstly, it involved a series of borrowing transactions of unprecedented scale in local government. In total £13.4bn was borrowed, £12.9bn of it from the PWLB, to finance the transaction. Shortly before the transactions took place, the government announced that rates on borrowing for this purpose only would return to their historic level of gilts +13-20bps. Prior to that announcement a number of councils had been considering accessing Debt Capital Markets to finance the transaction.

The reform of the HRA Subsidy System also has implications for prudential borrowing, as it enables local authorities to borrow against housing rental income for the first time since the creation of the Subsidy System. It is estimated by the Office of Budgetary Responsibility that the reform will create a ‘borrowing headroom’ of £3.5bn over the period 2012-2017. At present it is unclear how much of the borrowing headroom councils will utilise, as some councils may choose to use this to pay down their debt faster.

The Local Government Finance Bill and prudential borrowing

The Local Government Finance Bill 2012 will enable English local authorities to retain a proportion of increases in business rates locally. This reform does not apply to Wales. The current proposals would enable councils to retain this business rates growth up to 10-yearly resets, at which point each authority's baseline would be recalculated. This is significant for prudential borrowing because it opens up the possibility for local authorities to borrow against money to be raised from future business rates income representing the increased business rates income generated by new development.

This kind of borrowing is known as Tax Increment Finance (TIF) and the government envisages that it might happen in one of two ways. The first, TIF1, would be entirely at the discretion of local authorities within the Prudential Code. Councils would be free to borrow against all retained growth for a period of up to 10 years between resets. However, it is understood that many local authorities (and potential lenders) regard a 10 year period as too short to provide the requisite security of revenue. The alternative TIF2 would enable councils to borrow against ring-fenced business rates growth for a period of up to 25 years in a manner regulated by central government. At present the government has allocated £150m to funding TIF2 between 2013 and 2019. The government has also introduced Enterprise Zones, which enable councils to retain all business rates within designated areas for a period of 25 years. This potentially overcomes the barrier to TIF1 schemes for borrowing in these areas. The OBR forecasts that the net impact to the Exchequer of lost business rates income will be £205m between 2012 and 2015.

Local Government Association
May 2012

ANNEX

Case Studies – Councils using prudential borrowing innovatively

Newcastle City Council - Northern Rock Tower

Newcastle City Council used prudential borrowing to purchase the newly built Northern Rock Tower, which was then leased out to a private company on the day of purchase. The aim was to increase jobs by providing a headquarters for a growing local company, providing a boost to the local property market, as well as enhancing the Council's property investment portfolio. The initial rental stream more than covers the financing costs and after future rent reviews the rental income is estimated to be twice that of financing costs, creating a new revenue stream. Without prudential borrowing freedoms, Newcastle would have been unable to provide new office space to a local business and gain a valuable, revenue generating asset.

Northamptonshire County Council Road Maintenance Scheme

In April 2010 Northamptonshire used prudential borrowing to fund a preventative approach roads maintenance. The borrowing has enabled the council to address the short-term pressures of dealing with the increasing numbers of potholes on the network, caused by a deteriorating network and a succession of severe winters. A preventative maintenance strategy can reduce overall costs by up to five times compared with the reconstruction costs required if roads are left to deteriorate. It can also reduce the need for large-scale reconstruction schemes. In order to implement this approach the council required £10m in prudential borrowing to complement £20m of grant funding. As a result of this funding:

- The percentage of permanent & semi-permanent repairs against all repairs has increased by 50 per cent compared to the previous 12 month average
- The initial investment has freed up £1.7m per annum in revenue funding
- The number of customer reports of potholes has fallen by 23 percent - representing 2,579 less reported defects
- Initial figures indicate that the numbers of insurance claims made against the Council originating from poor road surfaces have reduced by 48 per cent on the previous 12 months. This equates to a reduction of 419 claims received