

Briefing Paper

HOUSING SUBSIDY AND THE MAJOR REPAIRS ALLOWANCE

Adrian Waite – July 2004.

Notional and Actual Housing Revenue Accounts

The 'Notional Housing Revenue Account' calculates an Authority's subsidy entitlement. Broadly speaking, the government takes what it believes an authority needs to spend, and deducts from this the income they believe an authority should raise. The difference is the authority's subsidy entitlement. In some cases an authority's notional income will be more than its notional expenditure. These authorities are described as being in negative subsidy.

At the same time, an authority has its Actual Housing Revenue Account. This reflects reality and can differ markedly from Notional account. However, the subsidy in the actual and notional accounts will be the same – because it is the notional account that determines the level of subsidy.

The Notional Account and how it works

The items that appeared in the Notional Housing Revenue Account until 2003/2004 are as follows:-

Expenditure

Capital Financing Costs
Management Allowance
Maintenance Allowance
Major Repairs Allowance
Rent Rebates
Other Reckonable Expenditure

Income

Rent Income
Interest Receivable

Surplus (Negative Subsidy)

---or---

Deficit (Subsidy receivable)

From 2004/2005 Rent Rebates will no longer appear in either the actual or subsidy accounts.

Subsidy is sometimes said to include three elements. Firstly, subsidy on rebates; Secondly, the Major Repairs Allowance; and Thirdly, the 'pure housing' element. If subsidy is analysed in this way, a large number of authorities that are in positive subsidy actually have positive elements for rent rebates and major repairs allowance, partially offset by a negative housing element. It was often considered that, in these cases, the government are requiring local authorities to use their rent income to finance their rent rebates. With the transfer of rent rebates to the general fund this will no longer occur, but many authorities will actually have to transfer cash to the government and it may be argued that this will still be used to fund housing benefits. Subsidy on all Housing Benefits will be paid in future by the Department for Work and Pensions. The negative subsidy paid to the government will be used to fund positive subsidy for other authorities and other government housing budgets.

Resource Accounting

Under the new financial framework and resource accounting, subsidy continues to be calculated with reference to a Notional Housing Revenue Account. However, there were changes in the composition of the notional account are as follows:

- While debt Charges were replaced with the 'true' cost of capital in the accounts, in the notional accounts subsidy continues to cover 'actual' debt charges as at present.
- An additional Major Repairs Allowance was introduced.
- From 2004/2005 there will be no rent rebates included as part of the Housing Revenue Account Subsidy.

The introduction of the Major Repairs Allowance led to many authorities that were previously in negative subsidy moving into positive subsidy with the result that their General Funds have potentially lost income. However, transitional arrangements were introduced for the authorities affected.

Items of Income

This section explains in more detail how each of the items in the notional account is calculated.

Rent Income

The Government assesses what is known as a 'Guideline Rent' for each authority and this along with the number of properties forms the basis of the calculation of the 'Rent Income' figure within the Subsidy Account.

The way the government arrived at an authority's notional rent income for the years up to 2001/2002 was as follows:

- (a) It took the average value of flats and houses which had been sold between 1996 and 2000 and multiplied this by the number of properties the authority had left! This produced a total value for the authority's stock. This was used to calculate half of the authority's "Guideline Rent Income".

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- (b) The other half was calculated by reference to the average weekly earnings of manual workers. Using this information the assumed earnings for each authority area was expressed as a proportion of the national assumed earnings of Council tenants.
- (c) These figures combined were used to calculate how much of the total national rent income should be raised by the authority.

In 1996, the government became concerned that many local authorities were increasing their rents by more than inflation. Because most tenants claimed rent rebates, the cost of this was being met by central government rather than by the tenants or the local authority. They therefore introduced a system called 'rent rebate subsidy limitation'. This consisted of calculating a 'limit' rent for each local authority. If the local authority increased its rents above the 'limit' rent the government 'clawed back' the subsidy that would otherwise have been paid on the additional rent rebates.

The 'limit' rent was calculated by looking at the 'guideline' rent and also at what rents would be if they had been increased from their actual 1996 level by the same proportion as the guideline rent. The higher of the two is the 'limit' rent. This meant that where a local authority set rents at the guideline level in 1996 their 'limit' rent was the same as their 'guideline' rent. However, where their rent in 1996 was significantly above their 'guideline' rent their 'limit' rent continued to be set significantly above their 'guideline' rent. If a local authority has a 'limit' rent that is greater than its 'guideline' rent it can increase rents above the 'guideline' and keep the proceeds. However, the Labour government decided that no authority should be penalised to a greater extent than the average, and so the maximum level of rent rebate subsidy limitation was reduced to 60% in 2000/2001 and 59% in 2001/2002.

The central proposal of rent restructuring is to introduce a common basis on which all rents in the social sector will be set. There will be a ten year transitional period during which authorities will move to the new system. The proposals for Housing Revenue Account subsidy are designed to assist in achieving these objectives. The principal changes are:

- The rent assumptions used in calculating the Housing Revenue Account subsidy paid to an authority – the guideline and limit rents – should be moved in approximately equal annual steps to the rents determined by the 'formula rent', starting in 2002/2003.
- The current system under which a limit is set on the rent rebates that are subsidised by central government should be extended so that it applies on a property-by-property basis and not just (as now) on the basis of an authority's average rent. This would encourage authorities to apply the new rents policy at the level of individual property rents. This change will begin to take effect in 2004/2005.
- Authorities should identify service charges separately and charge them in addition to the 'formula rent'.

The way the government arrived at an authority's notional rent income for 2002/2003 was as follows:

- (a) The 'formula' or 'target' rent was calculated as outlined above.

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- (b) The 'guideline' rent for 2001/2002 was increased by:
- (i) 2.5% for inflation.
 - (ii) 1% being the average increase in local authority rents.
- (c) The increased 'guideline' rent was varied by 10% of the difference between the 'formula' or 'target' rent and the increased guideline rent.

Expressed as a formula, the calculation was:

$$G2 = (G1 + (G1 \times 2.5\%) + (G1 \times 1\%)) + ((F - (G1 + (G1 \times 2.5\%) + (G1 \times 1\%))) \times 10\%)$$

Where:

F = Formula Rent 2002/2003

G1 = Guideline Rent 2001/2002

G2 = Guideline Rent 2002/2003

In 2003/2004 and 2004/2005 the same process was followed. The main features of the calculation of guideline rents for 2004/2005 were as follows:

- General increase to guidelines reflecting inflation at 2.46% plus 1.5% real increase plus move to targets around 1.6% overall
- Confirmation of caps and limits adjustments
- Continues to have a potentially significant influence on individual subsidy settlements
- Service charge de-pooling

Interest Receivable

Interest receivable consists of Interest received in respect of payments made by people who have bought their council houses by means of a Council Mortgage, and Interest received from investing the Capital Receipts, which the Government requires to be "set aside". However, the amount of interest that is credited to the Notional Account is not the actual interest received but is based on the average three-month sterling London Interbank Rate (known as LIBID).

Items of Expenditure

Capital Financing Costs

Most of an authority's Capital Financing costs are included in the calculation. With one or two technical exceptions, all of the capital financing charges arising through borrowing up to the Admissible Basic Credit Approval and Supplementary Credit Approvals until 2003/04 received by the authority for Housing Revenue Account purposes are included in the Notional Account.

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Despite changing the basis of capital financing costs in the actual Housing Revenue Account, the method of calculating notional capital financing costs has not changed significantly with the introduction of Resource Accounting. However, there have been some changes to simplify the determination. The introduction of the 'Single Capital Pot' meant that local authorities could only claim housing subsidy with respect to capital financing costs to the extent to which Basic Credit Approvals have been used to finance Housing Revenue Account schemes.

Under the new regime that will come into force in April 2004, local authorities will receive an allowance as part of the housing subsidy system that is designed to support borrowing. They will therefore have 'supported borrowing' that will be financed through the 'Supported Capital Expenditure' element of housing subsidy, and unsupported borrowing under the 'prudential borrowing' under the prudential borrowing regime that will have to be supported from other resources within the housing revenue account.

The following are the major changes that have been made to the calculation of capital financing costs in the notional housing revenue account for 2004/2005:

- Abolition of Minimum Repayment Provision and admissible set aside
- Introduction of subsidy Capital Financing Requirement

Management and Maintenance Allowances

In 1990, Management and Maintenance Allowances were based on actual expenditure in earlier years. The Government is now replacing the old Management and Maintenance Allowances with those based on an assessment of relative need to spend.

The method used was to do a calculation for Maintenance, based on the size, type and age of an authority's stock and to calculate what the average cost of maintaining such a mix of stock would be. Maintenance Allowances were increased by 3.4% in 2000/2001, 3.5% in 2001/2002, 5.5% in 2002/2003 and 5.55% in 2003/2004.

For management, only two elements were used originally - sparsity of local authorities' dwellings and the proportion of high-rise dwellings. The reason for this was that using these two items produced initial targets that gave the answers that were closest to past expenditure patterns. The formula for Management costs was later updated by introducing a factor whereby 10% of the available money was distributed by reference to social factors as indicated by the Index of Local Conditions. Management Allowances were increased by 1.9% in 2000/2001, 2.5% in 2001/2002, 7.5% in 2002/2003 and 7.95% in 2003/2004.

Changes to the housing subsidy system as a result of rent restructuring will lead to authorities being forced to spend on management and maintenance at the level of their management and maintenance allowances. This is not currently the case as authorities are able to set rents above the level assumed in the subsidy calculation and spend the difference on management or maintenance. As the ability to do this is being removed, government has recognised a need to increase the level of management and maintenance allowances nationally; and to review the formulae to ensure that the total is distributed amongst authorities equitably and on the basis of need.

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The government issued a consultation paper in July 2003 that proposes changes to the way that management and maintenance allowances are calculated. The housing subsidy determination for 2004/2005 reflects these changes. The main implications are:

- The government's need to spend model estimated total spending requirements in 2001-02 of £5-5.5bn so there is a need to increase management and maintenance allowances
- There will be a completely new subsidy allocation methodology introduced from 2004-2005
- There will be a significant redistribution of allowances
- Transitional protection will be provided for "losers" (paid for by others)
- Final refinements are to be made for 2005-06 (such as Crime and voids)

The main changes proposed for management allowances are summarised below:

- The existing formula uses proportion of flats to explain both the additional costs of managing flats and as a proxy for deprivation. The new formula retains a reduced emphasis on the proportion of flats, to cover the costs of managing communal and shared facilities, and because there is evidence of increased levels of rent arrears, neighbour disputes and racial harassment, particularly in medium- and high-rise flats.
- A separate deprivation factor is included, based on the measure of deprivation already used in the capital allocations.
- Total crime level by county is a new factor introduced as a proxy for the costs of dealing with anti-social behaviour.
- Population sparsity is no longer included. Instead, there is recognition that all authorities have a certain level of fixed costs, no matter how few dwellings they have.
- A measure of the actual number of voids and re-lets is used, as there is evidence of the significant costs to all authorities of managing and re-letting void properties. As with maintenance, voids have not been used in the calculation of management targets before now.
- There will continue to be an adjustment for geographical variations in costs.

The main changes proposed for maintenance allowances are summarised below:

- The new model follows a similar basic approach to the existing formula, using archetypes to model the impact of built form, age and size of dwellings on maintenance costs.
- But instead of one base weight per archetype, each archetype has three base costs associated with it – representing the differential costs of responsive repairs, planned repairs and works to voids. After other factors are added in, a 'sub-target' is produced for each of these three types of maintenance, which are summed to give the target prior to regional cost adjustments.
- A new 'backlog' factor is added to the responsive repairs target, representing the impact of the major repairs backlog on urgent, day-to-day repairs.
- A measure of the actual number of voids and re-lets is used in assessing the relative cost of void works for each authority. Voids have not been used in the calculation of maintenance targets before.

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- A social deprivation factor is no longer included. Instead total crime levels by county are used to represent the costs of graffiti and vandalism to responsive and void works.
- There will continue to be an adjustment for geographical variations in costs.

These proposals lead to a significant redistribution of resources. This is particularly because the proposed reduction in weighting given to flats will redistribute resources away from London boroughs and some core cities towards authorities that score highly on the new measures of need. Some authorities gain significantly; others, especially in London lose significantly. In response to consultation, the government has offered transitional protection to authorities that stand to lose.

The increases in the allowances for 2004/05 and 2005/06 are 10.7% for each in each year. This is made up of core inflation, a real increase to reflect the move to rent convergence in 2011/12 (around 2.5%) and a real increase of 6%. Given that those authorities whose proposed allowances reduce would be “cash frozen”, the effect is to distribute 10.7% national increases to only part of the country. Thus the majority of authorities will see real increases in their allowances per dwelling. Some of these increases are considerable.

In 2004/2005, Management Allowances will increase by £113million and Maintenance Allowances by £199million.

The variations in management and maintenance allowances and therefore housing subsidy are likely to affect the outcome of stock options appraisals. In particular, the northern councils that gain most may find that stock retention becomes a more financially viable option.

Changes in management and maintenance allowances in the 2004/2005 determination are analysed at a regional level below:

MANAGEMENT ALLOWANCES

	Allowances 2003/04	Allowances 2004/05	Increase
East Midlands	302.98	378.25	24.84%
Eastern	378.23	395.23	4.49%
London	771.34	790.32	2.46%
North East	279.76	378.34	35.24%
North West	332.64	415.26	24.84%
South East	429.03	441.20	2.84%
South West	366.50	379.03	3.42%
West Midlands	357.61	410.53	14.80%
Yorks & Humber	312.45	364.04	16.51%
TOTAL	429.69	475.83	10.74%

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MAINTENANCE ALLOWANCES

	Allowances 2003/04	Allowances 2004/05	Increase
East Midlands	617.81	732.35	18.54%
Eastern	603.46	758.89	25.76%
London	1,160.45	1,195.60	3.03%
North East	652.16	701.38	7.55%
North west	677.53	762.22	12.50%
South East	676.19	810.85	19.91%
South West	624.81	728.78	16.64%
West Midlands	718.34	776.66	8.12%
Yorkshire & Humber	653.05	720.41	10.31%
TOTAL	759.00	840.52	10.74%

Major Repairs Allowance

From 2001/2002 Local Authorities have been paid the Major Repairs Allowance.

The Major Repairs Allowance is designed to provide funding to housing authorities that would be adequate to maintain their housing stock in an acceptable condition on an ongoing basis. This excludes any funding for the backlog of repairs and renovation that is required to council housing stock.

The Major Repairs Allowance is allocated by:

- Establishing national standard likely timings and costs of replacement of building elements for a number of building archetypes.
- Totalling anticipated required expenditure over thirty years and converting this into an annual average amount.
- Calculating each authority's Major Repairs Allowance by multiplying the national average archetype cost by the number of dwellings of that archetype in the authority's stock and applying the regional cost compensation factor used for refurbishment work within the Generalised Needs Index.

Rent Rebates (Housing Benefits for Council Tenants)

Most Rent Rebates actually paid out are included in the Subsidy Account. The calculation of notional rent rebates is explained in Section 11 of this guide (Housing Benefit). This will cease to occur in the housing revenue account from April 2004.

Other Reckonable Expenditure

Subject to a number of detailed conditions and limitations, subsidy is paid on rental payments in respect of property in the account, such as hire purchase payments and a variety of leasing (rental agreements) arranged before 1990. There were also separate allowances for the implementation of Resource Accounting and Tenant Participation Compacts, but these were withdrawn from 2002/2003.

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The Effect of Rent Restructuring on Housing Subsidy

The government increased management and maintenance allowances by 5% and 3% respectively in real terms in 2002/2003 so that the total amount of subsidy remained at the level assumed in the spending review. In 2003/2004 the corresponding figures are 5.7% and 3.3%. In 2004/2005 both management and maintenance allowances increased by 10.7%. The loss of subsidy caused by increasing the guideline rent in real terms has therefore been offset by increases in subsidy due to the increased management and maintenance allowances. However, different authorities gained from the increased management and maintenance allowances, or lost from the increased rent guidelines to different degrees. There are 'winners' and 'losers'.

The use of the 'formula rent' to establish guideline rents would have a neutral effect on an authority that charges rents at the guideline level. Reductions in rent would be compensated by increases in subsidy, while increases in rents would result in a proportionate reduction in subsidy. Indeed, such an authority could see a net gain in subsidy if it also saw an increase in its management and maintenance allowances.

However, where an authority currently charges rents that are above the guideline rent, the effect of these proposals would be to reduce the resources that are available in the Housing Revenue Account. Almost every local authority charges rents at a level that is above guideline rents with the average variation being 17%, so this applies to most authorities. This occurs whether the 'formula rent' obliged the authority to increase or reduce rents.

Two examples follow to illustrate this point:

	Authority A Current Rent	Authority A Re-Structured
Actual Rent	£50/week	£60/week
Limit Rent	£50/week	£60/week
Guideline Rent	£40/week	£60/week

Authority A would see an increase in rent income of £10/week, but a loss of subsidy of £20/week, leaving it with £10/week less in its Housing Revenue Account. This may be offset by increases in management and maintenance allowances.

	Authority B Current Rent	Authority B Re-Structured
Actual Rent	£60/week	£50/week
Limit Rent	£60/week	£50/week
Guideline Rent	£50/week	£50/week

Authority B would see a reduction in rent income of £10/week, but there would be no increase in subsidy, leaving it with £10/week less in its Housing Revenue Account. This may be offset by increases in management and maintenance allowances.

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The effect of applying rent rebate subsidy limitation to individual dwellings will be to reinforce the requirement to bring the rents of all dwellings into line with the 'formula rent'.

The government advises authorities to assess the effect of the changes to subsidy using their own assumptions about the way in which inflation, Registered Social Landlord rents and allowances will change between now and 2012. However, it is suggested that the following assumptions be made:

- A 1.5% a year real terms increase in average local authority rents is required to bring council rents into line with rents for comparable Registered Social Landlord properties.
- Inflation is 2.5% a year over the period.
- Three options are modelled for management and maintenance allowance, including a 6%, 4% and 2% annual real terms increase in national allowances.

The Differences between the Actual and Notional Accounts

No allowance is made in the subsidy account for the provision for bad debts or rents written off. Neither is any allowance made for any Revenue Contribution to Capital the authority may decide to make.

There is a standard voids allowance within the rent calculation of 2%. Therefore an authority with less than 2% empty properties is gaining resources; an authority with more than 2% empty properties is losing resources.

Negative Subsidy

If the Subsidy Housing Revenue Account produces a result, which assumes that the authority's income is higher than its expenditure, a 'Negative' Subsidy situation arises. In this case the authority must pay an amount equivalent to the deficit, from its Housing Revenue Account to the government.

In the past authorities with 'negative' subsidy had to transfer their surplus to the General Fund. In the long-term, these authorities will have to reduce expenditure or increase Council Tax, but it has been decided to introduce transitional measures to ease the process. These transitional measures allow authorities that were in negative subsidy in 1999/2000 to continue to transfer resources from the Housing Revenue Account to the General Fund for a period of up to ten years.

Because rent rebates are being transferred out of the Housing Revenue Account from 2004/2005 many more authorities will move into 'negative subsidy'. The government has stated that:

- The new mechanism is essentially not very different to what happens currently, it just feels it
- Assumed Housing Revenue Account surpluses are currently netted off rent rebate subsidy. This is not sensible when the Department for Work & Pensions is responsible for rebate subsidy (paid at 100%)
- Amounts of negative subsidy are to be collected by direct debit where possible. There will be the same frequency as with Housing Revenue Account subsidy payments
- Transitional arrangements continue for a small number of previously negative subsidy authorities

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Subsidy Determination 2004/2005

The highlights of the subsidy determination for 2004/2005 are:

- No changes were made to guideline rents, mortgage interest and other items
- Management & Maintenance allowances were radically revised
- Capital financing charges were changed (see section seven)
- Abolition of Minimum Repayment Provision but introduction of admissible allowance
- Introduction of Subsidy Capital Financing Requirement and abolition of set aside (see section seven)

The draft subsidy determination, made in November 2003, included concessions for the London Boroughs on management and maintenance allowances compared with the initial consultation paper. In particular, the draft subsidy determination allows for extended protection for authorities where the new management and maintenance targets are below the current levels of management and maintenance allowances. In these cases management and maintenance allowances will increase by inflation rather than being frozen. This means that the authorities where the new management and maintenance allowances will have to wait longer before they gain the additional funding. Only a third of authorities will get a real increase in management allowances in 2004/2005. The average increase of 6% will therefore result in there being a 2.5% increase for most authorities and greater increases for those that will gain resources under the new formulae.

Future Developments

The following developments are expected for the 2005/2006 subsidy round:

- Final refinements to management and maintenance allocation methodology
- Move to thirteen long term Major Repairs Allowance archetypes based on floor area
- Need to sort out Housing Revenue Account capital inconsistencies
- Need to look at "threshold" arrangements

The following matters will be considered by government for the subsidy determination in 2006/2007 and subsequent years:

- Arguments for more resources as shown in the management and maintenance need to spend review.
- Current low levels of Exchequer support and Public Service Agreements surrounding the decent homes standard
- The Treasury may consider that there is still scope for greater efficiency in local authority procurement
- The Treasury might also argue that as stock gets more capital investment, revenue needs should reduce.
- The Treasury will ask what real benefits more resources will bring

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An example Housing Revenue Account and Subsidy Account

In order to illustrate the working of the subsidy system, reproduced below are the Subsidy and Actual Housing Revenue Account Budgets for a local authority for 2003/2004.

Notional Housing Revenue Account 2003/2004

	£ million		£ million
Expenditure			
Management	3.4	Rent	19.9
Maintenance	5.2	Interest	0.1
Major Repairs Allowance	4.8	Subsidy	7.5
Capital Financing	2.0		
Rent Rebates	12.1		
TOTAL	27.5	TOTAL	27.5

Actual Housing Revenue Account 2003/2004

	£ million		£ million
Expenditure			
Management	7.0	Rent	22.3
Maintenance	5.5	Other Income	1.5
Major Repairs	4.8	Interest	0.4
Capital Financing	1.3	Subsidy	7.5
Rent Rebates	12.1		
Bad Debt Provision	0.1	Deficit	0.1
Revenue Contributions	1.0		
TOTAL	31.8	TOTAL	31.8

It will be seen that the authority raises £4.3million more income than is accounted for in the subsidy account. This includes £2.4million in rents, £1.5million in other income, £0.3million in interest and £0.1million drawn from balances. This enables it to spend £3.6million more on management than its management allowance and to make a £1.0million revenue contribution to capital outlay. Changes to the housing subsidy rules will lead to the two accounts converging over time.

Conclusions

The Housing Subsidy system enables the government to exercise considerable control over local authority housing finance. This degree of control will increase as the changes to the system that are associated with rent restructuring are implemented.

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The government is moving to a situation where all rents will effectively be determined at national level through the rent restructuring formulae. Furthermore, as formula rents will be used to calculate both actual rents and the guideline rent that is used to calculate housing subsidy, the government will effectively take all the rent income away from authorities. Authorities will then be given back what the government considers that they should spend. As a result, government will also determine Housing Revenue Account budgets. The ability that councils currently have to set rents above guideline and to keep the proceeds to spend locally will be gradually eroded during the period of rent restructuring.

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