The financial environment for local authorities

*The **Governor** reviews progress since the introduction of the medium-term financial strategy in 1980.*[1] *Although the detail of the strategy has been modified—and its objectives not always achieved— inflation has fallen faster than almost anyone predicted and the economy is looking more healthy than for some time. The PSBR has been substantially reduced; but to achieve balanced, sustainable growth, the long-running tide of increasing public spending will have to be arrested.*

*The **Governor** draws four implications for public spending, with particular reference to local authorities:*

- *restraint in all parts of the public sector will be necessary;*
- *it is not clear that the right balance between capital and current spending has been achieved;*
- *accurate and speedy information is needed on public sector spending and receipts;*
- *local authorities must remember that the rate burden is substantial for many businesses, and it is a burden over which they have little control.*

The local authorities' borrowing requirements have been greatly reduced in the last two years and there has also been a marked shift in the sources of their borrowing, away from the banking system and towards the Public Works Loan Board. These changes, which have been promoted by government, have cut local authorities' borrowing costs and at the same time helped the operation of monetary policy.

Recent economic policy

The main objectives of government economic policy over the last four and a half years have been constant: these are to reduce the rate of inflation and to secure a lasting improvement in the performance of the UK economy, so providing the foundation for sustainable growth in output and employment. The need to curb inflationary expectations has been—and continues to be—vital. The uncertainty caused by high and variable inflation discourages long-term investment by both the public and private sectors. If this uncertainty is not greatly reduced, we shall not have lasting prosperity.

The strategy for curbing inflationary expectations has also remained constant. The medium-term financial strategy was introduced in March 1980 and it has subsequently set out each year the monetary targets which seemed appropriate for the maintenance of downward pressure on inflation. It has also set out the way in which the Government intends to operate fiscal policy so as to reduce public sector borrowing as a proportion of the nation's gross domestic product. The figures in the medium-term financial strategy have not remained engraved in stone from year to year: indeed, in the operation of monetary policy we now consider, and set targets for, a variety of aggregates, whereas there was initially an objective for only one such aggregate. Nor have the objectives always been achieved. But the thrust of policy from year to year has been the same; and as the Chancellor said a month ago in his Mansion House speech, the medium-term financial strategy is 'alive and well'.

Much has been achieved in this three and a half years. In particular, inflation has fallen faster than almost anyone had predicted. This success was somewhat overstated by the retail price index earlier this year, when the year-on-year rate of increase fell to under 4%, influenced by a number of erratically favourable factors; and by September, the annual rate of price increase had returned to 5%.

A better indication of the underlying trend is provided by the output prices of manufacturing industry, which have been rising, year-on-year, by about $5\frac{1}{2}$% for much of 1983. A similar picture emerges from the wider, but less speedily available, statistics of the deflator for gross domestic product. The picture is even more encouraging if one looks at unit wage costs in manufacturing industry, which in the three months to August were only $1\frac{1}{2}$% higher than a year earlier. In short, price inflation is currently down to between 5% and $5\frac{1}{2}$%—only one third of the rate three years ago—and the longer-term outlook remains promising. But if we are to see the full benefits of the success to date, further progress is vital.

The UK economy is looking more healthy than for some time. Output has been growing and unemployment has come down in two of the last three months. Of course, the

(1) In a speech at the Conference of the Chartered Institute of Public Finance and Accountancy on 16 November 1983.

base from which growth began was painfully low. And, as yet, the recovery has been narrowly based: consumer spending has been buoyant, but many other elements of demand have been subdued. For growth to be sustained, the base of the recovery will have to be broadened. But many of the building blocks for that sustained progress have been laid. In particular, British industry is now better placed to compete in world markets, thanks to major and widespread advances in industrial productivity.

Demands of the public sector

Progress on what can be described as the intermediate targets of economic policy, such as the public sector borrowing requirement (PSBR) and monetary targets, is also broadly encouraging, but more remains to be done. Fiscal policy has brought down the PSBR as a percentage of GDP from $5\frac{3}{4}$% in 1980/81 to $3\frac{1}{4}$% in the last financial year, and this improvement should at the least be maintained in the current financial year. In comparison with the mid-1970s, when the PSBR approached 10% of GDP, progress seems formidable indeed. But the pressure for higher public spending is always present; and if the Government is to achieve its objective of cutting the PSBR to around 2% of GDP by 1985/86 without raising the burden of taxation, considerable restraint will continue to be necessary.

The money supply will also need to be kept under firm control. Here, a number of aggregates are of concern to us, and all are—or have been—affected by rapid structural and technological change: the bare figures must therefore be interpreted with some care. At present, the growth of the three aggregates for which targets were set at the time of the last Budget remains at or somewhat above the top end of their target range of 7%–11%. This is better than during the summer but leaves no room for complacency, not least because monetary control is not an exact science. Lord Beveridge once said that 'the state is or can be master of money. But in a free society it is master of very little else.' I might add that mastery, even in this one area, is far from simple nor without painful choices.

If downward pressure on inflationary expectations can be maintained, I would hope to see sustained economic growth, accompanied by significantly lower interest rates. You will, I hope, forgive me if I refrain from being more precise. The adage that 'forecasting is difficult, especially if it is about the future' is a true one; and, of course, many factors are outside the government's control. All that the government can do, in an economy as open as ours, is to plan on the basis of the most likely course of world activity and prices, standing ready to adjust its policies, as necessary, in the light of major unexpected developments. Nevertheless, much of the hardest work to improve this country's position has been completed, despite a world background that has not always been as stable or as helpful as we might have wished.

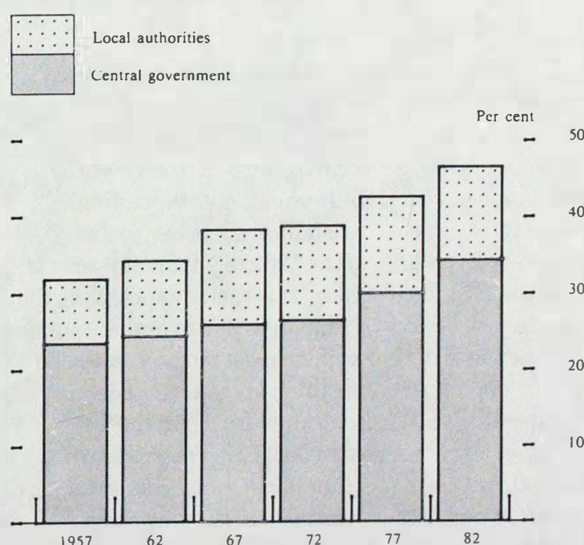
As economic activity recovers, it is important to leave room for the expansion of the wealth-producing private sector if we are to achieve balanced, sustainable growth. Public sector spending must be restrained, and that means arresting a tide that has run one way for a very long time.

To illustrate what I mean, let us look at the central and local government shares of GDP over the twenty-five years between 1957 and 1982. In that time their share of expenditure, calculated on the most conservative basis to include only purchases of goods and services, has risen from 20% to about 24%. On top of this, taxes have to be raised not only to pay for increased pension and other social benefits, which have more than doubled from 8% of GDP to 17%, but also to service the debt. The interest burden has risen slightly, with higher nominal interest rates more than offsetting a fall in the debt as a share of GDP.

Altogether in 1982, central and local government spent over 45% of GDP, against 32% in 1957. In these terms government spending has been increasing nearly twice as fast as GDP. In recent years, when the average rate of growth of GDP has been well under 1%, the disparity has been substantially greater than two to one, despite the Government's efforts to restrain public spending.

It is, of course, reasonable to note that the benefit element in public spending will have been raised in recent years as a result of the low level of activity in the economy, and that inflation has changed the relationship between the interest bill and the real cost of the national debt. These factors cannot, however, disguise the trend. It is also the case—as a statistical matter—that the way government output is measured in the national accounts may cast it in an unfavourable light. Much of the output of the government sector is measured simply by its inputs, so that gains in productivity are not taken into account. One does not ask 'what have teachers produced?' but rather 'how many teachers are there?'. For the private sector, in contrast, as for the public corporations producing for the market, an

Chart 1
Public sector share of GDP(a)



(a) Expenditure by central government and local authorities as a percentage of GDP at market prices. Figures for local authorities in 1982 would be reduced by 0.8% by treating council house sales as negative expenditure.

attempt is made to measure productivity gains, despite the problems involved in doing so.

I accept that public spending fulfills vital needs and that there are always areas in which a good case can be made for spending more. The Italian proverb—that public spending is like holy water because everyone helps themselves—is, however, not without an element of truth; and the Government—rightly in my view—has concluded that the public sector's claim for an ever growing share of national resources must be resisted.

It is not for me to say how the available money should be allocated between the competing demands for it. Nor do I wish to enter a detailed discussion of how the financial arrangements between central and local government should operate. The issues involved in such a discussion go far beyond those which naturally fall within the sphere of the central bank. It may, however, be appropriate for me to observe that a balance must be found between a worthwhile degree of local autonomy, without which local government is a sham, and sufficient cohesion for the public sector as a whole to operate in line with the Government's macroeconomic policies. There are, perhaps, four broad implications of all this for the future.

Implications of macroeconomic policy for local authorities

First, because the Government wants to see overall public spending fall as a percentage of GDP in the next few years, restraint in all parts of the public sector will be necessary. The need for restraint would be less, of course, if one made over-optimistic assumptions about the likely rate of economic growth in this period. Rapid growth is to be hoped for; but its benefits must be allocated after they have been earned, not before. Local authorities can reasonably ask, however, that central government should not impose additional responsibilities onto them unless the cost of these responsibilities is allowed for in the constraints within which they must work.

My second point is that all expenditures need to be reviewed. Up to now, capital spending has suffered most from restraint. In your own case, current expenditure has exceeded the relevant provision in the rate support grant settlements by between 6% and 8% in each of the last three financial years, while your capital spending, which is directly subject to cash limits, has increasingly undershot—by over 20% in the 1982/83 financial year. Up to a point, that is not surprising. It is easier to postpone the building of a new library or road than it is to find economies in the maintenance of those which exist already. It is also the case that capital spending often adds to subsequent current expenditure. Whatever the benefits to the community at large from a new local government project, they rarely do much to increase the income from rates and they often impose substantial new running costs. Nevertheless, it is important for our future to get the right balance between current and capital spending, and it is not clear that this has yet been achieved.

Third, it is important for the conduct of economic policy that accurate information about the revenue and expenditure positions for all parts of the public sector is available speedily, and that spending plans are adhered to. At present, the public sector has some way to go in this respect. For instance in the last two Budgets, the Chancellor of the Exchequer offered a forecast for the public sector borrowing requirement in the then current financial year that in the event proved to be in error by over £1½ billion—even though, when he spoke, the year had only about three weeks to run. Figures on the position of local authorities are particularly slow to arrive and are incomplete when they do come. Of the forecasting errors I have just described, over one third each year related to local authority borrowing.

This lack of precision would not be tolerated in a group of private companies, even where central management believed in substantial financial autonomy for its associates. It is equally unsatisfactory in the public sector, where policy is often made on the basis of inadequate and uncertain information about recent events within the public sector itself.

Finally, in respect of the balance between local autonomy and its responsibility to central government, local authorities must remember the importance of rates in the costs of many industries and the fact that a growing proportion of local authority income has been provided by non-domestic rates. These represented some 27% of local authority rate fund revenue in 1982/83, against only 22% in 1976/77. Over the comparable calendar years—from 1976 to 1982—the rate bills for industrial and commercial companies have increased by some 130%, against a rise of roughly 90% in their wage and salary bill and a 70% increase in the prices paid for fuel and materials used in manufacture.

The impact of non-domestic rates undoubtedly varies greatly between types of industry—most obviously because the rental value of land and buildings required by each also varies. For many smaller firms in distribution and services, rates are therefore a heavy burden. There are also problems resulting from the fact that many valuations are over ten years old. The decline of an industry will often be associated with a fall in the rental value of related assets, either because they are specific to the trade or because the industry is localised and thus property in the area is affected. In these cases the rate burden is unfairly distributed. This is separate from the point that, unlike profits, rental values and, even more so, rateable values do not vary over the economic cycle. Unlike corporation tax, the rates bill is as large in bad years as in good.

Unfortunately, I cannot demonstrate these points clearly from the available statistics. Let me just note that the rate bill for industrial and commercial companies now exceeds £4¼ billion a year, and is probably over half the total that they are spending before tax on the interest payments on all their borrowing. Put another way, suppose that industrial

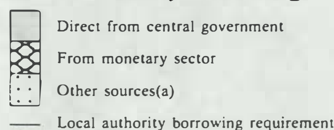
and commercial companies had paid no rates last year and that this had been fully reflected in their profits. Then the profitability of those companies not involved in North Sea oil activities would have risen by over one third in real terms—ie on the basis of current cost accounting. The rate burden is substantial for many businesses, and it is a burden over which they have little control because they have no vote and because they cannot generally move either quickly or cheaply to a lower rate area.

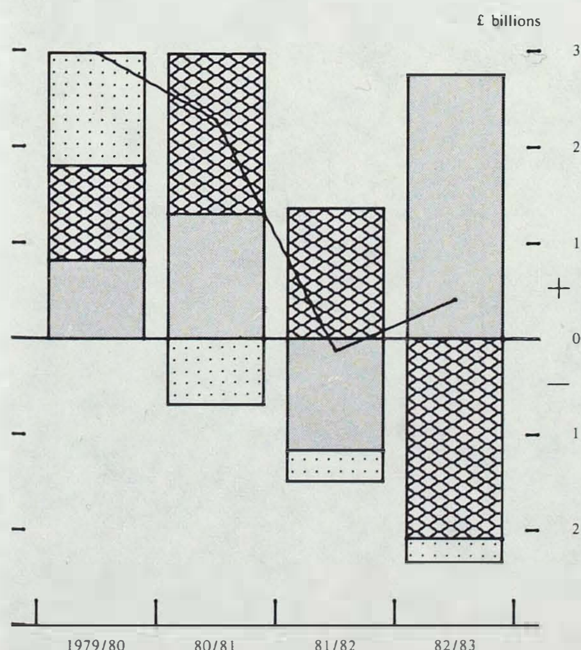
Local authority borrowing

Let me now turn to recent trends in the size, maturity and financing of local authority debt. The picture here is encouraging, not least because receipts on the sales of council houses and other assets, together with a low underlying level of capital spending, have greatly reduced your borrowing needs in recent years. Thus in the last two full financial years the borrowing requirement of the local authorities averaged only £150 million, against £2,600 million in the previous two years. At a time of often high nominal interest rates and volatile market conditions, it must have been helpful to you that you were not having to seek large amounts of new money.

Second, the average maturity of local authority debt has lengthened, with the period for new term borrowing in the last couple of years averaging around eight years, more than double the length of such borrowing in the mid-1970s. This development, like the slower growth of your debt overall, can only have been beneficial to the authorities' standing with—and flexibility in—the financial markets.

Chart 2
Local authority borrowing





(a) Non-bank private sector, overseas and indirect borrowing from public sector sources net of holdings of other public sector debt.

I should add, at this point, that it is important that the proposed changes to the structure of local government and to the powers of central *vis à vis* local government should not affect the reputation of local government in financial markets. On this subject, I welcome assurances given by the Government, both in the White Paper on rates and in the more recent White Paper entitled 'Streamlining the Cities'.

Finally, there has been a marked shift in the sources of local authorities' borrowing—away from the banking system, which now accounts for around 20% of total outstanding debt, and towards the Public Works Loan Board (PWLB), which lent £$4\frac{1}{4}$ billion in the year to June, taking its share of total debt to nearly half.

The Government has actively promoted this switch in your sources of borrowing. Its first step—in August 1982—was to introduce variable rate facilities for PWLB loans, something which local authorities had requested for some time. The terms on these facilities were initially set at levels that were very competitive with the comparable market rates and they were cut again after only four months to become an undoubted 'best buy' of their kind. Additionally, in November last year, the Government substantially increased the authorities' 1982/83 PWLB borrowing quotas and has maintained these higher quotas into the current financial year.

The benefits of the changes in PWLB facilities have been twofold. Most important for local authorities, their cost of borrowing has fallen. Eighteen months ago it was not uncommon for local authorities to be borrowing variable rate money from banks at a margin of $\frac{5}{8}$% or more above the London interbank offered rate (LIBOR—the usual reference rate for this type of borrowing); such funds are now available from the PWLB at LIBOR plus $\frac{1}{8}$%. Government can borrow more cheaply than the authorities, and it has passed on much of the benefit of this.

Also, and this is of particular relevance to us, the operation of monetary policy has been eased in one respect by the increased use of PWLB loans. For some time now, monetary policy has operated in a way that, as a necessary by-product, has required the banking system to make heavy net payments to the government. The Bank of England has needed to respond by channelling the necessary funds back to the banks, mainly by buying bank bills. Local authority borrowing from banks has contributed in considerable degree to the need for—and the size of—these flows. It makes no sense for local authorities to borrow from the banks—paying them for their intermediation—only for the banks then to refinance their lending by, in effect, borrowing in their turn from the central authorities. Consideration was therefore given to ways in which the government could supply funds directly to local authorities on terms which would be more attractive than borrowing from banks.

The results of this deliberation were the changes I have described. These changes have helped, but they have not solved the problem because, although it has been reduced,

the outstanding amount of local authority borrowing from banks is still substantial and it remains desirable that local authorities should continue to use fully the facilities now available from the PWLB.

Looking ahead

Let me conclude by stressing that much of the effort needed to set our economy on a sound footing has already been put in. Nevertheless, there is more to be done; and, over the next few years, the restraint, or lack of it, shown by the public sector in its spending will be of critical importance in determining the success of government policy.

What will be asked of all parts of the public sector goes beyond good housekeeping. That, of course, is important, but it is not enough. Mao Tse-tung once said that 'thrift should be the guiding principle of our government expenditure'. You would not expect the Governor of the Bank of England to quote too often or too approvingly from such a source but here I would wish to amend just one word: thrift must be *a* guiding principle. In addition, some difficult choices will have to be made if the hitherto inexorable rise in the share of public sector spending in the national cake is to be reversed. But reversed it should be, if the benefits which local authority treasurers and their private sector counterparts have already seen from the decline in inflation are to be consolidated and extended into sustained economic growth. Only out of that growth, in the long run, can come additional resources for use by the public sector.