Paying for Local Investment:

New Finance Mechanisms for Local Government

March 2005

This report is a supplement to a previous joint report by **nef** (the new economics foundation) and Policy Exchange on the reform of the revenue finance system of local government in England, *Nothing to lose but your chains: Reforming the English local government finance system,*[1] and focuses on the reform of the much-overlooked local capital finance system.

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About the author

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About **nef** (the new economics foundation)

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Introduction

This report has been prepared because of our concern about three issues. The first is that, for decades, central government has denied local authorities autonomy over both raising capital finance and capital expenditure in their local areas. There is little doubt that this has contributed to the decline in the quality of schools, housing, local transport, and other services. Central government has denied responsibility for this decline by saying the duty to invest is that of local authorities. However, local politicians have been unable to act because they have neither the funds nor the authority to do so. This impasse has not ended with the creation, in April 2004, of the new system of local authority funding called the 'Prudential Code', and as such still needs to be tackled. The proposals we make would restore appropriate decision-making power to local authorities. They are designed, in association with the revenue finance system recommendations in our previous joint report *Nothing to lose but your chains: Reforming the English local government finance system,* to provide local authorities with the means to fulfil their plans for local investment.

The second reason for this report is our concern that the new Prudential Code system of capital finance is poorly conceived and will lead to serious errors in decision-making by local authorities. Vital changes to this system are required. These involve the use of a wider base of lending sources than at present, when almost all local authority capital borrowing is from central government. We are convinced that any additional cost of such borrowings will be more than covered by the discipline required for properly implemented investment appraisals, both in terms of project selection and project planning. Again, these changes will be facilitated by the recommendations we have already made to provide local authorities with more control over their revenue sources.

Finally, we want to re-invigorate the local economy by giving local authorities access to the money markets and by encouraging people to save for the long term by investing in local authority bonds. These were once commonplace in the UK financial scene, and they still are in many countries, especially in the USA. At a time when saving is such a crucial issue, linked as it is to private pension provision, we believe it is an appropriate moment for people to be given incentives to save locally. This could fund the infrastructure improvements that they want to see in the short term, and from which they might benefit in their old age. As such, we promote the creation of a local authority bond market in the UK.

To achieve these aims, this report offers a brief review of the recent history of local capital expenditure and financing, and provides a critique of both the pre-March 2004 system, and the new Prudential System currently in operation. Suggestions as to the characteristics of a good local authority capital finance system, how to overcome the shortcomings of the current regime, and methods of reforming the capital finance system are set out at the end of the report.

As with *Nothing to lose but your chains: Reforming the English local government finance system*, this report is not intended to give a detailed, technical structure for a new system of capital finance. Its intent is to suggest a framework of general reforms within which a more comprehensive locally autonomous capital system could be designed.

Summary of recommendations

- Local councillors must be given back the confidence and means to control their capital expenditure budgets and how they finance them.
- The reforms to the revenue system proposed in our previous report, *Nothing to lose but your chains: Reforming the English local government finance system*, are a necessary part of the reform of the capital finance system for English local authorities. Unless local authorities have the freedom to control their revenue, beyond just Council Tax, they will never have sufficient funds to make appropriate choices on new capital spending.
- The Prudential Code should be reformed so as to encourage local authorities to properly appraise and structure their financing decisions. Currently, the Public Works Loan Board (PWLB) lends money to local authorities without seeing evidence that they have undertaken investment appraisals. The PWLB should require appropriate investment appraisals before lending to local authorities and should refuse funds if they are not considered adequate.
- The central government PWLB needs to take on a new role in local authority capital finance. It should be the lender of last resort. Currently, the PWLB crowds out other sources and types of capital finance by offering cheap loans.
- Local authorities should be required to consider the use of commercial funds to finance their capital expenditure. This is not as radical as it seems. The Government already raises its borrowed funds on the money market. Going directly to the capital market may be more expensive for local authorities than PWLB loans; however, the current low rates charged by the PWLB give an illusion of cheapness. Because neither the Prudential Code nor the PWLB requires a local authority to undertake a proper investment appraisal before borrowing, it is likely that many local authority capital spending decisions are far from optimal at present. If borrowing in the commercial market required local authorities to properly plan, control and account for their expenditure, the benefits of that process would more than cover any additional borrowing costs.
- Local authorities should be encouraged to issue local bonds, either by themselves or as a consortium. This would provide a vehicle for people to save locally with the immediate benefit that their savings would be used to enhance their local area. If modest tax incentives were given to such bonds, as are commonplace in other countries, especially in the USA, we believe that local bonds could become a key component of local authority capital finance and would provide a welcome additional savings medium at a time when one is needed.
- For small to medium-sized local authorities, tapping independently into the capital market may be difficult because of high transaction costs relative to capital needs. For these authorities – and those with infrastructure needs that extend beyond their government boundaries – pooled finance

mechanisms should be encouraged. Because capital is raised for a group of authorities and various investments, the risk to investors – therefore the interest rate for local government – is lower. The PWLB could take on a new role of brokering commercial capital finance for such groups of authorities.

- Great care should be taken to ensure that local authorities receive both the financial and technical help they need from central government and the private sector to apply for commercial finance.
- Central government capital and revenue grants to local authorities should continue with a particular emphasis on ensuring that no authority is denied access to capital spending because of its inability to raise the necessary finance from its local population.

Local authority capital expenditure: some definitions and statistics

What is capital expenditure? Why is it important?

Local government capital expenditure relates to spending on long-term assets that will bring benefits beyond the end of the financial year in which the expenditure is incurred. Examples include things such as land and buildings or large items of equipment. This is in direct contrast to revenue expenditure, which only produces short-term benefits within the year in which it is incurred.

Capital expenditure is vitally important in helping local government deliver on its public service objectives. For example, investing in new school buildings helps improve education; carrying out housing renovations improves local housing; and purchasing equipment for local police helps reduce crime.

Local authorities are never allowed to use the money they have raised to finance capital projects to pay for current year spending. The reverse is not true. Capital projects can be financed from current year revenue income from Council Tax. This is a common practice, with some 25 per cent of capital expenditure in 2002/03 being funded in this way.[2]

We doubt the wisdom of this method of funding capital expenditure. Any authority that uses its current year income to fund capital expenditure penalises current local taxpayers to benefit future ones. In our opinion capital expenditure by local authorities is usually best paid for by capital finance to ensure that the costs and benefits of the expenditure are matched over time.

Trends in spending: capital expenditure’s declining share of local government expenditure

Capital expenditure has always been the smaller part of total local government spending in England, but in recent decades it has seen a marked fall. Until about 1980, substantial council house building programmes inflated the figures for local authority capital expenditure with average capital spending being about a third of total local government expenditure in the early 1950s and almost one quarter throughout the 1970s. This compares to only 10.8 per cent in the 1980s and 8.6 per cent in the 1990s, reaching an all time low of 6.1 per cent in 2000/01, during which periods local authority house building programmes had ceased. This trend has now been reversed slightly with the average capital expenditure being 7.9 per cent of total local government expenditure in England over the last three years.[3]

As a result of this low level of capital expenditure many local schools, transport systems, roads, leisure facilities, houses, justice and welfare systems are becoming outdated and in need of upgrading. There is widespread recognition of the need for greater levels of local infrastructure investment. The question is how can this best be financed? This report addresses this issue.

The funding of local government capital expenditure until March 2004

A brief recent history of local government capital expenditure

The 1980s and 1990s saw local authority capital expenditure strictly controlled from the centre, "largely as a result of successive governments' relentless pressure on local authorities to limit their capital spending".[4] This approach was characterised by central government controlling the majority of local authority capital expenditure via the use of credit approvals, a system largely resented by local government.

The late 1990s began to see a shift away from these strict controls. Financing regimes were ring fenced with the introduction of measures such as the Single Capital Pot (SCP), which was proposed in the 1998 White Paper and introduced into the capital finance system in April 2002. In addition, for a limited period in the late 1990s, the Public Private Partnership played a role in local authority finance with surprisingly limited overall impact. The need to consider such arrangements for all projects costing less than £20 million has now been removed and, as such, they are unlikely to have much future impact in local government finance and accordingly have not been considered further in this report.

These changes were, however, limited in scope and of little overall effect. Of much greater significance was the introduction of the Prudential System for capital finance in April 2004. This is discussed in more detail below.

The English capital finance system pre March 2004

Prior to March 2004 local authority capital expenditure was financed in one of four main ways:

1. Borrowing with central government approval
2. Capital grants
3. Capital receipts
4. Revenue income

The first two of these methods were directly controlled by central government and the third method – the use of capital receipts – was subject to substantial central government control, so significantly limiting local authority financial freedom. The frustration of many local councillors, who felt they had almost no control over the capital spending of the authorities they were elected to run, was justified. Table 1 gives the provisional figures for the breakdown of financing sources for the year 2002/03.

Table 1: Breakdown of financing of local authority capital expenditure 2002/03

	% Total capital expenditure
Borrowing	28
Capital grants	26
Capital receipts	21
Revenue income	25
Total	**100**

Source: ODPM, 2004, Local Government Financial Statistics, Table 4.2a

The role of the Public Works Loans Board (PWLB)

Before April 2004 local authorities were legally allowed to borrow from a variety of sources and institutions, including commercial banks. Authorities were also allowed to issue bonds. Since 1981, however, successive governments have made clear their wish that local authorities only borrow from the centrally controlled Public Works Loan Board (PWLB) – effectively a division of the Treasury. They have ensured that this is the case by offering PWLB loans at lower interest rates than the market could usually compete with. The funds used for these loans are raised from taxation or government bond issues. "The consequence of this change in policy in 1982 was simple. Whereas before the early 1980s authorities had gone to the market if they needed to borrow in excess of their relatively small PWLB limits, they no longer needed to do so. Accordingly any issue of local authority bonds became very rare."[5] In March 2004, the PWLB estimated that it had 90 per cent of the local authority loan market in the UK, amounting to about £50 billion in all.[6] Less than 10 per cent in value of all local authority loans came from commercial banks and other sources.

Local authority bond finance had almost ceased to exist by 31 March 2004. The last major bond issues were made in the very early 1980s. A few further issues made in the early and mid-1990s appear to have been considered by the authorities involved to be disadvantageous as all were redeemed early. Despite this trend, the total loans outstanding from the PWLB only rose from £34.2 billion in 1978 to £50.9 billion in 2003. Inflation of the former figure would suggest it should have been at least £80 billion in 2003 if local government borrowing (and hence capital expenditure) had kept pace with inflation. In practice it has not. Over the intervening period, central government has placed considerable controls over local government spending, including the tightening of lending quotas, the promotion of the role of the PWLB, the cutting of effective access to other lending markets and the imposition of overall spending caps. It is hard not to link the fall in borrowing with the decline of much of the local infrastructure in England and Wales.

Problems with the capital system pre-March 2004

One of the main perceived advantages of strong central control of local government capital spending was that it was thought unlikely that local authorities would get themselves into financial trouble by over-indebting themselves, therefore protecting central government and their residents from any negative economic impacts.

However, there were clear downsides to the highly regimented capital funding system in place before March 2004:

- Lack of local control for funding local investment provided little incentive for local authorities to plan and manage their capital budgets effectively.
- Having to get central government permission for borrowing undermined incentives to be locally accountable and responsive, with local government focused on seeking approval from above rather than from local constituents. “It is difficult to exaggerate how resented this form of ‘control by approval’ is. Responding to the government’s 2000 finance Green Paper, 285 of 286 councils wanted the system abolished.”[7]
- Over time, the amendments to the capital system, which have been embodied in primary legislation, have been difficult to make. As a result, the system has not been particularly responsive to changes in local circumstances. “The result is a mass of complex and little understood regulation that has become an obstacle to effective capital investment and transparent decision making.”[8]
- The prominent and centrally backed role of the PWLB as the main lender to local authorities provided little incentive for the use of other sources of finance despite always having the freedom to do so.

The outcome was, as noted, frustration; a lack of accountability; poor decision-making criteria because responsibility devolved to central government whether that was the intention or not; and an inevitable feeling of powerlessness. This structure was bad for the practice of local government, bad for its status in the community, bad for the morale of local elected officials and unlikely to create effective local decisions on matters of priority. All of these undermined faith in local democracy, which, in itself, is a matter of concern. In the circumstances, any change was welcome, but, as the next section shows, those of April 2004 are not good enough.

The funding of local government capital expenditure from April 2004: the Prudential System

The Prudential System of capital finance

In 2001, a White Paper proposed a new Prudential System for local authority capital borrowing which would abolish the use of central government credit approvals and allow local authorities to decide their own affordable borrowing limits. It is important to note that this new system did not abolish the use of central government capital and revenue grants to support spending on capital investment by local authorities. Both these methods of funding continue to be used as a means of central support for local government capital expenditure. As such they are, of course, ways of controlling it, too.

The new Prudential System came into effect in England on 1 April 2004, and is based on the Prudential Code established by the Chartered Institute of Public Finance and Accountancy (CIPFA).

Under the Prudential Code, a local authority may set its own borrowing limits so long as it complies with the Code when doing so. The Code is a set of guidelines that local authorities must have 'regard to' when deciding the limits of their capital borrowing. It is not a prescriptive set of rules and regulations. The basic principle of the new system is that local authorities will be free to invest in capital expenditure so long as their capital spending plans are affordable, prudent, and sustainable. "The Code will not include suggested or indicative limits or ratios. These will be for the local authority to set itself."[9] A summary of the Code may be found in Appendix 1.

The benefits of the Prudential System

At first glance the Prudential System makes some welcome changes to the system of local authority capital finance:

(i) It encourages local discretion and increases local accountability

In appearance at least, the process of central control over local capital expenditure has been removed. Basic and Supplementary Credit Approvals to allow local authorities to borrow have been abolished and so long as they use the guidelines in the Prudential Code, local finance officers are able to set their own affordable borrowing limits within their overall budget and future plans. However, since central government retains absolute capping powers over local authority capital finances and still controls capital and revenue grants for capital expenditure, the degree of flexibility provided by the Prudential Code is limited, as is noted in Appendix 1.

That said, local authorities do not now need central consent when deciding which capital investments they want to undertake to bolster their local communities and help them provide services to their residents. This shift in emphasis appears to return autonomy for capital expenditure decisions directly to local councillors and,

as a consequence, has a positive effect on local accountability for capital financing decisions. It is also notable that, in principle, each authority may interpret the Prudential Code as best fits its local purpose. "In each authority this officer [the chief financial officer] alone will be the final arbiter of the professional good practice on which the system is based."[10] We suggest that this overstates the power of an unelected official, and that elected councillors have the duty to review any recommendations a chief financial officer may make, but, in principle, we agree with this comment.

(ii) The Prudential System simplifies procedures for applying for capital funds

Procedures for approval of capital expenditure under the Prudential System have been simplified and the whole system is much less prescriptive than the regime of approvals previously in place. In practice, loans from the PWLB can be applied for by telephone and no formal appraisal techniques are specified or required in order to obtain what are, on occasion, very substantial loans. This seems to make access to funds for capital expenditure a mere formality and some might welcome that as a cut in red tape.

The shortcomings of the Prudential System and the need for further reform

Despite its simplicity, and the apparent increased devolvement of decision-making authority to local government, the Prudential System has several shortcomings. This suggests that it cannot be the final stage in local capital finance reform if local authorities are to enjoy significantly increased autonomy and increased responsibility when making decisions to borrow and invest.

Some of the shortcomings of the Prudential System are set out below:

(i) It does not encourage 'good' capital financing decisions

Efficient capital financing for local authorities should be a two-stage process involving a cost-benefit analysis in which the following questions are asked:

1. Is the capital expenditure necessary i.e. will it add value to, or save cost in, the local area and in local service provision? This necessarily requires a monetary worth to be placed on that value or cost saving over the expected life of the project.
2. If the project can be shown to add value, is the cost of providing the service affordable? If the cost is to be covered by central government, this is relatively easy to answer, as the local authority does not make the decision. If it will not be centrally funded, the local authority has then to decide if the costs of the project and any associated borrowing or increase in Council Tax can be met over the life of the assets that are to be purchased.

If the benefits exceed the costs of the project then, logically, it should take place under normal and accepted investment appraisal procedures in use in most commercial enterprises, subject only to one constraint: that the cash flow of the organisation is not unduly strained by the investment at any point.

The Prudential Code does not match this normal standard for a decision-making process for capital expenditure. In fact, it only requires that at no stage should the decision to invest impose a significant strain on the cash flow of the local authority in the three years after the investment has been made.[11] In that sense, it will not encourage good decision-making by local authorities. That is because the Code does not require a local authority to consider, in detail, the decisions they are making: the Code does not require them to think beyond what will, in many cases, be one electoral term for the elected councillors making the decision. A three-year appraisal period for the project will inevitably mean that the longer-term impacts of

any expenditure are ignored. This has been a perpetual problem in all government decision-making; it would seem that substantially enhanced risk management and investment appraisal techniques are needed to ensure prudent borrowing really does take place. It is a serious weakness of the Code that it has failed to tackle this issue.

(ii) The continuing dominance of PWLB funding

Although under the Prudential Code local authorities have been given the power to borrow from whoever they feel appropriate, the PWLB has responded to this new freedom by producing simplified borrowing arrangements. Loan applications to the PWLB "may only be made by telephone".[12] Unlike the requirements for a commercial loan, there are no forms to complete or business plans to produce. Local authorities are simply asked to confirm that they are complying with the requirements of current PWLB policy and that the borrowing is considered to be within the limits set by the Prudential Code. The requested loan is advanced within 48 hours of this confirmation, without further questions being asked. This simple application procedure and the absence of a requirement to provide a formal appraisal of affordability will not improve financial management skills across local authorities when it comes to assessing their capital requirements. Indeed, it could easily do the reverse.

Despite this, the PWLB's policy from April 2004 makes very clear that it is the Government's intention that it be the main provider of local authority finance under the new Prudential System. "It would continue to be the Government's aim that the [PWLB] Board should be able to meet all of an authority's legitimate need for long-term loans. Accordingly, the Board would generally be prepared to lend to an authority up to the available capacity in its legal borrowing limit."[13] The PWLB also states its policy to be lender of last resort to local authorities regardless of their credit worthiness and ability to raise funds independently elsewhere. "The Board would continue to be the lender of last resort to local authorities…applications for loans would be considered on their merits…and without regard to the authority's ability to raise funds elsewhere."[14] In practice, there is an obvious paradox in these statements. As a lender of last resort, the implication is that the PWLB will lend only if others will not. This suggests that it thinks local authorities should look for loans elsewhere in the first instance. At the same time it is saying it is willing to meet all loan requests made to it by these authorities. As such it is not in fact a lender of last resort at all; it seeks to be the only lender to local authorities. This paradoxical approach effectively guarantees that the PWLB will continue to be the sole source of most local government loan finance in England unless there is a change in government policy.

The cost of borrowing from the PWLB is the rate of interest charged by it. This can be fixed or variable and is set by the Government. All local authorities are charged the same rate, irrespective of their financial capacity or loan amount. All authorities, therefore, face approximately equal costs of financing regardless of their actual credit-worthiness as might be assessed by the commercial sector. There could be no argument with this if it was not for the fact that the interest rates charged by the PWLB are almost invariably lower than those available commercially. This is not because the lower interest rates charged can be justified by the risks the PWLB takes, but because normal risk protection arrangements – including project appraisal reviews before lending takes place – have simply been eliminated from its procedures on the basis that it can transfer such risk to the future Council Tax payers in the borrowing authority who will have to bear the cost of any lending error it makes. This is, in our opinion, an unacceptable risk transfer, which could and should be avoided.

As a result, the PWLB crowds out all other sources and types of capital financing for local authorities without imposing the necessary constraints on local authority borrowing that a prudent lender would be expected to set. This failure is the basis for the concern we have about the PWLB system of lending. The cost of the PWLB system is likely to be borne by future Council Tax payers in the unfortunate areas that bear the consequences of its failure to act as a responsible lender

(iii) The Code does not encourage authorities to think about suitable forms of funding for their expenditure plans

The Code does not require proper investment appraisal by local authorities. It is inherently biased against any up-front costs on a project because only its first three years need to be appraised. The unlimited availability of cheap PWLB funding does not encourage local authorities to consider other sources of funding.

More efficient long-term forms of funding, such as commercial loans, bonds, leasing and other forms of asset finance will be severely discouraged by the Code. They will involve or require better project appraisal and more up-front arrangement costs, which are strongly discouraged by the three-year assessment period of the Prudential Code. This is a significant handicap to any realistic assessment of alternative appropriate forms of funding for local authority capital expenditure. It assists the virtual guarantee of PWLB funding for all projects, even if better long-term arrangements might be available. As a result, the Code does not encourage sound economic decision-making.

(iv) Central government still retains control of capital financing

Although local authorities are now able to spend whatever they wish on capital items, they must be able to afford to do so; the vast majority of their income continues to be funded by central government via grants and redistributed Non-Domestic Rates. The apparent relaxation of control is, therefore, more notional than real.

Central government may also re-introduce, at any time, overall limits on the borrowing of an authority or authorities in total. As such, central control has only been loosened slightly and the threat of central government approval being required in the future remains.

(v) Capital expenditure is still constrained by the overall system of local finance

Within the current overall system of local government finance, local authorities only have one revenue stream under their direct control – Council Tax. Higher levels of borrowing will almost certainly have to be financed from Council Tax revenues, or a reduction in spending on other locally provided services. As such, all capital expenditure, and decisions regarding affordability and financing costs under the Prudential System, will have to be made with regard to keeping Council Tax rates (and increases therein) at acceptable levels. Given the historical and current pressure on local authorities not to increase Council Tax (and indeed, central government intervention in the form of capping in 2004/05) the freedom to increase capital expenditure under the Prudential System is not as great as it would first appear.

The recommendations we have made for reform of the revenue finance system of local government in England[15] tackle the problems that reliance upon just one type of local taxation creates. We believe that these recommendations will also provide the flexibility to local authorities that want to fund substantial local infrastructure development, with the consent of their local taxpayers, by giving them the ability to raise the extra revenue needed to do so. As such, the proposals we make there, and in this report, are part of an integrated new system of local authority finance.

Conclusion – there is still more to do

The introduction of the Prudential System for capital finance is a step in the right direction towards increasing the autonomy of local government over capital expenditure, and is therefore welcomed. However, we are not in favour of giving back freedoms to local government without aligning this increase in autonomy with a corresponding increase in local responsibilities. Nor do we favour such an approach if it does not encourage what is really prudent and best practice. The dominance of the PWLB, the ease of loan applications, and the relatively cheap cost of financing those loans to all authorities regardless of their financial status or security does not encourage efficiency or the need to properly assess the necessity and impact of capital financing decisions. The current capital finance system, under the umbrella of the Prudential Code, provides a very comfortable deal for local government. We believe this needs to be rectified if local autonomy and accountability is to be properly restored, major lending and investment decision errors are to be avoided, and appropriate decision-making systems are to be created to ensure really effective local authority capital investment decision-making.

The characteristics of a good capital finance system

Further reforms are essential if an appropriate system of funding for capital expenditure by local authorities is to be developed. This section describes what we think the foundations of a good local capital finance system should be, and forms the basis for our recommendations as to how the Prudential System could be further improved.

The characteristics of a good local capital finance system

A good local finance system should have the following characteristics:

(i) Local accountability and autonomy for capital expenditure and financing is vital

In the recent **nef**/Policy Exchange report on local government revenue financing, we sought to promote local accountability in local authority revenue finance systems by increasing local freedoms and autonomy. Increased local autonomy and accountability are just as vital to the system of capital finance.

Local authorities should be directly responsible for deciding on capital projects, appraising them from a financial viewpoint, and seeking appropriate methods of finance, using consultants if necessary. The Prudential System, despite granting some increased freedoms, does not align these with a greater onus on local authorities to assess capital projects appropriately.

(ii) The capital finance system should be transparent

The visibility of loan relationships is an essential feature of a transparent finance system. The role of the PWLB in financing local authority capital expenditure is almost completely anonymous. There is no obvious relationship between the local authority and the source of funding for its capital expenditure. PWLB funds are provided by central government. This means there is no direct and visible link between the ultimate investor and the local authority in the loan relationship. Most commentators agree that a constructive relationship between loan parties improves the quality of financing and capital expenditure decision-making processes in the private sector; it is likely that the same benefit would be found in the public sector. This requires a radical change in the structure of the PWLB, or a change in the loan relationships local authorities enter into, or both.

(iii) The capital finance system should force local authorities to think more appropriately and, when relevant, commercially about capital financing decisions

Local authorities should think more appropriately and, when relevant, commercially about the process of capital investment, both in terms of project appraisal and in terms of choosing an appropriate financing method. For example, when a project has a clear revenue source or cost saving potential, an appraisal of

appropriate finance for the project should be undertaken rather than to simply decide whether the borrowing is prudential. In order to do this, enhanced and enforced appraisal techniques are essential.

The dominance of PWLB funding under the Prudential System has meant local authorities have simplified their investment appraisal techniques to an extraordinary degree. This systematic weakness almost certainly means that local authorities are not making efficient investment decisions and are not necessarily taking into account variables such as the time value of money, profiles of future risk, asset residual values or varying cash flows over project life when making investment decisions.

Any new system of local capital finance must therefore strike a balance between the relaxation of central controls and the onus on local authorities to become aware of the real costs of capital funding.

(iv) The capital finance system should ensure that the method of capital financing used is the most appropriate for the investment undertaken

The PWLB financing mechanism effectively means that local authorities have no incentive to match the method of capital financing they use to the nature of the capital investment being undertaken. This is a barrier to efficient and appropriate financing decisions, and prevents the private sector and individuals acting as sources of local capital funding through bond holding or other arrangements. We think this is wrong. Where there is a clear revenue stream attached to a capital project, and a local authority is creditworthy, the capital finance system should encourage the use of private sector borrowing by local government. There are a number of reasons for this:

- The discipline of applying for commercial funding will require appropriate investment appraisals to be undertaken and assessed.
- Projects that pass such an appraisal process are more likely to deliver the benefits that are claimed for them.
- The feedback from any such appraisal process will enhance future investment proposals from the authorities that submit them.
- The systematic relationship of review between an authority and their loan provider will provide continuing project oversight which will enhance the quality of management dedicated to that project and improve its chances of delivering the desired outcomes for which it was established.

Private sector loan facilities, however, will cost more than those supplied by the PWLB but it is an illusion to think that the interest rate alone is the sole cost determinant to be considered in these cases. If a loan is taken at a cheap rate for a project that fails under the current Prudential Code and PWLB loan arrangement, the loan has still to be repaid in full. As such, paying an additional cost to ensure that a project financed by a loan delivers the anticipated benefits for which it was created throughout its life can, in our opinion, justify, by itself, the additional cost of enhanced project appraisal and management implicit in the higher loan charges of the private sector when, as we note, the project is suitable for that form of funding.

(v) Specific security should be available for a loan.

Loan financiers always require reasonable assurance that their loan will be repaid. At present the only security a local authority may offer with regard to any loan is its future income stream from all sources. Specific loan security – for example, upon a property or the income stream of a particular project or activity – cannot be given.

We think that this is inappropriate. When a project is suitable for commercial funding, and in particular if the project is for a desirable but non-core activity, such as the provision of leisure, economic development or related activities, then the risk of a project should be matched by the loan security offered. This approach will also encourage:

- Specific project appraisal methods.
- The continuing oversight of projects by third parties as referred to above, which should encourage effective management of both loans and the investments to which they relate.

For these reasons a change in legislation in this area is a necessary condition of a balanced approach to future capital loan finance.

(vi) Specific grant funding from central government has a continuing role

Specific grant funding from central government will have a continuing and vital role to play in capital financing. This will be true especially in financing investment in social infrastructure where there are no direct revenue streams attached to the project making it inappropriate or difficult to finance privately. For these reasons a balanced perspective on financing is necessary to incorporate a wide range of funding mechanisms to suit particular projects which the current funding environment does not encourage.

(vii) The system should be as local as possible

Local spending provides a local benefit. If capital funding is needed to secure that benefit, then it makes sense to seek to raise at least some of that funding in the area that will benefit from the spending. As such, the revival of a local savings market to fund local infrastructure development, as existed when local authority bonds were commonly issued, is a necessary part of a good system of capital finance for local authorities, and is to be found in many countries in Europe and is widespread in the USA.

(viii) The system should be accountable

An expansion of local authority investment has a cost attached to it; ultimately someone has to pay for such expenditure. In some cases this funding will come from the facility that is created, as might be the case for a leisure centre with a fee charging arrangement. In other cases a subsidy will be needed. In some there will be no revenue stream other than central government grants, which may not cover all the cost. Local taxation might have to increase to cover the cost of funding these projects. Means of ensuring that local authorities are accountable for any increase in local taxation that they wish to impose are suggested in the **nef**/Policy Exchange report on local authority revenue finance systems and, as such, form part of the proposals made here.

A new system of local capital finance for England

The current system of local authority capital finance in England is not working. The Prudential Code is an improvement on what existed before March 2004, but many more changes are needed before an effective system is created. We suggest reforms in three main areas:

1. A revised and diminished role for the PWLB.
2. The encouragement of commercial sector loan finance.
3. The creation of the conditions necessary to allow a local bond market to flourish.

A new role for the PWLB

There are good reasons why the PWLB should not survive in its current form in any new local capital financing structure. As it is currently structured, it suppresses market involvement in the finance of local authority capital expenditure. Whilst having the appearance of cheapness, this in fact could create considerable costs in terms of failures of accountability and inappropriate project appraisal.

We do not, however, advocate the abolition of the PWLB. A range of financing mechanisms are needed to meet local authority needs, and a reformed PWLB would seem to have a role within a new system of capital finance. This role might be:

- As the lender of last resort for most types of local authority capital financing, but only being used when it can be shown that the market cannot supply finance for a project at a reasonable rate despite a proven need for that investment having been presented. As such it is likely to provide loan funds to authorities that:
    1. Have credit difficulties either because of their own track records or because, as a consequence of poverty in the communities they serve, they have insufficient revenue streams to borrow against because of their low tax base.
    2. Have developed a strong case for spending on a project which does not generate a revenue stream of its own and which, as a result, cannot offer the security that some lenders might seek to offer finance at reasonable cost.
    3. Need significant management support in developing or monitoring their capital development programmes, a role that the PWLB should assume in such cases.

- As a principle provider of loans to small authorities, such as some district and parish councils, where the amount of any loan and the resources available within the authority to source it from third parties would be small, and technical support in the process of project appraisal might be required. In these cases, the PWLB should still require a proper investment appraisal before a loan is granted, even if it has to assist in its preparation.
- As the broker of investments that benefit more than one local authority by creating cross-border financing packages and so helping local integration of infrastructure investment policies.
- As a supplier of technical support and training for local authorities to ensure that they can meet the standards of project appraisal required to raise the capital finance they need.
- As an agency monitoring the overall level of local authority debt, which will be an important and continuing macroeconomic task.
- As an adviser, with others, on the development of a regulatory framework for lending in this market as it develops.

In all of these cases, if services are supplied to assist project appraisal, we believe that the PWLB should charge for this to ensure that hidden subsidies are not provided to the authorities in question.

The resulting role of the PWLB would be positive reinforcement of best practice investment appraisal techniques and should prepare all the authorities to which it provides services to take responsibility for full management of their own capital expenditure and borrowing programmes. This change in the PWLB's role would solve some of the problems associated with the current Prudential Code. Over time, it might also allow the PWLB to be developed into a commercial operation capable of flotation or trade sale in its own right, subject to a requirement that market access always be made available for small-scale local authority loans.

Encouraging the use of commercial financing

This reduced role for the PWLB will require local authorities to look to the private sector when deciding how to finance larger capital projects. This is not as radical as it sounds. After all, the financial markets already provide much of the funding for such expenditure through guaranteeing to subscribe for government gilt issues.

It is inevitable that the requirements of private sector financial institutions will force local authorities to take account of the real costs of capital finance, and, as a result, require the use of commercial investment appraisal techniques to enable them to raise the appropriate level of funding. We would welcome this change, which would apply across the whole range of potential funding sources that might be used, including:

- Asset-based finance, such as leasing.
- Commercial loans, for example, from banks.
- Commercial mortgages.
- Bond issues.

As the take up of such facilities increases, it is likely that commercial finance providers will compete for local authority business just as they compete for private sector customers. This will lead to the development of a market for tailored local authority finance packages. It is also likely to encourage the creation of specialist consultancies to provide commercial assistance for local council officers who may

not currently have the requisite skills to apply for commercial finance. These consultancies could provide specific investment advice on how to structure investments and match loan instruments to the types of projects local authorities wish to undertake.

The creation of a bond market for local capital finance

The most radical change to the local authority finance market would be the creation of a market for new local bond issues. Local authorities in England have always been free to issue such bonds but have had no incentive to do so due to the current dominance of PWLB funding. It is important to note that local authority bonds were a normal part of the funding of local authority capital expenditure in the UK until the early 1980s when central government control of overall government borrowing through the PWLB loan mechanism restricted their issue.

Local authority bond finance is prevalent in the USA where almost all local authorities issue bonds to finance their local capital expenditure. These bonds are very popular with the investing public, partly because the interest paid on them is tax-free. This subsidy is, however, reflected in lower-than-average interest rates being paid by the authorities. $452 billion of such bonds were issued by US local authorities in 2003.[16]

In Europe, bond finance is less common than in the USA because, in many countries, municipal and regional banks have assumed a major role in providing such finance. This system is to be found, for example, in the Netherlands, Belgium, France and Germany. It is unlikely that such a system could now be created in the UK; it would require, in effect, the creation of new banks and the UK financial system is not now amenable to such a development.

Because the creation of a municipal bank is so unlikely in the UK, creating a bond market is the appropriate alternative that we suggest for the UK to replace centralised loans. The World Bank has noted this trend, or an intention to create such a market, in more than 50 countries in the world.[17]

It is possible that one objection to issuing bonds will be that no one authority will need sufficient finance at any one time to make such an issue efficient. In that case, we believe the PWLB should act as a broker for such bonds, bringing together several authorities in one geographic area to ensure a local, but not necessarily authority-specific, bond issue can take place. In that way local saving in local infrastructure will become a real possibility.

The advantages of using bonds to finance local capital projects

There are several advantages of using bonds as a local authority bond instrument that would make them an attractive vehicle for investors:

- The market has always responded positively to such issues in the UK. Until the early 1980s, underwriting and brokering services were readily available, Phillips & Drew (now part of UBS) being a major market leader at that time.
- Such stocks can be rated by market rating agencies such as Standard & Poors to give them tradable status. The achievement of reasonably good assessments will help reduce substantially the cost of this type of borrowing for local authorities, and will provide an added incentive for local authorities to be efficient and work hard to achieve good market ratings.
- The proposed bonds will have long-term investment appeal to both individuals and Funds. Anecdotal evidence suggests that, for this reason, when local authority bonds were in wide circulation, the level of trading and associated costs for the issuing authorities was low.

- The strong structure and sound history of local government in the UK makes it an attractive base for such a market.
- Bonds can be made attractive to individual investors via the use of tax incentives. We believe that local authority bonds should be treated as favourably as gilts for taxation purposes. This would involve exempting them from Capital Gains Tax, making the income free from all UK withholding tax and making income paid on them tax free in the hands of individual investors up to a holding level of £20,000 at redemption value. Provisions such as these have been central to the success of this market in the USA and have the additional advantage of reducing the overall cost of funding to the authorities involved. Making local authority bonds a tax-efficient investment in this manner would provide a significant incentive for individuals to invest in their local authority. It would also encourage local accountability by increasing the association of local people with direct financing of local capital infrastructure. The resulting increase in saving meets government objectives in this area, including an increase in pension saving for which the bonds would be very suitable.

The potential problems with creating an English local authority bond market

The creation of an effective bond market for local authorities will take time to achieve and will require a big shift in thinking both at the level of central and local government. This is largely because many of the necessary skills and structures required for local authorities to function in a commercial capital market are severely lacking due to the disproportionate reliance on non-commercial funding from the PWLB for capital projects. The necessary skills, such as effective project appraisal techniques, are all transferable however, and more to the point, are likely to become supported by the private finance market itself, as financial providers compete for local authority business. The more difficult process will be the creation of an appropriate legislative and regulatory environment in which bonds can be issued. This requires the fundamental changes to the Prudential Code recommended in this report.

Some consideration of equity

(i) A role for central capital grants

The overall aim of our suggested reforms is to encourage local authorities to properly appraise and structure their capital financing decisions. This involves choosing the most appropriate form of funding for the investment undertaken and promotes the use of appropriate private sector borrowing for creditworthy authorities.

There will be some capital expenditure on social infrastructure where the project – and investment undertaken – will not have clear revenue streams attached to it. An example would be a facility for the elderly provided by a council's social services budget without specific and identifiable grant finance being associated with the expenditure or subsequent maintenance of the facility. In cases such as these, private sector borrowing will be difficult to secure, and instruments such as bonds (which are more suited to projects with distinct future revenue streams) will not be the best method of finance. Investments in social infrastructure are a necessary function of local government and should be encouraged by the centre where private sector finance cannot, or would not, be appropriate.

In these situations we recommend that capital grants from central government be made available to local authorities. Grants such as these will, however, become the exception rather than the norm for capital financing. The grants will only be issued

for discrete projects where a local authority can demonstrate that the project to be funded is of social benefit to their community and that private sector finance could not be raised for all or some of the necessary investment.

(ii) Consideration of equalisation

There will, of course, be a variation in the amount of private funding each local authority will be able to secure based on its measured credit-worthiness, current levels of debt and the size of its tax base. As a result, there is a danger that poorer authorities with smaller tax bases will find it difficult to raise private sector finance and therefore will see their capital infrastructure and investment decline.

The proposals for equalisation with respect to capital finance mirror the suggestions regarding a reformed system of equalisation under the revenue finance system made in the previous report on revenue financing.[18] Central government should only be concerned with equalising extreme differences in capital raising abilities across local authorities. The system of revenue equalisation proposed previously fully equalises for differences in resource bases for local taxation (up to the level of the local spending assessment) and provides a simplified level of needs equalisation for all local authorities.

In addition, we suggest that local authorities should still be able to use revenue grant financing to fund capital projects. In our revised system of revenue funding based on three core local taxes, they will be able to vary rates of local taxation to help with financing. This power, in combination with a continuing system of capital grants for social infrastructure related projects – which could not generate income sufficient to support borrowed capital whatever its source – should be seen as the most significant tools for equalisation.

Behind these suggestions though is the remaining power we suggest: the PWLB should have to act as lender of last resort to local authorities who are unable to secure commercial funding for projects which would be viable but for circumstances of geography or the history of the local authority. In all such cases we recommend that the PWLB must accompany such loans with a programme to ensure that the authorities involved move towards capital financing independence for two reasons. The first is because this will prevent a pattern of dependency, which could develop in some authorities. The second is that the encouragement of such progress will, in itself, ensure enhanced skills are available in the authority needing the services of the PWLB, and that might increase the chance that they will not need them in the future.

Appendix 1

Prudential Code for Capital Finance

The Local Government Act 2003 created a new system of controlling local authority borrowing. This came into operation in April 2004. The new system requires authorities to determine how much they can borrow having regard to The Chartered Institute of Public Finance and Accountancy's (CIPFA) Prudential Code for Capital Finance (the Code). The key elements to that Code are that any authorities' planned investment expenditure on new capital assets must be financed in ways that are affordable, prudent and sustainable.

An authority meets these conditions if they comply with a number of prudential indicators, such as setting limits on total borrowing and by assessing the impact of any investment decisions on the level of current and future Council Tax. The required review period over which the impact must be assessed is the current budget year and the two following years, making three in all.[19] This limited period for assessing the impact of any investment decision has been set even though it is recognised that the period over which the investment will have consequence and the period over which the associated borrowing may be repaid may be much longer.

Whilst this change at local authority level has been quite dramatic, the system by which central government decided to support capital spending by local authorities did not changed significantly in April 2004. It continued to be based on either specific capital grants or revenue grants to meet the borrowing costs associated with capital spending. In the latter case the Government identifies the amount of capital expenditure it is prepared to provide revenue support for and this is then factored into the authority's formula spending share.

The Code enables any authority to incur higher levels of capital expenditure than these grants allow, if it so wishes. The revenue consequences of that decision need to be funded from:

1. Reduced revenue expenditure on services
2. Additional Council Tax
3. Revenue savings arising from 'invest to save' schemes

Given the pressure on current levels of spending in most authorities the first option is unlikely. Similarly, given the pressure to constrain the level of increase in Council Tax both from central government and local electorates, there is limited scope for the second option. As a result, the third scenario is likely to provide the most relevant opportunity presented by the new flexibilities, and therefore limits their usefulness to a very large degree.

Endnotes

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[1] Travers and Esposito (2004) *Nothing to lose but your chains: Reforming the English local government finance system,* (Policy Exchange, London)

[2] Source ODPM (2004) *Local Government Financial Statistics*, Table 4.2a

[3] HM Treasury Spreadsheet Download TME by sub sector, last updated 20 July 2004

[4] Wilson and Game (2002), *Local Government in the United Kingdom*, p181 (Palgrave Macmillan, Basingstoke).

[5] Murphy and Hines (2004) p9, *The Feasibility of Introducing Municipal Bonds*, (**nef** unpublished).

[6] PWLB (2004), *2004 Annual Report*, Appendix A, Table 14, p21

[7] Wilson and Game (2002) *op cit* p183

[8] CIPFA (2003) *The Prudential Code For Capital Finance In Local Authorities – Preliminary Guidance*, p4

[9] ibid, p2

[10] ibid, p9

[11] ibid, p12

[12] PWLB (2004) p2

[13] ibid, p9

[14] ibid, p 9

[15] Travers and Esposito (2004) *op cit*

[16] http://www.bondmarkets.com/Research/MuniIssuanceMO.shtml

[17] Peterson (2000), *Building Local Credit Systems*, (World Bank)

[18] Travers and Esposito (2004), *op cit*, Chapter 9

[19] CIPFA (2003)