National Federation of ALMOs

championing better homes and communities

Let's get building

The case for local authority investment in rented homes to help drive economic growth

A report published by the National Federation of ALMOs jointly with

Arch ASSOCIATION OF RETAINED COUNCIL HOUSING a fair deal for all our residents

CIH

Local Government Association

and in association with

cwag Councils with ALMOs Group

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A report by the NFA jointly with ARCH, CIH, LGA
and in association with CWAG

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Foreword

All of Britain's political parties want to see more house building. The property industry agrees. We know that the construction industry stands ready to deliver these homes. House building creates jobs and boosts the economy as well as providing much needed homes that people urgently need. Why can't we just get building?

Councils own around two million homes and they now manage their own 'self-financed' business plans. The debt on these homes is very low, on average £17,000 per house. A lot of businesses and homeowners would be delighted to have such a small amount of debt. They could take advantage of their situation to invest now for the future. We are asking in this report that councils be allowed to make the same sorts of choices as normal citizens and companies. Let us take advantage of low levels of debt to raise loans to build homes. We estimate we could deliver as many as 60,000 homes in five years.

We can get Britain building again very soon. There are many 'shovel-ready' sites standing idle. We are already working with the house builders and the construction industry to get on with the job but we could do more. What is stopping us? The answer is that each council has a centrally imposed debt ceiling. We just cannot use the borrowing power tied up in our stock. If the government is serious about building new homes this must change. It must make use of all options available to it, not just the private sector and housing associations. Councils can add significantly to the provision of much needed affordable housing. They must also be allowed to play their part.

We therefore spoke to the markets to see what they thought about our plans to borrow a maximum of £7bn over five years for house building. They said that this amount of money was insignificant in the scheme of things. It is a sum that falls well below the amount allowed for standard statistical errors in our public borrowing figures. Of course senior people in the markets also said that safeguards would need to be in place to continue to monitor the overall level of debt at a national level, and we would be happy to work with government to find a suitable way for them to control the level of additional borrowing that would take place. These days councils have a well-earned reputation for sound management of their finances. This shone through from the positive reaction from the markets.

Some economists argued that financing such an economic stimulus from additional borrowing would not only be inexpensive but – most importantly – would not be regarded as risky by the markets and by ratings agencies given the small size of the proposed programme – as long as it formed part of an agreed policy shift towards infrastructure and housing, and overall national debt levels were still managed carefully.

The report making this case has been jointly produced by a partnership of the Chartered Institute of Housing, the Local Government Association and the Association of Retained Council Housing, supported by the Councils with ALMOs Group and led by the National Federation of ALMOs.

The report makes use of two new pieces of work. The first one, carried out for ARCH in association with the LGA, NFA, HouseMark and CWAG by CIH, assesses in detail the capacity of the local authority sector and its readiness to build new homes. The full results from the ARCH-led study will follow on from the current report and, when available, will complement its findings and proposals. The second, commissioned by the NFA, LGA, ARCH and CIH from Capital Economics, assesses the market's reaction to the extra borrowing that would be required if the proposals made here were to be adopted. Its results are summarised later in the report.

The five organisations which are jointly supporting this study believe it makes a powerful case for change, and call for a response from government which recognises a golden opportunity both to help tackle the housing crisis and to stimulate the economy. Let's get building.

Councillor Paul Ellis
Chair, Association of Retained Council Housing

Robin Lawler
President, Chartered Institute of Housing

John Statham
Chair, Councils with ALMOs Group

Councillor Mike Jones
Chairman, Environment and Housing Board, Local Government Association

Sue Roberts MBE
Chair, National Federation of ALMOs

Executive Summary

In this report we demonstrate:

- The impact dedicated investment in housing could make to overall growth and to meet housing need locally. Investing in building an extra 60,000 homes would add 0.6% to Britain's GDP.
- The role that councils and ALMOs can play in meeting this challenge. Our work has demonstrated that, provided with the necessary financial flexibilities, councils and ALMOs could deliver 60,000 additional homes over five years – quadrupling current projections.
- That the market recognises the positive and stable track record of councils' financial management and sees the proposals in this paper to borrow a maximum of £7 billion over five years for house building as an insignificant amount in terms of the wider market impacts.
- Options available to allow councils and ALMOs to play a more proactive role and deliver significant numbers of new affordable homes through a relaxation or removal of the unnecessary, centrally imposed debt cap.
- Longer-term proposals which would bring the UK in line with approaches to measuring government debt employed by other countries.

Councils and ALMOs can play their part in securing future economic growth quickly and cost-effectively by further direct investment in housing.

If allowed by government, councils and ALMOs will:

1. Use their land and assets effectively to drive local growth.
2. Exploit and use to best effect the potential within the self-financing system to bring forward new homes in a managed and planned way.
3. Collaboratively develop and support voluntary standards led by the sector to maintain effective financial governance of housing accounts.

The five organisations sponsoring this report want to work with government to make the most of this potential. They therefore recommend that the government:

1. Unlocks the potential to invest in housing by removing the HRA borrowing caps and relying instead on prudential borrowing rules to ensure that investment is sustainable.
2. Considers the longer-term case for a planned and transparent move to adopt internationally recognised rules to measure government borrowing, to bring Britain in line with our competitors.

The key questions this report answers

Why do we need to boost construction?

- The construction sector has been hit hard by the current recession and has massive spare capacity, so it is well-placed to respond to any additional investment. The UK Contractors Group has shown that:
  - for every £1 spent in building, 92p stays in the UK
  - every £1 spent on construction generates a total of £2.84 in extra economic activity
  - for every £1 spent by the public sector, 56p returns to the Exchequer, of which 36p is direct savings in tax and benefits
  - government's role is key because it represents 30-40% of construction demand.
- Official figures indicate that investing in building 60,000 homes adds 0.6% to GDP.
- Of all aspects of construction, house building is one of the easiest to get 'shovel-ready'.

- Continuing low levels of starts by private developers result overwhelmingly from lack of effective demand. This is reflected in many housing market indicators, e.g. the CML forecast of total mortgage advances in 2012 being even lower than in 2010 and 2011.
- Developers therefore cannot sell houses to owner-occupiers because of the limited mortgage market, but they can build houses for rent.

What is the case for more investment in housing?

- Based on official household projections, there is a case to build 83,000 homes per year to be available at rents below market levels.
- A range of indicators, such as numbers on housing registers, poor affordability of private lettings and growing use of temporary accommodation, support this case.
- Overall housing supply, and supply of homes at less than market rents, are both well below what is needed. Total affordable supply at 57,950 in 2011/12 was about two-thirds what is required.
- The capacity of the whole social sector – local authorities and ALMOs as well as housing associations – needs to be used to fill this gap.

Can ALMOs and councils actually deliver? What is their track record?

- Since becoming Investment Partners with the Homes and Communities Agency (HCA) in the last few years, local authorities across the country have built over 3,000 homes and ALMOs specifically have delivered over 1,000 new homes. This demonstrates that councils and ALMOs can gear up quickly to deliver investment.
- In addition, local authorities have shown they can build at significantly lower levels of grant per unit for equivalent properties.
- Much available land is council-owned and councils are well-placed to get community support for new build. In some cases, land availability is dependent on the council controlling the development because of the nature of sites available.
- Surveys have shown most councils have released housing land and are willing to release more.
- Councils and ALMOs can link construction work to apprenticeship and work experience schemes, in partnership with private sector contractors.

Why should councils be allowed to borrow to 'prudential levels'?

- Council housing has been 'self-financing' since 1st April this year but councils and ALMOs are currently prevented from investing to their full potential, despite having low levels of current debt (just over £17,000 per house).
- Debt levels are restricted by 'borrowing caps' imposed by government, which are much lower than the levels at which councils could borrow sustainably.
- Currently councils have 'headroom' to borrow an additional £2.8bn to invest in housing. But without the caps they would currently make plans to invest a further £4.2bn. If encouraged to invest, their maximum potential might be £7bn over five years, building up to 12,000 extra homes per year.
- Borrowing to finance this investment would be well within the levels sustainable from projected incomes from rents.
- Councils adhere to the CIPFA *Prudential Code for Capital Finance*; they have a long record of responsible borrowing with virtually no defaults.

What are the implications for government?

- Increasing the amount of affordable or social rented housing would help reduce the housing benefit bill over time as it increases the availability of cheaper properties to rent, and there would be significant savings if tenants moved from more expensive private lettings or out of temporary accommodation for the homeless.
- Many authorities would be able to fund their increased build programme from additional borrowing. However a number of councils would still require limited access to grant funding to ensure viable developments.
- Additional local authority borrowing would add to total public sector debt levels under current fiscal rules; but the marginal increase in borrowing would be justified by the economic benefits and by the benefits of providing affordable homes.
- CIPFA has in any case argued that the 'borrowing caps' are unnecessary since borrowing can be controlled properly under prudential rules.
- While there are risks, these are manageable within prudential rules and with a proposed voluntary code that is being developed.

What are the alternative options?

- The UK uses a wide measure of public sector debt; most governments measure 'general government' debt which would exclude council housing because it is self-financing.
- There is not a level playing field between local authorities and housing associations as their borrowing is counted differently; this is not the case elsewhere in Europe.
- The government is planning guarantees for house builders which will produce a contingent liability in the event of default. However, if the government allowed more building by councils it would carry less risk to government and provide a more direct economic stimulus.
- Local authorities have high credit ratings and an excellent track record of sustainable borrowing over many decades.
- Any change to allow more freedom to borrow for council housing investment would therefore simply bring the UK into line with international rules.
- While market opinion suggests caution would be needed in making any rule change over the short term, the government could plan such a change in a transparent way, over a suitable time period, that would bring the UK into line with its competitors.

1 Economic stimulus and how housing can provide it

'Increasing the housing supply, especially of affordable homes, also has an important economic purpose... Building affordable homes, when you look at the bare statistics, is a great economic multiplier.'
Mark Prisk, Housing Minister, NHF conference, 17 September 2012

The need for stimulus

Britain's economy, along with those of most of the rest of Europe and North America, is barely growing. The case for economic stimulus through house building is generally accepted, because:

- construction is likely to be a particularly rapid and effective way of achieving stimulus
- house building has 'shovel-ready' projects already available
- building social housing would use spare capacity and provide immediate work for building firms when there is insufficient effective demand for new private housing.

For these reasons the government has already announced £10bn of guarantees for new building by housing associations and private developers. This report argues the case for a modest further stimulus that is highly cost-effective.

Advantages of investment in construction

One reason for focusing on construction is that the sector has contracted very sharply. Construction output is lower than at any time since 2000.[1] The ONS estimates that the sector's contraction accounts for one-fifth of the decline in overall GDP.[2]

Both the IMF and the Director-General of the CBI have made the case for a massive boost in construction spending, arguing that it is three times as effective as tax cuts in stimulating the economy.[3] The IMF argues that a fiscal stimulus with a strong multiplier effect not only boosts GDP but means that the economy is better placed to repay government debt through the tax yields that result.

The UK Contractors Group and Get Britain Building have argued in some detail (see Figure 1 on page 10) that:

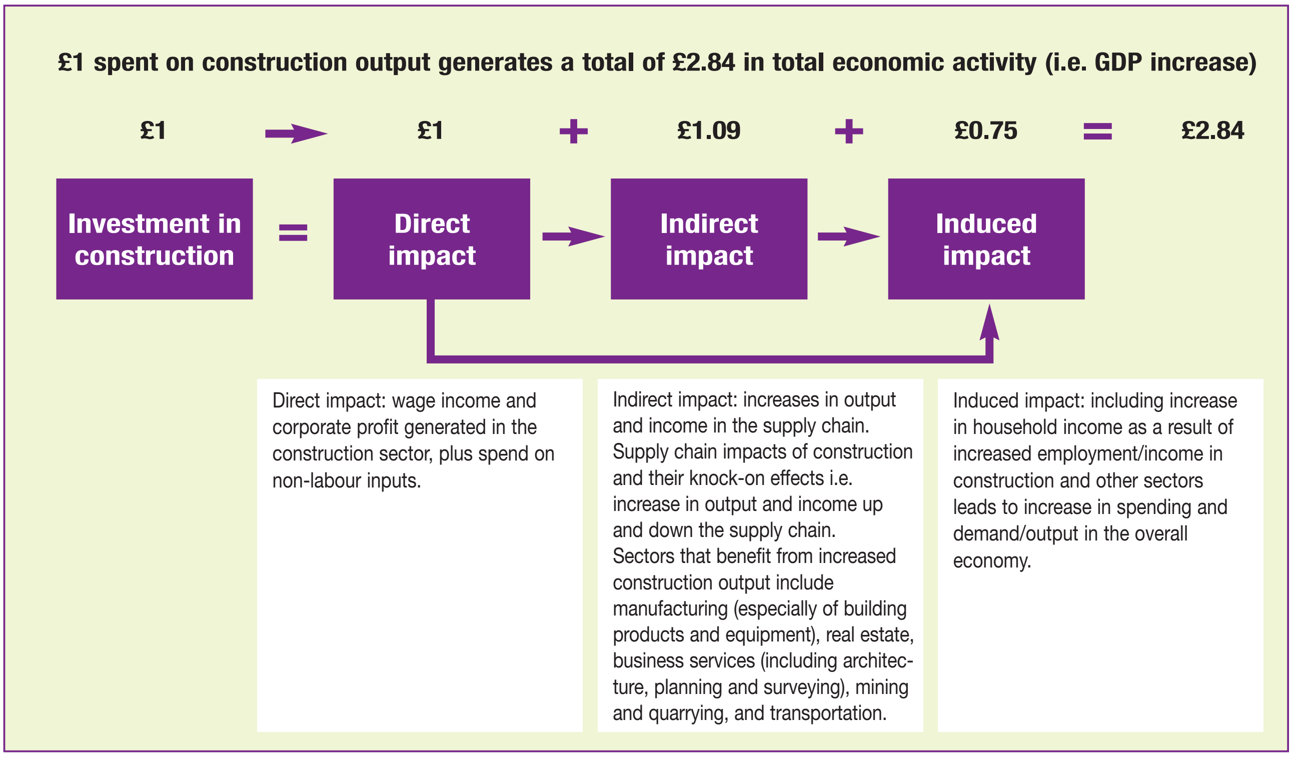
- for every £1 spent in building, 92p on average remains within the UK
- for every £1 spent by the public sector, 56p returns to the Exchequer, of which 36p is direct savings in tax and benefits
- almost 60% of construction employees are low-skilled, with relatively limited alternative employment opportunities
- government has a key role because historically it represents 30-40% of construction demand.[4]

Case study – Nottingham City Homes

Nottingham City Homes commissioned an evaluation of the impact of its 'Secure, Warm, Modern' investment programme from Nottingham Trent University Business School. Among its conclusions it found that the £37m programme had generated £56m of spending in the local economy around Nottingham, and that the employment training associated with the investment added at least £13m to the lifetime earnings of the participants.[5]

1 ONS (2012) *GDP Preliminary Estimate*, Q3 2012. London: ONS.
2 ONS (2012) *New Orders in the Construction Industry*, Q2 2012. London: ONS.
3 Freedman, C. *et al* (2009) *The Case for Global Fiscal Stimulus*. Washington, DC: IMF.
4 L.E.K. Consultants (2012) *Construction in the UK: The benefits of investment*. London: UK Contractors Group (see www.ukcg.org.uk).
5 See www.nottinghamcityhomes.org.uk/improving_your_home/impact_study/employment.aspx

Figure 1: Multiplier effect of construction spending in the UK economy



Source: *Construction in the UK economy: The benefits of investment.*

Case study – Gloucester City Homes

In Gloucester they calculate that if they provide an apprenticeship to an unemployed young person (under 25) with the construction of every new house, then there will be an annual saving to the public purse of more than £9,800 each in terms of saved welfare benefits and increased tax income. This very substantially offsets the cost of a typical apprentice's wages and associated employment costs.

Advantages of investment in house building

As a stimulus to the UK economy, there are at least five advantages to house building compared with investment in other forms of construction:

1. Housing construction can be 'shovel-ready': needs are already known, land is often available with planning permission, and house building can start more quickly on site than most other types of building.
2. House building can quickly add to GDP. Using official figures it is estimated that 60,000 new homes would boost GDP by 0.6%.
3. Such a programme would increase total housing output each year by over 10% on 2011 figures.
4. As the government acknowledges, every £1m of new housing output supports 12 new jobs (net) – seven direct and five indirect – for a year.[6]
5. Low housing output means there is considerable spare capacity in the industry. Compared with the first quarter of 2007, when almost 50,000 units were started, in the last eight quarters house building starts in England have been in the range 20-30,000.

6 Jobs estimate based on DCLG calculation, see DCLG (2011) *Laying the Foundations: A housing strategy for England*. London: DCLG.

2 Why we need more investment in affordable rented housing

The primary case for more investment in housing – and specifically in new housing built by councils and ALMOs – obviously rests on evidence of growing housing need and unsatisfied demand, and that this specifically requires more affordable rented housing in general and homes built by councils and ALMOs in particular. Recent research, often using official sources, makes a convincing case.

Housing need

Overall need for new homes

The government's housing strategy *Laying the Foundations* said that current household projections indicate a demand for 232,000 extra homes each year over the next 20 years. The *English Housing Survey* showed that, in 2010-11, 390,000 new households were actually created.

Alan Holmans, formerly the civil servant in charge of housing need projections, has recently done a fresh appraisal of needs which takes into account the household projections, loss of stock and other factors. He concludes that an average output of 252,000 new homes is needed annually over the period to 2026. Based on household characteristics and incomes, he projects that 169,000 of this new supply should be market housing (both for sale and rent) and 83,000 should be social housing at sub-market rents.[7]

Different types of housing need

As would be expected, the needs of new households arise primarily from young adults. Of new households formed in 2010-11, 89% were people under 35 years old. The *English Housing Survey* shows the importance of rented homes for such young households. For all but 14%, their first home is rented: one in five new renters are social tenants and four in five are private tenants.

Not surprisingly, young people's aspirations to homeownership have been tempered by the credit crunch. A CIH study found that only 69% of 25-34 year-olds thought that homeownership was their ideal tenure compared to 83% before the crunch.[8] Separately, Professor Steve Wilcox has estimated that about 100,000 (of mainly young) households annually are being prevented from becoming first-time buyers by the tighter credit restrictions applying since 2007.[9] A recent study suggests that 1.5m *more* young people (aged 18-30) will live in the private rented sector over the period to 2020, because of continuing constraints on access to homeownership and social housing.[10]

A further indication of unmet housing need is homelessness. Tackling this was described in *Laying the Foundations* as a 'demanding task'. The *Housing Report* published by CIH, NHF and Shelter in June 2012 pointed out that homelessness acceptances have increased by 27% since mid-2010 and there has been a sharp increase – of 37% – the use of bed and breakfast accommodation in the last 12 months, although overall homelessness acceptances have now fallen slightly.

Need for homes at affordable rents

National data continue to indicate that private sector rents are rising faster than inflation. For example, the *RICS Residential Lettings Market Survey* shows rents reported as 4.3% higher in the year to June 2012, with landlords projecting further rises of 2% and 3.9% over the next six and 12 months respectively.[11]

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7 Holmans, A. (2012) *Interim Revised Estimates of Future Demand and Need in England in 2006 – 2026*. Cambridge: CCHPR.

8 CIH (2009) 'Young people move away from home ownership,' Chartered Institute of Housing press release, 14 June. Coventry: Chartered Institute of Housing.

9 Wilcox, S. (2010) 'The Deposit Barrier to Homeownership' in Pawson, H. and Wilcox, S. *UK Housing Review 2010/2011*. Coventry: CIH.

10 Clapham, D. *et al* (2012) *Housing Options and Solutions for Young People in 2020*. York: JRF.

11 RICS (2012) *RICS Residential Lettings Market Survey* (www.rics.org/lettingssurvey).

Renting privately can of course be a preferred choice for many people. But as demand grows and rents increase, many households have no other option and need housing at more affordable rents or with more security than the private sector provides. For example:

- Analysis by Shelter showed that in 2011, using a yardstick of tenants not having to spend more than 35% of their income on rents, private rents were unaffordable at median incomes in 55% of local authorities.[12]
- A study by Alison Wallace[13] showed significant numbers of private renters preferring to be social housing tenants, including:
  - 37-44% of private renters with incomes below £29,999 per year
  - over half of those aged 45-64
  - over half of couples under 55 with children.
- More people are losing their private tenancies – Ministry of Justice figures on court orders for eviction show a 12% increase over 12 months and a 70% increase over three years; statutory homelessness cases involving loss of an assured shorthold tenancy rose 42% between 2009 and 2011.
- The recent *English Housing Survey* shows that 11% of private rented households have someone on a waiting list for social housing.
- Demand for social rented housing, with 1.84m households reported on council housing registers in April 2011, is 4.5% higher than a year earlier.

A thriving affordable rented sector is therefore important to complement private renting, both to ensure there are sufficient housing options for residents and to provide a more stable rental market.

Case study – Bristol

Bristol has a housing waiting list of over 13,000 applicants (June 2012) but in the past 12 months the city council has only built 12 new homes with plans for 16 this year. At the same time, housing associations built 292 homes last year and this year expect to build 241. The council has taken active steps to tackle empty property, reducing numbers by over 500 in 2011/12, although there are still 1,725 empties (84% privately owned). The private rented sector has doubled since 2001 to account for over 20% of the housing stock, bigger than the social sector, but demand is such that on average nine people are chasing every vacancy.

Source: Bristol Poverty Action (see: www.landlordreferencing.co.uk/blog/2012/08/10/shocking-bristol-poverty-report-reveals-an-average-of-9-people-are-chasing-each-private-tenancy/#).

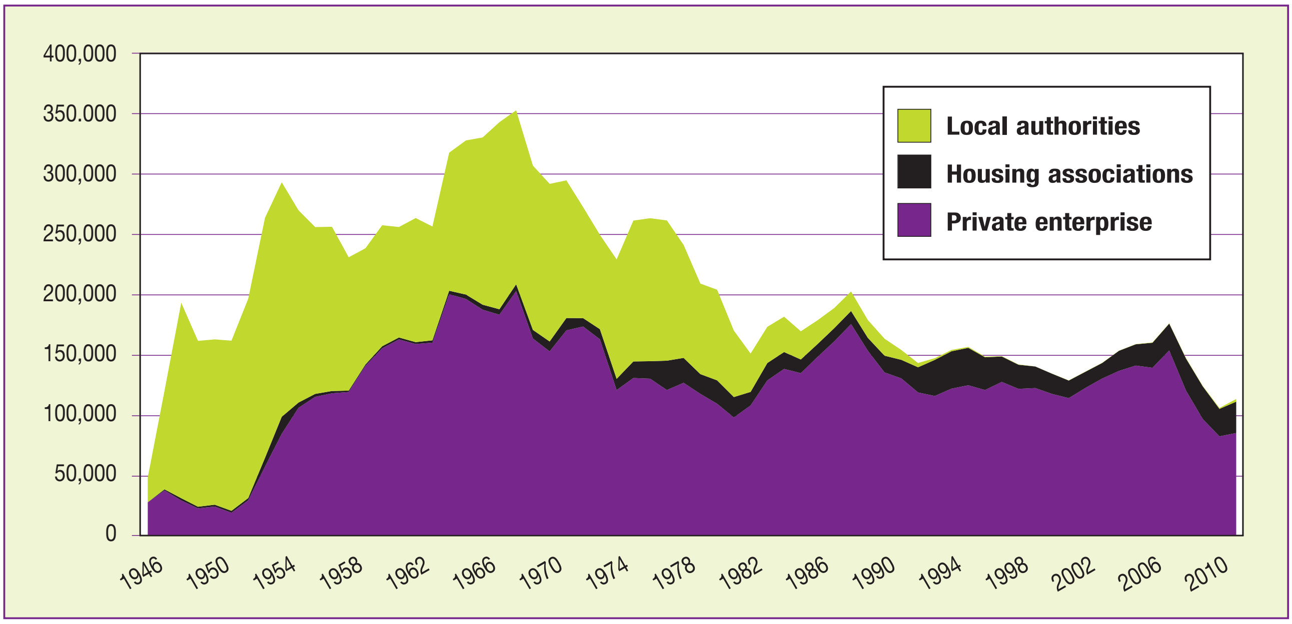
Housing supply

After the credit crunch, new house building fell to historically low levels and, despite a welcome improvement in 2011, output remains well below recent performance (see Figure 2 on page 13). The 2011 figure, of 114,160, compares poorly with the 2001-2010 average of 142,000, even though it represents a 7% improvement on 2010. It is still well below the requirements for new homes based on household growth, already mentioned.

Within total output, the key component is the numbers of units at below-market rents. As noted above, Alan Holmans projects a need for 83,000 new units per year. The government has a target output of 170,000 over the four years to 2015 (or about 42,000 per year).

12 Shelter (2011) *Shelter Private Rent Watch* (http://england.shelter.org.uk/).
13 Wallace, A. (2010) *Public Attitudes to Housing*. York: JRF.

Figure 2: New housebuilding in England to 2011



Source: DCLG Live Table 244.

In 2011/12, 57,950 homes were supplied at below market prices, exceeding the government target but well short of the Holmans estimate, and 4% below 2010/11.[14]

There are also concerns about aspects of the current programme:[15]

- In 2011/12, there were just 15,698 starts on site, suggesting that 2012/13 output will be much lower than last year's; indeed new starts in April-June 2012 were down 23% on the previous quarter.
- Within the 2011/12 total, the proportion of Affordable Rent starts is much higher than before (8,873) and of social rent units much lower (3,305), showing how the balance of the programme is changing rapidly.
- Government moves to ease 'planning gain' (or section 106) agreements will reduce affordable housing output that otherwise would have resulted from private development schemes.

Supply of social rented homes is therefore likely to fall substantially this year as the HCA concentrates its resources on the Affordable Homes Programme and developers concentrate on building for sale.

The demand-supply imbalance

New supply is falling significantly below projected needs. Government programmes to stimulate building of affordable homes for sale, while very welcome, have not yet had much impact on new starts. And as is well known, while there is likely to be further growth in private renting, in the past this has largely been through transfers of property from other tenures rather than new build for rent (one of the main reasons for the government inquiry led by Sir Adrian Montague). Action to promote further new build by councils and ALMOs is therefore very desirable but currently constrained by fiscal policies.

For applicants on housing registers, the crucial statistic is not new *output* but the availability of *new lettings* (from the current housing stock plus any new additions). The total number of new lettings improved slightly in 2010/11 (reflecting the increase in output of new homes noted above). At 231,000, lettings were 8% higher than the previous year's total. However, new lettings remain at historically low levels – two-thirds of their levels in the mid-1990s.

14 DCLG (2012) *Affordable Housing Supply, England, 2011-12* (see also DCLG Live Table 1000).

15 Analysis in this paragraph is based on HCA (2012) *National Housing Statistics 2012* (as revised in August 2012 – see www.homesandcommunities.co.uk/housing-statistics).

Quite apart from the overall demand-supply imbalance, there will also be changes in the make-up of new lettings by social landlords. Practically all new lettings are currently at social rents, but this will gradually change as new units are built for Affordable Rent, including replacements for right to buy sales, and as a proportion of existing units are changed to Affordable Rents when they are relet. Although it is difficult to project trends which are only just beginning, one estimate of the effects on the total stock of properties let at social rents is that there will be 250,000 fewer in 2015 compared with 2010.[16]

Making best use of the sector's capacity

Most housing association output is now via the government's Affordable Homes Programme. While this meets demands that cannot be met by the private sector, there is concern about how to satisfy the continued need for homes for lower-income households who cannot afford the new rent levels especially in regions where there is a big gap between social and private rents. Also, the Affordable Homes Programme is very 'back-loaded' and is likely to deliver most homes towards the end of its four-year life.[17] The Public Accounts Committee has drawn attention to other risks in the programme. For example, it will have used much of the capacity of the housing association sector to leverage-in private funding, leaving very limited capacity beyond 2015.[18]

Given the scale of housing need, it makes sense to use the capacity of councils and ALMOs to build homes *in addition* to using the capacity of housing associations. Indeed, this report argues that it would be a grave error to underutilise this capacity, especially given the favourable circumstances for new building by councils and ALMOs following the government's implementation of self-financing on 1st April.

Building new homes is also a crucial aspect of effective asset management – being able to respond to changing needs (e.g. for more small units, in response to welfare reform) or replace unsatisfactory/under-occupied stock. Housing associations have always had development programmes which have given them scope to reconfigure their stock, but local authorities have not: self-financing potentially provides the opportunity to do this as part of their business plans.

While the report therefore makes comparisons between local authorities and housing associations, these are purely to provide answers to potential questions as to why councils and ALMOs should build and to argue that it should not be left solely to associations, who of course have a long and admirable track record of delivering new homes.

The rest of this report is about using the resources of local authorities and ALMOs to complement the current Affordable Homes Programme with a further initiative that will secure additional, new rented homes. The original 'prospectus' for self-financing called on councils to use their new capacity to build 10,000 new homes per year. We believe that councils and ALMOs can rise to this challenge and indeed exceed it.

16 Assessment by Jules Birch, 15 June 2012 (see http://julesbirch.wordpress.com/2012/06/15/vanishing-act/).

17 Inside Housing (2012) 'HCA defends 2015 completion targets' *Inside Housing*, 10 August 2012.

18 Public Accounts Committee (2012) *Financial viability of the social housing sector: Introducing the Affordable Homes Programme*. London: PAC (Thirteenth report).

3 Why we need more house building by local authorities and ALMOs

Currently there are 167 English local authorities which own social housing, totalling 1.7m dwellings, managed either directly or through ALMOs. What is their recent track record, how well-placed are they to invest in more new housing and what are the advantages of them doing it? This section of the report specifically addresses the situation of English authorities, although Wales faces similar issues and has similar opportunities. Scottish councils do not face the same constraints (see box at end of chapter).

Recent investment in council housing

In recent years local authorities have made very significant levels of investment in social housing, but as is well known the vast majority has been investment in the existing stock to achieve the near delivery by 2010 of the Decent Homes Standard. As the latest *English Housing Survey* acknowledges, the local authority sector has outperformed all other sectors (housing associations, private landlords and owner-occupiers) in achieving the standard. In the case of ALMO authorities (and in the last year some authorities who manage their own stock) this investment was aided by significant amounts of extra subsidy. But quite apart from this, all councils have mobilised their own resources to make the required investment and in many cases have achieved higher than the required standard.

Because of the urgent need to concentrate on achieving decency, and the lack of specific financial assistance for new build, until 2010 local authorities built only 200-300 units per year, levels maintained continuously since 1997. However, only 20 years ago output was much higher, with (for example) as many as 14,000 local authority completions in 1990 alone.

Renewed grant funding from 2010 allowed councils to start 1,390 units in that year, almost a ten-fold increase on 2009. Over the two years 2010 and 2011, 3,020 units were completed and a further 430 added in the first half of 2012, demonstrating that councils and ALMOs can gear up quickly to deliver investment in new build – as well as in their existing stock.

The majority of these completed units were financed under the HCA's Local Authority New Build (LANB) programme, whose first approvals were only announced in September 2009. The LANB programme also demonstrated that local authorities and ALMOs can deliver at a lower per unit cost.[19] The level of central government grant received by local authorities was almost £10,000 lower than for housing associations overall. In some regions this was even more pronounced (for example, in London the difference was £36,000).

Councils are now also participating in the government's latest Affordable Homes Programme – 26 are so far taking part.

Councils and ALMOs are well-placed to start building

Not only are councils and ALMOs ready and with recent experience of building homes, but in the current situation they can do so when private developers cannot, and also make use of private construction capacity. This is because:

- Continuing low levels of starts by private developers are mainly the result of lack of effective demand, as is shown by many housing market indicators, e.g. the CML forecast of total mortgage advances in 2012 is lower even than in 2010 and 2011.[20]
- Public housing building can take up this slack, because almost all the work is done by private contractors and demand for rented homes is extremely high.
- While local authorities are already collaborating to stimulate private sector housing, as the HCA has pointed out,[21] they are also very willing and ready to build themselves.

19 LGA (2010) *Housing Shortages: What councils can do* (see www.local.gov.uk/web/guest/publications/-/journal_content/56/10171/3367721/PUBLICATION-TEMPLATE).

20 See the CML Housing and Mortgages Forecast (www.cml.org.uk/cml/publications/forecast).

21 HCA (2012) *Local government and home builders collaborate on delivery of new homes*. HCA press release, 22 June 2012.

- Local authorities have recent experience of getting investment moving quickly as demonstrated above.
- Government capital expenditure is due to fall in real terms by almost 8% over the current spending review period; but the cut in housing investment (through the HCA) is 63%, a further indication of spare capacity in the sector.[22]
- Long-term underinvestment in affordable rented housing puts a significant constraint on the UK economy, limiting labour market flexibility and absorbing resources into housing through rising house prices. A growing supply of affordable rented homes will contribute to Britain's competitiveness.

The potential of self-financed council housing

The reform of council housing finance and the start of self-financing on 1st April this year has been a massive boost to councils' ability to manage their housing finances more positively. Through this process, councils have taken on about £8bn of extra debt, but despite this are now financially much better equipped to make new investment because they have full control of their incomes and (like housing associations) no longer have any government subsidy towards their running costs.

Self-financing has created a new business framework with a range of factors that support new investment:

- Councils all now have proper 30-year business plans and asset management strategies for their stock, whereas before 1st April their business plans were far weaker, because of the uncertainty of annual decision-making through the HRA subsidy system.
- While councils are subject to borrowing caps, many have already been able to plan more investment than they were able to contemplate prior to self-financing, because of the headroom they have within the borrowing caps – this totals some £2.8bn.
- Councils have already or are in the process of separating out their housing debt and managing it as a distinct portfolio, enabling them to make their reserves work in supporting new investment.
- Council debt levels are modest on a per-property basis; average council housing debt is now just over £17,000 per property, similar to that for housing associations (but more evenly spread, so that the proportion of debt to equity (the 'gearing ratio') is typically 50% below those of developing housing associations).
- Councils have low borrowing costs for new debt which has also helped to create headroom in their budgets (see below).
- Councils have lower management costs than housing associations; rents for new lettings are on average £12 lower; average weekly housing benefit payments to tenants are some £9 lower.
- As a consequence of these factors, and the ability to cross-subsidise building costs from sales and other revenue and to provide free land, many councils' plans for new build include only limited or no reliance on grant funding from the HCA.
- Councils formally adhere to the CIPFA *Prudential Code for Capital Finance* and have a long-standing track record of responsible borrowing with virtually no defaults, over many decades.

The above is a brief summary of the advantages which council housing currently enjoys as a vehicle for investment in new housing. Some of the points mentioned will be picked up in more detail later in this report.

Councils' current potential and plans for house building

The current £2.8bn headroom available to councils following self-financing already enables them to plan a limited but still significant new build programme. The headroom is however very unevenly distributed: some councils have no or very limited headroom and may not be able to plan any new build.

Councils' current plans to use their headroom therefore vary considerably. The early evidence from the study being carried out by CIH for ARCH (in association with the LGA, NFA, HouseMark and CWAG) indicates that:

22 See NFA (2012) *Member briefing on the Government's housing and growth package*.

- some councils anticipate access to grants from the HCA at current rates under the Affordable Homes Programme; their lower borrowing costs would lead to lower rents
- others expect to build without grant
- some could maintain a modest annual new build programme from revenue resources, without extra borrowing
- many councils want to create mixed schemes of social rent and Affordable Rent, and for open market sale, with cross-subsidy within the scheme
- councils have mixed plans in terms of whether schemes are purely council-led or whether they involve partnerships with housing associations or private developers
- some councils have already been invited to work with private developers who have stalled schemes that are not currently viable as building for sale
- many developing councils and ALMOs currently look to provide around 50 new homes per year, but some would aim to provide (say) 500 if they were not limited by their current debt caps.

At this early stage following self-financing, not all councils have made firm new build plans as they will also (of course) have to plan and execute planned maintenance and decent homes work on their existing stock. However, the ARCH-led study so far suggests it is likely that plans for new build could be of the order of 15,000 units spread over five years, with the current caps in place, or about 3,000 per year.

Practical examples

Stroud District Council have a stock of 5,200 properties. They borrowed £91.7m as part of the transition to the self-financing regime The council plans to use the new flexibilities to invest over £23m in existing properties and build over 100 new council-owned properties to extend its stock. If Stroud were provided with the flexibilities we are seeking they would be able to build a further 188 properties – almost trebling their build programme.

If **Mid-Devon District Council** were provided with flexibilities and increased local discretion they could increase their new build programme by 1,000 homes over ten years.

Newark and Sherwood Homes manage a stock of 5,500; if provided with further flexibilities and increased local discretion through self-financing, up to 300 new homes could be delivered in ten years.

Councils' ability to facilitate investment

Quite apart from the benefits of self-financing, councils have several intrinsic advantages in making investment in new housing because of the way that their landlord role complements their strategic housing responsibilities. For example:

- Much building land is council-owned, often associated with existing council estates. Many councils have already used small sites (e.g. sites land-locked by other housing) in developments part-funded by the HCA. In some cases, land availability is *dependent* on the council controlling the development because of the nature of sites available.
- Councils are willing and able to release land. In a recent LGA survey, 75% of respondents said that their council released its own land for housing development over the last five years and 85% that their council planned to release housing development land in the next five years.[23]
- Use of council land keeps down costs and makes better use of existing public sector assets. Current unit costs in the Affordable Homes Programme are £127,000 (although a higher proportion of these units are probably in high-cost areas).[24] A survey of house building by stock-retaining councils found average costs of completed houses to be £119,000 per unit and £114,000 for those still under construction, including land.[25] In this report we have therefore assumed an average unit cost of £116,000.

23 *LGA (2012) Unlocking and Stimulating Housing development: A survey of councils* (see www.local.gov.uk/c/document_library/get_file?uuid=0ddb3e55-1772-46ba-b6a1-9686fe399b6d&groupId=10171).

24 HCA (2012) *Affordable Homes Programme 2011-15: Summary of offers accepted as of the end of June 2012*. London: HCA.

25 APSE (2011) *Firm Foundations: The holistic benefits of building by stock-retained councils*. London: ARCH.

- Councils can link new build to the reconfiguration of their existing stock, to produce housing which best meets current local needs. This might involve selective replacement of difficult-to-let or hard-to-modernise stock, or replacement of wrong-sized stock with new housing that better matches the profile of tenant needs (see examples).
- In these cases, councils need to liaise with tenants' associations and plan new developments that carry their support, especially ones in or adjoining existing estates. As landlords, they are best-placed to do this.
- Councils have enormous advantages because they know their communities. They can therefore develop the right product, plan developments and move through the planning process more quickly, make best use of small sites, get local communities on board and deliver more quickly.
- Councils which have housing stock are also strategic housing authorities which maintain Strategic Housing Market Assessments for their areas. This means that they can initiate new house building that complements the activity of other providers, including housing associations and private developers, in their areas.

Practical examples

Newark and Sherwood Homes delivered 52 properties during 2010 and 2011 through the Local Authority New Build (LANB) programme. They used eight infill sites and addressed issues relating to parking, rubbish dumping and anti-social behaviour. The project offered opportunities for local communities through a training plan and apprentice schemes, which allowed residents to gain skills and employment.

Exeter City Council used LANB to build 21 attractive small units aimed at people aged 55+, and intended to release family-size units in the existing stock in order to better meet Exeter's waiting list demands.

The London Borough of Wandsworth used LANB to build extra units onto unused land which was causing an environmental nuisance in one of its estates, and used its precise knowledge of local needs in specifying the make-up of the new units. Work has just been completed.

Northwards Housing in Manchester has plans to develop a number of inaccessible pieces of land within estates such as garage sites or demolition sites. They are considering modular forms of building allowing units to be completed on site quickly with minimum disruption to residents. They aim to move older people currently under-occupying family homes to new, energy-efficient homes within their existing communities, freeing-up much needed family housing.

Nottingham City Homes are building 27 new properties, using a local building firm, on four under-used garage or vacant sites, funded directly from the housing revenue account. They want to expand this programme because they are demolishing 1,000 flats that are no longer viable and they plan 350 replacement houses and bungalows to meet current needs.

The London Borough of Barking and Dagenham has committed to build 763 affordable homes by 2015. Of these, 477 are in partnership with fund manager Long Harbour, one in five at social rent. The remainder of the programme is HCA-funded, with Affordable Rents – but well below the maximum allowed.

Blackpool Coastal Housing with Blackpool Council is using its debt headroom to develop a new sustainable low-rise housing estate in Queens Park, to replace five 1960s tower blocks that are unpopular and costly to maintain. Construction will create local job opportunities, and the new design will tackle anti-social behaviour and crime issues. There will be a mix of family accommodation and flats that can be converted to family homes as and when required. All existing tenants who want a home in the new development are guaranteed one, maintaining the sense of community.

Six Town Housing in Bury has completed a development with 38 two-bedroom and two one-bedroom extra care apartments with associated communal facilities, including a bistro and hairdressers, for older people. The scheme at Red Bank, Radcliffe, was built by a private contractor with grant from the HCA.

The broader economic impact of investment by councils

In addition to the wider economic stimulus provided by new house building described in Section 1, local authorities are geared up to maximising the local benefits of new construction in a variety of ways:

- councils are able to link construction work to apprenticeship and work experience schemes, in partnership with their private sector contractors
- as well as directly creating jobs, new build can be tied into worklessness prevention schemes among council tenants, getting people into work and reducing benefit dependency
- councils can most readily identify and make available land from stalled private sector building projects
- many recent local authority new build schemes (e.g. those through the LANB fund) have achieved high energy-efficiency levels and serve as exemplar schemes locally.

It is important to recognise the wide differences between regions and that in some parts of the country the priority is regeneration, where replacing existing unsatisfactory stock can both provide housing that meets today's requirements and contribute a much-needed stimulus to local economies.

Practical examples

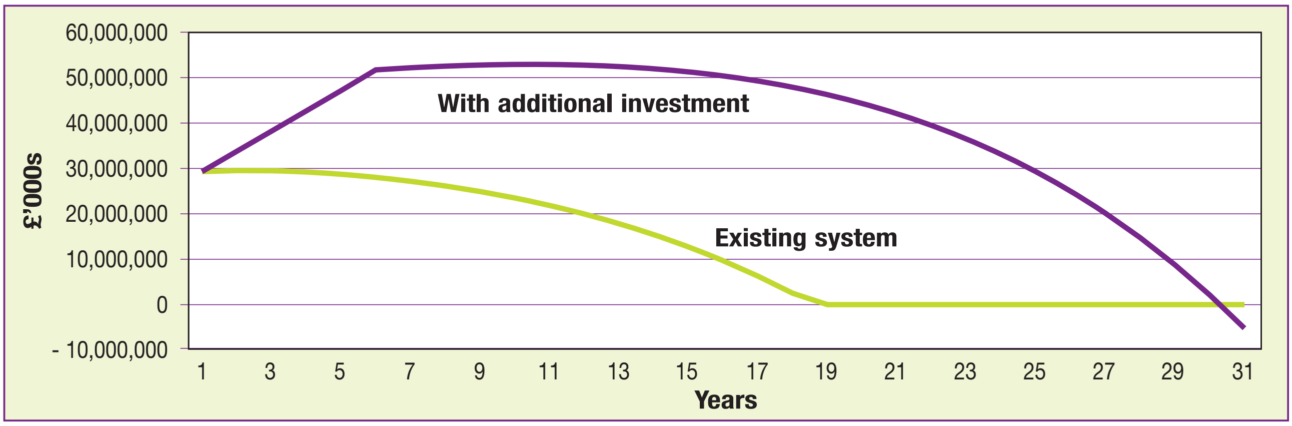
Wolverhampton Homes has a range of activities to promote jobs in the building industry among its tenants, including a programme called LEAP (learning, employment and achievement programme) which offers 10-month apprenticeships, with training, in building skills. It created 69 apprenticeships in two years, of which 58 have been sustained, and so far this year 17 apprenticeships and 14 trainee placements have been offered. It also supports a social enterprise called the Timkins Project which provides training in building skills for young people not in mainstream education and for adults referred from the health service and other agencies.

The London Borough of Croydon has been building houses since 2008, and uses its programme to provide training in construction skills. So far it has had 18 direct short-skill courses, 13 indirect short-skill courses and seven indirect employed placements. It has also introduced contractual requirements about training and use of local sub-contractors and suppliers.

How councils would invest further if they were able to do so

A provisional assessment of the full potential for councils to invest, if councils were able to make prudential use of their full borrowing potential now that they are self-financing, has been made using the DCLG self-financing model. It shows that they could theoretically borrow up to £20bn in the next five years with their current projected income and up to £27bn if they charged higher Affordable Rents on newly built stock. Figure 3 (based on these results, and taken from the ARCH-led study) shows the debt profile for the sector if borrowing above the caps were allowed (in this case with no change in income, other than increases in rents at RPI + ½%).

Figure 3: Potential for extra housing investment by local authorities, with the same income



This extra borrowing would enable 170-230,000 extra homes to be built in total, if all the potential investment were devoted to new build. This could of course be even more if grant were available from the HCA.

In practice, provisional results from the ARCH-led study suggest that authorities would *stay well* within their theoretical capacity, and at present might consider building a further 36,000 homes costing £4.2bn. These figures are very tentative and probably reflect reluctance to express a view given the reality that investment is still capped. Taking this reluctance into account, but also bearing in mind limitations such as land and organisational capacity, possible additional investment of £7bn over five years, to produce an extra 60,000 extra homes in total, would appear a reasonable estimate of the sector's *maximum* additional new build capacity. This is the headline figure used in the remainder of the report in considering the economic consequences of such increased investment.

Effects of potential new investment

If 12,000 new homes were built each year, in addition to the limited programme which councils already plan to finance, this would be a significant boost. It would raise overall house building output by more than 10% and compares favourably with the total of 15,000 homes promised by the government's plans to boost house building announced in September.

Using the multipliers noted in Section 1 of the report, additional investment of £7bn would be the equivalent of a £20bn boost to the economy and generate almost 17,000 new building industry jobs each year over five years.

These figures are necessarily tentative. Much fuller details of local authorities' actual potential to invest sustainably if they were no longer subject to same borrowing caps will be available when the ARCH-led study is released later this year.

Lessons from Scotland

In 2011, the 26 stock-owning Scottish councils started 1,224 new homes, the highest level for more than 20 years. Their performance is similar to that of England's even though Scotland only has one-tenth of England's population.

Local authorities' ability to build at relatively low grant rates has proved attractive to the Scottish Government, with flat-rate payments of £25,000-£35,000 per dwelling equating to only around 20%-25% of scheme costs (as compared with grants of around 60% needed by housing associations in 2009/10). Councils' ability to do this partly reflects the bolstering effect of local authority-owned land contributed at nil cost. In a few cases significant contributions have also come from second homes council tax income or developer payments levied under planning powers.

Delivery of new council housing at low grant rates has come mainly from additional investment via rent fund contributions or through prudential borrowing, where the cost of debt repayments is partly borne by *all existing tenants* rather than being accounted for just at scheme level, as has been traditional for housing associations.

Why has such performance by local authorities been possible in Scotland and not in England? Scottish local authorities are not constrained by borrowing caps. For many years they have had no subsidy system comparable to England's and they have been effectively self-financing. While (as in England) they are subject to prudential rules, they have been willing to finance extra borrowing from rents. Their extra borrowing counts against government borrowing measures, but has not been sufficient to cause difficulties.

Source: based on Pawson, H. and Wilcox, S. (2011) *UK Housing Review 2011 Briefing Paper*. Coventry: CIH, 2011.

4 How a new build programme could be financed and its implications for government

Overall effects

A new build programme of the scale outlined would be financed from a combination of new borrowing, local authority reserves and (in some cases) government grant. Each of these has different consequences for government expenditure and borrowing.

Revenue costs and savings

The implications for government of an expanded council new build programme, in terms of its revenue costs and savings, are complex, and the following is a summary and very approximate forecast of the effects:

- There is no longer any direct revenue subsidy to local authority housing accounts, so direct costs only arise from the financing of any grant (now known as 'social housing assistance') from the HCA. However, many authorities are planning to avoid the need to claim grant, funding the costs entirely from income (including, of course, the income from the new lettings). If grant were paid at a similar rate to that which applies in the Affordable Homes Programme (£20,000 per unit), and half of the possible output of 60,000 units required grant, the total cost would be £600m.
- Some 65% of council tenants receive housing benefit and to the extent that rents bear the costs of extra borrowing, this does of course imply higher levels of government spending (through rent rebates). However, the effects are not straightforward, because almost half of new entrants to social housing were previously private renters. In such cases (assuming any eligibility for benefit is the same), there are potential savings of (on average) £2,000 annually in benefit costs for each new unit let, because of council rents being much lower than private rents. If 60,000 units were built, and say one-third of the new lettings that resulted (both in the new units and in existing stock) were to go to benefit recipients moving from the private sector, there would be an annual saving of £40m continuing into the future.
- Government welfare reform seeks to limit the growth in the annual cost of housing benefit. However, it is clear that the private rented sector will continue to grow and – in the absence of alternatives – benefit-dependent households will have to continue to use the sector. Creating more new lettings in the social sector potentially creates more space for tenants who pay their own rents in the private sector, helping to reduce the benefit bill. Even though difficult to quantify, this is likely to be particularly important in areas of high demand where market rents and competition are high.
- Revenue savings could be even greater if new lettings go to people moving out of council-financed temporary accommodation (including bed and breakfast hotels) – see the box below. If the lettings that resulted from a new build programme reduced the overall use of temporary accommodation by 10% (not an unreasonable assumption) then the potential annual savings would be in the range £100m-£250m.
- In Section 1, we showed how any extra costs to government could be more than offset by the increases in tax revenue, at least initially, from extra employment and other additional economic activity produced by the new build programme. A £7bn investment programme would have a wider economic impact of around £20bn. If assumptions set out in section 1 are correct, there would be offsetting income to the Exchequer of £2.5bn over five years in extra tax and in benefit savings.

The points above show, albeit in crude terms, that any extra direct costs to government of an investment programme could be substantially offset by savings within the housing and welfare budgets – and potentially be more than matched by the tax income from the additional economic activity generated.

Potential savings from temporary accommodation

There is particular potential for substantial savings (as well as for relieving real hardship) if households can be moved from expensive temporary accommodation into permanent lettings, as a result of the extra lettings capacity which a significant new build programme would create. Currently (June 2012), there are just over 50,000 households in temporary accommodation.

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An indication of the savings is given by figures in a recent House of Commons Library Note.[26] A basic saving is that DWP allowances to local authorities per unit of temporary accommodation are £2,000-£3,000 annually (depending on location). However, a fuller estimate of savings to the public purse is that these would amount to about £5,000 per household annually – a significant figure to offset against the annual costs per unit of new building.

Capital costs and borrowing

From a central government perspective, the main concern about an enhanced local authority new build programme is the extra borrowing that would be required, which we assess as a maximum of £7bn over five years. If this were principally to be financed from new borrowing (although some may be financed from receipts and reserves) this would inescapably add to general government borrowing.

To the extent that local authorities borrow within the caps set by government, this should be within current Treasury and OBR forecasts of public sector net borrowing (PSNB) and total debt (PSND).

Where borrowing to fund an enhanced new build programme exceeds the current caps, as proposed here, there are implications for both PSNB and PSND. The government could respond to this in two ways:

- accept that Public Sector Net Borrowing will increase (or not contract as quickly as planned), as a valid price to pay for a much-needed fiscal stimulus and help to a struggling housing market, especially given that revenue income will be generated that can itself be used to pay off debt
- review its fiscal rules and bring them into line with international conventions, which would no longer require council housing investment to be counted against the main measures of government borrowing and debt.

The first of these – extra borrowing under current rules – is dealt with in Section 5. The second – reviewing and changing the rules – is dealt with in Section 6.

26 House of Commons Library (2012) *Homeless Households in Temporary Accommodation (England)*. HoC Library, 8 October 2012.

5 Extra borrowing under current fiscal rules

Why extra borrowing for new housing is justified under current rules

Section 1 of the report put forward the case for an economic stimulus and Sections 2 and 3 showed how building new houses, and specifically new rented homes built by local authorities, would not only be one very effective way of helping to create this stimulus but would also meet pressing housing needs and have wider economic and social benefits.

The organisations sponsoring this report recognise the importance of the government's overriding objective of reducing public sector debt. Even so, we believe that there is a straightforward case for some additional borrowing to achieve the beneficial outcomes of such investment for the economy. We have been joined in this argument by many other bodies who either call generally for an investment stimulus (most notably, the IMF) or specifically call for extra housing investment. Indeed, the economic case has recently been made by city broker Tullett Prebon for a specific local authority/housing association investment programme that would total £10bn annually.[27] The maximum programme we are proposing – amounting to some £7bn over five years – would be much less than this.

The case for additional borrowing rests partly on the intrinsic merits of the investment proposed and its expected outputs, but also on the argument that the UK economy has 'fiscal space' (the IMF's term) for limited extra borrowing aimed at promoting growth. The argument is based partly on UK debt levels and partly on the costs of servicing this debt.

The UK has significant advantages in financing its debt (and in adding marginally to its debt) compared with other countries. The average maturity of UK sovereign debt is about 14 years, meaning that it is not vulnerable to sudden increases in interest rates. Current borrowing costs are of course extremely low, an advantage in itself, but even if they start to rise the long maturity of Britain's overall debt means the effects will be limited. Furthermore, the UK is recognised as having the distinct advantages (in the current climate) of its own currency and central bank.

Some economists have therefore argued that financing an economic stimulus from additional government borrowing would not only be inexpensive but – most importantly – would not be regarded as risky by the markets and by ratings agencies given the small size of the proposed programme, as long as it formed part of an agreed policy change to shift expenditure towards infrastructure and housing and overall national debt levels were still managed carefully.

In this context, the extra borrowing proposed – adding only marginally to total public debt – would have strong economic advantages.

Who would provide the new borrowing?

Three-quarters of long-term borrowing by local authorities is currently from the Public Works Loan Board (PWLB). Many authorities would seek to borrow further from the PWLB, but already some are considering bond issues (usually on a joint basis among authorities), for example for investment in renewable energy for housing. Borrowing from banks and building societies might be attractive on a short-term basis, later to be refinanced through other mechanisms.

An issue arises if the proposal to be outlined in Section 6, to change fiscal rules, were to be adopted. The government would then encourage councils to use sources other than the PWLB, since PWLB borrowing is inescapably part of government borrowing. But as just noted, some councils are already exploring private sources of borrowing which may already be competitive with PWLB rates.

27 Morgan, T. (2012) *Building a Road to Recovery?* London: Tullett Prebon (available at www.tullettprebon.com/announcements/strategyinsights/notes/2010/SIN20120824.pdf).

How would the borrowing be managed?

If the principle of additional borrowing above the current caps were to be accepted, the government would have a range of options for managing such a move. Removal of the caps would of course be the option strongly preferred by the five bodies commissioning this report, since even in their absence the government would retain its statutory powers to intervene if borrowing became excessive, either generally or in a particular case. We argue below that there is a strong argument that the existing prudential framework is a sufficient safeguard that such borrowing would be sustainable, and the scale of borrowing anticipated is in any case well within the capacity to repay it.

However, if the government were not willing to go this far, the bodies sponsoring this report would of course be very willing to negotiate alternative mechanisms.

What are the risks?

The basic risks now carried by council housing are similar to those of housing associations, in that repayment of debt depends primarily on income from rents.[28] Rental income can be threatened by factors such as arrears, excessive voids, reduced demand, contraction of the asset base (e.g. through right to buy sales), etc. However, local authorities are well used to dealing with such risks and many ALMOs in particular have to manage the risk because they are paid via a fee relating to the numbers of units in management.

One new risk faces all social landlords: the progressive effects of the government's welfare reform programme, and especially the implementation of universal credit planned for 2013. Landlords are likely to be factoring in higher levels of potential arrears into their business plans, to reflect the new risk. However, as noted above, local authorities enjoy some protection because of their lower gearing levels and lower rent levels compared with associations, and also generally lower arrears and management costs.

Who carries the risk and how can it be monitored?

While many councils are now separating their housing and non-housing debt for treasury management purposes, any default would be a call on the local authority as a whole, not (as with associations) purely on the housing business.

Total local authority borrowing is currently about £81bn, including the additional borrowing taken on to enable council housing to be self-financing. The maximum £7bn extra investment proposed in this report would therefore be significant, although well within the sector's borrowing capacity and its ability to sustain debt given low debt levels per property and a buoyant income stream from rents. Local authority debt of course accounts only for a fraction of total government debt – just over 6%.

Nevertheless, the issue about who carries the risk of additional borrowing is bound to arise. The prime responsibility for treasury management risk lies with the local authorities themselves, and they are subject both to statutory guidance on this and to a CIPFA treasury management code. Councils have a strong track record of prudential borrowing governed by the code. In the event of failure, a local authority has to finance the costs itself.

A detailed case has been made by CIPFA (in evidence to the CLG Select Committee[29]) that the borrowing caps imposed on local authorities when self-financing began are unnecessary, arguing that:

> *'...the introduction of [the] Prudential Code has clearly proved that Local Authorities can be trusted to act prudently with regard to borrowing. Under prudential borrowing, a local authority must only borrow when and if the debt*

28 There is a comprehensive assessment of risks facing social housing, principally housing associations, in Jones, M. and Lupton, M. (2011) *Viability and Vitality: Sustaining the financial viability of housing associations*. London: Savills.

29 CIPFA (2012) Written submission from the Chartered Institute of Public Finance and Accountancy. London: House of Commons Communities and Local Government Committee.

repayments and interest are affordable. Affordability is crucial and therefore aggregate borrowing should never reach unaffordable levels. The cost and availability of loans in itself provides the commercial discipline, obviating any need for regulation.'

CIPFA went on to argue that the introduction of prudential borrowing for councils in 2004 had been a complete success, with borrowing levels remaining modest and prudent, and never with any indication that the Treasury might have to use its reserve powers to intervene. CIPFA added that 'councils can be trusted to manage complex finances on behalf of their local communities. Localism is a good model for ensuring joined-up decision-making, efficient outcomes and economic growth'.

It might be added that housing associations do of course have to manage their own debt, and while none have had direct recourse to government, the regulator has in the past intervened to secure solutions to major threats of default such as the Ujima case. Nevertheless the solution was contained 'within the sector'.

There is therefore a strong argument for the new investment proposed in this report, based on current fiscal rules and against the backdrop of the UK's debt position, simply to be financed from extra borrowing using the current prudential regime to govern the risk.

Additional safeguards being considered to ensure robust business plans

Local authorities are nevertheless conscious that self-financing does carry risks which they did not bear themselves when they were locked into and dependent on a national subsidy system. For this reason, work is already being done to develop a self-regulatory code of practice for HRA self-financing. No decisions have yet been made, but it is likely to focus on areas such as these:

- Business planning principles around long-term financial management, asset management and risk strategy (risk identification and management).
- Rent setting in the context of the viability of the self-financed HRA business plan – ensuring appropriate interplay with the democratic mandate.
- Models of governance for a self-financed HRA. This should be principles-based with supporting guidance or case studies on how it is working in practice at a number of places in the context of existing democratic and governance structures.

If it goes ahead, such a voluntary code will provide even greater protection from risk.

6 How fiscal rules hold back investment and why they should be changed

Although there is a perfectly credible argument for more investment under current rules, this report also wants to restate the case for a new approach that would bring self-financed council housing much closer into line with housing associations and make a permanent change towards facilitating sustainable investment in new homes.

This alternative approach rests on the fact that, according to the main international measures of debt that have been in place for many years, extra investment for council housing would not count as adding to government borrowing levels. In other words, such borrowing is an issue because successive UK governments have used a particular measure of public sector debt that is not widely used outside the UK. On the measure that is used more widely, the only part of the extra cost of any new council housing investment that would be counted would be any government grant, not the extra borrowing itself.

This section sets out this argument in more detail.

Fiscal rules – a brief outline

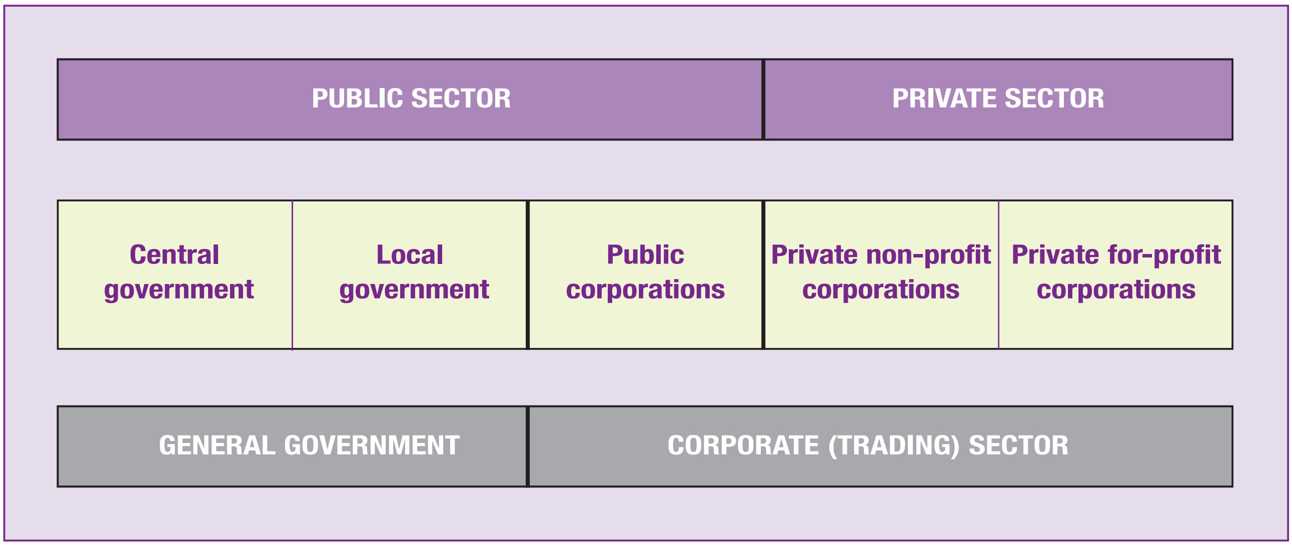
The government has two fiscal targets to help steer the UK's fiscal position back towards balance and ensure that the debt ratio as a share of the economy is on a sustainable, downwards trajectory:

- The government's forward-looking fiscal mandate is to achieve a 'cyclically-adjusted current balance' by the end of the rolling, five-year forecast period.
- The fiscal mandate is supplemented by a target for public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015/16.

Public Sector Net Debt (PSND) is the key measure by which the supplementary debt target is measured by the Treasury and by the OBR, alongside the fiscal mandate. However, other countries and international organisations use other measures of debt. The most widely used measure is General Government Gross Debt (GGGD), which is the main measure used by the EU, IMF, OECD and the credit-rating agencies.

The differences between the UK and international rules are illustrated by Figure 4. If the diagram is a sandwich, the 'filling' represents the classifications used by the ONS to identify different sectors of the economy; these follow rules set by Eurostat (the EU's statistical office). These classifications are common to both measures of debt. The difference between the UK and international debt measures are the 'slices of bread': the upper one shows the 'public sector' used to define PSND under current UK rules; the lower one shows the smaller 'general government sector' used to define GGGD.

Figure 4: UK rules compared with international rules



The essential difference is the inclusion or exclusion of the public corporate sector. This covers a range of bodies that are publicly owned but whose activities are financed principally from their incomes (fees, rents, etc.). Examples include Manchester Airport, local authority bus and tram companies, the Royal Mail, the Royal Mint, as well as rescued banks such as RBS. In the 1980s, this sector was far bigger as it included the likes of British Gas, BT, etc., which have since been privatised and are now classified as private for-profit corporations.

Fiscal rules – how they affect housing investment

Figure 5: Public borrowing definitions and housing

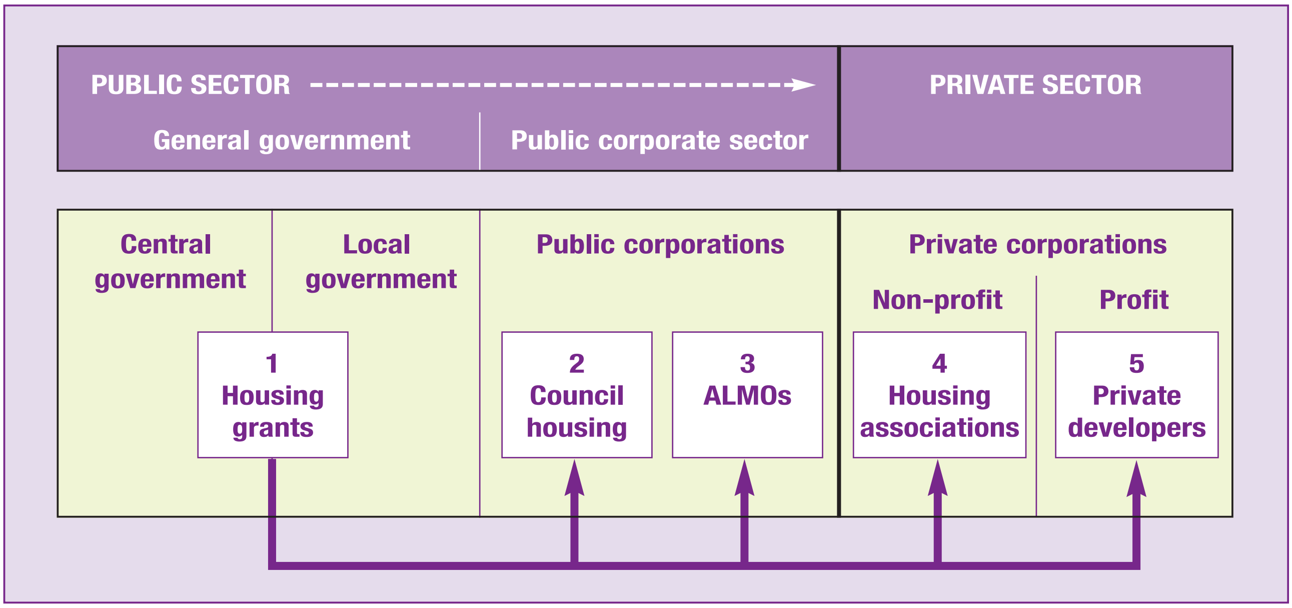


Figure 5 shows how the fiscal rules relate to the different bodies involved and flows of finance in housing. The main points about this are:

- Housing associations are classified as non-profit private corporations; private developers (including those receiving HCA grant) are for-profit private corporations.
- All ALMOs are individually classed as public corporations; council housing services are known as 'quasi-corporations' and are also part of the public corporate sector.[30]
- Government grants to councils and to housing associations are general government expenditure (as were local authority grants to housing associations, when they existed).

The effect of the rules is, of course, that while housing associations' expenditure and borrowing *does not count* against the current measure of UK debt (PSND), similar expenditure by local authorities *does count* against PSND, notwithstanding the different classification that council housing has compared with most other activities of a local authority. So, at present, while for housing associations only the grant they receive from the HCA is subject to the government's fiscal rules, for councils both any grant they receive *and their borrowing* are subject to those rules, even though for both types of body the costs of the borrowing are met from rents.

Fiscal rules – the arguments for and against change

The broad case for change is that moving towards international debt measures would bring the UK into line with other countries and would not affect the way our debt is viewed internationally. The change would recognise the fact that public corporations are different entities to government and give British public corporations the same freedom to

30 See ONS (2007) *UK National Accounts: Case law on classification of quasi-corporations*. London: ONS.

borrow to invest as their international counterparts. In housing, it would recognise the essential similarities of council housing and housing associations and allow much needed investment, again within prudential rules. The change does not prevent government from having rules to ensure that borrowing by corporations is prudential, and indeed could be more transparent and accountable than the current situation in which there are various exceptions or one-off arrangements to get round the present rules.

The government argues for retaining PSND as the key measure because it is the best principled measure of government indebtedness.[31] One reason for this is because the government is generally likely to step in if public corporations cannot service their liabilities, and so a focus on PSND provides a fuller and more transparent picture of government's total liabilities. If there are no controls over public corporations' accrual of liabilities then this means that government does not have control over its contingent liabilities, which if called upon would impact on the deficit as well as GGGD.

One argument for change is that where government has intervened in the financial sector to rescue banks, those interventions have been excluded from the PSND. However, the government justifies this because the measures have been non-discretionary and temporary policies and the government anticipates receiving a full return on the items excluded. In the government's view, such arguments would be less valid for excluding other policy decisions, which will be higher risk and thus more likely to permanently impact on debt and represent a long-term liability for government.

In response to these points, several arguments can be made:

- there are many bodies outside the public sector that also present contingent liabilities to government; they include privatised services like water and power, and PFI schemes where these run essential services such as transport or health
- government has already had to intervene in such cases, e.g. the taking into public ownership of East Coast Mainline
- unlike these bodies, where contingent liabilities may be called on very rapidly or even overnight, public corporations have ongoing accountability to government and strict rules can be applied to ensure they have minimum or no resort to government rescue
- as has been demonstrated several times this year, the banks continue to be a risk, yet they are excluded from PSND (if publicly owned) or are outside PSND (if private), despite considerable contingent liabilities for government that – again – may be called in at very short notice
- as demonstrated earlier in this report, council housing investment is not 'higher risk' – as evidenced by local authorities' high credit ratings, their excellent track record of sustainable borrowing for many decades and the very small proportion of public sector debt attributable to them.

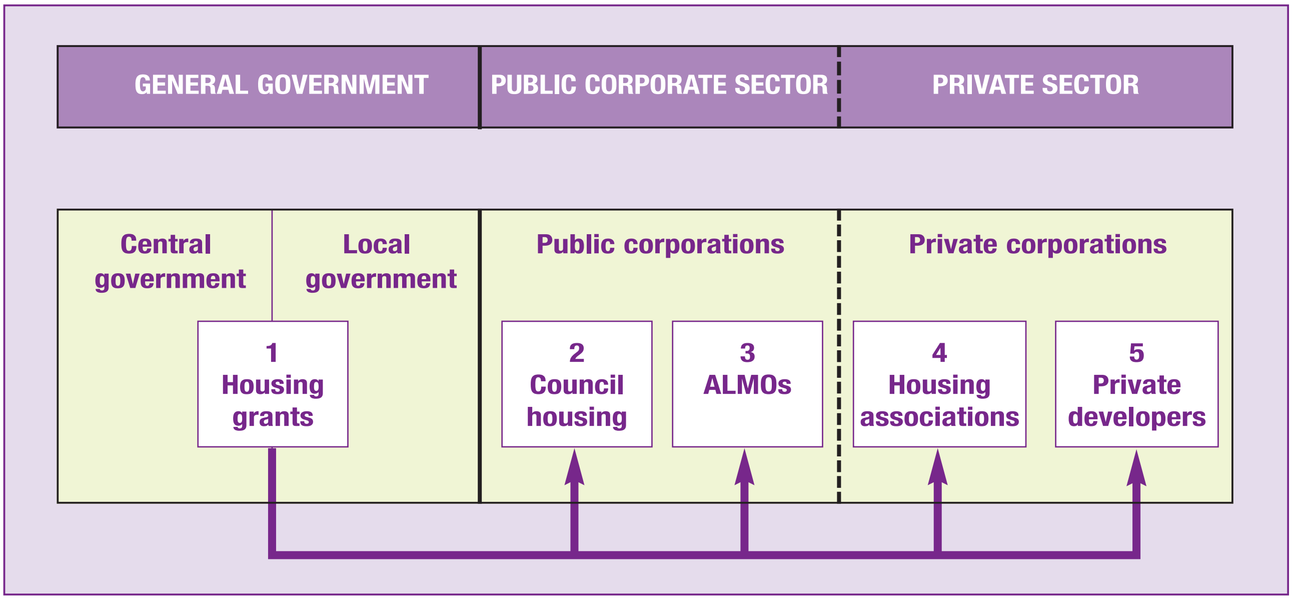
Fiscal rules – the key changes proposed

Figure 6 on page 29 shows how (compared with Figure 5) the dividing line between what does and does not count towards measures of UK debt would be moved to focus solely on government bodies (central and local).

This report accepts the importance to government of the current fiscal targets. The proposed change is that these (or any subsequent) targets are applied to government borrowing and debt measured against the GGGD rather than PSND. Such a change need not be made overnight, but the PSND measure could be progressively replaced by GGGD, and of course GGGD data are already published (e.g. in the Budget Red Book) and submitted to and published by Eurostat.

31 The text here is summarised from HM Treasury's response to the case made by Westminster and three other councils, which argued for similar changes in 2011 (HM Treasury, 7th March 2011).

Figure 6: Proposed new basis for measuring borrowing and debt



As a component of this change, it would be essential to establish additional measures to monitor/control the extent of contingent liabilities arising from public corporations' borrowing. It may be desirable, in addition, to build on the separation of HRA and non-HRA debt by changing the rules so that in future local authorities would secure their borrowing for HRA purposes on their housing assets, not on the general income of the authority.

It is outside the scope of this report to cover all the remaining bodies in the public corporate sector, but the framework for local authority housing investment described in Section 5, with the added safeguard of a voluntary code and with the government's reserve powers to intervene, would we believe provide a robust basis to manage these liabilities.

Fiscal rules – response to change

This report is of course not the first to advocate changes in the fiscal rules, especially from a housing perspective. The first attempt was made in 1995[32] and was followed by a report by Coopers Lybrand (now Pricewaterhouse-Coopers) showing how market opinion would be unlikely to respond adversely to such a change.[33] The case was rejected by the then government.

The most recent attempt was made by Westminster Council, on behalf of a number of councils, in 2011.[34] This was rejected by the current government.

This section has attempted to anticipate the response from HM Treasury to the proposed rule change, and to suggest ways in which obstacles might be overcome, based on the detailed reasons given by HM Treasury in a note explaining why it rejected the Westminster proposal.

Critical views also include those of the markets and credit ratings agencies, who judge and respond to the UK's performance in managing its debt and might react against any change seen as 'bending the rules'. Market responses to this and other aspects of the report's proposals are considered in the next section.

32 Hawksworth, J. and Wilcox, S. (1995) *Challenging the Conventions: Public borrowing rules and housing investment*. Coventry: CIH and Coopers and Lybrand.

33 Coopers and Lybrand (1996) *Consensus for Change: Public Borrowing Rules, Housing Investment and the City*.

34 Westminster Council (2011) *The Case for Borrowing for Investment in Housing*.

7 Market reaction to the proposals

Clearly the government will be concerned as to how the market would judge the various proposals in this report, and the likely reaction in terms of the government's credit rating and the effect on guilt yields (i.e. costs of new government borrowing). To make a preliminary assessment of market reaction, Capital Economics (CE) was commissioned to survey key market figures and produce a report on 'the view from the City'. This section summarises the report's findings.

Capital Economics' study

CE spoke to 13 economists, fund managers and credit ratings analysts in September and October 2012, using a semi-structured questionnaire, to provide a qualitative assessment of City opinion. The topics discussed and the responses (which were diverse and sometimes conflicting) are summarised below.

The full report will be available on the NFA website alongside this report.

Achieving growth – a priority for the government and for the markets

All interviewees saw achieving growth as an economic priority. One said:

> *'I do think there is need for fiscal stimulus and a scope for it, but I do think that government has to behave quite cautiously as there isn't a mechanistic connection between how much the market borrows and how the markets react... However, if the UK economy doesn't recover, although in the short term that may be good for bonds, in the long term it isn't good for bonds. What happens is that debt ratios continue to rise, policy becomes unpopular and the chances begin to grow that eventually there is some sort of disaster...* ***A well constructed and targeted package: I think the markets could accept that quite readily.****'*
> Roger Bootle, Managing Director of Capital Economics

David Kern, of Kern Consulting, explained that since 'Plan A' is clearly well behind schedule, the markets are more forensic now. But the markets also understand that we need growth to avoid a vicious circle of recession and ballooning deficits. The key is to persuade them that the measures taken will boost productive potential and help to eliminate the structural deficit, albeit later than originally intended.

Maintaining credibility is crucial

The majority of interviewees felt the government should stick to its current targets. However, it was noted that gilt yields may not react significantly to any increase in borrowing above current plans, especially given the scale of the plans proposed in this report (see below).

Ian Fishwick, fund manager at Fidelity Investments, explained:

> *'It would depend on how it was done: some relaxation would be perfectly sensible, but if they threw caution to the wind and went off down a completely different track that would change my assessment of UK gilts.'*

Peter Warburton, director of Economic Perspectives LLP, was also cautious:

> *'I'm on the side that I think a lot can be considered in terms of the redistribution of government spending, but it would be highly dangerous, given the vulnerabilities we have, to exceed our borrowing projections.'*

The size of the borrowing under consideration is too small for markets to worry about

All interviewees regarded the amount of extra borrowing in question that the local authorities might undertake, estimated at a maximum of £7bn over five years, as insignificant and far smaller than the standard statistical error for public borrowing figures. The extra debt would not concern them. However Roger Bootle noted that a large increase in debt is composed of many small increases in debt for particular policies, and as such a lifting of the current caps on local authority borrowing should be assessed in the same way as a policy that might potentially lead to much bigger increases in borrowing.

Effect on interest rates

Fund managers saw sticking to the current plan as key, but also looked at other factors such as the inflation and growth outlook and the Bank of England's actions when assessing UK gilts. Just a small increase in borrowing, or borrowing offset by further quantitative easing, might have a negligible effect on bond yields in the short term. One interviewee noted that even though he thought a large fiscal stimulus was not a good idea, he was unsure that it would lead to any increase in gilt yields, given the UK's safe haven status, the worsening situation in the Eurozone and the power the Bank of England has to purchase gilts.

Effect on credit rating

The ratings agencies have been clear that weak growth or further increases in debt would almost certainly lead to a downgrade of UK sovereign debt. Some respondents viewed a downgrade as overdue in any event, and any modest change might trigger it happening. However, there was no clear view on the effects of a downgrade and how important it would be.

Considerable support for greater priority for infrastructure investment and recognition of severe need for investment in housing

Interviewees generally felt that investment was important and several expressed the view that there should be a shift in government fiscal policy towards investment. A few noted that capital investment had fallen significantly and that capital spending has more effect on the economy.

Several pointed out that infrastructure investment only counted towards the supplementary debt target and not the fiscal mandate. Both Geoff Dicks of Novus Capital and Peter Warburton of Economic Perspectives said that in their view the fiscal mandate (which requires the structurally adjusted deficit to be zero by the end of the forecast horizon) was more important than the supplementary target (which requires overall net debt to be falling by 2015/16).

Most interviewees recognised that there was a severe need for investment in housing in the UK and this is consistent with the needed shift on spending priorities, although some saw transport infrastructure investment as a priority. Tim Morgan, Head of Global Research at Tullet Prebon, argued that housing investment would be a good fiscal stimulus policy.

There were few concerns about borrowing for local authority-managed projects.

Need for rationale for policy change

Several interviewees emphasised that the market would require a clear explanation of any policy change. One interviewee said that any change that increased borrowing would have to be backed up by a demonstration that the private sector could not do the job and that there was a genuine market failure. (We believe this is demonstrated clearly in this report.)

Change in fiscal rules

Most felt that moving to reporting the Gross General Government Debt definition of public debt (as opposed to the Public Sector Net Debt) in the current situation was not appropriate, but few objections were raised about a move in the long term.

International investors use the GGGD; the PSND is potentially confusing to investors based outside of the UK, but any changes to debt figures would have to be transparent.

Recommendations and our offer to government

Councils and ALMOs can play their part in securing future economic growth quickly and cost-effectively by further direct investment in housing.

If allowed by government, councils and ALMOs will:

1. **Use their land and assets effectively to drive local growth.**
2. **Exploit and use to best effect the potential within the self-financing system to bring forward new homes in a managed and planned way.**
3. **Collaboratively develop and support voluntary standards led by the sector to maintain effective financial governance of housing accounts.**

The five organisations sponsoring this report want to work with government to make the most of this potential. They therefore recommend that the government:

1. **Unlocks the potential to invest in housing by removing the HRA borrowing caps and relying instead on prudential borrowing rules to ensure that investment is sustainable.**
2. **Considers the longer-term case for a planned and transparent move to adopt internationally recognised rules to measure government borrowing, to bring Britain in line with our competitors.**

All of Britain's political parties want to see more house building. House building creates jobs and boosts the economy as well as providing homes that people need. Why can't we just get building?

Councils own around two million homes and they now manage their own 'self-financed' business plans. Debt on these homes is very low. They could take advantage of this to raise loans to build homes. We estimate we could deliver as many as 60,000 homes in five years.

We can get Britain building again very soon. There are many 'shovel-ready' sites standing idle. We would work with the house builders and the construction industry. What is stopping us? Each council has a centrally imposed debt limit and cannot use its full borrowing power. If the government is serious about building new homes, it should remove these restrictions and allow councils to play their part alongside the private sector and housing associations.

The report makes a detailed case to government, covering:

- how house building can stimulate the economy
- the need for more investment in rented housing
- the case for house building by councils and almos
- financing the programme and its implications for government
- extra borrowing under current rules
- the case for changing the fiscal rules
- how markets would respond.

The five organisations supporting this study believe it makes a powerful case for change, and call for a response from government which recognises a golden opportunity both to help tackle the housing crisis and to stimulate the economy. Let's get building.

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