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# Local government in England: capital finance

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# Contents

# 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. Alternative sources of borrowing have been explored in the 2010s and early 2020s. The Local Government Association established the Municipal Bonds Agency in 2016 to provide an alternative to the Public Works Loan Board.

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 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: 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

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

Capital Finance in Local Authorities; and by the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI 2003/3146), as amended. The Code was most recently published in 2021.

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] The Code applies to local authorities throughout the UK.

There is some flexibility in exactly how individual local authorities set these limits. The Prudential Code does not prescribe formulae for the exact calculation of prudential limits, so it is not possible to say definitively that an authority has calculated its limits correctly or incorrectly. The Code permits the authority to rely 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 local authority 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] and 43% by 2020-21.[8]

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.

CIPFA consulted on the 2021 edition of the code in advance of publication. A response to the consultation, published in June 2021, stated that CIPFA intended to introduce a new statement that "Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed. Therefore, local authorities must not

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4 Local Government Act 2003, s.13

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 MHCLG, Local Government Financial Statistics England no. 31, July 2021, p33

borrow to fund solely yield-generating investments".[9] This relates to controversy around local authorities borrowing to invest in commercial property in the late 2010s (see the Library briefing Local government: commercial property investments).

## 1.3 Borrowing statistics

Statistics for annual allocations, and for local authority capital receipts, are available on the DCLG website.[10] The DCLG's 2021 statistical release stated that total capital expenditure in 2019/20 amounted to £26.4 billion. The total in 2018/19 was £26.8 billion, and in 2017/18 £26.3 billion.

The MHCLG statistics also include figures for local authority capital spending on "acquisition of land and buildings". This rose from £1.286 billion in 2015/16 to £4.224 billion in 2017/18, before falling to £2.027 billion in 2021/22.[11] These figures can be viewed as a loose proxy for the increased spending on commercial property in the late 2010s. The most recent annual figures suggest that that spend is no longer increasing substantially.

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. These too have risen in recent years. In 2017/18, the total for operational boundaries was £119.1 billion, and that for authorised limits was £134.0 billion. For 2022/23, the figures were £161.2 billion and £177.6 billion respectively.[12]

## 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. Media reports occasionally note revisions to these ratings in response to economic conditions:

| | | |
|---|---|---|
| London Borough of Wandsworth | AA1 | Fitch |
| Guildford Borough Council | AA3 | Moody's |
| Cornwall Council | AA2 | Moody's |

9 CIPFA, The Prudential Code for Capital Finance in Local Authorities: Consultation response and proposed changes, 2021, p3. See also Gavin Hinks, "Code revision will end 'intentional misrepresentation'", Room 151, 28 Jul 2021

10 DLUHC, Local authority capital expenditure, receipts and financing

11 DLUHC, Local authority capital expenditure and receipts in England: 2021 to 2022 final outturn, 10 Nov 2022

12 MHCLG, Local authority capital expenditure and receipts in England: 2021 to 2022 final outturn, table 6

| | | |
|---|---|---|
| Lancashire County Council | Baa1 | Moody's |
| Woking Borough Council | AA- | Standard & Poor's |
| Greater London Authority | AA+ | Standard & Poor's |
| Warrington Borough Council | A2 | Moody's |
| Aberdeen City Council | A1 | Moody's |

Additionally, Transport for London has an A3/Prime 2 rating from Moody's as of June 2021.

## 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'.

The Government issues statutory guidance setting out circumstances when capitalisation is permitted (see section 15 (1) of the Local Government Act 2003). The latest guidance was issued on 2 August 2022. It gives permission for capitalisation for public service transformation purposes, for:

> 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.[13]

The guidance gives a number of examples of 'qualifying expenditure'. It makes a new provision that capital receipts from a disposal by a local authority where the authority retains an interest in the asset cannot be capitalised.

This guidance replaces previous editions published in March 2016 and July 2013.[14] The 2013 guidance made a total of £100 million of capitalisation available in 2013-14. Local authorities in England had to apply for a share of this capitalisation 'fund', and could then transfer the amount they are 'awarded' into their revenue account from their capital account.

Separately, the Government made bilateral capitalisation agreements, in the early months of 2021, with a number of authorities suffering from financial difficulties in the wake of the Covid-19 pandemic.[15] These agreements

13 DLUHC, Guidance on the flexible use of capital receipts, 2 Aug 2022, paragraph 4.1
14 DLUHC, Guidance on flexible use of capital receipts, March 2016; DCLG, Capitalisation Returns 2013-14: Policy and Procedures, July 2013, p. 3-4
15 MHCLG, Exceptional financial support for local authorities, 7 April 2021

included provisions for external assurance reviews of the local authority's spending, applied a higher interest rate to future PWLB loans (see section 1.7 below), and determined how the authority should make its minimum revenue provision in its accounts.

## 1.6 Local authority reserves

Section 31A of the Local Government Finance Act 1992 requires local authorities 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.[16]

Reserves held by authorities increased through the 2010s, before falling back by 2020. Statistical releases indicate that English local authorities' non-school reserves rose from £12.38bn on 1 April 2008 to £27.61bn on 1 April 2015, falling back to £24.7bn in 2020.[17] 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.[18]

Government statements later in the 2010s were more neutral in tone.[19] The Government publishes statutory guidance on local government investments under powers in the Local Government Act 2003, which applies to England only.[20] The latest version, published in 2018, does not address the issue of appropriate levels of reserves.

16 CIPFA, An introductory guide to local government finance, 2013 edition, pp. 41-2

17 DCLG, Local Authority Revenue Expenditure and Financing: 2014-15 Final Outturn, England, 2015, p.12; MHCLG, Local Government Financial Statistics England no. 31, July 2021, p27

18 DCLG, "Councils amassing secret stockpiles of taxpayer money says Local Government Secretary", 28 November 2013

19 See DCLG, "Councils have over £22 billion in reserves", 19 November 2015

20 See DCLG, Guidance on local government investments, 2018

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.[21] 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.[22]

Local authority reserves have come under particular pressure during the Covid-19 pandemic in 2020 and 2021. The NAO's 2021 report Local government finance in the pandemic said:

> 26% of respondents from single tier and county councils indicated that as of late December 2020 their forecast year-end position, ahead of any further action, was a "material overspend". Most of these respondents (81%) said they planned to apply their reserves to their overspend. Overall, 46% of survey respondents from single tier and county councils said that they had already used reserves this year, or planned to, to address COVID-19 pressures.[23]

The then MHCLG (now DLUHC) established a review of local authority finance data collection in mid-2021. In a response to the Public Accounts Committee in September 2021, MHCLG said:

> "…collecting more detailed information on local authority reserves levels will increase understanding and transparency around reserves. This will improve understanding of local authority reserves levels both within government and for the wider public. The department's Local authority COVID-19 financial impact monthly monitoring includes questions on reserves, which are useful but do not go through as much validation as official statistics so are less reliable.
>
> The department intends to make changes to the Local Authority Revenue Expenditure and Financing collections to require more detailed information from local authorities on the different types of earmarked reserves that they hold."[24]

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

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

23 NAO, Local government finance in the pandemic, HC-1240 2019-21, 10 Mar 2021, p10

24 MHCLG, Response to fourth report of Public Accounts Committee, HC-239 2021-22, 2 Sep 2021, p15

MHCLG committed, in this response, to write to the Public Accounts Committee with further details in October 2021.

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

The majority of local authority borrowing is sourced from the Public Works Loan Board (PWLB). For instance, of total borrowing of just over £131 billion in March 2022, £90.6 billion came from the PWLB.[25] 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, within the Treasury. 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 PWLB and the transfer of its powers to the Commissioners of the Treasury. This change was implemented by regulations in February 2020.[27] It made no change to the day-to-day functioning of the PWLB.

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%.[28] 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). 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.[29] 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.[30] A further discounted rate of 0.40% was introduced in April 2018 for “nominated infrastructure projects that are high value for money”.[31] A total of £1 billion of lending will be available at this rate, via a bid-based process.[32]

25 DLUHC, Live tables on local government finance, Borrowing and investment live table Q2 2022, 14 Nov 2022
26 Further information can be found on the PWLB’s website.
27 See the Public Bodies (Abolition of Public Works Loan Commissioners) Order 2020 (SI 2020/176)
28 See James Illman, “Council borrow costs rise 25%” [sic], Local Government Chronicle, 22 October 2010
29 See Public Works Loan Board, Concessionary Rates, for further details
30 See details on the PWLB website.
31 Public Works Loan Board, Concessionary rates, n.d.
32 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. 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.[33] At the same time, the Government increased the cap on the total amount that could 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.[34] 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.[35]

In March 2020, the Government published a consultation document on the PWLB's future lending terms.[36] 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",[37] once that framework was established. This took place at the November 2020 Spending Review, which reversed the 1% rise in interest rates of 2019. This

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

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

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

36 HM Treasury, Public Works Loan Board: future lending terms consultation, 11 March 2020

37 As above., p3

was accompanied by new requirements on authorities borrowing from the PWLB to confirm that they have no plans to buy assets primarily for yield.[38]

[38] HM Treasury, PWLB: Guidance for Applicants [PDF], May 2022; Public Works Loan Board: future lending terms – responses to consultation, November 2020, p4

# 2 New forms of borrowing against local revenue

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.[39] 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.[40]

## 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:

> 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.[41]

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

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

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

41 BIS, Local growth: realising every place's potential, Cm 7961, October 2010, p. 29

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 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.[42]

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), which was introduced in 2013-14.[43]

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.[44]

TIF has not featured in Government documentation in the late 2010s and early 2020s. It was referenced briefly in the 2020 Freeports bidding prospectus. Some of the funding for the extension of the Northern Line, on the London Underground, to Battersea and Nine Elms came from a TIF structure. The Scottish Futures Trust manages a number of TIF schemes, in locations including North Lanarkshire, Leith, Glasgow, Oban, Falkirk and Fife.

## 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.[45] The Non-

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

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

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

45 See Schedule 1 paragraph 39 of the Local Government Finance Act 2012; also the Library briefing paper Reviewing and reforming local government finance for an account of the Business Rate Retention Scheme.

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.[46]

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.[47]

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.[48] The Local Government Association suggested that all areas with good business cases should be able to take schemes forward.[49]

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

46 See the Library briefing 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),

47 HM Treasury, Unlocking growth in cities: city deals wave 1, 2012, pp. 15-19

48 HM Treasury, Budget 2012 announcements, 21 March 2012

49 LGA, Budget 2012: LGA briefing, 21 March 2012

> than 0.5 percent and represent just two percent of England's current annual business rates revenues (£20 billion).[50]

## 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 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.[51]

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.

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.[52] The operation of the 'earn back' scheme is now set out in the Government's National Local Growth Assurance Framework.

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50 Centre for Cities, A Taxing Journey, 2011, p. 13

51 Greater Manchester Combined Authority, Greater Manchester City Deal, 2011, p. 8

52 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 local authority borrowing during this period. Capital finance controls were replaced by the introduction of the prudential borrowing system in the Local Government Act 2003.

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 for the IPPR in 2013, suggested that a bond issue by a local authority would cost around £50,000.[53]

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, and a further one in August 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);[54]
- Aberdeen City Council (2016, £370 million, the funds from which will support redevelopment in the city centre);[55]

[53] Ed Cox and Katie Schmuecker, Beyond Banks and Big Government, IPPR, 2013, p. 7

[54] Luke Cross, "Warrington council issues first direct local authority bond in 10 years with CPI-linked deal", Social Housing, 26 August 2015

[55] Neil Stewart, "Aberdeen's £370m bond journey", *Room 151,* 18 January 2017

- The GLA (2015, £200 million related to the planned extension of the Northern Line; 2011, £600 million for Crossrail). This was the first bond of any kind to be linked to the Consumer Prices Index (CPI);[56]
- 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);
- Leicester City Council (1994, £80 million).[57]

## 3.2 The Municipal Bonds Agency

A UK Municipal Bonds Agency (MBA) 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.[58] 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 MBA (though any authority may borrow from it). The local government finance website Room 151 reported in August 2019 that the MBA had issued "a tender for a "managed service provider" to develop a new operating model and corporate structure for the agency".[59] The Municipal Journal has also reported that the LGA had committed to offering ongoing financial and operational support to the MBA until 2028.[60]

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.[61]

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56 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

57 Peter Rodgers, "Municipal bond market reopens", Independent, 11 January 1994

58 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'.

59 Colin Marrs, "Bonds agency seeks outsourced solution to achieve first bond launch", *Room 151*, 8 August 2019

60 As above

61 One basis point is equal to 0.01%.

The Municipal Bond Agency issued its first two bonds in 2020, both to Lancashire County Council, of £350m and £250m. An announcement of pooled bond issues in April 2020, with Westminster City Council and Barnsley Borough Council announced as participants, had not progressed as of September 2021.[62] This was followed by the announcement of a forthcoming bond issue to the North London Waste Authority in February 2022, valued between £250 and £400 million.[63]

A report from the Local Government Chronicle in August 2021, including an interview with Sir Merrick Cockell, chair of the MBA, suggested that "a viable long-term business model would involve issuing four bonds worth about £250m each a year".[64]

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.

62 Municipal Bonds Agency, UKMBA announces participants in pooled bond, plans for short-term lending product, 30 April 2020
63 Mike Thatcher, "Waste authority to issue green bond through MBA", Room 151, 2 Feb 2022
64 Jonathan Knott, "Cockell: Municipal Bonds Agency has never been busier", Local Government Chronicle, 9 Aug 2021

# 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 house-building 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 main 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 for capital finance 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 they were already subject to the Prudential Code and could demonstrate a good track record which should be viewed as a sufficient safeguard against imprudent borrowing.[65] 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).[66]

In 2012, the Communities and Local Government Committee concluded 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".[67] 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.[68]

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

65 DCLG, summary of responses to the prospectus, Council housing: a real future, November 2010, p7
66 Innovation and Ambition: the impact of self-financing on council housing, ARCH, June 2013,
67 As above, para 96
68 DCLG, Government Response to the Communities and Local Government Committee's Report on Financing of New Housing Supply, Cm 8401, July 2012, para 17

> 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 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.[69]

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.[70]

This was followed by the then Prime Minister, Theresa May, announcing that borrowing caps would be lifted to support more housebuilding.[71] The then Chancellor confirmed 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.[72]

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.[73]

The 2019 UK Housing Review highlighted several factors which could influence the degree to which councils would take advantage of the removal of the borrowing caps, including how much additional capital grant would be required, and councils' appetite for reopening HRAs where they no longer have one.[74]

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[69] Cm 8747, 2013 Autumn Statement, December 2013, para 1.228

[70] Budget 2017, November 2017, para 5.23

[71] Prime Minister's Conference Speech, 3 October 2018

[72] HMT, HC 1629, 2018 Budget, para 4.56

[73] Resolution Foundation blog, Lifting the lid on the borrowing cap, 31 October 2108

[74] Stephens M; Perry J; Williams P; Young G: 2019 UK Housing Review, Chartered Institute of Housing and Heriot Watt University, p62

For more information, see the Library briefing Social rented housing (England): past trends and prospects.

# 5 Local authority pension funds

The Local Government Pension Scheme (LGPS) is a public service pension scheme. It is a defined benefit (DB) scheme, which means it provides benefits based on salary and length of service. Unlike the other main public service pension schemes, the LGPS is funded, meaning that contributions are paid to a fund which is invested and from which benefits are paid at retirement.[75]

The LGPS (E&W) is the largest DB scheme in England and Wales. Made up of 88 LGPS funds, it had assets of £276 billion at end March 2020.[76] LGPS Scotland is made up of 11 funds. At end March 2020, it had 606,312 members, and assets of £46 billion.[77]

The rules of the LGPS are set nationally (by the Secretary of State for Levelling-Up, Housing and Communities for the LGPS in England and Wales (E&W), and the Scottish Government for LGPS Scotland). However, decisions on investments are made locally by administering authorities.

LGPS administering authorities must make investment decisions in accordance with LGPS legislation and general legal principles. Much work has been done to clarify the extent to which they can use their investment powers for other purposes – such as investing in local infrastructure projects. Legal advice produced for the Local Government Association in 2014 said that administering authorities must direct their investment power to achieving what is the best for the financial position of the fund. Provided this remains true, the precise choice of investment may be influenced by ESG (environmental, social and governance) factors, so long as that does not risk material financial detriment.[78]

In 2016, the Government changed the regulations applying to the LGPS (E&W), to require administering authorities to publish an investment strategy, which must include their approach to 'pooling investments' and taking account of ESG factors. The strategy must also be in accordance with guidance issued by the Secretary of State.[79]

Guidance published by the Secretary of State in September 2016 requires authorities to commit their assets to a suitable investment pool, which must meet certain criteria. The aim is to achieve economies of scale.[80] The

75 The other main public service pension schemes operate on a pay-as-you-go basis, which means that contributions are paid to a fund which is invested and used to pay benefits at retirement
76 LGPS (E&W) SAB – 2019 valuations; LGPS Annual Report 2020
77 LGPS Scotland – 2019 valuations detail report; LGPS Scheme Advisory Board Annual Report 2020
78 Advice on Fiduciary Duty in the LGPS from Nigel Giffen QC, April 2014
79 LGPS (Management and Investment of Funds) Regulations 2016 (SI 2016/946), reg 7
80 LGPS: investment reform criteria and guidance, November 2015

Secretary of State has the power to intervene if satisfied that an administering authority is failing to act in accordance with the regulations and guidance.

In January 2019, the Ministry for Housing, Communities and Local Government launched an informal consultation on new statutory guidance on asset pooling. It said that while much had been achieved in terms of pooling assets, now was the time for "new guidance to support further progress".[81]

The draft guidance said members of LGPS pools must appoint a pool company – regulated by the Financial Conduct Authority – to implement their investment strategy. There would be an expectation that all fund assets would transition to the pool over a relatively short period of time, with an exception for investments in "local initiatives," which "should not normally exceed five per cent of the value of the assets".[82] There would be no target for investment in infrastructure, but pool members should set an "ambition" for this. The Government's expectation was that pool companies could "provide the capability and capacity for pools over time to move towards levels of infrastructure investment similar to overseas pension funds of comparable aggregate size".[83]

Administering authorities expressed concern at aspects of the proposals. For example, there was concern that the requirement to appoint a pool company would over-ride the discretion afforded to administering authorities and could in some cases increase costs.[84] A formal consultation was intended to follow but has not yet done so.[85]

The issues are discussed in more detail in the Library briefing paper Local Government Pension Scheme investments (October 2021).

81 LGPS: statutory guidance on asset pooling - draft for consultation, January 2019

82 As above

83 As above

84 Response to consultation on draft regulations from the 11 administering authorities in the Access Pool, March 2019; Greater Manchester Pension Fund Annual Report 2019, p5; Northern LGPS response to Statutory Guidance on Asset Pooling, March 2019 LGPS Statutory Guidance on Asset Pooling, Consultation response from Westminster Council, 2019

85 Looking again at the government's pension pooling red lines, Local Government Chronicle, 4 September 2020; LGPS SAB website – investment pooling (viewed 12 October 2020)