centreforcities

Banking on Growth:
Trends in local government funding and finance

Zach Wilcox, Joe Sarling & Ewan Wright
July 2012

"The Centre for Cities is a research and policy institute, dedicated to improving the economic success of UK cities.

We are a charity that works with cities, business and Whitehall to develop and implement policy that supports the performance of urban economies. We do this through impartial research and knowledge exchange."

www.centreforcities.org

Executive Summary

The UK needs jobs and growth. An effective way to support employment is by investing in assets such as transport and education infrastructure to promote growth as the country heads into the next era of economic expansion. Much of the current debate is focused on how central government can stimulate growth, but this ignores the key role that local government can and does play in funding infrastructure at the local level.

Local government's capital investments can support economic growth. Investing in transport infrastructure can reduce bottlenecks and help workers and goods get to where they need to go more quickly and inexpensively. Information and communication technology investments have been shown to contribute between 0.3 and 0.9 percentage points growth to GDP across OECD countries.[1] The Eddington Transport study[2] suggested there is room for local government to have greater scope and control over local projects that could unlock growth.

"The growing gap between income and expenditure means councils will have to either cut their expenditure, find new ways to fund it, or a combination of both"

However, central government controls much of the purse strings. Our findings support the claim that a lack of financial freedom over local revenues restricts local government's ability to finance capital projects. In the current context of deficit reduction, if local government is to support growth, it must find new ways to finance the infrastructure the UK needs to restart growth. Understanding how local authorities can fund capital projects is essential in this age of austerity.

The gap between the total funding local government receives and its capital expenditure is growing:

- From 2006/07 to 2010/11, the level of self-financed capital expenditure – local government expenditure without the assistance of central government – more than doubled from £4 billion to £9.3 billion.
- Supported borrowing (i.e. money from central government to allow local government to repay loans) fell during that period from £3.1 billion to £1.9 billion and is now being phased out.
- On top of that, capital budgets are set to fall by 22 percent through 2014/15 as set out in the 2010 Spending Review.

The growing gap between income and expenditure means councils will have to either cut their expenditure, find new ways to fund it, or both. In fact, evidence suggests this is happening already.

Local government borrows money to fund capital projects:

- In 2011, local government[3] in England held over £45 billion in long-term debt.

1. Colecchia A & Schreyer P (2001) 'ICT investment and the economic growth in the 1990s: Is the United States a unique case? A comparative study of nine OECD countries.' OECD STI Working Papers 2001/7.
2. Eddington R (2006) *The Eddington Transport Study, The Case for Action: Sir Rod Eddington's Advice to Government.* London: The Stationery Office.
3. For the purpose of this research, "local authorities" include local government entities excluding "service authorities" such as fire, police and transport authorities unless otherwise stated. We also exclude authorities whose organisational structure or boundaries changed in the 2009 local government reorganisation. We include only local authorities in England.

- Of that, £34.3 billion (three-quarters of the total) was borrowed from the Public Works Loan Board (PWLB - the public lender to local government) with most of the remainder held by UK and foreign banks.

The recession and subsequent spending cuts are beginning to have an effect on local government borrowing. The uncertainty around local government funding from central government means authorities lack the resources and confidence to borrow as they did prior to the recession, and there has been a relative shift away from public sector borrowing:

- Between 2006/07 to 2010/11, borrowing from the PWLB dropped 65 percent from £7.5 billion to £2.6 billion per year.
- Local government debt held by banks increased by £2 billion between 2006/07 and 2010/11, while the amount of debt held by the PWLB only increased by half that amount.
- Urban authorities in particular have seen an increase in borrowing from foreign banks by over 20 percent or almost £200 million.
- Overall borrowing has slowed since the onset of the recession.

"In order for councils to make effective use of their new powers to support economic growth, localism in the UK must include localisation of funding"

The level and degree of borrowing varies widely among authorities and within cities in England. Factors which affect this variance include the appetite for risk of council officers, opportunities for capital projects, the level of locally-raised revenues and local economic growth.

The most important drivers of local borrowing lie in the hands of central government. Government's cuts to capital spending combined with central control over local authorities' income levels means that local government has fewer resources and less confidence to borrow for capital projects.

As part of its localism agenda, the government is implementing policies which could give more confidence and financial support to local government. Localised business rates retention is a small first step towards giving local government more power over their revenues. Opportunities for bundling funding streams (such as business rates and Community Infrastructure Levy), as well as pooling budgets across local authorities, may open new gateways to accessing finance in local government. Additionally, new funding and finance propositions are maturing in local government – from pension funds to bonds and City Deals. At a time of economic downturn, local government and central government must work together to make the most of the changes that lie ahead.

But more needs to be done. While central government may not want to underwrite additional local government borrowing, it should work with local authorities to explore ways to introduce more financial freedoms and flexibilities into the local government finance system. In order for councils to make effective use of their new powers to support economic growth, localism policies in the UK must include localisation of funding. As the policy debate progresses, Centre for Cities will continue to investigate how local government can best support capital investment.

1. Introduction

Imagine running a business, but letting someone else decide how much income you can earn. Instead of keeping your profits, you have to pass most of them to a third party to be shared among other firms in hopes that they grow as well. On top of that, the amount your business earns can change at short notice. What effect would this have on your firm? It would reduce certainty over future revenues; it would undermine your incentive to make a profit; and it would greatly hinder your ability to borrow money to grow your organisation.

This is the scenario that confronts local authorities in the UK. Grants from central government make up 64 percent of local government funding.[4] This is much higher than the OECD average for local revenues as a percent of total local budget, which is around 50 percent.[5] Local government is therefore highly reliant on central government for funds and has few mechanisms for increasing its income to pay for capital projects like schools, roads, communication infrastructure or housing.

"Connecting businesses to markets and people to jobs is imperative for local economic success, and the returns on urban infrastructure can yield a £3 benefit for every £1 spent"

The limited control local authorities have over their income undermines not only their incentive but also their ability to promote growth. Revenue expenditure plays an important part in helping local government support growth through services such as skills provision. However, capital investment makes places more productive over the long-term. Councils can invest to improve transport and infrastructure, provide facilities for healthcare and education and build housing. In fact, the Office for Budget Responsibility found that capital spending generates more output in the UK than tax cuts or spending on current goods and services.[6]

Connecting businesses to markets and people to jobs is imperative for local economic success, and the returns on urban infrastructure can yield up to £3 benefit for every £1 spent.[7] While not every infrastructure project lobbied for will bring such high returns, local government should have the resources and opportunity to invest in those capital projects that will help unlock growth in their city.

Yet local authorities are increasingly cash-strapped. The combination of the government's deficit reduction programme and the recession means that financial support for local authorities in the form of grants will decrease. Since 2007/08 there has been a significant decline in capital receipts (funds raised by local government through, for example, selling assets - 57 percent) and supported borrowing (money given to local government to fund the repayment of debt - 39 percent). The latter started being phased out in 2011.

As a result, the way local government funds capital projects is changing. This is important because capital expenditure matters to economic growth. Also, the gap between local funding from central government and local capital expenditure is likely to grow as central funding decreases through 2014/15. If current levels of capital

4. DCLG (2011) Local Government Financial Statistics England. No. 21
5. Blöchliger H & Petzold O (2009) "Taxes or Grants: What Revenue Source for Sub-Central Governments?", OECD Economics Department Working Papers, No. 706, OECD Publishing.http://dx.doi.org/10.1787/223111363085
6. Office for Budget Responsibility (2010) Budget Forecast, June 2010.
7. Eddington R (2006) *The Eddington Transport Study, The Case for Action: Sir Rod Eddington's Advice to Government.* London: The Stationery Office.

expenditure are maintained, this gap in funding will reach 43 percent. Finding new ways to pay for capital investments including improving transport, communications and social infrastructure has the potential to boost long-term, sustainable growth.

The government is taking a first step towards changing local authorities' over-reliance on central government by introducing local business rates retention in the Local Government Finance Bill. At the same time, local government has been given more freedoms, via the General Power of Competence. With new powers and some new funding streams, the question facing local authorities struggling to emerge from recession is this: **will new revenue streams give local government greater confidence and ability to borrow to support economic growth?**

"Will new revenue streams give local government greater confidence and ability to borrow to support economic growth?"

To start to answer this question, this report investigates the state of local government borrowing in England, with the aim of understanding the impact of changes in the economic landscape and in the relationship between government and councils. It looks at:

- Trends in local government spending, setting out how authorities allocate capital expenditure and how that is changing
- Levels of borrowing and shifts in preferred lenders
- Local authority borrowing behaviours, concluding borrowing levels are largely defined by the level of funding they receive from central government.

Our findings support the claim that a lack of financial freedom over local revenues restricts local government's ability to finance capital projects.

2. Capital Expenditure: Investing in assets that support growth

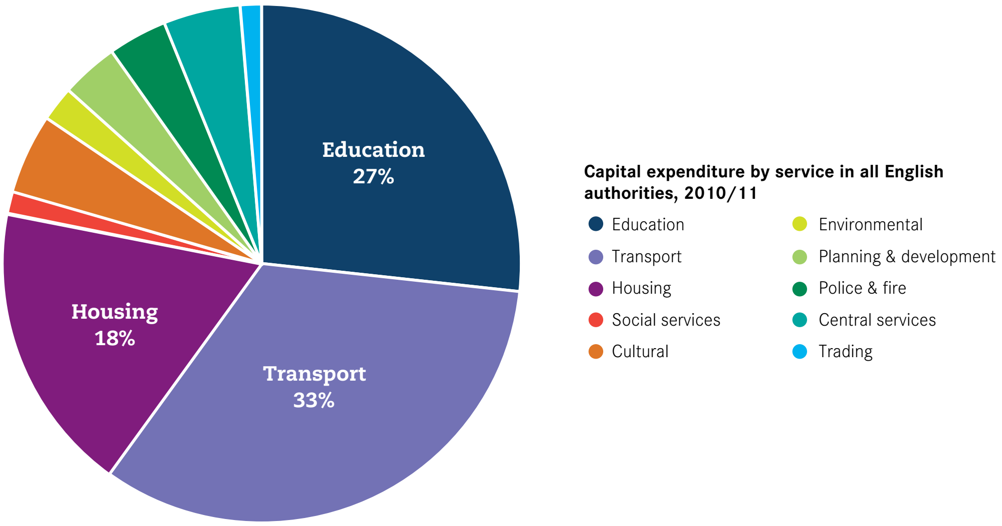
More than £3 of every £4 of local government capital expenditure is spent on education, transport and housing, which are all areas with the potential to directly influence economic growth. This means local government plays a significant role in determining the success of local economies. However, the growing gap between central government capital funding and local capital expenditure implies an increasing need for new funding streams and finance mechanisms to maintain existing investment levels. To understand how and why local government uses debt to fund capital projects, this report first investigates local authority spending patterns.

"Among English local authorities, 78 percent of capital was spent on transport, education and housing"

What is local government capital expenditure spent on?

Local government capital expenditure was nearly £22 billion in 2010/11. Capital expenditure on average accounted for 11 percent of total UK local government spending between 2006/07 and 2010/11.[8] **Among English local authorities, 78 percent of capital was spent on transport, education and housing.**

Figure 1: Capital expenditure by service area for all English authorities in 2010/11



Source: DCLG, Local Government Finance Statistics 2006/07 to 2010/11.

How is capital expenditure funded?

Capital expenditure is funded from a range of sources (see Box 1). These changed significantly with the 2003 Local Government Act, which gave authorities greater autonomy to raise funds through, for example, prudential borrowing and trading.[9] This has enabled a steady increase in capital expenditure across the UK in recent years.[10]

8. HM Treasury (2011) Public Sector Statistical Analysis: HM Treasury
9. Local Government Act 2003 http://www.legislation.gov.uk/ukpga/2003/26/pdfs/ukpga_20030026_en.pdf
10. Carr R (2012) *Credit Where Credit's Due–Investing in local infrastructure to get Britain growing.* London: Localism

Box 1 - Source of capital expenditure funding

- ***Capital receipts:*** Authorities are able to raise funds by, for example selling assets or trading.
- ***Capital grants:*** Government and private grants, usually for specific purposes and schemes.
- ***Supported borrowing:*** Support grants to finance borrowing up to a specified limit. This was abolished in May 2011 and is currently being phased out.
- ***Prudential borrowing:*** Additional borrowing made under the Prudential Code of which authorities must meet the corresponding interest and repayment costs.

"Local authority capital expenditure in England increased by 39 percent between 2006/07 and 2010/11 to £21.9 billion"

Capital expenditure in cities

Joint working between local authorities can support infrastructure investment within functional economic areas. With greater emphasis on cross-boundary working and pooling budgets across authorities, thinking about capital expenditure on the city region level is increasingly important for local government.

English cities[11] accounted for a total of 48 percent or £10.6 billion worth of local authority capital expenditure in 2010/11. There is a positive relationship between the size of a city's population and the level of its capital expenditure. Indeed, the authorities in Birmingham, London and Manchester accounted on average for 49 percent of all capital expenditure in cities between 2006/07 and 2010/11.

Cities in England are made up of combinations of Unitary Authorities, Metropolitan Districts and District Councils. Capital expenditure levels are influenced by the variation in service responsibilities between different authority types (Appendix Figure A1). While Unitary authorities and Metropolitan Districts control all areas of capital expenditure (education, transport, housing, waste etc), District Councils are not responsible for education, transport or waste disposal, meaning they have fewer obligations and therefore lower levels of spending. The differing remits of local government may introduce new challenges for capital projects in cities.

The growing gap between expenditure and income

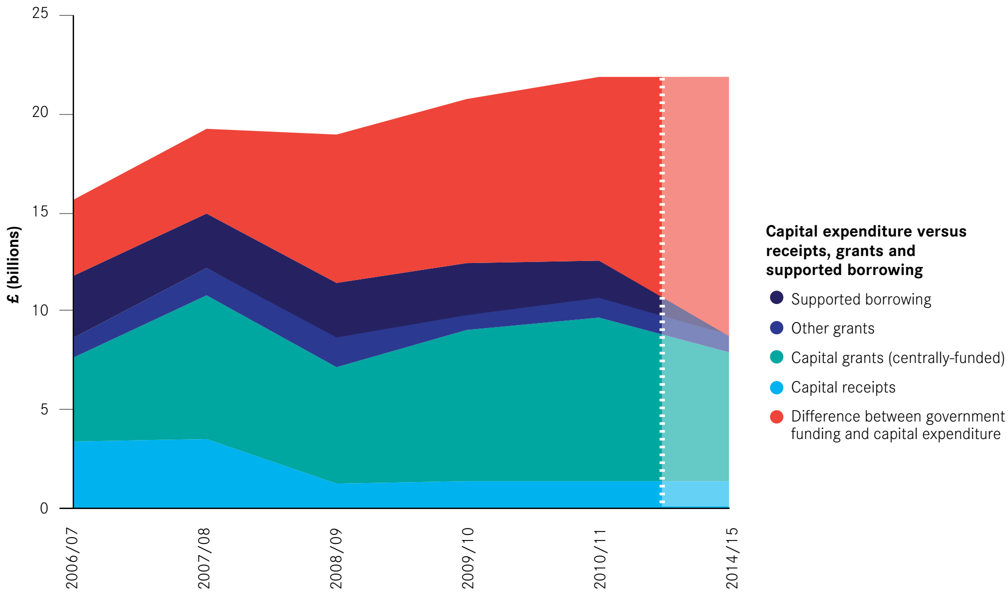
Local authority capital expenditure in England increased by 39 percent between 2006/07 and 2010/11 to £21.9 billion. Capital expenditure has continued to grow since the beginning of the recession (16 percent since 2008/09). As is shown in Figure 2, this has in part been supported by a 76 percent increase in capital grants. Also, capital expenditure often involves long-term programmes, meaning authorities cannot always reduce capital expenditure in a recession. The impact of reduced grants during the Spending Review period is likely to emerge more gradually over time.

Since 2007/08, English local authorities have experienced an increasing gap in the proportion of their capital expenditure funded by central government. The funding gap between capital expenditure and income (receipts, grants and supported borrowing) has grown from 26 percent to

11. Cities defined as Primary Urban Areas as defined by the State of the English Cities report by the Department for Communities and Local Government (DCLG).

43 percent from 2006/7 to 2010/11. This is partially a result of a significant decline in capital receipts and supported borrowing since 2007/08 (the latter is being phased out). The reduction in capital grant from central government and the end of supported borrowing could lead to a growing gap by 2014/15 if current levels of capital expenditure are maintained (Figure 2).

Figure 2. Rising difference between capital expenditure and central government funding of local government



Source: CLG capital expenditure and receipts: 2006/07 to 2010/11.

"The medium-term future of local government capital expenditure will be determined by decisions that were made in the 2010 Spending Review"

Changing landscape of local government funding

The medium-term future of local government capital expenditure will be determined by decisions that were made in the 2010 Spending Review. The review set out overall real terms reductions in capital budgets of 22 percent by 2014/15 across all departments. More specifically, the Department for Education and the Department for Health have pencilled in reductions of 55 percent and 10 percent respectively.[12] Those authorities that are responsible for education and health (social care) capital expenditure, including Unitary Authorities, County Councils, Metropolitan Districts and the London Boroughs will, therefore, be especially affected by the budgetary changes.

Infrastructure investment in particular, will require new funding and finance mechanisms to meet demand for transport, energy and communications projects. The Department for Transport's capital budget will see a real reduction of three percent by 2014/15.[13] In addition, the 2011 National Infrastructure Plan estimated a need for £250 billion of new infrastructure over the next decade.[14] While much of this will fall under the spending remit of central government, local government will play an important role in new infrastructure provision and funding. Local authorities will increasingly need new funding streams or alternative methods to finance capital expenditure if this level of transport infrastructure provision is to be achieved.

12. HM Treasury (2010) *Spending Review 2010*, London: The Stationery Office
13. HM Treasury (2010) *Spending Review 2010*, London: The Stationery Office
14. HM Treasury (2011) *National Infrastructure Plan 2011*, London: The Stationery Office

3. Trends in Local Authority Borrowing

An overview of local government borrowing

Local authorities, through their prudential borrowing powers, can use debt to fund capital projects. In 2010/11, English local authorities held over £45 billion in debt. Local government can borrow either from the Public Works Loan Board (PWLB) or from private banks depending on which offers the best terms and conditions.

A council's approach to borrowing is influenced by a wide range of factors. Some may be debt-shy, using investment revenues, raising council tax or reducing capital budgets rather than borrowing. Others view debt as a prudent option for funding capital expenditure. Differences in approaches to debt are also influenced by the varying roles and responsibilities between local government structures.

The **growing gap** between central government funding and capital expenditure means that more authorities may turn to **debt options** to support local spending.

"The growing gap between central government funding and capital expenditure means that more authorities may turn to debt options to support local spending"

Borrowing from public and private lenders

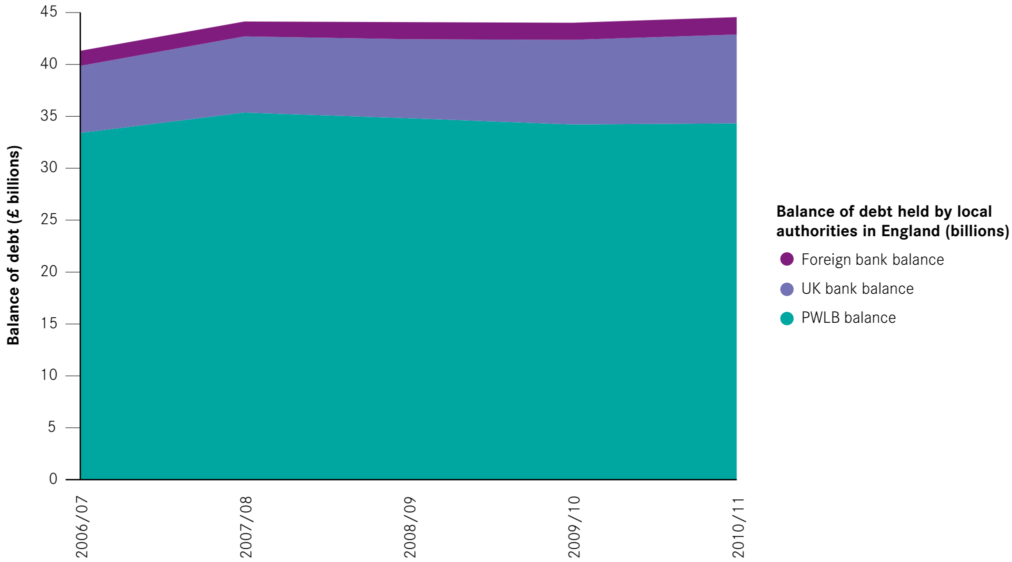
The primary lender to local government is the PWLB – the governmental lending body which offers low interest loans to local government. There are no set conditions for lending from the PWLB: an authority receives a loan as long as it is in a position to pay it back.[15] However, local government is rightly concerned with receiving the best rates, terms and conditions when it borrows, and that means that councils sometimes choose to borrow from private lenders instead – both domestic and foreign.

While the majority of local authority borrowing is from the PWLB, borrowing from private lenders has increased a little over the past five years (Figure 3). Between 2006/07 and 2010/11, authorities grew their debt balance with PWLB by about £1 billion. During the same period, they grew their debt held by domestic and foreign banks by over £2 billion. This equates to a three percent reduction in the share of debt held by the PWLB and a three percent increase in debt held by banks. However, the increase in bank borrowing was greatest before the recession, so whether this trend continues in the current economic climate is yet to be determined.

Local authority debt is almost risk-free. UK banks have a typical default rate on loans of between five and 10 percent. Because the default rate on local government borrowing is essentially zero, councils can access favourable conditions and present a desirable diversification strategy for banks looking to hedge default risk.[16]

15. The Chartered institute for Professional Financial Advisors (CIPFA) provides guidance on borrowing levels and on the mix of debt an authority should hold between variable and fixed rates. Authorities work under CIPFA guidance and publish a Treasury Management Strategy with HM Treasury each year outlining how they will manage their finances including debts and investments.
16. Moody's Investors Service (2012) 'Default and Recovery Rates for Project Finance Bank Loans, 1983-2010.' January 31,2012.

Figure 3: Borrowing balance for English local authorities



Source: DCLG

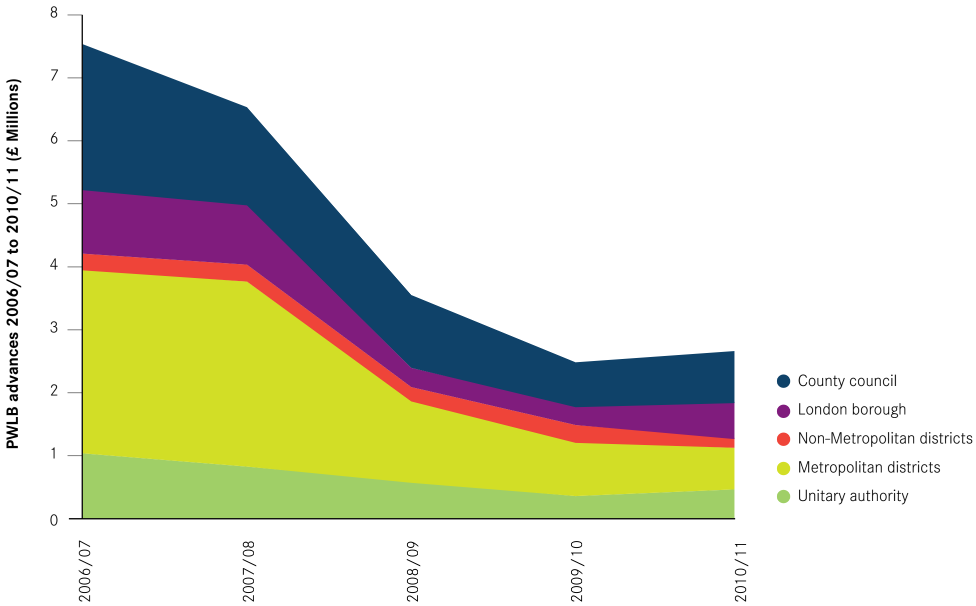
"Access to new sources of finance may lead to new financing approaches and opportunities for local government"

The shift to an increasing use of bank borrowing is relatively small, but is still an important trend because it represents an opportunity for new models of private-public investment to support local growth. Building diverse portfolios of investments and debts with both public and private lenders can help local authority finance departments share risk in new ways. Access to new sources of finance may lead to new financing approaches and opportunities for local government.

Trends in borrowing

While the total debt balance of local government is growing, the levels of new PWLB debt have been decreasing (see Figure 4). PWLB saw a steady decrease in value of new loans from over £7 billion in 2006/07 to around £2.5 billion in 2010/11.

Figure 4: PWLB advances 2006/07 to 2010/11



Source: DCLG, Capital Expenditure and Receipts 2006/07 – 2010/11

Shifting preferences: borrowing by authority types

Local authority attitudes towards and need for debt varies widely, reflecting the variation in remits between authority types. For example, the absolute size, length of loan and risk involved in borrowing for highway construction will be fundamentally different from that of schools or waste management facilities. Thus, the remit of local government - as reflected in the types of authorities - influences borrowing behaviours.

"Borrowing preferences have shifted towards private debt in many authorities"

All types of authorities increased their total debt balance (the amount of debt they hold from public and private lenders) from 2006/7 to 2010/11, with the largest increase among non-metropolitan districts (18 percent) and London boroughs (10 percent). However, borrowing preferences have shifted towards private debt in many authorities. All types of authorities (except non-metropolitan districts) decreased their proportion of total borrowing held by PWLB (the largest decrease being among London Boroughs, from 86 percent to 80 percent) and increased their proportion of privately-held debt.

Figure 5: Borrowing balance levels (£000s)

Balance of Debt	Unitary authority			Metropolitan District		
	2006/07	2010/11	% change	2006/07	2010/11	% change
PWLB	5,206,978	4,952,472	-5%	10,637,663	10,860,920	2%
UK banks	1,099,864	1,394,522	27%	2,656,116	3,487,928	31%
Foreign banks	106,733	115,602	8%	708,500	668,000	-6%

	Non-Metropolitan Districts			London Borough		
	2006/07	2010/11	% change	2006/07	2010/11	% change
PWLB	1,232,722	1,508,471	22%	8,424,257	8,685,861	3%
UK banks	311,456	367,087	18%	1,168,862	1,665,298	42%
Foreign banks	63,114	48,500	-23%	143,800	363,100	153%

	County Council			All		
	2006/07	2010/11	% change	2006/07	2010/11	% change
PWLB	7,895,145	8,321,008	5%	33,396,765	34,328,732	3%
UK banks	1,226,650	1,644,207	34%	6,462,948	8,559,042	32%
Foreign banks	430,982	479,229	11%	1,453,129	1,674,431	15%

	Urban			Non-urban		
	2006/07	2010/11	% change	2006/07	2010/11	% change
PWLB	23,412,407	23,701,155	1%	9,984,358	10,627,577	6%
UK banks	4,908,065	6,517,275	33%	1,554,883	2,041,767	31%
Foreign banks	938,164	1,136,950	21%	514,965	537,481	4%

Source: DCLG, Local Government Finance Statistics 2006/07 to 2010/11.

Much variation exists in borrowing trends between authority types over the period.

- Unitary authorities decreased their borrowing from PWLB but increased their UK bank debt.
- Metropolitan Districts decreased their foreign bank debt and increased their UK bank debt.

- Non-Metropolitan Districts decreased their foreign debt, but increased their borrowing from PWLB.
- The largest increase was seen among London Boroughs, which raised their foreign bank borrowing by 153 percent, although this may be explained by a low starting base.

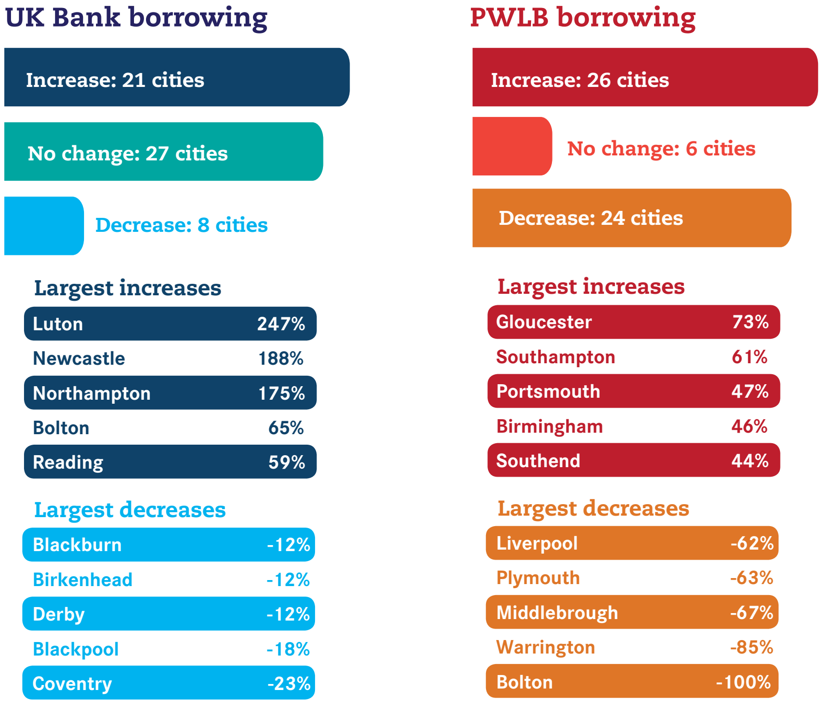
"Urban authorities may have larger, more sophisticated finance departments which can provide the financial expertise to access private debt"

Over 20 percent of urban authorities' borrowing comes from UK banks, while in non-urban authorities the proportion is only 14 percent. This difference could arise for a number of reasons. Urban authorities may have larger, more sophisticated finance departments which can provide the financial expertise to access private debt which has more stringent lending requirements. Urban authorities are more likely to take on larger capital projects which have scale that is more attractive to private lenders. Also, urban authorities experience greater population growth, contributing to larger future revenue streams from council tax; from fees such as Community Infrastructure Levy; and from population-based grants that may give them greater capacity to pay off debt.

Borrowing in cities

While few cities borrow on the PUA level, the patterns of debt across PUAs show what a joined-up apporach to borrowing would look like in English cities. There are significant differences in PWLB and private UK bank debt balance growth among PUAs. A total of 24 cities, of which Bolton, Middlesbrough and Warrington were the largest, paid off more than they borrowed from PWLB between 2006/07 and 2010/11, decreasing their debt balance. On the other hand, 21 cities increased their borrowing from UK banks, with the largest relative increases in Luton (246 percent), Newcastle (188 percent) and Northampton (175 percent).

Figure 6: Borrowing balance growth for English PUAs from UK Banks and PWLB, built up from local authorities' accounts



Source: DCLG. Note: Some cities show results of zero percent change because they started with zero borrowing in 2006/07. This only occurs in five observations.

Per capita capital expenditure is greatest in larger cities, which is likely to be because they are responsible for maintaining larger assets, for example public transport systems. Their growing use of borrowing may be partly because larger cities have the resources to pay back larger loans. They may also be better at matching capital projects to sources of income. For example, building a road to unlock the potential of a housing site can be financed by borrowing against future council tax revenues. Larger cities tend to have both the resources and confidence to take on debt to support growth, particularly as they become increasingly comfortable with private sector lenders.

"Larger cities tend to have both the resources and confidence to take on debt to support growth, particularly as they become increasingly comfortable with private sector lenders"

4. Why do cities borrow?

This paper has demonstrated that local government uses borrowing in different ways and to varying extents. Some authorities borrow very little, while others take out large loans to fund capital expenditure. Some authorities have large capital programmes largely funded by borrowing, while others are more reliant on government grants or local revenues. The variation in local authority borrowing can partially be explained by these financial metrics, but the management and risk profiles of local authority finance departments also influence the extent and nature of their borrowing.

"The management and risk profiles of local authority finance departments also influence the extent and nature of their borrowing"

What affects local government decisions to borrow?

The ability of local government to repay loans is not the only factor that influences whether the authority takes on debt. For example, the professional background and sophistication of finance officers influences the way they approach paying for capital programmes - both the funding mechanisms and their risk profile.[17]

Figure 7: Potential financial factors affecting local government borrowing behaviours

Factor	Effect
Capital grants	**Total money received by a local authority for investment in capital expenditure.** Capital grants are the main source of funding for local capital spending and include grants from central government as well as grants from the EU and developers/investors.
Supported borrowing	**Money from central government that enables local authorities to borrow or use other forms of credit to finance capital expenditure.** Central government provides a revenue stream to support repayment of principal and interest. Supported borrowing is being phased out since it ended in 2011. This is separate from prudential borrowing in which local authorities are responsible for repaying the loans from their own revenues and accounts.
General Fund Revenue Account size	**Account that holds the revenue transactions for local government, including council tax and local revenues.** Most of the day-to-day spending on services comes from this account, but it is also used–to a lesser extent–to fund capital expenditure.
Capital expenditure	**Total money spent by a local authority on capital projects.** The growing gap between capital expenditure and grants can have an impact on the use of debt, so borrowing should grow with capital expenditure.
Financial reserves	**Amount of money an authority has in reserves to act as collateral on a loan or to be used instead of borrowing (complement and substitution properties).** Local government holds over £14 billion in reserves in 2010/11 which are either saved for a rainy day or to build up capital for a specific investment. Reserves may either reduce the need to borrow, complement it as a resource to borrow against or be a coincidental financial account with no direct relationship to borrowing.
Prudential borrowing limit	**Limit on borrowing an authority places on itself during a given year.** The prudential borrowing limit of an authority both defines the upper borrowing limit during the year and provides a proxy for their risk propensity.
Investments	**Money used by the authority to invest in financial assets.** Investments can divert local resources from capital expenditure if an authority chooses to save for the future rather than spend on capital projects today. Or, revenues from investments can be used to fund capital expenditure.

17. Audit Commission (2011) *Tough Times: Councils' responses to a challenging financial climate.* London: Audit Commission: London

The behavioural aspects of borrowing decisions are worthy of a project in their own right, and therefore this research focuses on the financial factors affecting local authority borrowing habits. Data on local authority accounts and expenditure are used, covering 2006/07 to 2010/11.[18] Based on interviews with central and local government, the factors listed in Figure 7 represent the major aspects that should influence the levels at which local government uses debt to fund capital projects.

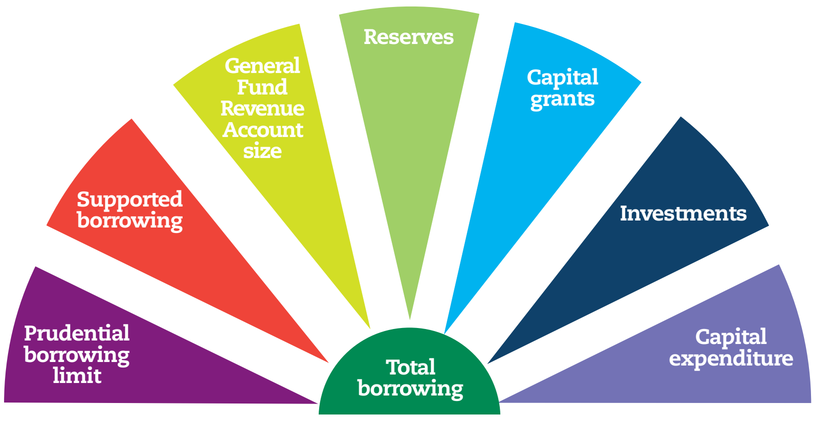
These factors cannot entirely explain the difference in borrowing patterns across local government. As previously discussed, responsibilities of authorities vary depending on the type of authority (Figure 5). Ultimately the amount of money borrowed, and the propensity of an authority to borrow, depends on their reasons for taking out loans. The statistical tests of the analysis do suggest, though, that much of the borrowing levels of local government can be explained by the financial factors detailed in Figure 7.

"Four consistent and significant factors arise from the analysis: revenues including capital grants, supported borrowing, capital expenditure and prudential borrowing limits"

What factors affect borrowing behaviours?

Regression analysis was used to test the effect of these factors, as well as the effect of local authority type on local authorities' average borrowing balance from 2006/7 to 2010/11.[19] Four consistent and significant factors arise from the analysis affecting authorities' levels of borrowing: revenues including capital grants, supported borrowing, capital expenditure and prudential borrowing limits.

Figure 8: Factors potentially affecting local government borrowing decisions



1. Government funding and supported borrowing affect local government's borrowing behaviours. Across all authorities, an increase in capital grants decreases the expected debt held by a local authority. This means that authorities receiving more grant funding rely less on borrowing to fund capital projects. Therefore central government plays a role in determining how much a local authority will borrow to fund capital expenditure through the level of grant it gives a local authority.

18. This analysis uses publicly available data on the local authority level from PWLB and DCLG. Due to the bumpy nature of the data (peaks and troughs due to time-specific circumstances, such as years when specific projects come into effect or major debts fell due) the 5-year average of the factors are taken into account.
19. This research evaluates the change in borrowing balance rather than the amount of loans taken out in the period. The change in balance reflects both authorities' loan advances and the rate at which they are paying off debt to pursue different finance strategies.

2. Supported borrowing funded by central government has increased local government's use of finance. By providing the revenue streams that support local government's repayments of principal and interest on certain loans, government has increased the use of debt by local government in funding capital projects. The end of supported borrowing, thus, should have a negative impact on local government's ability to use debt in capital projects in the future.

3. Those local authorities with higher capital expenditure levels are more likely to have higher levels of debt. However, the causal link between these factors is unclear. Those authorities which have the confidence to use debt to support capital expenditure may set larger capital budgets. Or, authorities with larger capital budgets may, due to lack of local revenue raising powers, borrow more to cover their costs.

4. Local government's borrowing tends to grow in line with their prudential borrowing limits. Those local authorities which set higher limits tend to borrow more, suggesting that local government sets appropriate prudential limits in accordance with their borrowing behaviours.

Overall, these findings are intuitive. Authorities which receive more government funding for capital expenditure do not need to use debt to support their spending, and, in fact, central government may well fill the borrowing gap in those authorities less able to borrow. Supported borrowing has increased local government's use of debt to fund capital projects. Also, the more an authority spends on capital projects, the more it is likely to need to borrow to fund them. Of equal interest however, are the factors that do not affect borrowing decisions in local government.

Which factors do not affect borrowing behaviours?

Interviews with experts in local government finance suggested that authorities' investments and reserves can shape local government's overall use of debt to fund capital expenditure.[20] However, no significant patterns have emerged for these factors.

"Interviews with experts in local government finance suggested that authorities' investments and reserves can shape local government's overall use of debt to fund capital expenditure"

Investment does not have a consistent relationship with borrowing. While, anecdotally, local government uses investment income to fund capital expenditure, the data suggests this does not happen in any strategic way across local government. This does suggest, however, that local authorities are using a variety of mechanisms to fund capital expenditure, depending on local attitudes towards debt.

Authorities' levels of reserves are not likely to affect the amount of money they borrow. A combination of saving for a rainy day and cautious finance departments contributed to a doubling of reserves in recent years. Reserves are also set aside for specific projects, thus diverting resources from capital expenditure in the short to medium-term. Yet reserves represent an asset local government can borrow against to support capital projects. Since authorities can build up or spend down their reserves as they see best fit, it is not surprising that there is no clear trend in the way they are used to support borrowing.

20. Centre for Cities interviews.

Localism and borrowing

The factors which determine local authority borrowing patterns reflect the relationship between local and central government in the UK. But local government finances are very reliant on central government, which funds around 50 percent of capital expenditure. This shapes local authorities' ability to spend on capital and to borrow against future revenues.

Local authorities have the decision-making freedoms to handle their finances in the way they see fit, as long as they do so within guidance from HM Treasury, DCLG and CIPFA. Prudential borrowing means authorities need to borrow within their capacity to pay back loans at the appropriate level of risk. Thus, an authority looking to borrow funds to build a new road to accompany housing growth must be certain of the grant funding it will receive, supplemented by local funding sources such as council tax revenues or Community Infrastructure Levy, in order to take out a loan.

"The reluctance of local government to use their reserves in the face of declining government funding may mean authorities will decrease their capital expenditure rather than dipping into their reserves"

Thus, local government's ability to finance major projects is restricted by the uncertainty around future levels of government funding and the limited power local authorities have to raise revenues to repay loans.

The freedoms afforded to local authorities, encapsulated in the General Power of Competence introduced in 2011,[21] mean that local government now has a wider choice of routes to funding the gap between revenues and capital expenditure. Local government operates under a range of different funding models. They may:

- Look beyond their investments and income to finance growth using debt from PWLB or bank.
- Fund most or all of their capital expenditure beyond their central government funding via sources such as investment income, meaning they do not need to take on debt.

As capital grants fall, government may see a trend involving the large levels of reserves in local government accounts - over £14 billion in 2010/11 - being leveraged to support investment in infrastructure, schools and housing, if local government has the ability and confidence to raise funds locally to pay back those loans. However, the reluctance of local government to use their reserves in the face of declining government funding may mean authorities will decrease their capital expenditure instead.

While it is prudent and right for authorities to borrow based on their ability to pay loans back, the ability to repay debt is defined - directly and indirectly - by central government. This creates a distortion in the system such that local government is constrained in their capital borrowing by a lack of local revenue raising powers.

21. HM Government (2011) *Localism Act 2011.* London: The Stationery Office

5. Changes to local government finance and possible impacts

This is a time of great change in the way local government accesses both funding and finance. With new local funding streams, shifting opportunities for finance and equity and decreased central government funding, local authorities must quickly adapt to a new financial landscape.

Currently, the extent of local government borrowing is defined by the limits to decentralisation in England. Because local government funding is centrally controlled and councils have little independent revenue raising power, borrowing for capital projects is determined and constrained by central funding as the regression analysis shows. Some authorities use debt to support capital expenditure while others turn to investment income, fees or even raise council tax.

"The City Deals process, which has allowed cities to gain greater financial powers and freedoms, is an important opportunity to think about joined-up approaches to financing investment"

Capital grants have reduced authorities' need to borrow. As government grants fall over the course of the current Spending Review period, local government must find new sources of funding to continue supporting capital projects. Combined with the phasing out of supported borrowing - which had the effect of increasing council's use of debt - the future for local government finance is unclear (as illustrated in Figure 2). Because of these constraints, local government will have to find ways to use existing and new funding streams more effectively.

With the gap between local government funding and capital expenditure growing, borrowing against new or bundled funding streams (like business rates or Community Infrastructure Levy) could become an increasingly valuable option for local authorities. Borrowing against reserves, or leveraging them with debt, could prove an important mechanism for funding capital programmes as well. However, the use of reserves is likely to be limited as many cities will choose to build them up to protect their budgets against continued reductions in government funding.

If use of private finance by local government grows, joint working between councils could release borrowing power to work on cross-boundary projects. The major projects brought forward by the Greater London Authority and by the Greater Manchester Combined Authority show how pooling budgets, responsibility and risk can open up new opportunities for cities. The City Deals process, which has allowed cities to gain greater financial powers and freedoms, is an important opportunity to think about joined-up approaches to financing investment.

The Local Government Finance Bill will give local government in England greater revenue raising powers, allowing them to retain a proportion of business rates income which they could use to support capital expenditure. Business rates retention may not prove a cash cow for most authorities, but it will provide a stream of funds which, when coupled with other funding streams, could be borrowed against to support investment in the infrastructure needed to support the local economy.

The shifting landscape of local government finance - with increasing gaps between capital expenditure and funding, new sources of revenue, and greater powers through the Localism Act - means the trends explored in this research are likely to change.

We can expect:

- Greater emphasis on pooling budgets within authorities (i.e. whole place budgeting, a combined budget approach across a range of public services).
- Opportunities for pooling budgets between authorities (business rates pooling).
- New roles for pension fund investment.
- Bundling funding streams (such as New Homes Bonus, Community Infrastructure Levy and business rates) to create larger funds.
- New funding mechanisms such as local bonds to come into play.

"How can local government use cross-border collaboration to make infrastructure investments across a city region? What role can local government bonds play?"

Centre for Cities will continue to research the ways that new funding, finance and equity options for local government can support investment in capital projects. For example, how should local government and pension fund managers adapt their skills, risk management practices and portfolios to support pension fund investment in UK cities? How can local government use cross-border collaboration to make infrastructure investments across a city region? What role can local government bonds play, given uncertainty around the PWLB borrowing rate? Answers to questions such as these will become increasingly important to UK cities as they seek ways to invest in their future despite a difficult financial climate.

Appendix

Data

This research uses local authority data publicly available from DCLG and PWLB on borrowing levels, borrowing limits, government grants and capital expenditure in England between the financial years of 2006/07 and 2010/11.

This research excludes service authorities, such as police and fire authorities, from the analysis as they cross political boundaries and cannot be directly allocated to specific authorities' financial behaviours. Those local authorities which changed authority type in the 2009 local government reorganisation have also been excluded, as their capital responsibilities and financial structures changed as a result. This research presents urban and non-urban trends. Local authorities which form part of a city, as per the Primary Urban Area definition, are treated as urban authorities.

Figure A1: Remits of local government by authority type

	Shire areas				London	
	Unitaries	County councils	District councils	Metropolitan districts	London borough	GLA
Education	●	●		●	●	
Highways	●	●		●	●	●
Transport planning	●	●		●	●	●
Passenger transport	●	●		●		●
Social care	●	●		●	●	
Housing	●		●	●	●	
Libraries	●	●		●	●	
Leisure & recreation	●		●	●	●	
Environmental health	●		●	●	●	
Waste collection	●		●	●	●	
Waste disposal	●	●		●	●	
Planning applications	●		●	●	●	
Strategic planning	●	●		●	●	●
Local tax collection	●		●	●	●	

Source: Local Government Structure: Overview. Local Government Association (2010).

Authors

Zach Wilcox is an Analyst at the Centre for Cities. Contact Zach on:
z.wilcox@centreforcities.org / 020 7803 4323

Joe Sarling is a Researcher at the Centre for Cities. Contact Joe on:
j.sarling@centreforcities.org / 020 7803 4310

Ewan Wright was an Intern at the Centre for Cities in 2012.

Acknowledgements

The Centre for Cities would like to thank those who gave their time to this project, especially officials at the Department for Communities and Local Government.

All views expressed in this report are those of the Centre for Cities and do not necessarily represent the views of those we interviewed. All mistakes are the author's own.

July 2012

Centre for Cities
Enterprise House
59 - 65 Upper Ground
London SE1 9PQ

020 7803 4300
info@centreforcities.org
www.centreforcities.org