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PRIME MINISTER ^l

1989-90 RSG SETTLEMENT

As I mentioned to you this afternoon, this meeting has been arranged at short notice to consider the urgent package of action proposed by Mr Ridley and the Chief Secretary. Those attending are Mr Ridley, the Chief Secretary, the Lord President, Mr Parkinson and, possibly, a Welsh Office Minister.

1. Is it legal - could the change be challenged
e.g. absence of consultation?

2. Truly difficult way - major bills still to be dealt with - would there be

jeopardised
and it looks inefficient
Ridley

3. L.A.'s already struggling with Community Charge

4. Could we do the same thing by a tough part?

The papers are:

Flag A - Mr Ridley's minute and detailed attached paper.

Flag B - Cabinet Office brief.

Flag C - Policy Unit comments.

The issues are complex, but the Cabinet Office brief offers you a helpful way through the undergrowth.

Essentially, there are three issues:

- (i) Should a package of measures to close down the existing Rate Support Grant system be urgently introduced involving legislation in the 1988-89 Session, or is it best to wait until nearer the time of the introduction of the Community Charge system? Mr Ridley and the Chief Secretary think urgent action should be taken.
- (ii) Is it acceptable to proceed with publication of the Local Authority Capital Consultation Document next week and leave consideration of any action to bring excessive use of cash-backed capital receipts until the Autumn? Mr Ridley and the Chief Secretary think it is.

(iii) If urgent action on the current expenditure front is accepted, should this be brought to Cabinet, and announced, on 7 July; or should a little more time be taken to ensure nothing has been overlooked, with the issue being brought for clearance and announcement on 14 July (when Cabinet will in any event be considering the overall public expenditure position)? Mr Ridley and the Chief Secretary argue strongly for 7 July.

As I mentioned to you, Mr Parkinson would welcome a word on the telephone over the weekend about all this. He would welcome a steer on what, if any, line you would like him to take at the meeting.

PLG.

PAUL GRAY
1 July 1988

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PRIME MINISTER

1989/90 RSG SETTLEMENT

Minute of 1 July from the Environment Secretary.

DECISIONS

Mr Ridley and the Chief Secretary are concerned about the extent to which local authorities may be able to exploit the transition from the rating to the community charge system, and the proposed changes in the capital control system. They are in particular concerned about two possibilities: that authorities might be able to use creative accounting and other devices to claim extra grant (possibly several £100m) at the expense of the Exchequer: and that they might be able to finance a substantial surge in spending in 1989/90, on revenue or capital account.

2. Mr Ridley and Mr Major have concluded that there are substantial risks in both areas, but particularly in relation to grant. They therefore seek agreement to the following action:

- i. to announce immediately - by which they mean Thursday 7 July - the closing down of the existing Rate Support Grant (RSG) system. Grant for 1988/89 and all previous years would be calculated conclusively on the basis of expenditure information already received. Grant for 1989/90 would be based on Government assumptions about spending by each authority (based on 1988/89 budgets) and would be fixed;
- ii. to legislate early in the 1988/89 Session to allow closedown on these terms. They say this would require a short Money Bill, which would need to be enacted by March 1989 so that grant payments could be made on the correct basis from the start of the financial year;



iii. to issue the consultation paper on the new system of capital controls (already approved), but to consider in the Autumn whether to use existing powers of consent to prevent the excessive use of cash-backed capital receipts in 1989/90.

3. The two Ministers are concerned that if authorities get wind of the proposals they will act immediately to circumvent them. They therefore seek agreement to take their package to E(LA) on Wednesday and to Cabinet on Thursday morning, and to announce it on Thursday afternoon. You will wish to decide whether to agree this timetable. If you feel that it is too hasty, one alternative would be to postpone collective discussion for a week, until Cabinet on 14 July which is anyway due to discuss public expenditure. This would provide a little more time to make sure that the proposals were sound.

BACKGROUND

4. Under the present RSG system each local authority's grant entitlement depends on its expenditure (on a definition known as "total expenditure"). Generally, if an authority increases its spending it loses grant, and if it cuts spending it gets more grant. Since 1987/88 RSG has operated in such a way that grant forfeited by individual authorities flows back to the Exchequer. On the latest information local authorities in England forfeited £298m of grant to the Exchequer in 1987/88, and £521m in 1988/89.

5. The main risk which worries Mr Ridley and Mr Major is that authorities will be able to manipulate their total expenditure in 1989/90, so that rather than forfeit grant to the Exchequer they may actually claim more grant than the Government originally makes available, possibly several £100m more. In addition authorities might be able to manipulate their accounts for 1987/88 and 1988/89 so as to cut or even reverse the grant underclaims in those years. They could do this by using a range of accounting devices, including use of special funds, rescheduling debt charges, and capitalising certain repair and renewal spending previously met from revenue. These devices will be of little value after 1 April 1990, because grant will not then depend on expenditure. The



potential scope for such action is very large indeed: Annex A to the paper identifies devices which might increase grant by as much as £1,200m.

6. There is also a risk of a substantial surge in spending in 1989/90. On the revenue side authorities have a choice: either they can use creative accounting to reduce total expenditure and therefore maximise grant; or they can use the same devices to increase real spending while keeping total expenditure and therefore grant constant. The Government is therefore at risk of either a surge in spending or higher grant payments or a mixture of both. On the capital side there is a concern that the imminent introduction of the new system, under which 50% of cash-backed receipts will have to be devoted to debt redemption, will lead to a surge in the use of receipts in 1989/90. This surge could either finance additional capital spending, or substitute for revenue expenditure.

MAIN ISSUES

REVENUE EXPENDITURE AND GRANT

The case for immediate closedown

7. Closing down the RSG system with immediate effect would have one great advantage: it would remove entirely the danger of authorities exploiting the Exchequer through accounting devices, possibly to the tune of several £100m. Mr Ridley also claims that it could be presented as a logical step to the new system (under which grant will be fixed from the start of each year), and that it would allow authorities to concentrate on introducing the community charge. But these are clearly incidental points.

8. Unfortunately immediate closedown also has substantial disadvantages:

- i. there would be no grant penalties for increases in local authority spending in 1989/90. Real spending could therefore rise by more than if the grant system operated normally;



- ii. there would be no grant underclaim as in recent years: all the grant made available would have to be paid out. This has implications for the RSG settlement (see below);
- iii. strong opposition from local authorities is to be expected. Many responsible authorities would claim that their reasonable expectations of additional grant (eg because they had managed to cut spending in 1988/89) had been unfairly withdrawn;
- iv. time would have to be found for a highly contentious Bill at the start of the crowded 1988/89 Session.

9. The alternative is to make a conventional RSG settlement for 1989/90 and leave until later the decision whether to close down the system in July 1989 (option G2 in Mr Ridley's paper). Because of the likelihood that there would be more use of special funds, additional capitalisation of revenue spending, and substantial use of other devices, the Government would probably need to take this into account in the assumptions underlying the settlement. If judged successfully, this would leave the authorities with very little room for manoeuvre. Even if they used the accounting devices to the extent assumed, and kept spending in line with provision (itself highly unlikely), they could still claim no more than the amount of grant made available in the settlement.

10. Under this option, the downward grant pressure on spending would continue to operate in 1989/90: authorities could maximise their grant only if they kept underlying spending down. Furthermore if authorities chose to maximise grant they would end the year with substantial cash balances. A low underlying level of spending in 1989/90 and high balances on 31 March 1990 might enhance the prospects for launching the community charge in 1990/91. On the other hand, in order to protect the Exchequer completely the Government would need to assume that authorities used every conceivable creative accounting device that DOE fear may be available to them. This would mean an extremely tough settlement which might in the event prove to be unreasonable if some of the devices proved unrealistic in practice. And there could still be



no certainly that authorities would be unable to find devices which DOE had not thought of. So there would still be risks for the Exchequer. As a final resort if authorities managed to find unforeseen ways of exploiting the Exchequer, the Government could decide to cut grant for 1989/90 in, say, July 1989, but this would be highly contentious.

11. You need to make two key judgements:

- i. how far authorities are really likely to be prepared to go in manipulating their expenditure to maximise grant in 1989/90 (and retrospectively in 1987/88 and 1988/89). All the potential devices have been available to them in previous years and have not been used to anything like the extent Mr Ridley and Mr Major fear. On the other hand 1989/90 will be the last year of the existing system, and the scope for manipulation will then expire;
- ii. how far the risks to the Exchequer justify the disadvantages of immediate closedown. Announcing an immediate closedown now might precipitate a row with local authorities. How serious would this be?

(i) If you were to decide against immediate closedown, you would probably need to ask Mr Ridley and Mr Major to produce proposals for a tough but realistic RSG settlement, taking account of the possibilities for manipulation, and to work up proposals for closedown in July 1989 for a later decision.

Implications for the RSG settlement 1989/90

12. The two key figures for the forthcoming settlement - total provision for local authority current expenditure and Aggregate Exchequer Grant (AEG) - are normally announced in July. If there is to be an announcement of closedown on Thursday, Mr Ridley and Mr Major will probably want to announce these figures at the same time although this could be done later.



13. E(LA) normally take these decisions. The Sub-Committee has so far met once, on 22 June, to discuss the settlement. They considered conflicting proposals from Mr Ridley (provision of £29,100m and AEG of £14,036m) and Mr Major (provision of £28,590m and AEG of £13,496m). Both Ministers take the view that, if grant is to be fixed under the closedown option, then less AEG should be made available to compensate for the fact that none will be forfeited to the Exchequer. They have agreed on a total of £13,575m, only £80m above Mr Major's opening offer (and £600m above 1988/89). I understand that they are also likely to be able to agree on Mr Ridley's proposal for provision of £29,100m (£1.3 billion above existing PES provision for 1989/90). On that basis DOE estimate that average rate increases might be around 6% if authorities increase spending by 3% above expected inflation (4%) as in recent years.

14. You will want to consider whether a settlement on that basis would be acceptable. You will also want to have it endorsed by E(LA). The problem will be with the Ministers responsible for individual local authority services (the Home Secretary and the Secretaries of State for Education, Social Services and Transport), who have all argued for provision substantially above the level proposed by Mr Ridley, to allow them to show that the Government has responded to priority needs in their services. You may want to ask the Energy Secretary for his views.

CAPITAL EXPENDITURE

15. There are two potential problems with the transition to the new capital control system:

- i. the possible substitution of capital receipts for revenue financing of certain spending. This is one of the devices for maximising grant discussed above, and would be of relatively little concern if the Government decided on immediate closedown or took it into account in a conventional settlement. Alternatively the Government could take action under existing powers to prevent or limit this use of receipts in 1989/90. But Mr Ridley and Mr Major agree



that such action should be considered in the Autumn, not now, because premature action could prompt authorities to exploit these options in 1988/89;

ii. additional capital expenditure out of receipts. DOE estimate that, as an upper limit, extra spending of £200m might be undertaken in 1989/90. There is no manipulation here: capital receipts are authorities' own money, and they have the power to use them in this way. Mr Ridley is likely to argue against any special action solely on this account.

16. The risks of manipulation on the capital side do not seem anything like as severe as on the revenue side. You will probably want to agree with Mr Ridley and Mr Major that the capital consultation paper should be issued immediately, and any action under existing powers to prevent or limit substitution of capital receipts for revenue financing in 1989/90 considered later in the year.

TIMING

17. Mr Ridley and Mr Major want to make an announcement immediately because they fear a leak which will prompt authorities to start manipulating their spending and to send in new budgets before a statement is made. But if you feel that more time is needed - to consider more fully the implications of their proposals or to check on the legal position - there is no overriding reason why a Cabinet discussion and a statement could not be delayed by a week or even two. Discussing Mr Ridley's proposals at the same time as public expenditure in Cabinet on 14 July would have a certain logic. E(LA) might then be convened to discuss the proposals on the previous day, to minimise the risk of a leak. The only real deadline is the need to make an announcement about the RSG settlement before the Summer Recess.



LEGISLATIVE IMPLICATIONS

18. The Business Managers cannot be expected to welcome the proposal for a further Bill at the very start of the crowded 1988/89 Session, even if it is short and is a Money Bill. You may want to explore the alternative possibility of legislating in Mr Ridley's Housing and Local Government Bill. That would mean that the new powers would not be in place until Summer 1989 at the earliest, and grant payments for 1989/90 might have to commence on the existing basis (depending on actual spending). This would not be ideal. But you may want to ask Mr Ridley to consider whether it is a workable option, given all the pressures against another Bill. He has copied his minute to the Attorney-General.

HANDLING

19. You will want to ask the Environment Secretary and the Chief Secretary, Treasury to introduce their proposals. The Chancellor of the Exchequer may wish to comment. The Lord President will want to comment on the proposal for a Bill in the Autumn which would need to be enacted by March. Finally, you might look to the Energy Secretary for an independent point of view on the proposals and their handling.

R.T.W.

R T J WILSON
Cabinet Office
1 July 1988

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cc BVP
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PRIME MINISTER

1 July 1988

IMMEDIATE CLOSE DOWN OF THE RSG SYSTEM

Nicholas Ridley has minuted you about the agreement he has reached with the Chief Secretary on immediate close down of the RSG system in order to prevent local authorities exploiting the transition to the Community Charge, to the disadvantage of the taxpayer.

Background

Under the present RSG system a local authority's entitlement to RSG falls as it increases its expenditure. Under the new system with Community Charge, grant will be independent of an authority's level of spending. Local authorities therefore have a strong incentive to find ways of artificially reducing their expenditure during the last years of the present system since they can then, if necessary, regain their position without penalty once the Community Charge has been introduced.

A second problem arises because local authorities at the moment may spend as much of their capital receipts as they like on maintenance and repair. When the new capital control system comes in they will be obliged to use a substantial proportion of their accumulated receipts to redeem debt and will therefore no longer be able to spend these receipts. Once the new capital control system is announced, we expect local authorities to seek to maximise use of receipts on capitalised repairs in order to avoid losing this spending power. A further incentive for them is that capitalising receipts reduces current expenditure and therefore increases grant as above.

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Proposed Counter Measures

Nicholas Ridley and the Chief Secretary propose to block off manipulation of the grant system by freezing entitlement to grant. From midnight on the date of an announcement entitlement to grant will be determined for this financial year and all previous financial years yet to be settled on the basis of information reported to date. For 1989/90 grant will be distributed on the basis of an assumption about each local authority's level of expenditure and will not depend on actual behaviour.

Action is not proposed to deal with the capital receipts loophole at this stage because such action would be impractical. Local authorities decide how particular items of expenditure are financed only at the end of the financial year. The only obvious means of controlling the use of capital receipts to finance repairs and maintenance is to require local authorities to seek permission for such spending. To do this in mid-year would mean requiring local authorities to close their accounts for the current year in mid-year and apply the new system to the remainder of the year. This would be enormously disruptive at a time at which local authorities are already wrestling with introducing the Community Charge.

In any case it is probably unnecessary to introduce controls immediately since local authorities will only begin to consider increasing capitalised expenditure on maintenance when they see the contents of the consultation paper. It will then take some months for them to plan additional expenditure and issue new contracts. It is therefore unlikely that much extra expenditure on capitalised repairs can occur this year.

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Nicholas Ridley therefore proposes to wait until around the turn of the year before announcing measures to control the use of capital receipts for repairs and maintenance during next financial year.

Assessment

Closing down the grant system has both advantages and disadvantages. The advantages are preventing further exploitation of the grant system and certainty for local authorities. It would also allow sympathetic local authorities to built up their balances in 1989/90 in order to reduce the impact of the Community Charge, without incurring penalties. The main disadvantage is that there will be less pressure on authorities to keep down expenditure and that the benefits of not having claw-back accrue mainly to those high spending authorities that increase their expenditure most.

Whether or not close down is worth doing depends on whether the extra expenditure that arises because the grant system contains no disincentives to extra spending is less than that arising from creative accounting devices if we leave the present grant system in place.

It is difficult to forecast what avoidance devices will be devised, but past experience strongly suggests that we should not be complacent. A reasonably tough grant settlement, as proposed, will in any case offset some of the effects compared to the more generous settlement Nicholas Ridley was proposing under the tougher existing grant arrangements.

On balance, it is probably better to bite the bullet now and give ourselves the benefit of certainty rather than face the prospect of a series of measures over the next 18 months to block loopholes as they arise.

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As to the proposals on capital expenditure we agree that action needs to be taken but that for practical reasons this should wait until the turn of the year.

Timing

It is important that no word of these proposals should leak. Otherwise there will be a rush of creative accounting deals. This suggests an announcement as soon as possible after spending Departments are brought into the picture.

Legislation

The legislation to implement the change in grant arrangements needs to be separate from the main Housing and Local Government Bill which is unlikely to receive Royal Assent before the start of the next financial year. Without an Act, DoE would have to take decisions about ratecapping and distribute grant at the beginning of the financial year on the basis of the present system since they could not anticipate legislation. This would be administratively chaotic.

Conclusion

We recommend that you agree to the proposals outlined in Mr Ridley's minute.

Peter Stredder

PETER STREDDER



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CCB/p

Prime Minister

1989/90 RSG SETTLEMENT

The Chief Secretary and I have identified a potentially serious risk that in the last years of running the present Rate Support Grant (RSG) system local authorities could manipulate the system to attract large additional sums of grant from the Exchequer. We also see dangers that they might use the final year of the present system to incur additional public expenditure. The attached paper identifies the issues and the options we have found for dealing with them.

In our view the way forward is as follows. We should act early to remove the present open-ended commitment on grant and to close down the present system in an orderly way in England and Wales before we introduce the new grant system in 1990. If we do not act to close down the system early it will continue to operate until spring 1992. The proposals would not, of course, apply to Scotland.

There are a number of ways of closing down the system early. The one we favour would be to make an early announcement - next week - that grant entitlements for 1989/90 would be fixed in the RSG Settlement and would not vary with an authority's actual expenditure next year. At the same time, to avoid manipulation of grant in earlier years, we would make final determinations of grant entitlements for all outstanding years including 1988/89.

This option has the advantage of minimising the period at which the Exchequer is at risk to higher grant claims. It has the disadvantage that by abolishing grant penalties it reduces the pressure on authorities to restrain expenditure before 1990; however if we allow authorities excess Exchequer grant that will of itself encourage them to spend more. The alternative is to wait until next summer before close down. But by then much of the grant at risk may have already been claimed and spent.

Consequences
on rates?



I have discussed with the Chief Secretary the grant that can be made available under our preferred option. I have agreed with him that it would be appropriate to provide £13,575m: this is £600m more than we originally provided for 1988/89 (after technical adjustments) and £1.1bn more than is actually being paid this year, since local authorities have lost about £500m of grant from the Settlement assumptions because of their overspending. It means that rate rises should on average be around 6% on the assumption that authorities again raise spending by around 7%.

Our preferred option requires an additional Bill next session. This is regrettable. But primary legislation will be necessary at some stage if we are to close down the present system before 1992. And, if we continue with the present system, further legislation may be necessary to close down new dubious accounting practices that may come to light. Fortunately the Bill I envisage will be only 2 to 3 clauses and will be a Money Bill. - *Are we sure?*

Capital

The Chief Secretary and I are also concerned on the capital side about a potential loophole in our capital control arrangements in the run up to the introduction of the new capital regime in 1990. Local authorities will have both the scope and incentive to use cash-backed capital receipts to finance non-prescribed expenditure on certain types of repair and maintenance and to replace revenue contributions to capital. This could lead to higher expenditure both on repair and maintenance and elsewhere. Without early close down this too could lead to substantial claims of grant from the Exchequer.

The Chief Secretary initially suggested that the transitional arrangements in the capital consultation document should be altered to prevent or discourage rundown of the cash-backed receipts before 1990. We have now agreed that the best way to deal with the problem would be to use existing legislation to



limit local authorities' use of capital receipts after 1 April 1989 to finance prescribed spending and debt repayment. But the Chief Secretary and I are agreed that no action can be taken now and we should consider this further in the autumn. Meanwhile we agree that we should publish the capital consultation paper in its agreed form next week, simultaneously with our proposal on Rate Support Grants.

Timetable

If we are to act on the grant side we must do so quickly. This will reduce the chance of local authorities getting wind of our proposal and acting to circumvent it. We therefore propose to proceed as follows:

- i. you may wish to discuss this with us early next week;
- ii. subject to your agreement, I will ask Cabinet Office to arrange a meeting of E(LA) on Wednesday 6 July to brief colleagues and conclude the main elements of the Settlement as usual;
- iii. seek Cabinet agreement to the package on 7 July; and
- iv. announce details to the House the afternoon of 7 July.

I have discussed this with Peter Walker.

I am copying this letter and enclosure only to Nigel Lawson, Cecil Parkinson, John Major, John Wakeham, Peter Walker, Malcolm Rifkind, Patrick Mayhew and Sir Robin Butler.

RB

NR
1 July 1988

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

CHANGES TO THE LOCAL GOVERNMENT FINANCE SYSTEM
IMPLICATIONS FOR GRANT AND EXPENDITURE

1. The 1989/90 Rate Support Grant (RSG) Settlement is the last under the present system prior to the introduction of the community charge in 1990. The central feature of the present system is that a local authority's grant entitlement varies with its expenditure. For almost all authorities higher expenditure means lower grant. From 1990 onwards, however, grant entitlement will be fixed at the beginning of the year and will not vary with expenditure; strong downward pressure on expenditure will, however, continue to exist since all additional expenditure will fall to be met by community chargepayers.

2. The change to the new grant arrangements gives local authorities an opportunity to reduce reported expenditure in the last years of the present system and thereby increase grant entitlements. In 1990 the capital control system will also be revised. This too will provide opportunities to local authorities to manipulate total expenditure to increase grant. Some reductions in expenditure will be genuine and rightly should lead to higher grant receipts. Others will be bookkeeping adjustments - such as use of special funds - that we have accepted recently should reasonably lead to additional grant. But some adjustments will be more dubious simply taking advantage of this unique opportunity to increase grant.

3. While authorities may be using these opportunities to reduce their "total" expenditure (total expenditure is the term of art for the measure of expenditure on which RSG is paid) and gain grants, they may alternatively increase their real underlying level of expenditure without foregoing grant, or strike some balance between the two. This note considers the risks of higher grant claims or higher expenditure and discusses options for reducing them.

ASSESSMENT OF RISK

(1) GRANT

4. Since 1987/88 the amount of RSG available to local authorities has been "open ended" i.e. dependent only on authorities' own expenditure decisions - the less they spend, the more grant is paid. The expectation, however, has been that the actual payments would be lower than allowed for in the RSG Settlements. In practice local authorities have indeed spent higher than allowed for in the RSG Settlements and have forfeited grant. On present information in 1987/88 authorities overspent by £811m and consequently lost £298m grant, while in 1988/89 authorities have budgeted to spend £1035m more than allowed for in the settlement and have lost £521m grant. /521

5. In the normal cycle of events we update our information after the year end to take account of first "unaudited" and subsequently "audited" out-turn and revise grant claims accordingly. Final calculations of grant are not made until at least two years after the end of the relevant financial year.

6. The particular grant risk to the Exchequer arises now because of the opportunity for local authorities to use accounting adjustments either to reduce reported total expenditure or to switch reported total expenditure from years in which it would reduce their grant entitlements to years where it has less impact on grant.

7. Throughout the 1980s local authorities have used a number of devices for reducing reported total expenditure in order to maximise grant. Common methods have been through the use of special funds, and by classifying expenditure on repairs and renewals as capital rather than revenue. Many rate capped authorities have indulged in a wider range of creative accounting arrangements.

8. We already know that many local authorities are wondering how best to take advantage of the opportunity presented by the change of system; and we believe that experts in the City are working up schemes to sell to local

authorities. Amongst the arrangements being considered are factoring - which involves "selling" future expected capital receipts - use of special funds, capitalising repair and maintenance, and reducing debt servicing costs.

9. We can anticipate the use of some of these schemes and take account of them in fixing the assumptions for the 1989/90 Settlement. In particular we can allow for use of special funds to reduce expenditure in 1989/90 and partly for further capitalisation of repairs and maintenance. We may also be able to prevent some abuses - such as factoring - using existing powers. But we cannot allow for other unwelcome accounting practices in the 1989/90 Settlement without effectively condoning them and thereby encouraging authorities to indulge them. Nor can we now change the assumptions for 1987/88 or 1988/89 which are the other years at risk of grant manipulation. Moreover it is always possible there may turn out to be other devices available to authorities to manipulate grant which we have not yet identified.

10. We cannot quantify precisely the extent to which Exchequer grant may be at risk. As an outer limit we note that in recent years rate capped authorities have understated true expenditure by around 12%. If all authorities were to understate expenditure to this extent the grant claim would rise by around £1700m in 1989/90. This certainly exaggerates greatly the extent to which grant might be manipulated. But we can expect manipulation even from authorities that would normally avoid such arrangements. In particular we can expect a herd instinct to develop as it becomes clear that many authorities are manipulating the system particularly as these accounting arrangements are all within the law. The risk to the Exchequer is at least £350m in respect of 1987/88 and 1988/89. For 1989/90 an expected grant underclaim of several hundred million pounds could become a grant overclaim. Moreover the proposed changes to the capital control system, which requires at least half of cash-backed capital receipts to be applied to redemption of debt in 1990, may encourage local authorities to make maximum use of capital receipts to reduce revenue expenditure, and hence gain grant, in the years up to 1989/90. Annex A sets out our present assessment of the maximum scope for manipulation by those means we have been able to identify.

(2) EXPENDITURE

11. Another risk is that the period of transition to the new control system will see a surge in overall spending by local authorities. There are three main ways in which this might come about.

12. First, the more grant the authorities succeed in obtaining from the Government, the more possible it will be for them to finance extra expenditure without additional calls on the domestic ratepayer. However, to the extent that authorities raise revenue spending in 1989/90 they will, under present rules, forego grant gains.

13. Second, the action which the Government takes to prevent local authorities from obtaining large extra amounts of grant on the strength of creative accounting could have the effect of reducing the marginal impact of extra spending on domestic ratepayers to a level far below that under the existing control system or the Community Charge system. This would reinforce the temptation which authorities may anyway perceive to spend more during the next 18 months when they will be able for the last time to raise extra sums from non-domestic ratepayers.

14. Third, some authorities may be prompted to undertake extra expenditure as a result of publication of details of the transition to the new capital control system. Although most capital expenditure by local authorities is "prescribed expenditure" and thus subject to control under Part VIII of the Local Government, Planning and Land Act 1980, there is also a considerable amount of "non-prescribed" expenditure. The largest element of such expenditure (about £500m a year) is capitalised repair and maintenance of buildings, roads, and structures. The amount of capitalisation has increased in recent years, largely in response to pressures to maximise grant and keep rates down. The 1980 Act limits the rate at which local authorities may use their capital receipts to finance prescribed expenditure and, at present, there are approximately £6½ billion of cash-backed capital receipts (of which £0.4bn are held by counties, £0.6bn by metropolitan districts, £1.2bn by London authorities, and £4.2bn by shire districts).

15. Under the new capital control system, local authorities will be required to apply a proportion of their cash-backed capital receipts to debt redemption. (The proportions at present envisaged are 75% for the proceeds of council house sales and 50% for other receipts). In terms of their ability to use capital receipts to finance capital expenditure, they will "lose" this amount and the Treasury's first concern is that this may provide an incentive to them to "use" their capital receipts in the interim to undertake extra capitalised repair and maintenance expenditure.

16. Quite apart from this, and leaving aside the question of RSG incentives to capitalisation, the Treasury's second concern is that the prospect of the new system may also provide an additional incentive to local authorities to transfer expenditure that they would otherwise have incurred on repair and maintenance from revenue to capital account. That would not represent additional expenditure, and would probably be accomplished by ex post facto bookkeeping adjustments, but would have the effect of converting a corresponding amount of capital receipts into revenue balances, which would be available to finance further expenditure rather than be applied (in part) to debt redemption.

17. There are a number of constraints or disincentives which will in practice limit the use of capital receipts (either to finance extra expenditure or to transfer expenditure out of revenue account) :-

- i) Not all repair and maintenance expenditure can properly be capitalised. (works which will lengthen the lives of assets or save expenditure in several future accounting periods may qualify - day-to-day repairs do not);
- ii) Although the sums available for capitalisation are significant there is a marked "mismatch" between the distribution of capital receipts (primarily in shire districts) and the distribution of the sort of structural maintenance that can properly be capitalised. (Some of the authorities who have latterly made extensive use of capitalisation have now used up their capital receipts);

iii) To the extent that capital receipts are spent before the new capital control system comes into effect, the amount of capital spending power which local authorities will derive in the new system from capital receipts will be reduced. (For any given level of capital receipts, the new system will, by comparison with the present system, give local authorities greater freedom to spend a smaller overall amount. But it will permit a larger proportion to be spent in any given year). Thus to use capital receipts for extra maintenance will make it more difficult to undertake future large projects.

iv) Depending on the choice made between options G1 and G2 below, the present strong grant incentive to capitalisation may be removed.

18. DoE's assessment is that the amount of additional repair and expenditure which might be undertaken as a result of knowledge of the proposals for the new capital control system would not exceed £200m in 1989/90. (This figure is an upper bound, not an estimate). The overall scope for capitalisation by bookkeeping adjustments might be as much as £1000m over the 3 years 1987-88, 1988-89 and 1989-90.

OPTIONS FOR REDUCING RISK

19. This section considers what action might be taken to reduce these risks. There are 2 grant options (G1 and G2) and two options on capital receipts (C1 and C2). Doing nothing is also an option in both cases.

20. In considering what might be done we have taken account of the situation regarding determination of grant for the forthcoming year after the next RSG Settlement, the present year (1988/89) and, past years. Grant entitlements for 1988/89 and all outstanding earlier years are due to be revised in Supplementary Reports later this year. These reports will take account of outturn expenditure for 1985/86 and 1986/87, of revised budgets for 1987/88 and budgets for 1988/89. Full sets of expenditure data for these Supplementary Reports are being put together now. This therefore provides a

good opportunity for changing the present system to reduce the risk to the Exchequer. The next such opportunity when we will have full sets of expenditure data for all outstanding years is July 1989.

21. We have identified two main options for reducing the opportunities to manipulate the system to increase grant claims. The first requires legislation in the next session to change the basis on which grant will be distributed in 1989/90, and to limit grant claims in respect of earlier years. The second option is to delay action until summer 1989 and then legislate to close down the present system.

OPTION G1 : Immediate closedown of the present RSG system

22. The main features of this proposal are: -

(a) grant entitlements for 1989/90 would be fixed in the forthcoming settlement and would not be linked to actual expenditure. This means that there would be no grant underclaim as in 1987/88 and 1988/89, but nor would there be any risk of grant overclaim.

(b) Final grant entitlements for 1988/89 and all outstanding earlier years would be determined on the basis of reported expenditure available on the date of the announcement in July of this year (possibly with a small adjustment reflecting the normal average reduction in expenditure from budget to outturn). These grant changes would be made through supplementary reports at around the end of this year : these would be the last reports under the present system.

23. Fixing grant in this way would remove the risks to the Exchequer on the grant side. But it would also reduce pressure on local authority expenditure since higher expenditure would no longer lead to lower grant. We do not know what effect there would be on expenditure in this transitional period before the discipline of the community charge system is introduced. But every 1% increase in expenditure is equivalent to £300m. Account would have to be taken of such grant and expenditure implications when determining the 1989/90 RSG Settlement.

24. If this option is pursued an early announcement is desirable to minimise both the risk to the Exchequer and the possibility of authorities getting wind of the proposal and adjusting the accounts before we act. A short Money Bill would be required in the autumn to achieve Royal assent by March in order to pay grant in 1989/90 on the correct basis. Apart from this the 1989/90 Settlement and the series of supplementary reports planned for the autumn would proceed as planned other than that no account would be taken of expenditure data reported to us after the date of announcement.

Option G2: Delay closing down until 1989.

25. Under this option the existing grant related restraints on expenditure would continue. For most individual authorities, higher expenditure would continue to mean absolute reductions in grant. The option consists of three elements:

(a) run the system for another year and announce close-down arrangements in July 1989. At that time we would have information on expenditure for all outstanding years of the present system. The legislation would simply state that for the purposes of calculating grant entitlements no account would be taken of later information expenditure in respect of any year. If at that time the scope for manipulation seems much reduced, it might even be possible to give authorities advance notice of closedown in respect of certain financial arrangements.

This element alone would carry a significant risk of grant manipulation in 1989/90. It would therefore also be necessary:

(b) to draw up a "tough" 1989/90 RSG Settlement to allow as far as possible for potential manipulation in deciding upon the spending assumptions and the grant total; and

(c) to take separate action to block off other manipulations of the system to the greatest possible extent. Action on capitalisation of repairs, etc. (Option C2 below) would certainly be necessary. Other

action, to prevent the use of other devices that come to light, would have to be taken as necessary if and when their significance or potential significance came to light.

26. The option on capital receipts is:-

OPTION C1 and C2 : Bring Capitalisation of Repairs under control.

The use of receipts to finance capitalised repair and maintenance expenditure is theoretically under the control of the Secretary of State, though that control has for many years now been waived by means of the issue of general consents and block borrowing approvals. Under the option, these consents would be modified so as

- (i) to preclude or limit the use of capital receipts for this purpose; or
- (ii) to require specific consents to be obtained; or
- (iii) to permit the use of receipts only for specified classes of expenditure.

There are limitations on the scope for changing the rules during a financial year, and in particular for changing them with immediate effect. This is because (a) changes cannot be made retrospectively in the absence of primary legislation and (b) it is only at the end of year, when the accounts are drawn up, that particular sources of finance are imputed to the particular items of expenditure. So to the extent that permission to use receipts for any given class of transactions is withdrawn during the year, the local authority could when drawing up their accounts impute receipts to all transactions in that class before the relevant date and other sources of finance to transactions after that date.

27. In DOE's view, it is not practicable to think of altering the rules for 1988-89 so as to impose restrictions on the use of receipts to finance actual repair and maintenance during that year. It would, however, be possible to prevent local authorities from entering into advance maintenance deals (on the lines of the advanced purchase deals for capital expenditure which were

brought into control by the Local Government Act 1987). This is because there is no evidence that authorities have yet started to enter into such deals. The immediate prohibition of advance maintenance deals is Option C1.

28. It would in DOE's view be practicable to impose a more rigorous control for 1989-90. It would be necessary for consultation to be undertaken and for the consents to be modified before the end of 1988-89 so that the modification took effect from 1 April 1989 and so that authorities could allow for this when setting rates. The modification would have to be accompanied (if this had not already been done) by action in relation to advance maintenance deals. This is Option C2.

29. Option C2 would be controversial and would be represented as being inconsistent with undertakings that Ministers have given about the ability of authorities to use capital receipts to finance repair and maintenance work and the encouragement that authorities have been given to do this in the field of housing. It would have to be justified on the basis that action was needed to prevent excessive expenditure in this area financed by capital receipts or the use of receipts to liberate revenue spending power. Option C1 would be much less controversial.

ASSESSMENT OF OPTIONS

30. Option G1 provides the greater certainty on grant as Treasury would know exactly how much grant has to be paid out under the present grant system up to March 1990. The change could be presented as an orderly transition to the new system where grant will also be fixed in the Settlement. By acting swiftly we minimise the risk to the Exchequer. Local authorities would also know precisely how much grant they would be entitled to and could concentrate on setting up the new system rather than expending energy trying to manipulate the present system.

31. The first option has four main disadvantages. The first is that there would be less downward pressure on local authorities' total expenditure following the July announcement. This could lead to higher local authority expenditure in the period to March 1990. A 1% increase, as noted earlier, is £300 million. DOE doubt whether the reduced disincentive to spend more at the margin would greatly affect the overall level of expenditure. In the

Treasury's view these marginal effects do influence behaviour. Under Option 1, an average authority would have to finance some 45% of any increase in expenditure from the domestic rate-payer, as against some 73% under option 2 and 100% under the community charge.

32. A second, related disadvantage is the loss of grant underclaim in 1989-90. The present estimates of underclaim in 1987/88 and 1988/89 are about £300m and £500m respectively. This needs to be set against the savings in grant from closing off the possibilities for manipulating accounts so as to increase grant entitlement.

33. A third disadvantage is that the Government would have to expect strident criticism from local authorities for changing the rules in mid game. Authorities who genuinely reduce their expenditure below present reported levels for 1987/88 and 1988/89, and below the 1989/90 settlement spending assumption would receive no reward. Further, authorities who have legally built up special funds would resent action by the Government to remove the grant entitlements which they assumed they would have on drawing down those funds. The Government would come under pressure during passage of the Bill to concede that authorities may enjoy the grant advantages of special funds: no significant concession would be possible, however, without destroying the whole approach.

34. Finally, option 1 would require a short but highly contentious money Bill in the 1988-89 Parliamentary session, where the pressures on time already promise to be intense.

35. Option G2 would have the advantages of retaining the grant-related restraints on total expenditure in 1989-90, at least until the authorities have set their budgets. There would also still be a grant underclaim in 1989-90 associated with decisions by local authorities to spend in excess of the settlement spending assumptions. And this option avoids legislation in the 1988-89 session and the opportunity that would provide for complaint and concessions.

36. This option also has several disadvantages. The main one is that between now and next summer the Government would have to be ready to meet

large claims for extra grant in respect of 1987/88 and 1988/89, and in respect of 1989/90 to the extent that the settlement did not allow for all opportunities to reduce expenditure and increase grant.

37. The second disadvantage is that at any time local authorities might bring forward new schemes to increase grant entitlements. We would either have to live with the grant consequences or stand ready to block such loopholes through further legislation. Most likely these would entail "midnight tonight" elements.

38. Thirdly we would expect a rolling barrage of criticism both any administrative and legislative changes necessary to block off loopholes, and about the toughness of the RSG Settlement. On the Settlement we would face particular criticism over assumptions that effectively required authorities to indulge in "creative accounting" arrangements such as capitalisation of which many would heartily disapprove.

39. Finally Option G2 would require a Money Bill in the 1989/90 legislative session, where pressures on time are also likely to be considerable.

40. It should also be noted that although this option would allow authorities with special funds to gain the grant benefits other authorities would receive correspondingly less grant within a given grant pool. The grant distribution in 1989/90 might therefore be very skewed leaving some authorities well placed for the introduction of the community charge but others poorly placed.

41. Options C2 will prevent exploitation of the freedom to capitalise repairs and renewals in 1989/90. If no action is taken authorities might at the outer limit be able to fund up to £500m of additional expenditure on repair and maintenance or elsewhere in their programmes through capital receipts. Action to prevent this would be badly received by local government (see para 28 above) even if the approach is modified e.g. to allow capitalisation on the level of recent years. Furthermore, authorities have to know what is proposed before they set their rates for 1989/90, but this fore-knowledge will give them an opportunity to maximise capitalisation in

1987/88 and 1988/89. This option cannot therefore be wholly effective. Option C1 would be less controversial and would operate successfully on one aspects of the problem. Neither of these options would require legislation.

42. Either Option G1 or G2 can be combined with Option C1, or Option C2. Option G1 (RSG Closedown in July 1988) would remove the grant incentives to undertake capitalisation and to that extent, but to that extent only, would make Options C1 and C2 less necessary. A combination of Option C2 and Option G2 would be an effective approach to 1989/90 provided allowance was made for potential manipulation in framing the 1989/90 Settlement, but this combination of a pre-emptive Settlement and the announcement of Option C2 might well lead authorities to maximise the opportunities still open to them in 1987/88 and 1988/89. Option C1 would, however, shut off one avenue of manipulation completely.

ANNEX A

Scope for Manipulating Total Expenditure In Order To Gain Grant

N.B. These figures are estimates of the maximum potential use of the various devices. We have no evidence that they will be used on this scale.

	Maximum grant at risk £m
Special Funds : £1.1bn of special funds available at April 1989. Use of up to £900m could be allowed for in 1989/90 settlement. Remaining £200m could be used in earlier years to increase grant claims by around £200m	200
Capitalisation of repairs and renewals: LAs have around £7bn of cash backed capital receipts that could in principle be used to finance repairs and renewals. In practice the scope is much lower as around £5bn receipts are held by shire districts. But as much as £1bn could be used between 1987/88 and 1989/90 to reduce total expenditure thereby increasing grant claims by £500m.	500
Factoring : This scheme is specifically designed to reduce total expenditure and increase grant. It involves "selling future capital receipts" for a lump sum which is then invested. The resultant interest receipts count as a reduction to total expenditure and hence increase grant. The future capital receipts are "repurchased" post March 1990. One London Borough is already planning to increase RSG entitlements by £1m in both 1988/89 and 1989/90 through this arrangement. The total RSG at risk in 1988/89 is probably small but in 1989/90 could in principle be up to £100m. Consideration is being given to ways of stopping this abuse of the system.	100
Debt Servicing: LAs could reduce repayments of outstanding debt from the revenue account by shifting the profile of repayments or by early repayment of outstanding debt from capital receipts. At risk here is up to £200m of expenditure and hence around £100m of grant for the period up to March 1990.	350

Short term delaying of expenditure :

There is scope for authorities to holdback expenditure from the early part of 1990 and have a surge of expenditure in April 1990. We have seen evidence of this when targets and holdback were abolished in 1986. Perhaps 2% of expenditure might be so delayed. This would increase grant claims by around £300m.

300

Interest rate swaps :

This involves swapping a low interest loan for a higher interest loan with an outside body for an up front premium. This premium is then invested and the interest receipts used to reduce total expenditure. Although the amounts swapped are large the effect on total expenditure is relatively small.

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Other schemes : We know of a number of other small scale schemes for reducing total expenditure. We cannot rule out however that new large scale schemes may be devised.

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