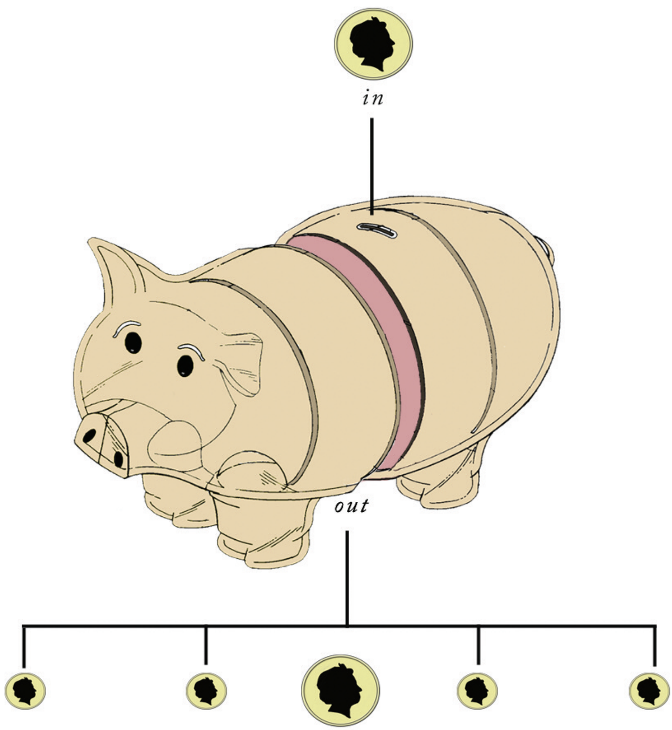
More for Your Money

Using Local Government Investments to Strengthen the Local Economy

Tom Shakespeare



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About the Author

Tom Shakespeare joined Localis in June 2008, having previously worked for Policy Exchange where he contributed to a report on party financing called 'Paying for the Party'. He graduated in both Mechanical Engineering (BEng) and Politics (MA) at the University of Nottingham in 2007. His final year dissertation looked into the potential application of the second law of thermodynamics to agent-based models of human action and ethnic conflict. Tom leads on research for Localis, and amongst other things, has written several reports, including 'Information, Information, Information' and 'The Future of Regional Governance'.

Acknowledgements

Thanks to the Stephen Hughes and Alison Jarrett from Birmingham City Council and Nick Chard from Kent County Council for their input on the practicalities and effects my recommendations would have on them. Thanks too to Toby Eccles from Social Finance who has been very helpful in explaining the social market and what is required for reform. Thank you to Rhodri Davies, research fellow at Policy Exchange for his input on the draft of this report and especially for his comments on social investment, and to James Morris and Mike Morgan-Giles from Localis for their extensive feedback and proof reading. Although their input has been invaluable, the responsibility for errors is mine only.

Executive Summary

This research presents some thoughts and recommendations around the need to fundamentally reconnect local government investments with the creation of a civil society and a sustainable environment. For too long the model for social and environmental investment has relied solely on philanthropic giving, or grants from the public sector. This has been categorised by the growth of large charities to the detriment of smaller, local charities – fundamentally undermining the connection between 'investor' and receiver. But there are huge opportunities for both an economic return on investment and better local outcomes, which are not recognised by the current financial markets. Local government, in its local leadership role is perfectly placed to begin to provide the investment which impacts directly on their local area, and which provides the funding for a new social and environmental market to emerge.

> For too long the model for social and environmental investment has relied solely on philanthropic giving, or grants from the public sector

This piece of research was written as part of Localis' research programme to explore ways of addressing the fundamental problems associated with the current system of local government finance and the related detachment between government and citizens. In this publication we make a number of recommendations for local government investments which are designed to address the current problems facing the economy – providing greater 'safety' of investments; stimulating new growth and improving what we call the 'wider economy'. It also sits in a wider context of reform and, for example, attempts to create a platform from which an independent system of local government funding redistribution can be built; reassesses the role of local government in terms of service delivery; creates emergent and meaningful cross-border partnerships, and; encourages economic development and a strong civil society for local areas to thrive. The key recommendations are below.

Key Recommendations:

- **Safety of reserves.** The Debt Management Office (DMO) should look to allow Local Authorities to provide additional flexibilities on reserves deposited with the Treasury.
- **Wider definition of 'capital'.** The Treasury should widen the definition of the 'Supported Capital Expenditure' (SCE) loan and rebrand it as a 'Local Economic Development Loan' (LEDL) so as to ensure that the wider meaning of 'capital expenditure' is captured.
- **Paying back the debt of nationalised banks.** The Government should examine opportunities to create a duty on part or fully nationalised banks to place a set proportion of their investments into social or environmental schemes, or allocate sold national assets directly to Community Development Finance Institution (CDFIs) or other suitable organisations.
- **Spreading risk and encouraging new growth.** Groups of Councils should set up a new sub-regional voluntary fund system for local Councils to replace or supplement PPP/PFI – which we call a 'Mutual PPP fund'. We believe this will help to encourage new growth schemes and will allow Councils to spread their risk more effectively over a larger area whilst simultaneously increasing investment.
- **Rethinking local government.** Councils should use their trading powers more widely to stimulate new markets and as a way of shifting service provision onto other providers and reducing Council tax. The use of these powers should be monitored by the existing local government bodies to ensure that the use of these powers is not creating distortions and pockets of deprivation.
- **Creating new social and environmental markets and growth.** Set up a Local Investment Fund to invest into the improvement of local areas. We recommend that this fund is managed by an existing organisation such as the Post Office. This would help to encourage investment into social/environmental improvement schemes and help to strengthen the existing social investment market. It will also begin to lay the part of the groundwork for a more independent system of local government funding redistribution. The government should set up a Parliamentary Steering Committee to oversee the creation and implementation of social and environmental investment marketplace.

Introduction

Background

Increasingly, Local Authorities have been looking for innovative ways of providing economic stability in a tumultuous economic environment. From equity based loans, factoring services and 'margin support' on mortgages to a local rental property fund, social enterprise investment and greater pooling of resources – there are a plethora of ways to improve the flow of relatively safe credit to bolster and boost local economies. However, the current economic climate also provides us with an interesting situation – what is the right balance between safety of investments and level of returns? And how far should the public sector go in supporting the local economy?

There has been much talk and debate in the local government community about the need for new and better ways of organising Local Authorities' finances in the wake of the Icelandic Banking collapse. Many Councils have argued that the safety of reserves is the top priority. One suggestion has been to set up a mutual Local Government fund. However, the rationale behind this has not been fully understood, and has been treated with some scepticism as to the role and nature of the fund. A strong argument against the need for a mutual fund is the fact that Councils already have most of the financial institutions to manage their risks adequately already. And more importantly, there are questions over whether it would actually provide any greater degree of safety than any other institution does already.

Safety and role of local government

But safety can mean a number of things to different people. The most obvious meaning – the one which 86%[1] of Councils prioritised for any use of reserves (or in other words, Iceland avoidance) – was in ensuring that cash deposits were not lost. Safety can also mean balancing low risk investments with high rewards. Or from the perspective of the local area itself, it can mean ensuring the longevity of the community – which can encompass anything from the quality of housing or the environment to the security of jobs and industry. This is clearly the more complicated task, and poses much more deep seeded systemic questions about the financial relationship between the private sector, local authorities and central government.

Systemic financial change

These questions go to the heart of the role of Local Authorities, and make an explicit case for the need for Local Authorities to receive the rewards for encouraging growth and improvement in their local areas. This implies allowing Local Authorities to raise a much larger proportion of their income locally, which goes beyond the scope of this research note. However, we will explore some options behind setting the groundwork for a radically different vision for Local Government Investments.

The rest of this publication will make recommendations around fostering a culture of 'safety' in Local Government investments, and then look at what Councils can do to encourage economic, social and environmental development and ask to what extent this role should be limited. Overall, this document is intended to firstly provide some practical recommendations for Councils to implement, and secondly to create a vision for the future of local government investments which fully embraces the wider strategic role of local government in creating a strong and prosperous civil local area.

Chapter 1
Enhancing the Safety of Investments

With over 86% of Council finance directors agreeing that 'safety' of deposited reserves is the number one priority in the current climate, clearly financial prudence has become the order of the day. The three key areas to address are: reassessing where to invest, the risk strategy and the financial management of the Local Authority.

Depositing reserves

As we have already suggested, many Local Authorities can meet their current financial needs through existing institutions. However, some Local Authorities may wish to have an extra level of security on a proportion of their reserves – a level of security which can only be backed by Government. This is a fact not un-noticed by Councils – who have transferred over £1.5bn into Government bonds in the last quarter of 2008 alone – far exceeding anything on this scale for at least the last five years. Local Authorities should be able to deposit a proportion of their reserves with the Government if it is deemed that they cannot achieve the necessary security in the market. Currently, Local Authorities who hold reserves with the Debt Management Office (DMO) in the Treasury have very little flexibility. Therefore, we recommend that the DMO look to offer greater flexibilities and extension of deposits from 6 to upwards of 12 months. Further flexibilities should also be explored in order to more closely align the services provided commercially with those provided by the Treasury, so as to not disincentivise Local Authorities who are fiscally prudent.

Recommendation: The Debt Management Office (DMO) should look to allow Local Authorities to extend their deposits for more than 6 months, and should also explore methods of more closely aligning their services with those offered by commercial organisations.

Risk strategy

Most Local Authorities already have a reasonably good record of managing their financial portfolios. However, the need for a good management of credit as well as reserves should be taken very seriously. Each Local Authority will have a different strategy to managing risk, and this should be encouraged. For example, some Local Authorities are looking at innovative ways of using their excellent credit ratings to provide support to local businesses and projects. Other Local Authorities are bringing forward or ensuring capital expenditure projects to bolster the number of jobs in the area. Others still are looking to readdress their exposure to the market and the level of risk they are willing to take. All of these things must be well balanced, and reflect the core strategy of the Council, whether that be to take up the slack from the private sector, to continue with bold investment strategies, or to rein in exposure to riskier investments, or anything else. Some Councils are always going to be more ambitious than others, but whatever the financial strategy, there are a number of rules which could be followed to ensure that the financial strategy sticks as closely as possible to the political strategy.

Recommendation: Councils should constantly review their financial strategy to ensure that the risks associated with their political strategy are hedged sufficiently so as to minimise any potential future losses.

Local Authority Management

A recent Audit Commission report[2] highlighted that Council treasury management is of variable quality, and that more information is needed to properly assess risk. The main recommendations from the report revolved around the need for regular expert monitoring of accounts; access to more relevant information; training for elected members, and; looking for economies of scale. Local Authorities should take heed of these recommendations, as 'safety' can only be achieved if accounts are managed properly. That said, Councils have a very good record of financial prudence – and a recent Government report showed that DCLG's procurement skills are far worse than other government bodies, and certainly far worse than Local Government's – who have made hundreds of millions of pounds worth of savings since 2004.

Recommendation: The Council cabinet should ensure that there is a strategy for ensuring all sources of information regarding investments are put in the hands of the financial management team, and also in the hands of the public.

Chapter 2
Supporting the Local Economy

The arguments for supporting businesses during the recession are fairly clear. Banks are overly cautious – even in providing practically failsafe Government backed loans; and local government is perfectly positioned to take up the slack as it has a good understanding of the value of that business to the wider community. But if Local Authorities become responsible for assessing the relative risks of investments on purely financial terms, they move beyond their public service remit and essentially become banks in their own right. This should be avoided wherever possible – and support should work through existing organisations, or be limited to marginal support, restricted to a curtailed number of functions which cannot be met by the market. The most important features of any public support or investment are: to make sure it is risk calculated, and fits within a fully balanced portfolio of investments as outlined in the previous section, and; that it does not result in any organisation or body becoming an unchallenged monopoly in the local area. The following recommendations are designed to fulfil these criteria.

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Bring forward capital expenditure projects

One way to provide support to local businesses is to bring forward and extend 'capital expenditure' projects. This would support businesses in the development and growth of particular projects, and more often than not, also support the surrounding businesses who will service the running of the project. Capital expenditure has the added bonus of being eligible for Government loans, and is therefore a good way of balancing the books and supporting the local economy.

Recommendation: Where possible, and where it will provide added value, Councils should bring forward capital expenditure projects to boost the economy of the local area.

Widen the definition of 'Supported Capital Expenditure' (SCE) loan

However, in some cases, these projects are not appropriate for a particular area, and returns are often difficult to envisage. One easy way of providing support is to widen the definition of capital expenditure so as to allow Local Authorities to use the funds in innovative ways which still achieve the aims of stimulating growth and attracting good returns on investment. I recommend renaming the loan: 'Local Economic Development Loan' to reflect this broader definition. These loans would still be provided under all the other regulations stipulated in the CSR07 Local Government Settlement.

Recommendation: The Treasury should widen the definition of the SCE loan and rebrand it as a 'Local Economic Development Loan' (LEDL).

Use prudential borrowing powers

Further to a widened access to SCE loans, prudential borrowing allows Councils to respond more quickly to the financial needs of the local area, and gives access to extended finances. Councils have excellent credit ratings, and it makes sense to use these if it is deemed to be beneficial, and a return on investment can be made. There is a high demand for a short term clearing bank for many businesses for example. Birmingham City Council, for instance, are in the process of exploring the use of prudential borrowing in order to provide factoring services, marginal mortgage support or collateral backed loans to social enterprises.

Recommendation: Where banks are deemed to be failing to provide adequate support to businesses, Councils should consider using their prudential borrowing powers in innovative ways to provide clearing bank type services or other appropriate types of support.

Support existing financial organisations

It is clear that the Government's plans to provide business support guarantees through banks have not been effective so far. There is no reason why a Local Authority couldn't work through existing banks, credit unions and other financial institutions to provide further support for small businesses etc. So far, I have limited our suggestions to using credit to support businesses, but there is no reason why if a Council has sufficient reserves they could not be used instead. Essex County Council, for example, is exploring this idea to support small businesses, as is East Sussex. Evidence from abroad suggests that a particularly powerful option would be for Local Authorities to provide guarantees for loans to SMEs and businesses up to a certain level, or provide extra support on top of the current government backed loans where needed. This could be negotiated between banks and individual Local Authorities, although caution needs to be taken by the Local Authority to ensure that the banks do not take an unequal proportion of profit and risk.

In a recent Localis survey, 70% of respondents agreed that there was a need for a safer place to deposit a proportion of their reserves. Interestingly however, over 60% of respondents also thought that reserves should be used to stimulate small businesses and social enterprises in the local area. There is certainly a decent proportion of capital available. Our estimates suggest that there are £12bn in local government reserves, but other estimates put this as high as £29bn, of which we estimate 20% to be currently unallocated.

Recommendation: Where it is appropriate, Councils should look to use their reserves to support local businesses and enterprises, through existing financial organisations where possible.

Stimulate demand

There are a number of locally specific ideas which could help to support or boost the local economy during a recession. A number specific ideas could include:

- Scrap short stay High Street Parking Charges
- Promote special shopping services (eg. late night shopping)
- Provide low cost or free market stalls areas and farmers markets
- Provide support at the margins to existing high street businesses affected by the recession
- Provide incentives to bring empty commercial properties back into use

These should not be treated in any way a panacea for local economic growth, as the strength of the economy is based on many nuanced and interrelated factors. Similarly, these measures should also not be understated, and the more that Local Government can do for the local economy, the better. Ultimately, it should be up to the local area to decide what is important, and what can be avoided for financial prudence.

Make efficiency savings

Running an efficient Council can be the first step to freeing up resources to support the local economy as best as possible. Local Authorities already outperform their Central Government counterparts in achieving significant efficiency savings. However, there remains a great deal of scope to make savings through an efficient delivery of services, and the Operational Efficiency programme has highlighted £5.5bn worth of savings by 2011. Although outsourcing has become a toxic word in some circles because of the connotations with Compulsory Competitive Tendering (CCT) under Thatcher, in some cases it is vital to free up capital, improve value for money, stimulate the local economy and improve all-round outcomes. Such considerations must, of course, be taken with a full consideration of all relevant factors, and a 'whole picture' view must be taken. Increasingly, further efficiency savings are being made by forming partnerships across the traditional borders. Multi-Area Agreements (MAAs) and improved local partnerships are increasingly becoming part of the political landscape and are a welcome move towards more efficient government. Shared services and management are just two examples of the multitude of potential opportunities. It is important that all types of partnership are fostered: formal and informal; small scale and large; private and public; so that the best use of resources is made at all times. Local Authorities should make the most of the financial crisis to make savings wherever possible, and hopefully come out of the crisis performing better than before.

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The current trials of 'total area' budgeting offer a good opportunity to make significant efficiency savings across a range of local and regional bodies, but also offer a chance to join up services in a much more coherent manner. This also has the potential to create an incentive to look on a much broader scale to make savings in the long term and across a range of issues – making it simpler for social enterprises to partner with Local Authorities to improve strategic outcomes and achieve the financial savings which are going to be demanded of Local Authorities after 2011.

Recommendation: Councils should pick up on best practice from other Councils, and look beyond the obvious to make significant efficiency savings – ensuring that they take a 'wider vision' approach to local improvement, looking to build on the 'total area' budgeting trials.

Accelerated Development Zones (ADZ)

Accelerated Development Zones offer Local Authorities the opportunity to recover some of the returns from development of their local areas. They are a good way of potentially ensuring that revenues made in local areas can be returned back to the same local area and reinvested, thereby ensuring local accountability of business revenues. However, Local Authorities should have much greater control over the flexibilities of the zones, and the Government should look to reduce bureaucracy as much as possible.

Recommendation: Where appropriate, Councils should look to set up Accelerated Development Zones. The government should also look to integrate ADZs with much wider schemes, such as mutual PPP or total area budgeting initiatives so that economic rewards can be captured in more nuanced and differing ways – back into the local economy.

Reinvigorating PPP/PFI

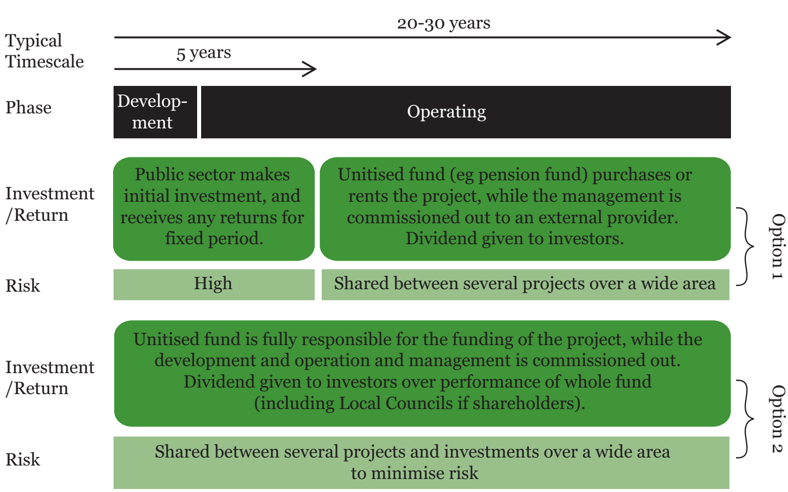
With the recession firmly upon us, many public/private finance initiatives have been dropped or postponed, and this is obviously not a desirable outcome for any local economy. The great advantage of private investment is the ability to share risk between two or more partners, thus freeing up further resources for other schemes. There are a few possible suggestions for how to reinvigorate these public/private finance schemes, revolving mainly around innovative partnerships or early management of risk by the public sector, with innovative private risk management tools for the final phases. Obviously, the level of private investment is dependent on the type of project, however one should be able to spread the risk over a range of projects with innovative financial tools, encouraging private, public and personal investments into a project, thus allowing PPP and PFI to go ahead when Councils and businesses are looking to prioritise the 'safety' of their investments but still extend their investment portfolio.

One approach which might be appropriate for larger authorities would be for the Local Authority to become the PFI partner itself. This is forbidden under Treasury rules, and would need to be repealed to become a reality. Such flexibilities would be very welcome in large metropolitan authorities.

Recommendation: The Treasury should look to support business and local government by providing financial resources to the initial stages of PFI schemes.
Recommendation: The Treasury should repeal rules for Metropolitan and County Councils to allow them to become their own PFI partners, or to allow partnerships with a range of other partners.
Recommendation: Councils should look to streamline the PPP/PFI process and create innovative new models with a range of partners.

One potential model for the standard 25 year PFI scheme could include the public sector making the initial investment with a unitised fund taking control afterwards – thereby getting around some of the associated risks. Another option for the future would be for unitised funds to take complete financial control of a project, with Local Councils being shareholders within the company. The two models are illustrated below:

Figure 1: The two models for a reformed PFI/PPP schemes



Option 1 is an attractive prospect for private investors and the public sector in the current climate. The public sector (either Treasury or Council or both) makes the initial higher risk investment for an initial period of five years. It still has the prospect of a return on investment, but it also has the guarantee that after five years, it can be removed from its balance sheet – or at least a Council can determine its level of investment into the fund. After that period, a commercial fund can take on the project at reduced risk, and with a return to investors (which can include Councils and other shareholders) paid out as with any other fund. It avoids the initial high risk stage, and has the added flexibility that commissioning can be flexible so as to provide best 'wider economic' value for the consumer.

Option 2 is also attractive for both bodies, but is probably more suited to more stable economic environments. It allows Local Authorities to have full control of their level of investment in the fund, and allows the fund to make the maximum profits from the increased risks.

For this to be a viable prospect, a group of neighbouring Councils could set aside a proportion of funds solely for this purpose, and advertise for commercial financial bodies to bid for the funds. Once an area fund has been established, the financial body can open up to the market investment as with any other fund, and the 'Special Purpose Vehicles' (SPVs) should be set up, and the projects can begin. The investments should be set aside solely for Council approved projects within a given area. The beauty of a unitised fund is that it is a highly flexible and less risky way of providing investment stability linked to place, but also a good way for Councils to invest flexibly in their local area. The funds of the future could even be linked to a proportion of personal pensions to reward growth and improvement.

Recommendation: Councils should review their PFI and other local investments and explore which model is most appropriate in the current climate. They should create voluntary groupings of Councils – pooling financial resources to invest into a fund for local or sub-regional development.

For those Councils who would like to spread their risk even further, there could also be the opportunity to invest in the improvement of a much wider (national) group of projects, by pooling resources and splitting them between different funds. This way, resources could be prioritised to the more deprived areas without the need for the local Council to risk any capital or affect their balance sheet. From our survey information, and extrapolating on an NLGN survey[3] that suggested an 80% popularity for the idea in theory of a mutual fund, we estimate that there could be an initial fund available of between £176million and £2.9billion, with a likely fund of about £1.4billion[4] for total investment into local and national funds. The options will be explored in the next chapter.

Chapter 3
Improving the Wider Economy

A recognition of the value of strong society and the environment is vital for a strong economy. The wider economic value of something is not always easy to see, and it is certainly the case that there are not, on the whole, sufficiently robust and intelligent financial tools to provide support to these hidden potential investments, some of which could be incredibly lucrative.

Many schemes have been trialled and tested around the world and the UK and have already been shown to be successful. For example, financing a savings and loans facility for families with disabled children has been shown to be highly lucrative, as it was proven that these families had a much higher chance of repaying the loan. Or funding for young people's care – where foster families get a small payment for looking after children currently in care – these are classic examples of where a much stronger market in social purpose businesses would help the local economy, local people and the locally elected representatives. Similar schemes for green initiatives too have an enormous potential. The great difficulty in providing these funding streams stems from the fact that there is currently not a robust working marketplace for social or environmental investment; there is little information available to investment organisations willing to invest in these kind of schemes, and the return on investment is often difficult to assess, or even access.

This chapter will go on to explore such issues and make some recommendations for improvements to the social investment marketplace. It will also explore the existing powers which Councils have to improve a more broadly defined local economy, and crucially, it will examine the role of local government and where the line should be drawn in its involvement in the free market.

Using trading powers

The use of existing (Local Government Act 2003) trading powers could allow Local Authorities to stimulate jobs and encourage new businesses to the local area. It can also supplement Council income where extra capital is needed. It is for these reasons that the extended use of trading powers could fit into either of the previous two chapters – providing extra capital into dwindling investments (safety), and support to the local economy. However, the use of trading powers also asks questions about the fundamental nature and purpose of locally elected government – precisely the kind of question which has been asked for generations, and is a long-standing party political issue: Is it the role of the Council to interfere where the market can (in theory) provide, and is it right for a public body to make a profit? That is why any questions about the use of trading powers must fit within the context of improving the 'wider economy' and must be treated very carefully.

The answer to this question though is an evolving dichotomy, and its mutation is certainly beyond the remit of this research note. However, to some extent the question is irrelevant because Councils are already using these powers. In fact, Councils already currently make £1billion through their trading powers, but with little return on investment. Furthermore, John Healey, former Minister for Communities and Local Government has suggested that Councils should not be afraid of using the powers to supplement their income – so it seems inevitable that Councils will continue to use these powers anyway. A simpler (although arguably not) question which therefore makes more sense in the current climate is: Will Council trading powers improve the local area and strengthen the local economy? And how can it be achieved without damaging free enterprise and local initiative?

The type of services provided by a Council company could range from housing services, such as Norfolk CC's company 'The Norse Group', to green companies responsible for installing home insulation or energy saving devices such as in Kirklees. Where services are deemed to be providing good value for the area, and where there is at least the potential for an open and free market in the provision of that service, a Council should be able to charge for it so long as its provision is not already covered statutorily by Council tax, or already interfering with an existing marketplace. If the service is already covered by Council tax, it would make sense to separate the trading component of the Local Authority from the public service provision so as to ensure full fiscal accountability. This should result in a reduction in Council tax, but a potential increased return from an independent trading company for the Council, on top of the increased benefit to the local economy and community. So long as public companies are expected to follow the same rules as any other commercial organisation (as is written into 2003 Local Government Act), markets should, in theory, be unaffected. They should be seen as market creators and not as market destroyers. They should operate on a level playing field with the free market, and in that sense they should also be seen as a way of moving towards a more 'pay as you receive' tax system, where 'customers' have freedom and choice to move between public, private or voluntary service providers. The main fear could be that if these powers were used extensively, it could disproportionately adversely affect the less well off (for example in health or social care), as a pay as you go service inherently affects those people who use the service more frequently, and hence the charges reflect this.

In the short term the solution lies in good regulation, and in ensuring that the actions of the Council are primarily motivated by the improvement of the area rather than in making a profit

The long term solution lies in enshrining a much wider and more long term economic value and reward into the actions of the Council – what Lyons termed 'place shaping'; but in the short term the solution lies in good regulation, and in ensuring that the actions of the Council are primarily motivated by the improvement of the area rather than in making a profit. Ultimately this should happen naturally through democratic elections – but it would also make sense to constantly review the use of these powers to ensure that they are being used appropriately.

Recommendation: Councils should carry out a full analysis of the services they provide, and explore more opportunities beyond the obvious for setting up publicly owned companies for the benefit of the local area; including private and third sector partnership providers as an alternative to contracting.

Recommendation: For all Councils who sign up to use trading powers for existing public services, create a duty to reduce the corresponding proportion of Council tax proportionate to the value of the service shifted to the public trading company.

Recommendation: The LGA and Audit Commission should agree some guiding rules and advice for Councils in the use of these powers, and constantly monitor their progress.

Accelerating innovation through the 'Power of Wellbeing'

Further to the trading powers, the 'Power of Wellbeing' Act is an incredibly powerful tool which potentially allows Local Authorities to do almost anything except raise Council tax, so long as it is in the interest of the local area. A number of Councils have already used these powers to good effect[5], but they could go much further, exploring and testing innovative new ideas for the improvement of the local areas and the governance of them. These ideas could come from local residents, Councillors, businesses or any other organisation in the local area. If local Councils were more extensively independent from the reins of central government, this Act has the potential to be the panacea for local government and localism. But in order to be fully realised, there needs to be a systemic and cultural shift in the way that public bodies obtain and share new ideas. Even though local government is far better than its central counterparts at sharing and testing innovative new ideas, there is still a long way to go in order to catch up with the likes of online organisations such as Wikipedia in garnering and utilising knowledge from the very people they serve. What is needed is a kind of 'post-bureaucratic age' of information and communication, and therefore innovation. Websites such as 'MySociety' are already pioneering ways of engaging residents with their elected representatives, but there are still opportunities to take this further, and local Councils should be at the forefront of this agenda.

Recommendation: Councils should engage residents and staff more fully in their decision making process in order to come up with innovative ways of using the Power of Wellbeing. They should experiment with innovative ways of capturing good ideas from all parts of the local area for the overall improvement of the local economy – such as creating competitions and prizes for the best ideas.

Encouraging banks to invest in social and environmental improvement

The social/environmental investment marketplace is complex, and lacks the existing infrastructure which exists in the financial market. However, investors are increasingly not just looking for profits, but they are also looking for some kind of social or environmental impact from their investment. According to a report by the Monitor Institute[6] – investors divide into 'financial first' investors, who look for financial returns over social/environmental impact and 'impact first' investors who look for a social or environmental impact over the return on investment. There are also pure philanthropists, and what the Monitor Institute report terms 'Yin Yang' deals – which combine all three elements to enable some financing to happen which wouldn't usually (see figure 1). Yet despite the complexity of the market, and the potential complexity of the funding to match the market – there is an enormous demand for these innovative products. There is no reason why a lack of commercial foresight should get in the way of good financial sense, and banks should be looking to explore 'financial first' opportunities much more extensively. Maybe the current economic climate will offer up an opportunity for the commercial sector to step in and begin to provide innovative financial products naturally, but it would make sense especially for those banks which have already been nationalised, to create a US style 'Recovery and Reinvestment' Act to make a sure that a decent proportion of investments reach the social and environmental marketplace. Essentially, banks should be looking to move a proportion of pure 'profit maximisation' investment to 'financial first' investment with a view to social and environmental impact.

Another option is to give the profits from the sale of troubled bank assets into the development of social finance through Community Development Financial Institutions (CDFIs). The government could also extend their £20million of backed loans from banks to CDFIs further as the market expands.

Recommendation: The government should explore the idea of a 'Community Investment Act' on all part or fully nationalised banks to invest an agreed proportion of funds into local social and environmental improvement. This should be reviewed at a later date to explore whether this duty should be passed onto other banks.

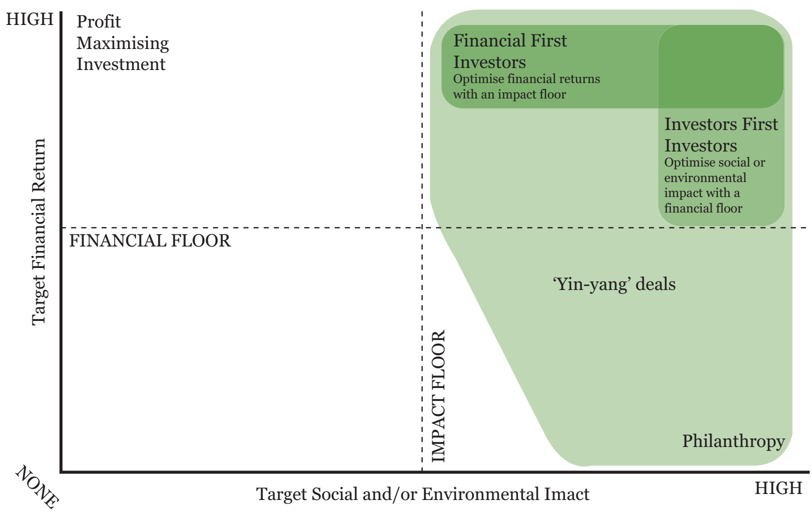
Recommendation: The government should explore other options for ensuring banks are investing in social and environmental schemes by backing loans to banks and using profits from sold assets to be invested into CDFIs.

Chapter 4
Creating a Social/Environmental Investment Marketplace

The current state of investment in the social/environmental market is in need of radical reform. Currently, most money is directed straight into the largest charities, with scant regard for smaller, niche organisations which provide an invaluable service to local communities. While philanthropic giving in the UK remains reasonably strong[7], there is an ever increasing demand for social investment with a view to achieving a return. Banks and central government need not be the only investors in the social and environmental improvement marketplace. Often, the major difficulty is in matching the investment expectations of the investor with the financial products for enterprising organisations. In some ways, the aims of local government are not dissimilar to the aims of the 'impact first' investor, while the aims of the commercial banks are in profit maximisation (see figure 2). The impact investors' overarching purpose is to boost investment into social and environmental projects whilst recouping a return for their investment – whilst local authorities' main aim should be to create an environment where people want to live and work and to improve the wellbeing of people within their area. The current model for supporting social or environmental ends relies on raising the finances first and then providing grants to such organisations. The main focus of this chapter will be to challenge this approach by integrating financial investment with social or environmental ends by improving and growing the social/environmental investment marketplace.

Much work has been done on establishing a social investment marketplace by organisations such as Social Finance, the Monitor Institute; the Commission on Unclaimed Assets; Venturesome; the New Economics Foundation, and; The Said Business School, Oxford, to whom this section can be largely credited. They make clear the types of investor (see figure 2), the scale of the market for such products, and

Figure 2: Types of social/environmental investor, taken from the Monitor Institute report[8]



the challenges we face in meeting the needs of both the investor and the market. According to a New Economics Foundation report[9], there are five clear steps required to complete the existing infrastructure:

1. Implement a simple and well designed tax mechanism to attract private investors, including financial institutions, to social enterprises, including CDFIs.
2. Legislate compulsory disclosure by financial institutions of lending and investment in disadvantaged areas, as a means of tracking performance and stimulating the flow of finance to communities in need of redevelopment.
3. Establish a grant fund for long-term public support of third sector finance, improve lending practices and enhance technical capability. Many third sector institutions will require ongoing grant funding to carry out the activities that have the most social benefit.

4. Design a matched funding scheme to incentivise charitable foundations to invest in social enterprises and encourage endowments for social investment purposes
5. Support development of a new social finance institution that can act as a wholesale organisation to co-ordinate and channel investment to existing third sector intermediaries, to link the social and financial sectors

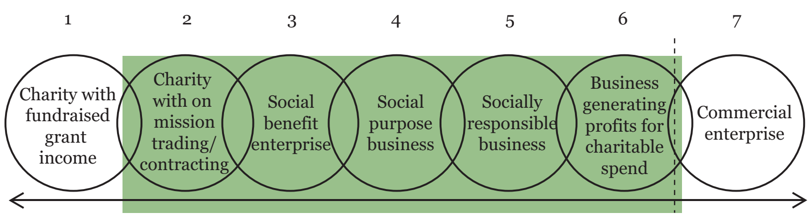
As well as strongly supporting points 1, 2 and 4, in this chapter we suggest that local government could be the first major institutional social/environmental investor to help provide the funding to set up the wholesale finance suggested in point 5, and to provide grants in point 3. We will firstly set out some ideas for supporting the existing market, and go on to suggest ideas for creating the marketplace supported by local government. These propositions are tested against the criteria highlighted in the Monitor Institute Report: 'Investing for Social and Environmental Impact' as an appendix. We will then go on in the final chapter of this research to position the recommendations within a wider scheme of local government finance reform.

Recommendation: Councils should recognise their role in the development of the 'wider' local economy. They should set the political strategy and priorities, and encourage the alignment of all investment to achieving these aims, whether from independent organisations or from local government itself.

Support the existing social/environmental market

There are a number of common themes running through almost all of the literature to help support and expand the current institutions involved in social and environmental investment. Amongst these are: Creating a common language for the market; sharing more information through perhaps a compulsory disclosure of investments for those organisations already investing in deprived areas; and tax incentives for private investors beyond the existing CDFI tax relief. Achieving all of these aims is non-trivial and requires more intelligent tools for distinguishing the type of demand and supply of funding for social or environmental investment, and for judging the impact of investment. This is a project in its own right, but Localis strongly supports most of the existing literature on this subject[10]. Figure 3 below shows the different types of organisational model which exist to supply investment for social/environmental outcomes, which demonstrates some of the non-triviality of the subject.

Figure 3: The social enterprise organisational models (taken from a Venturesome publication – 'Financing Civil Society')[11] which shows the 'grey' areas which exist between commercial and pure charitable organisations.



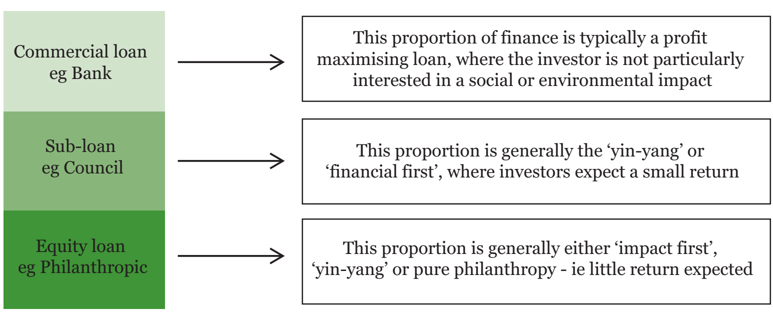
A number of other recommendations from various reports highlight the need for more public sector grant funds and more pooled resources, as well as a new social finance institution to act as an intermediary for social enterprise organisations. The next section will propose a model for such an infrastructure

Recommendation: Councils should invest in existing Community Development Finance Initiatives (CDFIs) to a much larger extent – ensuring that investment is aligned as closely as possible to the political strategy.

A Local Investment Fund (LIF)

The key purpose of the Local Investment Fund is to match the investment expectations of the investor with the financial products to suit the social/environmental organisation. A typical structure of a financial product is shown in figure 4. The great advantage of the fund is that it offers Councils an opportunity to invest in local development where there is no other locally working model. Those Councils which do not have effective PPP/PFI schemes can invest in the Local Investment Fund – which would be legislated to invest in the areas with the greatest need. So there is an incentive for Councils in poorer areas to invest, as they are likely to be the main beneficiaries of the funds, whereas Councils in richer areas are likely to use the fund as a means of spreading risk while still investing in social/environmental ends.

Figure 4: A typical social/environmental financial product



The fund would work by matching funds as already described to the independent organisations (Community Groups, Social Enterprises, Charities or CDFIs– see figure 3) who approach the fund for resources. The loans to the organisation would be treated on a commercial basis, and would be expected to meet the same conditions as in the commercial market. The LIF can also invest in any organisation whose aim it is to improve the social and environmental sustainability of the local area – defined by the local Council. The LIF will also provide advice as to where to find resources where no financial support can be given. The primary aim of the fund is to stimulate a growth in the market, and it should not aim to monopolise investment.

The main advantages of a mutual fund of this kind are that it allows councils to invest into the wider economic environment without taking on a large amount of risk on their own. It helps provide stability and funding to PPP/PFI initiatives and the local economy as well as to an emerging economy for social and environmental investments. Not insignificantly, it also begins to provide the groundwork by which Local Authorities can redistribute their own funds independently of central government. This will be discussed in the concluding chapter.

In terms of infrastructure and scale, the fund could operate through existing institutions such as the Post Office – which has already branded itself as the 'People's bank', or National Savings and Investment (NS&I) - which could broaden its position to incorporate or exclusively involve social or environmental investments, both of which have existing infrastructure to soften the impact of this kind of scheme. The governance of the fund would be crucial in ensuring that from the outset, the main thrust of investments did not become too risk adverse. The role of local authorities should be to continue to set the strategy for the local area and to advertise their priorities to the Fund, CDFIs and directly to social enterprises, but it would be vitally important that the governance of the fund remains independent from direct local government control. The overarching aim is that the fund acts as a wholesale organisation which channels funds to existing intermediaries such as CDFIs, or directly to organisations where appropriate. It is also important that the Local Investment Fund is not perceived to monopolise the social investment marketplace, and it should therefore prioritise its innovative financial products into existing social and environmental investment intermediaries.

Recommendation: Set up a local investment fund with a governing structure to reflect the aims of the fund. Investments by the fund will be prioritised to those areas in most need through existing intermediaries where possible.

Provide grants to Social/Environmental Purpose enterprises and charities

The simple fact is that there is insufficient investment into small local enterprises and charities. On top of this, social market investment is not easy to recoup. If Councils and central government could encourage more intermediary organisations to emerge to take control of some of the most pressing financial issues facing local areas, it could help government to take a much more long term approach to the improvement of local areas. It could also help to make stronger relationships between different government bodies (central and local), and actually help to move responsibility for public services towards local voluntary and commercial organisations. Social and environmental enterprises also provide a great opportunity to make huge financial savings over the long term.

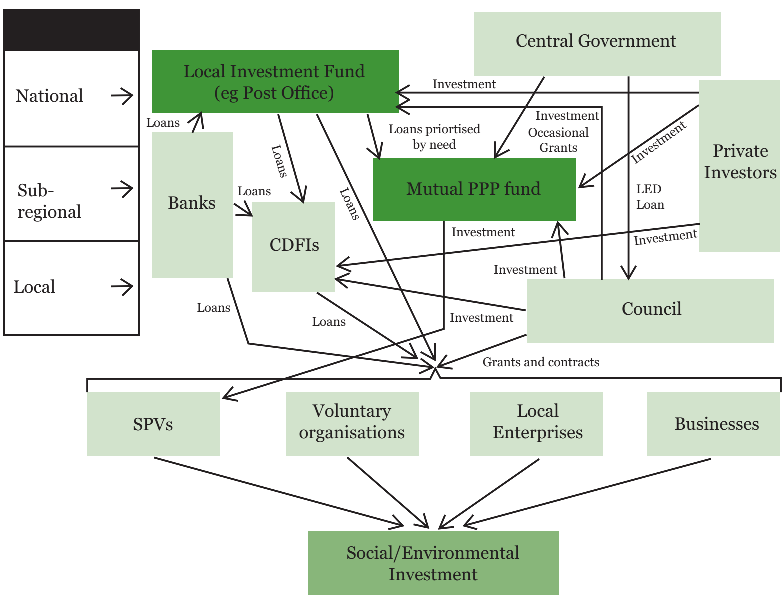
These organisations will work by identifying where money could be saved (for example – helping children into foster families to save long term prison and anti-social behaviour costs). The money saved will be split between those organisations affected, including the social/environmental purpose business or enterprise. A reasonable working model would be for the social purpose business to keep 50% of money saved, and 50% to all the relevant public bodies. The main difficulty in this approach is firstly having the relevant information to know where money can be saved, and secondly in drawing up the contract for where money should be distributed. By providing grants to such organisations – it will help to increase the market for them and will also save authorities a significant amount of money. Obviously the most obvious areas in which to invest for public bodies are those which have direct responsibility for both the running of the service and the costs of any repercussions. This actually raises an important question about responsibility and accountability for different services, and the finance mechanisms which fund them. This is a large scale piece of research which Localis is currently working on, and is beyond the remit of this research.

Recommendation: Councils should look to provide grants to social and environmental enterprises in order to encourage the market to grow and develop in the local area.

Chapter 5
A Vision for Local Government Investments

The following diagram (figure 5) should explain the direction and purpose of the two new funds (mutual PPPs and Local Investment Fund) which we recommend, and how they work with existing institutions such as CDFIs.

Figure 5: A model for investment into the social/environmental marketplace. Organisations in dark green boxes represent new ways of investment into local areas



The flow of these funds can be summarised according to the particular organisations as:

1. **Central Government** – Central Government will be responsible for occasional grants to Mutual PPP funds so as to provide support on projects which need a proportion of high risk initial capital. They will also have responsibility for providing loans to Councils under the remit of 'economic development' rather than 'capital expenditure'. Councils will also be able to use the Debt Management Office to deposit funds safely and more flexibly.
2. **Local Investment Fund** – A new 'Local Investment Fund' receives investment from Councils and any other investors from the open market. It also has access to bank loans should it need them. Its role is to provide financial tools for any organisation whose aim it is to provide social or environmental improvement to a local area, especially to existing intermediaries. The only other rule which they must follow is that the investment should be prioritised to those areas most in need. The sub-regional Mutual PPP funds can also access funds based on these rules.
3. **Mutual PPP Fund** – These are funds created by voluntary groupings of Councils whose aim it is to improve the local economic development of an area – the funds will be managed by any approved financial organisation (including existing banks). They help to spread risk for Councils and also accelerate development across traditional boundaries. They are designed to replace or supplement funding for PPP or PFI schemes in the local area and their role is not exclusively environmental/social – however, where it is – they have access to Local Investment Fund money too. They will also be eligible for central Government grants so as to allow the development of projects with a high risk initial stage. They are also open to investment from the open market as well as local government investment.
4. **Councils** – The Council will have access to a wider range of investment opportunities which impact directly on their local area. The

mutual PPP fund is designed to spread risk while still allowing locally targeted economic development. The Local Investment Fund allows Councils without a mutual PPP fund in their area to invest for social/environmental impact. Those Councils requiring the most investment will be prioritised, therefore Councils investing in the scheme are likely to do so for different reasons. Councils with existing investment strategies and more funds will most likely use the Local Investment Fund as a 'Finance First' investor, whereas those Councils looking to receive the benefits from investment are more likely to act as 'Impact First' or 'Yin-Yang' investors. The Councils will also have access to extended Government bonds and loan facilities for direct or indirect economic/social/environmental impact.

5. **Commercial banks** – Commercial banks will provide loans under on the existing commercial basis to any organisation who they wish. Under these proposals, banks will have even greater investment opportunities through the newly formed organisations – mutual PPP and Local Investment Bank. Nationalised banks may also begin to see some assets directed towards the social or environmental investment market with duties placed on them to explore new opportunities for development.
6. **Commercial (part nationalised) banks** – These banks will have the same opportunities as commercial banks, but with recommendations for central government to explore options to provide a duty for banks to invest into a certain proportion of sold assets or profits into social and environmental schemes. Investment opportunities include direct investment into small scale organisations or into the Local Investment Fund. This will ensure a decent return for taxpayer's money, and offer extra opportunities for investment.
7. **Community Development Financial Institutions (CDFIs)** – CDFIs are existing intermediaries which finance social or environmental initiatives for some tax relief for the investor. They will be eligible for funding from the Local Investment Fund as well as existing funding sources. They have the added bonus of being eligible for tax relief on a proportion of capital gains

8. **Special Purpose Vehicles** – These will operate similarly to those organisations operating under PFI, but will be parented by the mutual PPP fund and groupings of local Councils. There will be extra funding opportunities to the ability to share risk.
9. **Social Return on Investment, Voluntary and Local Enterprise Organisations** – These organisations will have a much wider choice of finance options and sources of money – Banks, the Local Investment Bank and local Councils - allowing smaller, local organisations to emerge and thrive.
10. **Businesses** – Businesses will have access to extra resources and financial products for those aspects of the business which improve the social and environmental outcomes of the area in which they are based.
11. **Other investors** – Individual or commercial investors will have a whole new market of investments with a range of social and environmental impact options – a market which is in demand, for which the supply has not yet been met.

Conclusion - Wider Systemic Reform

The schemes and recommendations discussed in this research address some of the investment issues that Councils are experiencing in the current economic climate. Some of the recommendations, such as reforms to PFI and borrowing powers could extend beyond the recession to address some of the more engrained financial issues that Councils face on a day-to-day basis. However, for Councils to fully embrace Lyons' 'place shaping' role, they must have a much greater stake in its improvement. Economic improvement is not just related to the number of businesses; it depends on the quality of the environment, and the people as well as the number and type of businesses located in the area. The most effective way for Local Authorities to capture this longer term vision for economic improvement is to have access to a wider and larger proportion of taxes, and for there to be explicitly clear lines of accountability and funding. This then allows reinvestment into the area – in short, an area which creates a stronger long term local economy will be rewarded through the increased income. This subject will be explored in depth in a forthcoming project into local government finance. However, there are a number of recommendations within this report that begin to lay the foundations for part of the extensive vision for local government. These include:

1. **The strategic role of local government** – Under these proposals Councils become more focussed on outcomes rather than on provision by aligning investment directly into the improvement of their area or other areas through Mutual PPP and Local Investment Bank. Developments in 'total area' budgeting combined with PPP and mutual fund proposals provide an opportunity to capture the economic benefits of social and environmental improvement.
2. **Emergent partnerships** – Councils working together for mutual

benefit of the regional economy through a reformed PPP scheme, which emerges through collaboration for mutual gain.

3. **Independent redistribution of local government finances** – Combined with an independent grant system, a Local Investment Fund could ultimately become one of the tools by which Local Authorities begin to redistribute their funds independently of central government, by creating a proportionate duty to invest in the fund dependent on income and performance.
4. **A strong civil society** – By creating the infrastructure and tools needed to create a market for social and environmental investment, we begin to integrate financial investment with wider social/environmental outcomes – thereby setting a framework to move beyond a dependence on tax and benefits towards an inherent reconnection between economic growth and economic development.
5. **Choice and freedom in public services** – By opening up the door to new and innovative models of service provision for the local area, this will offer opportunities to public, private and third sector organisations to work together to give people choice and freedom in their services. Ultimately it will free up Local Authorities to focus on their strategic role in the improvement of the local area. An added benefit could be that it could ultimately reduce the burden on local taxes too.

Appendix 1

Testing the propositions

In order to test the robustness of these propositions, we have tried to test the initiatives recommended in the Monitor Institute report into impact investing – these are split into three categories – 'Lack of efficient intermediation', 'building an enabling infrastructure' and 'developing the absorptive capacity for investment capital'. Where I feel that the recommendations so far have not fully met the expectations of the initiatives suggested in the report I have highlighted extra recommendations in bold.

1. Tackling the lack of efficient intermediation

Initiatives	Potential Local Government response
Create industry defining funds to serve as beacons for how to address social or environmental issues	Create a Local Investment Fund operated through NS&I or the Post Office, and a reformed mutual PPP fund which could also provide funds to social or environmental projects with a specifically defined remit. They can be launched with a specific attention grabbing purpose so as to highlight the benefits of investment.
Launch and grow dedicated impact investment banking capabilities	By allocating resources to a special purpose bank, they would be responsible for creating and utilising innovative new financial tools. With a duty on part-nationalised banks to invest for social and environmental ends, they too will be forced to set up new capabilities for investment
'Pull' existing intermediaries into impact investing by making business commitments	On top of providing grants to encourage intermediary organisations to emerge, **Councils should also state their intended aims in order to encourage the market to grow. These should be widely publicised on the Council website and any other appropriate location**

Initiatives	Potential Local Government response
Create investment clubs focused on specific themes	These will essentially be set by the Council itself through Council meetings, and through the aims of the new mutual PPP/PFI fund
Support the development of backable fund managers	**Local and central government should look to set up a national scheme to subsidise or fully support and fund managers to receive training and guidance on social investment strategies**
Create financial products to increase accessibility	The financial products will be set up the Local Investment Bank (through the Post Office or other organisation), and will be determined by the demand for them from a number of organisations with intensions of improving social and environmental outcomes.

2. Build enabling infrastructure for the industry

Initiatives	Potential Local Government response
Set industry standards for social measurement	To some extent the industry standards will emerge out of the proposed infrastructure, but it would also make sense to work with leading experts to establish some fun damentals. **We recommend setting up a steering committee comprised of politicians, experts, bankers and other interested parties to establish these rules**
To some extent the industry standards will emerge out	This document has made a number of recommendations with regards to extra freedoms with the treasury through to setting up new statutory organisations. **The government should also consult the steering committee with regards to further legislative amendments**

Initiatives	Potential Local Government response
Develop an impact investing network to accelerate the industry	The network will emerge from local government and has the potential to spread from there to the private sector
Develop risk assessment tools	**The steering committee should establish a process from which these should emerge – utilising the experience from the private sector.**
Coordinate development of a common language platform	**The steering committee will be responsible for overseeing this**
Create publicly available comprehensive benchmarking data	**The steering committee will be responsible for overseeing this**
Integrate social and environmental factors into economic finance theory	This is an enormous but fundamentally important question – and one that I believe can begin to be tackled by the emergence of intermediary organisations, and a clear delineation of public responsibility and accountability. It is also related the measurement techniques (such as the new CAA) used to judge the performance of local government. Localis will be producing some further research on this later in the year. Some interesting examples can be seen from abroad where performance measures such as GPI (Genuine Productivity Indicator) are beginning to be used to value the net development of society rather than gross.
Launch a targeted public relations campaign to promote demonstrated successes	**This should be orchestrated by central government departments through consultation with the relevant bodies (eg LGA)**

3. Develop the absorptive capacity for investment capital

Initiatives	Potential Local Government response
Support effective and scalable management capacity development approaches for entrepreneurs	**The steering committee will be responsible for overseeing this**
Provide tools to support research and development for innovative scalable models	**The steering committee will be responsible for overseeing this**

Recommendation: Set up a Parliamentary steering committee to oversee the creation and implementation of social and environmental investment marketplace recommendations outlined in above.

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