

The 30 Year General Fund Business Plan Model

Background

1. For many local authorities budgets used to be compiled one year at a time. This changed in the late 1980s. Codes of practice compiled by joint efforts of CIPFA, the Audit Commission and the then Department of the Environment placed obligations on Treasurers and local authorities to explicitly consider the longer-term consequences of financial decisions, especially those related to capital expenditure. The more recent emphasis on Corporate Governance has stressed the need for a wider consideration of future financial prospects. As a result there is now almost universal “medium term financial planning”, which in the main consists of a financial projection of 3 to 4 years ahead.
2. The introduction of a new “prudential” approach to borrowing for capital purposes requires local authorities to respond with a step change in financial planning. Under the prudential regime, local authorities do not need prior government approval to borrow to finance capital projects. Instead they need to consider a range of factors including critically the “affordability” of unsupported capital expenditure. The prudential regime itself specifies that a minimum of three year forecasts of spend and income need to be made, but it also makes reference to a need to consider longer time frames.
3. The essence of borrowing is that it provides a large amount of cash now, but obliges the borrower to make cash payments to finance interest charges and principal repayments over a much longer period. A high level of borrowing over a sustained period will soon lead to unsustainable levels of revenue expenditure. The table below shows how over 10 years borrowing £10m per annum rapidly leads to levels of repayments of around the same amount.

Year	1	2	3	4	5	6	7	8	9	10
Borrowing £m	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Repayments £m	0.4	1.6	2.8	3.9	5.0	6.0	7.0	7.9	8.8	9.7

4. An assessment of borrowing and repayments over a three-year period only will give only a partial picture of the viability of any particular borrowing strategy. There is a need to consider a much longer period in order to get the full picture. But considering only borrowing in isolation from the wider income and expenditure requirements of the local authority equally gives a false perspective.
5. Therefore there is a need for a comprehensive business plan over a long period in order to assess the overall viability and affordability of capital expenditure. The proposal for Brent is to develop and use a 30 year business plan to help support decisions members make about levels of capital and revenue spending over the next few years.

Building the model

6. It is clearly implausible to attempt to forecast accurately the level of spending that Brent needs to undertake in each of the next 30 years. That is not the aim of the model. Instead it is a diagnostic tool which can help assess whether current decisions are consistent with long term objectives. In other words taking account of known developments and existing trends what is the likely level of spending that can be afforded? If it cannot be afforded, then we can get an assessment of the scale of any adjustments that need to be made and begin to think about where changes in the plans are needed.
7. Local authorities already make use of long term business plans. For example, the HRA has a requirement to produce 30-year business plans as part of the test to ensure that the decent homes standard will be reached and sustained. Every PFI project requires a business plan for the length of the project to be able to test value for money and affordability.
8. The purpose of this model is to test the affordability of the Council's spending plans. Defining affordability is the first key task in building the model. The second is making the necessary assumptions to be able to project income and expenditure trends. Finally, the sensitivity of the results to the assumptions has to be tested. The following sections deal with these tasks in turn.

Defining Affordability

9. In relation to the General Fund the key variable in defining affordability is the level of the Council Tax. This is the main income variable that Members control.
10. In theory there is no limit to the level of Council tax, and so there is no level of Council expenditure that cannot be funded. There are, however, a number of practical and political limitations on Council Tax. At very high levels it is unlikely that sufficient tax could be collected, and even before such levels are reached the Council would face intervention from central government. Members take account of their electoral prospects using a complex calculus that includes considerations of levels of service and Council Tax.
11. Ultimately, the affordable level of Council Tax is whatever the Council each year decides it to be. This makes it a very slippery concept to include in a financial model. The approach here is to make a central assumption and then investigate how sensitive that is to alternatives.
12. The central assumption is that over the long run Council Tax can't rise faster than growth in earnings. This is assessed as the rate of growth of GDP plus the rate of increase in inflation. The main alternative investigated is increase in Council Tax at no more than retail price inflation. As will be seen below, this currently translates into average annual increases of 4% and 2.5% respectively.

13. In the short term it cannot be assumed that the current level of Council Tax is the “right” level. The Council has, over the past few years, been adjusting its tax from an artificially low base to a level more consistent with an outer London borough with inner London characteristics. This is much more clearly a political judgement, which members are in the process of making in constructing the 2004/5 budget. Therefore for the period of the medium term financial plan the long-term model assumes that members will choose an affordable level of Council Tax and will make necessary adjustments to spending to make expenditure consistent with their judgement.

Assumptions

14. The model needs some basic economic assessments. These are set out in the table below:

Price inflation per annum	2.5%
Local authority pay rises per annum	3.5%
Long term economic growth	1.5%
Long term interest rates (25yr PWLB rates)	5.0%

15. Secondly, the model needs some broad parameters with respect to grant, regulatory framework and savings. The pay and prices assumptions are as in the previous table, and the affordable Council Tax limit is taken as price rises plus long term economic growth. The other assumptions are therefore:

Increase in Government grant per annum	3.0%
Minimum revenue provision (GF)	4.0%
Efficiency savings per annum (not schools)	2.0%

16. Finally, there are a range of specific assumptions that need to be made relating to service pressures, legislative change, local discretionary growth, and particular financing arrangements applicable to Brent including pension contributions. The main assumptions made in the model for these issues are set out below:

Waste collection, disposal and recycling real growth rates	10% growth p.a. for 10 years then 3% p.a.
Social services client numbers and unit costs	3.5% p.a. real growth
Real growth in homelessness	Allowance made for S Kilburn redevelopment then neutral
Increase in schools budgets	As per grant increases

Increase in Benefits deficit	10% p.a. up to 2006/7, 5% p.a. next 10 yrs, then 2.5% p.a.
Legislative demands	£1m p.a. growing at grant rate
Local discretionary spend	£1m p.a. growing at grant rate
Employers Pension contribution rate	18.6% in 2003/4 rising to 25.2% in 2008/9. 25.2% for 2008/9 to 2010/11. 27% 2011/12 to 2019/20. 18% thereafter
Middlesex house	Equalise contributions as £353k in 2005/6 growing at 7.6% p.a. till 2019/20, then nothing
HRA Recharges	£1m switch to reflect stock change phased in from 2004/5 till 2009/10
New Wembley Civic Centre	See profile at Annex 1

Capital Spend

17. The other key parameter in the model is the level of capital spending. The model has been developed to assume the current level of the capital programme continues to which is then added sufficient additional borrowing to deal with the backlog within the asset management plan.
18. Excluding investment needed in the HRA stock, the asset management plan has identified £187m investment required to bring existing assets up to a reasonable standard. This includes £139m in roads and footways, £33m in schools and £21m in other assets.
19. This work cannot all be done at once. Not only would expenditure on such a scale be unaffordable, the borough would not have the capacity to carry out a capital programme of such magnitude. However, while the work is not done the scale of the backlog will rise. We have assumed an increase in the investment required of 2.5% per annum to account for this.
20. Three scenarios have then been developed to see how this can be financed:
 - (a) A relative high initial increase in capital spend in 2007/8 (£7.8m) and then growth of 2.5% per annum in that amount thereafter;
 - (b) A low initial increase in capital spend in 2007/8 (£2.7m) and then growth in that amount of 10% per annum thereafter;

- (c) Modest annual growth (2.5%) but with an initial investment level such as to keep debt charges as a percentage of total spend at the start and end of the model constant – which implies an initial increase in capital of £14.6m.
21. These different scenarios have different implications for affordability. The scenarios in 20(a) and 20(b) are designed only to fund the backlog of work. The scenario in 20(a) is used for the central case. The scenario in 20(c) keeps a key prudential indicator fixed and attempts to maximise the capital spend that can be achieved within that constraint. Under 20(c) a further £357m capital investment (over and above that needed to meet the backlog) can be financed over the 30 years of the business model.

Results of the central case

22. The model's results are shown in a series of charts attached at the end of the paper. What the charts show is the difference between the council tax level forecast by the model and the affordable level. Positive differences (i.e. points plotted above the x-axis) mean the forecast is above the affordable level, whilst negative differences mean it is below.
23. Chart 1 sets out a comparison of the Council Tax that arises from the central case compared to the long term affordable level both with and without the planned growth in the capital programme to meet the backlog in the asset management plan. The obvious points to make about this graph are:
- (a) In the early years (up to 2014/15) the forecast spend leads to a council tax above the affordable level even without a capital programme. The maximum level is £69 Band D above the affordable level in 2008/9, equivalent to £6.2 million spending.
 - (b) The addition of the capital programme leads to Council Tax rising to a maximum of £100 Band D above the affordable level in 2011/12, equivalent to £9.1m spending, or £2.9m more than in (a).
 - (c) After 2020/21 on either case Council Tax falls below the affordable level for the rest of the period.
24. The conclusion to draw from this is not that the capital expenditure is unaffordable. The impact of the capital programme itself is relatively small - £2.9 million over 6 years, which implies additional savings over those planned of under £500k per annum. This is well within the tolerances of the forecast model and would be achievable. However, the real task is to bring the whole spending programme down to the affordable level. This requires that the Council finds additional savings of (or reduces base expenditure by) £9.1m over 6 years – equivalent to finding an extra £1.5m per annum. In the context of a £500 million gross turnover budget this is a manageable task.
25. Therefore the conclusion that can be drawn, especially given the relatively positive long term prospects, is that funding the existing capital programme plus funding the backlog of arrears included in the Asset Management Plan is

feasible. It will require a redirection of resources, although this may only be temporary, and a few difficult years ahead.

Alternative Capital Programmes

26. Building on the information above, Chart 2 looks at the effect on the central case (including funding the asset management plan backlog under 20(a)) of the other two capital funding scenarios: 20(b) and 20(c).
27. The plan of having a lower initial increase in the capital programme but with faster growth in spend does reduce the Council Tax impact of the capital programme. Under this approach (i.e. 20(b)), the highest forecast council tax rises above the affordable level is just £78, equivalent to £7.1m spending. The savings required to accommodate this approach would be £1.2m per annum over 6 years.
28. Ultimately the level of council tax reaches the same level below the affordable level because the same amount of capital spending has been financed. It is just that on average the spend occurs at a later date than under the central case.
29. The third alternative (seeking to maintain debt charges as a constant ratio to total expenditure) gives a very different picture. The Council tax rises to a maximum of £139 above the affordable level by 2012/13, equivalent to £12.6m spending. This will require additional savings of £1.8m per annum over 7 years to bring spend down to the affordable level. Council tax still declines substantially below the affordable level eventually, but not as far as under the other scenarios. This is hardly surprising as an extra £357m capital expenditure is undertaken in this approach.
30. These cases demonstrate that there are a variety of approaches that can be taken to funding capital spend over the years. In all cases the underlying model suggests that additional savings will be required in the early years, but that there will be growing headroom later on.

Sensitivity of the Affordability assumption

31. The alternative assumption for long term affordability of Council Tax is that it should rise no faster than inflation (assumed to be 2.5%). Chart 3 compares the central case set out above with a case based on this lower assumption for long run affordable level of Council Tax.
32. It is clear that the current long run business model is unsustainable if this lower Council Tax assumption is made. By 2033 the gap in spending terms is £52 million. It will take an average additional saving of around £2m per annum over the entire period to close the gap, or close on 1% per annum of net service budgets. Under previous scenarios additional savings were required, they were not this high and nor were they for such a long sustained period. It is doubtful whether the authority has the capacity to achieve this on the basis of recent experience.

33. If the lower affordability limit were to be the target, then the Council would need to make some fundamental changes in the business plan and the assumptions driving spend set out above. The scale of the challenge is much greater than the contribution that the capital programme is making to the overall costs.

Other sensitivities

34. There are a few of the other parameters in the model that could have a profound effect on the conclusions. Collectively, if every one of the expenditure assumptions moved in the same direction (either up or down) this could have a marked impact. The key variables that could impact on the model in a significant way and which have been tested are pay relative to inflation, inflation rates, real interest rates, the passporting assumption and the grant assumption.
35. Chart 4 sets out the results of the sensitivity analysis. The central case is as described above and is used as a benchmark. The alternative models are:
- Assume that pay rises are +2% above inflation rather than +1%.
 - Assume that inflation is at 5% instead of 2.5%.
 - Assume real interest rates at 4.5% instead of 2.5%.
 - Assume the schools budget grows at 1% more than the grant rate.
 - Assume that grant increases are 2.5% per annum and not 3%.
36. The key results from the sensitivity analysis are set out in the table below:

Assumption	Maximum above affordable tax		Average extra saving & for how many years	Final position v affordable tax
	£Band D	£m		
			£m / No yrs	£ Band D
Central case	100	9.1	£1.5m / 6 yrs	414 below
Pay +1%	108	9.8	£1.4m / 7 yrs	192 below
Inflation @5%	45	4.1	£1.4m / 3 yrs	1530 below
Real interest rates up	113	10.3	£1.5m / 7 yrs	346 below
Schools up +1%	584	53.0	£2m / 27 yrs	584 above
Grant rate 2.5%	156	14.1	£2m / 7yrs	13 above

37. Increased real rates of pay have a relatively modest impact on the model. This is mainly due to the high level of outsourcing and the implicit assumption that the schools budget is driven by the grant increase rather than cost rises.

38. Under the higher inflation scenario pay inflation is also increased by 2.5% per annum and nominal interest rates are increased to maintain real rates. Increased rates of inflation have a significant positive effect on affordability. The key factors here are the large element of fixed costs (i.e. the bulk of historic debt is at fixed interest rates) and the increase in the affordable level of Council Tax due to the rise in general prices and wages.
39. An increase in real interest rates also has a relatively small impact in the short term and long term. This is because it is only marginal borrowing needed to fund new capital expenditure that has to be financed at the higher rates.
40. Growth of the schools budget by 1% more than the annual increase in grant does have a very significant impact on the model. There will need to be additional savings of £2m per annum over the whole period of the model to bring Council Tax down to the affordable level. This is probably true of underlying expenditure in general – if it outstrips the rate of growth of grant then it will in the long term be unsustainable.
41. This point is partially illustrated by the last exemplification. A cut in the growth in government grants by 0.5% to 2.5% wipes out the long-term benefits shown in the central case. The short-term effect is probably manageable, but it leaves the long-term position balanced on a knife-edge.
42. The sensitivity analysis shows that the overall plan is most vulnerable to increases in the schools budget. In theory that is a risk that can be managed by the authority, although it is clear that this may change. The government's intervention to set a minimum per pupil increase, which may not be funded centrally, could be a forerunner to a more general loss of control in this area. The impact of other changes is much more manageable, and increases in inflation may actually ease the overall position.

Summary and Conclusions

43. Expenditure in the 30 year business plan is based on current trends with respect to service pressures, an allowance for future unfunded legislative demands and local discretionary expenditure, and modest achievable levels of savings. It also includes the financing costs of an increased capital programme sufficient to fund the backlog of repairs included in the asset management plan.
44. The model assumes that by 2006/7 the level of Council Tax set by Members will be at its long-term affordable level. The central assumption is that Council Tax can rise after that in line with the underlying growth in the economy. On this basis, there are spending pressures in the early years of the plan, but considerable headroom later on. Typically, this will require that the Council finds around £10m additional savings over 6 or 7 years at the beginning of the planning period. This is considerable plausible, and that therefore the capital expenditure plans are affordable.

45. This conclusion is very sensitive to the assumption on affordability. If Members believed that council tax could only rise in line with price increases then the business plan is probably unsustainable over the longer term. It would need to be significantly revised. The Council would need to reduce expenditure on discretionary areas over a sustained period and probably reduce its capital expenditure plans.
46. The overall plan is not threatened to the same degree by changes in other assumptions. Increases in pay, interest rates or a reduction in the grant rate all reduce the headroom in later years but do not significantly increase the savings required in earlier years. A rise in inflation would significantly increase the flexibility available to the Council.
47. However, the plan would not allow much scope for a significant annual increase in the schools budget over the annual increase rate in government grant. While this is a parameter currently under the control of the Council, there may be changes in the near future by government that would reduce local influence. This is therefore an area of concern that needs to be closely monitored.
48. The Director of Finance's current assessment is that there is scope to allow an increase in the capital programme at present to take advantage of the freedoms in the new prudential regime. However this will need to be kept under close review.

Stephen Hughes, Director of Finance

October 03