National Federation of ALMOs
championing better homes and communities

# Treating council housing fairly

## How changed borrowing rules can help build more homes and boost the economy

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**There is a compelling case for the government to remove the restrictions which prevent councils from borrowing to build new homes. Increased freedom could deliver an extra 60,000 new affordable homes over five years – on top of just 9,000 that councils will be able to build under current borrowing rules. Such investment is an essential contribution to tackling the housing crisis, which requires us to more than double the number of homes built nationally in all sectors.**

**Investment in housebuilding also stimulates economic growth and creates jobs. Building 60,000 extra homes would add 0.6 per cent to GDP and create 19,200 jobs. Every £1 invested by the public sector in construction generates an extra £2.84 worth of activity in the wider economy. Of each £1 spent, an estimated 56p returns to the Exchequer in extra tax revenue.**

**This paper makes the case for a change in the borrowing rules to bring the UK into line with international practice. It would put council housing on the same financial basis as housing associations and boost councils' capacity to invest in new homes, alongside housing associations.**

## The growing case for change

The case for change received an enormous boost in April 2012 when council housing in England became self-financing: a reform which had cross-party support. For the first time, councils are now able to properly control their income from, and borrowing related to, housing. This has strengthened the ability of local authorities to treat council housing as a distinct business, whether by internal separation or by using an ALMO (arms length management organisation).

Following this major change, four national housing bodies and the Local Government Association published the report *Let's Get Building*, to make the case for new borrowing rules that would build on the self-financing reform.[1] Since the report came out in November 2012 it has received considerable support and has been welcomed by a range of local authorities across the political spectrum. This paper summarises and updates the case set out in *Let's Get Building*.

## Scope of this paper

The paper concentrates on the specific issue of the borrowing rules and why and how they should change. It does not repeat the lengthy case for building more homes and boosting the economy, set out in detail in *Let's Get Building.* Needless to say, however, a change in the rules would be an important contribution towards doubling the national output of new housing, because it would unleash local authorities' capacity (to raise finance and provide land) alongside that of housing associations.

## How UK borrowing rules compare with international rules

Under both this and previous governments the UK has established fiscal rules relating to debt levels and the current account deficit. Such rules require clear definitions of what expenditures and borrowing 'count'. The UK's definition covers the whole of the public sector and in this sense is unique: other EU countries and bodies such as the IMF and OECD use international definitions of what counts towards sovereign debt and current account deficits. And to complicate matters, the UK's debt is measured by these international rules for the purposes of monitoring its compliance with the Maastricht Treaty and (for example) in OECD comparisons of national accounts.[2]

[1] Perry, J. (2012) *Let's Get Building: The case for local authority investment in rented homes to help drive economic growth*. NFA with ARCH, CIH, LGA and CWAG (available at www.almos.org.uk).

[2] See the OECD comparisons of national accounts (www.oecd-ilibrary.org/economics/national-accounts-of-oecd-countries-general-government-accounts_22215352).

The key difference between the UK and other countries is in how different sub-sectors are treated in the UK fiscal rules. The UK government has for several decades applied an unusually wide-ranging definition of the ‘public sector’. Historically, the main measure used in monitoring debt was the PSBR (Public Sector Borrowing Requirement), now supplanted by either PSNBR (Public Sector Net Borrowing Requirement) or PSND (Public Sector Net Debt). All of these include not only government itself (central and local) but also bodies in what is known as the ‘public corporate’ sector. Other EU countries, most OECD countries and the most widely used international debt statistics focus on ‘general government’ and exclude the public corporate sector.

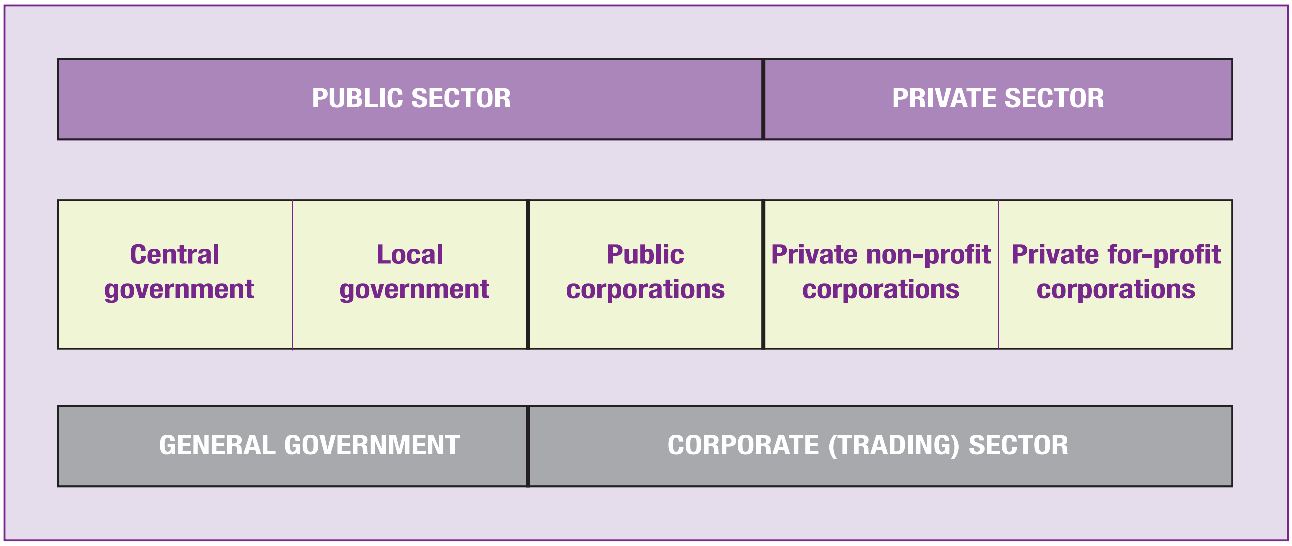
Until the 1980s this sector was large, including many of the now privatised utility industries such as water and energy. Although currently much smaller (but still accounting for about one-sixth of public sector capital expenditure), the public corporate sector includes a range of bodies whose borrowing is therefore caught by the UK fiscal rules, such as council housing and ALMOs, when similar borrowing would not be caught by the rules applying in other countries.

Whether borrowing by any undertaking is ‘caught’ by the rules depends on two factors:

1. Its **sector classification**, which is undertaken by the ONS following international rules set by Eurostat, the EU statistics agency. Broadly speaking, if classified as part of *government*, central or local, any undertaking’s borrowing is caught by both the UK and the international rules. If classified as a *private* body, its borrowing is not caught by either set of rules. However, between the two are the *public corporations*: their borrowing is caught by the UK rules but *not* by international rules.
2. The **borrowing rules** themselves. The UK is obliged to report its debt by international rules in order to adhere to EU treaties. These embrace only ‘general government’ borrowing and exclude that by public corporations. But the government maintains the historic practice of using a wider ‘public sector’ definition domestically which includes public corporations, and its fiscal rules are based on this definition rather than the widely accepted international one.

The differences are summarised in Figure 1.

**Figure 1: Sector classifications and borrowing rules**



If the diagram is a sandwich, the ‘filling’ represents the classifications used by the ONS to identify different sectors of the economy. These classifications are common to either measure of debt and apply across the EU. Public corporations, the key sub-sector discussed in this paper, are government-owned or government-controlled trading bodies that make an economically significant charge to consumers for the goods or services they provide; as opposed to government services provided free or with only nominal charges to consumers, and that are predominantly funded from taxation.

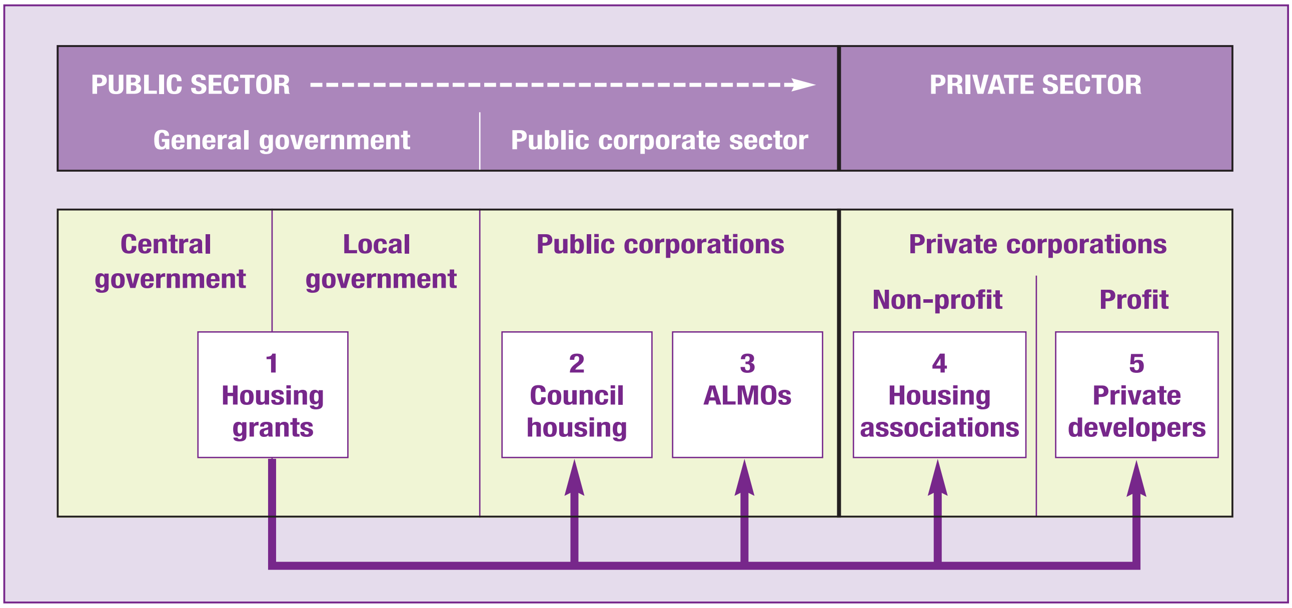
The difference between the UK and international debt measures are the 'slices of bread': the upper slice shows the 'public sector' used to define PSNBR and PSND under current UK rules; the lower shows the smaller 'general government sector' used to define the international measure, General Government Gross Debt (GGGD).

Despite its insistence on using the UK's own rules, the Treasury does of course have to report its debt levels according to international rules, and comparisons between the UK and other countries use these rules (since no one else uses the British rules).

## How do the rules affect housing?

Slightly more than half of social housing is run by housing associations, slightly less than half by local authorities. Of the latter, some 47 have contracted out their housing management to an ALMO. These bodies are affected in different ways by the rules, as shown in Figure 2.

**Figure 2: Public borrowing definitions and housing**


PUBLIC SECTOR
PRIVATE SECTOR
General government
Public corporate sector
Central government
Local government
Public corporations
Private corporations
Non-profit
Profit
1 Housing grants
2 Council housing
3 ALMOs
4 Housing associations
5 Private developers

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.[3]
- **Government grants** to councils and to housing associations are general government expenditure.

The effect of the rules is, of course, that while housing associations' own 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.

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

**From the Treasury's accounting perspective, the typical cost of building a housing association unit is the grant of £20,000, compared with a council unit which typically costs £116,000. However, the total cost of an average new HA unit is actually higher than that of a council house, at £127,000. But only the grant itself scores as public borrowing.[4]**

## How do borrowing controls work?

The borrowing implications of housing association building are limited to the grant paid by the Homes and Communities Agency (HCA). For council housing, both the grant (if any) and the council's own borrowing are counted. For this reason, the Treasury controls council investment not only through the HCA's grants programme but through 'borrowing caps' which apply to individual councils. These caps only apply to housing, not to the rest of council borrowing, and they do not apply in Scotland (which has had self-financed council housing for many years).

The caps essentially place an upper limit on the borrowing that councils collectively make which can be supported by the income from their self-financed housing revenue accounts (HRAs), even if under the 'prudential rules' that apply across local government they could afford to borrow more. Furthermore, at the local authority level the caps are arbitrary in their effects – some councils have higher caps than need, others have caps which are set far below what they could borrow prudentially.

## How is borrowing for social housing dealt with in other EU countries?

No other EU country treats social housing investment in the way that happens in England. In part, this is because England's 'council housing' model is unusual, because few other EU countries have social housing managed directly by local authorities and where they do, stocks are generally small.[5] However, the model of management or ownership being in the hands of a municipally owned company is relatively common (e.g. Sweden, Austria, Finland and parts of France), and such companies elsewhere in Europe enjoy the same borrowing freedoms as housing associations.

This means not only that council majority-owned bodies can, in effect, build alongside housing associations (or their equivalent in each country), but that they can also take advantage of the cheaper borrowing available to them because they are backed by local government. While in England councils or council-owned companies could also borrow cheaply from private lenders, this advantage is negated by any new borrowing being restricted because it counts towards public sector debt.

Incidentally, the same applies even more markedly in other sectors such as transport and energy, where companies which are majority-owned by other EU governments (e.g. Arriva buses and trains, the energy company EDF) enjoy the advantages of the international rules and have a huge role in the transport and energy sectors in the UK.

## How do the UK's borrowing rules hold back housing production?

It would be wrong to suggest that the self-financing settlement allowed no potential for new borrowing and investment. In total, councils are allowed £2.8bn of 'headroom' within their borrowing caps. The problem is that the headroom is very unevenly distributed and many of the councils with an urgent need to build have none or their headroom is insufficient.

If current borrowing caps were used to the maximum, councils could in theory build about 3,000 units per year in total. They are actually building at a rate of 1,800 per year.[6] The difference is undoubtedly due in part to the fact that the borrowing caps do not reflect variations in the need to build new homes. It probably also reflects the fact that councils are only now in their second year of running self-financed accounts and are still adapting to the new flexibilities. Many councils are also funding energy-efficiency programmes or (especially in London) outstanding work to meet the Decent Homes Standard in their current stock.

[4] Based on housing association and council costs in the Homes and Communities Agency's 2012 programme.

[5] Exceptions are generally EU countries in Eastern Europe, although Portugal has a small municipal housing sector.

[6] New starts by local authorities in the year to June 2013 (DCLG Housebuilding statistics, June Quarter, England).

Changed borrowing rules would give fresh impetus to a new build programme. In a recent survey, three-quarters of councillors said that if the government lifted the caps they would borrow to build new council housing and almost 80 per cent said if their borrowing headroom was to double, they would use the extra capacity to build new council homes.[7]

While recent suggestions that councils might be allowed to ‘pool’ their borrowing caps might help at the margins, pooling is unlikely to occur on any scale both because councils will be reluctant to give up borrowing capacity they may later need, and because those that do so are likely to want something in return, e.g. nominations to new units built by the partner council. This will require negotiations and contractual agreements. Pooling would be a very modest change and is no substitute for action to raise or abolish the borrowing caps.

## How would changed rules release new investment potential?

The *Let’s Get Building* report estimated that if councils were able to use their full borrowing potential – still under prudential rules – they would have capacity to borrow up to £20bn over five years, or up to £27bn if they were to let new homes at ‘Affordable Rents’. This could mean in theory having capacity to build 170-230,000 extra homes in total. In practice, work by the Chartered Institute of Housing (CIH) showed that, if the caps were removed, councils would aim to build rather less than this – some 60,000 extra, or an extra 12,000 units per year.[8] Nevertheless this would be an extremely valuable contribution towards any target to double England’s housing output.

It is important to recognise that much of this potential output is only achievable by councils themselves. The key constraint is land, and much of the land for new building by councils will be associated with existing estates, including replacement of unpopular or obsolete stock, using garage and commercial sites or unlocking ‘backland’ or garden land that is little used. Councils are best-placed to assemble such sites and work in liaison with existing residents of estates affected by new development.

## What are the costs and benefits of councils building more?

Clearly borrowing is only one (important) element in the costs of council new build. Here is a summary of the costs and potential benefits set out in *Let’s Get Building*:

- **Grant.** Some councils are building without grant but some require grant from the HCA. If half the 60,000 programme depended on grant, at £20k per unit this would cost £120m per year. Similar or higher levels of grant would be needed by housing associations, of course, for a similar output.
- **Housing benefit.** Grant costs would be partly offset by savings from tenants moving into social housing from private lettings, where rents are higher. If one third of lettings were used this way, the saving would be £40m annually, continuing into the future.
- **Reduced use of private sector by poor tenants.** Although difficult to quantify, there could be further knock-on savings if more private lettings were freed up for tenants who don’t depend on HB. In any event, if more council lettings were available this would reduce the inflationary pressures on private sector rents.
- **Reduced use of temporary accommodation and B&B.** Currently over 56,000 households are in temporary accommodation of which 2,000 are in B&B, all at costs much higher than normal rents. As extra new build leads to extra lettings, these totals should fall and costs will be saved. One estimate of these savings is £5,000 per year for every household that is able to avoid temporary accommodation.[9]
- **Wider benefits.** The *Let’s Get Building* report sets out the wider benefits to the local and national economies and the Exchequer that accrue from investment in new housing construction, which substantially offset any direct costs. Extra council housing investment would also help towards the goal of at least doubling national housing output to keep pace with growing needs.

[7] The Smith Institute (2013) *Does Council Housing have a Future?*

[8] See *Let’s Get Building* – cited above.

[9] House of Commons Library (2012) *Homeless Households in Temporary Accommodation (England).*

## What are the risks?

The basic risks now carried by council housing are similar to those of housing associations. Repayment of debt depends primarily on income from rents, which 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 and ALMOs are well used to dealing with such risks and have put in place sensible business plans to manage and improve their housing stock and invest in new build (described in the recent report *Innovation and Ambition*).[10]

One new risk faces all social landlords, and this is the progressive effects of the government's welfare reform on rental incomes. As shown in a recent study,[11] councils will now have to factor into their business plans higher levels of potential rent arrears. Local authorities enjoy some protection because of their lower rent levels compared with associations, and also generally low arrears and management costs; nevertheless this new level of risk must be taken into account.

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 the income stream from rents. Local authority debt, of course, accounts only for a fraction of total government debt – just over six per cent.

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.

Housing associations do of course 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. These solutions have always been contained 'within the sector' without extra government financial intervention.

## What are the arguments for and against changing the borrowing rules?

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 invest as their international counterparts.

In housing, it would recognise the essential similarities of council housing and housing associations and allow much needed investment, 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 sections below outline the main arguments that have been made against a change in the rules, and responses to them.

- **Transparency.** Because the current measure of debt, PSND, is all-embracing, it is argued that it gives a fuller and more transparent picture of public sector liabilities. But the financial flows of the public corporate sector are regularly published in the Treasury's Public Expenditure Statistical Analysis (PESA), so transparency itself should not be an issue. If separating out the £6bn annual expenditure of the public corporations is an issue, then surely the fact that the publicly-owned banks are accounted for separately from the public sector is a very much bigger one? In many respects the transparency argument should focus at least as much on the potential cost of guarantees and other interventions in the private sector, with their potentially large effects on public finances when things go wrong. Current examples include (in housing) the guarantees for housing association borrowing and (more widely) guarantees like those made to attract investment in nuclear power or universal broadband.

[10] ARCH *et al* (2013) *Innovation and Ambition: The impact of self-financing on council housing* (available at www.almos.org.uk).

[11] ARCH, CWAG and NFA (2013) *Welfare Reform Survey – Summary of responses*.

- **Sticking to the rules.** The government has a set of rules about the boundaries of the public sector, to ensure that the UK public accounts are taken seriously. Yet, these rules were first set decades ago and are not necessarily still fit for purpose. Because of this, in practice anomalies arise and changes are permitted when judged necessary. For example:
  - Public sector banks are outside the rules (effectively creating a very sizeable special sub-sector) – a practice also followed by other European governments that have made banking interventions. In Britain's case, it kept £1.5 trillion off the 'public sector' balance sheet.[12]
  - FE colleges were reclassified outside the public sector in 2012 despite their dependence on public funding. In the higher/further education sector, 'private' bodies receive £4.5bn annually through the Higher Education Funding Council. There are reports of this subsidy exceeding its 2013/14 budget limits.[13]
  - Government took over the Royal Mail pension fund to boost its finances prior to privatisation – assets of £28bn were used to offset government debt but liabilities were disregarded, amounting to £1.2bn worth of subsidy in 2012/13 alone.
  - Suggestions have been made that academy schools – currently part of central government – could be privatised to enable them to be profit-making (while presumably still receiving public subsidy).[14]
- **Having proper controls.** This argument clearly applies whatever the status of public corporations in the national accounts. In fact there is already a broad framework in place, described in Public Expenditure Statistical Analyses (see chapter 8 of the 2012 edition[15]). If this is insufficient, it should be made more robust. Public corporations are also subject to EU competition law and to procurement rules to ensure open competition for any contracting they do. Councils are already subject to statutory guidance and to the CIPFA treasury management code. Further safeguards are discussed below.
- **Need to reflect true public sector liabilities.** The Treasury argues that the wide 'public sector' definition of borrowing is the right one because it captures bodies whose finances would have to be underwritten by the state in the event of failure. There is of course little or no evidence of public corporations getting into serious difficulty in recent times. On the other hand, the examples of private firms having to be rescued by the state are plentiful. Council housing has transparent accounts, managed by their parent local authorities: the scope for unpleasant surprises is therefore much more limited. Furthermore, in the comparable housing association sector, the limited cases of financial difficulty have been resolved *within the sector*, without recourse to public funds.
- **Unfair advantage.** The argument is that public corporations can borrow more cheaply and can therefore 'crowd out' private competition. This of course is what is already happening with the foreign companies operating in the UK transport and energy sectors, so other countries don't seem to have the same inhibitions.

  In housing, lower borrowing costs give an advantage to councils over both housing associations and private landlords. However, higher output from associations is of course needed *in addition to* increased building by councils. Private landlords make low levels of investment in new stock and although they pay higher interest rates they have access to interest-only mortgages. It can therefore be argued that in housing the 'unfair advantage' argument is of little importance: given the scale of the shortfall in supply, there is little risk of 'crowding out'.
- **Market reaction.** The key argument is that the market would respond adversely to any rule change, believing that it was a government ruse to increase public borrowing, and that this would push up guilt yields or affect the government's rating by the rating agencies. This argument was addressed in an assessment by Capital Economics for the report *Let's Get Building*.[16] It needs to be faced, but it is also clear that the possible objections are either not as great as claimed or that they can with time be resolved without prejudicing the market's trust in government accounts.

  The large presence of foreign firms in which their own governments have big shares is a new argument which should carry sway with the City, too. Presented in the right way as sweeping away the anomalies in the UK rules, and fully complying with international conventions and guidelines, should not cause too many ripples given that the markets are scrutinising the internationally comparative data (which will not change) all the time.

  Finally, none of the City interviewees for the Capital Economics study thought that £7bn of extra borrowing was sufficient for the markets to worry about, irrespective of the issues about any rule change.

[12] See ONS (2009) *Public Sector Interventions in the Financial Crisis*.

[13] See www.theguardian.com/education/2013/nov/18/college-course-chaos-budget-shortfall

[14] See www.telegraph.co.uk/education/10456218/Parents-could-run-State-schools-for-profit-under-Tory-plan.html

[15] See www.gov.uk/government/uploads/system/uploads/attachment_data/file/220623/pesa_complete_2012.pdf

[16] Capital Economics (2012) *Let's Get Building: The view from the City.*

## What other changes would be needed along with new borrowing rules?

To take full advantage of any rule change and to protect the public finances a range of other reforms, some already taking place, would be required:

- **Monitoring by and returns to central government.** Councils already report their housing accounts in detail to DCLG. This would continue. Government would retain the reserve powers they already hold to restrain excessive borrowing.
- **Comprehensive code of practice for self-financed council housing.** While councils have to abide by CIPFA's prudential code and its treasury management code,[17] neither of these were devised with self-financed council housing services in mind. That is why CIPFA and CIH have jointly developed a *Voluntary Code for a Self-Financed Housing Revenue Account*.[18] Under changed borrowing rules, adoption of this code could be a requirement for councils wanting to borrow above their current caps.
- **Separation of HRA debt from local authority General Fund debt.** Many authorities have already done this: all would need to do so to facilitate this next stage of reform.
- **Reclassification of HRA debt by the ONS.** Because not all councils have separated out HRA debt, ONS treats it as part of local government debt in the public accounts. Separation would allow ONS to treat this debt as part of the debt of public corporations (as it does for other parts of the public corporate sector).
- **A clear rule on PWLB borrowing.** A considerable proportion of council borrowing is from the Public Works Loan Board, which is part of government. Continued borrowing from the PWLB would count towards central government debt. To overcome this, new borrowing would have to be from private sources. But brokers are keen to encourage councils to borrow from the bond markets.  This would currently be 0.25%-0.5% more expensive.

## What is the case for change *now*?

No one is suggesting that change should be made overnight, but there is a powerful case for taking steps towards change now, both to increase housing output and for its wider benefits for public sector investment. The reforms need to be carefully planned and shown to form part of responsible fiscal rules which aim to control and reduce sovereign debt. In addition, as this paper indicates, further detailed changes will be required relating to council housing debt. These changes could pave the way for a fully self-financing council housing service that can make a major contribution to meeting the demand for new homes at affordable rents. As an interim step, government could look at options such as raising the caps by a set amount to allow more building, or establishing a bidding round so councils and ALMOs could apply for flexibility in the debt cap tied to new development plans.[19]

There is a powerful wider case for change to the UK borrowing rules, to bring them into line with international rules and end the unnecessary restrictions on public corporations that do not apply in competitor countries in the EU. The case is particularly strong in the transport industry.

In housing, borrowing freedom for local authorities would be a vital component of any drive to double England's housing output across the public and private sectors. It would also end the unnecessary distinction between council housing and housing associations, which meet the same needs and operate under the same regulatory framework. Although it would not by itself solve the housing crisis, it would engage councils fully in the efforts to build homes and would ensure that investment is directed at households in the lowest income groups whose options have become even more limited since the financial crisis took hold five years ago.

[17] CIPFA (2011) *Treasury Management in the Public Services: Code of Practice*.

[18] See www.cih.org/publication-free/display/vpathDCR/templatedata/cih/publication-free/data/Voluntary_code_for_a_self-financed_Housing_Revenue_Account

[19] See NFA (2013) *Let's Get Building: Briefing on developing a ladder of options for lifting the debt cap.*

## Further publications on housing investment from the NFA

Available from www.almos.org.uk

*Innovation and Ambition: The impact of self-financing on council housing* (2013) (joint report – led by ARCH)

*Let's Get Building: Briefing on developing a ladder of options for lifting the debt cap* (2013)

*Let's Get Building: The case for local authority investment in rented homes to help drive economic growth* (2012)

*Let's Get Building: The case for local authority investment in rented homes to help drive economic growth* (2012) (Summary Report)

*Let's Get Building – The View from the City* (2012) (report by Capital Economics)

*Building on the Potential of ALMOs to Invest in Local Communities* (2011)

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