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PRIME MINISTER

LOCAL AUTHORITY CAPITAL: CONSULTATION DOCUMENT

A dispute has developed between the Chief Secretary and Nicholas Ridley about one aspect of the local authority capital consultation document currently planned to be published next Tuesday.

The Treasury have, rather belatedly, become exercised about the risk of a surge of local authority spending on repairs and maintenance prior to the introduction of the new capital regime in 1990. Peter Stredder's note of 23 June below summarises the position and comes down on the Treasury side of the arguments. There is force in his points. But the politics of emergency legislation immediately to restrict local authorities' ability to spend receipts would be extremely difficult.

Hopefully Mr. Ridley and the Chief Secretary will be able to sort out their differences at a meeting this evening, and ~~that~~ you will not need to get involved. But it is possible they may come to you for arbitration.

PRG.

PAUL GRAY

23 June 1988

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PRIME MINISTER 23 June 1988

LOCAL AUTHORITY CAPITAL: CONSULTATION DOCUMENT

John Major's letter to Nicholas Ridley of 22 June alerts him to the danger that there might be a surge in local authority capital expenditure on repairs and maintenance in the 21 months before the less generous arrangements under the new capital control system come into force. The Treasury believe that action needs to be taken to forestall this. This would entail holding back and rewriting parts of the consultation document due to be published next Tuesday.

The Problem

The problem arises because under the present capital control system local authorities can spend their capital receipts without limit on repairs and maintenance. There is an added bonus where such expenditure would otherwise be financed as revenue spending because this reduced revenue spending entitles the local authority to more Rate Support Grant.

Under the new capital control system local authorities will be required to use a proportion of their accumulated and in-year receipts to redeem debt. So if they use their accumulated receipts in the interim on repairs and maintenance they both are able to spend more and get more in grant since under the new system, grant will not depend on the level of spending. The Treasury believe that these are powerful incentives to extra spending before 1990 which we need to remove.

The DoE argue that the level of additional spending is unlikely to be large because:

- Local authorities are already been free under the present system to use capital receipts to fund repairs and maintenance and so will already be spending as much as they want.

- Those authorities with the largest stock of accumulated receipts are those with the least need to spend.

- The grant incentive to spending can be removed. Separate discussions are already under way with the Treasury on this because there is a more general problem with the introduction of the new grant system under the Community Charge that needs to be dealt with.

The first of the DoE's argument is not convincing. Local authorities do have an incentive to cram as much of this expenditure into the years before 1990 because thereafter they will have to use a proportion of their receipts to redeem debt. There is some force in the second argument, but the Shire districts still have a considerable housing stock which they need to repair and maintain and may see some value in bringing forward expenditure. The last point is certainly valid but dealing with the grant point would remove only half the incentive to extra expenditure.

Assessment

Essentially the issue is one of degree. If the risk of extra expenditure is small then there is probably little point in taking new legislative powers to forestall it. However, the history of local government capital expenditure has been one of the regular discovery of loopholes, rapid exploitation of these once they are discovered, and belated Government action to block the loophole. The onus must be on the DoE to show convincingly that the risk in this case is small otherwise we shall find we have to block off the resulting surge in expenditure by emergency legislation. If we cannot be sure, it would be better to act in advance with legislation to enable us to control the level of expenditure on repairs and maintenance financed from capital receipts.

Conclusion

Unles the DoE can show convincingly that the risk is small, there should be legislation to control the level of local authority expenditure on repairs and maintenance financed from capital receipts. Nicholas Ridley and John Major are meeting to discuss the position today. You may need to intervene if they fail to reach a satisfactory agreement.

Peter Stredder.

PETER STREDDER

GBG

SECRETARY OF STATE FOR THE ENVIRONMENT

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My ref:

Your ref:

The Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

23 June 1988

file with PG?

Dear John

I have received your letter of 22 June about the consultation paper on local authority capital expenditure and finance. The consultation paper had been the subject of extensive discussions by officials and by E(LF) and the version sent to the printer on 20 June had been cleared by your officials and incorporated amendments to meet the points in your letter of 17 June.

The issues which you have identified are not new. Local authorities have been free throughout the present system to use capital receipts to finance repairs and maintenance which would otherwise be carried out over time and charged to revenue account. This practice has had a fair measure of encouragement from Ministers. We have frequently drawn attention to it when responding to criticisms from our supporters about restrictions on the use of capital receipts, and we allow for it when deciding what level of capital allocations would be consistent with the cash limit for local authority capital expenditure. Your officials have long since been involved in discussion about the estimate to be made for 1989-90. The new capital control system proposed in the consultation paper has likewise always included the proposition that a proportion of capital receipts should be applied to debt redemption.

You mention what you describe as estimates by my officials of the amount of cashbacked receipts which might be applied to the capitalisation of repairs and maintenance and of the use of receipts as a substitute for revenue account contributions to debt repayments. There has clearly been some misunderstanding as to the nature of these figures. Neither was an estimate or forecast of additional expenditure that would be financed by these means. They were assessments of upper or outer bounds within which (and probably far within which) the reported total expenditure subject to reclassifications would necessarily be constrained. They were not estimates of what would necessarily occur nor of levels of actual additional expenditure. Moreover, they relate to the three open-ended grant years 1987-88 to

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1989-90. The £700m which you mention appears on reflection not to be an indication of the scope for reducing debt repayments from revenue. It assumed that authorities could use capital receipts in lieu of such repayments. But this is not possible under present legislation. £50m to £100m per annum at most would be a more realistic estimate of the scope for reducing total expenditure by adjustment of loan repayment profiles. In any event, it would be perverse to penalise authorities for repaying debt from capital receipts when that is what we propose to require them to do in the new system. The figure of £1 billion on capitalisation was likewise an upper limit of the bookkeeping adjustments that might be possible over the 3 year period. The actual sum could be less. But this would not be additional expenditure but simply a post hoc reclassification of expenditure in the revenue account to capital.

We do have a precedent. In 1986-87, local authorities in general faced for the first time negative marginal grant rates. At the same time, they had been presented with our previous proposals for a new capital control system, which envisaged restrictions on the future spending of receipts in some ways harsher than those we now propose. The effect on capitalisation appears to have been less than £100m.

Your officials have explained to mine what they had in mind by way of changes to the transitional arrangements set out in the consultation paper. My officials are not persuaded that the changes would be feasible. The financing of capital programmes is settled on an annual basis after the event rather than day to day as expenditure is incurred. (This issue was, as your officials will know, once exhaustively explored in the context of proposals that the prescribed proportion should be changed in mid-year.) Thus, because we are well into 1988-89 and because the relevant accounts for 1987-88 are still open, the changes would have to be retrospective for 15 months if they were to be fully effective. Nor would we have the data necessary to enforce them.

There is, however, a larger objection to the changes proposed by your officials. Because they would take immediate effect, and because of the penalties that capitalisation would be liable to attract, they would have to be specifically drawn to the attention of local authorities when the consultation paper was published. They would be perceived by our supporters, particularly in the Shires, as a further attack by the Government on the ability of local authorities to use their capital receipts under the present system. We would be seen as going back on what we have said about their freedom to use receipts to pay for repairs. This would create the worst possible climate in which to conduct the consultation on the new capital control system which otherwise offers the prospect of removing many of the difficulties which we have faced in recent years over local authority capital expenditure.

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I do not think that it would be right to use the new capital control system as a means of offsetting the effect of capitalisation of repairs and maintenance (or other revenue expenditure) on local authorities' entitlements to revenue support grant. You and I are considering separately options that would address this issue on a wider front.

I propose that we should proceed as follows.

For the reasons already set out, it would be wrong to delay or amend the consultation paper. It is still possible for it to issue on Tuesday, and it should be published then.

We then need to consider 1988-89 and 1989-90 separately.

In 1987-88, it is clear that there was a substantial underspend on the cash limit. That was attributable to a surge in housing receipts and led to criticism of the Government from those concerned with homelessness. Right-to-buy applications continue to be buoyant and the assumptions underlying the 1988-89 cash-limit already appear pessimistic. (This was drawn to the attention of your officials in connection with my announcement last week of the second tranche of EYF allocations.) We are already forecasting an underspend for the current year of £230m. As the cash-limit applies to net expenditure, I see no reason to be concerned by any increase in capitalisation of up to that amount.

For 1989-90, our officials have already adopted a provisional assumption about the level of non-prescribed expenditure. That assumption was made in light of both the proposals for the new capital control system and the effects of the present RSG system. It stands to be reviewed during the remainder of the Survey in light not only of any later information about historic levels of capitalisation but also of the response to the consultation paper and of our decisions (when reached and announced) about close-down, on which it is within our power to remove the RSG incentive to capitalisation.

We have in reserve for 1989-90 the possibility of amending the general consent for the use of capital receipts to finance repairs and maintenance within specific Ministerial control. (This again is something that would have to be done in relation to a whole year.) This would, however, be a significant and controversial step, which might well be as badly received as the measures which we had to take on 9 March this year. I do not think that we should commit ourselves to such a step now.

I am sending a copy of this letter to the Prime Minister.

Yours ever

Nick Ridley

NICHOLAS RIDLEY

Local Govt: Relations
Pt 35

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Treasury Chambers, Parliament Street, SW1P 3AG

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

22nd **June 1988**

Dear Nick,

LOCAL AUTHORITY CAPITAL: CONSULTATION DOCUMENT

Following discussions on the RSG settlement for 1989-90 earlier this week, officials have brought to my attention the risk of a surge in local authority capital expenditure between next week, when the capital consultation document is to be issued, and the introduction of the new control regime in 1990. Even though I understand the consultation paper is already at the printers, we need to meet urgently to discuss whether this risk can be reduced satisfactorily or eliminated by changes to the transitional proposals. I should emphasise that the changes I have in mind would be to details of the transitional arrangements before 1990, not our substantive proposals on how the new regime should work. I am well aware of the difficulties any further delay in publishing the consultation document will cause; but the sums at risk are so large, that if changes are found to be necessary, we must be ready to hold up publication for a few days.

The problem is the existence of some £7 billion in cash-backed capital receipts, mostly in the form of money on deposit. Around £5 billion is held by the Shire Districts. Under the proposals in the capital consultation document, 75 per cent of cash-backed housing receipts and 50 per cent of other cash-backed receipts held on 31 March 1990 must be used to redeem outstanding capital debt or set aside to meet future capital commitments. Local councils will therefore have an incentive to use cash-backed receipts before 31 March 1990, while they are available to be spent, rather than after that date, when more than half of them must be used to redeem outstanding debt.

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Of course, our present controls on the proportion of capital receipts which can be used to finance prescribed expenditure should help to prevent excessive prescribed spending. But there are no such controls over non-prescribed spending - the bulk of which comprises capitalised current expenditure on repairs and maintenance. So we will be at risk of cash-backed receipts being used on a major scale to finance such repairs and maintenance between next week and 1990. Your own officials have estimated that up to about £1 billion of cash-backed receipts might be used this way; and up to a further £700 million used to substitute capital receipts for due debt repayments rather than meeting these out of revenue account.

Moreover the incentives to use capital receipts in these ways are considerably enhanced by the present RSG system. Capitalising current expenditure allows local councils to reduce their recorded total expenditure and increase their entitlement to block grant. Indeed there has always been an incentive in grant terms to capitalise current spending: but that incentive will also disappear from 1 April 1990, with the introduction of the new Community Charge regime.

So, from the date the consultation document is issued, local councils will have an incentive to use outstanding cash-backed receipts over the next eighteen months rather than see more than half of that spending power lost after 1 April 1990. They will have the opportunity to use, in principle all though in practice considerably less, of the receipts to finance capitalised current spending which scores as non-prescribed (uncontrolled) capital expenditure. And to the extent they do use them in this way they will have the added financial benefit of extra block grant payments.

We must be at serious risk of a surge in expenditure. Difficult though any delay would be at this stage, my officials consider that the detailed transitional proposals in the consultation paper must be revised so as to prevent or at least strongly discourage local councils from excessive drawing down of the money held on deposit from cash-backed receipts. I suggest our officials meet urgently to consider how this could best be done.

In view of the possible implications for the publication date of the capital consultation paper, I am copying this letter to the Prime Minister.

Yours Ever,

John

JOHN MAJOR