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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

PRIVATE INVESTMENT IN CONSTRUCTION

Memorandum by the Secretary of State for the Environment

1. In conjunction with the Chief Secretary, Treasury, I have been invited to submit a paper considering the direct involvement of market finance in construction projects. The terms of our remit are at Annex A.
2. I consider that there is a powerful general case for stimulating the construction industry, and equally powerful arguments related to specific policies, as follows:

(i) The construction industry represents some 20% of total industrial production. This industry, 50% of whose output is purchased by Government, has suffered heavily from the cutbacks we have made in capital expenditure. Real output has fallen 20% in the three years 1979-81, 12% in 1981 alone. Unemployment has risen above 400,000 and is 25% of the industry's workforce. Much of the industry's decline is essentially cyclical; in the main the industry is not subject to foreign competition. The danger now present is that the intensity of the cyclical downturn in construction - resulting in the loss of management teams, skilled manpower and manufacturing capacity - will have seriously damaging effects on productive efficiency in all sectors when order books pick up.

(ii) We may well enter the General Election with a historically very low level of annual housebuilding starts, against the background of a visibly decaying housing stock. The housing stock needs both improving and augmenting to regain pace with household growth.

(iii) Much of the country's infrastructure is obsolescent. Sewer collapses are commonplace in the North. Moreover there is no lack of potentially sound projects which could usefully be brought forward. The age and condition of our industrial buildings compares poorly with France and Germany.

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(iv) The inner cities face a complex mix of problems - decaying infrastructure, poor environment, derelict and vacant land, and a labour force with a poor skill mix. We cannot afford to ignore these problems: to ensure that inner cities can become again places where people wish to live and work it is vital to encourage the private sector to rebuild the economic base. Confidence is a key factor. To encourage the financial institutions to put their funds into the inner cities, it will be necessary for the Government to provide a degree of "gap finance", and to invest money in carefully selected pump priming projects.

(ii)-(iv) above of course relates to specific policies which fall to my Department, and which would benefit from more private finance of construction. Other colleagues may have a similar interest; the Secretary of State for Transport for example has been discussing with Treasury Ministers a proposal on the use of private finance to build trunk roads.

The Economic Background

3. The Chief Secretary however is naturally concerned that schemes designed to attract private finance into construction should not undermine the Government's overall economic strategy. The difficulties with additional public expenditure as such are well understood but although the use of guarantees and the like by the public sector to secure additional private sector expenditure does not add to public expenditure or the PSBR its economic effect may be similar. The Chief Secretary takes the view that the effect would be to induce expenditure which would not otherwise occur if the private sector were left to make its decisions in normal market conditions; that this would raise the private sector's demand for funds and, in present circumstances, would lead either to a faster increase in the money supply or to higher interest rates; and that a policy of this kind would therefore have effects very like a policy of reflating the economy by fiscal means.

4. More generally, the Chief Secretary points out that the policy of reducing inflation by limiting the growth of the money supply without excessive interest rates implies a limit not only on the growth of public expenditure and in the size of the PSBR, but in national expenditure in money terms. This approach does not mean that real demand and output cannot rise; indeed the whole purpose of the policy is that, as inflation falls, there should be more scope for real increases in demand and output within a given monetary total. But if the influence of the public sector is used through guarantees etc to add to the total of spending by the private sector, this addition, unless matched by some new source of saving, is likely to exert inflationary pressures. Moreover although such spending is not classified as public expenditure, it is private only in name because its pattern is not determined by the market but by decisions taken in the public sector.

5. The Chief Secretary therefore considers that three questions must be considered in relation to schemes designed to attract more private finance to construction:

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(a) whether it is possible to use such devices in a limited and defined way, so that their effects are ascertainable and can be taken into account; and

(b) whether within such constraints the particular purposes of such devices should have priority, as against other activities, in either the public or private sectors, which might otherwise occur; and

(c) whether such projects stand up against the criteria set out in Annex B.

6. Whilst I certainly do not challenge the critical importance of curbing inflation, I believe that we must take care not to limit ourselves to an unnecessarily restrictive interpretation and application of the economic analysis summarised above, and that we should look for some room for manoeuvre to deal with the problems outlined in paragraph 2 above. I consider that we must go out and promote mixed public/private sector schemes as a means of unlocking opportunities for private capital. In many situations where public spending has been predominant it is positively desirable to encourage more private capital investment. The renewal of the inner cities cannot and ought not to be left to the public sector alone. We need more private capital in housing for rent and shared ownership. There are public works which might be undertaken by the private sector with a bonus of increased efficiency. We shall not secure private capital in unfamiliar situations unless we are adaptable and use public expenditure to achieve the maximum leverage of private investment. I review below a variety of schemes which I suggest that we should develop and promote.

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7. Schemes already in hand include:

Private sector projects primed with guarantees

(i) as an incentive for developers who take an industrial site for development with their own resources, authorities such as new towns may offer a guarantee of all or part of the market rent for a short period from completion;

(ii) under S.111 of the Housing Act 1980 local authorities may guarantee building societies against default on specific mortgage loans, including home-steading schemes. Authorities thus release their own funds for other purposes including new construction, and in the case of sales into the private sector they can apply 50% of the receipts to augment their capital allocations;

(iii) housing associations now obtain private development finance for shared ownership (£8m) and improvement for sale (IFS) (£20m) under Housing Corporation guarantees: no public expenditure is thus incurred until projects are complete, and then only to the limited extent of grant normally associated with shared ownership and IFS.

8. Further pump priming schemes include:

(i) for 1982/83 I am giving priority to applications for derelict land grant where a local authority proposes arrangements with the private sector to buy and develop the land after reclamation. In cases where the authority eventually sells at a profit it may retain part of the grant for reinvestment in further reclamation. Bids against my available provision of some £18m are being assembled; and I should like as soon as possible to announce a provision of say £20m for the same purpose in 1983/84;

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(ii) for 1982/83 I have also allocated an initial £5m from the urban programme for low cost home ownership schemes involving private finance. This has so far attracted bids of £14m involving some £35M of private finance;

(iii) I am looking carefully at schemes on the lines of the Urban Development Action Grant in the USA whereby authorities would bid for funds earmarked from the Urban Programme for 1983/84 for investment in schemes drawn up in partnership with the private sector. After thorough appraisal, other things being equal, those with the best gearing would get the money. The USA reckon on a gearing of 3:1 private to public funds. Again I should like to commit say £50m of Urban Programme funds as soon as possible.

I would strongly favour colleagues reviewing their 1983-84 programmes for opportunities to invite, without delay, bids from public bodies for a share of available resources on the basis of gearing into the private sector, provided that their public expenditure remains within agreed PES allocations.

9. Then there are joint ventures between public and private sectors:

(i) Local authorities already have wide experience of joint approaches to development projects. In a typical case an authority may undertake land assembly while an insurance company provides development finance in return for a long ground lease: the authority receives a guaranteed ground rent plus a share of the equity;

(ii) I am myself currently holding a competition for the Hampton Site to see if it can be developed privately to provide both commercial office space and an extension, made available without cost, to the National Gallery;

(iii) "Shared ownership off the shelf" enables private builders to build for sale with provision for local authorities or housing associations to buy in (sometimes under guarantee arrangements) for onward shared ownership sale to people on their waiting lists. The gearing could on average enable £30 of public money to attract £70 from the private sector, mainly building societies. An extension of the scheme linked to the employment of young labour and apprentices on Merseyside is under discussion.

10. I am also, in consultation with the Chief Secretary, considering:

(i) Opportunities for "privatising" public activities

I am exploring with the North West Water Authority (NWWA) how a private consortium might build and operate a major new sewage treatment plant on Merseyside, for whose services the NWWA would pay out of revenue at a rate

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calculated on the volume of sewage treated to a defined standard. The incentives to efficiency, including wage negotiations, are obvious: but the form of any guarantees required from a monopoly user are still under examination.

(ii) Realising financial assets

Warburgs are promoting a scheme for wholesaling local authority mortgages. A proportion of the consequent capital receipts would be used to augment the capital allocations of the authorities concerned, although this would reduce the potential PSBR benefits. There is scope here for a substantial realisation of authorities' paper assets with some recycling into additional construction.

(iii) Private financing of housing development

We already have arrangements for housing association development under guarantee (see para 7(iii) above). I should like to extend these, looking in some cases to developers to provide their own working capital, or to housing associations to raise working capital that is unguaranteed.

Conclusions

11. I believe that the promotion of schemes such as I have described would attract a significant and useful increase in the amount of private finance going into construction in policy areas critical to the Government, and that if we were to move forward positively now we would begin to see the benefits on the ground in 1983/84.

12. As to the schemes themselves, I accept entirely that they must satisfy proper tests to avoid simply increasing public borrowing under the guise of guarantees, and that it is important that a due element of risk should be incorporated and remunerated fairly and competitively by comparison with the traditional private sector. As for overall strategy, I do not believe that the likely scale of my proposals would be such as to undermine adherence to monetary targets and the assault on inflation. Expenditure on construction could be cost effective, with a high labour element and low import content; and under the competitive conditions now prevailing in the industry there need be little leakage into higher wages and prices.

13. I recommend colleagues -

(i) to endorse the principles for involving the private sector further in construction projects discussed in this paper and Annex ~~3~~ ₃

(ii) to agree to a public statement which makes it clear that the Government is ready to direct its construction policies toward securing the maximum involvement of the private sector and to consider sympathetically any proposals to this end that may be put to us, on the understanding

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that we are looking for genuine partnerships, involving a due element of risk borne on properly competitive terms;

(iii) to note the further initiatives which I am discussing with the Chief Secretary (paragraphs 8 and 10);

(iv) to invite all colleagues responsible for construction programmes, directly or indirectly, to review urgently the opportunities for associating private finance with their programmes on the lines I have illustrated, subject to consulting the Chief Secretary about the terms of specific proposals;

(v) to agree that, if colleagues so wish, the Chief Secretary should in association with myself and the Ministers concerned exercise a general oversight of these initiatives in order both to pool experience and to ensure that wider considerations of economic strategy are taken into due account.

MH

Department of the Environment
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ANNEX A

THE CONSTRUCTION INDUSTRY

The Secretary of State for the Environment, in conjunction with the Chief Secretary, Treasury, is invited to submit a paper which considers the direct involvement of market finance in construction projects in the public sector. The paper should take into account the effects of any such funding on the Government's wider economic policies, including the aim of limiting the extent of the public sector and the growth of the money supply and total nominal expenditure. It should also consider how market finance might be raised under conditions of fair competition with the private sector and how far the greater cost of market finance would be justified by additional pressure for better performance in each case. The paper should set out the various initiatives of this kind which have been taken or are being considered, including also schemes where a small amount of public expenditure or public guarantees might be used to attract additional private investment, and make recommendations as to what further initiatives might be proceeded with.

The paper should be submitted to E Committee not later than the end of February.

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ANNEX B

1. The measures discussed in the paper are of three basic kinds:
 - (a) Guarantees by the public sector, reducing the risks borne by investors in private projects.
 - (b) Introduction of private finance into what would otherwise be public sector projects.
 - (c) Public expenditure intended as leverage to generate additional private expenditure as well.

The following considerations apply to each of these.

(a) Guarantees

2. There is little in principle to distinguish the giving of a Government guarantee from direct Government borrowing and on-lending. The end-result is that the recipient of the guarantee borrows on terms reflecting the Government's credit and the Government carries the risk of his default. The marketing of Government-guaranteed paper is similar to other forms of Government borrowing; but it may be less efficient, with a higher rate of interest than would be available to the Government on a normal stock issue. For a project involving a guarantee to be worthwhile it needs to provide something (eg a more economically executed project) better than obtainable from straight public expenditure.

(b) Private finance for public projects

3. To justify the higher interest rates, the following criteria need to be fulfilled:

(i) there is a close link between the risk on the project and the risk on the private sector loan, and this risk provides an effective incentive for the project to be more efficiently executed;

(ii) the higher cost of any private finance for a project is offset by reductions in either capital or operating cost;

(iii) public sector bodies are prevented from using monopoly power to raise charges or prices to pay higher financing costs;

(iv) decisions are taken under conditions of fair competition with the private sector, avoiding arrangements offering investors a degree of security significantly greater than that available on private sector projects.

(c) Public expenditure to generate private expenditure ("leverage")

4. Construction is not the only area in which desirable private expenditure might be stimulated by grants or other initiatives involving expenditure by Government. Such proposals need to be seen alongside other claims and their priority assessed in that context.

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