# Corporate Services Scrutiny
# Government Bonds

**<u>Paying for Local Investment by Richard Murphy.</u>**

Page. 4:
"What is capital expenditure? Why is it important? Local government capital expenditure relates to spending on long-term assets that will bring benefits beyond the end of the financial year in which the expenditure is incurred. Examples include things such as land and buildings or large items of equipment. This is in direct contrast to revenue expenditure, which only produces short-term benefits within the year in which it is incurred. Capital expenditure is vitally important in helping local government deliver on its public service objectives. For example, investing in new school buildings helps improve education; carrying out housing renovations improves local housing; and purchasing equipment for local police helps reduce crime. Local authorities are never allowed to use the money they have raised to finance capital projects to pay for the current year spending. The reverse is not true. Capital projects can be financed from current year revenue income from Council tax. This ia a common practice, with some 25 per cent of capital expenditure in 2002/03 being funded in this way. We doubt the wisdom of this method of funding capital expenditure. Any authority that uses its current year income to fund capital expenditure penalises current local taxpayers to benefit future ones. In our opinion capital expenditure by local authorities is usually best paid for by capital finance to ensure that the costs and benefits of the expenditure are matched over time."

Page. 18:
"The creation of a bond market for local capital finance: The most radical change to the local authority finance market would be the creation of a market for mew local bond issues. Local authorities in England have always been free to issue such bonds but have had no incentive to do so due to the current dominance of PWLB funding. It is important to note that local authority bonds were a normal part of the funding of local authority capital expenditure in the UK until the early 1980s when central government control of overall government borrowing through the PWLB loan mechanism restricted their issue. Local authority bond finance is prevalent in the USA where almost all local authorities issue bonds to finance their local capital expenditure. These bonds are very popular with the investing public, partly because the interest paid on them is tax-free. This subsidy is, however, reflected in lower-than-average interest rates being paid by the authorities. $452 billion of such bonds were issued by the US local authorities in 2003. In Europe, bond finance is less common that the USA because, in many countries, municipal and general banks have assured a major role in providing such finance. This system is to be found, for example, in the Netherlands, Belgium, France and Germany. It is unlikely that such a system could now be created in the UK; it would require, in effect, the creation of new banks and the UK financial system is not now amenable to such a development. Because the creation of a municipal bank is so unlikely in the UK, creating a bond market is the appropriate alternative that we suggest for the UK to replace centralised loans. The World Bank has noted this trend, or an intention to create such a market, in more than 50 countries in the world. It is possible that one objection to issuing bonds will be that no one authority will need sufficient finance at any one time to make such an issue efficient. In that case, we believe the PWLB should act as a broker for such bonds, bringing together several authorities in one geographic area to ensure a local, but not necessarily authority-specific, bond issue can take place. In that way local saving in local infrastructure will become a real possibility.
The advantages of using bonds to finance local capital projects: There are several advantages of using bonds as a local authority bond instrument that would make them an alternative vehicle for investor: The market has always responded positively to such issues

in the UK. Until the early 1980s, underwriting and brokering services were readily available, Philips & Drew (now part of UBS) being a major market leader at that time. Such stocks can be rated by market rating agencies such as Standard & Poors to give them tradable status. The achievement of reasonably good assessments will help reduce sustainability the cost of this type of borrowing for local authorities, and will provide an added incentive for local authorities to be efficient and work hard to achieve good market ratings. The proposed bonds will have long-term investment appeal to both individual and funds. Anecdotal evidence suggests that, for this reason, when local authority binds were in wide circulation, the level of trading and associated costs for the issuing authorities was low. The strong structure and sound history of local government in the UK makes it an attractive base for such a market. Bonds can be made attractive to individual investors via the use of tax incentives. We believe that local authority bonds should be treated as favourably as gilts for taxation purposes. This would involve exempting them from capital gains tax, making the income free from all UK withholding tax and making income paid on them tax free in the hands of individual investors up to a holding level of £20,000 at redemption value. Provisions such as these have been central to the success of this market in the USA and have the additional advantage of reducing the overall cost of funding to the authorities involved. Making local authority bonds a tax efficient investment in this manner would provide a significant incentive for individuals to invest in their local authority. It would also encourage local accountability by increasing the association of local people with direct financing of local capital infrastructure. The resulting increase in saving meets government objectives in this area, including an increase in pension saving for which the bonds would be very suitable.

**Bond Development in India, by Professor K. Pradhan.**

Page. 89:
"The states and local bodies play a crucial role in delivery of social and economic services (public health, education, housing, and urban development), and in provision of infrastructure (power, irrigation, and transport). States and local bodies are responsible for implementing central government policies, including those to reduce poverty and provide social security."

Page. 91:
"Recently, commercial banks have begun to participate in urban finance through innovative mechanisms such as "take-out" financing or cofinancing. Development finance institutions and specialized financial institutions set up specifically for infrastructure development have been able to raise substantial capital by issuing tax-exempt bonds and lending them for infrastructure projects."

**Municipal Finance by George Paterson.**

Page. 1:
"Fiscal adjustments are impelling all levels of government to try to reduce their budget deficits. One of the favourite instruments of deficit reduction has been to cut back government subsidies in the financing of infrastructure projects. Studies in different parts of the world have found that capital investment support commonly reduced more steeply than any other element of spending during periods of tight budget constraint. To sustain investment levels in the face of reductions in central-government capital grants local authorities have had to make greater use of borrowing as a way to finance capital projects."

Page.7:
"Local governments that accelerate their borrowing often do so at the same time they are *cutting back* on their investment levels, or they may use a combination of heavy borrowing

and one-time asset sales to barely sustain investment spending, while cutting back steeply on the contribution of current account savings. This is not a sustainable condition nor an indicator of healthy credit market. It is a sign of fiscal stress."

**Urban Development Strategy by David Jones.**

Page. 12:
"There are, in theory, at least four ways of dealing with this concern. First, irrespective of the anticipated loan contracts, the model can be entered with the virtual equalized debt service expenditures. These would be derived from annuity calculations. When the actual debt service is expanded, this might be less than postulated by the model, leaving an executed budgetary cash surplus. This would be held as increasing working capital, to expand on the expected higher later debt service. The second option would be to actually budget for the equalized debt service payments and pay these into a debt service fund. The actual debt service expenditures would then be paid from the debt service fund, leaving a balance of cash to expand on later, higher, debt service."

**Municipal Bond Banks by John Petersen.**

Page. 6:
"Relevant International Experience. Visitors are often impressed by the large number of U.S. subnational governments that borrow directly in the securities markets each year. Less well known, but no less impressive, is the large number of smaller local governments that access the credit markets through the use of state-sponsored financial intermediaries. These loan pools, or bond banks, are employed in one from or another in most of the U.S. states and are even seen at local level, where intermediaries may be formed to finance governments in a sub-state region."

Page. 8:
"Revolving-loan Programs: Bond banks may offer revolving loan funds. These banks make loans (usually, subsidized) to local borrowers and the ensuing loan repayments are then re-lent to other issuers over time. Thus, moneys in the loan fund constantly "revolve," or are re-cycled to new projects. The assistance may enter in several forms but usually has to be with the capitalization of the bank. Bond bank revolving funds have typically been initially capitalized by a state appropriation, or receive a dedicated, on-going revenue stream from the state to support the subsidised program. Such funds can be popular with donors since they embody the notion of sustainability and constitute a "gift that keeps going"."