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Handwritten initials

Prime Minister

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

This could be controversial, but
some action does seem necessary. The

My ref:

Your ref:

Policy Unit (note below) report that the Chief Secretary very
support some strengthening of the package, and recommend you to
support him. Contact for Messrs Ridley
and Neja to agree the final terms of the
package?

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

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10/2

10 February 1989

Agreed

Dear Chief Secretary

LOCAL AUTHORITY CAPITAL FINANCE: STABILISATION MEASURES

Our officials have been discussing stabilisation measures to prevent an unacceptable surge in local authority capital spending over the next 14 months before the new capital finance is introduced. The danger arises because local authorities will have an incentive to spend as much as possible of their capital receipts before they are required to set aside a proportion of them for debt redemption on 1 April 1990.

The extent to which local authorities will embark on such a surge is very uncertain. But there are two potential devices for getting round the debt redemption provisions on which I think we must take action. I do not think that further action would be justified given the situation and the certainty of a good deal of enthusiasm from our own supporters as well as others but I understand that your officials feel further action would be appropriate. For the reasons I explain below, I think we now need to move urgently on one of these devices. What I therefore propose is that, without prejudice to discussion of further options between our officials, we should take the opportunity of announcing action on both devices in the Second Reading debate on the Local Government and Housing Bill next Tuesday.

My first proposal concerns "advance funding" deals. These are arrangements under which local authorities make payments now for assets to be acquired or work to be done in future years. This is undoubtedly the most likely way in which local authorities will try to get rid of their receipts quickly. It was used in 1985 when prescribed proportions were reduced and again in 1986 by the GLC prior to their abolition. The reason I think action is urgent is that, there is now some indication, since the publication of the Local Government and Housing Bill, that local authorities and their advisers are considering ways of salting away their receipts. If firms started to market advance funding deals, they could be put into effect very quickly.

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I propose to stop advance funding by administrative action. I would do this by revising the block borrowing approval under which I give authorities approval to borrow and the general consent I give for the use of their capital receipts. The revised approvals and consent would not allow authorities to borrow or use capital receipts for assets to be delivered in future years or for works to be carried out in future years. Although the action is administrative, the fact that it would have immediate effect makes an announcement appropriate, and the Second Reading debate is an opportunity to do this in a lower key fashion than a separate statement.

The second device I am concerned about arises because of the different debt redemption rates for housing and non-housing receipts. There is a danger that some of the £5 billion accumulated housing receipts will be used to purchase equities before 1 April 1990. Under our present proposals, if these equities were then sold after that date they would attract the 50% debt redemption rate as opposed to the 75% applicable to housing receipts.

My solution here would be to announce that the 75% will apply to disposals of share and loan capital as well as to housing receipts. This could be put into effect by an amendment to the Bill or by regulations in the new system. The need for an announcement is not as urgent but if we are agreed action is necessary I see merit in announcing it at the same time as prefunding.

Both these measures would of course draw the ritual criticism from local government interests, particularly because of the immediate effect of the prefunding changes. But I think we could present them as justifiable measures to deal with plain creative accountancy devices. They would not affect real "on the ground" expenditure. And if there were any particular cases of hardship I would have the power to issue specific approval to borrow or consent to use capital receipts.

I enclose a draft of what I might say during my Second Reading speech to announce these measures. I would be grateful for your agreement and that of colleagues to the measures and the draft announcement. I am afraid I must ask for this by lunchtime on Monday.

I am copying this to the Prime Minister, Douglas Hurd, Peter Walker, Kenneth Baker, Paul Channon, Kenneth Clarke, Patrick Mayhew and Sir Robin Butler.

Yours sincerely

RB

NICHOLAS RIDLEY

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

DRAFT STATEMENT

I am aware that not all local authorities have welcomed the provisions in the Bill for debt redemption. Whether their community charge payers will be of the same view is quite another matter. I therefore propose two measures to ensure that nothing untoward happens to the accumulated receipts of local authorities in the period before the discipline and financial accountability of the community charge take effect.

First, I am taking administrative action to secure that capital receipts cannot be used before the start of the new system to pre-fund acquisitions or works which will take place after the end of the next financial year. This is achieved by revisions to the block borrowing approval and the general consent to the use of capital money.

Secondly, I propose that the debt redemption rate applicable in the new system to disposals of stocks and shares and suchlike investments should be at the higher rate which we propose for capital receipts from sales of council housing. That will remove any temptation for housing receipts to be converted into non-housing receipts by being applied to the purchase of equities.

These measures take immediate effect. To have consulted in advance would have precipitated a flood of money into prefunding arrangements, as happened in 1985 when we announced changes in the prescribed proportions. Details are being sent today to all authorities and copies have been placed in the Library of the House. I do not believe that either measure will have any adverse effects on the legitimate capital programmes of local authorities over the next 14 months. But if any unintended consequences do arise, I will consider further amendments to the general consents or ad hoc consents in particular cases.

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PAUL GRAY

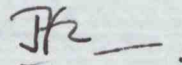
10 February 1989

LOCAL AUTHORITY CAPITAL FINANCE: STABILISATION MEASURES

Nicholas Ridley proposes, in his letter of today's date, to announce on Tuesday measures to ensure that local authority capital expenditure does not surge in 1989/90.

Authorities currently have about £4.6 billion on deposit, mainly council house sale receipts. There is enormous incentive to spend as much of this as possible ahead of new rules in 1990 (under the Local Government Finance Act 1988) which will force them to set a significant proportion aside for debt redemption. The GLC did this in 1986 before its abolition. Officials have got wind of plans by several authorities for creative "advance funding" deals to do just this and hence reduce their debt repayment obligations after 1990. Thus an urgent announcement is needed.

The Chief Secretary will, I understand, be strongly endorsing what is proposed, and will suggest strengthening the statement so as not to rule out further action if necessary. I recommend the Prime Minister agrees also on the basis which the Chief Secretary will put forward.



JOHN MILLS

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NBR

Recd

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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

13 February 1989

Dear Secretary of State,

LOCAL AUTHORITY CAPITAL FINANCE: STABILISATION MEASURES

Thank you for your letter of 10 February. ^{top enc}

You are already aware of my strong concerns about an unacceptable surge in local authority capital spending as the new capital finance regime is introduced. Our officials are agreed that the main danger lies in local authorities seeking to spend more of their extant capital receipts over the next fourteen months than they otherwise would have done; and finding ways to carry over the spending power available from these receipts into 1990 in order to boost expenditure thereafter.

The two measures you propose to announce on 14 February will go a considerable way to meet the second of those concerns. I therefore fully welcome them.

The measures you propose will not of course provide a complete solution to the problems our officials have discussed - in particular the concern about a surge in spending over the months before the new capital regime is introduced. I think therefore that your statement needs to leave open the way for further action without precipitating any avoidance measures. To that end I suggest two amendments to the draft statement as follows:

- (a) At the end of paragraph 1, you could strengthen the last sentence by deleting the words "two measures" and adding a new sentence at the end, "I have therefore decided at this stage to act against two potential abuses which have come to my attention."
- (b) I also suggest a new paragraph at the very end of the statement along the following lines:

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"My officials will continue carefully to monitor local authorities expenditure over months ahead. I shall not hesitate to take further action if necessary to ensure that the new local authority capital finance regime, and the transition to it, proceed in accordance with the Government's intentions."

I am copying this letter to the Prime Minister, Douglas Hurd, Peter Walker, Kenneth Baker, Paul Channon, Kenneth Clarke, Patrick Mayhew and Sir Robin Butler.

Yours sincerely,

P. Walker

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

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

13 February 1989

Dear Roger,

**LOCAL AUTHORITY CAPITAL FINANCE:
STABILISATION MEASURES**

The Prime Minister has seen your Secretary of State's letter of 10 February to the Chief Secretary. She is content for him to make an announcement along the lines proposed.

I am copying this letter to Philip Mawer (Home Office), Stephen Williams (Welsh Office), Tom Jeffery (Department of Education and Science), Roy Griffins (Department of Transport), Andy McKeon (Department of Health), Michael Saunders (Law Officers' Department) and Trevor Woolley (Cabinet Office).

*Yours
Paul*

(PAUL GRAY)

Roger Bright, Esq.,
Department of the Environment.

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