NORTHERN ECONOMIC FUTURES COMMISSION

IPPR NORTH

REPORT

BEYOND BANKS AND BIG GOVERNMENT

STRATEGIES FOR LOCAL AUTHORITIES TO PROMOTE INVESTMENT

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ABOUT IPPR NORTH

IPPR North is IPPR's dedicated thinktank for the North of England. With bases in Newcastle and Manchester, IPPR North's research, together with our stimulating and varied events programme, seeks to produce innovative policy ideas for fair, democratic and sustainable communities across the North of England.

IPPR North specialises in regional economics, localism and community policy. Our approach is collaborative and we benefit from extensive sub-national networks, regional associates, and a strong track record of engaging with policymakers at regional, sub-regional and local levels.

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INTRODUCTION

With the economy still flatlining, debate rages over how to stimulate investment and growth. Though much attention is focused upon the banks and their propensity to lend, central government is also under scrutiny, particularly regarding the question of whether borrowing to invest in infrastructure might be a form of 'good borrowing' that should complement the austerity programme.

Less attention, however, is given to local government and the role that it might play in stimulating investment. There are good reasons for this. Local authorities have borne the brunt of government spending cuts, and are often portrayed as under-resourced and risk-averse. More significantly, local authorities are highly dependent on central government rules and grants, which constrain their room for manoeuvre and limit their borrowing with a view to tightly managing the level of national debt.

But local authorities do have an important role to play in creating the conditions for economic growth in their area. Both alone and collectively, their capital investment programmes improve the public realm, maintain the assets they own, and ensure the development of critical infrastructure to support new businesses and growth sectors. They can also play a role in creating a positive environment for businesses, ensuring that they have access to finance, property and planning permission.

However to perform this role most effectively, local authorities also need a greater financial role. They need to be able to piece together funding and raise finance for investment in infrastructure and small business lending. While significant constraints remain, the number of finance options open to local authorities has increased in recent years. The current push for localism, and the City Deal process in particular, has opened up some new opportunities for local authorities to assume stronger economic stewardship of their area, and these opportunities need to be seized.

As a contribution to this debate, this short paper:

- outlines the nature of the UK's investment problem
- provides an overview of some of the current and emerging finance options available to local authorities
- looks at international case studies which could be applied in the UK
- makes some recommendations about new financial tools for local authorities.

Our principle argument is a simple one: local authorities need to collaborate more effectively to unlock investment potential in the North.

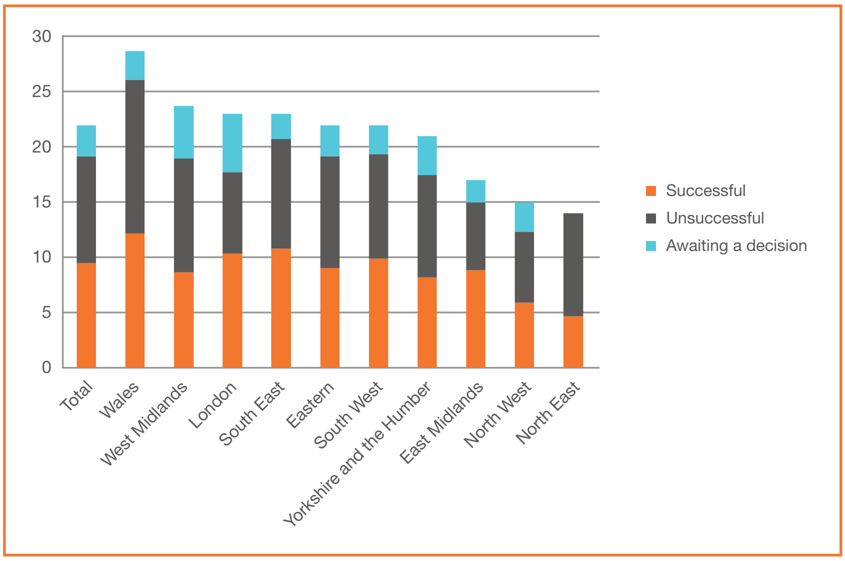
1. WHAT IS THE PROBLEM?

Investment in the economy, by both business and government, is a key driver of productivity and economic growth. Insufficient investment holds areas back. The UK has a longstanding problem of underinvestment, and this problem is comprised of two major elements: a lack of long-term investment in business, especially small and medium-sized businesses; and a lack of investment in infrastructure.

This lack of access to investment funds for small and medium-sized enterprises (SMEs) was noted as long ago as 1931, when the MacMillan Committee on Finance and Industry gave birth to the term 'MacMillan gap'. The committee noted that finance and industry in the UK lacked the symbiotic relationship that they then enjoyed in Germany and the United States (and which have largely been maintained since). Banks clearly have a pivotal role to play here, but a key difficulty for them is the transaction costs of carrying out due diligence on individual SMEs. This leads them to rely on formulaic approaches – for example, firm track record and level of collateral – which make life particularly difficult for new entrants.

As in other parts of the country, SMEs in the North report finding it particularly difficult to access lending from banks in the current climate. The government has recognised this problem, but its appeals to banks to lend more would appear to have fallen on deaf ears as banks seek to shore-up their balance sheets. Furthermore, figures provided to IPPR by the Federation of Small Businesses show that northern businesses are less likely to have sought credit from their bank in the first place – and where they have, their success rate has been lower (see figure 1.1). It seems there is a problem of both supply and demand in the North.

Figure 1.1
Status of applications for credit (loan or overdraft) by small businesses to banks (%)



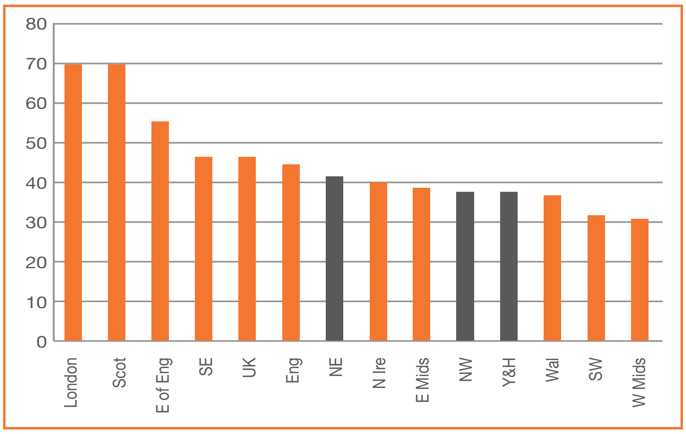
Source: Data provided by FSB, authors' own calculations

Businesses find it particularly difficult to access funding of between £500,000 and £2,000,000, as this is too much to raise informally but too little to be of interest to institutional investors. This general problem of access to the venture capital and equity that businesses need in order to start up and grow is acute in the North. Figures published by the British Private Equity and Venture Capital Association (BVCA 2011) demonstrate the deep concentration of private equity and venture capital in London and the South East. In the past the public sector has stepped into this investment supply gap. Prior to the recession around 75 per cent of early-stage investment activity in the North was supported by the public sector, compared to around 30 per cent in London (Mason and Pierrakis 2009). This has changed dramatically following the government's austerity drive.

The UK's – and the North's – investment problems are not confined to business investment. Levels of infrastructure investment in the UK are also low compared to competitors, consistently ranking bottom of the G7 for investment as a percentage of GDP. As a result, the World Economic Forum ranks the UK 24th out of 139 countries for overall infrastructure quality, behind 10 other EU countries (WEF 2012).

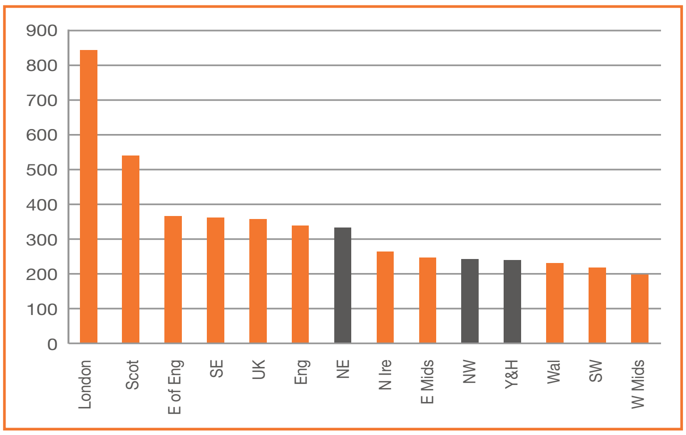
This UK-wide problem is especially acute in the north of England. Looking at the overall distribution of public spending across the UK, while the north of England receives one of the highest regional spends per head, that spend is concentrated on benefit payments, pensions and spending on services like health and education. If we look at spending to grow the economy – what we might call investment spending in areas like science, technology and infrastructure – the North fares considerably worse, as demonstrated in figures 1.2 and 1.3 below.

Figure 1.2
Identifiable public spending on science and technology in 2010/11 (£ per head)



Source: HM Treasury 2011 (PESA)

Figure 1.3
Identifiable public spending on transport in 2010/11 (£ per head)



Source: HM Treasury 2011 (PESA)

Again austerity will be felt here, with deep cuts made to the housing and transport capital budgets. This has a knock-on effect for local government budgets, which have also experienced deep cuts. The 2010 spending review heralded a 74 per cent cut to the Department for Communities and Local Government capital budget, reducing it from £6.8 billion in 2010/11 to £2 billion in 2014/15.

Underinvestment in business and infrastructure is a long-term trend which has been exacerbated by recession and austerity. The reality of these market failures is demonstrated by the multiple measures that have attempted to overcome them over many years (and which have, by and large, failed). Even the current government, with its austerity drive, has introduced successive schemes such as the Regional Growth Fund, the National Loan Guarantee scheme, the Bank of England's Funding for Lending scheme and Vince Cable's proposed British Business Bank.

Yet despite this policy hyperactivity, after the recession northern business and local authorities find themselves in the worst of all possible worlds. At a time when local government, particularly in those hardest-hit areas, ought to be stimulating local demand and investing for the future, its budgets are cut deeply. Likewise, at a time when businesses need credit to consolidate their position or invest in their future, they struggle to find lenders and investors. This lack of investment finance prevents counter-cyclical spending to stimulate demand in the economy.

But the North suffers not only from a lack of investment: it also lacks the autonomy to do anything about it. Through the City Deal process and the drive for localism, areas are being given greater powers and flexibility. Yet to have the power to act without the resources to enable action is to have no real autonomy at all.

Looking back in time, the industrialisation of the North was largely funded by local resources and the strong regional and municipal northern banking systems in the 19th century. In order to develop a sustainable platform for long-term economic growth, the North needs to reclaim and rediscover a much higher level of financial and fiscal autonomy. This means having greater capacity to raise finance to invest in economic growth as well as greater control over public spending carried out in the area and the ability to raise more revenue locally. While IPPR North will continue to work on issues of fiscal autonomy, this report focuses mainly on the question of greater financial powers.

2. OPTIONS FOR LOCAL AUTHORITY BORROWING AND INVESTMENT

2.1 Traditional options for borrowing

The freedom of local government to raise taxes and borrow has changed markedly over the decades. From the late Victorian age of great municipal industrialists through to the 1970s local government had considerable autonomy. This changed during the Thatcher era, when business rates were centralised and stringent capital controls imposed by central government to limit local authority spending.

This remained the case for many years, with any attempt by a local authority to access finance from the money markets requiring central government approval. As a result, in the years between Leicester and Salford seeking finance for housing and infrastructure in 1994 and the Greater London Authority (GLA) doing the same for Crossrail in 2011, not one English local authority made a bond issue (Carr 2012). This is despite the introduction of the Local Government Act 2003, which brought in the prudential borrowing regime.

Since then there has been a very slow loosening of the grip of centralism. There are now two main options for local authorities looking to borrow money to finance investments: the Public Works Loans Board, and issuing bonds. We will examine each of these briefly here before going on to consider some newer developments in local government finance.

2.1.1 Public Works Loans Board (PWLB)

The PWLB exists to lend money to local authorities and other prescribed bodies, although at present almost all of its lending is to local authorities seeking finance for capital investment – including for transport, infrastructure and housing.

The rate of interest at which the money is lent is determined by HM Treasury. Traditionally it has been a relatively cheap source of finance for local government, with rates at approximately 0.2 per cent over the yield on a UK gilt. As a result, over the last decade the PWLB has represented the vast majority of all long-term borrowing by local authorities in England and Wales.

But the 2010 spending review hiked the rate to 1 per cent. This should serve as a stark warning to local government: as long as the Treasury controls the rate of the PWLB, local government will have to dance to its tune. This is further evidenced by the fact that, in response to the outcry from the local government community, the 2012 budget partially reversed the decision by offering a discounted rate to authorities that lay out their spending plans in advance, and that are deemed most efficient by the Treasury.

2.1.2 Municipal bonds

Local authority bonds used to be relatively common in the UK. They were popular both with local authorities, since they provided a measure of financial independence from central government, and with local residents, as they provided a stable investment (a sort of 'micro-gilt') that virtually guaranteed a modest but worthwhile return. Since the 1980s the practice rather fell out of favour as capital controls were imposed and the PWLB provided a cheaper source of borrowing.

England is unusual internationally for its local governments' reliance on a central government source of finance to fund capital expenditure (the PWLB). It is far more common in developed economies for local or municipal authorities to use bonds as a means of promoting economic development, particularly for one-off schemes. They offer a key mechanism through which local authorities can boost investment to stimulate growth. Now is a particularly good time to do this, as the current level of yields is extremely low.

Recent years have seen a renewed interest in municipal bonds, partly because the cost of borrowing from PWLB has fluctuated. This has prompted a number of authorities to apply for and receive credit ratings, as the table below shows.

Table 2.1
Local authorities' credit ratings in 2012

Authority	Rating
Birmingham	AA+
GLA	AA+
Woking	AA-
Cornwall	Aaa
Lancashire	Aa1
Guildford	Aaa
Wandsworth	AAA

Source: Carr 2012

In 2011 the GLA issued £600 million in bonds through a special purpose vehicle (SPV) created by an investment bank. This worked out to be 0.17 per cent cheaper than it would have been for the GLA to secure the same finance through the PWLB. Given the slow and faltering nature of the current economic recovery, there is a strong case for quick action to stimulate investment in the North, and bonds could offer an important tool in this respect.

However, it is an expensive process, costing up to £50,000 per issuance. A further challenge for some local authorities is that they lack the scale necessary to enter into public offerings or private placements. Club placements (or pooled issuance) are important here. This is an issue we explore in more detail below.

2.2 Emerging approaches for domestic investment

Alongside these two traditional measures, a number of newer finance mechanisms for local authorities are emerging. There are also examples of local authorities taking innovative action with their existing powers to ensure that capital investment takes place, and taking up opportunities to secure new powers through the City Deal process.

2.2.1 Tax increment financing

Tax increment financing (TIF) has been part of the infrastructure and regeneration financing toolkit in the United States for many years. It works by allowing local government to raise money by borrowing against the expected increases in tax revenue associated with a new development. It allows local authorities to use future tax growth to unlock finance for upfront project costs, allowing some public investments to pay for themselves in the long term.

In the US, TIF zones are usually small sites. The current property tax receipts from the site are fixed, with the additional growth in these taxes – for a period of up to thirty years – taken as an increment. The municipality then issues a bond to be repaid on receipt of the future tax revenues.

Deputy prime minister Nick Clegg has championed TIF, resulting in their inclusion in the 2010 spending review and the Local Government Finance Act 2012. This marks an expansion of local authority borrowing powers – they are now able to borrow against business rates, whereas previously they could only borrow against other revenue streams.

TIF could be an important weapon in the arsenal for many localities, but it will not be a silver bullet. As Centre for Cities point out:

> **‘TIF will only be appropriate in those cities with sufficiently robust private sector demand and cities with real scope to grow their business rates tax base ... Moreover in some cities, TIF may not be needed because a lack of infrastructure is not the primary barrier to growth.’**
> Wilcox and Larkin 2011: 5

Furthermore, care has to be taken to ensure that schemes result in net new economic activity, not simply displacement from surrounding areas.

There is also some dissatisfaction with the form of TIF that has been devised for England. Two options have been set out. Option one would allow local authorities to themselves decide to borrow against the future uplift in business rates that they would receive through the business rate retention scheme. However this sort of scheme would receive no special treatment from central government, and would not be subject to top-up, tariff or levies through the local government business rate retention scheme in the usual way (Sear 2012). As the business rate retention scheme is anticipated to be reset every 10 years, local authorities wouldn’t have much certainty, so option one would be likely to be used only for relatively small projects (Wilcox 2012). Under option two, a designated area would be exempted from the business rate retention scheme, reducing the risk of loss caused by the levy or reset process. However funding would be provided from a fund run by the Treasury that local authorities would have to submit bids to, which means that the scheme would be rationed (Sear 2012). Once again, local government’s options would be fettered by Treasury decision-making.

Newcastle and Gateshead Accelerated Development Zone (ADZ)
As part of Newcastle’s City Deal, four sites across the core of Newcastle and Gateshead have been designated as part of an ADZ, where a 25-year TIF scheme will operate. Through TIF a £92 million programme of infrastructure investment is anticipated to lever in £800 million of private sector investment and unlock significant development. The scheme is expected to generate additional annual business rates of up to £21 million (and £320 million in total) by 2038, enabling borrowing to be paid back by 2031. The deal requires the Treasury to allow the retention of all business rate growth over the 25-year time horizon. The projected business rate growth figures are thought to be deliberately conservative in light of the difficult economic climate, and the actual income could be higher.

Alongside the TIF agreement, the deal includes arrangements for UK Trade and Investment to work closely with the councils to bring relevant inward investors to the areas. Both councils will also actively seek to lever in private sector money as well as investing a further £100 million themselves.

Greater Manchester earn-back model
A variation on the use of TIF is the Greater Manchester ‘earn-back’ model. Under this deal, £1.2 billion is provided upfront by the 10 Greater Manchester local authorities through a combination of prudential borrowing and a levy paid by each local authority. The pot is then invested in infrastructure projects, prioritised according to the contribution they’re likely to make to gross value added (GVA) growth in Greater Manchester.

BOXED TEXT CONTINUED

The 'earn-back' element refers to Greater Manchester's ability to keep some of the proceeds from tax growth resulting from its investments. A baseline of expected growth is agreed, and from 2015/16 Greater Manchester will be rewarded for value created beyond that baseline. The reward is capped at £30 million per annum for up to 30 years. The level of earn-back will depend on the city region's growth performance.

2.2.2 Local authority pension funds

While pension fund investments need to be safe (in terms of securing a reasonable yield for pension holders), they can also be patient, making them perfect for long-term finance projects. And, as returns from some traditional pension fund investments are proving volatile or limited in the current economic context, a number of schemes are increasingly interested in investing more in infrastructure to diversify their portfolios (Carr 2012).

But local authority pension schemes are held back from investing in infrastructure in general – and local infrastructure projects in particular – by a range of concerns. The Smith Institute carried out interviews and workshops with local authority pension fund managers and economic development officers to identify a range of barriers. These included:

- the rate of return and risks in an unfamiliar field
- potential conflicts of interest
- sustained commitment to projects
- track record of delivery
- lack of a clear exit strategy.

The skill of investment officers to put together suitable vehicles was also identified as an issue (Smith Institute 2012).

Central regulation also acts as a barrier. Currently CLG places a 15 per cent cap on investments in partnerships, which are often used as vehicles for investment in infrastructure, private equity and real estate. This is in stark contrast to the Treasury which is actively encouraging the pensions sector to invest in infrastructure, something the pension industry has been interested in for some years. The consequence of this 15 per cent cap is that, where pension schemes are already committed to investments elsewhere, their capacity to invest in more infrastructure projects will be limited (Smith Institute 2012). CLG is currently consulting on whether to increase the cap to 30 per cent (CLG 2012).

Scaling up may offer a key route to overcoming a number of these issues, as we explore below. Nonetheless, some local authority pension funds have already begun to invest in local infrastructure, as the Greater Manchester case study below demonstrates.

The Greater Manchester Pension Fund property investment
The Greater Manchester Pension Fund, administered by Tameside council, brings together the pension funds of all 10 local authorities in Greater Manchester plus those of over 200 other employers in the area. It is therefore able to invest across a wide area, reducing concerns about individual local authorities investing in their own back yard. The fund, which already invests in commercial property, is now actively exploring the potential for investment in residential property, to build new houses for sale or rent. The fund has twin aims: achieving a commercial return, and supporting the local area. It cannot simply be a source of 'soft capital', but it can legitimately look to invest in the local area provided that the investment meets its primary aim of commercial return: its two interests need not conflict. Recently, its board raised the maximum limit for the proportion of its funds that can be invested locally from 3 per cent to 5 per cent (equivalent to approximately £500 million), enabling it to invest at scale. The fund's managers are currently looking to put together possible packages – involving the fund, a local authority, a contractor and a landlord – to reach their target rate of return (Hull et al 2011).

Leeds city-region investment fund
The Leeds City Deal takes a different tack. Rather than using TIF-type mechanisms, it seeks to create a single pot for investment from existing funding streams and financing tools.

The deal lays the foundation for a 10-year, £400 million investment fund. This will be generated by Leeds city-region local authorities contributing £200 million by pooling a proportion of their capital budgets, Growing Places funds and enterprise zone receipts, and, over time, pooling their business rate retention and revenue from the Community Infrastructure Levy. It asks that government match this with a further £200 million of existing and future capital spend, including round three of the Regional Growth Fund. They have also requested discounted borrowing through the PWLB.

Over time the aspiration is to move to a single capital pot which includes Homes and Communities Agency funding, and to look at how pension fund investments can be mobilised where appropriate.

Projects funded through the investment fund will be evaluated according to a single evaluation model that gives priority to projects delivering GVA growth and new jobs, and which contribute to carbon reduction.

2.2.3 Gap financing
Bradford council also offers an example of how local authorities can use their existing powers and financial weight in an innovative fashion to support economic development.

Bradford found itself in a difficult position when a major city-centre development (the £45 million Southgate development) ground to a halt at an advanced stage when the developer was unable to secure bank finance when the downturn hit, despite having a number of pre-lets agreed.

In order to de-risk the development and get construction moving, the council provided a secured commercial loan of £6 million to the developers. This allowed the developers to complete the scheme, with major tenants like Provident Financial and a Jury's Inn hotel moving in, securing and creating hundreds of jobs. The loan was repaid in full, with interest and ahead of schedule.

2.3 Emerging approaches for international investment

Alongside domestic sources of finance, there are also opportunities for councils – individually or collectively – to package-up investment opportunities for international investors.

2.3.1 Sovereign wealth funds (SWFs)

SWFs are special investment funds, created by some governments since as far back as the 1950s, for the purpose of holding foreign assets. They have accumulated reserves rapidly in recent years and their assets are expected to grow from their current level of $4.8 trillion to $5.2 trillion by the end of 2012 (TheCityUK 2012). Emerging Asian economies, especially China, are quickly moving into this market. An expanding area of their activity is foreign direct investment, both in individual firms and in infrastructure developments.

SWFs tend to have a higher risk tolerance and to expect higher returns than traditional official reserves managed by monetary authorities. The US is the primary destination for SWF investment, followed by the UK; however much of this UK investment is channelled to London. Forward-thinking local authorities, like Birmingham city council, are trying to secure a larger proportion of this investment.

2.3.2 International pension funds

It is not only local authorities' own pension funds that offer an investment opportunity: a number of international pension funds are actively looking for investment opportunities in infrastructure. However this is a small but growing area of activity: it is estimated that less than 1 per cent of the total value of pension funds worldwide is invested in domestic and foreign infrastructure. Often, pension funds are put off by this asset class due to lack of expertise, perceived risk and lack of certainty over whether projects will retain political support (Croce 2011).

However, some larger funds are beginning to invest more internationally in infrastructure. Australian and Canadian pension funds are considered leaders in this field, with some having more than 10 per cent of their portfolio in foreign infrastructure (Croce 2011). Infrastructure looks more attractive as an investment at present as institutional investors, trying to spread their investments across a much wider spectrum, seek new sources of return and better diversification of investment risk. In this process they are searching beyond the traditional asset classes of equities, bonds, cash and real estate.

This presents an opportunity for local authorities seeking infrastructure investment, but it will require steps to make it easy for investors to find the right sorts of opportunities. Birmingham city council has been quick off the mark, as the box below outlines.

Birmingham city council: packaging up and promoting investment

Birmingham city council is currently offering a partnership to sovereign wealth funds as a means of attracting around £1 billion of investment into the city. The council launched the Sovereign Wealth and Institutional Funds Prospectus in March 2012 (Birmingham city council 2012). The prospectus highlights nine particular investment opportunities for SWFs to consider. Some of these opportunities include 'Eastside', a site that will house both the new HS2 high-speed rail station and Eastside Locks, a new commercially dense business park with 74,000m^2 of Grade A office space (at a cost of £310 million). Big redevelopments in the city centre are also on the cards – it is hoped that Paradise Circus will become one of the biggest city-centre regeneration projects across all of Europe (cost: £100 million).

3. SCALING UP FOR IMPACT

Two themes have run throughout this paper: first, the problem of relying on central government for access to finance for investment; and second, the limitations of local authorities acting alone. While there are outstanding examples of local authorities innovating to increase capital finance in their area, there are occasions where more can be achieved by acting together. By operating at scale, costs can be brought down, expertise shared, and larger investments achieved alongside on-lending for smaller projects.

This section gives two international examples of collaborative working at scale, before going on to consider what might be done in England.

3.1 Kommuninvest, Sweden

Kommuninvest is a Swedish local government investment agency which was founded in 1986 as a cooperative. Since then it has raised significant sums for Swedish local authorities and regions. In 2010 it lent £13 billion, which represented 54 per cent of all annual local authority borrowing (Anderson 2011). Kommuninvest is estimated to have saved Swedish local authorities £170 million by comparison with the alternative sources of finance available to those authorities. By operating at scale it is able to reduce the costs of borrowing.

The agency began as a regional body and took five years to become a national one. The transition was made easier by a Swedish banking crisis in the early 1990s, which prompted more authorities to join. In 2011, its membership comprised 90 per cent of all Swedish local government bodies, and Kommuninvest has a target of increasing this figure to 100 per cent by 2015.

It issues maturities at between 20 and 50 basis points above Swedish government debt and retains a liquidity reserve of 20–40 per cent of lending, which enables it to meet lending requirements. It also has access to the short-term credit facilities of the Riksbank (Swedish central bank). Investors in Swedish bonds can be confident that their debt will be repaid, as Swedish local authorities have significant fiscal autonomy (Carr 2012).

Kommuninvest enjoys a triple-A credit rating, equivalent to that of the Swedish government itself. This is because of the strict credit checks required at sign-up and on an ongoing basis, with each member subject to two credit checks each year with continued membership contingent on these being passed. So far no member has ever defaulted.

3.2 Kreditanstalt für Wiederafbau (KfW), Germany

Established in 1948 as part of the Marshall plan to help fund the reconstruction of Germany after the second world war, the KfW remains to this day a state-owned development bank. It lends to small and medium-sized businesses, as well as providing capital for housing and supporting the transition of the German economy to a low-carbon future.

It is jointly owned by the federal republic of Germany (80 per cent) and the states of Germany (20 per cent). It is led by a five-member managing board which in turn reports to a 37-member supervisory board chaired by the federal minister of economy and technology. It lends to SMEs (via intermediaries) although it also provides up to 50 per cent of investment costs for major projects including housing, infrastructure, environmental protection, and venture capital. Additionally, KfW finances telecommunications, transportation, energy infrastructure and industrial projects around the world.

The bank receives funds from the federal budget as well as from its own investments in the domestic and international capital markets.

The KfW does not lend directly to enterprises or individuals – instead, it provides commercial banks with liquidity at low rates and long maturities. These banks then lend to SMEs. KfW loans are an extremely well established part of the German commercial and small business landscape, and so are instinctively called upon by SMEs. However, the system is intricate, balancing risk and reward for the banks that partner with KfW. These commercial banks act as crucial intermediaries, via the following methods.

- The commercial banks levy the KfW with modest charges for transactional costs.
- More importantly, the KfW underwrites most but not all of the risk: 70 per cent of the loan is financed by KfW, and 30 per cent by the bank concerned.
- Thus the bank receives a slice of the return on the loan and so has a commercial reason to offer it.
- However the bank cannot lend irresponsibly merely as a way of levying charges.

The banks are part of the solution while also doing what they are designed to do: assessing risk and making a profit. The KfW benefit from banks' expertise in assessing risk, and the banks benefit from a sustainable return.

During 2010 the KfW lent to 100,000 German families looking to purchase homes, made €6 billion available for infrastructure investment and helped create or secure 124,000 jobs (Carr 2012). Global Finance has rated the institution the safest in the world.

4. STRONGER TOGETHER?

Drawing on this knowledge, and the general direction of trends, this section outlines two ways in which northern local authorities can work together to boost capital finance in order to promote economic growth.

4.1 Creating a vehicle for pooled bond issuances and pension fund investment

Municipal bonds offer a good opportunity for local authorities to independently access finance, without requiring sign-off from the Treasury. But the cost of issuing bonds prohibits some authorities, and others lack the scale to be able to do this alone.

Club placements (or pooled issuance) become important here. These involve the use of a vehicle which issues a bond on behalf of a number of organisations, and then on-lends to these organisations. This permits local authorities to access the debt capital markets for smaller sums, which would benefit smaller authorities who wish to invest in smaller projects. Pooled issuances also enable borrowing at a scale to fund large projects that are of city-regional significance, bringing benefits to multiple local authority areas. Some of the institutional framework to enable this is already in place – for example the combined authority in Greater Manchester. In addition, pooled issuance shares the administrative cost across a number of authorities.

The LGA undertook a study which modelled the impact of a pooled issuance-type scheme in England. They proposed that local authorities could borrow up to £7 billion and in the process save up to £500 million in costs over 25 years. Such a scheme (covering tens if not hundreds of authorities) would be able to borrow at a rate of 70–80 basis points over gilts or 20–30 below the standard PWLB rate (LGA 2012).

In an era of economic instability and austerity, when investors and lenders are looking for stable and secure places for their money, British local government could offer an opportunity. By clubbing together, local authorities can achieve scale and collectively overcome barriers created by costs and lack of expertise. This could provide crucial access to finance and overturn decades of chronic underinvestment in infrastructure.

This would require an investment vehicle to be established, one which could also provide a platform for pension fund investment. This would complement the aims of the Pension Infrastructure Platform (PIP) which is currently being developed by the Treasury in collaboration with the National Association of Pension Funds and the Pension Protection Fund. The PIP will be a not-for-profit mutual owned by pension funds. It is hoped that it will raise £2 billion from pension funds (leveraged up to £4 billion), and enable an otherwise disparate industry to pool expertise and resources to invest in infrastructure. This investment will primarily consist of debt-based finance, but will also include an infrastructure equity option which will allow schemes to actually own physical assets.

There are clearly further opportunities for attracting investment from local authority pension schemes. The northern local authority pension schemes alone hold significant sums, as table 4.1 sets out.

By creating an investment vehicle that spans local authority boundaries, not only can concerns about conflicts of interest be assuaged, but more appealing investment packages can be put together to attract investment, incorporating the best propositions from across the region.

Table 4.1
Value of selected northern local authority pension schemes

Greater Manchester	£10.4bn
West Yorkshire	£7.9bn
Merseyside	£4.3bn
Tyne and Wear	£4.3bn
South Yorkshire	£4.1bn
Lancashire County Council	£4bn

Source: Carr 2012

4.2 A British investment bank with regional structures

Another option would be for northern local authorities to lobby for a state-backed investment bank, learning from the KfW experience in Germany but with a clear regional allocation of funds. This would help to fulfill the need for more autonomous, long-term financial instruments and institutions.

There has been considerable political debate in recent years regarding the formation of a state or British investment bank (see for example Dolphin and Nash 2012, Tott 2012, Skidelsky et al 2011). The purpose of such a bank would be to overcome the twin market failures of a lack of long-term lending to SMEs and underinvestment in infrastructure.

The government has taken a small step in this direction, with Vince Cable announcing the foundation of a British Business Bank established to provide long-term loans to small business. However, the initial capital injection for this bank is a mere £1 billion, insufficient for the scale of the challenges faced. Furthermore, the bank is only guaranteed to be operational between 2013 and 2015, and so is hardly the new institution to correct long-standing market failures that is required. It also fails to address the issue of underinvestment in infrastructure. Recent IPPR research has set out a blueprint for a far more ambitious investment bank, as outlined in the box below.

IPPR's proposal for a British investment bank[1]

This would be a state-owned bank that acts commercially. Its objectives would be to overcome the twin market failures of underinvestment in infrastructure and long-term lending to SMEs. Each of these objectives would be dealt with by a different part of the bank, with small business lending taking place through a number of intermediaries – either high street banks or local agents appointed through a competitive tendering process.

An initial one-off injection of startup capital would be needed for the bank. IPPR proposes that this would come from the public sector, with £10 billion per year for the first four years raised through a combination of asset sales and borrowing. A one-off levy on commercial banks could also provide some of the capital, although it would not raise the total amount needed.

Another more radical option would be to initiate a further round of quantitative easing (QE) to provide the bank with startup capital. Some would question whether it is sensible to mix monetary policy and measures designed to address long term structural problems in this way – not least because, as the economy returns to balance, the Bank of England will scale back QE, but would not be able to reclaim the money that was used to capitalise the investment bank.

1 For a full account of IPPR's proposals on this topic see Dolphin and Nash 2012

BOXED TEXT CONTINUED

The alternative would be for the Bank of England to capitalise the investment bank outside of the QE programme, which would require a substantial extension of its remit.

Either way, the initial capital would most likely only need to be earmarked for the investment bank and not actually spent, as this should be sufficient to enable it to leverage funds in the capital markets. This should be capped at a ratio of 2:5.

The investment bank would be subject to rigorous scrutiny arrangements. Politicians must play a role in this, as they are accountable for the public funds spent by the bank; however, there must be absolute clarity about where the remit of politicans ends and that of bankers begins. A small board of governors, comprising relevant ministers and a small number of others, should set the strategic objectives of the bank and receive the annual report and accounts. They would play no role in the day-to-day decision making, which would be overseen by the bankers

The prospects for the establishment of a British investment bank are improved by similar initiatives in other areas, such as the establishment of the Green Investment Bank[2] and Big Society Capital[3]. It would require approval from the European Commission to ensure it did not breach state aid rules, which would require the additionality of the bank to be clearly demonstrated, but this should be possible given the clear market failures that exist in the areas the bank would operate in. Furthermore, as the European Commission tends to favour measures that bring economic benefit to areas eligible for regional aid, building a regional element into the bank could assist with this process.

But the danger for the North and other regions is that they are left out of the debate about a British investment bank. Any new institution that continues to operate under the same tired economic modeling and investment methodologies and centralised ways of working that have so damaged the North over the last few decades (see NEFC and IPPR North 2012) will not address the problems of underinvestment in northern infrastructure and a lack of long-term lending to SMEs in the North. The North must be ready with its own proposals to show how a British investment bank can be made to work for the regions. One promising solution is for such a bank to have a regional structure, enabling it to respond to the different economic contexts of different parts of the UK. To ensure this happens, the bank should have clearly defined ways of working regionally.

As such, with regard to infrastructure investment, the British investment bank's startup capital should be allocated to regions using a simple formula – perhaps combining measures of population with a measure of economic potential. Exactly what this formula looks like should be established by an independent commission comprising representatives from different parts of the UK. Essentially, the British investment bank should have a regional lending mandate. However this is not to say that it should work within the old confines of there being 10 regions within England, plus Scotland, Wales and Northern Ireland. Indeed, to ensure that lending can take place at scale, and that the bank is able to have the intended impact, larger groupings make sense. This is why we argue for a northern investment capacity within a national British investment bank,

2 http://www.greeninvestmentbank.com/

3 http://www.bigsocietycapital.com/

rather than a smaller geographic scale. It would be for other parts of the UK to identify what geography is workable and capable of delivering sufficient scale for their area.

There sould be scope for this regional investment capacity and the northern investment vehicle (set out in section 4.1, above) to collaborate and jointly invest in major schemes where there is mutual benefit in doing so.

The solution to inadequate long-term lending to SMEs is relatively straightforward: it is proposed that the bank would work through intermediaries – either existing banks or appointed regional agents. This element of the bank's activity would naturally be more local in its orientation.

This regional structure of the bank would need to be reflected in how it is governed. Clearly, a governance structure would need to be put in place that draws a firm line between the work of politicians and that of bankers, who would be the ones making the investment decisions.

The overall objectives of the bank would be the same across the UK: to overcome the twin market failures of underinvestment in infrastructure and a lack of long term funding for SMEs. These high-level objectives would be set by the board of governors. However there should be additional scope for setting specific, high-level regional objectives for different areas, to prioritise infrastructure and supply chain development in support of key growth sectors such as offshore wind.

Assessing and recommending more locally nuanced objectives would be the job of an advisory council comprising local leaders, representatives of the devolved administrations, UK ministers and civil servants. They would be helped in this task by hearing evidence from technical advisory groups: there would be one of these for each of the bank's regions, with membership reflecting local economic development expertise. These groupings would together set the strategic direction for the bank's investment; the actual investment decisions would be taken by bankers. A separate supervisory board would scrutinise activity to ensure the bank's objectives are being met.

5. RECOMMENDATIONS

This short paper has argued that local authorities have a vital role to play in stimulating investment for economic growth. While their ability to act may be more limited than that of banks or central government, there are a number of opportunities which need to be seized in order to stimulate more locally-led and autonomous sources of investment. To this end, we make the following recommendations:

1. Local authorities across the north of England – together with their local enterprise partnership (LEP) partners – should make greater use of municipal bonds to enable investment at scale, and on-lending for smaller projects in their areas.
2. Local authorities and LEP partners should club together to create an effective northern investment vehicle, capitalised by public and private pension fund investment, to raise finance for housing and other northern infrastructure projects.
3. Northern stakeholders should lobby for the formation of a well-resourced British investment bank, with a clear regional allocation of funds to provide for a northern investment capacity with its own strategic funding priorities.

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