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Local government in England: capital finance

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Contents:

1. Capital expenditure
2. New forms of borrowing against local revenue
3. Local authority bonds
4. Housing finance
5. Private Finance Initiative
6. Local authority pension funds

Contents

Summary		**3**
1.	**Capital expenditure**	**4**
1.1	Local authority capital expenditure: how it works	4
1.2	Borrowing under the Prudential Code	4
1.3	Borrowing statistics	6
1.4	Credit agency ratings	6
1.5	Capitalisation	7
1.6	Local authority reserves	8
1.7	The Public Works Loan Board	9
2.	**New forms of borrowing against local revenue**	**11**
2.1	Tax increment financing	11
2.2	New Development Deals	12
2.3	Earn back, gain share and investment funds	14
3.	**Local authority bonds**	**15**
3.1	Recent use of bonds	15
3.2	The Municipal Bonds Agency	16
4.	**Housing finance**	**17**
5.	**Private Finance Initiative**	**19**
6.	**Local authority pension funds**	**20**

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]

CIPFA's *Councillor's Guide to local authority finance* notes:

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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 key objectives of the Prudential Code developed by CIPFA are to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable. As part of this framework, the Prudential Code sets out the factors that must be used:
>
> These indicators include forecasts of and actual figures for:
>
> - Capital expenditure;
> - Capital financing requirement – a measure that reflects an authority's underlying need to borrow;
> - External debt – gross borrowing and other long-term liabilities;
> - Operational boundary for external debt – based on an authority's working estimate of most likely, ie prudent but not worst-case scenario;
> - Authorised limit for external debt – the intended absolute limit that has to be set by the full council.[5]

There is some flexibility in exactly how individual local authorities set these limits. The Prudential Code does not prescribe formulae allowing 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).[6] 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 finance in 2005-6 to some 23% in 2009-10.[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.

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5 CIPFA, *A Councillor's Guide to local authority finance,* 2009, p.218

6 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

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

1.3 Borrowing statistics

Statistics for annual allocations, and for local authority capital receipts, are available on the DCLG website.[8] The DCLG's 2015 statistical release states:

> Capital expenditure by local authorities in England increased to £21.5 billion in 2014-15 from £19.7 billion in 2013-14, a year-on-year increase of 9.5%. However, it is 20.5% lower than the original forecast of £27.1 billion.
>
> Capital receipts have increased in 2014-15 to £3 billion from £2.7 billion in 2013-14, a year-on-year increase of 12.2%. It is 8.3% higher than the original forecast of £2.8 billion.[9]

The statistical release notes the actual debt held by local authorities. This also includes details of the overall expected limit (the operational boundaries), based on the most likely scenario under prudential behaviour; and the absolute limit on borrowing (the authorised limits), which must be set by the full council:

> At the beginning of 2014-15, local authority external debt stood at £97.6 billion. At the end of 2014-15, local authority external debt stood at £100.4 billion, an increase of 2.9%.
>
> At the beginning of 2014-15, the England total for operational boundaries was £111.8 billion, and that for authorised limits was £128.7 billion. At the end of 2014-15, the England totals for operational boundaries and authorised limits stood at nearly £113.7 billion and £130.9 billion respectively, an increase of 1.7% for both.[10]

DCLG statistics also note the sums coming from each of the various sources of capital finance; and capital finance statistics at local authority level.[11] Initial estimates for 2015-16 are available at the time of writing on the DCLG website.

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	AA1	Moody's
Birmingham City Council	AA1	Standard & Poor's
Cornwall Council	AA1	Moody's
Lancashire County Council	AA2	Moody's
Woking Borough Council	AA-	Standard & Poor's
Greater London Authority	AA+	Standard & Poor's

[8] See the website *Local authority capital expenditure, receipts and financing*.
[9] DCLG, *Statistical Release: Local authority capital expenditure and receipts, England: 2014-15 final outturn*, 2015, p.1
[10] DCLG, *Statistical Release: Local authority capital expenditure and receipts, England: 2014-15 final outturn*, 2015, p.9
[11] See DCLG, *Local authority capital expenditure, receipts and financing*.
[12] Richard Carr, *Credit where credit's due*, Localis, 2012, p. 46

Warrington Borough Council	AA2	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]

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'.

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.[14]

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 2018-19 financial year.

This guidance replaces earlier (more typical) guidance issued in 2013.[15] 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;

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

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

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

- 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.[16]

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 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.[17]

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 £25,188 million on 1 April 2015, of which £4,483 million were non-earmarked.[18] 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.[19]

More recent Government statements have been more neutral in tone.[20] The Government publishes statutory guidance on local government

16 Ibid., p. 7
17 CIPFA, *An introductory guide to local government finance*, 2013 edition, pp. 41-2
18 DCLG, *Local Authority Revenue Expenditure and Financing: 2014-15 Final Outturn, England*, 2015, p.12
19 DCLG, "Councils amassing secret stockpiles of taxpayer money says Local Government Secretary", 28 November 2013
20 See DCLG, "Councils have over £22 billion in reserves", 19 November 2015

investments under powers in the *Local Government Act 2003*, which applies to England only.[21]

Reserves are not necessarily large additional sums of money which are freely available to councils. Some 70% of the £25,188 million figure above takes 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.[22] 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 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.[23]

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.

The National Audit Office reported on the risk levels to local authorities arising from their capital investment strategies in summer 2016.[24] The NAO expressed some concerns at the emergence of far broader commercial investment strategies by local authorities. In particular, many have developed significant commercial property portfolios, the net income from which can be reinvested in local services. This decision reflects the fact that, whilst levels of Government revenue grant to local authorities have fallen by some 25-40% since 2010, capital grant levels have held steady.

1.7 The Public Works Loan Board

In recent years the vast 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.[25]

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21 See DCLG, *Guidance on local government investments*, 2010

22 Audit Commission, *Striking a balance: improving councils' decision-making on reserves*, 2012, p. 19

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

24 NAO, *Financial sustainability of local authorities: capital expenditure and resourcing*, HC234 2016-17, 15 June 2016; see also Public Accounts Committee, *Financial sustainability of local authorities*, HC 708 2016-17, 2016.

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

In recent years, the PWLB has tended to offer an interest rate only 0.15-0.20% above the Government's borrowing costs, but in October 2010 this differential was raised to 1%.[26] 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%, available from 1 November 2012.[27] A further discount to 0.60% for borrowing regarding an infrastructure project nominated by a Local Enterprise Partnership was introduced in November 2013.[28]

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. The consultation will close on 3 August 2016.

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

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

28 See details on the PWLB website.

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.[29] 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.[30]

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 current 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.[31]

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 likely to be 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

29 Centre for Cities, *A Taxing Journey*, 2011, p. 4-5

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

31 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.[32]

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.[33]

Under the BRRS, 50% of business rate income is retained by local government collectively, and redistributed to local authorities on the basis of a formula decided by central government. Local authorities may then retain half of the growth in business rates revenue above their baseline funding level in 2013-14. This will be subject to a levy on authorities with larger business rates taxbases. The system will be 'reset' – i.e. a new baseline will be set – in 2020, to ensure that the disparity between high-growth and low-growth authorities does not grow too large.[34]

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.[35]

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.[36] 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.[37]

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

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

34 Further details can be found in the 2013 DCLG document *Business rates retention and the local government finance settlement: a practitioner's guide*.

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

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

37 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*

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 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.[38]

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.[39] The Local Government Association expressed disappointment that the Government were choosing to restrict tax increment financing in this way, suggesting that all areas with good business cases should be able to take schemes forward.[40]

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).[41]

It is unclear what impact the Government's proposals for local government to retain 100% of business rates by 2020 will have on New Development Deals and existing TIF agreements.

(Designated Area) Regulations 2015, (SI 2015/353), and the *Non-Domestic Rating (Designated Areas etc.) Regulations 2016* (SI 2016/317).

[38] HM Treasury, *Unlocking growth in cities: city deals wave 1*, 2012, pp. 15-19

[39] HM Treasury, Budget 2012 announcements, 21 March 2012

[40] LGA, *Budget 2012: LGA briefing*, 21 March 2012

[41] Centre for Cities, *A Taxing Journey*, 2011, p. 13

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.[42]

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

Many of the devolution deals negotiated between several local areas and the Government from 2014 onwards include a commitment to an 'investment fund', typically of £30 million per year over 30 years (see the Library briefing paper Devolution to local government in England). There are indications that those areas will seek to borrow against the guaranteed income of the investment fund. In 2014, the Manchester 'earn back' scheme was replaced by the investment fund in the first Greater Manchester devolution deal (see below). This followed substantial difficulties in agreeing on the formula to be used to determine revenues for Greater Manchester under the 'earn back' scheme.[43]

The investment fund will be subject to five-yearly assessments: though the terms of these have not yet been agreed, the operating principle is likely to be that the continuation of the fund will depend on evidence that its use has contributed to economic growth. This approach was first used in the Cambridge city deal of July 2014, and was described as a 'gain share' model (though this term has not been used in the devolution deals since).[44]

These investment funds too are not tax increment financing schemes, as there are no local tax revenues involved. They resemble conditional grant schemes, albeit with the 'grant conditions' open to central-local negotiation.

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42 Greater Manchester Combined Authority, *Greater Manchester City Deal*, 2011, p. 8

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

44 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.[45]

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

In August 2015, Warrington Council issued £150 million in bonds, with a 40-year repayment period. The majority of the funding is to be used to redevelop Warrington town centre.[46] The council will seek to repay the bonds via the proceeds from this redevelopment, whether in the form of business rates revenue, or the sale and rental of the properties in question.

Prior to this, the most recent bond issues by local authorities have come from the GLA (£200 million in 2015 related to the planned extension of the Northern Line, and £600 million in 2011 for Crossrail);[47] Birmingham City Council in 2005 (some £200 million, as part of a refinancing related to the National Exhibition Centre); and Salford and Leicester city councils in 1994 (£100 million and £80 million respectively).[48] The 2015 GLA bond is the first bond (of any kind) to be linked to the Consumer Prices Index (CPI): this was sought by the GLA as its repayment plan is closely linked to business rates, the annual rises in which are also linked to the CPI.[49]

[45] Ed Cox and Katie Schmuecker, *Beyond Banks and Big Government*, IPPR, 2013, p. 7
[46] Luke Cross, "Warrington council issues first direct local authority bond in 10 years with CPI-linked deal", *Social Housing*, 26 August 2015
[47] See "Government bonds: are they about to make a comeback?", *Mindful Money*, 1 September 2011
[48] Peter Rodgers, "Municipal bond market reopens", *Independent*, 11 January 1994
[49] Richard Johnstone, "CPI-linked bond 'could provide model for local government borrowing'", *Public Finance*, 20 May 2015

3.2 The Municipal Bonds Agency

As of 2016, a new UK Municipal Bonds Agency has been established. The launch was the culmination of some four years of debate and preparation. It is owned by some 56 shareholding local authorities. 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. This would be achieved by obtaining a good collective credit rating for the agency, based upon the credit ratings of participating councils.

The Municipal Bonds Agency will be 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.[50]

At the time of writing the Municipal Bonds Agency has yet to issue any bonds. The *Municipal Journal* reported in January 2017 that the Agency expected to issue its first bond early in 2017.[51] The Agency's chief executive, Aidan Brady, has said that the agency's first bond would require at least nine councils to borrow a total of £200 million to £300 million.[52] It is anticipated that the first issue will be a medium-term issue.[53]

The LGA first produced a report proposing to create a collective bond issuing agency in mid-2012.[54] A number of councils expressed interest in joining. This was followed by an outline business case, published in March 2014. The initial report also noted that it would be necessary for central government not to oppose the scheme.[55] Local authority borrowing impacts on the Public Sector Borrowing Requirement (PSBR), meaning that the UK Government will have at least a tacit interest in developments in this area.

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50 One basis point is equal to 0.01%.

51 "UKMBA scheduled to issue first bond in 2017", *Municipal Journal*, 26 January 2017, p.9

52 Sarah Calkin, "Bonds agency open for business", *Local Government Chronicle*, 25 January 2016.

53 See UK Municipal Bonds Agency Questions and Answers. A 'medium term' bond would normally mean one lasting 2-10 years.

54 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'.

55 LGA, *Local authority bonds: a local government collective agency*, 2012, p.7

4. Housing finance

Local authorities with retained housing stock became 'self-financing' from April 2012. Within the new system, they may 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.

There is 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 restricts the level of housing investment which local authorities can undertake. Authorities argue that they are already subject to the Prudential Code for Capital Finance and can demonstrate a good track record which should be viewed as a sufficient safeguard against imprudent borrowing.[56] Housing commentators have estimated that lifting the borrowing cap has potential to release additional investment of £7bn over five years which, in turn, could produce 60,000 homes (12,000 extra per year).[57]

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".[58] 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.[59]

As part of the 2013 Autumn Statement (December) the Chancellor announced a limited increase in local authorities' borrowing caps:

> **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 housing to support growth. The government will prioritise bids on

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

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

[58] *Ibid.*, para 96

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

> 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.[60]

A number of local authorities have established companies to build additional housing in their areas. Local authority companies have the same legal status as private sector companies, and thus may enjoy greater flexibility with regard to obtaining finance and choices around building:

> There is ample room for councils to enter the market. They have land, money to invest and local knowledge. They know failure to house workers will impede local employers. They also need a lasting form of income, such as that brought in by rent, as revenue support grant disappears.
>
> The question to ask is: 'Why have 23 housing companies have been set up?' While housing companies will not be appropriate for all, the housing shortage is so acute and the scope for lasting income so tempting that this should be a viable model for many more authorities.[61]

Further information on local authority housing finance can be found in the Library standard note Local housing authorities: the self-financing regime (SN/SP/06776).

60 Cm 8747, 2013 Autumn Statement, December 2013, para 1.228
61 Nick Golding, "Ministers must release housing companies from their shackles", *Local Government Chronicle*, 27 April 2016

5. Private Finance Initiative

Private Finance Initiatives (PFIs) are a form of Public-Private Partnership (PPP), first introduced in 1992. Under a PFI, the private sector will typically design, build, finance and maintain infrastructure facilities under a long-term contract. The public sector body which uses the infrastructure repays the debt over a long period, often 25-30 years.[62] As at 31 March 2015 there were 722 current PFI projects across central, local, and devolved government with a capital value of £57.7 billion.[63]

As PFI contracts allow a local authority to embark on large capital projects with little upfront commitment of resources, it has been a popular option for capital financing in the past. The 1997-2010 Labour government issued 'PFI credits' to local authorities, which were guarantees of funding to help pay for the capital costs of PFI projects. The 2010 Spending Review announced the end of this system.[64]

Since 2010, the number of new PFI projects has fallen sharply. In the years running up until the financial crisis, roughly 50-60 PFI projects were typically agreed per year, across the public sector. In 2014/15, just seven projects were agreed and there were only a handful more in the pipeline in March 2015.[65]

In December 2012, the Government announced the replacement of 'PFI' with 'PF2', which sought to address some of the weaknesses that exist in the old PFI model: for example, through reforms to speed up and reduce the cost of the procurement process. [66] The Infrastructure and Projects Authority has said that it is working with HM Treasury and other departments to identify a pipeline of public sector projects which could be delivered via PF2.[67]

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62 HM Treasury, A new approach to public private partnerships, December 2012

63 HM Treasury, Private Finance Initiative and Private Finance 2 projects: 2015 summary data, March 2016

64 HM Treasury, Public Private Partnerships - Technical Update 2010. Figures for PFI credits can be found in Richard Carr, Credit where credit's due, Localis, 2012, p. 15

65 HM Treasury, Private Finance Initiative and Private Finance 2 projects: 2015 summary data, March 2016

66 The HM Treasury paper 'A new approach to public private partnerships', December 2012, summarises the key differences between PFI and PF2 on page 13

67 Infrastructure and Projects Authority, National Infrastructure Delivery Plan 2016–2021, March 2016

6. 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. For example, the think tank *Localis* produced a report in March 2012 arguing that local authorities should be prepared to see an additional 8.5% of LGPS monies invested in domestic infrastructure.[68] And in September 2012, the Smith Institute produced a report looking at how local authority pension funds could do more to "invest for wider economic and social benefit."[69]

The primary responsibilities of Local Government Pension Scheme (LGPS) administering authorities regarding investments are to deliver the returns needed to pay scheme members' pensions, and to protect local taxpayers and employers from high pension costs.[70] Thus pension funds do not represent large additional sources of capital expenditure that could be made freely available to local government.

In 2013, the Department for Communities and Local Government (CLG) consulted on possible changes to the structure of local authority pension funds in England and Wales, with the main aims of dealing with deficits and improving investment returns.[71] In May 2014, it announced that it had decided to consult further on proposals to establish "common investment vehicles."[72]

In October 2015, the Chancellor of the Exchequer announced an intention to work with councils to create half a dozen British Wealth Funds able to invest in infrastructure.[73] Authorities were asked to develop proposals for pooling assets.[74] Drawing on discussions with local government and the fund management industry over the summer, the Government prepared criteria against which the authorities' proposals for pooling would be assessed.

A consultation on proposals to revoke and replace the LGPS Investment Regulations proposed measures to ensure that "guidance on pooling of assets is adhered to". This included granting the Secretary of State a

68 Credit Where Credit's Due – Investing in local infrastructure to get Britain growing, Localis, March 2012
69 Smith Institute, Local authority pension funds: investing for growth, September 2012
70 CLG, Local Government Pension Scheme: Investment in Partnerships – consultation, November 2012
71 CLG, Call for evidence on the future structure of the Local Government Pension Scheme, June 2013
72 CLG, Call for evidence on the future structure of the Local Government Pension Scheme - Government response to the call for evidence, May 2014, para 2.29; LGPS, Opportunities for collaboration, costs savings and efficiencies, May 2014
73 George Osborne's speech to Conservative Party Conference 5 October 2015
74 CLG, Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies. Consultation response, November 2015

power of intervention."[75] A petition calling for a debate on the regulations has over 83,000 signatures.[76]

A group of local authorities published Findings of Project Pool in February 2016. This looked at how asset pooling could work and argued that improve access to infrastructure was most likely to be achieved through the establishment of a national infrastructure investment platform for local authorities.[77]

At the 2016 Budget, the Government announced that it would work with LGPS authorities to establish a new "Local Government Pension Scheme infrastructure investment platform" in line with their proposals.[78]

In May 2016, in response to a question about how to ensure that LGPS funds were safeguarded in the event of an infrastructure project failing, Local Government Minister Marcus Jones said:

> Local government pension scheme benefits are set out in statute and are not linked to the investment performance of funds. However, those responsible for investment decisions should have regard to the need to achieve an appropriate balance between risk and return and act in the best interests of scheme members and local taxpayers.[79]

The issues are discussed in more detail in the Library briefing paper *Local Government Pension Scheme investments*.

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75 CLG, Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 Consultation, November 2015

76 Petition – Debate in the House the Local Government Pension Scheme Investment Regulations

77 See also, 'Set up infrastructure investment platform for LGPS, say councils', *Public Finance*, 25 January 2016

78 HM Treasury, Budget 2016, HC 901, March 2016, para 1.284

79 PQ 37032, 24 May 2016

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