Local authority commercial property investments

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POLICY RESEARCH SERIES

Contents

Page

Executive summary **3**

Introduction **4**

Section 1: council investment properties explained **5**

What are councils buying? 5

Why are councils investing in commercial property? 6

How do councils pay for commercial investments? 8

The governance of council commercial investments 8

Could council commercialisation lead to lower council tax? 11

Section 2: What are the risks of councils investing in commercial property? **12**

Do councils lack sufficient expertise to make sound investments? 12

Can council investments in commercial property cause market distortion? 13

How successful have investment strategies been? 14

Are commercial investment strategies too risky for local authorities? 16

Conclusion and recommendations **20**

Appendix **21**

Executive summary

- From 2016-17 to 2018-19, councils in England spent £6.6 billion on commercial property, 80 per cent of which is accounted for by just 49 local authorities, predominantly in the South East.[1]
- Since 2010-11, the amount spent on commercial properties by councils has increased from £53 million to £2.2 billion in 2018-19.[2]
- On average, only 52 per cent of investments take place within a council's operational area.[3]
- Council investments in commercial property made up almost a third of all office acquisitions in the South East from 2016-17 to 2018-19.[4]

Local authority commercial property investments have proven to be successful sources of income for many councils across England. Because councils are forbidden from borrowing to cover running costs, many have used commercial property investments, often funded by debt, to supplement their revenue streams as revenue support grants declined. In the case of some councils, this has even limited the need for council tax rises and allowed them to maintain or even increase services.

However, these investments also place taxpayers' money at a potentially unacceptable level of risk. Commercial property investments are inherently risky and should returns fall these investments could become a drain on council finances or have to be sold off at a loss. While some councils may maintain the expertise to ensure only sound investments are made, council leaders have expressed concern that this is not the case across the country. Those same councillors also expressed concern that access to loans was, if anything, too straightforward. To mitigate against the likelihood of inexperienced councils making poor investment decisions, the government should increase scrutiny of Public Works Loan Board loans to ensure fewer such decisions are taken. Another way to accomplish this would be by making it a statutory requirement for local authorities to maintain audit committees.

The covid-19 crisis also affects the sustainability of investment strategies significantly. Incomes from both retail and office units (which make up a majority of all council investments) are being especially affected. It is not clear how they will recover in the future. High street retailers were already struggling before the current recession and the ability of many retailers to survive remains in doubt. What is less certain is what effect the widespread embrace of work-from-home measures may have on the future value of office buildings.

Though commercial property investments have generally been considered a stable investment, these factors may prove that conventional wisdom wrong.

[1] National Audit Office, *Local authority investment in commercial* property, 13 February 2020, p.4.
[2] Ibid, p.23, p.33.
[3] Ibid, p.7.
[4] Ibid, p.9.

Introduction

Commercial property investments have increasingly become a hallmark of local authority finance in recent years. Unlike in the past, English councils have now been committing to commercial property investment strategies in a wide-ranging and orchestrated way.

These investments can place taxpayers money on the line should investments fail to provide expected returns. If properties are not occupied, not only does this represent lost income for councils, but they must also spend more taxpayers' money maintaining them. TaxPayers' Alliance research last year revealed that in 2016 and 2017 councils spent at least £74 million maintaining, renovating, securing and insuring empty commercial properties.[5]

Commercial property investments are not the only investments that councils may possess but are the sole focus of this paper. This paper aims to assess whether councils can make these forms of investments effective on behalf of their residents. To that end, this paper will investigate the efficacy of commercial investments in several areas.

In section 1, the paper looks into the background of council commercial property investments. This explores what sort of investments are being made, why councils are making them and how they are paid for. It also examines the wider governance of council commercial investments and questions whether increased reliance on these forms of income could lead to council tax reductions.

Section 2 investigates the risks surrounding commercial property investments, specifically those that arise because of local authorities' involvement. This section looks at expertise, market distortion, the success of investment strategies and questions whether the risks are too high for local authorities. This is then followed with a conclusion and a set of recommendations.

To conduct this research, both existing secondary resources and primary research has been undertaken. Primary research has been completed through interviews with council leaders and freedom of information requests to select local authorities.

[5] Hutton, J, *Hollow Highstreets: Empty council-owned commercial properties*, TaxPayers' Alliance, 3 June 2019, p.2.

Section 1: council investment properties explained

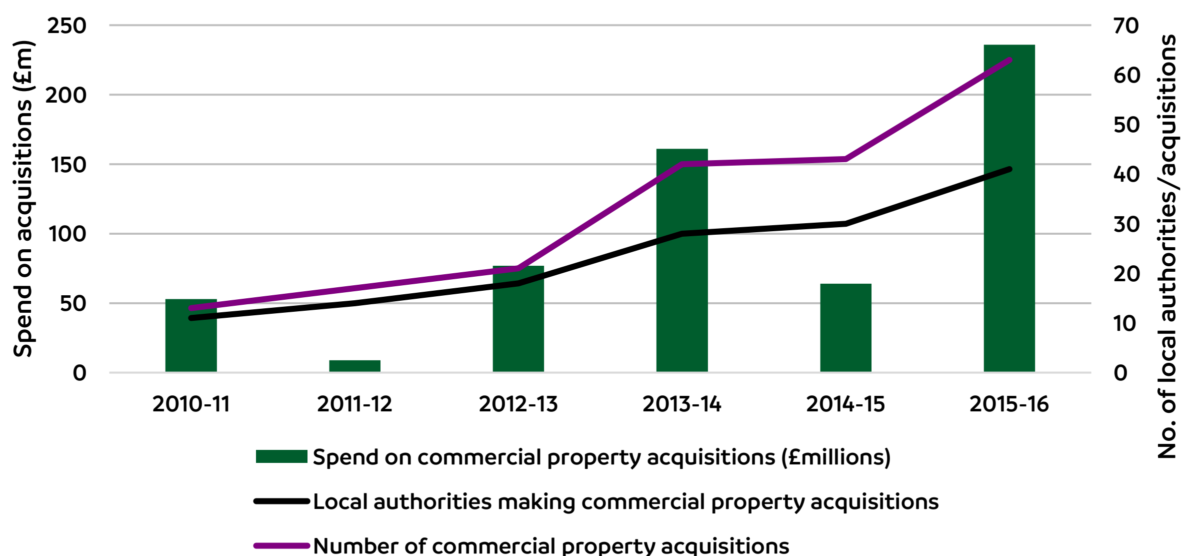
What are councils buying?

Commercial property investments can cover a range of properties, including office blocks, supermarkets or the business campuses of large multinationals. If local authorities can secure the requisite investment funding, these have the potential to provide an additional revenue stream for councils.

Although councils have long bought commercial properties, the amount they were investing was relatively low in the past. In the latter half of the 2010s, however, this changed.

In 2010-11, English councils spent £53 million on purchasing commercial properties. Between then and 2015-16, the amount spent fluctuated significantly year-on-year in a way that obscured any clear trend. Underlying this, however, a less visible trend can be discerned. While the total value of investments was erratic, the number of acquisitions made consistently increased, as did the number of councils making the investments.

Chart 1: commercial property acquisitions by local authorities, 2010-11 to 2015-16[6]



In 2016-17, however, acquisitions increased significantly by every measurement (see chart 3 on page 21 for a chart extending to 2018-19). The number of commercial property investments rose by 39 per cent and the amount of councils making such investments more than doubled. The total spent on acquisitions meanwhile increased by more than seven times in a single year to £1.8 billion.

Mostly, councils have been investing in a mixture of retail and offices. In 2016-17 and 2017-18, 84 and 83 per cent of acquisitions respectively were on these property types, with similar amounts spent on each (£733 million on retail and £776 million on offices in 2016-17; £1.078 and £1.058 billion in 2017-18). In 2018-19, though, this changed with the amount spent acquiring retail properties falling by approximately half a billion pounds. Simultaneously, office acquisitions rose by £160 million.[7] The remainder was spent on industrial and other properties. Notably, the amount spent on other properties (comprising leisure, speciality, sports and healthcare), while still low (£146 million in 2018-19), has risen by 2,820 per cent since 2015-16.

[6] See chart 3 on page 20 for a full graph covering the period 2010-11 to 2018-19. National Audit Office, *Local authority investment in commercial* property, 13 February 2020, p.23.
[7] Ibid, p.24.

Acquisitions undertaken from 2016-17 to 2018-19 have overwhelmingly been conducted by councils in the South East of England, which have made 53 per cent of all investments in terms of value. 73 per cent of investments by South East councils have taken place within the region, rising to 85 per cent if including London. Every region of the UK echoed this with home region investment being higher than out-of-region investments. Councils in the East Midlands, however, spent the least within their own region, with 42 per cent of investments taking place outside the region. Councils in the North West, North East, West Midlands and Yorkshire and the Humber exclusively invested in their home regions.[8]

A high proportion of investments are made beyond council operational areas. In 2018-19, 48 per cent of council commercial property investments were outside of their operational area. Whilst 14 per cent of these were at least within a council's local enterprise partnership area, 86 per cent were not.[9]

Why are councils investing in commercial property?

Although the use of commercial investments should not be considered explicitly tied to the recession that followed the 2008 financial crisis, there is a clear connection. When the coalition government came to power in 2010, it was made clear that local authorities would have to make savings, as central government reduced revenue support grants (albeit with greater retention of business rates revenue). Councillor David Bittleston, leader of Woking council, remarked in an interview that this was clear to councils from the get-go:

"We knew in 2010, when the Conservatives went into government…we knew then we wouldn't get any money because the proposition in 2010 was of fiscal restraint".

The reduced revenue support grants affected different councils to different extents, with some local authorities still receiving the grants, and others not (in 2019-20, central government continued to disburse over £653 million through revenue support grants).[10] Spelthorne council, as an example, ceased receiving any revenue support grant in 2017-18. Councillor Ian Harvey, leader of Spelthorne council, explained how the revenue loss had affected his council:

"*When I became a backbench councillor in 2013, we were receiving about £2.4 million a year revenue support grant from the government. It has been decreasing and decreasing and it is now at £0. It was projected that by this year we would be at minus £750,000. I would have to write a cheque to central government*".

While many councils addressed reduced central government revenue by reducing wasteful spending, an initially small number of local authorities explored other areas with their finances and bought commercial properties.

The intent of most of these councils was predominantly to pursue yield. In a 2020 National Audit Office (NAO) study, they found that for 42 of 45 local authorities yield was a 'significant objective'.[11] Among those 42 was Spelthorne council. Cllr Harvey, however, was unapologetic and outlined the measures the council would have had to take to balance the budget without investing in commercial properties. According to Cllr Harvey, in addition to efficiencies already made, this would have necessitated selling key assets (including the central council offices), cutting staff and services, and using up Spelthorne's "dwindling reserves."

Cllr Harvey stated that such an approach would have been short-term, which could have increased costs to the council over the long term while only providing immediate security. He was open to alternative strategies, but incredulous about their feasibility, stating that "…nobody has yet to

[8] Ibid, p.35
[9] National Audit Office, *Local authority investment in commercial* property, 13 February 2020, p.33.
[10] Ministry of Housing, Communities & Local Government, *Key information for local authorities: final local government finance settlement 2019 to 2020*, 29 January 2019, www.gov.uk/government/publications/key-information-for-local-authorities-final-local-government-finance-settlement-2019-to-2020, (accessed 20 April 2020).
[11] National Audit Office, *Local authority investment in commercial property*, 13 February 2020, p.7.

come up with a better plan as to how to sensibly protect services. When they do, there is the door, they can come in and tell me."

One such alternative plan was offered by Cllr Ferris Cowper, formerly the leader of East Hampshire council and then a cabinet member, who spearheaded a commercial property plan for councils which he explained at a TaxPayers' Alliance panel event in 2019.[12] Although Cllr Cowper agreed council finance was changing ("anyone saying carry on as you are lacks grip on reality,") he held major misgivings about commercial strategies like Spelthorne. The problem, as Cllr Cowper described, was that Spelthorne had "one chance of success" and were "putting all their eggs in one basket." Like Spelthorne, East Hampshire now derives a substantial proportion of its income from commercial property, but a significant difference as described by Cllr Cowper is that "diversification is key." This seems to be why East Hampshire has also invested in service provision to other councils. Services that East Hampshire sells to other councils (and also the Ministry of Defence) include development control, planning services, enforcement and regeneration to name just a few.[13]

Another council identified by the NAO study was Portsmouth city council. In the same 2019 panel discussion, council leader Gerald Vernon-Jackson noted that he had had to find some way to balance the books. This may have required more taxpayers' money, which he admitted was "unrealistic." Other options would have included cutting services, raising taxes, finding efficiency savings (which he explained Portsmouth had managed to an extent), or to increase income through other means. Cllr Vernon-Jackson explained that the investment strategy had enabled Portsmouth to "keep taxes as low as possible, but to protect services."

However, not all councils have been making investments based upon yield alone. Some councils are motivated by rejuvenation, or 'place-making' strategies. While such plans can still generate yield, they can contain long-term goals separate to cash flow. In contrast, the primary intent of yield-based strategies is to support council services through increased income.

Woking council is a notable council concentrating on local rejuvenation. In recent years it has redeveloped the main shopping centre, erected three high rise blocks (the highest being 34 stories) and has further plans across the city including the regeneration of a housing estate.

While the reduced revenue grant gave Woking the incentive to seek other forms of income, unlike Spelthorne the primary motivation was so that the council could proceed with a 15-year place-making strategy.

Woking council began considering town centre regeneration in the shadow of the 2007-08 financial crisis. According to Cllr Bittleston, having assessed the state of the town centre and the retail environment more widely, the council concluded that if they failed to intervene the town centre would struggle in the future. This resulted in a 15-year plan being agreed in 2012 which sought to transform the town centre to address potential future challenges. Neither Woking nor Spelthorne council expects to continue expanding their commercial property portfolios much further, however. Spelthorne decided in February 2019 to instead focus on housebuilding. Cllr Harvey explained that the council had succeeded in restoring their finances, which facilitated this shift to prioritise housebuilding. The council is also moving towards a place-making strategy, which is why the council recently bought a shopping centre in Staines. As Cllr Harvey explained:

"*It's not that we want to be high street landlords…It's more a case of medium-term place-making to bring the heart back to the town in terms of protecting the town and also making sure there is a destination. Getting people back into the town centre again*".

[12] TaxPayers' Alliance, Panel discussion: Should councils spend taxpayers' money on commercial property and investments? 7 March 2019, www.taxpayersalliance.com/panel_discussion_should_councils_spend_taxpayers_money_on_commercial_property_and_investments, (accessed 20 April 2020).
[13] Ibid.

Cllr Bittleston meanwhile described periods of significant local investment as cyclical, occurring every few decades between which the council will "take a deep breath and just consolidate."

How do councils pay for commercial investments?

Primarily, councils have paid for their acquisitions by borrowing money. Largely, but not entirely, this is through the Public Works Loan Board (PWLB).

The PWLB is a part of the Debt Management Office (itself an agency of HM Treasury) which exists to provide loans to local authorities (and some other public bodies) to fund capital projects. From 2011-12 to 2018-19 the PWLB lent £46 billion per year on average to English authorities, in contrast to £8 billion lent by banks and building societies, and smaller amounts from other local authorities and other sources.[14] The NAO estimates that anywhere between 38.5 per cent and 91.2 per cent of commercial property acquisitions have been financed by prudential borrowing in this way.[15] When councils use prudential borrowing for investments, they are obligated to repay some of the loan every year so that it does not burden future taxpayers.

In the 2000s, PWLB loans were usually 0.15 to 0.2 per cent above the gilt rate, but in 2010 this was raised to one per cent above gilts, before a discount ('certainty rate') was introduced in 2012.[16]

These discounts made PWLB loans increasingly attractive to local authorities as it often undercut commercial lenders. In 2018, PWLB loans would usually be offered at rates between 1.5 and 2.5 per cent (raised by 1 percentage point in 2019).[17] In contrast, a private loan may be as low as 2 per cent above the base rate[18,19] though could be much higher.

Following the NAO report, the Treasury announced a consultation into council investments and announced a slew of proposed changes which would heavily discourage investing for yield and impose a range of additional restrictions. These proposals will be explained further in the following section.

The governance of council commercial investments

Prior to 2016, there was seemingly little central government interest in the growing shift in commercial investments. It is possible that the reduced value of investments concealed the growing trend displayed in table 1. In late 2016, however, the public accounts committee took note. The committee warned that the then Department for Communities and Local Government was 'particularly complacent' about the risks of council commercial activities.[20] In their report, the committee highlighted numerous other concerns including inadequate departmental data.[21]

The inadequacy of available data does not seem to have been addressed. In a recent report the NAO had to purchase a commercial property investment dataset because government data was insufficient.[22]

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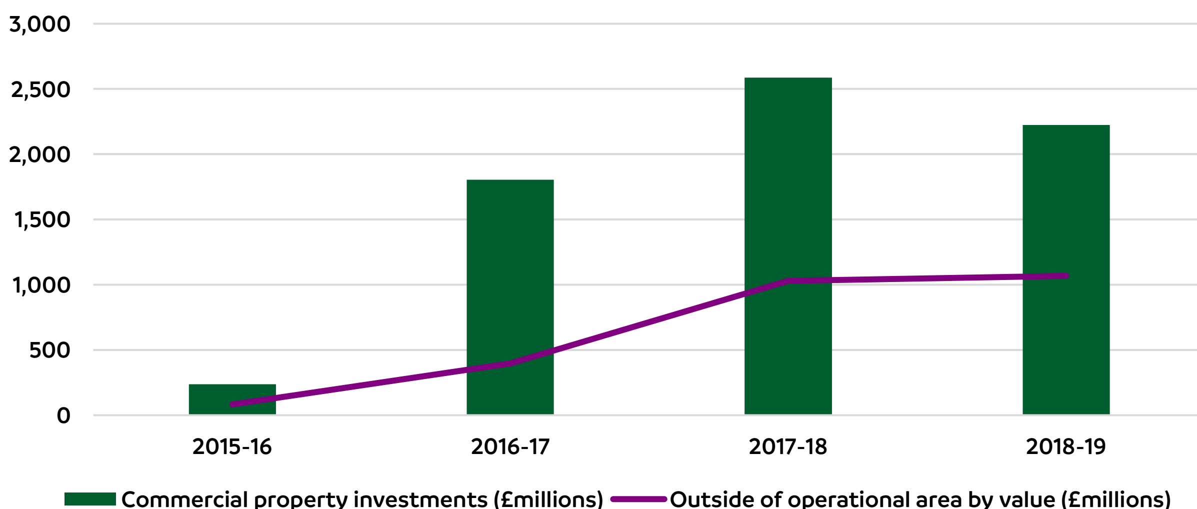
[14] National Audit Office, *Local authority investment in commercial* property, 13 February 2020, p.39.
[15] Ibid, p.36.
[16] Sandford, M., *Local government in England: capital finance*, House of Commons Library, 30 October 2019, p.9.
[17] Ibid, p. 10.
[18] Goodman Corporate Finance, *Commercial Investment Mortgage*, 2020, www.goodmancorporate.com/property-finance/commercial-investment-mortgage/ (accessed 10 February 2020).
[19] Brightstar Financial, *The property investors guide to commercial mortgages*, Property Reporter, 8 August 2019, www.propertyreporter.co.uk/landlords/e-property-investors-guide-to-commercial-mortgages.html, (accessed 10 February 2020).
[20] House of Commons committee of public accounts, *Financial sustainability of local authorities*, House of Commons, 14 November 2016, p.5
[21] Ibid, p. 6.
[22] National Audit Office, *Local authority investment in commercial property*, 13 February 2020, p.67.

New editions of the HM Treasury management code and prudential code published in late 2017 imposed a range of obligations upon councils including the following:[23]

- Obligated councils to prepare an annual investment strategy which explained how investments related to their core purpose
- The investment strategy should include understandable quantitative indicators for the public and for councillors
- Councils should make clear how reliant the provision of services is upon commercial income
- Councils would not be required to prioritise security and liquidity when it comes to property investments, allowing them to retain them when their financial situation is at risk

Effectively, these changes incentivised greater caution, but did little to seriously discourage councils' approaches to commercial property investments. A notable intention of the changes was to reinforce that authorities should not be borrowing money purely to invest for future yield.

Chart 2: local authority purchases of UK commercial property, (£m)[24]



What may have had a much greater effect was the unexpected increase in PWLB loan rates in October 2019 that increased interest rates by 1 per cent, though it remains too soon to make a full assessment. In some cases, this more than doubled the interest on loans. Trafford council reported that their repayment rates rose from 0.8 to 1.8 per cent.[25] It also led West Berkshire council to consider stopping its investment strategy prematurely, and re-investing in other areas instead.[26] At the time, the government received a large amount of criticism for the decision. The leader of Plymouth council called it a "hammer blow for local authorities" and "financially illiterate." The leader of Stevenage council said it had "blown a hole in the middle" of their plans.

Cllr. Bittleston of Woking explained in full the effect of the rates change:

[23] Sandford M., *Local government: commercial property investments*, House of Commons Library, 2020, p.11.
[24] National Audit Office, p.23, p.33.
[25] Richardson, A., Government hike in interest rates could hit vulnerable residents, warns council, *Manchester Evening News*, 15 October 2019.
[26] Seabrook, A., Council set to abandon commercial property plans and spend money on social housing instead, *The Reading Chronicle*, 7 January 2020.

"*...in October the PWLB moved the interest rates from 1.8 to 2.8 per cent. But actually — all councils did their calculations for 2019-20 on an assumption of 2.8. All they were doing was adjusting it to where they said it would be. They stole that 1 per cent from us and everybody has whinged about it. And it does make a difference going forward, but if you actually look at councils making decisions at 1.8, then you are being a fool, because actually government had told us to assume 2.8. The fact that it had dropped to 1.8 was luck. If you actually managed to borrow in the period that it was below 2.8, you did well*'.

At the time, the rates rise was not announced in connection to the wider growth in commercial investments, but due to a number of councils substantially increasing their borrowing due to the low interest rates. However, the HM Treasury consultation paper released on 11 March 2020 made the relationship clear. Although the rates had not been raised to discourage investment activity specifically, the rise was driven by increased investment activity rather than capital spending.[27]

This was effectively the bluntest way for the government to restrict PWLB borrowing prior to long-term changes being implemented.

A notable element of PWLB loans – and part of why it is where councils go first for loans, in addition to generally low interest rates – is the ease with which councils can gain this finance. The HM Treasury consultation paper describes the process as thus:

"*The application process is currently deliberately permissive: if the finance director of the applicant authority can confirm that they are acting in line with statute and can afford to repay the loan from their revenues, the PWLB will issue the loan within two working days*".[28]

Cllr. Harvey explained his surprise at how easily loans were available through the PWLB upon being presented with the opportunity to purchase the BP campus at Sunbury:

"*...it is essentially you ask for the money and three days later you get it...Personally I think it is crackers. Absolutely bonkers".*

Changes proposed by HM Treasury would, however, impose a significant caveat upon lending terms. Essentially, the changes would end access to the PWLB for councils that want to buy assets primarily for yield. Crucially, the proposal suggests that if a council wanted to fund an asset purchase through a private loan, it would still be able to do so but would be refused further PWLB loans for the remainder of that financial year (this change would not be retrospective). A further reform HM Treasury might consider is to forbid the PWLB from issuing loans below market rates if the loans are not used for non-key infrastructure.

An additional way to increase scrutiny of commercial property investments would be to make it a statutory requirement that all English councils have an independent audit committee. Among other duties, an audit committee must scrutinise all high value investments as well as those beyond a council's operational area. Audit committees should approve investments based on the feasible potential for returns in line with the UK average for commercial properties. However, as the NAO identified in 2019, only 33 per cent of audit committees in English councils have a single independent member on them.[29] This raises the risk that committees become overly politicised and its decisions improperly influenced. To counter this, audit committees should have at least two independent members.

[27] HM Treasury, *Public Works Loan Board: future lending terms*, March 2020, p.1-2.
[28] Ibid, p.7.
[29] National Audit Office, *Local authority governance*, 15 January 2019, p.4.

Could council commercialisation lead to lower council tax?

An interesting implication of growing council commercial property investments is whether this will allow councils to reduce council tax.

A vocal proponent of this is Ferris Cowper, former council leader of East Hampshire. Writing in 2018, Cllr. Cowper declared his council's intention then to abolish council tax within four years.[30] This was to be done through gradually increasing commercialisation and simultaneously lowering council taxes. East Hampshire markets a range of services to other public sector clients that include other councils and, in at least one instance, the Ministry of Defence.

Over the past nine years, East Hampshire has raised council tax only twice and it is now lower than it was in 2012-13 and has remained so over the last eight years. By contrast, council tax in Spelthorne and Woking is now £33 and £40 higher than in 2012-13, outstripping the average for English district councils.

Table 1: band D, council tax levels 2012-13 to 2020-21 (excluding parish precepts)[31]

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
East Hampshire	135	137	137	137	135	131	131	131	134
Spelthorne	172	176	179	182	187	192	197	202	205
Woking	205	209	213	217	222	227	233	240	245
England average (district councils)	169	170	171	171	175	179	184	189	195

The question was put to both the leaders of both Spelthorne and Woking as to whether they believed their investments had helped them to keep council tax low.

Cllr Bittleston of Woking admitted that Woking had always taken as much in council tax as they could in recent years. This was justified because, as Cllr Bittleston put it, "If we had £5, the maximum, what we get is so insignificant in comparison with the county council and the police….there aren't many people who would ring me up and thank me for saving them £5."

Cllr Harvey of Spelthorne agreed that the council received a low proportion of council tax payments, with most again going to the county council and the police. Cllr Harvey explained that if council tax was not consistently raised then there was a threat of eroding the tax base. Because legislation prevents tax rises over 4 per cent, without a referendum, this would, in theory, make it difficult to ratchet up tax rates later should council finances deteriorate in the future and increased tax revenue be desired.

When these points were put to Cllr Cowper, however, he strongly rebutted them both. On the immateriality of a £5 increase Cowper said:

[30] Cowper, F, *Ferris Cowper: Our ambition is to abolish Council Tax in East Hampshire within four years*, ConservativeHome, 27 February 2018, www.conservativehome.com/localgovernment/2018/02/ferris-cooper-our-ambition-is-to-abolish-council-tax-in-east-hampshire-within-four-years.html, (accessed 27 July 2020).
[31] Ministry of Housing, Communities & Local Government, *Council tax statistics*, 25 March 2020, www.gov.uk/government/collections/council-tax-statistics, (accessed 20 April 2020).

"*For people on low fixed incomes, any expenditure that they cannot avoid matters. Remarks like this are made by people with big dogs, huge SUVs and a lovely detached house. Talk to someone on a state pension about whether council tax matters*".

Cllr Cowper also saw no issues with eroding the council tax base as far as possible, even to zero, highlighting that it was an "appallingly regressive tax that is unfair, hurting the most vulnerable in society with disproportionate severity."

These councils highlight the division over how effective a commercial investment strategy can be in keeping taxes low as a priority for local authorities. It is appropriate to question how many councils could undertake such a strategy. The council's commercial strategy is also largely reliant on the sale of services to other councils, but it is difficult to imagine how such an approach could be sustainable en masse.

Section 2: What are the risks of councils investing in commercial property?

Investing for yield is not without risk. No matter the quality of an investment, revenue can never be completely guaranteed. When investments are funded by borrowing, this adds an additional burden through interest payments and loan repayments which can subsequently affect cash flow. Private entities risk investors' money, yet public sector bodies potentially imperil taxpayers' money.

The mid-2000s Icelandic bank crash provides a cautionary tale for those councils attempting to become more enmeshed in the investment market. A series of mostly English and Welsh councils placed large sums of money on deposit with three Icelandic banks in the hope that the high interest rates on offer would be worth the risk. The three banks subsequently crashed in the 2008-09 financial crisis, losing councils more than £1 billion (the money was later reclaimed over several years).[32]

Similar to the Iceland bank crash, when a local authority invests in commercial property for yield, it is doing so in the expectation of a profit over a long period of time which it can invest in services or other investments. But if that investment fails, it is taxpayers who ultimately have to meet the cost of that failure. This could happen through council tax rises, increases in fees for non-statutory services, cutting services, or selling off assets. Those sceptical of councils investing in commercial property have typically highlighted these concerns.

Do councils lack sufficient expertise to make sound investments?

The question of council expertise in this area has been a common point of contention. Speaking in 2019 Meg Hillier – the chair of the public accounts committee – complained that there were too many 'rank amateurs' working in local government that lacked the experience to make sound financial decisions.[33]

At a previous TPA discussion of council investment properties, Cllr Ferris Cowper, who had a long career at Mars Incorporated before becoming a councillor, remarked that poor performing councils could ruin things for others. Ben Bradley, MP for Mansfield, outlined the example of the chief executive of his local council, who had started working for the authority behind the front desk and

[32] BBC, *Councils recoup most of deposits lost in Icelandic banks crash*, 5 February 2014, www.bbc.co.uk/news/uk-politics-26052949 (accessed 11 August 2020).
[33] Hill, J., *Hillier: Too many 'rank amateurs' making commercial decisions*, Local Government Chronicle, www.lgcplus.com/finance/hillier-too-many-rank-amateurs-making-commercial-decisions-12-06-2019/ (accessed 20 April 2020).

had limited external commercial experience. Despite this, Mansfield council has purchased commercial properties throughout the United Kingdom.[34]

When asked about the levels of expertise at their own councils, the leaders of Woking and Spelthorne explained that they had become councillors following long careers in the private sector themselves, and that such experience was reflected in their officers and the processes that ensure their continued level of expertise. However, despite this both councillors lacked complete confidence in local government when it came to council investments. Cllr Bittleston remarked that "…there are lots of councillors who, when you start talking about numbers, they start closing their eyes."

Cllr Harvey meanwhile gave the example of councils who spent five years deliberating over relatively small investments. "…if it takes you five years to decide then you probably haven't got the necessary knowledge, support, background to make that decision. I could make that decision in half an hour."

Speaking at the panel event in 2019, Ben Bradley MP put it more bluntly still: "Not every council can be led by former chief executives from Mars."

The effect of a lack of experience can, however, be mitigated to an extent by the employment of specialist consultants. According to two such consultants, this can allow local government leaders to approach investments from an informed position, and curb irresponsible investments.[35] However, as one former councillor noted, the credibility of the motivations of consultants may be questionable, as they are employed by councils to give advice on investments and so do invariably benefit before any returns fail to meet expectations.[36]

Can council investments in commercial property cause market distortion?

A recurring criticism of council investments in commercial property is the threat of market distortion. Although fears of this may be overblown at a national level, there seems to be a genuine threat of this in the South East. The recent NAO report into this revealed that councils were responsible for 27 per cent of all office acquisitions in the South East, and 17 per cent of retail.[37] It has been long held that commercial activity generally performs better in private hands than public. If this theory is correct, it could mean that council commercial investments could have the counter-cyclical effect of reducing their tax take due to lower levels of profit.

When this commercial activity is funded by debt, it can have even greater macro – or 'crowding out' – effects.

Crowding out refers to the economic effects of expansionary fiscal actions. Effectively, it refers to government investment, funded by public debt, failing to stimulate economic activity and thus lowering or preventing other private sector-led economic activity.[38] This happens because there is a finite amount of private finance available. Other negative effects of crowding out can include increased interest rates if lenders judge the financial sustainability of a country to be at risk, and a lack of investment and consumption in fear of anticipated tax increases later.[39]

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[34] Basey, P., *Mansfield is not worth investing in – it's official*, TaxPayers' Alliance, 2019.
[35] Goacher, S., *Councils shouldn't be chastised for acting commercially*, LocalGov, 4 March 2019, www.localgov.co.uk/Councils-shouldnt-be-chastised-for-acting-commercially/46982, (accessed 20 April 2020).
[36] Terry, J., *Judy Terry: Councils should not be playing the property market*, ConservativeHome, 24 April 2017, www.conservativehome.com/localgovernment/2017/04/judy-terry-councils-should-not-be-playing-the-property-market.html, (accessed 20 April 2020).
[37] National Audit Office, *Local authority investment in commercial property*, 13 February 2020, p.9.
[38] Carlson, K & Spencer, R, W., *Crowding out and its critics*, Federal Reserve Bank of St Louis, 1975, p.2.
[39] Picarelli et al., *Does public debt produce a crowding out effect for public investment in the EU?* European Stability Mechanism, 2019, p.2.

A 2006 study of 16 OECD countries (which did include the UK) concluded that investment declined as governments built ever higher 'debt mountains'.[40] Another 2012 study examining advanced and emerging economies over a 200-year period also found that in scenarios where debt exceeded 90 per cent of GDP, countries experienced lower growth. In many cases this low growth persisted for over a decade.[41]

It is difficult to reduce this theory to the level of local authorities, because there are multiple overlapping areas of governance that should be accounted for. However, in theory this would suggest that when local authorities use debt to fuel their commercial investments, they (or rather the Public Works Loan Board) are ultimately contributing to a nation-wide crowding out effect that may be inhibiting economic growth.

Another area worth consideration is whether councils are able to exert the maximum gains from an investment, as opposed to a private landlord. During the 2019 panel discussion, Ben Bradley MP gave the example of one property in Mansfield that the council gained a four per cent profit margin on. Yet a private landlord who bought it off the council was later able to gain a 12 per cent profit margin.

A 2015 study of UK companies from 2003-2012 found that not only were private firms more efficient relative to state-owned enterprises, they also invested more in research and development, and had reduced costs from their ownership structure. Another notable finding was that public firms held an advantage over private companies thanks to easier access to capital.[42] A separate 2015 study came to a similar conclusion, claiming that there was 'robust' evidence that private companies experienced greater future profitability.[43]

While local authorities may be using other metrics for investment success – such as the social value of some enterprises (such as theatres) – such variables are irrelevant if the council is investing primarily for yield, as the NAO found.

Unfortunately, there has been little deeper exploration into whether council investments are generally causing market distortion. On balance, however, evidence suggests that public sector debt-fuelled investments could contribute indirectly to reduced national growth. It also seems probable that councils may be unable to exact optimum profitability from those investments. If this is indeed the case, over the long-term council investments could have a counter-cyclical effect that diminishes tax revenues.

How successful have investment strategies been?

Since acquiring commercial properties, a number of councils have enacted poor strategies and projected returns have not materialised.

A 251-bed student housing block near Cambridge provided significantly underwhelming returns in 2019, returning £180,000 less than anticipated amid an overall shortfall of £877,000 from Cambridgeshire council's property portfolio. The council blamed this in large part on the 'aggressive' marketing and pricing strategy of a competitor in the same area.[44]

Sedgemoor council has seen its portfolio value decline by £917,000, which can largely be attributed to declining value in retail investments.[45] Brighton's portfolio, which includes the underperforming

[40] Heinneman, F., *Factor Mobility, Government Debt and the Decline in Public Investment*, Centre for European Economic Research, 2002, p.8.
[41] Reinhart et al, *Public Debt Overhangs: Advanced Economy Episodes Since 1800*, Journal of Economic Perspectives, 2012, p.1.
[42] Agkuc et al., *Do Private Firms Perform Better Than Public Firms?*, working paper, Temple University, 2015, p.3.
[43] Allee et al, *Private versus public corporate ownership: Implications for future profitability*, Journal of Management Accounting Research, 2019, p.29.
[44] Elworthy, J., New competitor's "aggressive marketing" blamed by Cambridgeshire County Council for shortfall in income from £38m student housing block, *Cambridgeshire Times*, 9 February 2020.
[45] Salter, S., Value of Sedgemoor District Council commercial property investments falls, *Bridgewater Mercury*, 18 March 2020.

£36 million i360 observation tower,[46] is apparently performing well. Concerns have been raised, however, on the council's reliance on retail units which make up 46 per cent of its portfolio.[47]

Several councils have reported numerous boons from their investments. Cllr Harvey reported that it has allowed Spelthorne to expand its offering to residents. Several councils such as Basildon[48], East Hampshire and Kettering[49] meanwhile have reported that it has allowed them to freeze council tax.

However, it remains difficult to assess the success of many investment strategies in lieu of reliable data. In the National Audit Office's investigation they found that out of 45 councils only 16 councils were producing data sufficient to tentatively assess the success of the investment strategies. Of these, 13 were receiving the minimum necessary returns to repay the loans and three were making less than that. Those councils meeting the minimum level were generally making returns below 2.6 per cent; only councils who had paid off their investment debts were able to see higher returns of around seven per cent. However, the NAO were unable to produce a 'meaningful assessment' of investment returns due to a lack of sufficient data.[50]

Separate to that, to gain further understanding of how well council commercial investments were doing, freedom of information requests were sent out to a select group of councils known to have invested significant amounts in commercial properties in recent years. This selection of councils included a mixture of unitary, metropolitan district, borough and county councils from several different regions of England. The request asked for lists of commercial properties bought, the value of each property and how actual income was differing from forecasts. The data is presented in table 2.

Table 2: forecast and actual yield, select local authorities, most recent full year

Authority	Value (£)	Forecast yield (£)	Actual yield (£)	Difference (£)
Buckinghamshire	146,687,085	18,455,617	18,182,716	-272,901
Leeds	119,425,300	6,578,107	6,557,000	-21,107
Portsmouth	152,440,000	n/a	n/a	n/a
Runnymede	367,450,214	19,037,401	18,211,212	-826,189
Shropshire	64,530,000	2,831,000	2,400,000	-431,000
Spelthorne[51]	n/a	31,133,065	31,133,065	0
Surrey	374,215,000	54,800,000	54,900,000	+100,000
Torbay	193,300,000	7,940,000	8,800,000	+860,000
Woking	n/a	13,488,000	12,997,000	-491,000
Total	**1,418,047,599**	**154,263,190**	**153,180,993**	**-1,082,197**

Although several thorough responses were returned, the data was itself inconclusive. In many instances it was also the case that investments were below forecast in their first year due to the

[46] Youde, K., i360 architect defends Brighton tower amid 'white elephant' claims, Architects' Journal, 15 August 2019, www.architectsjournal.co.uk/news/i360-architect-defends-brighton-tower-amid-white-elephant-claims/10044057.article, (accessed 13 July 2020).
[47] Booker-Lewis, S., Council's property investment portfolio 'performing well', *Brighton and Hove Independent*, 17 February 2020.
[48] Ferris, M., Basildon Council agrees council tax freeze and investment programme, *Yellow Advertiser*, 15 February 2020
[49] Ward, S., Kettering freezes its council tax for eleventh year, *Northamptonshire Telegraph*, 27 February 2020.
[50] National Audit Office, *Local authority investment in commercial* property, 13 February 2020, p.48.
[51] Spelthorne did not have full-year data available for five other investments that combined had a forecast yield of £20,217,170. As such they have been excluded, however, four of the five are 'in line with expectations'. The fifth was purchased only shortly before the FOI was sent.

purchase happening several months into the year, or short lease-free periods having been reported as part of the purchase.

Spelthorne council was the only local authority asked that reported all investments were returning income in line with forecasts. This excluded one bought in September 2019, for which data was not available. Torbay reported income was actually £860,000 above forecasts in 2018-19, though this did follow a £540,000 deficit in 2017-18.

Leeds, Shropshire, Buckinghamshire, Surrey, Runnymede and Woking all reported that rental income was less than expected. The difference in income ranged from £21,107 to £826,189. Of the nine councils surveyed, five reported that rents were below forecasts in the most recent year for which data was available, in total by £2 million.

It should be noted, however, that several councils reported brief rental discounts had been included in the early stage of the council becoming the property owner. As such, early years may not be fully representative of longer-term sustainability. Torbay, with its 2017-18 deficit followed by a 2018-19 surplus, may be indicative of this. It is also worth mentioning that yields not matching forecasts do not mean overall investment strategies are not generating profit.

To fully ascertain how successful investment strategies have been will require continued attention on how yields are faring over the next few years. However, the recession caused by covid-19 will prevent a reliable assessment of how effective investment strategies are within normal economic circumstances within that timeframe. That being said, the covid-19-related recession may also prove exactly why councils should not undertake risky commercial investments in the first place.

Are commercial investment strategies too risky for local authorities?

A frequent concern surrounding council commercial investments is that the investments place taxpayers' money at an unacceptable level of risk. Former Liberal Democrat leader Sir Vince Cable compared it to 'gambling' and that it suggested 'desperation'.[52] The Bureau of Investigative Journalism called it 'the public service gamble'[53] and the head of the Institute of Economic Development warned councils could easily become like 'gamblers chasing their losses'.[54]

These concerns were echoed by Dom Peebles, head of policy and technical at CIPFA, who said:

"*If commercial investment does remain part of the future strategies of local authorities, it should not be one of the core pillars of funding. To do so ties public services to the property market, and the less proportional the borrowing which has occurred, the greater the risk will be.*"

Peebles was particularly concerned about the risk of a downturn in the property market affecting the value of investments:

"*One obvious risk which local authorities face from these investments is a downturn in the property market, which could lead to lower rents or higher vacancies. This could mean that authorities will need to cover future borrowing costs from other funds. Fluctuations in property values in our history shows that this is almost a given, with the continuity of the boom, slump and recovery*

[52] Harvey, E., *Councils' property investments are 'gambling' with public money*, BuyAssociation, 17 November 2017, www.buyassociation.co.uk/2017/11/17/councils-property-investments-gambling-public-money/, (accessed 21 April 2020).
[53] Davies, G., *The Public Service Gamble: Councils borrowing billions to play the property market,* The Bureau of Investigative Journalism, 4 December 2018, www.thebureauinvestigates.com/stories/2018-12-04/councils-borrow-billions-to-buy-real-estate, (accessed 21 April 2020).
[54] Wilcox, N., *Commercial investment is a risky strategy for councils*, Local Government Chronicle, 18 February 2020, www.lgcplus.com/finance/nigel-wilcock-commercial-investment-is-a-risky-strategy-for-councils-18-02-2020/, (accessed 4 March 2020).

cycle of the market. With retail in turmoil while web based retailors march on, there are structural challenges as well as these cyclical ones."

Such concerns are not universal, however. Mat Oakley, director of European commercial research at Savills, remarked that:

"*Commercial property is generally perceived* [to be] *a reasonably stable source of income, with MSCI, the global benchmarking service, reporting an average income return of 5.9 per cent per annum for UK property since 1980.*"

The MSCI average income quoted is reinforced by the latest yield guide released by Knight Frank, which shows forecast yields of at least 5.8 per cent for retail and 4.8 per cent for office buildings. In both cases, this excludes prime London locations which return a lower yield presumably due to much higher acquisition cost.[55]

However, while these returns may be enough to insulate councils from poor-performing investments in the short-term, they may be vulnerable to larger downturns. During the 2008 financial crisis, commercial property returns fell dramatically. According to a study by the University of Ulster, retail property returns fell by 16.9 per cent while returns for office properties fell by 24.1 per cent.[56]

When asked about the risks in such a downturn, Cllr Bittleston explained the council's approach. Investments are approved based on a range of resulting scenarios. If a council is responsible, it will measure its expectations and make plans based on a moderate rate of return.

"…if you've got a reasonable spread and you take reasonable precautions over anything, you dampen down your expectations about what you expect to get. And you're not being greedy to start with. But if you say, I'm doing this expecting a 12 per cent return, and you do all your modelling based on a 12 per cent return and you end up with a 2 per cent return you're in a mire. Whilst if you are modest with your expectations, [you say] I'll put anything better than that into reserves, a rainy-day fund, then I think you can be prudent."

One form of downturn that councils may not have specifically prepared for – from a commercial investments perspective – is that which is currently being experienced in the UK as a result of the covid-19 pandemic. To suppress the spread of the disease, a range of businesses have been forced to close their premises. These include pubs, restaurants, and shops. Office workers, meanwhile, have been encouraged to work from home wherever possible. Although high street businesses have been given 12 months without the burden of paying business rates, with incomes effectively wiped for many high street businesses, their ability to pay rents has been significantly inhibited.

In an analysis of 10,000 commercial properties just a month into the 'lockdown', it was found that only 54 per cent of rent had been paid within 20 days of the due date. In a normal year this would be 79 per cent. The report notes that, despite retail tenants representing the most of non-payers, industrial and office occupants have also been affected.[57] This is, of course, only an analysis from the first month of Britain's 'lockdown' which only formally began on 23 March. Footfall began to decline significantly at the beginning of March as the public became increasingly aware of the pandemic.[58]

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[55] Knight Frank, *Yield Guide*, April 2020, www.knightfrank.co.uk/research/investment-yield-guide-april-2020-7082.aspx, (accessed 11 August 2020).

[56] McGreal et al, *The Global Financial Crisis: Impact on Property Markets in the UK and Ireland*, University of Ulster, 2009, p.51.

[57] Millard, R, Utley, H and, Wallace, T., Commercial landlords feel pinch as rent takings dive, *The Daily Telegraph*, 23 April 2020, p.105.

[58] Hammond, G, and Hancock, A., Landlords and tenants feel the pain as coronavirus hits rents, *Financial Times*, 2 April 2020.

Later figures vindicated these fears. The British Property Federation estimated that just 15 per cent of the £2.5 billion owed to landlords will be collected in June.[59]

Councils whose commercial portfolios consist disproportionately of retail properties, like Brighton, may be particularly affected by this. Even councils who had primarily invested in office blocks have been particularly hard hit. One of Spelthorne council's tenants, WeWork, has reportedly requested an 18-month rent free period which would cost the council approximately £4.5 million.[60] The council's head of communications recently wrote a blog defending the council's investment strategy stating that 91 per cent of rent due in March had been collected. However, WeWork's request indicates the situation could have grown much worse since.[61]

Even after Britain has recovered from the pandemic, Britain's working culture could remain significantly different.

Speaking long before covid-19 was of much public concern, Cllr Bittleston remarked how office space utilisation is changing significantly:

"*What will happen to big offices, between now and then? We've already managed to halve the number of people in our organisation and get rid of at least one third or half of our office space. The police are below, Surrey county council are above. We also have the bottom floor. So we got rid of a lot of our space but increased flexible working, and that's the future for business, it's to be much more flexible about your workspace. There is (sic) only 3 people with an office here. And in fact, I let anyone use my office as a meeting room for example. It's about using space properly*".

It is possible, and has been widely speculated, that with the amount of people working from home increasing substantially as a result of the lockdown, this behaviour may not be completely reversed and working behaviours may not return to where they once were.[62] Though difficult to be definitive at this time, it could impact the long-term value of office properties into the future.

Another risk may arise as a result of councils owning a significant proportion of properties within their operational area. According to Cllr Vernon-Jackson, this can lead to councils investing with emotion, and becoming subject to emotional blackmail when popular local businesses are threatened with collapse. This downside to local investments could be proven on a mass scale in the wake of the current crisis, whereby some councils have already announced they won't collect rent for certain periods of time. While these periods should last only the duration of the crisis, the effective emotional blackmail may yet play an increased role as renters potentially lobby for extension of these.

York council has already announced it is suspending rent for 350 commercial properties and has been praised by local businesses for the step.[63] Bournemouth council, however, urged businesses to continue paying rent and emphasised government support schemes instead.[64]

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[59] Onita, L, Millard, R and, Burton L., Landlords and retailers braced for disaster as £2.5bn rent bill looms, *The Daily Telegraph*, 8 June 2020.
[60] Gore, G., *Council's £1 billion property bet shaken by WeWork rent waiver request,* Reuters, 24 June 2020, uk.reuters.com/article/us-we-work-council/councils-1-billion-property-bet-shaken-by-wework-rent-waiver-request-idUKKBN23V21V, (accessed 29 June 2020).
[61] Medcraff, J., *Spelthorne: Setting the record straight on commercial investments,* Room151, 24 June 2020, www.room151.co.uk/funding/spelthorne-setting-the-record-straight-on-commercial-investments/, (accessed 29 June 2020).
[62] Edmunds, C., Covid-19 crisis 'will change way we work, live and travel forever': AA boss says coronavirus will trigger PERMANENT reduction in road and train use 'because people can now work from home', *Mail Online*, 3 April 2020, www.dailymail.co.uk/news/article-8183933/AA-boss-says-coronavirus-trigger-PERMANENT-reduction-road-train-use.html, (accessed 24 April 2020).
[63] Laversech, C., CORONAVIRUS: Council praised for steps to help York businesses, *York Press*, 27 March 2020.
[64] Slade, D., BCP Council warns seafront businesses to pay their rent despite coronavirus, *Bournemouth Echo*, 27 March 2020.

In summary, increased commercialisation has clearly placed taxpayers' money at some risk as council finances become increasingly reliant on rental income. Despite this, according to Mat Oakley of Savills, commercial property is considered a generally stable source of long-term income which can overcome most short-term challenges. However, in the case of councils which have not allowed sufficient flexibility in their financial planning and purchased properties that promise low returns, they have exposed themselves to an additional level of risk that will make them more susceptible to short-term downturns. If a council undertakes due diligence prior to any acquisition, this risk is reduced. As long as acquisitions are handled by sufficiently experienced council officers, and preferably overseen by councillors with relevant private sector experience, commercialisation strategies can be relatively secure. However, as some have made clear (including several councillors), there are many local authorities which simply do not have this expertise and could make acquisitions with too high a degree of risk.

At this stage, we can only speculate to what degree council finances are impacted by the current crisis. However, rental incomes are clearly being significantly impacted in the short-term. It could be several months before a clear picture emerges over whether councils with large commercial property portfolios are disproportionately exposed to the current crisis compared to those who do not. It may be the case that, where councils have used rental incomes to bolster their sinking fund, these funds will be sufficient to maintain their revenue levels and that investments may continue to meet long-term forecast returns. However, councils that have not been so prudent will be especially exposed. This will highlight those councils who have constructed sustainable property portfolios and those which have not undertaken the due diligence such investments require.

Conclusion

Commercial property investments can, in stable times, represent a substantial source of revenue for councils which can allow them to minimise tax rises upon local residents. If acquisitions are handled by experienced teams led by councillors with relevant understanding of this area, the gains can outweigh the risks.

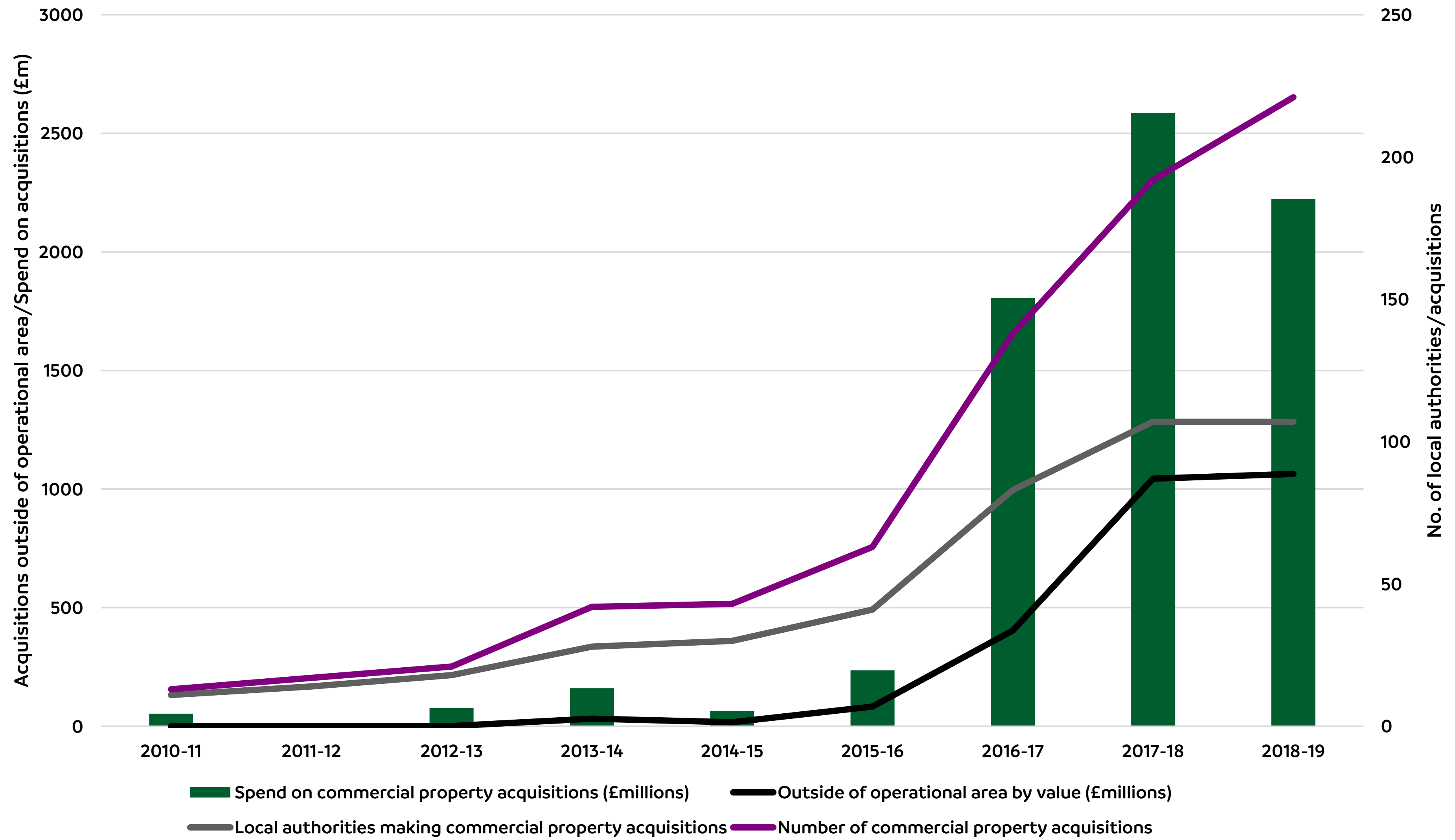
It cannot yet be ascertained with any authority whether council investment strategies are delivering the anticipated returns as many acquisitions have been accompanied with initial rent-free periods or renovations. Furthermore, the covid-19 pandemic is having a substantial impact on rent collections, which will further distort the collection of representative data. However, that same crisis emphases the risk at which some councils have placed taxpayers' money.

It is clear that there are numerous issues outstanding with local authority investments that must be considered by local councils and central government:

1. The matter of requisite expertise within councils is of great concern and may have led to numerous councils undertaking investments that expose taxpayers to an unacceptable level of risk. Councils should be required to prove this expertise before being allowed to undertake any investments.
2. Access to PWLB loans is considered almost too easy for councils. To mitigate the possibility of councils making investments without sufficient expertise, it should be made a statutory requirement for English councils to maintain an audit committee and for these committees to retain at least two independent members. These committees should assess any commercial property investment where the property is either above the average local market value for commercial properties or outside of the local authority's operational area.
3. In the future, PWLB loans should only be available below the market rate if they are required for the provision of key infrastructure.
4. The impact of councils investing in commercial properties via debt has not been widely explored. However, there is a clear threat that these investments are leading to both market distortion and may have a wider crowding out effect. In future government and parliamentary investigations into the efficacy of council commercial property investments, these are areas that must be considered for further exploration.
5. Councils must ensure any commercial investment strategies are sufficiently diversified. The current covid-19 crisis proves the need for this, as rental incomes are likely to suffer significant falls.
6. There are both advantages and disadvantages of focusing investment on local commercial properties. While it means councils will benefit from local knowledge, there is also a risk that councils become susceptible to 'emotional blackmail'. Local investments also increase councils' susceptibility to localised downturns. In contrast, spreading investments across a wider area can mitigate this. Neither approach is clearly superior to the other.

Appendix

Chart 3: local authority commercial property investments, 2010-11 to 2018-19[65]



[65] National Audit Office, *Local authority investment in commercial* property, 13 February 2020, p.23, p.33.