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SECRETARY OF STATE FOR THE ENVIRONMENT

Prime Minister

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

At E(LF)(88)4th meeting, attached I was invited to bring forward a draft consultation document covering the control of capital expenditure on both housing and other local authority services.

Such a draft is now attached. Whilst it has substantially the same structure as the version annexed to my minute of 15 March, it covers both housing and other services and endeavours to take account of the helpful points which colleagues made at the E(LF) discussion. I would draw attention to the following points:-

a. The main features of the new system proposed are set out in the foreword. It is primarily a control on the use of credit to finance capital expenditure. By credit is meant not merely borrowing but also deferred purchase and lease/leaseback, which have the same economic effect. Local authorities will have to set aside a proportion of their capital receipts for debt redemption or investment, but otherwise may make free use of revenue contributions and capital receipts.

b. The proposals for capital expenditure on council housing are very similar indeed to those on other services. The main difference is that a greater proportion of housing receipts will have to be applied to debt redemption and that (to preserve the principle of ring-fencing housing expenditure) any revenue contributions to housing capital expenditure must come from the housing revenue account.

c. The question of the compatibility of the proposals with past assurances on the use of capital receipts is dealt with (in paragraph 28) by comparing the present proposals with those made in 1986 (which was very shortly after the

SECRETARY OF STATE FOR THE ENVIRONMENT

assurances were given). The 1986 proposals were not criticised on the grounds of incompatibility and thus the present (less restrictive) proposals should not attract this criticism.

d. The draft includes (in paragraph 30) a reference to the scheme for the voluntary transfer of spending power from housing authorities to other authorities providing services in the same area, which we are discussing. I do not think we need to go into greater detail about this scheme at this stage, but I propose the paragraph should stand unless colleagues see any difficulties.

The technical annex is being cleared by officials.

The main proposals, namely that controls should in future primarily apply to the use by local authorities of credit to finance capital expenditure and that they should be free, though subject to the discipline of the community charge, to finance capital expenditure from revenue contributions, will be welcomed, and not least by our supporters in local government. Indeed, the proposals are in many respects rather similar to those that I would expect to find favour with the Association of District Councils.

There are pressing reasons for issuing the consultation paper as soon as possible. We need a new capital control system to replace the existing ramshackle provisions which we are constantly having to amend. If the new system is to come into effect from 1 April 1990 along with the community charge, then we need to legislate next Session and to have gone through the consultative processes before then. If you and colleagues are content with the present draft, then I would aim to publish later this month. To achieve this, it would be helpful to have clearance by Thursday 16 June.

SECRETARY OF STATE FOR THE ENVIRONMENT

I am minuting separately on the question which we discussed at E(LF) about the use of in-year receipts.

I am sending copies of this minute to the other members of E(LF) and to Sir Robin Butler.

NR

N R

9 June 1988

ELBCNK

cc BG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

13 June 1988

Dear Roger,

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

The Prime Minister was grateful for your Secretary of State's minute of 9 June and the enclosed draft consultation document on control of local authority capital expenditure.

The Prime Minister is content for the consultative document to be issued along the lines proposed. She has commented that the draft foreword is very good. She would be grateful however if a further look could be taken at the detailed drafting on two points.

First, she thinks it is important that the document should make as clear as possible the position for accumulated receipts; for example explaining the difference between the figure of £10 billion in paragraph 10 for nominal accumulated receipts, the £6 billion figure for unspent accumulated receipts that can be deduced from that figure, and the £2.8 billion of accumulated cash receipts referred to in paragraph 26. Although the Prime Minister recognises the difficulties of explanation in this area, she thinks it important to try to explain more clearly the term "cash receipts" and suggests an additional paragraph be inserted to clarify this issue.

Second, she thinks the material on local authorities being allowed to transfer spending power to other authorities might be expanded. She understands that the intention underlying paragraph 22 of the draft is that local authorities will be able to transfer to any other authority part of their basic credit approval and also any proportion of the part of their receipts they can spend. She suggests this might be discussed more fully in an additional paragraph before paragraph 30, which refers only to transfer in the limited case that the local authority making the transfer has redeemed all its outstanding debt.

The Prime Minister has also commented that it may be necessary to consider further the arrangements mentioned in the last sentence of paragraph 25 whereby local authorities would be allowed to "roll over" debt where property occupied for a particular purpose is to be replaced by other property to be used for the same purpose. She thinks the Government

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should keep an open mind at this stage on whether some further help may need to be given to local authorities in such circumstances. But she is content with the drafting of the consultation paper on this point, and considers this is a point that can be considered further if necessary after responses to the paper have been received.

I am copying this letter to Private Secretaries to members of E(LF) and to Sir Robin Butler.

Yours,

Paul

PAUL GRAY

Roger Bright, Esq.,
Department of the Environment.

JD3BKN

PRIME MINISTER

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

Mr. Ridley's minute of 9 June (Flag A) attaches a revised draft consultative document on local authority capital control. This follows the discussion in E(LF) on 19 April (minutes at Flag B).

The draft is a much better document than the earlier version you saw in the spring, both in substance and in presentation. But the Policy Unit (note at Flag C) have drawn attention to two aspects where the explanation could be improved, and one further point where, in the light of comments on the consultative document, further thought might be required.

Content to agree the draft consultative document subject to the Policy Unit comments?

Yes. – but not worth making

PRCG.

It is a very good foreword

PG

10 June, 1988.

C

PRIME MINISTER 10 June 1988

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

Nicholas Ridley has circulated a further draft consultation paper on the new system for controlling local authority capital expenditure.

Summary

The draft paper is generally a good one. It describes succinctly the proposed new capital control which will essentially be an annual control on credit arrangements. Local authorities will be able to spend 25% of housing and 50% of non-housing receipts to finance additional capital expenditure with the balance used to redeem debt. They will also be able to use cash backed accumulated receipts and revenue from the Community Charge to finance additional capital expenditure. There are three aspects of the paper that might be improved.

Accumulated Receipts

The paper should contain a fuller and clearer discussion of the difference between the figure of £10bn for nominal accumulated receipts in paragraph 10; the £6bn figure for unspent accumulated receipts that can be deduced from that figure and the £2.8bn of accumulated cash receipts referred to in paragraph 26. To do this it needs to explain more clearly the term 'cash receipts' which is used several times.

Essentially the point is that under the present control system capital receipts fulfil two functions. Firstly, they provide the local authority with cash and secondly they give it a permission to spend (currently 20% of housing receipts and 30% of non-housing receipts). When a receipt is generated the permission to spend is either used and financed with the cash from the receipt, or it is not and the cash is used in one of three ways:

- To fund expenditure that is justified by a capital allocation thereby leaving the spending power from the receipt unchanged.

- To redeem debt. No public expenditure is involved so the spending power from the receipt remains unchanged.

- It is put on deposit.

The £10bn figure refers to receipts in all three categories. The £6bn to receipts in the second and third and £2.8bn receipts in the third.

Only receipts in this last category will be allowed to be spent under the new system although public discussion often focusses on receipts in all categories. Many commentators do not understand the subject and often refer to local authorities having "£10bn from receipts lying idle in the bank".

It may be that Mr Ridley has deliberately decided to make the paper obscure on this point so as to give the impression that the Government is being more generous than is really the case. If so, this seems unwise as experts in the subject will certainly not be fooled and this could backfire. We suggest an additional paragraph inserted in the paper to clarify this issue.

It isn't easy to explain

<u>Helping Local Authorities to make better use of their property</u>

The last sentence of paragraph 25 of the paper refers to an arrangement under which local authorities would be allowed to "roll over" debt where property occupied for a particular purpose is to be replaced by other property to be used for the same purpose. It is intended that, for example, a local authority that spends money to replace a school on a split site side with one on a single site, and finances this by disposing of one of the sites, will be allowed to spend the receipt from disposal in full and will not be required to use a proportion of it to redeem debt.

In practice there may still be a timing problem for the local authorities since expenditure on building work may take place in, say, years 1 and 2, but the receipt will not be realised until year 3. The DoE argue that the local authority should not have difficulty in finding the resources to incur the initial expenditure because most do not use in full their spending power from capital receipts.

However this will not necessarily be so and suggest that the Government should keep an open mind at this stage on whether some further help may need to be given to local authorities in such circumstances and reconsider when we have received responses to the consultation paper. We do not suggest any change in the drafting.

Transferring Spending Power

Paragraph 30 refers to a scheme allowing local authorities to transfer spending power to other authorities only in the very limited case that the local authority making the transfer has redeemed all its outstanding debt. It is primarily seen here as providing a use for the 50% or 75% of receipts that cannot be spent when it cannot be used to redeem debt.

The last discussion at E(LF) appeared to envisage a more general scheme allowing the transfer of receipts. I understand from the DoE that it is implicit in paragraph 22 of the draft that local authorities will be able to transfer to any other authority part of thier basic credit approval and also any proportion of the part of their receipts they can spend to any other local authority. This is far from clear in the present draft and we suggest that that the issue of transfer of spending power needs to be discussed more fully, possibly by adding a paragraph before paragraph 30.

Conclusion

The draft paper on the capital control system is satisfactory subject to the following amendments:

- There should be a clearer exposition of the concept of 'cash receipts'. Otherwise the obscure treatment in the present draft could backfire with accusations that the Government is being deceitful by trying to conceal that much of the present spending power from accumulated receipts will be withdrawn under the new system.

- There should be a fuller discussion of the circumstances under which local authorities will be able to transfer spending power to other local authorities.

In addition, we suggest that you comment that it is not entirely clear that the arrangement proposed at the end of paragraph 25 will be sufficient to enable local authorities to rationalise their assets where this makes economic sense but is not a high political priority. The Government should keep an open mind on this subject and consider the issue further in the light of the comments received on the consultation document.

Peter Stredder.

PETER STREDDER

24/1/DGS/1801/9

CONFIDENTIAL

CBG

CHIEF SECRETARY TO THE TREASURY

NBPM
at m stage.

PRCC
25/6

Treasury Chambers, Parliament Street, SW1P 3AG

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

17 June 1988

Dear Secretary of State,

LOCAL AUTHORITY CAPITAL CONTROL REGIME

Thank you for copying to me your minute of 9 June to the Prime Minister covering a revised draft of the consultation paper on the control of local authority capital expenditure. I have also seen a copy of the letter of 13 June from the Prime Minister's Private Secretary to yours.

at flag

at flag

I appreciate that the consultation paper needs to be issued as soon as possible and I remain content with the broad capital control regime proposed. I also agree that the new scheme should apply to housing and I am content that the proportion of housing receipts which local authorities will be allowed to spend on capital projects should be set at 25% in the consultation document.

I share however the Prime Minister's concern about the drafting of paragraphs 22 and 30 in the consultation document which describe the proposals to transfer spending power from one local authority to another. We have of course not discussed this further at Ministerial level since the E(LF) meeting in April. But my own view is that any such scheme should be confined to transferring capital receipts and only those local authorities with surplus receipts should be eligible. For other authorities still in debt, the first call on any capital receipts should be the extinction of outstanding debt. I do not see a case for any easing of the requirement to repay debt from the proceeds of assets built with public money, until all such outstanding debt is relinquished.

However I would be prepared to go along with a more limited scheme which applied to those local authorities with surplus receipts, providing there are no implications

Local Govt: Relations Pt 35

CONFIDENTIAL

for total local authority capital expenditure. I think the draft in paragraph 30 would therefore need to make clear that the incentive on local authorities to participate in such schemes would involve some element of local but not national additionality. Any such scheme could not be allowed to add to aggregate capital spending by local authorities and would therefore need to be taken into account in determining credit approvals at the national level.

Finally I am particularly concerned at your proposal for the scheme to allow surplus receipts to be transferred to health authorities for capital projects. The additional capital spend would inevitably generate current expenditure requirements which might not be sustainable from the income available to health authorities. To avoid such problems arising I consider that any transfers from local authorities would have to be offset by a reduction in the voted allocation for capital expenditure. However, this in turn could lead to a distortion of priorities in the NHS capital programme. Overall therefore I think it would be better if health authorities were not included in such a scheme.

I am copying this letter to the Prime Minister, the other members of E(LF) and to Sir Robin Butler.

Yours sincerely,

Jill Rutter

pp JOHN MAJOR

(Approved by the Chief Secretary and signed in his absence).

SECRETARY OF STATE FOR TRANSPORT

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

My ref:

Your ref:

cc BG

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

NBPM
RRC6
17/6

16 JUN 1988

Dear Nicky.

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

at flar

Thank you for sending me a copy of your minute to the Prime Minister of 9 June, to which you attached a further draft of your consultation paper on the proposed new capital controls system. I have also seen the letters of 13 June from No 10, and of 16 June from Kenneth Baker.

In my view the proposals should bring about a much better matching of capital borrowing and need to spend, which will lead to better value for money without an increased call on the LABR. I therefore support the issue of the paper.

I am sending copies of this letter to the Prime Minister, the other members of E(LF) and Sir Robin Butler.

Yours,

Paul

PAUL CHANNON

Vaal Gov'ts Relations

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cc BG

NBPM
PRCG
16/6

HOME SECRETARY

QUEEN ANNE'S GATE
LONDON SWIH 9AT

16 June 1988

Dear Secretary of State

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

FILE WITH PG

Thank you for sending me a copy of your minute of 9 June to the Prime Minister.

I have no comments on the proposed consultation document. The Annex, which has been cleared at official level, makes it clear that there will be separate consultation on whether to bring the law and order services into the new system and if so with what modification. My officials will be consulting your officials and the Treasury about the draft.

I am sending copies of this letter to the Prime Minister, other members of E(LF) and to Sir Robin Butler.

Yours sincerely
N. L. [illegible]
(approved by the Home Secretary and signed in his absence)

The Rt Hon Nicholas Ridley, MP.

LOCAL GOVT: Relations PT35

CCBG

SECRETARY OF STATE FOR EDUCATION AND SCIENCE

ELIZABETH HOUSE
YORK ROAD
LONDON SE1 7PH
01-934 9000

NBPM

RRC6 16/6

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

16 June 1988

Dear Nick

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

Thank you for sending me a copy of your minute of 9 June to the Prime Minister attaching a further draft of your consultation document on the control of local authority capital expenditure.

I think that the new draft provides a very satisfactory basis for consultation; and I agree that we should mention the proposals for transfer of spending power from housing authorities to benefit other services in the same area. I suggest that the reference in the first paragraph of the helpful foreword should be to "schools and colleges" - not just to schools.

We shall need to consider further the detailed mechanics of the new system to which there is reference in the annex. In particular, I shall want to be satisfied that the planned capital guidelines which it is envisaged that I should issue for education will be sufficient to meet the agreed objectives of our present plans - that is to cover the basic need for new schools and for statutory re-organisation schemes as well as a sizeable improvement programme for schools and colleges. I accept however that this can proceed alongside the consultations with local authorities about the principles of the new arrangements.

I am copying this letter to the other members of E(LF) and to Sir Robin Butler.

Yours

Kenneth

Local Gov. Relations Pr 35

KH/3674p

ec BG

DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Richmond House, 79 Whitehall, London SW1A 2NS

Telephone 01-210 3000

From the Secretary of State for Social Services

NBPM at this stage.

BRG 16/6

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

16 June 1988

Dear Nicholas.

LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

at Flag

Thank you for the copy of your minute of 9 June to the Prime Minister and its enclosure. With one exception I am content for you to issue the proposed draft for consultation. The proposals undoubtedly represent a significant improvement on the present unsatisfactory system and will I am sure be welcomed by those in local authorities prepared to consider them objectively.

I am afraid that I do see difficulties in connection with the specific references to health authorities in paragraph 30. As I pointed out at the E(LF) meeting there are a number of practical difficulties - such as the lack of statutory cover for health authorities' borrowing - but more fundamentally I understand that Treasury officials are not at this stage prepared to concede that additional NHS capital expenditure funded by loans from local authorities should be additional to the capital resources allocated to me through PES. While I can understand their reluctance to agree to this it means that the aggregate resources available to the NHS would in effect be reduced by the amount required to service any loans.

In the absence of the prospects of a speedy resolution to this problem I must ask you to delete the reference to health authorities in the parenthesis in paragraph 30(a) and generalise the reference at the end of the paragraph to "used to finance additional expenditure by other public bodies." I should make it clear that I do not regard this as a closed issue; I am prepared to ask officials

E.R.

Local Govt: Relations
Pt 35

to take discussions further, with a view to identifying the scope for some additionality at the margin, but in the absence of agreement on the fundamental issue I think it would be better not to include a specific reference in your consultative paper.

I am sending copies of this to the Prime Minister, other members of E(LF) and to Sir Robin Butler.

Yours
John

JOHN MOORE

DRAFT OF 9 JUNE 1988

LOCAL GOVERNMENT IN ENGLAND AND WALES

CAPITAL EXPENDITURE AND FINANCE

A CONSULTATION PAPER

DEPARTMENT OF THE ENVIRONMENT

WELSH OFFICE

[DATE]

FOREWORD

This consultation paper is about capital investment by local authorities and the means by which they pay for that investment. This year, councils in England and Wales will spend about £6 billion on home improvements and new house-building, on new roads, schools, health centres, and other buildings, on vehicles, computers, and other plant and machinery, and on derelict land reclamation and urban renewal. They will raise about £2.8 billion by selling houses and other property; the remainder will be paid for by borrowing, or from Government grants, or from revenue.

Over the years, councils have built up a very large stock of capital assets. Much of this was paid for out of borrowed money. Their borrowings are now about £45 billion, which is roughly 25% of the total national debt. Debt charges, which fall to ratepayers and tenants, amount to £6 billion a year.

Local authority capital expenditure and finance is a major component of the national economy. It has to be regulated as part of the Government's task of managing the economy as a whole.

During the 1980s, our control system has focussed on the capital spending itself. But the system has been unsatisfactory for both central and local government. Everyone agrees that we need a change.

The reform of local government finance from 1990-91, and in particular the accountability which will be brought about by the community charge, gives us the opportunity to make a radical change. This consultation paper proposes a switch from controlling capital spending as such to controlling the money used to finance it. The main sources of finance for capital spending, and the way they would be treated under these proposals are:-

* Borrowing. Money raised through borrowing and other forms of credit would be controlled within annual limits set by Central Government. This is necessary because of the impact of such borrowing on the

Public Sector Borrowing Requirement and the national economy, and in order to control the extent to which some local authorities have sought to spend now and pay later. We propose that authorities should receive provisional credit limits up to three years in advance.

* Government grants. The Government would continue to pay grants towards some capital expenditure.

* Revenue contributions. Local authorities would be free to pay for capital spending from revenue. They could thus balance the benefits of capital and revenue spending against each other, though in each case subject to the accountability of the community charge.

* Capital receipts. Between 1981-82 and 1987-88, local authorities raised about £17 billion by the sale of capital assets. Of this, £12.5 billion were housing receipts and £4.5 billion came from the sale of other property. Of the £17 billion, about £11 billion has been spent, either on new capital investment and on the repair and modernisation of property (about £6½ billion) or on the redemption of debt (about £4½ billion). But at the end of the last financial year, local authorities still had £4.4 billion of unused housing receipts and £1.8 billion of other unused receipts. We expect authorities to continue to realise receipts at a rate of about £1.9 billion a year from council house sales and about £1 billion a year from other sources. And, within the last year, it has become apparent that there are real prospects of the transfer en bloc to new landlords of whole council estates or even of the whole stock of individual local housing authorities. The benefits of the success of local authorities in realising receipts should be returned to the residents of the areas concerned, either by way of new capital investment or by way of a reduction in debt interest falling to be met from the community charge. The paper proposes a framework within which part of the cash from existing and future receipts will be used for the repayment of debt or as a substitute for future borrowing and part will be available for capital expenditure which will benefit the areas of the local authorities concerned.

These proposals will provide the Government with control over the effect of local authorities' capital programmes on the public sector borrowing requirement. They will also provide a sound basis for local authorities to plan their capital programmes, in particular through the provisional credit limits for future years and the flexibility provided by the free use of revenue contributions and a proportion of capital receipts.

NICHOLAS RIDLEY
Secretary of State
for the Environment

PETER WALKER
Secretary of State
for Wales

INTRODUCTION

Purpose and scope of consultation paper

This consultation paper invites comments on the Government's proposals for the reform of the legislation which regulates the capital expenditure and finance of local authorities in England and Wales. In very broad terms, the existing system of controls on the amount of capital expenditure by local authorities and on the use that they can make of capital receipts (referred to in this paper as the "1980 system") and the existing system regulating borrowing by local authorities (referred to as the "1972 system") would be replaced by a system (referred to as the "new system") which would control the amount of new credit obtained by local authorities and which would incorporate requirements for a proportion of capital receipts to be applied to the redemption of debt or to be set aside to meet future commitments. The new system would take effect from the beginning of the financial year 1990-91, in parallel with the new system of local authority current finance in the Local Government Finance Bill now before Parliament.

The paper first describes the circumstances which led to these proposals and the defects that have become apparent in the legislation as it now stands. It then describes the objectives which the Government is seeking to achieve, and provides a broad outline of the new system and how it will meet those objectives.

The Annex to the paper describes the new system in detail and, in particular, indicates:-

a. the local authorities to which it will apply;

b. the definition of capital expenditure that will be adopted;

c. the methods which will regulate local authority capital expenditure financed by credit;

d. the other sources of finance (including revenue contributions and part of their receipts from sale of assets) that authorities will be able to use to finance capital expenditure;

e. the provisions for investment by local authorities of temporarily surplus funds;

f. the regime which will apply to borrowing by local authorities from external sources; and

g. the transitional arrangements proposed.

In this consultation paper, references to "the Secretary of State" are references to the Secretary of State for the Environment in the application of the new system to England and to the Secretary of State for Wales in its application to Wales. References to "Departmental Ministers" are references to the Ministers with policy responsibility for particular services on which local authorities incur capital expenditure, including not only the Secretaries of State for the Environment and for Wales but also the Secretaries of State for Transport, Social Services, Education and Science, and the Home Department, the Minister of Agriculture, Fisheries and Food, and certain others. The Glossary summarises the abbreviations and other special terminology used.

The White Paper "Housing: The Government's Proposals" (Cm 214) stated that the Government would be bringing forward proposals for a new financial regime for council housing which would reinforce the present statutory distinction between the provision of housing and other local authority functions. This paper sets out the special provisions which it is proposed that the new regime should include in relation to capital expenditure by local authorities on housing of which they are or will be the landlords and capital receipts from the disposal of such housing. It does not deal with the revenue aspects of the new housing finance regime. The new system will apply to capital expenditure in connection with other local authority housing functions, including home improvement, renovation, and insulation grants, slum clearance and area improvement, assistance to owners of defective housing, mortgage lending to private persons (other than to those purchasing council houses), and development loans to housing associations, in the same way as it applies to non-housing services.

This consultation paper does not deal with the question of capital expenditure and borrowing undertaken by companies which are controlled or influenced by local authorities. A separate consultation paper has been issued covering all aspects of local authority companies.

Submission of responses to consultation paper

Comments on the general principles of the proposals and on their implications for capital programmes of English local authorities should be sent to:-

Department of the Environment
Finance Local Capital
Room N9/04
2 Marsham Street
LONDON SW1P 3EB

Comments on the general principles of the proposals and on their implications for capital programmes of Welsh local authorities should be sent to:-

Welsh Office
FL1 Division
Room 2-001
Cathays Park
CARDIFF CF1 3NQ

Comments should be submitted not later than 30 September 1988. It would be helpful if, when sending comments to either Department, respondents would say whether copies have also been sent to the other.

Availability of further copies

Further copies of this consultation paper can be obtained from the addresses above, telephone 01-276 3042 (England) and 0222-825307 or 825668 (Wales).

Public release of responses to consultation paper

Those who respond to this consultation paper are asked to indicate whether they propose to publish their responses, or to make them available to the media, and whether they would be content for the Departments to make their responses available to Parliament and to the public by placing copies in the Libraries of both Houses of Parliament and in the Departments' libraries. Respondents who wish their responses to be made available are asked to provide four extra copies for this purpose. (Otherwise, the Departments do not undertake that responses will be released.) Unless respondents indicate that they wish their responses to be made available, the Departments will assume that they wish them to be treated as having been given in confidence. Summaries of views received which are published but which do not identify the views of individual respondents, may, however, incorporate such responses.

Department of the Environment
Finance Local Capital
Room N9/04
2 Marsham Street
LONDON SW1P 3EB

Comments on the general principles of the proposals and on their implications for capital programmes of Welsh local authorities should be sent to:-

Welsh Office
FL1 Division
Room 2-001
Cathays Park
CARDIFF CF1 3NQ

Comments should be submitted not later than 30 September 1988. It would be helpful if, when sending comments to either Department, respondents would say whether copies have also been sent to the other.

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LOCAL AUTHORITY CAPITAL EXPENDITURE AND FINANCE

Background

1. Capital expenditure by local authorities accounts for about 40% of all civil capital expenditure by the public sector. In England and Wales, it is about £6 billion a year, that is £170 per adult. It covers the purchase, construction, renovation and improvement of buildings and roads; the purchase of land, vehicles, plant and equipment; and the making of grants and loans to other people and bodies for capital purposes.

2. Local authorities have traditionally financed most of their capital expenditure by borrowing. But Table 1 shows how the capital receipts generated by local authorities have grown during the 1980s.

TABLE 1 LOCAL AUTHORITY CAPITAL EXPENDITURE AND RECEIPTS ENGLAND AND WALES (£m)

	Gross expenditure	Receipts	Net expenditure
1981/82	4078	1348	2730
1982/83	5214	2174	3040
1983/84	6046	2244	3802
1984/85	6248	2257	3991
1985/86	5707	2276	3432
1986/87 (provisional)	5669	2752	2918
1987/88 (forecast)	6088	3259	2829

Some of these receipts have been used to repay debt or have been held as balances. But Table 2 shows how capital receipts have come to finance an increasing proportion of gross capital expenditure.

TABLE 2 FINANCING OF LOCAL AUTHORITY CAPITAL EXPENDITURE ENGLAND AND WALES

% (rounded) of expenditure financed by:-	1981/82	1985/86
Borrowing (including advances from capital funds)	70	57
Capital receipts	7	25
Government grants	12	7
Revenue contributions (including transfers from special funds)	9	7
Leasing	2	5

3. Because of the extent to which local authorities borrow for capital expenditure, the Local Authority Borrowing Requirement (LABR) has always been an important element of the Public Sector Borrowing Requirement (PSBR), accounting for more than a quarter of it in some years. Notwithstanding the importance of capital receipts as a source of finance, borrowings by local authorities in England and Wales from banks, the Public Works Loan Board, and other sources had grown to £45 billion by the end of 1986/87. The cost of servicing that debt amounts to about £170 a year for each adult.

4. Controls on borrowing and capital expenditure by local authorities have been exercised by Central Government ever since local authorities in their modern form were constituted in the last century. The reasons for these controls include the need to manage the national economy in view of the effect on public spending and the PSBR discussed above; to ensure that investment by local authorities responds to national priorities; to maintain accountability, since the financial effect of expenditure financed by borrowing is felt only to a very limited extent when it is incurred; to safeguard the interests of future local tax payers; and to maintain the high credit standing which local authorities generally still enjoy.

5. Since local government reorganisation in 1974, the control on borrowing has been operated under the Local Government Act 1972. But, during the later 1970s, it became clear that the 1972 system alone offered the Government of the day too little influence over either capital expenditure or the LABR.

6. The Local Government, Planning and Land Act 1980 introduced, beginning with the financial year 1981-82, the present system of controls on capital expenditure and the use of capital receipts by local authorities.

<u>The problems of the 1980 system</u>

7. The 1980 system has suffered from four major problems.

8. First, it has failed to bring about net capital expenditure consistent with the Government's public expenditure plans. Table 3 shows outturn since 1981/82 against the DOE/LA1 and WO/LA1 cash limits, which cover most capital expenditure and receipts in England and Wales.

TABLE 3 OUTTURN AGAINST DOE/LA1 AND WO/LA1 CASH LIMITS

DOE/LA1	Cash limit £m (net)	Outturn £m (net)	Overspend (+)/ Underspend (-) £m	%
1981/82	3139	2610	-529	-17
1982/83	3385	2515	-870	-26
1983/84	2935	3350	+415	+14
1984/85	2453	3525	+1072	+44
1985/86	1911	2908	+997	+52
1986/87 (provisional)	2369	2387	+18	+1
1987/88 (forecast)	2834	2070	-764	-27

WO/LA1 (LA element)	Cash limit £m (net)	Outturn £m (net)	Overspend (+)/ Underspend (-) £m	%
1981/82	220	173	-47	-21
1982/83	275	249	-26	-9
1983/84	305	315	+10	+3
1984/85	237	256	+19	+8
1985/86	249	266	+17	+7
1986/87	268	323	+55	+21
1987/88 (forecast)	298	350	+52	+17

The cash limit applies to the difference between gross expenditure and capital receipts in any year. Many of the problems have stemmed from the difficulty of forecasting receipts during a period in which they have been growing significantly. But gross expenditure has in most years been higher than had been assumed when the cash limit was set; these overspends have been as much as 44% of the planned gross expenditure.

9. Secondly, the 1980 system has brought about a distribution of capital spending power which does not match the need for expenditure. The amount of capital expenditure which it permits each local authority to incur in any year is determined as the sum of several components. The two main components are the capital allocations issued to the authority by Departmental Ministers and a proportion of the unused capital receipts which the authority have generated both in the year concerned and in previous years. But the 1980 system does not permit the Government to take account when issuing allocations to individual authorities of the ability of those authorities to finance expenditure from receipts. So the Government cannot distribute allocations so as to "top up" spending power from receipts and thus to produce a distribution of total spending power which matches the need to spend. Table 4 shows how the distribution of allocations between classes of authority, which reflects the Government's assessment of need, differs from the distribution of total spending power.

TABLE 4 PERCENTAGE BREAKDOWN OF SPENDING POWER BETWEEN CLASSES OF AUTHORITY 1987/88

(% rounded)

DOE/LA1	Allocations	Total Spending Power
Shire Counties	22	14
Shire Districts	27	40
Metropolitan Areas	28	22
Inner London and City	12	12
Outer London	11	12
WO/LA1		
Counties	41	32
Districts	59	68

10. This problem has been exacerbated by what is known as the "cascade". It had been the intention of the 1980 system that only a proportion ("the prescribed proportion") of receipts would be available to justify new expenditure and that the remainder would be applied to debt redemption. But it has since been accepted that the Local Government, Planning and Land Act 1980 permits the prescribed proportion of receipts to be used to justify prescribed expenditure in the year of receipt, the prescribed proportion of the unused balance in the next year, and so on. Authorities can thus use all their receipts over time although the rate at which they may use them is restricted. Under the "cascade", large amounts of receipts have accumulated and the nominal value of such receipts now exceeds £10 billion. About 40% of these receipts are notional in the sense that the cash has been spent on other things (such as repaying debt) and is thus not available to finance new capital expenditure. Nevertheless, spending power from receipts has grown to over £3½ billion per year and is now greater than the rate at which new receipts are being realised. For any given level of planned local authority expenditure, higher spending power from receipts leaves less room for allocations and consequently reduces the Government's ability to target resources on areas of need. Table 5 shows how receipts in England have grown as a proportion of total spending power in recent years.

TABLE 5 SPENDING POWER ON DOE/LA1 CASH LIMIT

	1985/86	1986/87	1987/88 (forecast)	1988/89 (plan)
DOE/LA1	£m	£m	£m	£m
Spending power from:-				
Allocations	3045	2755	2639	2626
Receipts	2313	2779	3298	3583
Other	344	314	304	302
Total spending power	5702	5848	6241	6511
of which receipts are:-	41%	48%	53%	55%

11. Thirdly, the legislation governing the 1980 system has not prevented local authorities from undertaking capital expenditure outside the framework laid down by the legislation. Amending legislation, including the measures relating to leasing and barter in the Local Government Finance Bill now before Parliament, has closed the most widely exploited loopholes.

12. Fourthly, because the problems outlined above have led to frequent changes in the primary and secondary legislation and in the other factors governing the system, the 1980 system has not provided a stable framework within which long term capital programmes can be efficiently administered.

The "Paying for Local Government" Proposals

13. The Government and local authorities have long recognised the deficiencies of the 1980 system. Following a joint review in 1985, the Government put forward in the Green Paper "Paying for Local Government" (Cmnd 9714) two possible new systems:-

(i) a control over all external borrowing by local authorities for revenue and capital purposes, through annual external borrowing limits (EBLs); or

(ii) a control over gross capital expenditure.

14. The Government was attracted in principle to an EBL system, but had doubts about whether it could be made to work in practice. It therefore saw the gross expenditure option as the more likely solution and issued a consultation paper setting out the details of such a system.

15. The responses to that consultation paper confirmed the Government's doubts about the practicability of EBLs but also showed that a system based on control of gross expenditure would not command general support. The Government considered that any new system should offer improvements for both central and local government and decided to reconsider the control of capital expenditure alongside the proposals for the wider reform of local government finance set out in "Paying for Local Government". The Government also wished

to consider the recommendations of the Public Accounts Committee in their report on the "Control of Local Authorities Capital Expenditure" (HC 444, Session 1985-86).

The Government's Objectives and Proposals

16. The Government's objectives for a new system to regulate local authority capital finance remain broadly the same as those set out in "Paying for Local Government":-

* To provide effective Government influence over aggregate levels of local authority capital expenditure and borrowing.

* To bring about a distribution of capital expenditure, both as between areas and between services, which reflects both national and local needs.

* To promote the Government's aim of reducing the size of the public sector by asset sales and efficient asset management.

* To provide a sound basis for local authorities to plan their capital programmes with confidence.

17. The Government remains committed to the firm control of public expenditure and borrowing. But the community charge will reduce the need for direct controls on total capital expenditure. All expenditure financed from revenue, whether for current or capital purposes, will be subject to the discipline imposed by the accountability inherent in the community charge. The new system proposed in this consultation paper is therefore primarily a control on the use of credit by local authorities to finance capital expenditure. Its secondary purposes are to secure that local authorities make prudent provision for the repayment of debt both during the periods for which assets are held and when they are sold and that there is, in time, a reduction in the overall level of local authority indebtedness.

Outline of the new system

18. The new system will provide a framework for all financial commitments of a capital nature entered into by local authorities. The main classes of such commitments are:-

(i) the acquisition of rights to use (other than on a temporary basis) land, buildings, plant, machinery, vehicles, and other tangible fixed assets;

(ii) the construction of buildings, roads, and other structures, and the carrying out of improvements to land, buildings, or other property used by local authorities or of works which enhance the value of the property or lengthen its useful life;

(iii) the making of grants or loans in support of capital expenditure undertaken by other persons; and

(iv) the making of investments (other than the temporary deposit or placement of surplus funds).

19. When a local authority wish to acquire the use of assets, or to improve or to have works done to assets which they use, they may pay immediately and in full for the assets or works. They may, however, make arrangements under which the immediate costs are met, or the assets are provided, by some other person to whom they make payments over a period of time or at some later date. In economic terms, the effect of such arrangements is as if the authority had met the costs outright and had borrowed the necessary sums from the other person concerned. The new system will treat such arrangements, which in this consultation paper are called "credit arrangements", like borrowing.

20. Under the new system, there will be three sources of finance for capital commitments:-

(a) borrowing or credit arrangements;

(b) Government grants or contributions from third parties (including other local authorities), whether in the public or the private sector; and

(c) local authorities' own resources (including revenue contributions and cash realised from disposals of assets to the extent that it is not used to redeem debt or set aside to meet future commitments).

21. The Government will place limits on the level of commitments which individual local authorities may enter into in any year and finance by borrowing or credit arrangements. Before the beginning of each financial year, each authority will be told the amount of their basic credit approval for that year. That amount will have been calculated in light of the Government's assessment of the appropriate shares for the authority of the provisions in public expenditure plans for the services administered by the authority. To assist forward planning, each authority will at the same time be given an indication of levels below which their basic credit approvals for the next two financial year will not be reduced. Basic credit approvals may be enhanced by supplementary credit approvals covering particular projects or programmes.

22. Local authorities will additionally be able to undertake capital expenditure which is to be paid for from Government grants or from contributions from other sources (including other local authorities).

23. Local authorities will also be free to use revenue contributions to finance additional capital expenditure, though such contributions will have to have been provided from the appropriate service account. In particular, any revenue contributions by a local authority to capital expenditure on their own housing will have had to have come from their housing revenue account. Revenue contributions may be used immediately or carried forward to future years.

24. The total capital borrowings of local authorities in England and Wales were £34 billion in April 1981, when the 1980 system came into effect, and now amount to about £45 billion. The Government considers that proper provision should be made for the repayment of local authority debt and that reductions in the direct provision of services (for instance housing) by local authorities should be accompanied by an appropriate reduction in indebtedness. The new system will provide that:-

(a) insofar as capital expenditure under the new system is financed by credit, authorities will be required to make charges to revenue account sufficient not merely to cover interest but also to repay the principal by equal instalments over appropriate periods; and

(b) part of the proceeds of disposal of fixed assets must be applied to debt redemption or be set aside to meet future capital commitments which would otherwise have to be met by borrowing or reborrowing.

These provisions will correct two unsatisfactory features of the present legislation, namely that amortisation of principal is required, but that the rate at which this must be done is not specified and that the proceeds of property disposals must be applied either to debt redemption or to other capital purposes, but there is no requirement that any definite part should be applied to the former purpose. Most authorities already provide for debt redemption. The new system will require all to do so at a prudent rate.

25. Local authorities will be able to use part of the cashproceeds of disposal of fixed assets for capital investment. The Departments consider that initially up to 25% of the proceeds from the sale of council houses and flats and up to 50% of other capital receipts could at the authorities' discretion be available for new capital investment. The remainder would be applied to debt redemption or set aside to meet future capital commitments or as a substitute for future borrowing. For some receipts, however, different proportions would be appropriate. For instance, if a housing authority were to dispose of all or the greater part of their housing stock, redemption of housing debt should be a first charge on the proceeds of sale. Equally, where property occupied by an authority for a particular purpose was to be replaced by other property to be used for the same purpose, it will be possible for the debt to be rolled over.

26. In proposing the percentages above, the Departments have had in mind:-

(a) the accumulated cash receipts which under the transitional arrangements proposed will be carried forward from the 1980 system and which, it is estimated, will provide authorities collectively with spending power of £2.8 billion;

(b) the level of new receipts likely to be realised in the early years of the new system; and

(c) the need to accommodate within the total public expenditure provision for capital expenditure by local authorities an adequate level of credit approvals as well as the spending power arising from receipts.

Any increase in the percentages proposed above would, for any given level of gross public expenditure provision for local authority capital expenditure, imply a commensurate reduction in credit approvals.

27. Under the 1980 system, the Government may not when making allocations take any account of the ability of individual authorities to use receipts. This has seriously reduced the scope for making allocations available to those areas where needs are greater. Under the new system, the Government will be able to take into account the ability of individual authorities to finance expenditure from sources other than credit and revenue contributions. But the Departments propose when issuing credit approvals to take into account only part of spending power from receipts. They will not, however, take revenue contributions into account.

28. The Government's previous proposals (published in February 1986) for reform of the 1980 system envisaged that local authorities would be able to use all their cash receipts realised before 1 April 1987 ("old" receipts) for new capital expenditure but that only a proportion of receipts realised after that date ("new" receipts) would have been available for spending, and the rate of use of those receipts which were available (both "new" and "old") would have been strictly controlled and taken into account in setting capital allocations. The present proposals do not distinguish between "old" and "new" receipts and do not include any restriction on the rate at which council's may spend those receipts which are available or use unbudgeted revenue contributions. Bearing in mind this increased flexibility, and also the forecast growth in accumulated receipts between 1 April 1987 and 1 April 1990, the Departments consider that the present proposals are as regards services other than council housing more advantageous to local authorities, in terms of their ability to use receipts to finance capital expenditure, than those put forward in 1986. As regards council housing, the White Paper "Housing: the Government's proposals" (Cm 214) noted that the continuing success of the right to buy, which has exceeded even the Government's own expectations over the last two years is generating new capital receipts, would need to be reflected in the new capital control system. This need has been

reinforced by the prospect which has recently emerged of a number of local authorities generating substantial additional receipts from the disposal of large parts, or even the whole, of their housing stock to other landlords. Against this background of higher receipts from the sale of council housing, the Government consider it appropriate that a lower proportion of these receipts should be available to finance new investment by local authorities than was envisaged in 1986.

29. Local authorities do not generally raise specific loans to finance the acquisition of specific assets (though credit arrangements have generally been tied to specific items). It has instead been the practice for loans to be "pooled", by which means authorities can seek to manage their borrowings as a whole and thus to achieve lower overall interest rates. The new system will be consistent with this practice and will also permit monies set aside to reduce indebtedness not to be used immediately for this purpose but rather, if this will contribute to efficient management of authorities' debt portfolios, to be invested in a range of secure investments until they are needed. Such monies may also be used by authorities as a substitute for new borrowing from banks, the Public Works Loan Commissioners, or other lenders.

30. An authority who were successful in realising receipts might find that in time those set aside came to exceed both the authority's existing debt and their foreseeable programme of new investment. Some district housing authorities may presently be in this position if they succeed in transferring to the private sector all or a substantial proportion of their existing housing stock. The Departments propose that, in such circumstances, the districts concerned should have a choice between investing the surplus receipts or using all or part of them to finance capital expenditure which would

(a) be carried out by the county councils or other statutory agencies (such as health authorities);

(b) be for the benefit of the areas of the districts concerned; and

(c) be in part additional to the capital resources which the counties or other agencies would otherwise have available.

In the case of county expenditure thus financed by districts, the mechanism by which this would be achieved would be that a district which had reduced their net indebtedness to zero would be permitted to lend to the county receipts which would otherwise have to be set aside to meet future commitments. The county would be able to use the full sum borrowed to finance capital expenditure but only a proportion would need to be authorised by a normal borrowing approval. The proportion will depend on the number of authorities who have reduced their net indebtedness to zero. The district would not be obliged to lend under these arrangements, or the county to borrow, but they would provide a means by which the county could enhance their capital programme, if the district were willing to assist the expenditure concerned.

Counties which had reduced their net indebtedness to zero would likewise be able to lend to assist district projects. The Departments are considering how similar arrangements could be made to enable surplus receipts of counties, districts (including metropolitan districts), and London boroughs to be used to finance additional expenditure by health authorities.

31. The new system will provide a clear framework for borrowing by local authorities from third parties. It will also specify a range of secure investments in which local authorities may invest monies (other than monies in trust and superannuation funds the investment of which will be governed by the relevant trust deeds and regulations) which they hold pending use for the purposes for which they are held.

32. Various arrangements will be specified to cover the transition from the 1980 system to the new system. Cash (or certain investments) representing unspent capital receipts from the 1980 system, will be treated in the same way as capital receipts generated under the new system. Outstanding borrowing from the 1980 system will be subject to similar amortisation provisions to those applying to borrowing under the new system. And the cost of credit arrangements entered into between the date of this consultation paper and 1 April 1990 will be charged to authorities' revenue accounts during the first five years of the new system.

Relationship with the new regime for local authority revenue finance

33. The Government intend to legislate for the new system in the next Session of Parliament and, subject to Parliament's endorsement, to bring it into effect from 1 April 1990. It will complement the new regime for local authority revenue finance which, if the present Local Government Finance Bill is approved by Parliament, will take effect from the same date. By regulating the way in which the financing costs of capital expenditure are charged to revenue account, it will ensure that the community charge levied is a fair reflection of capital as well as of revenue expenditure. By not continuing the practice under the 1980 system of exempting some categories of capital expenditure from control, and by allowing free use of revenue contributions for capital expenditure, it will remove an incentive for authorities to capitalise expenditure which should properly be charged to revenue account.

Relationship to capital accounting

34. A Working Group has recently been set up by the Chartered Institute of Public Finance and Accountancy to make proposals about the accounting for capital assets and capital financing of local authorities. It includes representatives of the Local Authority Associations and of other interested parties. The Departments do not intend that the present proposals should imply any particular accounting framework or conventions. The detailed description of the proposals in the Annex is intended to explain their substantive effect and not how capital transactions will in future be accounted for.

Summary and assessment of the new system

35. The main features of the system outlined above are:

* It will set an annual limit on capital expenditure by local authorities financed by credit.

* That limit will apply both to expenditure financed by borrowing and to arrangements which have the same economic effect as borrowing.

* Part of existing and future capital receipts will be required to be set aside for debt redemption or to meet future commitments.

* When debt has been redeemed, such receipts may also be used to finance additional expenditure by other authorities for the benefit of the areas concerned.

* Local authorities will be free to finance capital expenditure from revenue and from receipts not set aside for debt redemption.

* Local authorities will be required to make provision from revenue for interest on, and repayments of principal of, their borrowings.

* When local authorities receive credit approvals for a year they will also be given provisional approvals for the following two years.

36. The Government believes that the new system will deliver the objectives outlined in paragraph 16 above. It will provide control over the underlying level of the LABR. There will be no control over the annual fluctuations in revenue borrowing and balances, but control of these could only be achieved through an EBL system, which the Government accepts is unworkable. The new system will also provide a strong influence over capital expenditure, through the control of capital expenditure financed from credit and the discipline placed on revenue contributions by the community charge.

37. It will be possible to target resources more efficiently than at present. Accumulated capital receipts will in time be reduced, leaving more room for credit approvals. And the provisions which will enable the Government to take account of part of the spending power from individual authorities' receipts when setting credit approvals will permit the overall distribution of spending power to be matched more closely to need than under the 1980 system.

38. Local authorities will have a strong incentive to make efficient use of their capital assets, to rationalise their holdings, and to dispose of surplus property. Those receipts set aside for debt redemption or to meet future commitments will reduce net loan charges and hold down the community charge. The flexibility provided by the freedom to use revenue contributions and the lifting of constraints on the rate at which other receipts can be used will make it easier than at present for rationalisations to be carried out.

39. Finally, the provisional credit approvals given for future years will provide a sound basis for local authorities to plan their capital programmes. Their planning will be strengthened by the provisions now added to the Local Government Finance Bill which will require local authorities not only to consider the interests of community charge payers when formulating their capital programmes but also to consult with representatives of business and commerce and others who will be contributing to the cost of those programmes through the national non-domestic rate. And the improved national control which the new system will provide should lead to a more stable background against which local authorities can plan.