UNISON

Open College

BLOCK HFFS.103

LOCAL AUTHORITY FINANCE

UNISON Open College, 1 Mabledon Place, London WC1H 9AJ

Preface

This Block examines the provision of finance for local authority housing.

It begins in Section A with capital finance, and the types of expenditure which this covers. It then examines the mechanisms for the control of local authorities' borrowing for capital spending. Next, it looks at other sources of capital funding, including revenue sources and grants.

In Section B, the mechanics of how capital finance works are set in a larger context. This part of the Block looks at overall government policy - in particular Decent Homes, stock transfer, ALMOs and PFI - and local housing strategies.

Section C examines revenue finance for local authorities. It identifies the main features of the Housing Revenue Account, and the effect of the introduction of the new 'resource accounting' arrangements.

Finally, in Section D it identifies different rent setting systems, and explains the main features of the rent restructuring regime.

Outcomes

When you have completed this Block, you will be able to:

- describe the main sources of finance for local authority housing;
- distinguish between capital and revenue finance; and
- discuss the main features of rent setting and rent restructuring.

Contents

A. Capital Finance

In Block HFFS.102 you became familiar with the distinction between capital receipts and spending, and revenue income and spending. In public sector housing this is an important distinction. Generally, capital and revenue spending are for different purposes, and are controlled by different rules.

1. What is Capital Spending?

As you learned in the previous Block, capital spending is expenditure for the creation or improvement of assets which remain more or less permanently within the organisation. Revenue spending pays for day-to-day costs or management costs – for example, wages or salaries.

The long life of the capital asset in the public sector justifies paying for it over the whole of its lifetime. It will be enjoyed by future generations of tax/rent payers, so it is fair that they should make a contribution to its costs. Otherwise the costs would all fall on the tax/rent payers at the time the asset was created. This would require very large sums from revenue income.

'Capital' spending may:

- create an asset (e.g. build a house);
- protect an asset (e.g. re-roof a house);
- improve an asset (e.g. put in a new kitchen).

Capital spending is clearly different from revenue spending. However, there are some grey areas, where you might make a choice between paying for an activity by borrowing, or paying for it as you "go along" (from revenue).

For example, if routine maintenance of a group of houses is being done at the same time as other modernisation work on those houses, you might decide to pay for all the work together and borrow to pay for the whole scheme.

It is important to realise that while capital spending may appear to be cheaper than revenue spending, it may still have a revenue cost: you will recall that interest payments to lenders come under the heading of revenue spending. In the 1980s, some local authorities tried to keep their revenue expenditure down by labelling routine maintenance as capital works and borrowing to pay for it. Although this was cheaper at the time, it left them with debts to pay for a long time afterwards.

Activity 1

Identify some recent examples of capital spending by your organisation, and list them here. (If you are not aware of any, look at the Capital or Development programme.)

Beside each, indicate whether it is intended to create, protect, or improve an asset.

Time allocation: 15 minutes

If you are employed by a local authority, you will probably find that very little capital spending is intended to create assets. Local authorities have spent very little on new building over recent years, as you discovered in Block HFFS.101. Most capital spending is directed toward protecting assets (such as “enveloping” schemes, to extend the life of houses of non-traditional construction, or re-roofing). Or it is intended to improve the properties, by refurbishing, adding porches, etc. If you are employed by a housing association, you are more likely to discover capital spending to create assets – building new homes.

2. Paying for Capital Spending

Capital spending may be paid for in a number of ways, of which borrowing money has historically been the most important, although this is changing. We will look in turn at paying for capital spending by:

- borrowing, including the new ‘prudential borrowing’ arrangements
- using money (capital receipts) from council house sales or other sources;
- using revenue income: increasingly important;
- government grants.

Local authorities historically have in the main borrowed to finance capital spending. The money to create the asset is borrowed; the loan is theoretically calculated over the lifetime of the asset. This loan is called the ‘principal’. The lender charges a fee for loaning the money: this is the ‘interest’.

The proportion of the principal to be paid back in a particular year, plus the interest on the remaining loan, make up the sum of money which appears in the housing organisation’s annual budget as loan charges, debt charges, or financing charges.

2.1 How are capital financing charges reflected in rents for houses?

In local authority Housing Revenue Accounts, the annual debt repayments in the account are spread over the rents for all the houses in the account. The debt is spread over the whole of the council’s housing stock and, therefore, between all its tenants.

So there is no direct relationship between the actual capital costs of building a particular house and the rent for that house. This is called rent ‘pooling’, and has historically meant that tenants in older houses (where the debt may have been paid off, or is very low) have subsidised the building of new houses, or modernisation programmes, for other tenants.

3 . The History of Controls on Capital Spending

In the post-war years when local authorities were in the forefront of mass housebuilding to deal with the housing shortage, there was little control over how much they borrowed to finance their capital programmes. However, the oil crisis of the mid-1970s and the consequent restrictions on all public expenditure, led to the introduction of a system of controls on capital spending which lasted from 1979 until 2004. Under these controls, local authorities were obliged to bid annually for permission to borrow money to fund their capital programmes. The government of the day found this a useful tool, not just in limiting public expenditure, but in directing expenditure to the current policy priorities.

The reason for these controls was - and is - that both spending and any borrowing they undertake ‘counts’ as public expenditure: the principle is that as they are public organisations, the government guarantees the borrowing and therefore needs to set money aside to cover that guarantee.

Under these controls, each local authority had to prepare an annual Housing Investment Programme (HIP) and bid. The HIP bid included an assessment of the needs in the borough and was accompanied by a Housing Strategy which explained how the local authority intended to meet those needs. There was an annual cycle in which:

- in June, the local authority would submit its HIP bid to the local Government Office;
- in the summer, consultation meetings would take place;
- in the autumn, the Chancellor would announce the total funding available for the following financial year. These funds would be distributed by the ODPM on the basis of the relative needs of each area, using a Generalised Needs Index;
- around the New Year, local authorities would be informed of their allocations.

Remember, these allocations were not actually funds, they were permissions to borrow and spend.

The annual ‘credit approvals’ were cash limits on the financial commitment which a local authority could enter into in that financial year to finance capital spending.

The advantage of this for the government was that there was a cash limit to total local authority borrowing for the whole country, regardless of upward movements in interest rates.

4 . The Current Regime: Prudential Borrowing

The arrangements described in the section above changed substantially in April 2004, following the provisions of the **Local Government Act 2003** for England and Wales, and the **Local Government in Scotland Act 2003** for Scotland. This legislation introduced the concept of *'prudential borrowing'*.

The idea behind prudential borrowing is that local authorities should be able to borrow as much money as they like for capital projects so long as this borrowing is 'affordable'. This appears on the face of it to be a significant relaxation of the previous capital controls. Indeed in explaining the new arrangements, government acknowledged the defects of the previous system which had "effectively shifted control from local to central government, blurring accountability, limiting local freedom and introducing an obstacle to capital investment" (*Local authority housing finance – a guide to the new arrangements*, ODPM 2003).

Prudential borrowing is intended to reverse this. However, borrowing still counts as public expenditure and, not surprisingly, there are a number of key ways in which government continues to influence it.

1. Local authorities have to work within the professional code drawn up by the Chartered Institute of Public Finance and Accountancy (CIPFA). This sets out the way in which local authorities must come to a judgement about whether their spending plans are affordable and prudent, and their calculations need to look forward three financial years.
2. Every ingredient in each local authority's Housing Revenue Account, from which any borrowing is repaid, is now influenced by central government as you will see in the later sections of this block. So the extent of capital borrowing is restricted indirectly by the ability of the local authority to repay the borrowing (just like a home owner is restricted in how much they can borrow by how much the monthly repayments will be).
3. The government limits how much of the capital borrowing is 'supported', that is, eligible for subsidy on the repayments. It does this by an annual announcement of a **Supported Capital Expenditure** (SCE) level. This will, of course, influence the local authority's decisions about whether borrowing is 'affordable'.

Although the move towards prudential borrowing (which applies to other local authority capital projects as well) has been welcomed as allowing more local accountability for local decision-making, as you can see there is little risk that the Chancellor's overall budget provision for housing will be breached.

In addition to borrowing for its main programme, a local authority can bid for extra borrowing support for specified programmes, the largest of which is the ALMO, or Arms Length Management Organisation programme.

5. The Current Regime: Capital Receipts

Between 1979 and 2004, the use by councils of their capital receipts was increasingly controlled by government. Over two million homes have been sold under the Right to Buy in Great Britain, representing a huge, though uneven, influx of receipts for local authorities, totalling over £25 billion. During the 1980s, the proportion of these receipts which each local authority could re-use on its housing capital programme was increasingly restricted so that council spending would not breach overall public expenditure targets. Also, the value of any capital receipts which a local authority planned to spend was deducted by government from the amount they were permitted to borrow, so that overall spending was controlled.

From 1989, the government placed specific controls over a local authority's ability to spend capital receipts by restricting the proportions available for capital expenditure to 25% of the money received from the sale of council houses and 50% of the money received from the sale of housing land and other assets. (The remainder had to be used to pay off debts which had accumulated from past capital projects or set aside as a provision for future credit liabilities.)

Much more recently, the system for Scottish authorities, who traditionally had freedom to use 100% of capital receipts, was altered for a time to equate with that applying in England and Wales. That freedom has now been restored.

5.1 The capital receipts initiative

The Labour government elected in 1997 gave a manifesto commitment to release those capital receipts from the sale of council houses which had not been spent. However, since the distribution of unspent funds did not match the needs for housing investment (the areas which had sold most stock and, therefore, had the most receipts were those where the houses were more desirable and were in better condition, while the areas which had sold least/had least receipts had higher than average housing problems) it decided to 'redistribute' the funding through issuing **Supplementary Credit Approvals**, (SCAs).

The distribution method adopted was based two-thirds on housing need, and only one-third on the proportion of receipts generated by each authority. This meant redistribution: the government was redistributing the proceeds of sales from less needy to more needy boroughs.

£174 million was released in 1997/8 and £610 million in 1998/9. A further £3.6 billion was identified in the Comprehensive Spending Review (CSR) of 1998 for the 3 years 1999/2000–2001/2.

5.2 Capital receipts since 2004

The redistribution arrangements used in the Capital Receipts Initiative became part of the new capital funding arrangements introduced in April 2004, together with prudential borrowing. The government has spelt out that, in its view, council housing is a national resource (at least in England) and that government is entitled to 'harvest' funds from more affluent local authorities with fewer housing needs to finance poorer authorities with greater need.

Under the new arrangements, in England, local authorities have to pay over part of their receipts to a central 'pool' for redistribution. The amount they have to pay varies depending on the source: 75% of receipts from the Right to Buy has to be paid over, and 50% of land sales, but there is some discretion for this to be waived, if used for regeneration projects, for example.

In Scotland, there is no pooling and now capital receipts are left with the local authority which generated them to reuse as they see fit. And in Wales, the situation is similar, although where a local authority has debt, it is expected to use up to 75% of receipts to help repay this.

6. The Current Regime: Revenue Income

As you learned earlier, local authorities may use revenue income to add to their ability to undertake capital projects. This is known as a **Revenue Contribution to Capital Outlays** (RCCO) or **Capital From Current Revenue** (CFCR) in Scotland.

RCCOs used to amount to a relatively minor source of capital finance. Any revenue used in this way had be financed from tenants' rents, as there was no government subsidy to support it.

However, under new revenue financing arrangements introduced for local authorities, which we discuss next in this block, a revenue subsidy called the **Major Repairs Allowance** was introduced by government in 2001 which is intended to be used on capital projects, to keep council homes in good repair. In practice, this is now a larger and more important source of funds for the capital programme than borrowing.

7. The Current Regime: Cash Grants

Playing a minor but still important role in financing the capital programme are cash grants.

Some regeneration funding for special projects has been made in the form of cash grants, as well as Supplementary Credit Approvals – the Single Regeneration Budget, for example. And grants are still made for the provision of disabled facilities such as ramps and adaptations in residents' own homes.

Self Test 1

1. *Identify four ways that a local authority might fund capital expenditure.*

2. *With 'prudential borrowing', how does government continue to influence how much councils borrow for their housing capital programmes?*

3. *What is the purpose of a national 'pooling' of housing capital receipts?*

4. *Why has revenue income become more important as a source of capital funding?*

Now turn to the Answers at the end of the Block.

B. Investment Policy and Housing Strategy

In this part of the Block, we pull back from the mechanics of how capital finance works to look at the larger policy context. What are the government's overall objectives that have led it to establish the current regime? The most important of these is the introduction of the **Decent Homes Standard**. Government intends that all council homes should reach this standard within a prescribed timescale, and has offered four routes, or options, to achieve this:

- traditional funding (discussed above);
- stock transfer;
- Arms Length Management Organisations, or ALMOs; and
- the Private Finance Initiative (PFI).

This part of the Block will look at these, and at local Housing Strategies.

1. The Decent Homes Standard

We saw earlier in the Block that government investment in housing was enormously reduced over the two decades after 1979. It is now generally accepted that a major consequence was a lack of investment in existing council housing to keep it in a good state of repair and with reasonably modern facilities. Remember, too, that the Right to Buy tended to be used for properties in better condition, and for houses, which are easier to maintain than flats. The consequence of both these factors was that, by the end of the century, much remaining council stock was in poor condition. In 1998, the Chartered Institute of Housing undertook its own investigation (published as *Council Housing – Financing the Future* (1998) by G Moody) which estimated that there was a backlog of maintenance and improvement work which would cost in the order of £22 billion to put right.

In 2000, government decided to tackle this by establishing a new standard for social housing in England – the Decent Homes Standard; a timetable to achieve this; and a set of options as to how it could be paid for.

The Decent Homes Standard sets out a standard that every socially-owned home should reach. There are four elements to the Standard: each home should:

- *meet the 'fitness' standard*, the current statutory minimum (free from damp, having basic amenities etc.);
- *be in a reasonable state of repair* (all key building components in an adequate state, and with no more than two other components needing replacement or repair);
- *have reasonably modern facilities and services* (maximum ages are set for bathrooms and kitchens, and both they and other amenities need to be adequately located: a home must lack at least three of these indicators to breach the Decent Homes Standard);
- *provide a reasonable level of thermal comfort* (cost effective heating and insulation).

The Decent Homes Standard applies in England. Scotland and Wales have established their own standards, called the **Scottish Housing Quality Standard** and the **Welsh Housing Quality Standard** which, if anything, go beyond the English standard.

The timetable set in 2000 in England was that every socially-owned dwelling should reach the standard over the next 10 years, that is by 2010. In Scotland the target is 2015 and in Wales 2012.

The implication of setting such a standard is that investment funding will be made available to pay for the work that is necessary. In introducing the Decent Homes Standard, government did in fact commit itself to increasing direct, conventional housing investment. But it also set out a number of other ways in which local authorities could find the finance to achieve the Decent Homes Standard. And as part of the same exercise, it required all local authorities to undertake an 'Options Appraisal' to review all the different 'routes' to achieving the Decent Homes Standard and to choose the option or combination of options which suited the particular circumstances of that local authority best.

2. The Options: Stock Transfer, ALMOs and PFI

The four options open to councils, in England at least, are

- traditional funding;
- stock transfer;
- Arms Length Management Organisations (ALMOs); and
- Private Finance Initiative (PFI).

The increased investment available as traditional funding (higher credit approvals for capital investment and more subsidy for revenue investment) is still, for many local authorities, insufficient to bring their stock up to standard within the timescale. Some have chosen to transfer all their stock to housing associations, while others have chosen to combine options: the London Borough of Islington, for example, has transferred some stock, set up a PFI and created an ALMO for the rest.

While there is strong support for the Decent Homes Standard, there has been considerable opposition from many local authorities, trade unions and tenants to the choice of options other than traditional funding. All the other options involve the transfer of the management and sometimes also the ownership, of council housing out of the control of local authorities, perceived by some as routes to privatisation. This has been resisted as a policy, most recently at the 2004 Labour Party Conference; and also borough by borough with the support of lobby groups such as Defend Council Housing.

In Scotland and Wales, stock transfer is the main alternative to traditional funding; ALMOs and PFI do not exist as choices in the same way.

We will now look at the options in turn to understand the implications of each in terms of housing finance and of policy. If you are interested in finding out more details about each option, you will find a good deal of information on the ODPM website, www.odpm.gov.uk, including up-to-date guidance for local authorities interested in pursuing each option.

2.1. Stock transfer

Stock transfer has a history that goes back to the mid-1980s, when some mainly rural councils in the South developed the idea of using existing legislation to transfer the whole of their housing stock to housing associations set up for the purpose (often called **Large Scale Voluntary Transfer**, or LSVT). The first successful transfer was from Chiltern District Council to Chiltern Hundreds HA in 1988. The reasons for transfer were various, but generally involved a combination of anxieties about the future of the stock and tenants in the light of reduced investment and the advent of new 'Tenants' Choice' legislation; and the very real prospect of gaining a substantial capital receipt from transfer.

The main financial features of stock transfer are:

- it is the transfer of council housing to a housing association or RSL;
- at a price calculated according to an agreed formula;
- which is low enough to allow the RSL to raise a conventional mortgage to pay for major repairs and improvements;
- which means the stock can achieve Decent Home Standard without additional public expenditure (housing association borrowing does not 'count' as public expenditure).

It is clear that the way the price is calculated is absolutely key. The calculation is known as a '**New Present Value**' calculation, and is familiar in the private rented sector where the buying and selling of tenanted property is the norm. It has no relation to the open market value of the stock, that is, the price it would reach if sold with vacant possession. In outline, the council assesses:

- what the rent income would be over the next 25/30 years, minus the projected cost of management and maintenance;
- this translates to what the stock is worth in today's terms, using a discount factor – its investment value;
- less the capital cost of bringing the stock into good repair.

to decide on the sale price.

The housing association can then obtain a mortgage from a building society for the investment value, and use part of the mortgage to pay the sale price and the remainder to invest in bringing the stock up to the Decent Homes Standard.

Activity 2

Southern Shires District Council owns 5,000 homes which are worth £20,000 each as their investment value today. They are estimated to need an average of £11,000 spending on each to bring them up to the Decent Homes Standard.

1. *What is the price for which the council would sell the stock to Southern Shires Housing Association ?*

2. *How large is the mortgage which Southern Shires HA would take out with a local building society?*

3. *How much can the HA then spend on repairs and improvements?*

Time allocation: 10 minutes

The answer to Question 1 is £9,000 x 5,000, or £45,000,000. This sale price - £9,000 per dwelling – may seem low, but it is actually higher than the average dwelling sale price for all stock transfer dwellings, £8,096 up to March 2003 (*UK Housing Review 2004/05*). Though low compared to the open market value of a vacant dwelling, the sale still represents a very substantial capital receipt for the local authority.

The answer to Question 2 is £20,000 x 5,000, or £100,000,000. After paying the council its capital receipt, the HA would then have £55,000,000 left to spend on repairs and improvements (Question 3).

It is clear why in investment terms governments since 1988 have been keen on stock transfer: it allows stock to be improved with no public funding. However, critics of stock transfer argue that if councils were free to raise mortgages on their own stock they could unlock its huge asset value themselves. For most councils, the restrictions on borrowing and new building since 1979 mean that their debt is low. They are in a comparable position to a home owner in a £100,000 house, with only a £20,000 mortgage, who needs to spend money on a new roof. The home owner can remortgage with their building society, borrow an extra £30,000, repair the roof and put in a new bathroom as well. The council are not allowed to do this, because their borrowing would count as public expenditure, but housing associations are treated as part of the private sector and can.

One key feature of stock transfer is that, as the ownership of their housing changes, tenants have to agree (on a simple majority) to the transfer. In becoming tenants of a housing association, council tenants become assured rather than secure tenants, with consequential changes to their rights and responsibilities. In about a third of all transfers, including the high profile case of Birmingham City Council, tenants have said no to transfer.

Although stock transfer has so far resulted in the sale of over 800,000 dwellings to housing associations, the rate at which transfer is taking place falls far short of government plans. In 2000, in the Housing Green Paper, a programme of up to 200,000 dwellings a year for England was set out. In no year since then has this target been achieved.

One reason for this is tenant opposition. Another is the different way in which the costs stack up, outside the small rural district council areas where stock transfer originated. In larger urban areas, where more of the dwellings may have been built using system building, or be high-rise, with higher levels of expenditure needed to bring them into good repair, the sums look rather different. In many areas, councils have to face the prospect not of a capital receipt, but of paying the housing association a 'dowry' so that they will have enough funding to carry out the improvements. They, in turn, have had to call on central government for help in paying for this.

2.2. Arms Length Management Organisations (ALMO)

The alternative option local authorities in England are likely to consider is an ALMO. ALMOs are quasi-independent management organisations, where the local authority retains the ownership of the stock and the tenants remain as secure tenants of the council. The ALMO is something like a wholly-owned subsidiary of the council.

Of course, as it is owned by the council, the spending and borrowing of an ALMO is currently governed by the same public expenditure rules as if it were the council itself. There is not then the same advantage to government in public expenditure terms as there is with stock transfer. However, government has thought it worth while encouraging councils to apply for ALMO status by offering substantial extra funds (by subsidising extra debt repayments) for those that succeed: enough (it is intended) to achieve the Decent Homes Standard for their stock.

To be awarded the extra funds, a local authority's housing service needs to be awarded at least two stars by the Housing Inspectorate in a Best Value inspection, and to be improving its standards: so the extra funding is an added inducement for services to improve. There is a formal contract between the ALMO and the council specifying their respective roles, with the council generally responsible for making policy in respect of council tenants and the ALMO implementing it.

Activity 3

List 10 functions of a local authority housing department. Then identify which would be the responsibility of an ALMO and which the council, where an ALMO had been set up.

Time allocation: 15 minutes

The kind of activities which would be the responsibility of an ALMO would be the day-to-day management activities of a landlord: recording rent payments, chasing rent arrears, reporting and organising repairs, dealing with neighbour disputes, arranging viewings and sign-ups. The council would remain responsible for the housing strategy, policy on lettings and tenancy conditions, antisocial behaviour, etc. The council would also remain responsible for all housing services other than those to council tenants, e.g. homelessness, renovation grants to owner-occupiers: remember, the ALMO only deals with council stock.

In practice, of course, there is dialogue: a change to lettings policy, for example, would not be made by a council without consulting those who would have to implement it.

At present it is not entirely clear why government has been prepared to offer such substantial inducements to set up ALMOs. It is true that there are arguments in favour of making a clear distinction between a council's landlord role and its strategic housing role, allowing the council to develop its enabling and strategic role without having to deal with bread and butter housing management issues. This is consistent with the theories of management supported by both Conservative and Labour governments over the last two decades that councils should be directing resources rather than providing services themselves (like rubbish disposal, for example). But it is still the case that, at present, funding ALMOs creates extra public expenditure while retaining council housing as a public asset.

There is some evidence that government is considering giving ALMOs more powers and developing their role. Even as they are currently constituted, however, they have met with opposition in some areas. Although the setting up of an ALMO does not require a tenant vote, some local authorities have instituted a ballot, and some have been opposed by tenants concerned that the ALMO is a first step towards privatisation. One suspicion is that government might think it will be easier to secure tenant agreement to stock transfer in the future if the stock is already managed by an ALMO: the ALMO could become a housing association and tenants would already be familiar with the organisation and its staff. The future of ALMOs is a developing topic and likely to increase its importance over the next few years.

There are about as many council dwellings managed by ALMOs in England as have transferred under stock transfer – 740,000 in April 2005.

2.3 Private Finance Initiative

The last option is a **Private Finance Initiative** scheme. Although government remains enthusiastic about introducing PFI for improving and providing socially owned homes, the few pilot projects it has run have taken a long time to prepare and appear to be very complex to introduce.

You may be more familiar with the use of PFI to construct and manage hospitals, schools and roads, and, as a financing mechanism, it has been around since the early 1990s.

In financial terms, PFI involves a contract between a private sector provider and a public sector service, in which:

- the private sector provider borrows and spends the money needed for a capital-intensive project (builds the hospital, the roads, brings the housing estate up to the Decent Homes Standard);
- in exchange for a long term contract (30 years), under the terms of which the private sector provider manages the capital asset and is paid for this, PLUS the necessary repayments on the money it borrowed in the first place.

Supporters of PFI claim that:

- by using this device, public sector assets can be created now which we would have to wait much longer for if the public sector had to borrow the money, as the cost in public expenditure terms would be prohibitive;
- this is the only way to compensate quickly for the under-investment in public services of the last two decades.

Opponents of PFI claim that:

- we are ‘mortgaging our future’, that is, instituting the obligation for massive debt repayments stretching forward 30 years at least;
- public services should generally be managed by a public sector, not private sector, workforce.

The complexity of the scheme lies in the contract. It needs to specify all aspects of the service provided and paid for, for a long time to come. Ultimately, it may be this complexity which restricts the development of PFI for housing schemes.

2.4 The options appraisal process

All local authorities in England, Scotland and Wales have had to go through the options appraisal process, and to have determined an overall strategy for achieving the Decent Homes Standard: in Wales by 2004, in Scotland by April 2005 and in England by July 2005. These deadlines were set because, although some councils were well ahead with their planning, or had already completed their proposed course of action by setting up an ALMO or carrying through a stock transfer, others were not so advanced, and the administrations of all three countries were becoming anxious about the timescale for achieving the agreed targets.

You may find it interesting to find out from your own local authority website, or housing offices, what conclusions were reached and what action has been taken. Was your local authority one which has only just undertaken its Options Appraisal, or did it institute its strategy some time ago?

3. Local Authority Housing Strategies

Ever since the introduction of the Housing Investment Programme system in 1979, local authorities have been obliged to produce Housing Strategy Statements. For most of that time, the strategy statement was written in support of the annual bid for borrowing approval, and much of its focus has been on capital investment in each council's own stock.

Since the late 1980s, councils have been encouraged to take a more strategic responsibility for all the housing stock within their borough, and to develop their role as 'enablers' – making sure housing needs were met, even if this was not directly by them. For England, government set out its priorities in 2000, suggesting that local authorities should develop 'a stronger strategic role in housing, meeting needs across all types of housing and integrating housing policy with wider social, economic and environmental policies' (*The Way Forward for Housing* (2000)).

Under current arrangements, all local authorities in England, Wales and Scotland are required to produce a housing strategy, although the precise brief for, and frequency of this varies. Even if a local authority has transferred all its stock to a housing association, it retains its strategic responsibility for housing locally. The key areas which the Housing Strategy needs to address are:

- an analysis of housing markets across all sectors;
- the condition of housing stock across all sectors;
- the role of housing in community cohesion, and needs of particular sections of the community;

- the wider issues of relevance to housing (e.g. HB, Neighbourhood Renewal);
- the relationship between housing and other strategies e.g. a Community Strategy, Regeneration Strategy;
- working in partnership with other stakeholders e.g. tenants associations, RSLs.

The Housing Strategy also needs to explain why specific options for action have been chosen, set timescales, and establish ways in which the local authority's success or otherwise in meeting its targets will be measured.

If the Strategy Statement is judged 'fit for purpose', it will only need to be prepared in full every three years, with an annual update (in England). In Wales and Scotland, strategies are prepared on a five-year cycle. You will find your own local authority's Housing Strategy in the public library, or on the council website.

4. Regional Housing Boards

The final change introduced in 2004 in England was the development of the role of Regional Housing Boards in determining capital allocations.

The Regional Housing Board consists of representatives of the Government Office for the Region:

- Housing Corporation
- Regional Development Agency
- Regional Assembly
- Regional Housing Forum
- English Partnerships

They are something of a stop-gap measure: it is intended that as Regional Assemblies develop, these will take over their responsibilities.

The responsibilities of the Board are to develop a regional housing strategy, and advise ODPM on the way allocations are made to support housing capital expenditure in the region in the following financial year. The regional housing strategy builds on those produced by local authorities within the region. One important feature of the regional strategy is that it brings together planning for RSL investment and local authority spending on capital projects, for the first time. With only one annual cycle complete, it is too early to judge the effectiveness of these new arrangements.

Self Test 2

1. *What are the four general requirements of the Decent Homes Standard, and by when should all social homes meet it?*

2. *Whose responsibility is it to undertake an Options Appraisal, and what options must it consider?*

3. *Why is government particularly keen on stock transfer as a way of ensuring social homes are brought up to the Decent Homes Standard?*

4. *Which local authorities are required to draw up Housing Strategies, and why?*

Now turn to the Answers at the end of the Block.

C. Revenue Finance

1. Introduction

You will recall that revenue expenditure is day-to-day spending. For example, spending on salaries and wages, office costs, transport expenditure, or small items of equipment, are all revenue spending.

It must be matched, over the financial year, by income. If necessary, look back to Block HFFS.102 to remind yourself of the difference between capital and revenue spending.

We also discussed earlier one way in which these categories can sometimes overlap. For example, some maintenance work may be small, regular items of work that should be treated as revenue expenses; other maintenance work can enhance the life or quality of a house and may, therefore, be treated as capital spending. This is a grey area, and different housing organisations have different practices in dealing with it.

2. Paying for Housing Revenue Services

Housing revenue services are paid for out of two different accounts. These are:

The **Housing Revenue Account,** which pays for all services to council tenants and their homes: this will include management and maintenance costs, rent and subsidy income, and the costs of paying back the capital finance borrowed in previous years. Every local authority which owns housing is obliged by law to maintain this separate account of the revenue income and expenditure which relates to it.

The **General Fund,** which pays for all housing services for the general public, for instance homelessness support, housing advice, housing benefit for private tenants. The General Fund is financed in four main ways: the average proportions of each in England is shown in brackets to indicate their relative importance

- Council tax (20%)
- Business rates (25%)
- Grants from government (45 – 50%)
- Fees and charges (5 – 10%)

Before 1990, councils had a good deal of freedom to vire, or switch, money between these accounts, but this is no longer the case. The last 25 years have seen a series of changes to the rules governing the Housing Revenue Account, each of which has tended to restrict the freedom of action of the council and increase the influence of government. As you will see, local councils now have very little freedom of action in respect of their housing stock revenue expenditure and income.

3. General Features of the Housing Revenue Account (HRA)

The current arrangements for the HRA were, in the main, instituted in 2001/02, but grew out of previous legislation in 1980 and 1989 and still include some of those earlier features. These earlier features which are still present are:

- the HRA accounts for *income and expenditure* on all *housing owned* by the local authority;
- the HRA should *balance*, although there is some power to carry deficits and surpluses forward to the next financial year;
- government subsidy is calculated on the basis of what government thinks the local authority should be spending on management and maintenance, and receiving in rent, not the actual figures. This is called *the 'notional' HRA* and it has proved a useful tool for central government in reducing subsidy and thereby raising council rents since it was introduced in 1980;
- the HRA is *ring-fenced,* that is, it cannot be subsidised by the General Fund. This policy was introduced in 1989 to stop councils using the rates (now council tax) to keep rents lower.

The government's aim in 1989 was that Housing Revenue Accounts should be structured like the trading account of a private landlord, in order to help councils to become more businesslike and efficient. Between 1989 and 2001, the key elements in the HRA were:

Expenditure

(i) loan charges, or the cost of repaying the money borrowed to pay for capital spending.

(ii) *Management costs*. The running costs of paying employees, including their national insurance, superannuation and transport allowances, keeping offices open, training, and so on.

(iii) *Maintenance and repair costs.*

(iv) *'Revenue contribution to capital outlays' (RCCO)/Capital from current revenue (CFCR):* If the local authority has decided that it does not have enough capital resources to fund all the projects it wants to, it may decide to pay for some of them out of revenue, as you discovered earlier in this Block.

Income

(i) *Rents and charges to tenants.*

(ii) *Housing Revenue Account subsidy (Housing Support Grant in Scotland).*

This is an annual payment from the government to the local authority and is supposed to cover the difference between "notional rent" and "notional expenditure". We examine this shortly. Because of the rules by which the government now calculates subsidy, rent income has become relatively more important. A local authority's success in collecting its rent income is now very important in balancing the Housing Revenue Account.

Although many of these ingredients have remained, major changes was introduced to the HRA in 2001/02 in England and Wales, under the general name of 'resource accounting', or the 'New Financial Framework'. As in 1989, the intention was to enable local authorities to take better and more businesslike decisions, in particular about the management of their capital assets.

4. Resource Accounting

Resource accounting is a method of keeping accounts which is being applied generally within the public sector and government: it is also used, for instance, in the health sector, and in other parts of council activity. Government's thinking is that as public sector organisations own substantial assets (hospitals, schools, homes, land) their accounts should be kept in such a way that reflects the value of those assets, to encourage their public sector owners to make better use of them, including investment to keep them in good repair.

If we look at the HRA elements set out above, we can see that they reflect the historic cost of providing a dwelling (the loan charges from the original building costs, perhaps 20 or 30 years ago), rather than its current value. In the government's view, this leads to poor decision-making about the use of assets. To take an example, a council car park in the middle of town which appears to make a profit under the old accounting system (because the original cost of buying the land has long been repaid) might make a loss under resource accounting. Resource accounting would identify the value of the site, underlining the fact that the council has a valuable asset there tying up capital, and would require the council to make the same sort of return on that capital as if it were invested instead.

Under this new financial framework, two new elements were introduced to the HRA. The first of these is the 'cost of capital', that is, the expected rate of return which the council should make on the value of its housing stock. To arrive at this figure, every local authority has had to value its housing stock; and the return is currently calculated at 3.5% of this figure per annum. This equates to the investment income which the council is foregoing in order to provide council housing.

The 'cost of capital' figure is entered on the expenditure side of the balance sheet, in the place of the loan charges. One way to understand its role is to think of it as a sum out of which the council continues to pay loan charges, but the rest of which the local authority has to pay to government; and as council borrowing continues to decrease, and loan charges reduce over time, more and more of this sum will be paid to government.

The other new element introduced to the HRA is a new subsidy, called the **Major Repairs Allowance**. This is a sum per dwelling which government estimates is sufficient to keep a dwelling already at the Decent Homes Standard in good repair – originally set on average at around £500 per annum.

So the new HRA looks like this:

Expenditure

- Cost of capital (3.5% of stock value)
- Management costs
- Day-to-day maintenance costs
- revenue contribution to capital outlay, with a payment equivalent to the Major Repairs Allowance to a Major Repairs Fund

Income

- Rents and charges
- Housing Subsidy, including the Major Repairs Allowance

On the face of it, this looks like a balanced outcome - new payment to government, new subsidy from government - but when looked at over time it takes on a different aspect.

The larger picture is that over the previous 20 years, from 1980, housing subsidy in the housing revenue account has been steadily reduced year on year, with the general consequence that council rents have had to rise faster than inflation to make up the shortfall. Council rents aggregated now more than pay for the costs of managing and maintaining council housing and the costs of loan repayments. The way that subsidy is calculated, as explained below, allows government to progressively turn off the subsidy 'tap'.

Many local authorities are now getting very little or no subsidy at all towards the costs of providing their council housing. It used to be the case that once there was no more subsidy being paid - the tap was fully turned off - the council was free to make its own spending and income decisions. But under resource accounting, each local authority now has to pay 3.5% of the value of its stock over to government each year.

Some councils and their representative bodies have described this as a 'tax' on council housing. The government defends the policy on the grounds that public subsidy paid in part for the housing in the first place and that is it right for rent surpluses to be paid back into a national fund for redistribution.

5. How Subsidy Is Calculated

The government has a complex method of judging how much subsidy each council should get. This means that the amount of Housing Revenue Account Subsidy/Housing Support Grant can vary between local authorities, and can vary relative to each local authority's spending.

The government starts with its concept of a notional, or ideal, housing revenue account for each local authority. This sets down a notional income and notional expenditure into the Housing Revenue Account. The level of subsidy is set to cover the difference between these 'notional' amounts.

The main features of the calculations are:

(a) Notional rent

Since the idea of a 'notional' HRA was introduced to calculate subsidy in 1980, the subsidy calculation has included as income the amount which government thought should be charged - the notional rent - rather than the actual rent. In 2002, as described in the last part of this block, a new system of rent restructuring was introduced which calculates rent using a formula. In time, when it is fully introduced - by 2012 - this formula rent will replace the notional rent in the subsidy calculated. At present, an interim figure is used.

- *Arrears*

  The government assumes that all the rent is gathered; there is no allowance for arrears. If the council's tenants have arrears, then the rents of the other tenants will have to cover the sum of money involved.

- *Empty property*

  The government allows the local authority to have 2% of its property empty (void) over the year. If the authority has a higher voids level, then rents of existing tenants will have to cover the rents that would have been paid on those extra void properties.

(b) Notional expenditure

The government also calculates an allowance for notional management and maintenance costs, taking into account the difficulty each class of council (London borough, metropolitan district, non-metropolitan district) is likely to have in managing its properties and reflecting to some degree the different types of dwelling in each area.

Since the inception of this notional system of calculating subsidy in 1980, government has consistently presumed that notional rents will rise faster than management and maintenance costs, and reduced subsidy accordingly. You will note it has not prescribed that rents must go up or costs down: but local authority landlords have had to take and implement such decisions to make the HRA balance year on year.

The introduction of the Major Repairs Allowance as an additional subsidy looks like a reversal of this policy. In fact, this is being funded for the most part by a significant reduction in borrowing, which is less necessary with this new contribution to financing the capital programme.

.

Remember that the changes to the Housing Revenue Account which we have just described apply to England and Wales only. In Scotland, government subsidy to councils is in the form of Housing Support Grant, but many Scottish local authorities no longer receive subsidy.

.

Self Test 3

1. *What are the two revenue accounts for local authorities' housing services?*

2. *Identify the differences between them.*

3. *What is meant by "ring fencing"?*

4. *What were the two new ingredients of the HRA introduced by resource accounting?*

Now turn to the Answers at the end of the Block

D. Rent Setting and Rent Restructuring

1. Introduction and History

Until 2002, housing organisations, whether housing associations or local authority housing departments, set their rents in the wider context of government expectations about how much rent they needed to collect.

- Local authority housing departments needed to set their rents in order to get enough rent income in total to balance the spending from their housing revenue accounts.
- Similarly, as you will learn in the next Block, housing associations needed to set rents to raise sufficient revenue to balance their property revenue accounts.

While one preoccupation was to collect enough rent in total to meet their obligations, housing organizations also needed to think about how rents should differ between different properties in different locations. These are called rent setting systems, and there were a number of different schemes which were used by housing organisations. The features they looked for were that the scheme should be:

(i) *Easy to implement*. Many intricate schemes have to be altered or abandoned because they cost too much to administer.

(ii) *Flexible*. Some schemes are easier to alter in part without redoing the whole scheme. This is important when overall housing finance arrangements are constantly being changed by government.

(iii) *Cost effective*. The simpler the scheme, the cheaper.

(iv) *Equitable*. Tenants live in different sorts, ages, and conditions of property, and in different areas. Rents should be fairly calculated between them.

If you think carefully about these characteristics, you can see that it is difficult to think of a rent setting scheme which would score highly on all four factors. The choice of a scheme might be a balancing exercise between them.

A new rent restructuring regime described below has now been introduced in England. However, housing organisations have a 10 year period to implement it, and it is useful to consider some of the features of their original schemes. These are, of course, all options which private landlords could still use, together with social landlords in Wales and Scotland.

2. Rent Setting systems

There are broadly four methods of rent setting:

2.1 Gross values (mainly used by local authorities)

This is calculated using the following formula:

$$\text{Rent} = \frac{\text{Rent income required x Gross value of the property}}{\text{Total gross value of all property}}$$

Gross value is the district valuer's estimate of 'the rent at which the property could be let if the landlord paid for repairs, insurance and maintenance', and assuming there is no shortage of housing. It was the basis for assessing liability for rates.

The actual rent is then calculated simply by working out what the organisation needs to raise from the housing stock as a whole, then the share for each property, taking its value into account.

One major disadvantage of this system is that gross values are now very out of date and bear little relation to rent levels.

2.2 Capital values (mainly used by local authorities)

The formula for this calculation is as follows:

$$\text{Rent} = \frac{\text{Value of a property x total rent required}}{\text{Total capital value of all property}}$$

There are two types of capital valuation:

(a) *Current capital value*

This is based on an estimate of the current capital value of the property: that is, the amount it could be sold for at the time of valuation.

(b) *Inferred capital value*

The value of the property can be inferred from the valuations of similar properties sold under the right to buy legislation.

The advantages are:

- The scheme is sensitive to movements in the local housing market and can ensure that higher rents are charged in areas of high demand.
- It helps to tackle under-occupation of properties in popular areas, because rents will be higher.

The disadvantages are:

- Constant revaluation is expensive, but essential if valuations are not to become out-of-date.
- Tenants with similar properties in different areas may be charged very different rents.
- There is no clear recognition of the value put on particular amenities or improvements.
- It is not easy for tenants to understand.

2.3 Comparability systems: points systems (both local authorities and housing associations)

The formula used is:

$$\text{Rent} = \frac{\text{Points for property x total rent required}}{\text{Total points value of all properties}}$$

These schemes set rents by putting a value on set criteria for each property, based on its tangible attributes and its location. These values are then used to set a rent in relation to all the other properties owned by the organisation. The attributes might be its age, size, room size, heating system, dwelling type, insulation, garage, condition, popularity, location and so on, each attracting a different number of points.

The main difference between such schemes are the numbers and choice of attributes and the relative weighting given to them.

The advantages are:

- They are flexible; attributes can be changed or weighted differently without causing great swings in individual rents. Changes can be ‘damped’, or introduced gradually.
- Tenants can compare rents easily.

The disadvantages are:

- They are expensive to start up because all properties have to be accurately assessed for all their attributes. Schemes are sometimes introduced using only attributes which are already known to the housing organisation – but they may not be the attributes which are most important to the tenant.
- The schemes depend on good quality information on each property being kept up-to-date.
- They can produce very large differentials between the best and the worst properties.

2.4 Comparability systems: formula systems

These schemes combine some form of valuation of the property with a variation calculated on the basis of the relative value of its attributes.

They are worked out by a two-stage calculation:

(a) $\text{Average rent} = \dfrac{\text{total rent required}}{\text{total stock}}$

(b) Rent = Average rent + total attribute adjustments

For example, the base (average) rent might be calculated on total floor space, or on gross values (see 2.1) or capital values (see 2.2). Amounts are then added or subtracted for positive or negative attributes.

The advantages are:

- The required amount of variation between rents can be built in from the start of the calculation.
- Affordability issues can be built in.
- Flexibility: the choice and weighting of attributes can be varied.

The disadvantages are:

- The formula is more difficult to explain to tenants than a points system.
- The weight given to attributes is not clear to tenants.
- The schemes depend on constant revaluation plus high quality information on the attributes of each property.

3. Rent Restructuring: Calculation

At the time of the Housing Green Paper in 2000, government expressed concern about the inconsistencies in rent levels in England between RSLs and local authorities generally, between different social landlords in the same area, and between homes of different sizes. In considering what should be done about this, the government's stated aims were:

- to keep rents 'affordable';
- to make rents simpler to understand;
- to establish a closer link between rent levels and the qualities tenants value in their home;
- to provide more opportunities for tenants to exercise choice;
- to reduce differentials between rents of similar properties owned by different social landlords: "the aim is that social housing rents on similar houses in the same area should be the same, no matter who is the landlord" (*ODPM Consultation Paper 2001*).

The Green Paper rehearsed a number of different rent setting schemes which could be used across the whole country. Its reasoning was that if all social landlords used the same formula to calculate the rent, the rent outcomes would be the same for similar properties. These different alternatives included the rent setting systems outlined above; but in addition to the disadvantages already discussed, should be added the difficulty of introducing a scheme country-wide, which would work equally well in areas of high and low demand without creating large differentials in rent levels in different parts of the country. You can find a discussion of the full range of options in the Green Paper (*Quality and Choice 2000*) on the ODPM website.

The option which has been implemented is a formula based:

30% on capital values (reflecting the size, desirability and location of the dwelling), and

70% on regional earnings (reflecting affordability, with a weighting for the number of bedrooms).

The key figures to use in calculating a formula rent were set in 2002 at

- national average LA rent £45.60
- national average RSL rent £53.50
- national average LA home value £41,350
- national average RSL home value £49,750
- national average earnings £316.40 pw

Example

3 bed LA property in Gloucestershire, worth £60,000

Step 1

30% of average sector rent				
30% x £45.60	=	£13.68		
multiplied by local value		£60,000		
divided by average value		£41,350	=	£19.85

Step 2

70% of average sector rent				
70% x £45.60	=	£31.92		
multiplied by county earnings		£308.00		
divided by average earnings		£316.40		
	=	£31.07		
multiplied by bedroom weighting		1.05	=	£32.63

Step 3

Add them together			=	£52.48

Activity 4

Calculate the formula rent for a 2-bed RSL flat in a London borough, worth £100,000. The London earnings figure is £358.10 and the bedroom weighting is 1.00.

Time allocation: 15 minutes

Step 1 should have produced a figure of £32.26 (remember to use the figure for RSL average rent and value). Step 2 should have produced a figure of £42.39, giving an overall total of £74.65.

You can see that using the formula means that rents in higher value, higher earning parts of the country are higher than in lower value, lower earning parts, but the discrepancy is nothing like as great as if capital values alone, for example, were used. You can also see that social landlords working in the same area would come up with much the same rents for similar properties, one aim of the exercise.

4. Rent Restructuring: Implementation

The goal is to achieve rent restructuring over the 10 years from April 2002 to March 2012. Every social landlord - RSL and local authority - should have assessed a formula rent for each dwelling in April 2002, that is, the rent that each property should reach by 2012 (ignoring inflation). The actual rent charged should move towards the formula rent in increments of one-tenth of the gap the first year, one-ninth the second, and so on. Of course, inflation in practice makes the sums more complicated: the formula rent has to be updated each year in line with cost of living increases.

There is some fine-tuning of the general formula. There is ‘damping’ of changes to protect tenants facing very high increases, even if this means the formula rent will take longer than 10 years to reach. Social landlords will retain the discretion to vary the formula by 5% to reflect local circumstances. At the end of the period, ODPM expects RSL rents still to exceed LA rents because their properties are generally newer. In addition, because of the distorting effect of very high property prices in the South East, an overall ‘rent cap’ has been introduced there.

Implementation has not been without its critics. Some housing providers, in some parts of the country, have had to face substantial rent reductions overall, which has created problems in terms of cash flow and business planning. Others, for instance some BME RSLs working in inner city areas, have faced the equally unwelcome prospect of rent rises for most tenants. Overall, government maintains that around half of all tenants will face rent rises and half rent reductions: this is not a rent raising exercise.

However, the most important and surprising feature of the introduction of rent restructuring does not lie in the detail. It is that it was introduced at all: that social housing providers have given up the responsibility for rent setting to government with so little objection.

Summary

1. There are two accounts from which housing services are provided by local councils:
   (a) The Housing Revenue Account (HRA) paying for services to council tenants.
   (b) The General Fund Account, the council's main revenue account.
2. The HRA was put on a resource accounting basis in 2001/2002.
3. Subsidies from the government are the Housing Revenue Account Subsidy/Housing Support Grant.
4. The Housing Revenue Account Subsidy is calculated as a proportion of a notional Housing Revenue Account, produced by government, and based on calculations of rents which the government thinks the council should be collecting.
5. Proportions of revenue income from rents and subsidy vary from one authority to another because of:
   (a) the way the government calculates the notional Housing Revenue Account for each council;
   (b) how much extra spending a council makes.
6. General Fund Account spending can vary from council to council according to the perceived housing needs of an area.
7. The main sources of income for the General Fund Account are the Revenue Support Grant, the Council Tax, and the Uniform Business Rate.
8. There are four main methods of rent setting:
   (a) based on gross values;
   (b) based on capital values;
   (c) comparability systems - point systems;
   (d) comparability systems - formula systems;
9. Rent restructuring was introduced in England in 2002, with a new calculation for assessing a formula rent dependent 30% on capital values, 70% on local earnings. Formula rents should be reached by 2012.

Answers

Self Test 1

1. Local authorities may pay for spending by:
   (a) borrowing;
   (b) using capital receipts, i.e. proceeds of council house sales;
   (c) using revenue income;
   (d) government grants.
2. By controlling the elements of their revenue budgets; by limiting how much spending is subsidised; by requiring councils to follow a prudential code of practice.
3. So that government can redistribute resources to the local authorities where the housing need is greatest.
4. Because of the introduction of a substantial extra revenue subsidy in the Major Repairs Allowance.

Self Test 2

1. All social homes should, by 2010 (England):
   - meet the fitness standard;
   - be in a reasonable state of repair.