Finance Committee

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Devolved Funding: Borrowing Powers and Capital

This paper is broken into three parts. Part 1 deals with local authority funding arrangements (p.1-8). Part 2 deals with the devolution of borrowing powers (p.8-10) and part 3 deals with innovative finance (p.10-13)

Part 1

Local Government in Wales: Funding Arrangements

Introduction

There are three separate systems to fund the three main blocks of local authority spending. These are:

- current spending on council housing;
- spending on capital projects such as roads, school and library buildings or computers; and
- general revenue expenditure, mainly on pay and other costs of running services apart from council housing.

Revenue

Revenue funding can be broken down into core un-hypothecated funding to support the ongoing delivery of a range of services and hypothecated funding through specific grants to support particular, sometimes time limited revenue costs.

Un-hypothecated funding

The core funding is provided through the revenue settlement and amounts to just over £4 billion in 2012-13.

In mid October each year, the Minister for Local Government and Communities announces a provisional Local Government Finance Settlement to the Assembly and to local authorities.

There is then a period of consultation, leading to the Welsh Assembly approving a final Local Government Finance Settlement in early January and early February in the case of police authorities, in time for authorities to set their budgets for the next financial year.

The Welsh Government then considers whether to use its powers to limit council budget increases. If the Government uses these powers, it will tell an authority how much it can increase its budget by. The Government then considers any arguments the authority puts forward to be allowed to spend more.

Welsh Government starts by deciding how much core spending by local government as a whole it is prepared to support. This amount is known as Total Standard Spending (TSS).

Welsh Government supports approximately 80 percent of Total Standard Spending by distributing Revenue Support Grant (RSG) and redistributed national non domestic rate income (NNDR). Together this funding is known as Aggregate External Finance. The difference between Total Standard Spending and Aggregate External Finance is the modelled amount local authorities are assumed to raise through Council Tax if they spent at the level of Total Standard Spending.

Specific and special grants

The Government covers other specific local government expenditure through specific and special grants which fund particular activities.

Sharing out resources between authorities - the Standard Spending Assessment

To work out each council's share of Total Standard Spending, the Government calculates a Standard Spending Assessment (SSA). The total of all councils' Standard Spending Assessments, makes up Total Standard Spending.

When working out Standard Spending Assessments, the Government takes account of the population, social structure and other characteristics of each authority. The Government (in consultation with local government) has developed separate formulas covering the following major service areas.

- Education
- Personal social services
- Police
- Fire
- Highway maintenance
- Environmental, protective and cultural services
- Capital financing

These formulas are based on research and analysis of statistics. They apply to all authorities providing a particular service. There is an ongoing programme of work under the auspices of the Partnership Council to ensure that the formulas remain relevant and up-to-date.

Redistributed National Non Domestic Rate Income

People who occupy non-domestic properties (such as shops, factories, offices and warehouses) do not pay Council Tax on those properties. Instead they pay business rates - otherwise known as National Non-Domestic Rates.

One council in each area collects business rates and pays them into a national ‘pool’ which the Welsh Government then shares out between all authorities.

Before the start of each financial year, an estimate is made of the amount in the pool which will be available to local authorities. This amount, known as the Distributable Amount (DA), is fixed and then distributed among all local authorities according to the number of residents aged 18 or over that each authority has according to the latest available mid year population estimates. For 2012-13 the DA amounts to £911 million.

Once the Distributable Amount has been fixed, the total amount distributed in this way does not vary, even if more or less is actually paid into the pool in the financial year. Any resulting surplus or deficit within the pool as a result, is carried forward into the calculation for the following year’s distributable amount.

Revenue Support Grant

The Revenue Support Grant is simply the part of Aggregate External Finance that is not provided from NNDR.

Broadly speaking, the Government distributes AEF so that if every authority set its budget at the level of its Standard Spending Assessment, the Council Tax would be the same for all properties in the same valuation band throughout Wales.

The amount of Revenue Support Grant a local authority receives is:

- its Standard Spending Assessment; less
- the amount it will receive from the national pool of business rates; less
- its share of council tax at standard spending.

Setting Council Taxes

Local authorities start preparing their budgets for the coming year several months before they know exactly what funding they will receive from the Government. Once an authority knows the level of funding, it can make final decisions on:

- how much it expects to spend in the coming year;
- what income, other than that from Government, it expects to raise next year; and
- how it can use its financial reserves to fund spending or keep down its Council Tax.

A local authority's planned spending, after deducting any funding from reserves and income it expects to raise (other than general funding from the Government and the Council Tax), is known as the budget requirement. The amount of Council Tax an authority needs to raise is the difference between its budget requirement and the funding it will receive from the Government.

Each local authority then sets its Council Tax at the level necessary to raise this amount.

In 2011-12, local authorities were estimated to raise £1.3 billion (including police authorities). This equated to 23% of the local authorities budget requirement.

Capping

Welsh Government retains the power to set a 'cap' or budget requirement limit, for each council if it considers the budget requirement and Council Tax have gone up by too much. The Local Government Act 1999 introduced new reserve powers which are more flexible than the previous capping powers. They allow the Government to reduce the budget requirement in the following year as well as in the current financial year which was previously the only option. If it has to, the Government will use these powers to protect Council Tax payers from large rises in their Council Tax bills.

The Localism Act 2011 introduced changes to the capping arrangements in England to pass responsibility to local communities for decisions on capping via council tax referenda. These changes do not apply in Wales.

Fire authorities

Fire service funding is an integral part of local authorities' budget setting process.

The regulations setting up the combined fire authorities place a duty on constituent local authorities to fund their fire authority sufficiently to enable it to meet its statutory obligations. This includes additional payments in-year if requested by the fire authority.

It is up to each fire authority to set a budget which will enable its fire service to meet its statutory obligations whilst ensuring that services are provided as effectively and efficiently as possible.

Fire authorities submit their budgets to constituent local authorities which contribute in proportion to their population. The fire authority has the option to include a contingency element in its budget to minimise the risk of payments which might cause financial difficulties for any of the constituent authority once its own budget had been set.

Capital Funding

Capital funding for local government is a mixture of revenue support for borrowing and specific capital grants.

In 2012-13, capital funding provided by Welsh Government amounts to £424 million.

Prudential Borrowing

Prior to 2004-05, local government bodies could only borrow when they had a ‘credit approval’. However, the Local Government Act 2003 (LGA 2003) provided local government bodies with the power to borrow for any purpose relevant to their functions or for the prudent management of their financial affairs.

As a consequence of the LGA 2003, the extent of borrowing is controlled by the local government bodies themselves, through the determination of the ‘affordable borrowing limit’, although the Welsh Government does have reserve powers to impose limits on borrowing. The LGA 2003 therefore provided local government bodies with more discretion regarding the amount of resources they commit to capital investment and the amount they commit to current (revenue) expenditure. It also created a distinction between ‘supported borrowing’ (borrowing backed by Welsh Government financial support) and ‘unsupported borrowing’.

Local government bodies are required to have regard to the proper practices specified in the *Prudential Code for Capital Finance in Local Authorities* published by the Chartered Institute of Public Finance and Accountancy (CIPFA) when determining the affordable borrowing limit.

The overarching requirements of the code are that borrowing must be prudent, sustainable and affordable. Supported borrowing will meet the affordability requirement because the repayment of debt will be factored into the revenue settlement.

Prudential indicators

In order that local authorities may satisfy themselves that any prudential borrowing will be affordable, prudent and sustainable, the Prudential Code prepared by CIPFA establishes a number of Prudential Indicators. These establish upper limits on overall and day-to-day external debt, measures of capital expenditure and debt levels and treasury management indicators. These include the “authorised limit” and “operational boundary” indicators.

These indicators are not limits for the amount of prudential borrowing that an authority can undertake but set the ceiling for the amount of external debt that the authority can prudently bear at any given time. An authority is required to set both these indicators for its total external debt, gross of investments and borrowing from other long term liabilities.

The resources of local government bodies are finite. Therefore, to undertake unsupported borrowing a local government body will need to identify:

- revenue savings arising from the capital expenditure
- reductions in service expenditure to finance the expenditure; and / or
- increases in income from other sources, including receipts and council tax.

The reduction in expenditure and / or increased income would need to be sufficient to service the repayment of the borrowing plus related interest costs.

Enquiries made by auditors in 2008 suggested that local government bodies in Wales had been initially cautious in exercising the increased freedom to borrow provided by the LGA 2003. Generally, unsupported borrowing had, at that time, been limited to acquiring short life assets that were previously leased and some invest-to-save projects. Unsupported borrowing was, therefore, largely being financed from the reductions in revenue expenditure realised by the capital expenditure.

The Local Authority Capital Forecast: 2011-12 (SDR 90/2011) issued by the Welsh Government Statistical Directorate indicated that local government bodies are planning to make increased use of unsupported borrowing to finance capital investment in 2011-12.

The actual level of unsupported borrowing used to finance capital investment in 2009-10 was £106 million and increased to £144 million in 2010-11. It is forecast that this will increase further to £256 million in 2011-12. Unsupported borrowing would thus finance 24% of capital investment in 2011-12 compared to 11% in 2009-10. The additional prudential borrowing has enabled county and county borough councils to increase their forecast spend in 2011-12 compared with the previous year.

Based on the forecast figures local authorities will in 2011-12 be raising more funding through prudential borrowing than through any other individual source of funding including capital grants and supported borrowing. The take up of prudential borrowing varies between local authorities.

Capital Grants

As with the revenue funding, capital grant funding comprises non hypothecated and specific grants.

The unhypothecated funding provided through general capital funding is distributed using indicators of need to spend in the various service areas similar to the unhypothecated revenue settlement.

Specific capital grants are designed and managed by the relevant policy area to deliver specific purposes.

Capital Grants account for 75% of the capital funding available in 2012-13, the remainder is supported through the provision of revenue funding for borrowing.

Local authorities have also been able to bid for wider public service funding for capital projects latterly from the Strategic Capital Investment Fund and more recently from the Centrally Retained Capital.

Local Government Resources Review

The UK Government has undertaken a review of local government funding, focussing particularly on the scope for relocalising business rates.

Until now the system of collection and distribution of business rates has been the same in England and Wales. This review focussed on the issues involved on allowing local authorities to retain more of the business rates collected locally.

The system of funding in England is such that it is not possible to completely localise business rates without creating instability.

Implications for Wales

The nature of the distribution of business rate generation in Wales is even more skewed than it is in England. Consequently there would need to be even greater cross subsidisation retained within the system. Any changes to the system in Wales would need to consider the extent to which the additional complexities built into the system outweigh potential benefits.

The Minister for Business, Enterprise, Technology and Science has set up a Task and Finish Group chaired by Professor Brian Morgan to review business rates policy in Wales. Its role is to:

- consider the relative importance of the non-domestic (business) rates regime as a lever for supporting economic growth;

- assess the implications of specific policies in relation to small business rate relief, empty property rate relief, and rate relief as a targeted policy intervention to encourage economic development (to include renewable energy businesses as well as assistance in disadvantaged areas);

- make recommendations on the above, taking into account that non-domestic (business) rates exist to raise funding for local services and recognising that non-domestic rates do not just apply to businesses but to all non-domestic properties.

Any consideration of specific policies would need to take account of the fiscal, financial, legislative, distributional and economic impact.

The Group is due to report its findings in May.

Police authorities

Revenue

The police receive their core funding from government in two streams. The Police Grant that is paid by the Home Office and the Revenue Support Grant and their share of the distributed national non-domestic rate income that is paid to them by the Department for Communities and Local Government in England and the Welsh Government in Wales.

In addition to those two streams, there are specific grants, which largely the Home Office is responsible for allocating but which Welsh forces may bid against.

Capital

Responsibility for approving police authority capital projects rests with the Home Office. However, the Welsh Government is required to provide the revenue support. The assumption for capital projects procured by the conventional route (public sector) is that provided the total Home Office capital allocation for Wales does not exceed the Barnett formula share then the revenue resource is contained within the budget for the local government revenue support grant settlement in Wales.

For police authorities' PFI projects the arrangements are more complex. The Home Office takes the view that provided the notional PFI credits for police projects in Wales do not exceed the Barnett formula share then the Welsh Government should provide the appropriate revenue support. However we have no way of telling from the Spending Review settlement in which years specific resources to support PFI schemes are added to the CLG budget for local government.

PFI

The Welsh Government provides local authorities, including police and fire authorities in Wales, with approximately £35 million per annum to support the revenue consequences of PFI projects.

The projects were agreed in principle by the first Welsh Assembly Government, although some projects took considerable time to get to completion stage.

Subsequent Welsh Governments have not approved funding for any further local authority PFI projects. PFI remains an approach open to authorities but funding is a matter for each individual authority to address. On the 15 November 2011 the UK Government announced a review of PFI. The UK Government intends to bring forward proposals for a new approach to using the private sector in the delivery of public assets and services. The consultation period closed on 10 February.

<u>Part 2</u>

Devolution of Borrowing Powers

Summary of Welsh Government's position

The Welsh Government already has certain borrowing powers for a wide range of activities under the terms of the Welsh Development Agency Act (1975). Those powers are summarised in Annex 1. At present, Treasury rules prevent these powers being exercised in a meaningful way. The Welsh Government strongly believes that it should be allowed to exercise its existing borrowing powers to fund capital investment.

The Welsh budget for capital expenditure has been cut by 41% in real terms over the next four years, putting a major constraint on our ability to invest in the infrastructure of Wales and support the Welsh economy. Early acquisition of borrowing powers would help us to offset the damaging impact of these cuts.

The Northern Ireland Executive already has powers to borrow to fund capital investment, and the Scotland Bill proposes similar powers should be transferred to the Scottish Government. Plus of course, all levels of local government including Community Councils have long been able to borrow. Such powers are part of the normal range of tools available to elected governments across the UK to manage their finances in an effective way. It is simply unsustainable for Wales to be the only part of the UK denied access to this power.

Over the medium term we believe it would make sense for devolved borrowing powers to be put on a new and broader legal footing, operating within a sensible set of rules that should be jointly agreed with the UK Government. We recognise that devolved borrowing powers need to operate within a framework that provides extra flexibility for Wales, while also respecting the role of the UK Government in managing the fiscal position of the UK as a whole.

Intergovernmental talks

The Welsh Government is currently engaged in a series of discussions with HM Treasury on financial reform, including the scope to allow Wales to exercise its existing borrowing powers. In those talks, we are pressing to use our existing powers to finance major infrastructure initiatives that would otherwise be unaffordable. For example, large transport infrastructure projects, with high up-front costs and long lifespans, are ideally suited to being financed via borrowing.

Discussions with the UK Government are ongoing. The issues under consideration include not just the use of our existing borrowing powers, but also the case for a funding floor or similar mechanism to tackle convergence in Welsh relative funding. It is anticipated that the talks will conclude with an inter-government announcement ahead of the publication of the Silk Commission's report on fiscal devolution due in late Autumn.

Silk Commission

The Silk Commission is considering the case for devolving further fiscal powers to Wales, including the scope for additional devolved borrowing powers.

The Welsh Government has submitted written evidence to the Commission (Annex 2), and is keen to assist the Commission's work where appropriate.

We look forward to the publication of the Silk Commission's proposals towards the end of this year. We will give serious consideration to any package of measures that offers a better funding deal for Wales.

Sources of finance

The Holtham Commission made a good case that the best way forward for Wales is likely to be to borrow via the Treasury's Debt Management Office (DMO). The DMO has in the past offered relatively competitive borrowing terms that would be unlikely to be matched by banks or by Welsh Government-issued bonds.

That said, in principle the Welsh Government favours devolution of the broadest possible range of borrowing powers that are consistent with the UK Government's legitimate interest in retaining control of borrowing at the macroeconomic level. This would provide maximum flexibility to Welsh Ministers to respond to Welsh circumstances.

Therefore we would not wish to rule out the option that a Welsh Government might in the future wish to issue its own bonds - provided it could be done in a way that was consistent with the UK Government's legitimate interests.

Constraints on borrowing

The UK Government has a legitimate interest in being able to manage the fiscal position of the UK as a whole. For that reason, it makes sense for there to be a set of jointly-agreed constraints on the ability of the Welsh Government to borrow. For example, the recently-passed Scotland Act enables the Scottish Government to borrow up to 10% of its capital DEL per year, within a total debt ceiling for Scotland of £2.7 billion.

For example, it is right that Wales should only borrow to invest in capital projects. It would not be sustainable over the medium term for Wales to borrow to fund recurrent expenditure such as staff costs.

Also, the Welsh Government and the UK Government might want to agree to a ceiling on the total amount of debt that the Welsh Government could carry at any one time. That would be consistent with prudent financial management - no organisation should be able to run up excessive debts.

Legal powers

The legal position with regards borrowing powers is complex. The Welsh Development Agency Act (1975) gave the former WDA limited powers to borrow. Following the merger of the WDA, those powers transferred to the Welsh Government. However, the Treasury's rules mean that if we were to borrow they would adjust our grant downwards in such a way as to leave us no better off.

All that needs to happen is for the Treasury rules to change and then we would be able to borrow for the purpose of the functions under that Act. That should be a simple process and could happen without the need for a change in the law. That would not be a substitute for the broader borrowing powers which we seek, but it would be a useful start.

Part 3

Innovative Finance

In the Programme for Government, the Welsh Government made a commitment to explore innovative ways of raising capital for investment in public service infrastructure. Ministers consider this imperative given the unprecedented scale of cuts to the Welsh Government capital budget in the current Spending Review period, which will approach 45% in real terms in 2014-15 compared to 2010-11.

Financial innovation should not be seen in isolation. It is linked to the need to improve the efficiency of government spending through better and more consistent application of business assurance disciplines, and to the Programme for Government objective to develop a 10-year, Wales-wide, National Infrastructure Plan. Work on this latter document, which will identify and prioritise capital schemes of national significance, will come to fruition with the publication of the first Wales Infrastructure Investment Plan (WIIP) on 22 May.

As the need to raise innovative finance in support of strategic infrastructure priorities increases, the Welsh Government is responding to the challenge. Indeed, it has already successfully created a number of innovative financial schemes, combining public and private capital to boost the Welsh economy. These include:

The Local Government Borrowing Initiative (LGBI)

The LGBI was launched on 31 January, as a means of securing additional investment in Welsh highways. In the current economic climate, falling capital budgets and mounting revenue pressures affect local authorities as well as national governments. The LGBI was designed as an initiative to provide a new tranche of support to local authorities to address revenue shortfalls, allowing them to eke out additional resources with which to undertake prudential borrowing. The funding arrangements will enable up to £170 million of capital investment to be made in Welsh highways improvements, across all 22 local authorities, over the next 3-years. Without this innovative approach, those improvements would simply have been unaffordable. Announcements regarding the successful projects will be made in the coming weeks.

Welsh Housing Partnership (WHP)

In August 2011, the Welsh Government implemented the WHP. The initiative is a partnership made up of the Welsh Government, the Principality Building Society and 4 Welsh Housing Associations, who are working together to provide quality, affordable rented homes to people living in north and south Wales. The WHP will purchase an expected 150 properties, leasing them back to the Housing Associations for a period of 10-years. The WHP has a capital value of £16 million - a combination of £3 million of Welsh Government grant funding, a £12 million loan from the Principality Building Society's commercial division and a total of £1 million from the 4 Housing Associations in the partnership.

The Welsh Government is also making progress with a number of other innovative approaches in the housing sector that use public sector assets to attract private investment. This model could see the delivery of significantly more social housing and affordable homes than would otherwise have been the case, given the current economic climate and financial constraints. For example, last month the Welsh Government and Principality Building Society announced the creation of the Ely Bridge Development Company (EBDC). A social enterprise, the EBDC will lead a new venture using an innovative investment model to unlock capital funding to build much-needed housing. EBDC will deliver around 700 homes, more than half of which will be affordable properties.

Enterprise

In the area of small business enterprise**,** the Welsh Government has established a number of bespoke investment funds. The largest of these is the JEREMIE fund, the first to be established in the UK, with a capital value of £150 million, which includes £75 million of European Investment Bank (EIB) support. The JEREMIE (Joint European Resources for Micro to Medium Enterprises) fund will support the expansion of more than 800 businesses and create up to 15,000 jobs across Wales. Over £80 million has been invested in more than 390 businesses in just over two years, and it is proving to be the best performing fund of its type in the UK.

The Regeneration Investment Fund for Wales (RIFW), otherwise known as the JESSICA (Joint European Support for Sustainable Investment in City Area) fund, was launched in 2010 with a capital value of £55 million, which includes £25 million of European investment. The fund aims to provide support for urban areas of Wales by providing finance to kick start regeneration projects.

In March, the Welsh Government's SME investment fund, with a capital value of £40 million, opened for business. The fund, which will provide access to finance for business growth and job creation for SMEs not eligible for funding under the JEREMIE initiative, will run for 4-years and is intended to create up to 4000 jobs.

In March, the Welsh Government announced plans to establish a new Micro Business Fund with a capital value of £6 million, and a Life Sciences Investment Fund, providing dedicated equity funding for life sciences businesses located in Wales. The Welsh Government is putting £25 Million into the latter fund to enable its first investments to be made in 2012.

Each of the financial engineering instruments above will create a lasting legacy of funding, to be recycled and reinvested over the long term in support of number of projects for the benefit of regions and people of Wales. The continuing use of these instruments in the next EU programme period (2014-2019) is currently under consideration.

Waste Infrastructure Programme

The Welsh Government has developed an innovative waste infrastructure procurement programme, an investment programme to deliver waste treatment capacity across Wales to meet landfill diversion targets specified by the EU Landfill Directive (1999) and the Landfill Allowance Scheme Regulations (Wales) 2004. The Government is working in partnership with local authorities and other stakeholders to ensure that future waste treatment facilities are sustainable, represent good value for money and meet policy objectives (70% recycling). The Waste Procurement Programme Office (WPPO) provides advice and funding to local authorities, managing two sub-programmes: the food and organic waste treatment programme and the residual waste treatment programme. In each programme, local authorities have joined together as procurement Consortia. The long term provision of gate fees provides the incentive for the private sector to deliver the required infrastructure. The total capital value of the projects is in the region of £780 million.

Together, these innovative financial vehicles will generate more than £1bn of capital investment in Wales.

Private Finance

Securing private finance is central to the Welsh Government's objective of boosting investment in Wales's infrastructure. Indeed, a number of the schemes above rely to a lesser or greater extent on the provision of private capital.

However, the Welsh Government has made it clear that it does not favour the use of the Private Finance Initiative (PFI), and welcomed the announcement last year of a fundamental review of PFI following critical reports from both the Treasury Select Committee and the Public Accounts Committee. One consequence of the Welsh Government stance regarding PFI is that Welsh budgets are not burdened with large revenue liabilities. For example, the liability for PFI schemes in Wales is about one tenth of the level in Scotland – £100 million per year in Wales compared to £1 billion per year in Scotland.

This relative lack of indebtedness provides policy space for the Welsh Government to consider an optimal level of revenue support for investment. With that in mind, the Welsh Government is keen to continue to develop new, innovative mechanisms to attract private investment into public infrastructure in the coming years.