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My ref:

Your ref:

11 November 1980

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Dear Nigel

LOCAL AUTHORITY BORROWING

Thank you for your letters of 17 October to me and 22 October to Tom King about local authority borrowing.

I agree that this is a very important issue. Local authorities' net external borrowing (LABR) is a significant part of the PSBR. I would like to discuss this urgently but it is clearly not an issue that we can settle overnight - our first priority is launching an RSG quickly with a reduction in the volume of current expenditure, a tight cash limit and a cut in the grant percentage. I would however urge that we have the earliest possible meeting after the RSG settlement has been made.

In the meantime I do not think we can go along with the suggestions made in your letters for the reasons set out in the attached note. We cannot hold up the rate support grant settlement in order to accommodate your suggestions for using the RSG system to reduce local authorities' propensity to borrow. This would be very harmful. Local authorities' budgeting processes are going forward day by day and any delay in announcing the settlement could only reduce our ability to influence authorities' spending for 1981/82.

We also cannot cut the 100% borrowing approvals which we have offered local authorities as a quid pro quo for the introduction of a tight control on their capital expenditure. This was a decision of colleagues and we have all committed ourselves too far in public to withdraw. It would in any case be impracticable to try to introduce a control on borrowing for 1981/82: a blanket reduction in the borrowing approval would be impossible because authorities' cash flow positions vary too much, and neither DOE nor Treasury have either the information readily available or the machinery to decide appropriate levels of borrowing for individual authorities.

In view of this I am sure we must issue the memorandum on the capital controls scheme - with its reference to 100% borrowing approvals - as early as possible next week. Our continued failure to produce it is a source of embarrassment as it is holding back effective capital expenditure planning by local government.

I am copying this letter to the Prime Minister, George Younger and Nicholas Edwards.

yours ever

MH

MICHAEL HESELTINE

Nigel Lawson Esq MP

ANNEX

LOCAL AUTHORITY BORROWING

1. Treasury have suggested that steps should be taken to reduce local government's propensity to borrow - although of course the consequence must be an automatic increase in the propensity to increase rates and/or charges - presumably in order to contain the PSBR in a predictable way. These suggestions appear to fall into three groups: first, to increase the cost of borrowing by reducing the rate support grant (RSG) on interest rates; secondly, imposing quantitative controls on the amount of external borrowing; and thirdly restricting access to the PWLB.

RSG

2. The first proposition is open to three basic difficulties. First, it is not evident that increasing the price of borrowing to local government by reducing the RSG subsidy would reduce the PSBR, because to the extent that this led to an increase in financing capital expenditure from revenue, local government would attract a greater amount of grant - ie on the full capital cost of the financing of capital schemes in a year and not only on the loan charge element. Each £1 financed from revenue attracts on average 61p in grant: each £1 financed by borrowing attracts grant on interest payments of say 15p ie about 9p. The result would be an increase in the central government borrowing requirement (CGBR) offsetting the LABR reduction. Nor would it help to reduce that rate of subsidy on revenue finance of capital, as this would neutralise the incentive for authorities to switch away from borrowing. Secondly, it would tend to undermine one of the fundamental objectives of the RSG, which is to equalise the resources of all local authorities, as it would put greatest pressure on authorities with the lowest resources. Thirdly, under the existing RSG system, if local authorities borrow more than the forecast agreed for the settlement each year, they bear the full cost themselves in that year.

3. Any scheme based on a reduction in the proportion of loan charges accepted for RSG would in any event require primary legislation. This means that such a scheme could not be implemented before 1982-83, because it is clearly too late to introduce such a controversial proposal into the Local Government Planning and Land Bill. One variant could be introduced without primary legislation - to cash limit loan charges for the RSG settlement for 1981/82. This runs into the difficulties mentioned in paragraph 2 above. Furthermore, if it was presented as a signal of a tighter control of the LABR in later years, it might prompt local authorities to borrow more in the next financial year than might otherwise be the case.

QUANTITATIVE CONTROLS

4. The second proposal requires the imposition of a quantitative control on local government borrowing ie that a lower limit might be placed on the amount of borrowing approvals which would be given to local authorities in the next financial year which is the first year of operation of the new capital expenditure controls scheme.

5. Such a limitation on new borrowing approvals would not be effective because even if a reasonable formula could be found for deciding how much each authority should get by way of borrowing approvals those authorities with substantial balances could circumvent any new borrowing limit by converting internal to external loans ie the internal loans are backed by valid loan sanctions. There could also be off-setting increases in the PSBR by additional revenue borrowing which

authorities might have to resort to, and by additional central government borrowing to cover the additional RSG which would have to be paid on the extra capital spending financed from revenue.

6. It has also been agreed that as part of the "quid pro quo" of greater operational freedom in return for the imposition of a tight control on the total of annual capital expenditure, local authorities should be given the right to finance their annual capital expenditure allocations in any way they chose in the first year, including external borrowing, although it has of course been made clear that this freedom would be reviewed after the first year of operation of the scheme. It would be reneging on this undertaking to say there will be lower limits of borrowing approvals next year. It is now too late and the Government would be accused of bad faith. DOE Ministers have all made reference in Parliament to the new freedom to finance expenditure from borrowing or revenue at local authorities own discretion. In any event, the Government's argument has been that the need is to control expenditure and that the old system of controlling borrowing can be relaxed because the new scheme will be more effective. It would be embarrassing that the Government should now have to admit that having forced the new scheme through Parliament they now believed it to be inadequate.

PWLB

7. The third proposition concerned restricting the access of local authorities to sources of loan finance, notably the PWLB. This presumably could put up the price of borrowing to local authorities, and might also reinforce any tendency for a two-tier local authority market to develop. Further discussion is needed on this whole question of making use of market disciplines to influence borrowing behaviour.

LA CONTRIBUTION TO PSBR

8. The local authority contribution (LABR) to the PSBR has steadily diminished from 1968/69 when it was $2\frac{1}{2}$ times the total PSBR to 1978/79 when it accounted for only 13.9%; in 1979/80 it increased again to 29.5%. Local authorities have been able to hold down their net external borrowing in recent years by financing much of the overall agreed annual expenditure level from their internal balances and funds. This has been in constrast to the performance of central government which, by running large deficits on current account, has had to resort to higher levels of borrowing. The increase in local authority borrowing in 1979/80 was itself at least in part the result of central government policies since the volume squeeze caused by tight cash limits on rate support grant and unexpectedly high inflation caused authorities to run down their balances and, therefore, the potential for internal borrowing.