SERC Spatial Economics Research Centre

SERC POLICY PAPER 3

Local Authorities and the Downturn: A Review of Issues, Experience and Options

Ian Gordon (SERC and LSE)
Tony Travers (SERC and LSE)
Christine Whitehead (SERC and LSE)

June 2009

This work was part of the research programme of the independent UK Spatial Economics Research Centre funded by the Economic and Social Research Council (ESRC), Department for Business, Enterprise and Regulatory Reform, Communities and Local Government, and the Welsh Assembly Government. The support of the funders is acknowledged. The views expressed are those of the authors and do not represent the views of the funders.

SERC Policy Paper 3

Local Authorities and the Downturn: A Review of Issues, Experience and Options

Ian Gordon (SERC and LSE)

Tony Travers (SERC and LSE)

Christine Whitehead (SERC and LSE)

June 2009

This report considers the potential/appropriate role for local authorities (LAs) in relation to the downturn phase of the current recession. It focuses on the most valuable functions which they can fulfil in this context, and takes a cautious view about the potential for extending any boost to local authority activity beyond this phase. It offers a rapid survey of roles, opportunities and constraints, drawing both on general principles (grounded in economic analysis) and an appreciation of practical experience. It proceeds from a brief review/comparison of the experience of the last two recessions, via a typology of potentially relevant LA roles in the present one, to a set of general issues that need to be addressed in considering what *they* should/could appropriately do in this situation. It then focuses on two more specific issues. The first is the significance of financial and other constraints for what LAs are likely/able to do. The second addresses LAs' role in the field of housing market/financial issues, which is identified as the one where their contribution can be most crucial.

Key conclusions are that: local government can do very little without active central government support and cannot substitute for it in raising general demand; local expenditure will need rebalancing to meet shifting needs within constrained levels of overall activity; LAs' most positive/appropriate role is to mitigate effects (on assets and vulnerable people) and relieve specific market/government failures; the emphasis should be on short term gains, rather than pursuing unrealistic development initiatives, though nothing should be done in the name of that is not long term viable/desirable; incentivising the private sector is crucial, since they will have to take the strain in the end; LAs should avoid area discrimination, by 'shielding' *people* and *assets*, rather than protecting *places*.

This report has been produced by Ian Gordon, Tony Travers and Christine Whitehead under a contract with the Department for Communities and Local Government. Any views expressed in this report are not necessarily those of the Department for Communities and Local Government.

1 Introduction

The combination of intense credit crunch (experienced since late 2007) and the depth of the emerging general economic recession presents major challenges to English local authorities They are far from alone in this position, but because of their multi-functional responsibilities and physical proximity to the people and firms most directly affected by these crises, they face a much broader and more concrete set of challenges than other governmental institutions.

One of the most immediate challenges was the issue of security of their own financial reserves deposited in banks subject to varying degrees of risk. The two main continuing challenges, however, relate to:

(a) Sustaining the **development** process in their areas, with the choking off of funding for new commercial projects and the disappearance of expected land value gains, on which local authorities (as well as private developers) have come to depend for their own developmental/housing activities; and
(b) Protecting the **welfare** of residents, who are becoming exposed to much higher risks of housing repossession, homelessness and unemployment, with predictably negative social consequences including a higher incidence of family break-ups and of some types of crime – with all of which local authorities are naturally concerned.

Seen in these terms, one immediate implication is the need for some re-balancing of local authority activity, since (for some time to come) the workload associated with physical development is liable to be substantially reduced, while that in support of welfare functions of one kind or another is likely to be greatly increased.

A counter-argument of a kind may be made, to the effect that it is precisely in times of market retreat from commercial development that local authorities need to be most pro-active in securing the kinds of development required to sustain their economies. Understandable as this view is, however, it is unrealistic to expect that general market trends can be bucked in this way – and hard to justify more vigorous inter-area competition for a much reduced 'pot' of potential investment in development projects.

The focus of this report, undertaken on behalf of the Regeneration and Economic Development Analysis Expert Panel[1] group for CLG, is on the potential/appropriate role for local authorities (LAs) in relation to the economic crisis, within a short-run perspective - identified notionally with the next couple of years, but corresponding essentially to the downturn phase of the recession. Some attention is given to the need to prepare for a subsequent upswing, but the needs of the immediate future are clearly both more urgent and quite distinct. What will be required thereafter must depend to quite a large degree on how well the downturn has been weathered, in terms of avoiding large numbers of business closures and concentrations of job losses. But in the light of the very large increase in public borrowing already incurred in stabilising financial markets, and seeking to mitigate collapsing private demand, we cannot assume that 'normal life' will be resumed in the upswing, or that there will be scope to sustain any boost to local authority activity thereafter. It is appropriate to be cautious then about moving beyond evidence that there are a series of valuable functions which local councils can fulfil in the present crisis (LGA, 2008a) to an expectation that this will ground a case for any continuing extension of LA activity in the long-run?.

In this rapid survey of roles, opportunities and constraints we draw on a combination of general principles, grounded in economic analysis, with an appreciation of practical experience, both in the current context and that of the last two national recessions. Since there are important points of similarity between the current recession and that of the early 1990s, there was a prior expectation that much could be learned from how local authorities had responded to that earlier crisis. In practice, however, it became obvious that (for quite understandable reasons) the scale and range of LA response to the 1990s recession was very restricted, providing little ground for direct lessons. Some local authorities (at least) had been much more active in responding to the recession before that, during the early 1980s – however the political circumstances of that period were so radically different, and its economic character so distinct that again we have found few very direct lessons that can be drawn. Then, as in the urban regeneration programmes developed (under central government leadership) from the mid-1990s, the emphasis was largely on structural adaptation of one form or another, rather than on countering a collapse of credit and demand, which will be the key issue over the next couple of years or so.

[1] The REDA Panel is one of three expert panels established by Communities and Local Government (CLG) to improve analytical capacity and to provide provide fresh and challenging insights to policy makers. The views expressed in this document are those of the authors and should not be taken as representing the view of CLG, More information about the REDA panel can be found at http://www.ljmu.ac.uk/EIUA/reda/index.htm.

Given this context, the structure of this report is as follows. The next section (2) proceeds from a brief review/comparison of the experience of the last two recessions, via a typology of potentially relevant LA roles in the present one, to a set of general issues that need to be addressed in considering what *they* should and could appropriately do in this situation. The following section (3) takes up these general issues, with a particular emphasis on the significance of financial and other constraints for what LAs are likely and able to do. The penultimate section (4), before a short conclusion, focuses on LAs' role in a particular problem area – that related to the housing market/finance – which we identify as the one where their contribution can be most crucial.

2 Local Authority Responses to Recession: Contexts, Principles and Issues

2.1 LAs in three UK recessions: 1980-2008

To understand what LAs might usefully and practically do in the present recession, we start from a rapid review of its two immediate predecessors, how their particular economic/political contexts conditioned what LAs did then - and how these compare with the current situation.

The Early 1980s: the key element of a downturn, extending from 1979-1983, was the impact on structurally weak parts of the economy of a national economic strategy which deliberately exposed the whole economy to more intense competitive pressures. The impact of recession was thus especially concentrated in areas of elderly/middle-aged production industries, many of which (especially in the 'north') had experienced relative decline and recurring high unemployment stretching over several previous decades. For other of these areas (notably in the midlands) this was a more novel experience, but not a short-lived one, becoming structural in character, as substantial parts of a (mid-20th century) industrial base were lost or moved into long-term decline.

The expectation that local authorities might have an economic role was low at this time; central government did not see it as appropriate for them to counter the impact of market forces; and particular efforts were being initiated to bring LA expenditure 'under control'. However, an increasingly activist stance developed in a substantial number of local authorities, partly as a direct reaction to the emergence of high levels of local unemployment. In the most significant cases, however, it was also in large part a 'political' reaction against central government economic and expenditure control policies, with an 'exemplary purpose' in relation to Labour's *Alternative Economic Strategy* (Mawson and Miller, 1986, 145). Among these the emphasis was less on physical restructuring or inward investment and more on people-based policies and the use of financial support to lever company policies, in relation particularly to personnel and investment strategies/practices (Harding and Garside, 1995). There was evidence that these approaches were relatively cost-effective in terms of job-saving, within the limited scale in which they operated (Mawson and Miller, 1986).

Many more LAs pursued some form of economic development activity, though the scale was often limited/more-or-less symbolic, with the exceptions depending not on the scale of local problems, but on a combination of Labour control and having access to more discretionary financial resources (Boyne, 1988). Most authorities felt constrained principally by lack of finance, but also suffered from lack of expertise in dealing with these issues (including making commercial judgements). They also tended to be very localist in their approach (Mills and Young, 1986), presenting the risk that the easiest gains for one area might be made largely at the expense of neighbours and other areas with comparable needs (Cheshire and Gordon, 1998).

As in earlier (more limited) downturns, investment in social housing was seen as a potentially important element in counter cyclical policy. However in practice financial constraints made it difficult actually to implement such policies. At this time, local authority powers to borrow for housing had been heavily constrained, direct labour organisations were being closed down and rents were controlled. Local authorities therefore had less capacity to undertake counter-cyclical expenditure than they had had in the past. The most important positive housing policy was the Right to Buy – but the capital receipts went to the Treasury rather than local authorities (Whitehead, Gibb and Stephens, 2005).

The Early 1990s: this recession emerged in the context of anti-inflationary macro-policies, in the wake of a south-east-focused boom in the mid-1980s[2], which had continued past the 1987 financial markets crisis thanks to

[2] This boom and bust, like the boom of the late 1990s and the current bust, were focused on the three regions of the Greater South East in the sense that the biggest deviations from trend were seen across these regions, both in the upswing and the downswing. In fact, actual employment growth in the late 1980s was especially concentrated in the South East/East Anglia,

a supportive monetary policy. Its impacts were most strongly felt in the areas and (service) sectors which had benefited most from the speculative boom – rather than in the industrial regions hit by the 1980s recession (though most of those had not fully recovered since then, and experienced the highest levels of unemployment through the recession years).

Local authorities *had* just acquired statutory powers to pursue economic development, but their responses to the recession were muted, because expenditure controls were now more effective (with arrival of the poll tax) and kept tight as part of central government's anti-inflationary policy. With the disappearance of the most activist (metro) authorities, there was little explicitly counter-cyclical activity, and much more emphasis on lobbying higher levels of government for support via assisted area status or discretionary funding opportunities (Ball, 1998; Harding and Garside, 1995).

These opportunities did increase during the later stages of the recession, as central government developed an urban policy emphasising regeneration and involving 'challenge'-funded activities by local authorities. These were, however, essentially directed at long term structural issues, rather than at overcoming recession.

The housing market suffered very significantly in this downturn (from the late 1980s on). There were both large cutbacks in development and rapid declines in house prices and (especially) transactions, resulting in unprecedented numbers of arrears, possessions and households in negative equity. These in turn reduced flexibility in the labour market and silted up the housing market until the mid 1990s. The major players responding to this challenge, especially with respect to buying up private sector homes as part of the Housing Market Package (which involved social purchase of private sector homes by social landlords, and some assistance to limit repossessions) were actually Housing Associations rather than local authorities, who had no borrowing powers and few other available resources. Local authority responses were effectively limited to addressing homelessness issues.

The Late 2000s: the triggers for the current recession are quite different from those of the early 1990s, stemming from a loss of confidence in financial instruments tied directly/indirectly to lending in the US sub-prime mortgage market. The context, however, has substantial similarities with the last recession, involving the puncturing of a boom which was focused on financial services, house price growth, and credit-based personal consumption, notably in/around the London region.

Our expectation is that the impact of the recession on jobs will again be strongest in this region – at least in terms of the difference between likely employment levels in (say) 2010 and those which would otherwise have been expected (Gordon et al, 2008). Various sub-regions elsewhere with less favourable underlying trends may also experience substantial job losses (LGA, 2008b), but there is no reason to expect that impacts of the downturn will be especially severe in the traditional regions of high unemployment. Using local government spending as a means for mitigating the impacts in regions of concentrated job loss through spatially targeted boosts to LA activity is thus a less relevant response than it would be if the impacts well more heavily on areas where labour demand was already weak. Nor, except perhaps in some major financial centres (if these turn out to have lost long-term competitiveness) does it seem appropriate(at this stage) to treat the current crisis as one involving major structural changes in local/regional economies, and thus calling for the development of restructuring strategies.

Recession in the housing and construction markets has led this cycle in unprecedented ways. Developments on the demand side of the housing market have many similarities to those in the last recession – although the speed of decline has been much more rapid. As such there are large implications for local authorities in terms of increasing homelessness responsibilities and involvement in addressing problems of arrears and possessions. The most important distinction from earlier cycles is the lack of funding for both mortgages and small businesses. This is impacting most heavily on new build programmes, both private and social, but also on LAs' role in planning agreements for the provision of affordable housing and local services. It is also likely to have a negative impact on capital receipts and therefore their own capacity to undertake investment.

---

while job losses in the subsequent recession were heaviest in London. Similarly, in terms of sectors, it was services (and construction) which were most affected by both boom and bust, though job losses during the recession were actually greatest in manufacturing, where the long-term downward trend was intensified.

2.2 A set of potential roles for LAs in the current crisis

As a preliminary to considering the specific ways in which local authorities could most appropriately respond to the current situation, we have identified 5 broad roles, involving different types of LA response, with particular considerations affecting each, including the types of action which would most useful.

(a) *Contributing to national demand reflation*

The immediate cause of the current recession is understood to principally involve cutbacks in private consumer demand, partly as a consequence of tighter consumer credit, but largely as a result of less optimistic beliefs about the value of personal assets and future employment prospects. Some downward adjustment in personal spending is clearly required over the medium-run, but the obvious main target for public policy at the present time is to seek to prop up private consumer demand.

The case for using LA activities as another vehicle, alongside national fiscal/monetary policy, for reflating (national) demand in this context rests largely on issues of timeliness. To make a particular contribution of this kind, LAs need to be able to inject additional demand into their economies more rapidly than general consumer demand can be raised. This may actually be a substantial constraint, since available additional/marginal projects (of real value) that can be brought forward will often involve substantial planning/ preparatory processes that cannot readily be accelerated. Timeliness is also an important consideration in relation to the speed with which additional activities can be terminated when boosts to demand are no longer required – given that the aim must be to restore private demand/investment, and that there are likely to be rather tight constraints on public expenditure in the wake of the recession.

Two other important considerations about the kind of LA activity which is promoted to boost national demand are, firstly, that it should not be contingent upon complementary private investment/job creation (which will be in short supply) and that they should not involve substantial displacement of other activities/sources of demand.

(b) *Targeted reflation in the worst affected areas*

Where, as in the 1980s recession, job losses are disproportionately concentrated in particular localities/regions whose labour markets were already relatively slack, there is an argument (on equity and/or efficiency grounds) for using local agency spending as a means of trying to support demand in these particular areas. This is more likely to be relevant in the case of broad regions than of more local areas, which tend to be very open in economic (and labour market terms) and because at the local scale there are greater dangers of simply displacing demand (from existing local activities and/or from nearby regions). At levels below that of functional urban regions, it is likely to be very ineffective in relieving an intensified concentration of unemployment in localities with the most disadvantaged residents (since targeted demand injections will mostly leak out, to the benefit of others in a stronger competitive position; Gordon, 1999). Its salience is also going to be less in recessions involving nationwide contractions of demand, or ones more heavily focused on the (service) activities of affluent regions (as in the early 1990s or as is expected in the current recession).

(c) *Mitigating major social effects of credit crunch and recession*

Across a wide spectrum of their activities, LAs have clear responsibilities/competences for addressing actual and expected impacts on individuals, families and social groups/neighbourhoods from the inevitably uneven impacts of recession and credit shortage via job loss, housing insecurity etc. After a long period of economic stability and full employment in many areas, substantial adjustments may be required to match the scale and form of demands now likely to be faced.

An example is in relation to local authorities' responsibilities with respect to homelessness, which take on a very different complexion in the context of present crises in the owner-occupied market. Government has already identified a role for local authorities in mortgage rescue as well as perhaps in increasing direct involvement in partnership with housing associations and other stakeholders in increasing provision and investment in the existing stock.

LAs could also reasonably seek to do all they can through their own routine activities (including paying bills) to ease pressures on local businesses during these difficult times, both in order to avoid unnecessary job losses, and to protect assets in otherwise viable concerns.

(d) *Responding to specific market/governmental failures*

The character of this recession is clearly bound up with a series of 'failures' in the relations between financial institutions, the housing system and business – with others arising as the crisis and governmental responses to it develop. Likely knock-on effects will certainly include 'failures' in labour market operations. The point is not, however, that a great array of such market (and government) failures provide a general ground for 'interventions' by LAs and others – but that there will be a need to identify and respond to particular ways in which *at a local level* interactions between institutions and patterns of behaviour make the impacts of recession more inefficient, inequitable and persistent than is necessary. There are several clear instances of this in relation to LAs' housing/planning responsibilities.

One important example, new since the last recession, involves the role of section 106 agreements in LAs' land use planning activities. Under the 1990 Act they negotiate such agreements to achieve local infrastructure investment from planning gain (Crook et al, 2008). The vast majority of that planning gain comes in the form of affordable housing negotiated in relation to planning permissions for residential development. This has both positive and negative implications. Most importantly local authorities are enabled to undertake investments to benefit the local community can in the current environment. However, these contracts are negotiated at the time of planning permission and reflect expectations of land values at that time. Equally they can involve up front cash flows that become more problematic when the development cannot be sold as rapidly as expected. Finally in the context of affordable housing, the form of the s106 agreement which identifies the numbers of social rented and intermediate housing may make it difficult to maintain development in the context of a declining market. Thus a policy which aims both to reduce bottlenecks in physical and social infrastructure as well as improve distribution by providing more affordable housing may both reduce overall output and worsen the capacity to adjust to the changing economic circumstances because of the contractual nature of the obligations.

Local authorities also play an important role in providing information aimed at overcoming market failures in financial information and potentially to address issues of risk management. This is part of their normal role but becomes more important (and requiring greater resource commitments) in the current environment. These powers are implemented through the Citizens Advice Bureau as well as through debt counselling and other similar services provided by central government.

Traditionally local authorities have had a further role in overcoming market failures in terms of mortgage provision to lower income households – through mortgage provision in the 1960s and 1970s and versions of mortgage guarantees. These powers have not been used since the early 1980s because the market has been able to provide all appropriate mortgages. In the current environment, when the market is not delivering mortgages for first-time buyers and those without large deposits, there is a case for re-examining the possible use of these powers to enable local authorities, either on their own account or as agents of central government or on their own initiative in addressing current failures of mortgage provision and the possibility of possession.

(e) *Sustaining those long-term investment projects for which a clear economic case remain*

In addition to the cases which might be made for bringing forward such projects as a means of restoring demand, there are more defensive issues about ensuring that projects which are low risk in terms of their long run payoffs, given current and predictable levels of demand, are not threatened simply because of a (relatively) short-term crisis which does not affect their viability.

Major examples for which such a case has been made, include overdue upgrades in the London underground, but this case can also be made more generally in relation to housing investment. This has two main benefits in the present climate:

(i) the longer term case for it is clear - whether or not the demand is there at this moment the need for additional housing and particularly for affordable housing is well evidenced (eg by the Barker Review, subsequent NHPAU reports and reports by Shelter and the TCPA – Holmans et al 2008; and Holmans with Whitehead, 2008). These reports recognise that there will be short and medium term dips in demand but that any reasonable longer term estimates will require very significantly more housing than is currently available. They also make clear that the requirements are more for larger homes than have been provided over the last few years;

(ii) many of the institutional arrangements and instruments are already in place for government support to ensure additional housing and the scale of individual sites means that it is possible to bring projects forward fairly rapidly.

In addition the decline in investment has been precipitous, so resources are available and some evidence of turnaround can help to build confidence. Thus carefully assessed projects which meet identified needs can be encouraged and generate both short and long term value.

(f) *Preparing for recovery*

Over the short-run at least, attempts to respond to falling demand and job losses by intensified economic development activities are more likely to be counter-productive than helpful to the economy, especially when it involves competing for a shrinking pool of mobile projects or consumer demand (Cheshire and Gordon, 1998). Several respects have already been noted, however, in which they can usefully act to protect (or secure provision of) assets of predictable long term value. In addition, authorities have a potential role in preparing their local economies for the up-turn that will follow the recession – not least by taking a hard-headed look at what is likely to survive/thrive in post-recession circumstances, and the priority steps which are required to facilitate this. This may include seeking to identify those potential growth sectors for which the area has real competitive advantages, and means of promoting them. Few commentators would support any attempt to 'pick winners' on a company-by-company basis. But efforts to encourage enterprise in sectors that might be expected to show long-term growth would be a reasonable activity for authorities facing significant restructuring as a consequence of particular ways that recession turns out to impact on their economies. Such activity is obviously best undertaken on a collaborative (sub-) regional basis rather than by LAs working in isolation.

2.3 Key issues

This review suggests three sets of strategic issues which need to be considered in relation to the ways in which LAs could effectively respond to the present crisis.

(a) The need to understand the circumstances under which LA initiatives are more appropriate than national CG action

We see a distinction here between action directed at stimulating demand, and those aimed at mitigation and remedying market failures, on the other. In the former case, the key considerations over the short-run are timeliness, the reliability of impacts on aggregate spending, and independence of any substantial private investment. So long as there is a potential for private consumer demand to be raised via macroeconomic stimuli, these criteria are more likely to count against an LA focused approach. This is particularly so in the context of a nation-wide downswing. In the recovery phase, or if the recession turns out to have its most severe impacts in the 'north' (rather than the more resilient 'south'), the situation might well be different – and some preparation should be made for this – but it is not the current situation.

In the latter case of mitigating and remedying market failures, the key considerations involve: the degree to which existing capacities/local networks allow more flexible response to specific local problems (while avoiding capture by more politically active local groups); and identifying current LA practices (including bill paying) that should be adapted to reduce economic damage to those local businesses which are currently vulnerable, but with long-run competitive prospects.

(b) The importance of avoiding protectionist local responses

At the national/international scale there seems to be a healthy recognition at present of the need for concerted policies to promote a general reflation while sustaining open economies, rather than seeking to favour or protect domestic economies at the expense of others. The same concerns need to be secured at a local scale by avoiding local protectionism (favouring local suppliers) or pursuit of zero-sum competition for scarce investment at the expense of other areas. So far there have only been isolated suggestions of this kind, though a rhetoric about the need for LAs to move from 'place-making' to 'place-shielding' (Quirk, 2008) could be interpreted in this way. In truth, places cannot be shielded from the current recession, though LAs could and should seek to shield both (vulnerable) *people* from the worst consequences of the downturn and *assets* of continuing value (including skills).

(c) The need to understand and respond to those constraints which may inhibit/distort LA action

In the last two recessions, LA responses were seriously constrained, and also significantly distorted by financial/legal constraints. In broad terms, these reflected central government strategies of the times, which were radically different from those of the present administration. If a more positive role is to be encouraged now, however, it is especially important to understand how similar kinds of constraint condition the impacts that LA action can be expected to have.

The next section (3) of the report takes up the constraints issue particularly in terms of funding challenges. Our general judgement in relation to the other two sets of issue is that the fields in which LAs have most to contribute in this particular economic crisis relate in one way or another to housing and related planning issue. The penultimate section of the report (4) thus focuses on these.

3 Funding Challenges

Local government has long had an important role in building and maintaining the infrastructure related to economic growth. Councils were the original builders of sewers, roads, utilities and public transport systems. In recent years, 'economic regeneration' has been a key theme of many councils, particularly in major cities. Programmes have included land clearance, construction of new infrastructure and partnerships with the private sector.

The government's *Sub-National Review* emphasised the importance of local authorities in strengthening local economies. Councils now have a duty to assess the economic conditions of their area (together with economic components to their Local Area Agreements). They can be expected therefore to have an important role in sustaining favourable conditions during the recession. However, there are a number of constraints on potential action.

3.1 Constraints on what authorities can spend

Comprehensive Spending Review 2007 and *Pre Budget Report 2008*

The 2007 CSR set revenue and capital expenditure plans for local government for the years 2008-09 to 2010-11. The 2008 PBR set indicative spending plans for the whole of UK public expenditure for the years 2011-12 to 2013-14. The CSR set a Departmental Expenditure Limit for local government which increased by an average of one per cent real growth over the CSR period[3]. The same volume makes the point that in the previous decade, central support for local authorities had risen by 39 per cent in real terms. Councils have thus been given a clear signal that their spending is expected to rise significantly less rapidly from 2008-09 onwards than previously.

From 2011-12 to 2013-14, the PBR stated the government's intention to hold overall public expenditure down to increases of 1.2 per cent per year in real terms. This figure will be below the real increases planned for 2008-09 to 2010-11 and significantly below those in the seven years up to and including 2007-08. Table B.3 of the PBR shows new public sector investment rising to 2.7 per cent of GDP in 2009-10 before falling sharply to 1.8 per cent over the period to 2013-14[4].

Local government's one per cent real terms spending rise between 2008-09 and 2010-11 compares with an overall real terms public expenditure increase over the same period of 2.1 per cent per year. The widely-reported deterioration in the public finances is likely, in the view of expert independent economists, to mean local government's real growth will be lower (than in recent years) in the period after 2011-12, possibly for a number of years[5].

The implication of this scenario would be strongly to suggest that any effort by local government to raise investment or revenue expenditure in an attempt to combat the effects of the recession should be limited in nature and, crucially, that there should be little or no public expenditure impact beyond 2010-11. The local government minister has stated the Government's expectation that the average rise in council should be "substantially below five per cent"[6] in 2009-10.

Against the economic and financial background cited above, there will be little room for councils to increase their real terms capital investment during 2009-10 and 2010-11. Achieving efficiency savings in line with central government requirements and holding down council tax are the government's overriding stated objectives.

[3] HM Treasury, *Pre-Budget Report and Comprehensive Spending Review October 2007*, Cm 7227, page 221.
[4] HM Treasury, *Pre-Budget Report November 2008*, Cm 7484, page 190.
[5] Institute for Fiscal Studies, *Green Budget*, January 2009, Chapter 9.
[6] John Healey, MP, Local Government Minister, Statement on local government finance settlement for 2009-10, 26 November 2008, available on DCLG website, www.communities.gov.uk.

If, at some point in the future, a government wished to ease the downward pressure on local authority expenditure growth, there are a number of initiatives that local authorities might consider. However, councils would be wise to assume they are very unlikely to occur in the period covered by the spending numbers in the Chancellor's 2008 *Pre Budget Report*.

The main limits on local government action are as follows:

- The government's desire to hold down capital spending to planned levels.
- Council tax capping.
- Financial caution in relation to reserves.
- Definitional issues affecting joint public-private projects.
- Longer-term uncertainty about financial settlements.

Each of these constraints will be briefly considered.

1) Keeping capital spending to planned levels

Successive UK governments have believed it is important to control the overall total of public sector borrowing. Macro-economic policy has required tight control of borrowing by the Treasury, even at times when the overall level of borrowing has been increasing. Thus, during the period from 2000 to 2007, there was a sharp move from a public sector surplus to deficit. However, in any particular year the government wished to determine the total of public sector borrowing by central and local government.

Local government is, therefore, part of the national public expenditure planning system. As borrowing rises sharply during the period from 2008 to 2010, it is likely the margin of additional spending from year to year will be even more important. The government is committed to bringing down borrowing in the medium term and is therefore unlikely to wish to allow councils to borrow at levels significantly higher than those in recent years. Indeed, there must be a risk there will be pressure to constrain local government borrowing so as to help constrain overall public borrowing. If this were to happen, councils would be less able to play a part in maintaining and improving economic-oriented infrastructure.

2) Pressures on capital expenditure: history and today

In previous recessions since the mid-1970s, public sector net and gross investment has fallen as a share of the economy. During the long period of economic difficulty from 1976-77 to 1981-82, net public sector investment fell from 5.6 per cent of GDP (in 1975-76) to 1.0 per cent in 1980-81. Gross investment (at a higher level because of asset sales) fell from 10 per cent in 1975-76 to 5.4 per cent in 1981-82. Current expenditure either increased or stayed constant as a share of GDP. A similar pattern was repeated after 1991-92[7]. The Chancellor has recently announced a reduction in capital investment as a share of GDP after 2011-12, which implies a repeat of the pattern of earlier recessions. It is, of course, possible that the government will choose to make smaller – or larger – reductions than occurred during previous recessions.

Many authorities privately report that the threat and use of capping has had a side-effect that could be important in the next few years. Despite the introduction of a 'prudential rules'-based system of capital control, local authorities have been more cautious about using their new freedoms than is likely to have been the case if capping were not in place. The prudential rules arrangements allow councils to increase their capital expenditure and borrowing so long as overall indebtedness was reasonable and they were able to make the necessary repayments. Capping can constrain revenue spending which includes such repayments.

If capital expenditure were to be increased by borrowing, there could be longer-term consequences for revenue expenditure and council tax. Interest charges and re-payments of sums borrowed would score against a council's revenue account. Many (probably most) councils are likely to be sufficiently concerned about the risk of capping – or of additional capital-related spending displacing existing programmes – that they will not use their 'prudential rules' capital freedoms as local government funding settlements become tighter.

Looking ahead, it is widely assumed ministers will wish to retain capping and to reduce the annual increase in council tax. There is a risk authorities will react to expected tighter caps by becoming less willing to incur new borrowing or capital expenditure. If the government wished to encourage additional economic development in the next two or more years to mitigate the impact of the recession, it will be necessary to be aware of the likelihood that authorities might react with caution because of capping.

[7] HM Treasury, *Pre-Budget Report November 2008*, Cm 7484 Table B22.

3) Reserves and investments

Reserves are an indicator within local government's overall financial position. A perception within councils that 'next year may be worse' may have influenced the overall total of reserves and investments. Total Local Government investment – for the UK – was £38.5billion at the end of the third quarter of 2008[8]. Because of uncertainty about their future financial position, councils may choose to use a part of this money or, alternatively, to build it up further.

4) *Definitional issues in relation to public-private initiatives*

Local government has been very willing in recent years to work with the private sector – generally developers, house-builders, banks and land-owners – to deliver regeneration and housing projects. But even at the zenith of the long economic boom there were problems associated with creating joint vehicles to deliver projects. For example, certain predominantly privately-led ventures have been defined as being 'public sector'. Elsewhere, tax issues have impeded progress.

If such blockages are to be reduced in the years ahead, there would probably need to be an analysis of the kind of impediments that currently exist. If regeneration and housing schemes are to continue at a time when private sector capital is scarce, there will have to be an increase in public sector contributions. Public-private initiatives involving local government would be less likely to succeed if certain definitional obstacles are not removed.

5) Longer-term uncertainty about financial settlements

Local authorities depend on central government for half of their revenue income. If schools' funding is included, about three-quarters of such income comes from Whitehall. There are now three-year financial settlements for councils, covering Formula Grant, schools' grant and specific grants. The current three-year settlement comes to an end in 2010-11.

In the current economic climate, most councils will, on the basis of the analysis of the Pre-Budget Report in the paragraphs above, expect less generous settlements in the years from 2011-12 onwards. Directors of finance will inevitably advise caution. The greater the degree of security of funding offered to local government, the less likely it will be that councils continue to add to their reserves.

3.2 Possible solutions to a lack of private capital – medium-to-longer term

Funding innovation
Local government has, since the 19th century, used a range of mechanisms for raising resources for investment purposes. Local taxation and borrowing are the basic funding options. While council tax is the only locally-retained source of taxation, borrowing (subject to the discussion earlier in this section) can be delivered in a number of different ways. The threat of tightened capping in future years may deter a growth in borrowing.

In recent years, councils have generally borrowed from the Public Works Loans Board (PWLB), a government agency whose purpose is to supply funds to local government. Borrowing from the PWLB has generally been cheaper than from other sources, although banks have sometimes offered better rates. Authorities have therefore raised the bulk of their resources from the PWLB. It is impossible to predict the future relative rates of the PWLB and banks, but there is always a risk that the government will want to reduce the level of access to relatively cheap money. However the limit was raised by statutory instrument (SI no. 3004) on 19 November 2008 with the new limit of £70bn coming into effect on 20 November 2008.

Moreover, councils may wish to consider a wider range of borrowing options, particularly if banks remain unwilling to lend money. One possibility would be the issuance of municipal bonds, although these are likely to be more expensive than the PWLB, while other attributes may be more attractive. This already happens to a limited extent and has long been the way municipalities in the United States borrow for major projects, as it was in Britain in the past. Bond issues would allow local people to lend money to a reputable source, with the promise resources would be re-invested in the local or regional economy. As such, local bond issues would deliver two or three benefits at once – a trusted place for the public to lend money, resources for investment and a boost to the economy.

<u>Reserves</u>, which were discussed above, could theoretically play a role in providing additional resources to fund investment. Indeed, any resources liberated from local authority reserves would not require borrowing, though

[8] Office for National Statistics, *Financial Statistics*, Table 1.3D.

they would count as public expenditure. However, if councils are to be willing to use reserves in this way, they would need to feel certain that they had a reasonably secure medium-term funding regime.

There might also be a problem because not all authorities would have reserves they could use in this way. Many small districts have substantial resources put aside after the sale of their social housing. Other, larger, districts and counties have few spare resources. But the possibility of using reserves remains.

Mechanisms and project development
Local government has in recent years worked with the private sector and other partners to develop projects to deliver regeneration, housing and other objectives. Looking ahead, projects of this kind will – at least for a while – become more difficult because private sector partners will find it hard to raise the necessary capital. Risk-averse lending institutions will make it difficult or impossible to provide the money to allow public-private initiatives to proceed.

This issue may be compounded by the weakening capacity of Private Finance Initiative and formal Public-Private Partnership-type deals to continue to deliver new projects at the rate of recent years. Problems associated with raising funding will extend to PFI and PPPs just as much as to one-off local schemes. In the longer term, the market will doubtless correct itself, but in the short-to-medium term, project finance will be problematic in all sectors.

If local projects are to go ahead, it may be necessary for the government to change legislation or regulations so that councils can more easily put up the funding for 'public-private' projects, though still ensuring the private sector expertise is used to deliver the design, build and operating stages. Put simply, the financial risk will need to be shifted from the private sector to the public.

There may be public expenditure recording issues here. If local authorities were to assume greater responsibility for the funding of major projects, the way they 'score' in public expenditure terms may be different from earlier majority-private or PFI-type schemes. This issue would need to be discussed with the Office for National Statistics. Moreover, any threat that additional public funding might add an additional burden to revenue expenditure – and thus risk the authority being capped – would need to be borne in mind.

Incentives
Formula Grant, which comprises Revenue Support Grant, redistributed business rates and principal formula Police Grant, where appropriate, is designed to operate in such a way as to take into account the relative needs and resources of authorities, and there is widespread support for this. However, there is an unintended consequence of the attempt to deliver equalisation. Because any growth in tax base is over time offset by grant increases, there is no incentive for any council to build up its council tax base. For slightly different reasons, the same is true for the NNDR. In the Lyons Inquiry, published in March 2007, Sir Michael Lyons stated that

"I believe that a further objective needs to be considered for the funding system: providing financial incentives for local authorities and communities to promote economic prosperity and residential growth, and to take into account their benefits and costs fully… Financial incentives should give local authorities more reward for owning and growing their own tax bases without such growth being immediately equalised away, and enable them to benefit from growth more directly, either in terms of population or more business activity in their areas"[9].

The government appears unenthusiastic to this view. However, the Local Authority Business Growth Incentive scheme had already been introduced to give local authorities an incentive to encourage local business growth by allowing them to benefit from growth in their NNDR tax base. Receipt of LABGI was determined – in its original form – by an authority's performance in relation to both its previous performance and that of other authorities in the region, making it hard for an authority to predict its incentive payment.

As a result of the experience of operating LABGI, and recent wider policy developments, the Government has reconsidered its approach to the scheme. In a government document about reforming LABGI, published in October 2007, it was stated that ministers wished to:

> "…strengthen the incentive for every Local Authority to take a stake in local economic well-being by sharpening the link between financial rewards and local growth, recognising the relative scale of the challenge in different places

[9] *Lyons Inquiry into Local Government Place-shaping: a shared ambition for the future of local government*, London: TSO, page 318.

and delivering opportunity for all"[10].

A consultation paper was published in August 2008. This proposed a revised scheme, in which LABGI receipts would be based on increases in the business rates yield and would be allocated to sub-regions, then distributed to local authorities by population. CLG is still considering the responses to the consultation and is planning to publish a summary of consultation responses along with the Government's response soon.

If councils are to be given an unambiguous incentive to give permission to build homes and encourage new businesses by use of the local tax system, changes could be considered that allowed councils to keep a greater proportion of any additional tax base they can generate. Such gains might be time-limited, so as to avoid undermining equalisation objectives. However, it is important to note that some experts believe that the creation of any incentive of this kind would lead to wasteful competition between authorities.

Innovative funding schemes
In the short-to-medium term, when there may be a shortage of conventional resources for projects, the government may wish to consider experimenting with new kinds of project funding mechanism. For example, municipalities in the US have long used methods such as 'Tax Increment Finance' (TIF) to allow projects to go ahead. Projects are prepared by the public authority and/or a developer on the assumption that the additional tax generated by the completed project will provide a revenue stream to repay the borrowing costs incurred by the development.

TIF is not a new idea. The Urban Task Force made a proposal for something similar in 1999[11]. In 2007, the All Party Urban Development Group published a report[12] proposing the use of TIF schemes. Despite these and other proposals, there was no legislation to allow TIFs during a period when growth in the economy possibly made their operation more likely than at present when the economy is not buoyant.

At present, it is not possible for local authorities, Passenger Transport Authorities or regional development agencies to undertake projects funded in this way. But there are schemes, such as the reconstruction of Birmingham New Street station[13], where the city authority has identified a TIF-type mechanism as the best way of going ahead with a development of great importance to the wider economy.

Of course, there are significant downsides to any major schemes during a deep recession, so TIF schemes would only work if (a) legislation were passed and (b) an authority could convince lenders that it would be able to raise net additional tax income by going ahead with a scheme that otherwise would not go ahead.

Business rate supplement
Legislation is about to be introduced into Parliament that would allow the Greater London Authority, metropolitan districts, shire counties and unitary authorities to set a business rate supplement of up to 2p in the £. However, during the recession, councils would wish to weigh up the downside of adding any additional burden to hard-pressed businesses. Many businesses are experiencing cash-flow difficulties as a result of the sharp decline in economic activity. Thus, any possible benefits to an area in terms of a boost to the economy and improved infrastructure would need to be weighed against the threat posed by higher taxes on non-domestic ratepayers.

4 Housing and Planning

Land use planning and housing are the two main areas where local government can play a large and immediate role in supporting both households in need and investment. Local authorities have both responsibilities and some powers to help to ensure that local housing systems are operating as effectively as possible in the current climate and to assist those who are in particular need. These come under four main headings:

(i) ensuring adequate information to local households;
(ii) ensuring that both the planning framework and development control are fit for purpose;

---

[10] HM Treasury and DCLG, *Building better incentives for local economic growth: reforms to the Local Authority Business Growth Incentives scheme*, October 2007, London: TSO, page 5.
[11] Urban Task Force, *Towards an Urban Renaissance*, London: E&F Spon, 1999.
[12] All Party Urban Development Group, *Loosening the Leash*, London: Centre for Cities/British Property Federation.
[13] All Party Urban Development Group, *Loosening the Leash*, London: Centre for Cities/British Property Federation.

(iii) supporting central government initiatives to assist housing provision and sustain occupation; and, at least potentially

(iv) meeting aspects of the financing gap in the short term in ways that meet longer term objectives of sustainable home ownership.

In most cases effective use of these powers will require support from central government and from its Agencies. Equally in most local areas local authorities need to act together with housing associations as they remain the key providers of new social and affordable housing.

(i) Ensuring adequate information

The most important areas where households require independent professional advice are in relation to (a) addressing issues where they are falling behind with their mortgage payments because of loss of income or being overstretched because of excessive borrowing; and (b) problems associated with renegotiating short term fixed rate or sub prime mortgages because of lack of funding. These are part of a more general requirement to assist households to manage their finances and their debts of all kinds. Housing is of particular relevance because of the potential loss of the home and the subsequent local authority responsibility to support those who are regarded as involuntarily homeless.

The government has identified this as a major immediate priority in the pre budget report. Equally in the last crisis advice and sometimes small scale assistance worked better to help maintain people in their homes and limit costs to the public purse than did either addressing the consequences of repossession through homelessness policies or transfer of stock to the social sector (Whitehead and Gaus, 2007).. The main way in which local authorities can assist is through Citizens Advice Bureau funded in part by local authorities and which play a major part in providing these information and advice services. They can also help directly through their housing departments; through advice on homelessness and the administration of housing benefit for tenants whose circumstances change.

Finally, local authorities have a clearly identified role in the government's mortgage rescue plans where authorities are expected to act as gatekeepers to central government assistance. Given the range of government initiatives and the rapidly changing situation with respect both to finance and employment accurate and up to date advice is paramount. This is a traditional and important role for local authorities.

(ii) Land use regulation

There are number of distinct roles for local authorities to play in the context of land use planning and development controls. First, local authorities have the responsibility to ensure the provision of land for housing based on long term requirements – not in relation to the economic cycle. Maintaining the flow of land into the longer term remains a core responsibility even though there are emerging pressures to cut back supply in the face of short term demand decline. This is a major opportunity to bring land supply more in line with long term requirements and to help enable development to respond effectively as demand returns to the market.

Second, and most immediately, it will almost certainly be necessary to renegotiate s106 agreements in the light of changing financial viability. The immediate requirement is to identify schemes that have immediate potential to go ahead; where infrastructure requirements are not too onerous and where there is appetite on the part of developers and housing associations alike to do so. These are likely to be smaller less complicated sites where the majority of housing will be at least 2 bedrooms. This is likely to involve open book renegotiations with developers and changes in the extent and nature of the affordable housing requirement. In some cases the most likely option will involve larger proportions of intermediate housing – where there is a potential for risk sharing with government. Inhere may be a need for up-front investment by the Homes and Communities Agency. The objective must be to identify those projects where there is immediate and ideally to organise these sites in such a way that longer term benefits to the public purse can be maintained.

The opportunities available will depend heavily on local circumstances and must take account of the strength of potential demand for intermediate and market housing (which local authorities have a responsibility to monitor) and the need to achieve sustainable home ownership and recycled capital grant to enable the next round of development to be achieved.

A rather different potential role is in identifying publicly owned sites where similar developments could be undertaken reasonably rapidly. This is already part of the government's current remit to local authorities.

An important element in housing development has been to ensure mixed tenure development and more generally mixed communities. There is obviously a case at the present time for concentrating on social rented housing – with the help of additional support from the Homes and Communities Agency. However the inclusion of risk sharing intermediate products will both reduce the cost to the public purse and enable more mixed communities to develop over time. Where possible, market housing should also be included in the development. What is required is to overcome immediate planning constraints as rapidly as possible; stimulate construction and improvement – but to build developments that will meet longer term requirements.

(iii) Supporting government initiatives to increase housing provision and maintain sustainable home ownership

The major constrain on local authorities in playing a direct role in investment is the current Housing Revenue Account Review which will not come to fruition until 2009. Once this is in place it is likely that local authorities will have greater powers to act in partnership with other stake holders to develop additional housing.

At the present time the role of local authorities is mainly restricted to powers determined by government to allocate government funds in the context of mortgage rescue and to the operation of the normal procedures for dealing with homelessness and the operation of local housing markets. Local authorities need to streamline their procedures with respect to homelessness application; to provide advice and information as discussed under (i) and to identify emerging problems with respect to the private rented sector. In this context there are areas where the very local market depends on the operation of buy to let and these areas may come under particular pressure. Local authorities have, limited, powers in this context – but the objective be to use these innovatively to maintain minimum standards and where possible to keep tenants in their homes.

(iv) Financing mortgages

This is a fast moving area where government initiatives are still in the process of being identified and their exact form detailed. In principle local authorities still have the power to borrow in order to provide mortgages for those unable to obtain them through the market. These powers were used in the early 1970s and were also part of the Right to Buy programme. There is the potential to revive these powers particularly in the context of intermediate market housing where lenders are failing to provide mortgages on adequate terms. Similarly there is the potential to support the provision of intermediate rental housing – although this is more likely to be done via s106 modifications. The most fundamental change which could have immediate value would be to modify regulations and central government funding to enable the re-introduction of a form of LA HAG (Munro et al., 2005) which could support a broader based low cost home ownership programme.

Any local government initiative will depend upon central government authority and at the present time it looks more likely that government will concentrate on making the private market work more effectively. However there are potential areas where local authorities might have comparative advantage.

The majority of local government initiatives are likely to be concentrated under groups (i) and (ii) because these are the areas where authorities already have clear roles and responsibilities.

5 Key Conclusions

From this broad review of issues about the role of local authorities in facing the downturn, there are a small number of general points which we would emphasise:

- Local government can do very little without central government support (particularly in relation to finance) – and cannot substitute for it in raising general demand;
- Need for rebalancing of local expenditure to meet shifting needs within constrained levels of overall activity
- Local authorities' most positive and appropriate roles would be in relation to mitigation of effects (on assets and vulnerable people)and relief of specific market/government failures
- A priority is to identify immediate constraints on LAs capacity to respond, and examine how these might be overcome
- During the downturn, the emphasis should be on reducing its impacts, with a focus on short term gains, rather than pursuing unrealistic development initiatives
- Even so, nothing should be done in the name of relieving short-term pains that is not long term viable/desirable – there are plenty of positive opportunities

- Concentrate on incentivising the private sector – even if it means more short term support - they will have to take the strain in the end
- Avoid area discrimination – ‘shield’ *people* and *assets,* rather than protecting *places.*

References

Ball, R. M. (1995) *Local Authorities and Regional Policy in the UK*, London: Paul Chapman.

Barker, K. (2004) *Review of Housing Supply*, London: HM Treasury.

Boyne, G. A. (1988) 'Politics, Unemployment and Local Economic Policies', Urban Studies, 25, pp.474-486.

Cheshire, P. and Gordon, I. R. (1998) 'Territorial Competition: Some Lessons for Policy', Annals of Regional Science, 32, pp.321-346.

Crook, A., Henneberry, J., Rowley, S., Smith R. S. and Watkins, C. A. (2008) *Valuing Planning Obligations in England, 2005 - 06*, London: Department of Communities and Local Government.

Gordon, I. (1999) 'Targeting a Leaky Bucket**'**, New Economy, 6, pp.199-203.

Gordon, I. R., Travers, T. and Whitehead, C. M. E. (2008) *London's Place in the UK Economy 2008-9*, London: City of London Corporation.

Harding, A. and Garside, P. (1995) 'Urban and Economic Development', in J. Stewart and G. Stoker (eds.) *Local Government in the 1990s,* Basingstoke: Macmillan.

Holmans, A. and Whitehead, C. M. E. (2008) 'New and Higher Projections of Future Population in England', TCPA Tomorrow, Series No 10, London: TCPA.

Holmans, A., Monk, S. and Whitehead, C. M. E. (2008) *Homes for the Future,* Shelter Research Report, London: Shelter.

Local Government Association (2008a) *Global Slowdown: Local Solutions Councils Helping People and Businesses*, London: LGA.

Local Government Association (2008b) *From Recession to Recovery: the Local Dimension*, London: LGA.

Mawson, J. and Miller, D. (1986) 'Interventionist Approaches in Local Employment and Economic Development: the Experience of Labour Local Authorities', in V. Hausner (ed.) *Critical Issues in Urban Economic Development, Vol. 1*, pp.145-199, Oxford: Clarendon Press.

Mills, L. and Young, K. G. (1986) 'Local Authorities and Economic Development: a Preliminary Analysis', in V. Hausner (ed.) *Critical Issues in Urban Economic Development, Vol. 1*, pp.89-144, Oxford: Clarendon Press.

Munro, M., Pawson, H. and Monk, S. (2005), *Evaluation of English Housing Policy 1975-2000 Theme 4: Widening Choice,* London: ODPM.

National Housing and Planning Advice Unit (2008), *Meeting the Housing Requirement of an Aspiring and Growing Nation, Advice to the Minister*, Fareham: NHPAU.
[http://www.communities.gov.uk/documents/507390/pdf/863376.pdf]

Quirk, B. (2008) 'The Shield of Survival', *Local Government Chronicle*, 2ist October.

Whitehead, C. M. E., Gibb, K. and Stephens, M. (2005) *Evaluation of English Housing Policy 1975 - 2000 Theme 2, Finance and Affordability*, London: ODPM.

Whitehead, C. M. E. and Gaus, K. (2007) 'At Any Cost? Access to Housing in a Changing Financial Marketplace', Policy Discussion Paper, London: Shelter.
[http://england.shelter.org.uk/__data/assets/pdf_file/0008/38672/32142.pdf]

Spatial Economics Research Centre (SERC)
London School of Economics
Houghton Street
London WC2A 2AE

Tel: 020 7852 3565
Fax: 020 7955 6848
Web: www.spatialeconomics.ac.uk

SERC is an independent research centre funded by the Economic and Social Research Council (ESRC), Department for Business, Innovation and Skills (BIS), the Department for Communities and Local Government (CLG) and the Welsh Assembly Government