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CABINET

CAPITAL FINANCE FOR LOCAL AUTHORITIES

Memorandum by the Chancellor of the Exchequer

Under the present system the local authorities can choose the source from which they borrow to meet approved capital expenditure. There is no limit to the amount that they raise from the Exchequer through the Public Works Loan Board (P.W.L.B.) and the rates at which they borrow are in line with Government credit.

2. I propose to change the system in two respects -

(i) to limit the demands on the Exchequer by asking the Board to grant loans only when it is satisfied that the applicant has made an effort to borrow elsewhere, i.e. in the stock and mortage markets, and cannot reasonably do so;

(ii) to prescribe rates for the P.W.L.B. based not on Government credit, but on the credit of local authorities of good standing in the market.

3. The present system dates from 1945, when the local authorities were charged with a programme of reconstruction and housing far in excess of the capacity of the stock and mortgage markets. For seven years the local authorities were in effect denied access to the stock market. In 1952 they were given back their freedom to go to the market if they wished. But the Government did not take the further step of limiting their access to the P.W.L.B. The local authorities still had a big programme of commitments authorised by the Government. Parliament was told that in this situation the authorities must be given access to all the sources of finance, and that it was not the Government's policy to force local authorities into the stock market.

4. The present system has two disadvantages.

5. First, the authorities have lost the habit of considering before they incur capital commitments how the money to meet them will be found - since the tap is open from which they can draw the money when the commitments mature. Their sense of financial responsibility is also weakened if they borrow at rates which reflect not their own credit but the credit of the Government.

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6. Second, the system is unhealthy for the Exchequer. The deficit below the line this year includes £193 millions of capital advances to local authorities made in six months compared with a Budget estimate for the whole year of £320 millions. This drain is not due to any increase in the capital formation of local authorities which is, in fact, tending to fall. It is due to the fact that, when interest rates have been rising, the local authorities have chosen to concentrate their borrowing on the P.W.L.B. As a direct result, the Exchequer has been obliged to raise these large sums by increasing the Floating Debt, and this increase has diminished the pressure on the liquidity of the banks and added to the difficulties of credit control.

7. We now have an opportunity to adopt a more healthy system. Local authorities' capital expenditure may be expected to fall in the next 18 months or so, for it is probable that the reduction in housing expenditure will continue while, if the local authorities succeed in carrying out the Government's request in the rest of their programmes, their other capital expenditure will be no larger than it was last year. This contraction of expenditure provides the opportunity for a change in the local authorities' arrangements for raising the capital finance. The fact that their capital requirements will tend to fall means that a greater proportion of them can be met from the stock and mortgage markets. Moreover, we are moving into a situation in which the local authorities will have a somewhat greater degree of freedom to decide for themselves the size of their capital expenditures - particularly on housing - and this carries with it a greater degree of independence and financial responsibility for the local authorities.

8. This development calls for a corresponding modification of the system of financing, for the authorities will no longer be under such compelling pressure from the Government to embark upon specific programmes of capital expenditure.

9. I therefore propose that the Exchequer should resume the right to grant or withhold advances to local authorities. This step does not require fresh legislation. It can be done by a request from myself to the P.W.L.B. who, under the present law, have full power to grant or withhold advances.

10. At least for the present, I would not propose to revert to the pre-war system under which the Board were instructed not to lend (except for certain specified services) to large authorities (defined as authorities with a rateable value of more than £200,000 a year). The larger authorities are responsible for about half the present advances from the P.W.L.B. - say £150 millions a year. There can be no assurance that the stock and mortgage markets will find additional finance of this amount. But I believe it will be feasible to have a selective and flexible system. I propose to ask the Board, before they grant any advances in future, to satisfy themselves that the applicant has made an effort to raise the finance on its own credit in the stock and mortgage markets, and only to lend from the Exchequer insofar as, in the Board's judgment, the applicant could not reasonably raise the money elsewhere.

11. But I do not think this change will be feasible unless the instruction to the Board is supported by a further step - a change in the basis on which the Treasury calculates the lending rates of the Board. At present the rates are based on Government credit for loans of comparable periods.

The result is that - unless an authority decides to pay more for the flexibility and prestige of a market loan - it is to the financial advantage of the local authorities to borrow from the Board as opposed to the market. They will certainly claim when it suits them that it is their duty to do so: and the Board will be given a very difficult task in deciding how far they can press an applicant to go back to the market when the applicant claims that the market's terms are unreasonable.

12. I believe that the right solution is to prescribe lending rates for the P.W.L.B. based, not on Government credit, but on the credit of local authorities of good standing in the market. This again does not require legislation, as the Treasury has full discretion to prescribe whatever rates they think fit under the existing law.

13. Clearly certain safeguards are needed before the new system can be put into operation. The main points to be safeguarded are -

(a) the market prospects;

(b) the effect on local authority credit; and

(c) the administrative arrangements to avoid dislocation of local authority finance.

14. Market prospects. The success of the plan depends on an active market in local authority issues. The Bank of England have been closely consulted on this point. No assurance can be given of an immediate flow of local authority issues or of consistently favourable markets. But there exists already a list of local authority stocks to go on the market; and there is a reasonable prospect of making steady progress with the orderly flotation of these issues in the first place, followed by others on which preparations could start as soon as the new policy was announced. Similarly there are good prospects of an active mortgage market. This is an encouraging report. But I must emphasize that it is conditional on a new Local Loans rate based on local authority credit. Progress cannot be made in either stock or mortgage markets if they have to compete with the P.W.L.B. lending at finest gild edged rates.

15. Local authority credit. It is not intended that the pressure of the local authorities on the market should drive up their borrowing rates to penal levels. The authorities are entitled to protection against that risk. They will get protection from the lending rates prescribed for the P.W.L.B. Some margin is bound to develop between the full gilt edged rate and local authority rates, and it is right that it should. But local authority credit will continue to rank in the market next after Government credit. This standing will be reflected in the lending rates prescribed for the P.W.L.B., who will be given guidance not to press applicants to borrow in the market at rates significantly higher than the Board's own lending rate.

16. Administrative arrangements. I am satisfied that the P.W.L.B. as at present constituted can carry out the function now to be given to them. They will not be concerned in the merits of the capital expenditure, but with the market prospects of the local authorities who come to them. In practice the Board will accept the statements of small applicants that they were unable to raise their finance elsewhere, and will concentrate

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on the large authorities of known market standing. On these the Board will be advised by the Bank of England who are in a position to report on the prospects of such authorities in both stock and mortgage markets.

17. As far as the Board and the Bank are concerned, this system is ready to be put into operation immediately. From the standpoint of the local authorities, however, a transitional period may well be required. It is the present practice of many local authorities to decide the amount and source of their loans only when commitments mature for payment. But the new system will mean that local authorities must work out forward borrowing programmes, taking account of their broker's advice on the prospects of their stock issues, etc. before they can justify the amount of their proposed borrowing from the P.W.L.B. It will also take a little time for the authorities and their market advisers to organise the flow of new issues in the stock market. Clearly the Board must be ready to make such advances as are required to help the authorities through this transitional period. I would propose to make these transitional arrangements by meeting the Standing Consultative Committee of Local Authority Associations immediately after the new policy was announced. But to avoid forestalling, the new lending rates for the P.W.L.B. must be prescribed and operate immediately.

Summary

18. (i) Under the present system, there is no limit to the amount of approved capital expenditure that local authorities can finance by borrowing from the Exchequer at rates based on Government credit.

(ii) I propose that (a) the Public Works Loan Board should only grant Exchequer loans so far as the applicants cannot raise the money in the stock and mortgage markets; and (b) the Board's lending rates should be based not on Government credit but on local authority credit.

(iii) In order to succeed, the new system requires an active market in local authority issues, safeguards against penal rates for local authority borrowing, and workable administrative arrangements, particularly to begin with. All these points are covered.

(iv) If the scheme is agreed, I would propose to announce it on 27th September and to fix the new Local Loans rates, based on local authority credit, on the same day.

R.A.B.

Treasury Chambers, S.W.1.

19th September, 1955.