Local housing authorities – the self-financing regime: progress and issues

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Section Social Policy Section

This note explains the implications of local housing authorities (with retained stock) moving to a self-financing regime from April 2012. It considers what use authorities are making of their new financial freedoms and the case for some continuing restrictions (borrowing caps) to be lifted.

Background on the move to self-financing can be found in *The reform of Housing Revenue Account Subsidy* (Library note SN/SP/4341).

Local authorities have welcomed the new financial framework and evidence to date suggests that they are responding well to it. The key priority for most authorities is continued investment in their existing housing stock to ensure it meets and maintains the decent home standard; some have adopted a higher, locally determined standard.

The Coalition Government took powers under the *Localism Act 2011* to impose a cap on the level of borrowing that local housing authorities can undertake under the self-financing regime. The decision to cap debt at its opening level of £29.8bn was, and is, controversial. Local 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. Housing commentators calling for the cap to be lifted have estimated potential for additional investment of £7bn over five years which could produce 60,000 homes (12,000 extra per year).

As part of the *2013 Autumn Statement* the Chancellor announced a limited increase in local authorities' borrowing caps resulting in authorities gaining additional borrowing capacity of £300m over 2015-17. It also commissioned the Elphicke-House report into the role local authorities can play in supporting overall housing supply, published in January 2015.

The final section of the note considers the case for bringing UK borrowing rules in line with international practice. This would have the effect of putting council housing on the same financial basis as housing associations and could boost councils' capacity to invest in the development of new housing.

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1 Introduction

Local authorities with housing stock are required to record all income and expenditure in relation to these dwellings in their Housing Revenue Account (HRA).[1]

The HRA is often referred to as a 'landlord account'. It is a ring-fenced account within the General Fund; this ensures that rent levels cannot be subsidised by increases in Council Tax and that rents cannot be increased in order to keep Council Tax levels down. The main items of income to the HRA are council tenants' rent and service charge payments while a key item of expenditure is the day-to-day management and maintenance of the housing stock. Historically, local authorities experienced a deficit on their HRAs, i.e. the rental income they received did not cover all outgoings on the account. In very simple terms, this was met by Government in the form of annual payments of HRA subsidy.

Full background on the operation of the old Housing Revenue Account (HRA) subsidy system and the process leading to its abolition in April 2012 can be found in *The reform of Housing Revenue Account Subsidy* (SN04341).

By 2007 it was recognised that the Housing Revenue deficit subsidy system had become discredited and unsustainable. A majority of local housing authorities were in "negative subsidy" and made annual contributions *to* the Treasury rather than receiving subsidy towards the management and maintenance of council housing stock. The then Labour Government began to review the system in 2009. When the Coalition came to power in 2010 the review and consultation process continued. Provisions allowing for the abolition of the HRA subsidy system and its replacement with a self-financing regime were included in Part 7 of the *Localism Act 2011.*

[1] The requirement to keep a HRA dates back to the *1935 Housing Act*

Local authorities with retained housing stock became 'self-financing' from April 2012. Some of the key aspects of the model include:

- a one-off redistribution of 'debt' between local authorities. Some authorities (136) took on more debt while others had their debt levels reduced or they became/remained debt free;[2]
- HRAs remain ring-fenced;
- although authorities are self-financing their borrowing is limited by a debt cap – the overall local authority housing debt was initially capped at £29.8bn;
- capital receipts money raised from the sale of council homes is split between the Government and the local authority.[3] The split was initially 75/25% but is now 70/30%;
- management, maintenance and major repairs allowances payable in the last year of the old system were increased to cover historic less-than-inflation settlements in the past; and
- the model does not assume that there will be substantial development of new council housing.[4]

Local housing authorities have now developed 30 year business plans for their HRAs. They must ensure that they generate enough rental income each year to run an efficient and effective housing management service. Rental income must also be sufficient to service any outstanding housing debt.

What authorities can achieve under self-financing differs significantly depending on their individual profiles. Factors such as the level of debt they need to service, political priorities and the level of risk an authority is prepared to take on, are key to these decisions. However, it has given them the opportunity, within certain parameters, to use their rental income to support housing investment. Authorities can use the whole of their rental income to support housing investment – rental income can be invested directly or can be used to finance additional borrowing.

It has been estimated that most local authorities have a debt level that is lower than the notional debt derived from the stock valuation used to calculate the borrowing limit. This means that around 85% of authorities have headroom for borrowing underneath the cap set in April 2012 – overall this amounts to £2.8bn in additional borrowing capacity. The picture is inconsistent across authorities – 28 councils moved into the new system with no borrowing headroom.[5]

Annex B of *The housing revenue account self-financing determinations* sets out each authority's maximum housing debt as at 1 April 2012.

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2 The debt settlement was intended to allow each council, from rental income, to manage and maintain its stock in a good state of repair for 30 years, or replace it where necessary, with enough left over to meet debt interest and repay the debt over the same period.

3 Labour's model proposed that councils would retain 100% of their capital receipts and interest derived from investing the receipts.

4 This represents another departure from the model developed by Labour – the Labour Government expected councils would begin to build again on a reasonable scale using loan finance based on a recalculation of the value of their existing stock. The original Prospectus published by the Labour Government (*Council housing: a real future*) intended one outcome of self-financing to be councils building around 10,000 new homes per year.

5 *Innovation and Ambition: the impact of self-financing on council housing*, ARCH, June 2013, p8

2 What are authorities doing?

The Association of Retained Council Housing (ARCH) in association with the Councils with ALMOs Group, HouseMark, the Local Government Association (LGA) and the National Federation of ALMOs, commissioned the Chartered Institute of Housing (CIH) to assess the impact of self-financing on council rent decisions and spending plans. *Innovation and Ambition: the impact of self-financing on council housing* was published in June 2013. 167 stock owning authorities were asked to complete a structured survey; responses were received from 81 (49%) covering 57% of the total local authority stock. Follow-up visits were conducted with 7 authorities to provide more in-depth understanding of how authorities were reacting to self-financing.

Overall councils were found to be responding well to the new framework. 99% of respondents had prepared a formal business plan under-pinned by a 30 year financial model. The CIH concluded that councils had taken the time to understand their financial position and that investment plans reflected their individual circumstances and priorities.[6]

The report identified most authorities' key priority as investment in the existing housing stock to ensure it meets and maintains the decent home standard. Some authorities are adopting a more aspirational, locally determined standard for their housing stock. Other activities most often mentioned were:

- investment in new build (71% of authorities);
- regeneration (46%)[7]; and
- the green agenda (39%).

Councils' priorities reflected the different positions they found themselves in at the start of self-financing. The CIH report estimated that over the next 5 years councils would invest at least £15bn in their existing housing stock representing an average of around £9,000 per property. In addition, three quarters of councils were planning to build around 20-25,000 new units of council housing:

> Of those authorities that have indicated they are planning to undertake new build, 50% are planning to use Affordable Rents to help finance the new homes. The other 50% are planning to continue to use Social Rents.[8]

The additional resources for investment could come from a combination of borrowing headroom, reserves, right to buy receipts or revenue generated by councils' business plans. The £15bn referred to above compares with £8.5bn the sector would have been allowed to invest in major repairs under the old regime over the same time period.[9]

A survey of 45 councillors with lead responsibility for housing conducted by the Smith Institute between July and October 2013 (published November 2013) found that 93% had plans to build new council homes under the self-financing regime but aspirations were relatively modest – most hoped to build up to 1,000 homes in the next decade.[10] In terms of

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6 *Ibid* p6

7 For example, demolition and replacement. Prior to self-financing this would only have been possible with special funding (area based initiatives or Housing Market Renewal Pathfinders).

8 *Innovation and Ambition: the impact of self-financing on council housing*, ARCH, June 2013, p6

9 Pawson & Wilcox, *UK Housing Review 2013*, Chapter 2, p24

10 Smith Institute, *Does council housing have a future?* November 2013

debt management, only 9% of participants said they would seek to increase the level of housing debt – nearly 60% expressed a desire to pay off their debt or reduce it.[11]

The research at this point identified that there was potential, and an appetite, amongst authorities to build more new affordable housing if the framework within which they were now operating could be further reformed.

3 Issues and risks

The following sections explain some of the factors within the regime which are operating to restrict local authority borrowing and outline some of the emerging risks to authorities' business plans.

3.1 The borrowing cap

As explained in section 1 of this note, the Coalition Government took new powers under the *Localism Act 2011* to impose a cap on the level of borrowing that local housing authorities can undertake under the self-financing regime. It had also been Labour's intention to control borrowing by retaining some elements of the old HRA subsidy system.

The decision to cap debt at its opening level of £29.8bn was, and is, controversial. Local 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.[12] The CIH and others argued that capping debt at opening levels would artificially restrict "spend to save" type investment which has the capacity to provide better value for money in the longer term.

As part of *Innovation and Ambition: the impact of self-financing on council housing* (June 2013) authorities were asked if they could deliver additional new homes in the event of the debt cap being lifted. 25 authorities said they could build an additional 6,913 units over the next 5 years and an additional 16,208 over the next 10 years in these conditions. The CIH stresses that these figures are very tentative. Bearing in mind land constraints, the impact of welfare reform and organisational capacity, potential additional investment of £7bn over five years (i.e. over and above the £2.8bn of existing headroom) is estimated which could produce 60,000 extra homes (12,000 extra per year).[13] The theoretical maximum financial capacity within the overall national council housing asset and resource is estimated to be up to £27.5bn.[14]

In *Let's get building* (November 2012) John Perry, on behalf of the National Federation of Arm's Length Management Companies (ALMOs), set out the case for using capacity across the whole of the social housing sector to assist in meeting the need for 83,000 homes a year at rents below market levels.[15] The report, which calls on authorities to be allowed to borrow to prudential levels, emphasises the multiplier effect of investment in construction:

- for every £1 spent in building, 92p on average remains within the UK
- for every £1 spent by the public sector, 56p returns to the Exchequer, of which 36p is direct savings in tax and benefits

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[11] *ibid*

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

[13] *Innovation and Ambition: the impact of self-financing on council housing*, ARCH, June 2013, p16

[14] *ibid*

[15] *Let's get building,* NFA, June 2012

- almost 60% of construction employees are low-skilled, with relatively limited alternative employment opportunities

- government has a key role because historically it represents 30-40% of construction demand[16]

CIPFA's evidence to the Communities and Local Government Select Committee's 2010-12 inquiry into *Financing New Housing Supply* called on the Government not to press ahead with the borrowing cap:

> 3.2 CIPFA has long considered that such a cap is totally unnecessary because the introduction of Prudential Code has clearly proved that Local Authorities can be trusted to act prudently with regard to borrowing. Under prudential borrowing, a local authority must only borrow when and if the debt repayments and interest are affordable. Affordability is crucial and therefore aggregate borrowing should never reach unaffordable levels. The cost and availability of loans in itself provides the commercial discipline, obviating any need for regulation.
>
> 3.3 The building of new homes would also generate additional rental income that could be used to meet the increased costs of borrowing.
>
> 3.4 When it was introduced in 2004, prudential borrowing marked a major shift in how local authority capital spending was controlled. The previous prescriptive central controls were swept away and instead councils were given responsibility to make their own decisions and manage their own affairs. We believe that local authorities rose to that challenge. Borrowing since 2004 has been both prudent and modest, and focused on financing spending that delivers savings or service improvements. Capital spending has been better linked to business objectives and better value for money has been realised with the ending of the perverse incentives in the earlier system—for example to take on leases when purchase was clearly more economic.
>
> 3.5 Currently, local authority borrowing for council housing is around £7,000 per unit—less than half that of housing associations—and will be restricted under the cap to the level that applies in each authority at the time of implementation. However councils could borrow more than this and still stay within the agreed borrowing rules under the prudential borrowing framework. In CIPFA's view, such necessary local authority borrowing can be properly and prudently financed and used to meet urgent housing needs.
>
> 3.6 Throughout the period since 2004, the Treasury has never had to use its reserve powers to intervene in these borrowing arrangements—and the costs of central oversight and control have been reduced. There are broader lessons too. Councils can be trusted to manage complex finances on behalf of their local communities. Localism is a good model for ensuring joined-up decision making, efficient outcomes and economic growth.
>
> 3.7 CIPFA believes the prudential borrowing framework has worked very well. We would urge the Government to retain the full flexibilities of these arrangements and not to press ahead with the introduction of a cap on housing borrowing.[17]

After considering the evidence the Committee recommended that the borrowing cap should be lifted:

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[16] *Ibid* p9

[17] Eleventh Report of 2010-12, Volume II, *Financing New Housing Supply,* May 2012, Ev w102

> We recommend that the Government lift the cap on local authorities' borrowing for housing, and allow councils to borrow in accordance with the Prudential Code. We are also concerned at the Government's warning that it will "take action" if public borrowing increases as a result of Housing Revenue Account reform. It is important that it does not place any further constraints upon local authority borrowing for housing. The cap is already unnecessary and further borrowing restrictions would have a detrimental impact upon the contribution councils can make to new housing supply.[18]

The Government responded thus:

> Our reforms must not jeopardise the Government's first economic priority, which is to reduce the national deficit. Borrowing made possible by any income stream, including housing rents, must be affordable not just locally but within the national fiscal framework. The prudential borrowing rules were designed to focus solely on local affordability. It is for this reason that the Government also has reserve powers to address any nationally unsustainable increase in borrowing. The housing borrowing cap will help to ensure that such exceptional measures do not become necessary.[19]

The case for lifting the borrowing cap is supported by a wide range of bodies in the housing industry including London Councils, the Local Government Association, the British Property Federation and the Royal Town Planning Institute,[20] in addition to those already referred to in this note. The CIH included a call to raise the borrowing cap in its November 2013 *Autumn Statement Submission*:

> **Supply - increasing local authority capacity**: New housing supply remains well below the required levels. We urgently need to see a significant increase in the number of new homes we build. By raising Local Authority Housing Revenue Account debt caps by £7bn government would allow local authorities to invest in economic and housing growth through financing housing development, enabling up to 75,000 homes to be delivered over five years.[21]

In making the case for giving authorities more freedom to invest by lifting the borrowing cap reference is frequently made to the experience of Scottish councils:

> Lessons from Scotland
>
> In 2011, the 26 stock-owning Scottish councils started 1,224 new homes, the highest level for more than 20 years. Their performance is similar to that of England's even though Scotland only has one-tenth of England's population.
>
> Local authorities' ability to build at relatively low grant rates has proved attractive to the Scottish Government, with flat-rate payments of £25,000-£35,000 per dwelling equating to only around 20%-25% of scheme costs (as compared with grants of around 60% needed by housing associations in 2009/10). Councils' ability to do this partly reflects the bolstering effect of local authority-owned land contributed at nil cost. In a few cases significant contributions have also come from second homes council tax income or developer payments levied under planning powers.
>
> Delivery of new council housing at low grant rates has come mainly from additional investment via rent fund contributions or through prudential borrowing, where the cost of debt repayments is partly borne by *all existing tenants* rather than being accounted for just at scheme level, as has been traditional for housing associations.

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18 HC 1652, Eleventh Report of 2010-12 Volume I, *Financing New Housing Supply*, May 2012, para 93

19 Cm 8401, July 2012, para 16

20 "Stop block on new homes, housing sector urges," 12 March 2013

21 CIH, *Autumn Statement Submission,* November 2013, p4

> Why has such performance by local authorities been possible in Scotland and not in England? Scottish local authorities are not constrained by borrowing caps. For many years they have had no subsidy system comparable to England's and they have been effectively self-financing. While (as in England) they are subject to prudential rules, they have been willing to finance extra borrowing from rents. Their extra borrowing counts against government borrowing measures, but has not been sufficient to cause difficulties.
>
> [Source: based on Pawson, H. and Wilcox, S. (2011) *UK Housing Review 2011 Briefing Paper*. Coventry: CIH, 2011.][22]

The 2013 Autumn Statement – additional borrowing approved

As part of the *2013 Autumn Statement* 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 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.[23]

The announcement was welcomed but the CIH described it as "far too modest" a step. There were concerns that any gains from the increased borrowing capacity could be offset by the requirement to sell high-value social housing and through an expansion of the Right to Buy.[24] London Councils echoed the view that the measure did not go far enough:

> By 2021, over 800,000 new homes will need to be built in London, but the government's latest attempt to address this crisis through increasing council borrowing capacity does not go far enough and has too many strings attached.
>
> In order to qualify for extra borrowing capacity, councils will have to sell off high value vacant housing stock. This unfairly prejudices London, which has both the most acute housing need and the highest value stock in the country.
>
> London Councils will continue to call for the complete removal of the artificial housing borrowing cap, among a raft of other measures, so that boroughs can properly address London's housing crisis.[25]

Despite the CIH's concerns, Housing Minister Brandon Lewis announced on 9 October 2014 that only 22 councils had successfully bid for additional borrowing, and that only £122m of the £300m had been allocated.[26] Under-Secretary of State Stephen Williams expressed

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22 *Let's get building,* NFA, June 2012, p20

23 Cm 8747, *2013 Autumn Statement,* December 2013, para 1.228

24 CIH, *What you need to know about the Autumn Statement 2013*, December 2013

25 London Councils response to Autumn Statement, 5 December 2013

26 DCLG press release, 'Councils can do their bit to get Britain building', 9 October 2014

surprise at the limited uptake from councils, and told the 2014 Liberal Democrat Conference this may have been a result of inexperience in the implementation of building plans.[27]

This is also highlighted by the National Federation of ALMOs and ARCH in their joint election manifesto, along with concerns about council contingencies:

> Some have argued that it is unnecessary to lift council debt caps because councils are not currently using the headroom available to them. An immediate response is that it is not reasonable to expect headroom to be used in full – a prudent council will need to retain some spare capacity to respond to contingencies. The evidence also shows that councils are still in the process of gearing up building programmes – in many cases from a standing start only two years ago.[28]

The LGA also argued that the application process needed to be simpler and more flexible,[29] whilst the Labour Party-commissioned Lyons review argued that:

> The tight timescales for submission of bids, the requirement that the new homes must be Affordable Rent and a strong steer that successful bids should include disposal of high value stock meant many authorities did not bid.[30]

The Elphicke-House report (2015)

The 2013 Autumn Statement also announced that the Government would launch a review into the role local authorities can play in supporting overall housing supply.[31]

The Elphicke-House report, published in January 2015, recommended local authorities become "housing delivery enablers", through the use of innovative financing mechanisms. These include the creation of housing companies funded by the General Fund, private finance initiatives and housing investment from local authority pension funds. These were to be the main levers to enable housing delivery, rather than removal of the borrowing caps:

> A number of stock owning council respondents indicated that they would not be able to build more homes without additional borrowing capacity. However, local authorities with little or no borrowing headroom have developed innovative finance models, including via local housing delivery vehicles, to lever-in private finance to support house building programmes.[32]

The report did however recommend flexibility around borrowing rules in relation to Right to Buy replacement (see section 3.5).

The LGA and the CIH were critical that the terms of reference of the report did not allow it to look at the removal of borrowing caps, although the authors felt this was unnecessary.[33] ARCH argued that the review was not ambitious enough:

> Overall, the reviewers make few recommendations for changes in Government legislation or policy. The main thrust of the report is that councils can do more within the current framework - as the more innovative councils are already demonstrating. Of the report's 30 recommendations, 11 are for action by councils, and of the 15

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27 *Inside Housing*, 'Councils fail to tap into 'vast majority' of extra headroom', 7 October 2014

28 ARCH/ NFA. *For a council housing renaissance*, February 2015, p4

29 Review of the Local Authority role in housing supply, evidence from the LGA, 11 November 2014

30 The Lyons housing review, October 2014, p142

31 Cm 8747, *2013 Autumn Statement,* December 2013, para 1.229

32 The Elphicke-House report, *From statutory provider to housing-delivery enabler*, January 2015, para 4.24

33 *Inside Housing*, 'House-Elphicke review 'hamstrung by terms of reference'', 29 January 2015

recommendations for Government, the majority relate to publicizing, clarifying or issuing fresh guidance in relation to existing legislation.[34]

3.2 Pooling borrowing capacity

There is no correlation between an authority's need and desire to invest in its existing stock or develop new housing and its ability to utilise additional borrowing capacity under self-financing. London Councils' evidence to the Communities and Local Government Committee's inquiry into *Financing New Housing Supply* highlighted this issue and proposed that authorities should be able to share their borrowing capacity:

> Given this limit in borrowing, it may be the case that some boroughs will have the desire or need to access capital to invest in their housing stock, but are constrained by their debt cap from doing so. Similarly, some boroughs will find themselves with some borrowing capacity that they do not need to use, as their investment priorities can be met without borrowing. In these circumstances, there is the potential for the authority with higher needs but no borrowing headroom to access the borrowing headroom of the "better off" authority. The lending authority could charge a fee for providing this capital, and the borrowing authority would benefit from being able to access resources which it could use to invest in its housing to produce a higher return in future, from which the cost of the loan could be paid back. This would in effect merely re-distribute existing debt around local authorities and would not add to the aggregate HRA-related debt. However, at the moment it is not possible and would need central government's approval to happen. As such a move would not add to the aggregate debt, and would allow boroughs to act far more like the housing business managers that HRA devolution implies, the freedom to swap headroom in this manner is something that we would strongly urge the Government to actively consider in the coming months.
>
> It is not merely swapping headroom for capital that becomes a possibility following devolution. There may be a situation where one borough has borrowing capacity but limited land on which to build new housing. If it were able to partner with another borough with land but not capital resources, it may be that the two could negotiate so that the former lends capital to the latter in exchange for a proportion of the nomination rights to the new social housing that the latter builds on its land. Equally, this sort of cooperation could happen between more than two boroughs or, in London, even on a sub-regional basis. In this way, imaginative inter-borough cooperation could enable delivery of new or improved housing where previously controls over boroughs' HRA operations would have prevented such an approach.[35]

The 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."[36] 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.[37]

The Liberal Democrats voted in support of a motion to allow local authorities to pool their borrowing capacity during their 2013 Party Conference.[38] This followed the contribution of Annette Brooke to a Commons debate on housing in March 2013:

[34] ARCH blog, 'Councils should become Housing Delivery Enablers, say Elphicke and House', 30 January 2015

[35] HC 1652, Eleventh Report of 2010-12 Volume I, *Financing New Housing Supply*, May 2012, Ev 134-5

[36] *Ibid* para 96

[37] Cm 8401, July 2012, para 17

> **Annette Brooke (Mid Dorset and North Poole) (LD):** I was going to stand on the next Question. Will the Minister for Housing consider a mechanism by which the borrowing capacity of an authority that has chosen not to use or is unable to use all its borrowing facilities can be passed to an authority that, in turn, could facilitate arm's length management organisations to build housing when there is capacity to do so?
>
> **Mr Prisk:** The hon. Lady is slightly ahead of herself. We are considering such issues when we consider the spending review in the round. I will consider her representations carefully.[39]

John Perry's November 2013 paper commissioned by the National Federation of ALMOs, *Treating council housing fairly – how changed borrowing rules can help build more homes and boost the economy,* describes pooling as a "modest change and no substitute for action to raise or abolish the borrowing caps."[40]

During the 2014 Labour Party Conference, Shadow Housing Minister Emma Reynolds told *Inside Housing* that the Lyons review's recommendations would consider allowing councils to pool unused borrowing.[41]

The Lyons review, published in October 2014, articulated this in terms of allowing flexibility within the Government's total borrowing headroom:

> There should be provision to raise individual HRA borrowing caps where councils present a business case and an investment plan that sets out the extra borrowing needed and the additional homes that will be delivered in return.
>
> The Treasury would be able to ensure that the additional flexibility does not see an increase in total borrowing over and above that currently planned for. And it should do so in a way that does not involve increased bureaucracy for councils in managing their Housing Revenue Accounts.[42]

The Elphicke-House report, although it did not make any specific recommendations on pooled borrowing, did highlight the salience of the issue:

> As more councils develop proposals for combined authorities, and where enabling housing delivery becomes a shared responsibility, the issues around sharing borrowing capacity will grow.[43]

3.3 Rent setting & rent convergence policy

Labour's 2010 prospectus, *Council housing: a real future,* proposed that under self-financing local authority landlords would still be required to follow national social rent policy which essentially involved increasing rents by RPI + 0.5% plus £2 per week.[44] This approach was confirmed by Grant Shapps in his Written Statement of 13 December 2010:

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38 Liberal Democrat motions on Strengthening the UK Economy, 2013, p2

39 HC Deb 18 March 2013 c603

40 John Perry for the NFA, *Treating council housing fairly – how changed borrowing rules can help build more homes and boost the economy,* November 2013

41 *Inside Housing,* 'Labour considers allowing councils to share borrowing capacity', 25 September 2014

42 The Lyons housing review, p145

43 The Elphicke-House report, para 4.25

44 For additional information see Library Note SN/SP/1090

> The income assumptions built into the valuation will be based on the existing social rent policy for councils that their rents should "converge" with standard housing association rents in 2015/16.[45]

Assumptions around future rent increases are key to effective business planning for local authorities. Prior to the 2013 Spending Review housing commentators emphasised the need for clarity on how social housing rents would be set in future as the date for rent convergence drew nearer. As part of the 2013 Spending Round, the Government announced that "from 2015-16 social rents will rise by CPI plus 1 per cent each year for 10 years."[46] The Spending Review document states that the Government will save £540 million in 2017/18 as a result of the change in formula.

Housing organisations welcomed the certainty delivered as a result of this announcement but some concerns were expressed over whether the change in formula would reduce landlords' incomes and thus have an impact on their ability to invest in existing and new homes.[47] Matthew Warburton, Policy Adviser to ARCH, provided the following assessment of the implications of the formula change:

> The self-financing settlement assumed that rents would increase annually according to the retail price index plus a half per cent plus a convergence factor. With convergence in theory achieved by 2015, rents would rise after that by RPI plus 0.5% for the remainder of the 30 year business plan period. So what are the implications of replacing RPI + 0.5% with CPI + 1%?
>
> It is generally accepted that CPI will rise more slowly than RPI, since it does not include housing costs, but by how much is debatable. Between 1989 and 2011 the average annual rise in CPI was 0.7% less than RPI, although in 2009-10 the relationship was reversed, with CPI over 3% more than RPI.
>
> A deeply technical paper published by the OBR in 2011 argues that the future gap is likely to widen to a long run average of 1.4%. If this is true, the long run effect of the new formula would be a cumulative reduction in rent income by 0.9% a year compared with current business plan assumptions, with a significant impact on the scope for new building. However, the composition of CPI is due to be reviewed, putting a question mark over any long run prediction.[48]

Modelling carried out by the Chartered Institute of Housing also indicated that landlords would be likely to experience some loss in rental income as a result of the formula change compared to what they would have received had the current system been extended:

> This could of course affect their ability to invest, for example in developing new affordable housing, however the extent of this will depend on what assumptions they had previously made in their business plans about future rent increases.[49]

While social landlords were still digesting the implications of the formula change, DCLG sent a letter to housing bodies on 2 July 2013 in which plans to cut short the policy of converging council and housing association rents were revealed. The letter also referred to the potential for the formula change to result in lower rent increases:

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[45] HC Deb 13 December 2010 WS

[46] Treasury, *Investing in Britain's Future*, Cm 8669, June 2013

[47] *Inside Housing,*" Rent changes to save Treasury £1bn", 26 June 2013

[48] ARCH, *The new rent formula – what does it mean*, 27 June 2013

[49] CIH Briefing on rent setting from 2015, 2013

There has been some speculation that the new formula will lead to lower rents than the current formula. This will depend on the level of future inflation under the two measures. Over the last twelve months, RPI has been on average 0.5% higher than CPI – the latest figures show a 0.4% gap – suggesting the formula should give broadly the same rent change in the short-term. In the long-run, the difference between RPI and CPI is more uncertain, and will obviously vary year-on-year.

Having considered the issue carefully, we are minded not to extend rent convergence beyond 2014-15 – and the policy costings published by the Office for Budget Responsibility are based on that assumption. So when we say rent increases of up to CPI + 1% from 2015/16 onwards, that is what we mean.

We expect most landlords to have achieved rent convergence by 2015. By that point, rent convergence policy will have been in place for almost 15 years – this is a significant period of time for landlords to make full use of the rent flexibilities the Government has provided, and most have done so.

We will set out details on limit rents for local authorities in 2014/15 in due course.

In coming to a decision on our future rent policy, we have struck a balance between protecting tenants – ensuring rents remain affordable – and giving social landlords the income they need to invest in new housing (helping more people in housing need) and provide good services to their tenants. We think CPI + 1% strikes the right balance and represents a good deal for both landlords and tenants.[50]

For landlords with properties that have not reached their target rent (the optimum rent they should be charging based on a valuation rent formula) the end of rent convergence (i.e. the ability to adjust social rents by a further +/- £2 per week from 2015-16) will result in a loss of rental income:

The end of rent convergence will not affect all organisations, the vast majority of social rented homes are now ‘converged’, but could have a greater impact on those whose rents are currently still significantly below target level. For example for an organisation managing 10,000 homes, a loss in rental income of £2 per week on each property would equate to over £1m in a single year. The effect will be particularly substantial for organisations whose business plans currently assume a rent increase of this type for several years beyond 2014-15.[51]

The worst affected councils are, reportedly, in high value areas such as London where the gap between target rents and average rents is highest. There are concerns that some local authorities will have to rewrite their 30 year business plans (prepared as a result of the move to self-financing in April 2012) and that the loss in rental income will challenge their ability to repay debt taken on as part of the move to the new financial regime. An article in *Inside Housing* (July 2013) provided an indication of the potential impact on certain landlords:

Southwark Council has been particularly badly hit. The 40,000-home borough took on £323 million of debt under the HRA reforms and is repaying £80 million a year. It has an 8 per cent gap between target rents and average rents. According to Ian Wingfield, deputy leader at Southwark, 55 per cent of the south London borough’s homes won’t have achieved rent convergence by 2015 - despite having instigated the maximum increases every year. The council’s HRA 30-year business plan had been predicated on the assumption that convergence would be extended and that rents would continue

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[50] DCLG letter to the Association of Retained Council Housing, 2 July 2013
[51] CIH Briefing on rent setting from 2015, 2013

> to be linked to the retail price index. This means Southwark now faces a potential black hole in its business plan of between £300 million and £430 million.
>
> 'This will impact our ability to pay as much [debt] as we can now,' says Mr Wingfield. 'It will hit our housing services. We will have to revise our plans in terms of what we can pay.'[52]
>
> [...]
>
> Bolton at Home has 12,000 homes that will be charging below target rents by 2015. As a result, according to Edward Mellor, assistant director of finance at the 18,000-home association, it faces a £2.5 million-a-year loss in income that will make it struggle to repay its £4.5 million debt without a 'significant' overhaul of its business plan. The CLG says in cases like this, associations should contact the regulator which can grant waivers to the rent standard for extreme cases where an association's viability is threatened.
>
> 'It's a big problem for us,' says Mr Mellor. 'The HCA has asked us to model what the impact will be. Two thirds of our properties are affected, and over 30 years it is a huge loss. I can't see how we could continue making debt repayments.'[53]

A consultation paper on the announcement, *Rents for social housing from 2015 to 2016,* was issued in October 2013.

A proposal to offer 'temporary waivers' to some housing associations who would be adversely affected by the ending of rent convergence has been branded "unfair" by ARCH, as an equivalent offer has not been made to local authority landlords.[54]

The Government published a summary of responses to its consultation on Rents for social housing from 2015 to 2016 in May 2014. A number of concerns were raised about the end of rent convergence, particularly the removal of the additional £2pw to facilitate it:

> A number of local authorities and representative bodies said that the removal of the £2 flexibility was not in line with the calculations underpinning the Housing Revenue Account self-financing settlement. They said this would result in a loss of rental income which could affect their business plans. Some also said that they were concerned that this policy change had been proposed so soon after the start of self-financing.[55]

Additional concerns were raised that the use of CPI, rather than RPI, would have a negative impact on HRAs over 30 years.[56]

In May 2014, the Government published its final policy on rents for social housing for the next ten years, from April 2015 onwards - *Guidance on rents for social housing*. The Government's guidance confirmed it would proceed with its policy of abolishing the provision for landlords to increase rents by an additional £2 per week to achieve convergence, as well as its use of CPI to calculate maximum rent increases.

The guidance does however explain that local authorities should set rents above the social rent policy expectations for tenants with high incomes. It also allows for some flexibility for authorities to set rents above the standard calculation, to maintain financial viability:

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52 *Inside Housing*, "Missing the Target", 19 July 2013
53 *ibid*
54 *Inside Housing*, "CLG under fire over rent plans," 8 November 2013
55 DCLG, *Rents for Social Housing from 2015-16, Consultation: Summary of Responses*, May 2014, para 3.19
56 *ibid,* para 3.13

> As a result, the policy contains flexibility for authorities to set rents at up to 5 percent above formula rent (10 percent for supported housing and sheltered housing). We expect authorities to use this flexibility in a balanced way, and not set all rents at 5 percent (or 10 percent) above the formula rent.[57]

3.4 Welfare reform

In making decisions over whether to take advantage of their increased borrowing capacity (where applicable) local authorities are also taking account of uncertainties around income collection as a result of various welfare reform measures. ARCH identified increased bad debt provision within authorities' business plans ranging from 1.11% in 2012/13 rising to 1.61% by 2016/17.[58]

There is some evidence that the under-occupation deduction from Housing Benefit (introduced in April 2013) is impacting on social landlords' rent collection rates

> The report for the November 2013 welfare reform impact club meeting shows that landlords with poor rent collection rates before the bedroom tax have lost out on millions of pounds since April as they struggle to collect more money direct from tenants. The situation is particularly acute in the North, where collection rates are lagging behind the UK median by as much as nine percentage points.
>
> Larger landlords with existing high arrears rates have seen them increase further since April to around 5% of rent charged - at a time when top performers have managed to minimise the effects.
>
> Rent collection costs are rising faster than inflation. The report shows that more staff are being employed to collect rent and this is forcing up overheads - whilst pay costs have reduced in real terms.[59]

Council landlords will no longer receive Housing Benefit direct[60] as Universal Credit (UC) is phased in. This is of considerable concern to social landlords who believe that it will result in increased rent arrears and impact on their revenue streams.[61] Although implementation of UC has been delayed, councils may proceed cautiously in terms of additional borrowing if they believe that the income stream needed to service this borrowing may be adversely affected by welfare reform. The Government intends to fully introduce UC by 2017:

> We will introduce Universal Credit in a managed way, progressively rolling it out nationally from October 2013. The transition from the current system of benefits and tax credits to Universal Credit will be gradual and it is expected to be completed by the end of 2017.[62]

The 2017 target may however be missed due to concerns about the transfer over of existing Employment and Support Allowance claimants.[63]

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57 DCLG, Guidance on Rents for Social Housing, May 2014, para 2.14

58 *Innovation and Ambition: the impact of self-financing on council housing*, ARCH, June 2013, p11

59 HouseMark, *The tipping point*, November 2013

60 Council tenants currently receive their Housing Benefit as a rent rebate and their rent accounts are adjusted accordingly.

61 For more information see Library note *Paying Housing Benefit direct to tenants in social rented housing* (SN/SP/6291)

62 DWP, 'Government policy on Universal Credit: an introduction' (last accessed 10 February 2015)

63 *Inside Housing*, 'IDS admits universal credit roll-out may miss 2017 deadline', 5 December 2013

3.5 Right to Buy

The self-financing settlement for local authorities included an assumed annual receipt from Right to Buy sales. In April 2012 the Government increased the maximum discount for tenants exercising the Right to Buy to £75,000 and in March 2013 the maximum discount was further increased to £100,000 for council tenants in London. These measures have resulted in an increase in Right to Buy applications. Alongside the changes to maximum discounts the Government adopted a different approach to the treatment of receipts raised over and above those already assumed in the self-financing settlement:

> The Government does not propose to require councils to use this part of the receipt to repay loans. We instead plan to use mechanisms related to the Housing Revenue Account ring-fence to ensure that the Housing Revenue Account receives the benefit of this compensation. We intend to achieve this through a change to the definition of the Housing Revenue Account Capital Financing Requirement (now set out in the Limits on Indebtedness Determination 2012). This will require a local authority to reduce the Housing Revenue Account Capital Financing Requirement by this amount, but would leave the local authority free to make treasury management decisions about how the receipt is used. The Government will consult local housing authorities and relevant professional bodies on the changes to the Limits on Indebtedness Determination.[64]

In addition to reinvigorating the Right to Buy the Government committed to one-for-one replacement of lost stock at an aggregate national level. In its research for ARCH the CIH identified that 56% of responding authorities thought they would have additional receipts for re-investment totalling around £34m and had factored these into their business plans.[65] On 2 December 2013 *Inside Housing* reported that since 2012/13 just one home had been built for every seven sold under the Right to Buy:

> The government promised that a new council house or flat would be built to replace every one sold to tenants when it announced the new drive for the scheme by increasing discounts.
>
> However, in 2012/13 and in the year to date, 10,954 council homes have been sold through the right to buy scheme, but only 1,662 replacements were started in the same period.[66]

In March 2014, then Housing Minister Kris Hopkins reported a similar 1:7 ratio for Right to Buy replacements, although this was approximately 1:4 for replacement of additional sales:

> The one-for-one replacement policy applies to additional local authority sales, that is sales above the level forecast before the reinvigoration of the policy in April 2012. Since the reinvigoration, local authorities have sold 13,800 homes, approximately 8,300 of which are additional, and over 2,000 dwellings have been started on site or acquired.
>
> There will be a time lag between the right to buy sale and the construction of the new build home, but the replacement timetable is in control of the local authority. If a council were to fail to spend the receipts within three years, it would be required to return the unspent money to Government with interest. This provides a strong financial incentive

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64 DCLG, *summary of responses to the consultation and the Government's final response*, March 2012

65 *Innovation and Ambition: the impact of self-financing on council housing*, ARCH, June 2013, p16

66 *Inside Housing,* "Only one home built for every seven right-to-buy", 2 December 2013

> for any slow-coach councils to use this new funding and get on with building more homes for local people.[67]

The Government has further plans to increase Right to Buy sales. Measures in the *Deregulation Bill* (currently at Report Stage in the House of Lords) will reduce the qualifying period for the Right to Buy from five to three years. The *2013 Autumn Statement* contains the following commitment:

> The government's reforms to the Right to Buy scheme in 2012 have delivered a step-change in sales, supporting new affordable housing through 1:1 replacement of additional homes sold and helping buyers onto the housing ladder. Sales more than doubled from 3,740 in 2011-12 to 8,400 in 2012-13. **The government will further support Right to Buy by introducing Right to Buy Agents to help buyers complete their home purchase, and provide £100 million to establish a fund to increase Right to Buy sales, by improving applicants' access to mortgage finance.**[68]

The Labour Party-commissioned Lyons review, published in October 2014, argues that the current Right to Buy rules are resulting in council stock being sold faster than it can be replaced. Although it does not outline specifics, it calls for reform of Right to Buy to "enable councils and housing associations to re-invest in genuine one-for-one replacement".[69]

Concerns about the ability of local authorities to offer local one-for-one replacement were also highlighted in the Government-commissioned Elphicke-House report. In its response to council calls for additional borrowing headroom, it noted that replacements delivered this way would not be classed as additional, above the assumed sales in the self-financing agreement. As a result, it recommended that:

> Government considers within its overall current spending plans flexibilities in any possible further HRA borrowing programme to enable councils to use both additional borrowing and 1:1 receipts to enable councils to deliver replacement units for Right to Buy stock.[70]

The Government's initial response to the report noted it would adopt some recommendations immediately and further explore others, but did not explicitly mention the Right to Buy recommendation in either of these categories.

3.6 Breaching the ring-fence

Councils' Housing Revenue Accounts are ring-fenced; there should be no transfer of funds out of the HRA into the General Fund or, indeed, from the General Fund to the HRA. It appears that a handful of local authorities took advantage of a 'loophole' under Schedule 4, Part 3(2) of the *Local Government and Housing Act 1989* prior to 1 October 2013 (the date on which the power was repealed) to transfer HRA funds into their General Funds. 7 councils are reported to have been involved, with a total value of almost £40 million transferred.[71]

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67 HC Deb 13 March 2014 c314-5W
68 Cm 8747, *2013 Autumn Statement,* December 2013, para 1.233
69 The Lyons housing review, p146
70 The Elphicke-House report, para 4.27
71 *Inside Housing,* 'Report: 'Use housing cash for other council services'', 11 April 2014

The Housing Minister, Kris Hopkins, wrote to all local authorities requesting information on any such transfers. The letter indicated that authorities may be required to return the transferred funds:

> The Department is considering whether it would be appropriate, where funds have been transferred, to determine or direct that such funds should be returned to the Housing Revenue Account.[72]

In addition to the loophole, *Inside Housing* published an investigation which alleged that up to 115 councils had used a number of measures to lock transfers into 30-year business plans. It also reported that, in response, DCLG would consider a review of HRA rules.[73]

4 UK borrowing rules – the case for change

As explained earlier in this note, the main justification for the imposition of borrowing caps on local housing authorities is that additional debt incurred by these authorities currently adds to overall Government debt. Certain housing bodies, including the Chartered Institute of Housing, have long argued for a change to fiscal rules to bring the UK in line with the system used by other EU countries. The CIH commissioned John Hawksworth (then of Coopers & Lybrand) and Steve Wilcox (then with the University of Wales) to explore the potential impact of moving to a position where council borrowing for housing investment is not subject to Treasury controls. The resulting report, *Challenging the Conventions: Public Borrowing Rules and Housing Investment,* was published in 1995 – the authors identified 'a strong case' for a shift in emphasis in UK fiscal policy:

> We believe there is a strong case, independent of specific implications for housing, for a shift of emphasis in UK fiscal policy objectives from the PSBR to the General Government Financial Deficit (GGFD). This would bring the UK into line with accepted international government accounting standards and general European practice. It would also provide a more appropriate degree of commercial freedom both to existing UK public corporations and to other largely self-financing activities, including council housing, whose investment levels have been tightly constrained in recent years by the present PSBR-focused regime. Given an appropriate range of checks and balances, this additional commercial freedom should not pose any threat to the government's own finances.
>
> In the case of council housing, such a change would provide a major opportunity to mobilise private finance to make up the backlog of necessary repairs to the existing housing stock. It could also help to address projected increases in affordable rented housing needs in the future in conjunction with other providers such as housing associations, local authority minority influenced housing companies and other private sector landlords.[74]

The move to self-financing has, commentators suggest, given added weight to the case for amending UK fiscal rules:

> In the context of local authority housing, self-financing has given added weight to the argument that councils, although closer to parity with housing associations in now having control over their own revenues, still suffer unnecessary restrictions. Even though their borrowing costs remain at historically low levels, the logic of the UK's rules

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72 Minister's letter to local authority chief finance officers, 26 November 2013

73 *Inside Housing*, 'HRA rulebook reviewed as councils raid budgets', 20 June 2014

74 CIH & Coopers and Lybrand, *Challenging the Conventions: Public Borrowing Rules and Housing Investment,* 1995, pp13-14

> requires government to impose artificially low borrowing caps. At the same time housing associations, while not constrained by these rules, are in danger of over-leveraging as they take on increased levels of debt. Indeed, the government is offering guarantees to associations (and to private developers) to ease these pressures.[75]

A comprehensive briefing written by John Perry on behalf of the National Federation of ALMOs, *Treating council housing fairly – how changed borrowing rules can help build more homes and boost the economy* was published in November 2013. The briefing explains how UK rules currently compare with international rules on the treatment of debt:

> Under both this and previous governments the UK has established fiscal rules relating to debt levels and the current account deficit. Such rules require clear definitions of what expenditures and borrowing 'count'. The UK's definition covers the whole of the public sector and in this sense is unique: other EU countries and bodies such as the IMF and OECD use international definitions of what counts towards sovereign debt and current account deficits. And to complicate matters, the UK's debt is measured by these international rules for the purposes of monitoring its compliance with the Maastricht Treaty and (for example) in OECD comparisons of national accounts The key difference between the UK and other countries is in how different sub-sectors are treated in the UK fiscal rules. The UK government has for several decades applied an unusually wide-ranging definition of the 'public sector'.
>
> Historically, the main measure used in monitoring debt was the PSBR (Public Sector Borrowing Requirement), now supplanted by either PSNBR (Public Sector Net Borrowing Requirement) or PSND (Public Sector Net Debt). All of these include not only government itself (central and local) but also bodies in what is known as the 'public corporate' sector. Other EU countries, most OECD countries and the most widely used international debt statistics focus on 'general government' and exclude the public corporate sector.
>
> Whether borrowing by any undertaking is 'caught' by the rules depends on two factors:
>
> 1. Its **sector classification**, which is undertaken by the ONS following international rules set by Eurostat, the EU statistics agency. Broadly speaking, if classified as part of *government*, central or local, any undertaking's borrowing is caught by both the UK and the international rules. If classified as a *private* body, its borrowing is not caught by either set of rules. However, between the two are the *public corporations*: their borrowing is caught by the UK rules but *not* by international rules.
> 2. The **borrowing rules** themselves. The UK is obliged to report its debt by international rules in order to adhere to EU treaties. These embrace only 'general government' borrowing and exclude that by public corporations. But the government maintains the historic practice of using a wider 'public sector' definition domestically which includes public corporations, and its fiscal rules are based on this definition rather than the widely accepted international one.[76]

The paper draws comparisons between the treatment of borrowing by housing associations, which does not count against the current measure of UK debt (PSND), and borrowing by

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[75] Pawson & Wilcox, *UK Housing Review 2013*, p27

[76] John Perry for the NFA, *Treating council housing fairly – how changed borrowing rules can help build more homes and boost the economy,* November 2013

local authorities, which does[77] and goes on to compare how borrowing for social housing is treated in other EU countries:

> No other EU country treats social housing investment in the way that happens in England. In part, this is because England's 'council housing' model is unusual, because few other EU countries have social housing managed directly by local authorities and where they do, stocks are generally small. However, the model of management or ownership being in the hands of a municipally owned company is relatively common (e.g. Sweden, Austria, Finland and parts of France), and such companies elsewhere in Europe enjoy the same borrowing freedoms as housing associations.
>
> This means not only that council majority-owned bodies can, in effect, build alongside housing associations (or their equivalent in each country), but that they can also take advantage of the cheaper borrowing available to them because they are backed by local government. While in England councils or council-owned companies could also borrow cheaply from private lenders, this advantage is negated by any new borrowing being restricted because it counts towards public sector debt.
>
> Incidentally, the same applies even more markedly in other sectors such as transport and energy, where companies which are majority-owned by other EU governments (e.g. Arriva buses and trains, the energy company EDF) enjoy the advantages of the international rules and have a huge role in the transport and energy sectors in the UK.

The NFA briefing contains a section setting out the arguments for and against changing the borrowing rules – it is reproduced in full below:

> The sections below outline the main arguments that have been made against a change in the rules, and responses to them.
>
> **Transparency.** Because the current measure of debt, PSND, is all-embracing, it is argued that it gives a fuller and more transparent picture of public sector liabilities. But the financial flows of the public corporate sector are regularly published in the Treasury's Public Expenditure Statistical Analysis (PESA), so transparency itself should not be an issue. If separating out the £6bn annual expenditure of the public corporations is an issue, then surely the fact that the publicly-owned banks are accounted for separately from the public sector is a very much bigger one? In many respects the transparency argument should focus at least as much on the potential cost of guarantees and other interventions in the private sector, with their potentially large effects on public finances when things go wrong. Current examples include (in housing) the guarantees for housing association borrowing and (more widely) guarantees like those made to attract investment in nuclear power or universal broadband.
>
> **Sticking to the rules.** The government has a set of rules about the boundaries of the public sector, to ensure that the UK public accounts are taken seriously. Yet, these rules were first set decades ago and are not necessarily still fit for purpose. Because of this, in practice anomalies arise and changes are permitted when judged necessary. For example:
>
> - Public sector banks are outside the rules (effectively creating a very sizeable special sub-sector) – a practice also followed by other European governments that

[77] Only social housing grant paid to associations by the Homes and Communities Agency is subject to the Government's fiscal rules.

have made banking interventions. In Britain's case, it kept £1.5 trillion off the 'public sector' balance sheet.

- FE colleges were reclassified outside the public sector in 2012 despite their dependence on public funding. In the higher/further education sector, 'private' bodies receive £4.5bn annually through the Higher Education Funding Council. There are reports of this subsidy exceeding its 2013/14 budget limits.

- Government took over the Royal Mail pension fund to boost its finances prior to privatisation – assets of £28bn were used to offset government debt but liabilities were disregarded, amounting to £1.2bn worth of subsidy in 2012/13 alone.

- Suggestions have been made that academy schools – currently part of central government – could be privatised to enable them to be profit-making (while presumably still receiving public subsidy).

Having proper controls. This argument clearly applies whatever the status of public corporations in the national accounts. In fact there is already a broad framework in place, described in Public Expenditure Statistical Analyses (see chapter 8 of the 2012 edition). If this is insufficient, it should be made more robust. Public corporations are also subject to EU competition law and to procurement rules to ensure open competition for any contracting they do. Councils are already subject to statutory guidance and to the CIPFA treasury management code. Further safeguards are discussed below.

Need to reflect true public sector liabilities. The Treasury argues that the wide 'public sector' definition of borrowing is the right one because it captures bodies whose finances would have to be underwritten by the state in the event of failure. There is of course little or no evidence of public corporations getting into serious difficulty in recent times. On the other hand, the examples of private firms having to be rescued by the state are plentiful. Council housing has transparent accounts, managed by their parent local authorities: the scope for unpleasant surprises is therefore much more limited. Furthermore, in the comparable housing association sector, the limited cases of financial difficulty have been resolved *within the sector*, without recourse to public funds.

Unfair advantage. The argument is that public corporations can borrow more cheaply and can therefore 'crowd out' private competition. This of course is what is already happening with the foreign companies operating in the UK transport and energy sectors, so other countries don't seem to have the same inhibitions. In housing, lower borrowing costs give an advantage to councils over both housing associations and private landlords. However, higher output from associations is of course needed *in addition to* increased building by councils. Private landlords make low levels of investment in new stock and although they pay higher interest rates they have access to interest-only mortgages. It can therefore be argued that in housing the 'unfair advantage' argument is of little importance: given the scale of the shortfall in supply, there is little risk of 'crowding out'.

Market reaction. The key argument is that the market would respond adversely to any rule change, believing that it was a government ruse to increase public borrowing, and that this would push up guilt yields or affect the government's rating by the rating agencies. This argument was addressed in an assessment by Capital Economics for the report *Let's Get Building*.[16] It needs to be faced, but it is also clear that the possible objections are either not as great as claimed or that they can with time be resolved without prejudicing the market's trust in government accounts.

> The large presence of foreign firms in which their own governments have big shares is a new argument which should carry sway with the City, too. Presented in the right way as sweeping away the anomalies in the UK rules, and fully complying with international conventions and guidelines, should not cause too many ripples given that the markets are scrutinising the internationally comparative data (which will not change) all the time.
>
> Finally, none of the City interviewees for the Capital Economics study thought that £7bn of extra borrowing was sufficient for the markets to worry about, irrespective of the issues about any rule change.[78]

Other changes that John Perry has identified as necessary to take full advantage of changes to the borrowing rules include:

- Monitoring by and returns to Government – councils already report to DCLG on their housing accounts. This would continue and it is envisaged that Government would retain powers to curb excessive borrowing.
- Code of practice specifically for self-financed council housing – CIPFA and CIH have devised a *Voluntary Code for a Self-financed HRA.*
- Separation of HRA debt from General Fund debt – some authorities have already done this.
- Reclassification of HRA debt by the ONS – this would allow ONS to treat this debt as part of the debt of public corporations.
- A clear rule on Public Works Loan Board (PWLB) borrowing – borrowing from the PWLB would still count towards Government debt. In order to overcome this John Perry suggests that new borrowing will have to come from private sources. This is not viewed as problematic as brokers are keen to encourage councils to borrow from the bond markets – this would be 0.25% - 0.5% more expensive than borrowing from the PWLB.[79]

Not surprisingly, several housing organisations made the case for the reclassification of housing debt in their evidence to the Communities and Local Government Select Committee's 2010-12 inquiry into *Financing New Housing Supply.* The Committee recommended "that the Government thoroughly examine a move to the General Government Financial Deficit rules and then consult on proposals."[80]

The Government rejected this recommendation:

> The Government uses a range of measures of public borrowing and debt, including the General Government Financial Deficit measure. Public Sector Net Borrowing, which includes borrowing of public corporations, is the key indicator used in setting fiscal policy and for assessing changes in the public finances. This is a prudent measure of public borrowing which Government intends to continue using.[81]

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78 John Perry for the NFA, *Treating council housing fairly – how changed borrowing rules can help build more homes and boost the economy,* November 2013

79 John Perry for the NFA, *Treating council housing fairly – how changed borrowing rules can help build more homes and boost the economy,* November 2013

80 HC 1652, Eleventh Report of 2010-12 Volume I, *Financing New Housing Supply*, May 2012, para 103

81 Cm 8401, July 2012, para 19