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cc B/Gp

PRIME MINISTER

FUTURE OF LOCAL AUTHORITY CAPITAL CONTROLS

[E(LF)(87)41]

DECISIONS

E(LF) needs to agree on a new system for controlling local authority capital expenditure in England and Wales, to take effect in 1990/91 at the same time as the introduction of the community charge. Mr Ridley wishes to initiate consultations on the new system before the end of this year, with a view to preparing a Bill for introduction in November 1988. At this first meeting you will probably want to have a "Second Reading" debate on the general nature of the new system. In particular, Mr Ridley seeks agreement to four basic proposition -

i. That the new system should operate through controls on borrowing for capital purposes rather than on capital expenditure as at present.

ii. That the new system should be designed as far as possible to prevent creative accounting by local authorities using devices such as sale and lease back schemes.

iii. That the use of capital receipts should be controlled so that authorities with receipts can undertake some additional spending, but not to the extent where it threatens the Government's ability to target resources.

iv. That the new system should include requirements about debt redemption, partly to mop up capital receipts, and partly to prevent creative accounting.

Depending on the outcome of your discussion, you will either wish to ask Mr Ridley to develop his proposals further in the form of a consultation paper, or to bring forward revised proposals.

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BACKGROUND

2. The present system of capital controls was introduced in the Local Government, Planning and Land Act 1980 and has been in force since 1981/82. It sets a limit on the capital expenditure which each authority can undertake each year. The limit comprises capital allocations issued by Government plus various additions, of which the most important is a prescribed proportion of capital receipts from sales of assets. (There is also a secondary control over borrowing for capital purposes). The system was designed to control aggregate capital expenditure net of receipts against the Government's public expenditure plans. But in practice it has failed to do this: in some years there have been large overspends against the national cash limit, while in other years there have been equally large underspends. The system has also been subject to a large volume of criticism, both from local authorities and from bodies like the Audit Commission and the National Audit Office.

3. The Government therefore instituted a review of the system in 1984 in consultation with the local authority associations. After further work within Government, two possible new systems were set out in the Green Paper "Paying for Local Government" -

i. A system based on External Borrowing Limits (EBLs) for local authorities, similar to the EFLs which apply to nationalised industries. However the Green Paper acknowledged that there were severe practical problems with a regime of this sort, and that it might not in any case be suitable for controlling local authority expenditure.

ii. A system based on control of gross capital expenditure, whether finance from borrowing, capital receipts or contributions from the revenue account. The Green Paper made it clear that this was the Government's favoured approach at that time.

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Most respondents to the Green Paper took the view that the EBL approach was unworkable, and Ministers accepted this. But there was also considerable opposition to the second option of control over gross capital expenditure.

4. Nevertheless in July 1986 Mr Ridley sought agreement from E(LA) to legislate in the 1986/87 Session for a new system based on control of gross capital expenditure. He hoped to secure the necessary legislation before 1 April 1987, so that the new system could be introduced in 1987/88. His haste was due in part to problems in setting capital allocations for 1987/88 within the constraints of the public expenditure provision and commitments made to local authorities by his predecessors. But after E(LF) discussions in both July and September 1986 the Government decided that it was neither practical nor desirable to attempt to legislate for a completely new system on this timetable. Mr Ridley therefore announced in October that the Government would not proceed with reform in the last Parliament, but would work towards introducing a new system alongside the community charge in 1990/91.

MR RIDLEY'S PROPOSALS

5. The system which Mr Ridley now recommends is a substantial departure from the earlier proposals. Its key features are -

i. The main control would be on borrowing for capital expenditure rather than on expenditure itself. One consequence is that local authorities would have the discretion to incur extra capital expenditure if they could finance it from revenue sources - but the new community charge regime would of course be a constraint on the amount of the expenditure which could be financed in this way.

ii. Authorities would be able to undertake some additional capital expenditure where they had capital receipts. The use of receipts would still have to be controlled, but the rules would be different from those of the present system.

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Mr Ridley's proposal is that authorities should be able to spend 50 per cent of receipts, either in the year they were received or in any subsequent year.

iii. Common creative accounting devices like sale and lease back would be treated as capital borrowing under the new system, which should remove their attraction for local authorities. Similarly leasing transactions and capital expenditure by local authority companies would fall within the controls.

iv. Local authorities would be required to make a standard level of provision for debt redemption. The aim would be to prevent the use of debt rescheduling as a creative accounting device on the revenue side.

6. The treatment of housing capital expenditure is one key issue which is not properly addressed in the paper. Mr Ridley earlier proposed to establish Unified Housing Accounts (UHAs) which would subsume housing capital spending, and take it out of the capital controls system. I understand that he is now considering substantially different proposals, although he still envisages that housing capital would be outside the general control system. Nevertheless, all the figures for receipts in his paper appear to include housing. This is a crucial point because the high level of housing capital receipts (arising from the right to buy) has played a large part in the problems of the present system. You may want to ask him to clarify the position on housing, and to bring forward proposals in that area as soon as possible. It is difficult to see how he could possibly issue a consultation paper on capital controls without also making proposals about housing capital.

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MAIN ISSUES

7. You will want to consider the implications of Mr Ridley's proposals in a number of key areas -

i. For the control of economic aggregates such as public expenditure and the Public Sector Borrowing Requirement (PSBR).

ii. For the targetting of resources.

iii. For their likely reception by your supporters in local government.

Control of Public Expenditure and the PSBR

8. There are no less than three economic aggregates which the Government might want to influence through the capital controls system -

i. The Local Authority Borrowing Requirement (LABR) which is a component of the PSBR.

ii. Net capital expenditure by local authorities, which is what scores in the Government's public expenditure (PE) plans.

iii. Gross capital expenditure by local authorities, which is what scores for the national accounts.

The present capital control system was designed to deliver net capital expenditure in line with PE plans, but has generally failed to do so. The Green Paper proposals aimed principally at the control of gross capital expenditure. In contrast Mr Ridley's new proposals are designed primarily to control the LABR. I understand that Treasury Ministers will be briefed to support Mr Ridley's proposals on this score - the Treasury take the view that the LABR is the most important of the three aggregates to control, given its influence on the financial markets. Your reaction will depend in part on whether you share this view.

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9. Even with the system outlined by Mr Ridley, there will be very little chance of delivering a particular figure for the LABR in a particular year. That is effectively ruled out by the level of local authority capital receipts and the freedom which authorities will retain over their use. Nevertheless the treatment of receipts proposed by Mr Ridley has some substantial advantages over that in the present system -

i. The restriction on the proportion of capital receipts which local authorities can use to justify additional spending will apply both to the year in which the receipt accrues and to any future year. This will correct the flaw in the present system (the "cascade") which limits authorities to using 20 or 30 per cent of a receipt in the year it occurs, but allows them to use the whole of the remainder in future years.

ii. Capital receipts which are not backed by cash - eg because the money has been used to redeem debt or for another purpose - will not be available to justify additional spending.

iii. These two features will result in a dramatic fall in the amount of spending power resulting from past capital receipts. Under the present system there is an overhang of some £8 billion of receipts which authorities could use to justify additional spending. Under the new system that part which is not backed by cash - over a third of the total - will no longer be available. Furthermore authorities will be limited to additional spending equal to only 50 per cent of the remaining receipts. The overhang will therefore be reduced immediately to between £2 billion and £3 billion.

The new system will therefore result in an immediate cut in the overhang of spending power from past receipts. The overhang is likely to be further reduced in subsequent years as the new system obliges authorities to use up the spending power of their receipts. The proposed system therefore promises improved control of the LABR

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in later years. But you will need to weigh these advantages against the implications for the reception of the new system by local authorities (see below).

Targetting of Resources

10. The system proposed by Mr Ridley also offers better targetting of the available resources on local authorities with real needs. Under the present system Ministers cannot take account of the availability of capital receipts to individual authorities when they make capital allocations. Under the new system they will be able to take account of capital receipts in setting borrowing approvals. They could for example give higher borrowing allocations to inner city authorities who have comparatively small receipts, and smaller allocations to rural authorities which have large receipts, eg from council housing. But such targetting could also have disadvantages. First, it may lead to opposition among those authorities who are effectively required to use up their spending power from past and present receipts before they get borrowing allocations. Second, it further reduces the incentive to generate capital receipts: although an authority will in theory be allowed to use 50 per cent of receipts to justify additional spending, if it knows that the additional spending power will be taken into account in its borrowing allocation for the next year, the incentive will effectively be removed. To counter this, Mr Ridley may propose that only half of the additional spending power accruing from new receipts should be taken into account in borrowing limits. But of course this will blunt the extent to which resources can be targetted. You may wish to probe Mr Ridley about the trade off between targetting of resources and incentives to generate receipts.

Likely Reaction of Local Authorities

11. Mr Ridley's proposed system has some substantial advantages for authorities -

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i. It is based on control of borrowing for capital purposes, which is the system which the local authority associations have argued for in the past.

ii. It allows authorities additional spending power to the extent that they can afford to finance it out of revenue spending. This is an important new flexibility, although it will be restricted by the constraints of the community charge regime.

iii. It appears to allow a more generous use of capital receipts, up to 50 per cent compared to the limits of 20 and 30 per cent which apply at present.

But against this there are also substantial disadvantages for authorities -

iv. Much of the spending power resulting from the present overhang of receipts will be extinguished as noted above. New receipts will generate no more than the 50 per cent spending power, removing the cascade effect which applies to present receipts in subsequent years.

v. Taking account of the spending power associated with receipts when making borrowing allocations will oblige many authorities to use up their receipts. Those who see allocations transferred to authorities without receipts, either because they have been unable or unwilling to generate them, may resent the fact. (However it should be noted that there is no question of transferring the revenue benefits of receipts - authorities which have generated receipts will benefit either from the interest they generate or from avoiding interest on new borrowing).

vi. The proposals on leasing, capital spending by local authority companies and debt redemption will remove a lot of flexibility they currently enjoy over capital financing.

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You may want to ask Mr Ridley how he thinks that different groups of local authorities will react to his proposals.

Overall Assessment

12. Overall Mr Ridley's proposals do look like a substantial improvement on the present system and even on the package considered by E(LA) last year. They offer a better chance of controlling the LABR, particularly once the overhang of capital receipts is reduced. They will provide better targetting of the available resources on authorities with real need to undertake borrowing for capital expenditure. They will clamp down on a number of common creative accounting devises. And they do appear to strike a reasonable balance between the Government's need to control the aggregates and the desire of the local authorities for flexibility, particularly over the use of capital receipts. But you will want to form your own view about the balance of advantages and disadvantages, taking into account in particular the political implications.

VIEWS OF OTHER MINISTERS

13. I understand that the Chancellor of the Exchequer is likely to support Mr Ridley's proposals, both from the point of view of controlling economic aggregates (as noted above), and in terms of their impact on local authorities. Service Ministers are also likely to be in favour of Mr Ridley's proposals, subject to concern about a number of matters of detail which will need to be dealt with in further work. In particular, the Education Secretary and other Ministers will be keen to retain individual allocations of some sort for their own services. The Home Secretary will also need to consider how he wishes to deal with capital spending on the police, magistrates and probation services, which are handled outside the general capital controls system at present. The Secretary of State for Wales will not be at the meeting, but is expected to write beforehand supporting the general thrust of Mr

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Ridley's proposals, but expressing concern about the absence of proposals on the control of housing capital expenditure.

HANDLING

14. You will want to ask the Environment Secretary to introduce his paper. The Chancellor of the Exchequer will want to comment in general terms. Service Ministers will wish to speak about the implications for their responsibilities.

RTJW.

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Cabinet Office

23 October 1987

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The Rt Hon Peter Walker MBE MP

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26 October 1987

with DRN?

E(LF)(87)(41): FUTURE OF LOCAL AUTHORITY CAPITAL CONTROLS

I thought it might be helpful if I set out my comments on this paper in writing in advance of Tuesday's meeting.

I am somewhat unhappy that we are discussing the capital control system in isolation from new proposals on housing finance when, after all, housing and in particular housing receipts is the most significant single component in the local government capital package. Certainly by the time any consultation paper is issued to local government I think we need to be in a position to describe at least in general terms the linkages between the proposed capital control system and changes to housing finance.

That apart I am content for Nicholas Ridley to work up these proposals and to draft a consultation paper. Clearly though there are a number of points which will need to be explored more fully during that process; I see the following as amongst the more important:

Papar para 4; I am not sure that local authorities' judgements on community charge levels will necessarily lead to the level of capital expenditure which we want. I would prefer a more direct control on revenue contributions to capital expenditure;

Paper para 11; I would prefer to continue to issue approvals on the basis of service blocks ie "housing" and "non housing" in the case of Wales as well as being able to link specific elements with specific projects. I am therefore happier with the description at para 5 of the annex than with the rather ambivalent phrasing on para 11 of the main paper;

/...

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Annex para 20; The treatment of receipts will have to be looked at carefully. There must be some incentive to authorities to raise receipts, there may be a case for taking only a proportion of their receipts capacity into account when making borrowing approvals, or for allowing a 100% addition to their approval level. As at present I would need to have the power to set different proportions in Wales;

Annex para 25; I do not think that, politically, we can simply wipe out existing accumulated receipts which do not happen to be backed by cash. Local authorities, rightly or wrongly, would simply represent this as a seizure by central Government of their money.

Annex para 27; It seems to me that repair and maintenance should continue to be treated as capital expenditure. The 'wider consents' would need to be exercisable separately in Wales.

/ I am copying this letter to other members of E(LF) and to Sir Robert Armstrong.