1. MR F E R BUTLER

2. CHIEF SECRETARY

1 Alex
2 C.

FROM: B H POTTER

Date: 27 August 1987

cc Chancellor
Sir P Middleton
Mr Anson
Mr Gilmore
Mr Hawtin
Mrs Lomax
Miss Peirson
Mr Scholar
Mr Turnbull
Mrs R Butler
Mr Pratt
Mr Perfect o/r
Mr Tyrie

* esp Sale-&-Leaseback

Cl
I agree that this looks promising
AA

I agree. The key problem is 4(v)/5(i). This* is what sank the old (pre-1981) loan sanction control. 5(ii) is much less of a problem! So far as housing is concerned, sales are driven by the demand from the tenants. N.

POTTER → CST 27/8

LOCAL AUTHORITY CAPITAL CONTROLS

As you know, work has been underway for some months on a new system for controlling local authority capital expenditure. DOE's proposals are now beginning to take shape. It will still be several weeks however before firm proposals can be put to Ministers. But, not least because colleagues may refer during the bilaterals to the need to reform the capital control system, you will wish to be aware of the progress to date and the planned timetable for action.

Need for reform

2. The Government is committed to reforming the present local authority capital control system, first because it failed to stop massive overspending in the period 1983-84 to 1985-86 and second because the growth in spending power from accumulated receipts has reduced the scope for allocations. The overspending problem is now less serious - partly because of cuts in allocations but also because in-year receipts have recently been higher than expected. But the reductions in allocations mean the present system is not good at matching provision and hence resources to needs. Services which generate few receipts - Transport, Education and Personal Social Services, suffer as a result.

? (LAs can vire freely).

The point is (this is what makes the ...) that the County Councils have the expensive services & finance but the District Councils have the bulk of the receipts.

Paying for Local Government Proposals

3. The Green Paper included proposals for a control on gross local authority capital spending. The public reaction was overwhelmingly hostile and the Environment Secretary announced in October 1986 that he would not go ahead with the planned reform in the 1986-87 Session. Annex A describes these proposals in more detail and why they failed.

New proposals

4. Department of the Enviornment have reconsidered their proposals and have developed a new scheme which concentrates on controlling borrowing for capital purposes and the use of capital receipts. The scheme would leave local authorities free to finance extra capital spending from own current revenue (ie local taxes), subject to the same constraints they face on current spending. The main features of the proposals are:-

i) control over new capital borrowing;

ii) control over use of accumulated and in-year capital receipts; 50 per cent of all cash backed receipts to be paid into new debt redemption funds and used to reduce net indebtedness;

iii) only temporary borrowing for revenue purposes allowed as at present;

iv) local authorities allowed to draw on revenue balances as at present;

v) capital borrowing to be broadly defined to include creative financing deals that postpone costs into the future.

5. The scheme looks promising. In principle, it could achieve the main Treasury objectives for the LA capital control regime of controlling total capital expenditure and matching resources

more closely to needs. But we are exploring some detailed practical aspects with DOE officials such as:-

i) how can the scheme best be designed to block existing and likely future creative accounting devices;

ii) how can the incentive to sell assets and generate capital receipts be maintained at the same time as taking into account capital receipts when distributing borrowing permissions?

Once the proposals are further advanced, we will also need to consider how the new scheme would fit in with our own proposals for a new public expenditure planning total.

Timetable

6. Department of the Environment propose to revise their proposals in the light of comments we have made on the details and show them to the other service departments concerned. Their timetable is as follows:

i)	detailed proposals considered collectively	Sept/Dec 1987
ii)	revised proposals published	Nov/Dec 1987
iii)	comments received	March 1988
iv)	legislation drafted	March/Oct 1987
v)	legislation on statute book and basis of 1989 Survey agreed	July 1987
vi)	new control system introduced	April 1990

Treasury has a particular interest in ensuring the details of the new system are clear by July 1989, so that the basis of the 1989 Survey discussions is clear.

Line to take in Survey

7. If colleagues complain about the existing control system, particularly its failure to match resources to needs, you may wish to refer to the fact that work is being done to develop a new capital control system. But as the timetable indicates, we will have to work with the existing system in this and next year's Surveys. Whatever its microeconomic shortcomings, colleagues must live with it so that total LA capital spending remains under control.

Action

8. We will try to sort out as many details as we can at official level so you are presented with a choice between:-

i) a system that concentrates on capital borrowing, as now proposed; and

ii) continuing to refine the existing system, probably by stopping the "cascade" of accumulated receipts and taking spending power into account when distributing allocations.

Department of the Environment are likely to seek your views on (i) in the next month or so before going to colleagues. We will provide a full assessment at that stage.

Barry H. Potter

B H POTTER

Annex A

PAYING FOR LOCAL GOVERNMENT: LA CAPITAL PROPOSALS

Objectives

The Paying for Local Government Green Paper identified three objectives for any control of local authority capital:

i. it should provide effective Government influence over aggregate levels of local authority capital expenditure and borrowing;

ii. it should promote asset sales;

iii. it should provide a sound basis for local authorities to plan their capital programmes.

Two possible approaches were discussed.

1. External borrowing limits (EBLs)

2. The Green Paper reported that the Government had looked closely at introducing a control over local authorities' total net external borrowing, for revenue and capital purposes. But severe practical difficulties were identified in setting tailor-made annual EBLs for more than 405 local authorities. If they could be solved, some safety value would be needed to cover unforseen expenditure, or shortfall in income. Local authorities would then be able to use the safety value to avoid restraining spending. All of the local authority associations, CIPFA and the Audit Commission rejected an EBL system.

2. Gross expenditure control

3. The Government saw more merit in a gross expenditure control. This would be much the same as the existing net expenditure control. But the PES forecast of in-year receipts would be excluded from the cash limit. And it was proposed to tackle a number of problems with the existing control system.

(a) Spending power from receipts

4. The Government proposed to take account of spending power from receipts when distributing allocations. No proposals were made to reduce the overhang of cash-backed accumulated receipts, though it was proposed to end the cascade under which the non-prescribed proportion of receipts is added to the backlog of accumulated receipts and the spending power from non-cash backed receipts would be abolished.

(b) **Revenue contributions to capital spending**

5. It was proposed to allow local authorities limited freedom to increase capital spending by financing it from local income. The Government proposed to restrict this freedom so the new gross cash limit could be met. But the comments on the proposals questioned the need to restrict the use of local income for capital spending beyond the constraints for current spending.

(c) **Leasing**

6. Finance leasing was to be brought under control. This has since been achieved by secondary legislation.

(d) **Other non-prescribed (uncontrolled) spending**

7. Other non-prescribed spending was also to be brought under control although the need for some exemptions was recognised. Housing repairs financed either by capital receipts or by local income is the major element of this spending; it remains to be brought within the control system.

(e) **Advance and deferred purchase schemes**

8. These schemes were to be brought under control. This was achieved by the Local Government Act 1987.

Reasons why gross expenditure control failed

9. The proposals for gross expenditure were:

i. **not integrated** with the proposals on local authority revenue spending; partly because it was envisaged that the new capital control system would be introduced two years before the community charge system.

(ii) **Insufficiently radical on receipts**. By failing to tackle the backlog of accumulated cash backed receipts, little room was created for improving the match of resources with needs. Tackling this backlog is essential if resources are to be released to distribute to areas of high need. The proposal to remove spending power from non-cash backed receipts irritated many local authorities even though it would have little real effect.

(iii) **Not designed to tackle creative accounting.** By the time Ministers came to take decisions in September 1986 new creative accounting devices were coming to light that would not have been stopped by the gross expenditure control system. These included sale and leaseback deals and creative accounting deals backed by local authority guarantees.

The comments from CIPFA, the Audit Commission and the local authority associations were hostile. Rather than proceed, the Environment Secretary announced on 15 October 1986 that improvements would be made to the existing system but no major overhaul to the capital control system would be made in the 1986-87 session of Parliament. The statement said:-

> "There would be obvious advantages in introducing changes in the arrangements for current and capital together"; implying that a new capital system will be in place by 1 April 1990.

pwP

FROM: A C S ALLAN
DATE: 2 September 1987

PS/CHIEF SECRETARY

cc Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Gilmore
Mr Hawtin
Mrs Lomax
Miss Peirson
Mr Scholar
Mr Turnbull
Mrs R Butler
Mr Potter
Mr Pratt
Mr Perfect
Mr Tyrie

ACSA → PS/CST 2/9

LOCAL AUTHORITY CAPITAL CONTROLS

The Chancellor has seen Mr Potter's minute to the Chief Secretary of 27 August, and agrees that the scheme now proposed by Department of the Environment looks promising.

2. He feels the key problem is creative accounting (4(v) and 5(i) of Mr Potter's note). This (especially sale and leaseback) is what sank the old (pre-1981) loan sanction control. He feels that the problem of maintaining the incentive to sell assets and generate capital receipts is much less of a problem: so far as housing is concerned, sales are driven by the demand from the tenant.

ACSA

A C S ALLAN