CONFIDENTIAL

PRIME MINISTER

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Local Authority Capital Expenditure Controls in England and Wales 1985/86

FLAGS A+B (memoranda by the Chief Secretary, Treasury and by the Secretary of State for the Environment)

BACKGROUND

In recent years local authorities have been encouraged to realise some of their capital assets (notably local authority housing, but also including surplus land, etc) by means of permission to spend the proceeds over and above their basic capital allocations. Since, however, the ability of authorities to generate such receipts differs, some proportion of the receipts generated each year has been 're-allocated' to other authorities, who have thereby been given permission to borrow additional amounts to fund new capital expenditure. At the same time, in order to restrain the overall public expenditure impact of this, local authorities have only been permitted to spend a 'prescribed' proportion of their receipts in the first year (with receipts over and above the prescribed proportion notionally allocated to other authorities). But although the rate at which authorities generating receipts can spend them has been controlled, they have not in practice been deprived of the money notionally reallocated to other authorities, which is then in principle available to them to spend in subsequent years. Thus over time an authority realising an asset may spend the entire proceeds; but the 'allocated' proportion is spent a second time by other authorities. This is the 'double counting' referred to by the Chief Secretary.

2. As well as realising physical assets, local authorities have been encouraged also to realise financial assets - the mortgages they have given to their residents, often for the purchase of local authority houses. Since it is not the purpose of local authorities to act as financial intermediaries, it makes good sense that building societies and other financial

institutions should take over their mortgage loans, so ending the borrower's relationship with the local authority in question. Some authorities (notably Liverpool) have recently seen in mortgage refinancing an opportunity to generate additional income outside Government controls; this is being done by transferring their mortgage books en bloc to banks, against advances from these banks, but without transferring the risks or changing their present relationships with individual borrowers. The transaction thus becomes essentially a financial device enabling the authority to borrow additional sums at rather onerous terms in an uncontrolled way; but there is no reliable legal basis for a Government challenge to this behaviour by local authorities.

Proposals

3. The Chief Secretary proposes that clauses be included in the Local Government Bill to be enacted in the 1985/86 Session which would:

(i) Prevent 'double spending' of capital receipts by depriving local authorities making sales of assets of that proportion of the receipts which has been reallocated to other authorities; and

(ii) Defining 'capital receipts' so as to exclude block transfer of mortgages without transfer of risk.

The Secretary of State for the Environment rejects the first proposal, on the ground that the Government cannot reasonably deprive authorities of the benefit of money which is properly theirs, and that commitments have repeatedly being given in the context of debates about 'prescribed' expenditure that local authorities would be permitted over time to spend 100 per cent of their receipts. (For example, Mr Jenkin said on 13 March (OR col 345) 'there is nothing in the regulations to prevent these receipts in due course from being spent by the authorities to which they belong'.) On mortgage refinancing, although Mr Jenkin appears to disagree with the Chief Secretary's proposal,

or they have come to believe are properly theirs he in fact puts forward an alternative method of attaining the same objective; instead of redefining 'capital receipts', he would forbid the transfer of a mortgage without consent of the borrower.

MAIN ISSUES

4. The main issues are:

(i) Whether local authorities should be deprived of that proportion of their capital receipts 'reallocated' to other authorities.

(ii) Whether action should be taken to restrict the generation of capital receipts by mortgage refinancing devices which do not involve any transfer of risk away from the local authority lender.

The wider question of the future control of local authority capital expenditure is under study in the E(LF) context, and it would not be appropriate for E(A) to tackle this more fundamental question now. Decisions will, of course, be required in the Public Expenditure Round about the level of local authority capital expenditure to be accommodated in 1986/87 and subsequent years, and these decisions will need to reflect the decisions on the proposals currently before the Sub-Committee. If Ministers conclude that it is not possible to deprive authorities of the benefit of their accumulated unspent capital receipts, it may well be necessary to consider, initially in the course of the public expenditure bilaterals, the case for some further restriction of 'prescribed expenditure'; but there is no need for E(A) to tackle this issue now.

Treatment of accumulated unspent capital receipts

5. The Chief Secretary's case for a change is that the £6 billion of accumulated unspent capital receipts represent a severe threat to public expenditure control, and that this can only be overcome by depriving the authorities which hold these

balances of the benefit of that proportion of the receipts which has already been allocated to other authorities. The argument against this is essentially political; that the Government has given repeated commitments that it would not do this. Mr Jenkin undoubtedly feels bound by the commitments he has given, and as he says, the Government might find considerable difficulty in convincing their supporters of the desirability of depriving local authorities of £4½ billion of the £6 billion they consider to be 'rightfully theirs'. Nevertheless if Ministers consider it essential to restrict local authorities' spending power in this way, the forthcoming Local Government Bill represents an opportunity, and it would be as well for work to begin as soon as possible to specify precisely how the desired effect was to be achieved; the legislative provisions necessary seem likely to be very complicated.

The way through is to leave existing accumulated receipts untouched — but stop cascade swelling them in the future.

Restriction of mortgage refinancing

6. Despite their apparent disagreement, there is in practice a substantial meeting of minds between Mr Jenkin and Mr Rees on this issue. It is clearly desirable to prevent local authorities from securing extra funds outside Government control through devices of the kind operated by Liverpool. It may be sufficient to invite Mr Jenkin and Mr Rees to arrange for further study of the most convenient way of achieving the desired objective, and to report back in due course. It seems unlikely that further collective discussion of the problem will be required; subject to agreement on the detail, this discussion would constitute sufficient policy authority for the preparation of the necessary clauses for inclusion in next Session's Local Government Bill.

HANDLING

7. It may be convenient to divide the discussion into two parts, and start with the treatment of accumulated unspent capital receipts, on which the Chief Secretary, Treasury and the Secretary of State for the Environment could be invited to state their cases. (You may, however, feel that the politics of the situation

are so clear that you would wish to state your own position at the outset). You will then wish to establish the sense of the Committee on the possibility of legislation on the lines proposed by the Chief Secretary, Treasury. On mortgage refinancing, the main protagonists might again be invited to state their positions; in view of the extent of agreement on substance, there is probably no need for an extended discussion.

CONCLUSIONS

8. You will wish to reach conclusions on:

(i) Whether or not provisions should be included in the forthcoming Local Government Bill to restrict local authorities' use of their accumulated unspent capital receipts.

(ii) Whether or not provisions should be included in the same Bill to prevent local authorities from securing additional funds by mortgage refinancing devices which do not involve the transfer of risk to a new lending institution.

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