SECRET - CMO

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pm. 1 of 11.

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

The Rt Hon The Viscount Whitelaw CH MC
Lord President of the Council
Privy Council Office
Whitehall
LONDON
SW1

23 October 1986

Dear Willie

RATE SUPPORT GRANT AND RATE-CAPPING: TOTAL EXPENDITURE

I am sorry to come to you with another serious problem in the operation of the rate support grant and rate-capping to which the only remedy seems to be urgent legislation. Knowing your problems, I have not come readily to this conclusion but I see no alternative if we are not to lose the 1987/88 round of rate-capping and the forthcoming RSG Settlement and Supplementary Reports.

In a nutshell we have followed a practice since 1980 of calculating total expenditure - which is the basis for the distribution of block grant to local authorities, and which plays a key role in the rate and precept limitation process - so that it approximates to net payments out of the rate fund revenue account of an authority, even though the main relevant legislation is drafted in terms of the rate fund (which is a wider concept embracing all the accounts of a local authority including, for example, the captial account and special funds). All the local authority associations pressed us to adopt this practice in 1980 as reflecting better the way in which they ran their business, and we did so even though there were some uncertainties as to whether it was strictly correct. The climate was, of course, entirely different at that time.

Recently certain local authority accounting practices have come to light which were not acceptable, given the approach we were following. However, in the changed climate, the necessary step was taken of seeking Counsel's opinion on the legal position before proceeding against these practices. I have subsequently consulted the Attorney General. His letter to me and the opinion of leading counsel (Mr Robert Alexander) are attached.

The Attorney's view is that the practice we have followed since 1980 is in conflict with the statutory definition. He advises that, in the knowledge that this is so, it would not be right for me to make the Rate Support Grant report for 1987/88 (or further supplementary reports for earlier years) or for us to proceed with rate or precept limitation until matters are put right. Until then the rate limitation process for 1987/88 is at serious risk of successful legal challenge.

We must legislate, therefore, if there is to be rate limitation next year, and if the rate support grant system is to function. So far as past years are concerned we must put ourselves in a position to made future supplementary reports on the basis of the practice we have adopted so far. To do otherwise would be enormously disruptive in terms of individual authorities' grant entitlements over the whole period. For the future, in theory we have an option: we could either come broadly into line with Counsel's and the Attorney's interpretation of the existing statute, or we could confirm the practice we have followed in the past as valid for the future. The first course has some attractions - it would cut off some avenues for creative accounting- but I have had to conclude that the practical difficulties rule it out: we would have to start again on RSG and rate limitation for 1987/88 on a basis where we do not have accurate information, creating great delay and uncertainty for authorities; the legislation would itself be hotly contested and protracted giving rise to further delay; because they would no longer be of value to them, authorities would no doubt disgorge their special funds (totalling more that £1 billion) into earlier years creating great volatility in grant entitlements (and perhaps eliminating holdback and calling the £500 million recycling guarantee given by Kenneth Baker earlier this year); finally, rate and precept limitation would be jeopardised. In the face of all these difficulties, I cannot regard this course as a practical option. We must in my view proceed along the course of confirming present practice. This should not be controversial, will avoid grant volatility, and be easier to legislate.

However, even this course is by no means without difficulty. Timing is critical. If, once the issue has become public, we do not act immediately to protect rate limitation, there is a considerable risk of successful challenge to the designation report made in July which selected authorities for rate limitation in 1987/88. If that report is quashed, the rate limitation process would collapse until legislation to reinstate it is enacted. Authorities are required to set their rates by 10 March (precepting authorities) or 1 April (rating authorities). They need time before that to finalise their budgets. As a consequence 1 March is the latest practical date for letting authorities know what their rate or precept limit is. Before that there must be adequate time for authorities to consider our proposals on expenditure and rates and to make representations - at present several months are taken by these stages; 6-8 weeks is probably a minimum requirement. Even with fast-track legislation, securing Royal Assent in say mid-February, time would be desparately short and heavily truncated procedures, inevitably very controversial, would have to be provided for.

We would also need to include in a Bill on this timing measures to secure the implementation of the RSG Settlement in the few weeks remaining before the start of the financial year. Again we would have to cut through the consultation requirements and in effect enable ourselves to implement without change draft proposals I would have to bring forward earlier.

Against this background I see no satisfactory alternative to taking a Bill through both Houses on an emergency timetable of a few days as soon as possible. Such a Bill, by its very speed, should pre-empt legal challenge, minimise disruption to the Settlement, and avoid the need for complicated and perhaps controversial provisions to deal with the timetable problems on rate limitation and RSG; it should be possible to confine its provisions to the single issue of validating existing practice on total expenditure and putting it on a proper basis for the future (it would consequently be more likely to be a Money Bill).

I would thus be grateful for your and colleagues' agreement to:

a) my preparing a Bill to validate existing practice on the calculation of total expenditure for both past and future years;

b) the processing of the Bill to an urgent emergency timetable, and its coming into operation immediately on Royal Assent.

I am, of course, ready to discuss.

Clearly this strategy depends for its success on no public mention of the problem being made until we are ready to bring forward legislation. I am therefore marking this letter 'CMO' and restricting the copy list to the Prime Minister, the Lord Privy Seal, the Secretary of State for Wales, the Chief Secretary, the Attorney General, the Chief Whip and those colleagues concerned with precept limitation, the Home Secretary, the Secretary of State for Education and Science and the Secretary of State for Transport, together with Sir Robert Armstrong and Sir George Engle.

NICHOLAS RIDLEY

012/2769

SECRET - CMO

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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Viscount Whitelaw PC CH MC
Lord President of the Council
Privy Council Office
Whitehall
London
SW1A 2AT

28th October 1986

Dear Willie,

RATE SUPPORT GRANT AND RATE-CAPPING: TOTAL EXPENDITURE

I have seen a copy of Nicholas Ridley's letter of 23 October and Michael Havers' of the 22 October.

It is extremely annoying that yet again we are faced with the need for emergency legislation to remedy defects in earlier legislation. But, as I mentioned to you, I nevertheless strongly support the proposal to introduce emergency legislation early in the new Session. Otherwise there would be a considerable risk of the authorities provisionally selected for rate-capping in 1987-88 escaping from the net.† That would have a serious impact on our policies for public expenditure.

I am copying this letter to the Prime Minister, Douglas Hurd, John Biffen, Nicholas Edwards, Nicholas Ridley, Kenneth Baker, John Moore, Michael Havers, John Wakeham, Sir Robert Armstrong and Sir George Engle.

† to give best one possible.

Yours ever,

JOHN MacGREGOR

SECRET - CMO

LOCAL GOVT Relations PT30

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

Robin Young Esq
Private Secretary
Secretary of State for the Environment
2 Marsham Street
LONDON SW1P 3EB

27 October 1986

Dear Robin,

RATE SUPPORT GRANT AND RATE CAPPING : TOTAL EXPENDITURE

Unfortunately, a line was omitted from my ~~Secretary of State's~~ shredded letter of today's date to ~~Mr Ridley~~. I should therefore be grateful if you could destroy the earlier letter and substitute the attached in its place.

I am copying this letter to the Private Secretaries of the Prime Minister, the Lord President, the Home Secretary, the Secretary of State for Wales, the Lord Privy Seal, the Secretary of State for Education and Science, the Chief Secretary, the Attorney General, the Chief Whip, Sir Robert Armstrong and Sir George Engle.

Yours ever,

Jon.

JON CUNLIFFE
Private Secretary

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DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

COPY NO. 2 OF 13

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON SW1P 3EB

27 October 1986

Dear Secretary of State,

RATE SUPPORT GRANT AND RATE CAPPING : TOTAL EXPENDITURE

Thank you for sending me a copy of your letter of 23 October to Willie Whitelaw.

It is obviously deplorable that we have yet again to be contemplating emergency retrospective legislation on the rate support grant system. The sooner that simpler arrangements which are both fairer and less susceptible to this kind of difficulty are put in place, the better.

I see no alternative to legislation and strongly support your proposal that this should be on an emergency timetable. As you know your policy and mine has been to use precept control to make very significant reductions - around 33% over three years - in public transport expenditure in the metropolitan counties. So far we have been very successful in implementing this policy, but the opposition of the Passenger Transport Authorities make it seem certain that they will use every opportunity to challenge these controls. I have little doubt that if there is any delay in obtaining Royal Assent for your proposals there may be a number of legal challenges to the Expenditure Levels I have determined for 1987/8, challenges which could well be successful. The outstanding application from South Yorkshire PTA for judicial review is now due in any case to be heard in January, and if legislation has not been passed by that time the Government's defence may well be more difficult.

A further possibility is that if ELs for 1987/8 cannot be statutorily determined until next February, the PTAs may use the interim period to place more contracts for tendered bus services, so making it more difficult for me to enforce the reductions I intend.

Presentation of your proposals will clearly require careful handling, and I hope that you will keep my officials closely in touch as the Bill is drafted.

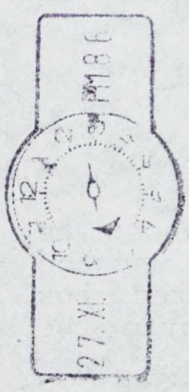
I am copying this letter to the Prime Minister, the Lord President, the Home Secretary, the Secretary of State for Wales, The Lord Privy Seal, the Secretary of State for Education and Science, the Chief Secretary, the Attorney General, the Chief Whip, Sir Robert Armstrong and Sir George Engle.

Yours Sincerely

J. Moore

P.P. JOHN MOORE

(approved by the Secretary of State and signed in his absence).



SECRET - CMO

Prime-Minister (1)

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HOME SECRETARY

QUEEN ANNE'S GATE LONDON SWIH 9AT

27 October 1986

WBM

Dear Willie,

RATE SUPPORT GRANT AND RATE-CAPPING: TOTAL EXPENDITURE

I have seen Nicholas Ridley's letter to you of ~~23~~ 24th October.

For the reasons Nicholas gives, legislation seems essential. As to timing, apart from the RSG considerations he mentions I think it is in our general interests that it is through as quickly as possible. We must avoid a period of confrontation with the local authorities stretching into next Spring.

I therefore strongly support Nicholas' case for a Bill and for its proceeding on an emergency timetable.

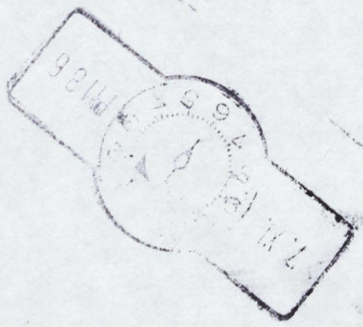
Yours,

Douglas.

The Rt Hon Viscount Whitelaw, CH, MC

SECRET - CMO

LOCAL GOVT Relations PT30



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PRIME MINISTER

RATE SUPPORT GRANT AND RATE CAPPING: TOTAL EXPENDITURE

Mr. Ridley's letter below reports yet another problem with rate legislation. He concludes that he sees no satisfactory alternative to taking a Bill through both Houses on an emergency timetable of a few days as soon as possible.

Block grant to local authorities depends on their total expenditure. Under the legislation, total expenditure is defined in terms of the rate fund. But since 1980 the DOE has treated total expenditure as being more or less equal to net payments out of the rate fund revenue account. This is a narrower concept than that of the rate fund because it excludes among other things the capital account and special funds. (Special funds hold e.g. money being saved up for lumpy expenditures.)

The DOE's approach has on the whole worked well enough. The system gave a degree of flexibility to local authorities because expenditure was scored when it left the rate fund revenue account not when money left the capital account and the special funds. So local authorities could "save", for example, to build up money for the construction of a school. When the lumpy payments for the school, or whatever, were made, the local authority would not run into exceptional grant penalties because the expenditure would have been scored earlier year by year.

This was fine while the local authorities in general were behaving responsibly. But some have been abusing the system. DOE took legal advice before acting against these abuses and the result has been advice that total expenditure must be defined in relation to the rate fund as a whole not just the rate fund revenue account.

Mr. Ridley has concluded that he needs urgent legislation to prevent this year's settlement falling apart, and also those

for earlier years.

Lord Whitelaw is holding a meeting about this on Monday but on the face of it Mr. Ridley's conclusion seems inescapable. I suggest you leave it to Lord Whitelaw to pursue.

This will no doubt make life more difficult for any emergency legislation to abolish Burnham: two sets of emergency legislation will cause irritation.

DAVID NORGROVE
23 October 1986

EL3BLY

ROYAL COURTS OF JUSTICE
LONDON, WC2A 2LL

01-936-6201

22 October 1986

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
2 Marsham Street
LONDON S W 1

Dear Nicholas.

DEFINITION OF TOTAL EXPENDITURE

I think you have seen a copy of Robert Alexander's Opinion expressing in the clearest terms his view that the present method of calculating "total expenditure" under section 56(8) of the Local Government, Planning and Land Act 1980 is "in conflict with the statutory definition" and "impermissible". That was the view I had formed on reading Junior Counsel's advice, but I had hoped Robert might be able to divine a convincing counter-argument which would at least justify awaiting an authoritative ruling from the court. Alas, he sees in the scheme of the legislation an intention to be concerned with the entire estimated expenditure of an authority in any particular year, and there is nothing in the individual statutory provisions which detracts from that overall purpose.

I accept his advice, and in the circumstances I am clear that emergency legislation is necessary to put matters right, even though the current interpretation of the law has yet to be challenged in the courts. "Total expenditure" is so fundamental to the Rates Support Grant system and to rate limitation that I do not think it would be right to continue to make decisions on these matters in the knowledge that the base-figure from which you were working was incorrectly calculated. Nor do I think it would be right to try to persuade Warwickshire that the accounting practice they are now adopting is wrong, when there is firm legal advice to the contrary.

/I

ATTORNEY GENERAL

I would therefore favour legislation on grounds of legal propriety alone. But quite apart from that consideration I should have thought there was a substantial risk of legal challenge from any authority which stood to gain by adopting the correct accounting method. I have little doubt that the advice given by Warwickshire's auditors will become widely known in local government circles, and were it to emerge that the Department had received legal advice to the same effect, the risk of legal challenge would of course be substantially increased.

The choice between the two legislative options is really a matter of policy, but I think there is much to be said for validating the current interpretation of "total expenditure" and protecting past decisions and determinations by retrospective legislation. This approach would be the least disruptive and, as Counsel points out, it would help justify the payment of further instalments of grant which have been calculated on the present basis. I agree with his view that, pending legislation, it would not "be administratively correct to make any further Rate Support Grant Reports or Supplementary Reports, or to proceed with rate limitation".

I am sending copies of this letter to the Prime Minister, the Lord President, the Lord Privy Seal, and the Chief Whip.

Yours ever Michael.

OPINION

1. The calculation of "total expenditure" under section 56(8) of the Local Government, Planning and Land Act 1980 is central to the operation of the rate support grant system. The essential issue which now arises is as to whether it is permissible to exclude expenditure and income shown in accounts other than the "Rate Fund Revenue Account". In my view, such an approach is in conflict with the statutory definition and is impermissible. Both the statutory provisions and the arguments have been fully rehearsed in detailed memoranda and in the clear Opinion of Miss Presiley Baxendale. I agree with her views and I will therefore give my own reasons only briefly.

2. It is appropriate to stress at the outset that the calculation of "total expenditure" is designed for the purpose of calculating the amount of grant. While the expenditure of an authority is, for practical reasons, generally estimated, it is clear from the scheme of the legislation that there is an intention, except where otherwise provided, to be concerned with the entire estimated expenditure of an authority during a year so as to assess what that authority's grant should be. This calculation affects the prima facie amount of grant, assists in the determination of whether an authority could be regarded as a "high spending" authority or a "low spending" authority, and ultimately affects whether that authority is considered to have overspent to such a degree as to warrant

rate-capping. There are specific provisions in the legislation for exemption from the calculation of total expenditure. It would, however, not easily conform with the purpose of the legislation if as a matter of practice accounting decisions could be taken which derogated from the true estimate of the overall expenditure of an authority. The practice currently adopted, however, has this consequence in a number of ways:

(i) Any transfer from the general rate fund to any other fund, whether or not to meet a liability incurred in a particular year, is to be counted as total expenditure.

(ii) Similarly, any expenditure out of those funds, even if made to meet a liability incurred in that year, is not counted as total expenditure.

(iii) Transfers from the special funds to the general rate fund are treated as income of the authority, whether or not they are derived from income receivable during that year.

These are obvious examples of the way in which the present practice operates to prevent the assessment of an estimate of what is actually the true expenditure of an authority. The problem with this approach is illustrated by the difficulties which at present arise with Warwickshire and Newham to which I shall return. Indeed the present practice

introduces and permits variations from the actual total expenditure which are not contemplated by statute and which give rise to a greater divergence from reality.

3. This practice falls to be considered in contrast with the definition of "total expenditure" in the 1980 Act. In summary, total expenditure is defined in section 56(8) of the Act as meaning "relevant expenditure" less certain specified grants adjusted by the addition or subtraction of either expenditure or receipts of such a description as the Secretary of State may direct. In turn, "relevant expenditure" is defined by section 54(5) of the Act as meaning expenditure which falls to be defrayed out of the rate fund, reduced by the amount of any payments of such a description as the Secretary of State may specify which fall to be made for that year into the rate fund and exclusive of some specific items of expenditure. Other specific statutory provisions affecting the meaning of "relevant expenditure" can be ignored for present purposes. For ultimately, once reductions and adjustments permitted by the legislation have been taken into account, the issue as to whether expenditure is "relevant expenditure", with its consequential impact on "total expenditure", is determined by whether such expenditure is defrayed out of the rate fund of the local authority.

4. "The rate fund", as defined in section 54(8) means- allowing for variations in terminology - the general rate

fund. The operation of the general rate fund is governed by section 148 of the Local Government Act 1972. In particular it is provided by section 148(4) that all receipts shall be carried to, and all liabilities discharged from, the general rate fund. Section 148(5) does not derogate from this provision despite the fact that it permits the keeping of special accounts. A similar provision has been adopted for new authorities in section 72 of the Local Government Act, 1985.

5. The effect of section 148(4) is to provide a definition of the "rate fund" which is basic to the calculation of total expenditure. This definition is in clear, wide terms and it would only be possible to ignore elements of the rate fund so defined if there were specific legislative provisions enabling this to be done for the purpose of operating the 1980 Act. I do not consider that the nature of the rate fund can be altered by the various statutory provisions which enable or require separate funds to be brought into existence. In particular;

(i) Provisions (such as Schedule 13, paragraph 16 of the 1972 Act) which enable a local authority to establish certain funds are, in my view, provisions which enable sensible accounting but do not as a matter of definition affect the meaning of the rate fund.

(ii) Statutory provisions which require a local authority to keep a separate fund or account, such as the Housing Finance Act 1972, the 1980 Act, the Housing Act 1980, and the Lotteries and Amusements Act 1976 do not limit the definition of the rate fund. Whilst it is true that in certain such provisions there is a facility to transfer funds to a specific fund from the general rate fund to meet deficiencies, this is explicable on the basis that once the separate fund has been established it might otherwise be impossible to meet deficiencies on that fund from the general account. Moreover, transfers to meet deficiencies would all be transfers to meet liabilities which fell to be discharged, and likewise transfers to the general rate fund would reflect income received. So that facility for transfer is fully consistent with the ordinary meaning of "rate fund" and its operation. Thus statutory provisions for the maintenance and use of separate accounts or funds, whilst not free from difficulty, all appear to be designed to enable separate accounts or funds to be kept by the local authority without derogating from the clear definition of the rate fund. I consider that a specific provision would be required to narrow the definition.

6. In regard to the present practice, even if it was permissible to exclude certain expenditure from the definition of the "rate fund", there would seem to be no

basis on which it was even arguable that capital expenditure or receipts should be excluded. The concept of the "rate fund revenue account" appears to be absent from any of the statutory provisions, and the fact that there is often room for argument as to what is properly chargeable to capital account indicates the degree of extra-statutory judgment which, under present practice, is being allowed to individual authorities.

7. The problem in the present practice is also vividly indicated by the positions of Warwickshire and certain councils led by Newham. The approach which Warwickshire are taking with regard to a transfer from a special fund is correct: this is not income of the authority. This is so even if in the past the transfers to that special fund have been regarded incorrectly as expenditure. Conversely the artificial inflation by Newham and other authorities of their total expenditure by making a contribution to special funds is contrary to the statutory provisions.

8. It was accepted in consultation that I should only deal with the legal issues raised in paragraph 18 of the Memorandum to the Attorney General, and not those which involve considerations of policy. To summarise my views:-

(i) It does not seem to me to be administratively correct for the Secretary of State to make any further Rate Support Grant Reports or Supplementary Reports, or to

proceed with rate limitation without legislation.

(ii) I consider that it would be reasonable in administrative terms to continue to pay instalments of grant which have been calculated on the present basis, particularly if it is intended to pursue option 2.

(iii) It does not seem to me to be open for the Secretary of State to prescribe interim maxima for rate limited authorities under section 5 of the Rates Act 1984 as such a prescription is dependent upon the authority having been properly designated under section 2 of that Act. The designation under section 2 involves the Secretary of State having regard to the authority's total expenditure, and the present calculation of total expenditure could in my view, be validly challenged by an authority.

(iv) I consider that it would be appropriate to validate past decisions and determinations by retrospective legislation, although it is unlikely that a challenge out of time would be successful given the co-operation of local authorities in the present practice.

Robert Alexander

Temple
London EC4

20th October 1986