capital crisis

enabling investment in London

LONDON COUNCILS

contents

01
the issue

For many months now there has been mounting anecdotal evidence that the capital finance system in London's 33 local authorities is under increasing pressure, from both a decline in capital receipts and a virtual halt to all private sector regeneration and investment.

In response, London Councils commissioned LG Futures to work with boroughs to analyse the scale of the problem and identify ways in which capital investment could be (re-)enabled.

In their final report: *Enabling capital investment by London local government*, LG Futures make a number of recommendations to boroughs for actions they could consider taking within the existing capital finance system, and London Councils is now exploring these with colleagues across the boroughs.

The focus of this booklet, however, is to highlight the actions London boroughs need central government to take if the capital finance system is to operate more effectively at the local level.

London Councils believes that if the government proactively works with us to swiftly advance our recommendations the capital finance system can provide the framework to re-enable the investment the capital's residents and economy need to accelerate London out of recession.

The full report: *Enabling capital investment by London local government*, along with an executive summary, is available to read or download at www.londoncouncils.gov.uk/publications

Hugh Grover
Director of Fair Funding

02 our findings

The need for investment in London

The report importantly highlights the need to distinguish between enabling capital investment and the ability to raise finance. Local authorities have not generally experienced problems in raising finance; their difficulty lies more in affording the repayment of that finance when revenue budgets are already under pressure from limited income and increasing demands for services.

A survey of London's boroughs generated responses from 25 (76 per cent), with 19 of them providing specific data for unmet need. This showed the average annual 'funding gap'– the difference between existing capital resources and the resources required to deliver boroughs' capital priorities/ needs fully – was **£34 million per borough**.

Bearing in mind that a number of boroughs pointed out the true level of unmet need is likely to be effectively hidden (even from them), given that an annual capital bidding round is no longer in place, a simple extrapolation across all 33 London local authorities would suggest the total funding gap is at least **£1.1 billion over and above existing resources.**

Boroughs highlighted education and housing as the most significant areas in need of major investment, for which funding is currently insufficient.

For some boroughs unmet need in schools ran into tens of millions of pounds. In the context of a dramatic increase in the school age population, resulting in an unprecedented surge in demand for reception places at local primary schools, this lack of investment capacity must be a worry, not just for London's local authorities, but for government as well.

Boroughs also highlighted a potential funding gap to bring all local authority homes in London up to the Decent Homes standard, a situation that could worsen still if the continuing uncertainty over the future of the Decent Homes Programme is not resolved. Local authorities that have been able to meet the standard for all their homes have since found maintaining it across their stock challenging within the constraints of the current housing finance system.

A number of boroughs also pointed out they had needed to deliberately constrain their capital investment programme, given that all available capital resources are under pressure and have generally reduced, whether they come from central government by way of grants, from the sale of assets, or from planning contributions.

Barriers to capital investment

Given there is so much unmet need for investment capital in London, the question must be why and what can be done to improve the situation? The research identified barriers to capital investment that broadly fall into two categories: (i) financial barriers, and (ii) legislative and technical barriers.

(i) Financial barriers

The 'top five' barriers to capital investment identified by London local authorities are all financial/ income based. They are (in order):

- a reduction in the level of capital receipts (100 per cent of respondents)
- limited availability of revenue budget resources to support capital borrowing (96 per cent of respondents)

- falling property prices (91 per cent of respondents)
- reducing private sector contributions (78 per cent of respondents)
- reducing levels of capital grant (74 per cent of respondents)

The first and third of these are likely to be related as falling property prices would inevitably reduce receipts from the disposal of assets. This, and the reported decline of private sector contributions, combine to indicate the significant impact of the economic downturn and, indeed, the significant majority of boroughs said the economic climate had affected their capital planning adversely.

It is a serious source of concern that the limited availability of revenue budget resources to support capital borrowing is already identified as a major issue by boroughs. This clearly indicates that greater pressures on local authority funding from 2011/12 onwards will prove a major constraint on local authorities' ability to invest.

(ii) Legislative and technical barriers

In addition to financial and income barriers, the research identified barriers resulting from legislation, regulations or accounting practice as the next set of priority issues. Changing the rules in these areas will provide more flexibility, more resources or more choice in how local authorities manage capital investment.

Based on the findings of its borough-based study, LG Futures identified scope for removing legislative and technical barriers in 14 different areas. Government officials and council officers with a specialist interest in capital finance are encouraged to read the full report for more detail, but below we set out the issues that London Councils believes to be the most important for London's boroughs and on which we urge the government to take swift action:

- *Reduction of ring-fencing of capital grant.* Since LG Futures conducted their research the government has committed to reducing the amount of ring-fencing across specific and area based grants, and to consider single area based capital funding. London Councils welcomes this commitment as a move in the right direction to address the complex range of capital grants currently available and the differing arrangements for each which can lead to a lack of flexibility at the local level. **London Councils asks the government to press ahead with this commitment while protecting the quantum for London and ensure it leads to a more standardised approach to the capital grant arrangements.**

- *Revenue funding for supported capital borrowing.* For authorities below the Formula Grant floor, which in London means 24 out of the 33 local authorities, supported borrowing is not working effectively; increases in net support for capital financing do not feed through into the grant actually received by a council. So, while on paper it appears that boroughs are getting funds to support borrowing, in reality this is not the case. **To address this it is vital that government returns to making adjustments, in the way it did until 2005/06, to ensure that any increase in notional capital financing is reflected in the actual amount of grant received by authorities.**

- *Capitalisation of procurement costs.* Allowing local authorities to capitalise procurement costs in respect of all capital projects, including PFI (without the risk that they might have to be charged to revenue if the project failed), would free up revenue resources, and reduce concern about embarking on capital projects with an element of risk. **London Councils asks government to agree further flexibility to capitalise procurement costs.**

- *Widening the scope of capitalisation orders*. The research highlighted the scope for an order which would defer revenue costs from impacting on the revenue account for a defined time – this could be for procurement costs as above or for projects where the future revenue stream will pay for the current costs but where there is a deficit in the short term. **London Councils asks government to agree such a capitalisation order.**

- *Mortgaging of assets*. Allowing mortgages against defined assets, which is currently not permitted, might have the potential to lever in some additional resource, for example for income generating assets, such as car parks. This can already be achieved by the use of local authority companies and by structured procurement. However, allowing loan finance through the authority, rather than through off-balance sheet arrangements, could secure finance at lower cost. **London Councils asks government to permit mortgages against defined assets.**

- *Securitisation of income.* Although currently not permitted, this approach could be used to finance income generation schemes, either revenue or capital. This has been achieved when authorities have used off-balance sheet vehicles or linked asset creation with procurement processes. **London Councils asks government to agree to permit securitisation of income.**

- *Tax Incremental Financing Schemes (TIFs)*. The development of TIF arrangements could facilitate regeneration projects. A number of cases have been developed for Accelerated Development Zones (ADZs), which would require legislation (or modification of existing regeneration/enterprise zone legislation); allowing authorities to regenerate defined zones based on future incremental tax increases (from, for example, Non-Domestic Rates). **London Councils asks government to move swiftly to make the necessary legislative changes to facilitate TIFs/ADZs, in order that much needed regeneration in London can go ahead now as part of the economic recovery package.**

- *Well-being powers*. There continue to be concerns that the Well-being powers are insufficiently robust to provide legal backing to the collaborative working that government very much wishes to see. This was highlighted by the London Authorities Mutual Limited (LAML) case. Although an amendment to the Local Democracy, Economic Development and Construction Act 2009 was introduced to provide a specific power to enable councils to engage in mutual insurance arrangements, there remains uncertainty as to how far local authorities can, in practice, proceed with joint and collaborative ventures. **London Councils asks government to provide councils with robust and wide-ranging powers to support partnership working.**

03 the solution

The London-based research into capital finance has identified a number of constraints to better and more effective investment and has put forward proposals which would help tackle these problems. London Councils asks the government to act swiftly on these proposals and to prioritise the following three key recommendations:

- Tax Increment Funding/Accelerated Development Zone pilots
- to re-introduce adjustments for authorities on the funding floor to ensure that increases in notional capital financing actually feed through to revenue grant
- to provide greater flexibility around the scope for local authorities to capitalise specific costs, where these have the potential to free-up revenue resources.

These key changes, which London Councils believes are within government power to realise, have the potential to significantly enable capital investment, both contributing as a catalyst to wider economic recovery and delivering the benefits of improved assets and infrastructure to London's residents.

contact

Hugh Grover
Director of Fair Funding
hugh.grover@londoncouncils.gov.uk
020 7934 9942

London Councils
59½ Southwark Street
London SE1 0AL
www.londoncouncils.gov.uk

design: Copyprint
images: Third Avenue, Philip Wolmuth
publication date: January 2010

London Councils supports environmentally-friendly products. This publication is printed on NAPM accredited paper that uses 75% recycled fibre and manufactured in the UK at mills with ISO 14001 accreditation.