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SECRETARY OF STATE FOR THE ENVIRONMENT

PRIME MINISTER

LOCAL AUTHORITY CAPITAL EXPENDITURE 1986/87 — Flap PE27.

At the meeting which you chaired on 31 July, it was agreed that further consideration should be given to a proposal by the Policy Unit.

I attach a note prepared by officials in this Department, in all the local authority spending departments and in the Treasury, analysing the proposal. The conclusion, with which I am bound to say I very much agree, is that the attractions which we saw in this at your meeting do not stand up to closer examination. There are a number of difficulties, but the overriding one is that on any realistic assumption about planned levels of expenditure basic allocations would fall to a level which would be highly damaging, politically and practically. Local Government, and their supporters in Parliament, would be up in arms; and we would find it quite impossible either to provide adequately for authorities with genuine spending needs or to exercise any real influence over local spending decisions.

Reluctantly, I believe that we should now settle for living with the present system for next year. We have failed to come up with any change for 1986/87 which does not create greater problems than it solves. The imediate difficulty about retaining the present system is that, if we wanted to be reasonably sure of delivering a cash limit derived from the present PESC baseline, then allocations would be demonstrably inadequate. In total, they would amount to some 77% in cash terms of the level for 1985/86 - and that level is already well below, even in cash terms, what we had given in previous years. Accordingly, in common with my colleagues in other spending departments, I shall have to continue to press in the bilaterals the case which we have already made for raising provision to more realistic levels.

I recognise that the failure to find an interim system which stops the accumulation of receipts leaves a longer term problem. It makes it all the more important to introduce long-term changes without further delay. Of the options we have been considering I am very attracted by the more radical borrowing systems, either EFLS or a control of net external borrowing for capital purposes. We are exploring various ways of approaching these options with local authority associations, including one which is based on similar principles to the Policy Unit proposal.

I am determined that we should devise an effective system, which those who have to operate it believe will work at national and local level. I will make firm proposals shortly.

I am copying this to the other members of E(A), to Norman Fowler, Keith Joseph, John Biffen, John Wakeham and Sir Robert Armstrong.

KB
4 September 1985.

K.B.

LOCAL AUTHORITY CAPITAL EXPENDITURE 1986/87: ANALYSIS OF NO 10 POLICY UNIT PROPOSAL

1. This note has been prepared by officials following the Prime Minister's meeting on 31 July, at which it was agreed that the ideas put forward by the Policy Unit should be developed further. Paragraphs 2-13, containing a factual description of the proposal and its effects, have been agreed between the major spending departments, Treasury and the Policy Unit. The assessment in paragraphs 14 to 26 represents the views of the spending departments and, where mentioned Treasury, but not necessarily those of the Policy Unit. This agreement by officials in no way implies the commitment of Ministers.

Details of the proposal

2. The details of the Policy Unit proposal, as originally envisaged, are as follows:

a. Each authority would be given a borrowing approval (not, as now, an expenditure allocation).

b. In addition, it would be able to spend:

i. a proportion, say 10%, of its receipts accumulated up to 31 March 1986;

ii. its in-year receipts in full; and

iii. contributions from revenue to capital, limited only by the constraints on revenue spending created by block grant mechanisms and, where appropriate, by rate limitation.

c. At national level, there would be no change in public expenditure definitions. But the only controlled elements would be new borrowing and the use of accumulated receipts. A control total covering these two elements would be set in the PESC round. Borrowing approvals would be equal to the control total less the assumed use of accumulated receipts. The use of in-year receipts and revenue contributions would be uncontrolled.

Giving effect to the proposal

3. The Policy Unit envisaged that the new regime would be introduced for 1986/87 by means of urgent primary legislation. The Secretary of State indicated in discussion that it might be possible to introduce it without such legislation.

4. The following features of the proposal need primary legislation if they are to be carried through exactly as envisaged:

a. Changing from expenditure allocations to borrowing approvals as the basis for control. Under present legislation, the Secretary of State has a duty to set an allocation for each authority.

b. Prescribing different proportions in respect of accumulated and in-year receipts. Under present legislation, different proportions may only apply to different classes of receipt.

c. Providing for the spending power from in-year receipts, and from the permitted 10% of accumulated receipts, to disappear at each year end if unused. Under present legislation, the cascade rule applies.

5. A further piece of legislation would be helpful to the system. If the spending power from receipts is to disappear at each year end, it must not be possible for the cash from such receipts to be channelled into capital expenditure in the guise of revenue contributions in a subsequent year. The most certain way to achieve this would be to define "borrowing" for the purposes of the annual borrowing approval as external borrowing for capital. The drawing down of cash from earlier years' receipts would then count against the borrowing approval. Legal advice suggests that a slip in consolidating legislation may mean that borrowing is correctly so defined under present legislation. But within local government, borrowing approvals are universally taken to apply to new borrowing for capital by service departments from the authorities' own loans funds, ie internal borrowing. (External borrowing, as such, is not therefore controlled.) DOE officials believe that the more restrictive interpretation would be so controversial as to be quite impossible to impose in practice without amending legislation. Besides, finding a means of operating a control over external borrowing for capital would be difficult; no satisfactory method has been found to date in the longer term review.

6. QL reserved one clause in the Local Government Bill for capital. Space problems apart, there are political difficulties about interim primary legislation. A close proxy for the Policy Unit proposal which would require only secondary legislation might operate as follows:

a. Each authority would be asked to provide information as to the level of its accumulated receipts.

b. It would be given a capital allocation, which would contain basic elements reflecting spending departments' assessments of relative need as now, plus an amount equal to 10% of its accumulated receipts (either as part of service allocations or as a single separate block).

c. It would be given a borrowing approval equal to the basic elements (plus or minus marginal adjustments, as now)

d. A regulation would be made to the effect that receipts arising prior to 1 April 1986 would not count as receipts. (This would need to be rolled forward each year.)

e. All prescribed proportions for receipts would be revoked, with the effect that in-year receipts could be spent in full in addition to allocations.

f. Expenditure financed from revenue would be exempted by regulations from being prescribed expenditure, so that authorities could finance as much spending that way as they could afford.

7. Three legal issues are being checked:

a. The Solicitor General advises that allocations to individual authorities may not take account of those authorities' individual levels of receipts. Under the proxy system described above, allocations would include an allowance for accumulated receipts.

It may still be regarded as acceptable to take account of sums which have been deemed by regulations no longer to be receipts. If not, the proxy system founders without legislation.

b. Is the cutting off of <u>all</u> accumulated receipts a reasonable use of the relevant regulation-making power? Again, this is crucial to the proxy system.

c. "Revenue contribution" would have to be defined tightly enough to exclude cash from accumulated receipts. An alternative approach would be to make revenue contributions allowable as a supplement to allocations only up to a certain limit. This would make the source of the revenue contributions very much less relevant. It has other attractions, but also substantial drawbacks. It is further discussed in paragraph 11 below.

<u>The numbers</u>

8. The Chancellor indicated at the 31 July meeting that he was prepared to consider agreeing to uncontrolled use of revenue contributions, and to accept that overall levels of local authority expenditure might rise above present provision as a result, provided that the system led to a worthwhile switch from current to capital expenditure. The likely effects of the proposal have been analysed with this in mind.

9. The results are set out in Table 1. Two scenarios have been used. Column 1 is based on the assumptions that, as the Policy Unit originally envisaged, the control total would be equal to the basic elements in allocations plus the assumed level of use of accumulated receipts; and that it would be set around the level of baseline net provision, £2150m*. Given further assumptions, described in the footnotes to the table, gross outturn would be around £4750m, which happens to be broadly the level implied by departments' bids in the present PESC round. Column 2 is based on the assumption that gross expenditure is intended to be at the level of baseline gross provision, £4150m.

10. We assume that the pressures for capital expenditure will lead to some switching from current to capital if revenue contributions are unconstrained. But the pressures for current spending are themselves considerable. We have therefore assumed that at least 20% and no more than 50% of the increase in revenue contributions will be in substitution for current spending, and that the rest will be an absolute addition to public expenditure. But these estimates are necessarily extremely uncertain. The figures are given in the Table.

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* This and certain other numbers used in the analysis are those familiar from earlier Ministerial discussions. Latest figures vary slightly, but not enough to affect the argument.

11. We have also examined the option referred to above of limiting the amount of supplementation from revenue contributions. Such a limit might be selected not only to get round any definitional problem but also because it would enable basic allocations to be greater. It would have the disadvantage of offering authorities less flexibility, and in particular preventing them from saving from revenue over a number of years for a major project, and would make the presentation of the system as offering new freedom harder to substantiate. Realistically, the extreme case of such a limit would be where it was set to deliver present levels of revenue contribution, ie around £500m excluding the GLC. The effects of such a limit, on the same two scenarios as before, are shown in Columns 3 and 4 of the Table.

12. Columns 5 and 6 show the effects of the status quo, again on the same two assumptions as to intended gross outturn. This assumes no changes in either primary or secondary legislation. Use of capital receipts would be subject to the same prescribed proportion as now. The amounts available for allocation service by service would be derived from net provision and the non-prescribed proportion of estimated in-year receipts. For 1985/86 they were modified by adjustments having regard to the planned gross expenditure figure. The figures in the table assume that a similar adjustment would be made for 1986/87 designed to deliver spending within the cash limit. The calculation is shown in more detail in Table 2. Column 7 shows for comparison the allocation figure this year.

13. The results may be summarised as follows:

ie the level implied by departmental bids.

a. To achieve gross outturn of £4750m, basic allocations would be in the region £1450m to £1700m with no limit on revenue contributions, and around £1950m with the lowest feasible limit, compared with £3075m under the status quo and £3045m this year. Capital expenditure would exceed baseline by some £600m. With no limit on revenue contributions, up to £250m of that might be a switch from current; the rest would be an addition to public expenditure. With the limit on revenue contributions, it would all be additional.

ie baseline gross provision

b. To achieve gross outturn of £4150m, basic allocations would be in the region £850m to £1100m with no limit on revenue contributions, and around £1350m with the lowest feasible limit, compared with £2350m under the status quo and £3045m this year. Capital expenditure would be at baseline. With no limit on revenue contributions, and hence a switch from current, there could be a reduction in public expenditure of up to £250m.

Assessment

14. As stated above, the assessment in the remainder of this note represents the views of the spending departments and, where mentioned, Treasury, but not necessarily those of the Policy Unit.

15. Table 1 demonstrates that, for a given level of intended gross expenditure, the Policy Unit proposal - with or without a constraint on the supplementing of allocations from revenue - will always give lower allocations, and permit greater additions on top of allocations, than the status quo.

16. Authorities would welcome the unconstrained use of in-year receipts and the scope for additional revenue contributions. (Their enthusiasm for the latter would be tempered if the scope were subject to a fixed limit. In that case, the total of allocations plus additions from revenue would be fixed and it would be hard to stop authorities thinking of that fixed total as merely equivalent to old-style allocations but with a reduced rate of borrowing approval.) On the downside, the proportion of accumulated receipts which could be spent would be reduced, as would allocations.

17. There are thus in presentational terms both advantages and disadvantages to the Policy Unit proposal as compared with the status quo. The factor which, in the view of officials in the spending departments, tips the balance of advantage heavily against the new proposal is the scale of the reduction in allocations - only about 60% of those available under the status quo, even with limited revenue contributions. Such a reduction, coupled with the cut in the use of accumulated receipts, and notwithstanding the added flexibilities, would create uproar with local authorities and with their supporters in Parliament.

18. There are severe practical implications too. Possible levels of allocation for each service block are illustrated in Table 3. Table 4 shows the consequential levels of spending power for each class of authority. The areas of greatest spending need tend to be those least able to generate receipts and most tighly constrained on the revenue side. Spending departments regard it as essential to be able to adjust relative levels of allocation year by year to reflect changing need; but with such low levels of allocation the scope for this would be severely damaged. The scope for the expression of central government policies for individual services through the allocations given for each service block would also be reduced.

19. For Housing, the Housing Investment Programme system in its present form would probably have to be scrapped. Allocations would have to be heavily concentrated on urban authorities, many of which have very little scope for selling assets to raise receipts. Other authorities would receive little or no allocation. Even with such a drastic change, inner city authorities' allocations would still be very sharply reduced (to less than half their 1985/86 level on the most restrictive version of the proposal). Many autorities would be unable to meet their contractual and statutory commitments.

20. For Other Services, local authorities' spending choices indicate that provision and allocations for this block are already seriously inadequate. Again, the Policy Unit proposal would bear very hard on those authorities unable to generate their own spending power. The local authority associations would almost certainly refuse to make recommendations on the distribution of the tiny residual allocations.

21. For Transport, DTp say that they require a high level of allocations in relation to PES provision, as a means of influencing local authority spending on transport. Local authority roads complement the national network and therefore the Secretary of State needs to be able to indicate his priorities. Similar considerations apply to airports, where the Government are committed to supporting financially worthwhile

investment with capital allocations. Transport authorities rely heavily on allocations because the proportion of receipts in relation to gross spending on transport is lower than for other services, and because the authorities concerned have relatively little access to receipts from other services.

22. For Education, where local authorities are under statutory duties to make a sufficient level of provision, to carry out approved proposals and to meet prescribed standards, similar considerations apply. DES believe that the lack of scope for distributing spending power to reflect need would leave many local education authorities unable to meet contractual commitments and statutory obligations which are dependent for their fulfilment on capital expenditure. They believe that the levels of allocation would be seen as derisory.

23. For Personal Social Services, authorities are being encouraged to develop community care for clients in line with Government guidance. DHSS point out that social services departments have relatively small capital programmes and only limited possibilities for generating receipts. They consider that the proposed restriction on the use of receipts after the year in which they are generated is likely to prove fatal to modernisation programmes which rely on sales of existing capital stock to allow new development to take place.

24. The Audit Commission report on capital said that local authority capital programmes need to be planned at least three years ahead if waste and inefficiency are to be avoided. Substantial staff and financial resources will already be committed to 1986/87 projects. In the absence of any guidance, local authorities will be assuming that the regime next year will be substantially the same as this, with unchanged prescribed proportions and allocations running at least at 70% of 1984/85 levels for Housing and Other Services. Discussions with local authorities about provision for 1986/87 are already under way: for example, DOE regional offices are in the middle of their round of meetings with all housing authorities, while transport authorities have made their programme bids for capital allocations and TSG and DTp regional offices are at an advanced stage in preparing advice on these bids. The effect of the Policy Unit proposals would be a considerable shift of resources (which are in any case in aggregate well below recent years' outturn) towards those authorities with the prospect of substantial in-year receipts at the expense of the rest. DOE estimate that if the system had operated for 1985/86, some authorities' resources from receipts and allocations would have been more than halved, others'
very substantially increased, compared with the actual position. Some authorities would have been unable even to meet their commitments. The disadvantaged would include not only authorities which are unwilling to sell assets but also those with few assets to sell and - crucially, from the point of view of equity - those which most enthusiastically adopted Government policy in earlier years and have already disposed of their readily saleable assets. The scope to make revenue contributions would give such authorities theoretical flexibility, but in practice the RSG regime for 1986/87 is designed to maintain a strong disincentive to revenue spending.

25. The proposals would only be announced in September or more likely October, very late indeed for what would represent a radical shift in the Government's approach to the control of capital spending. The Government would be criticised for acting directly contrary to the recommendations of the Audit Commission and causing waste and inefficiency. Treasury share the concern of spending departments about the disruption which switching to the new system for 1986/87 at such a late stage would cause.

26. Such an announcement would also complicate at a very late stage the rate support grant settlement for 1986/87. The likelihood that the new arrangement would lead to higher revenue contributions than hitherto assumed would necessitate reconsideration of the aggregates of relevant expenditure and grant. GRE methodology would need to be recast to take account of the new capital control system, inevitably in a rough and ready way: this would add to the distributional upsets already expected from the decision to increase block grant pressures on expenditure, and from the abolition of the GLC and metropolitan county councils.

Conclusion

27. The raison d'etre of the Policy Unit proposal is to stop capital spending power from accumulated receipts mounting up. The spending departments believe that it would achieve that only at a very considerable political and practical price. Politically, there would be an outcry at the low level of allocations, despite the offset of greater freedom to add to them; at the further reduction in the prescribed proportion for accumulated receipts; at the unfairness of penalising those which have responded to Government policy by selling assets; and at the lateness of the change. Practically, the lateness would be highly disruptive. The ending of redistribution would leave many needy authorities short of resources; would destroy an important means of influencing local government policies in the direction of achieving greater value for money; and would run counter to the Audit Commission plea for greater stability to promote sensible long-term planning. The change in the system would be seen as very substantial and would be hard to present as a reasonable short-term measure pending the outcome of the present review.

28. The status quo has none of these disadvantages. It avoids the need to put any proposals to Parliament. At baseline, it gives higher allocations than any other proposal which has been under discussion, except the Treasury version of ending the cascade, which would have secured higher allocations only at the price of the virtual elimination of receipts as a spending power. Even with the status quo, if baseline provision were not increased allocations would be very much reduced from this year; but the level of provision can be debated further in the PESC round. The split between services will also need further discussion. All solutions for 1986/87 are far from perfect, because the position we start from is the product of an imperfect system. But maintaining the status quo looks the least unattractive.

TABLE 1

1986/87 DOE/LA1 ALLOCATIONS AND EXPENDITURE ASSUMPTIONS

£m

	Col 1	Col 2	Col 3	Col 4	Col 5	Col 6	Col 7
	POLICY UNIT PROPOSAL (with unconstrained revenue contributions)		POLICY UNIT PROPOSAL (with contrained revenue contributions)		STATUS QUO		1985/86 ALLOCATIONS
1. Gross capital expenditure assumption[1]	4750	4150	4750	4150	4750	4150	
2. Assumed use of in-year receipts[2]	1500	1500	1500	1500			
3. Assumed use of revenue contributions[3]	750 to 1000	750 to 1000	500	500			
4. Assumed level of notional non-prescribed expenditure[4]	250	250	250	250	SEE TABLE 2		
5. Allowance for accumulated receipts[5]	550	550	550	550			
6. Total for basic allocations (1-2-3-4-5)	1450 to 1700	850 to 1100	1950	1350	3075	2350	3045[8]
7. Reduction in revenue expenditure[6]	100 to 250	100 to 250	nil	nil	nil	nil	
8. Increase (+)/decrease (-) in public expenditure over present baseline	350 to 500	-250 to -100	600	nil	600	nil	
9. "Capital contr ibution" to LABR[7]	1500 to 1750	900 to 1150	2000	1400	2000	1400	

FOR FOOTNOTES PLEASE SEE OVERLEAF

NOTES:

1. Calculations are shown for gross capital expenditure assumptions of £4750m and of £4150m (PESC baseline).

2. It is assumed that 75% of the baseline level of receipts (£2000m) would be used.

3. Revenue contributions (including transfers from special funds) were about £700m a year between 1980/81 and 1983/84 (the latest available year). The GLC accounted for about £200m of this. It is assumed that there would be a rise in such contributions but revenue constraints would prevent their exceeding £1000m. It is assumed that in the constrained version of the Policy Unit proposal they could not be reduced below their historic level (excluding GLC).

4. Non prescribed expenditure includes both real expenditure (eg on de minimis items) and notional expenditure on leasing. The latter would still be an addition to public expenditure. The former would have to be met from borrowing allocations or revenue contributions and is omitted from the above figure.

5. It is assumed that 85% of the £630m available would be used.

6. For assumptions, see text.

7. This is not equivalent to a true capital borrowing requirement since it ignores grants, repayment of debt etc. However comparison between columns provides an indication of the relative effects of the various options on the LABR.

8. Including up to £100m in supplementary allocations for compliance within the request for restraint in 1984/85 and for Housing defects.

TABLE 2

1986/87 DOE/LA1 ALLOCATIONS UNDER THE PRESENT SYSTEM WITH GROSS PROVISION OF £4150m (BASELINE) AND £4750m

		£m
Gross capital provision	4150	4750
Spending power compatible with provision (assuming 85% use)	4875	5600
less spending power from:		
in-year receipts (25% of 2000)	500	500
accumulated receipts (25% of 6300)	1575	1575
non-prescribed expenditure	450	450
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Available for allocation	2350	3075

1986/87 DOE/LA1 ALLOCATIONS BY SERVICE BLOCK (SPLIT PRO RATA TO THE MID POINT BETWEEN NET AND GROSS PROVISION[1])

£m

	POLICY UNIT PROPOSAL (with unconstrained revenue contributions)		POLICY UNIT PROPOSAL (with constrained revenue contributions)		STATUS QUO		1985/86 ALLOCATIONS
Gross capital expenditure assumption	4750	4150	4750	4150	4750	4150	
Allocations:							
Education	160	100	200	140	315	240	315
PSS	45	25	55	35	85	65	70
Transport	360	225	445	310	705	540	640
Housing	800	495	990	685	1560	1190	1600
Other Services	210	130	260	180	410	315	320
TOTAL	1575	975	1950	1350	3075	2350	3045[2]

1. This split is for illustrative purposes only. It does not necessarily represent what the actual distribution between services would be.

2. Including up to £100m in supplementary allocations for compliers with the 1984/85 request for restraint and for housing defects, not included in service totals.

TABLE 4

1986/87 SPENDING POWER FROM RECEIPTS AND ALLOCATIONS

NB Excludes spending power from notional non-prescribed expenditure and revenue contributions. See cols (8) and (9) for levels of those in earlier years

	POLICY UNIT PROPOSAL (with unconstrained revenue contributions)		POLICY UNIT PROPOSAL (with constrained revenue contributions)		STATUS QUO		1985/86 SPENDING POWER	1984/85 NOTIONAL NON-PRES. EXPENDITURE	1983/84 REVENUE CONTRIBUTION
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Gross capital expenditure assumptions	4750	4150	4750	4150	4750	4150	–	–	–
SPENDING POWER[1]									
Shire Counties	620	480	700	565	955	790	865	35	210
Shire Districts	1710	1540	1820	1645	1840	1630	1780	60	145
Metropolitan areas	810	655	910	755	1110	925	1065	105	100
London	1065	930	1150	1015	1245	1080	1185	50	245[2]
TOTAL	4205	3605	4580	3980	5150	4425	4995[3]	250	700
of which:									
Allocations	1575	975	1950	1350	3075	2350	3045[3]	–	–
In-year receipts	2000	2000	2000	2000	500	500	500	–	–
Accumulated receipts	630	630	630	630	1575	1575	1450	–	–

1. Assumes allocations are split to classes by service departments pro rata to 1985/86 split.

2. Of which GLC accounts for £200m.

3. Including up to £100m for supplementary allocations for compliers with the 1984/85 request for restraint and for housing defects, not included in class totals.