

CHIEF SECRETARY

FROM: B H POTTER
 DATE: 22 October 1987
 Chancellor
 Sir P Middleton
 cc Mr F E R Butler
 Mr Anson
 Mr Gilmore
 Mr Hawtin
 Mrs Lomax
 Miss Peirson
 Mr Scholar
 Mr Turnbull
 Mr Burr
 Mr Instone
 Mr Mowl
 Mr Pratt
 Mr Revolta
 Mr Perfect
 Mr Call

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FUTURE OF LOCAL AUTHORITY CAPITAL CONTROLS

E(LF)(87)41 sets out the Secretary of State for the Environment's proposals for a new control on local authority capital borrowing. Mr Ridley is seeking colleagues' endorsement of the broad outline of the system and agreement that a consultation paper should be prepared.

2. The proposals were foreshadowed in my minute of 27 August and we recommend you accept Mr Ridley's proposals which fully reflect our comments. The Chancellor has commented that the scheme looks promising but the key problem is creative accounting (discussed in paragraph 11 below).

Background

2^a The Government needs to reform the present local authority capital control system, first because it failed to stop massive overspending in the past 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 allocations have been cut to reflect the growth

in spending power from accumulated receipts but also because in-year receipts have recently been higher than expected. The latter has helped us to keep within the cash limit on net provision. 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.

3. Broadly two approaches were open (others floated earlier in the Green Paper and a Consultation Document have failed to attract support). The first was to improve the present system which aims to control expenditure:

- to stop the 'cascade' of receipts
- to allow Ministers to take account of access to capital receipts when distributing allocations; and
- to outlaw creative accounting etc.

But local authorities would not accept the further tightening of what is seen as an unfair control system, in order to achieve this. We have concluded, like DOE, that a new approach which can, inter alia, address these problems should be introduced.

The Proposed Scheme

4. The DOE proposals aim to control capital expenditure principally by controlling borrowing for capital purposes and the use of capital receipts. The scheme would leave local authorities free to finance extra capital spending on top of that from own current revenue (ie local taxes), subject to the same constraints they face on current spending. The proposals are set out in Annex A; in summary they 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;

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- (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.

Assessment

5. The Treasury's main objectives from the new capital control scheme are to control gross capital expenditure; to ensure better influence over the LABR; to achieve a closer match between resources and needs; to encourage asset sales (so as to reduce net provision); and to curtail as far as possible creative accounting.

(i) Control of capital spending

6. The proposals allow central government to constrain local authority spending financed by borrowing. Annual limits for such borrowing will be issued, and they are likely to be used in full. It should therefore be possible to forecast better the use of borrowing than the present use of allocations. Once the community charge is in place there will be no reason in principle to control local authority capital spending financed from local income more tightly than current spending financed the same way. So no separate control over locally financed capital spending is proposed; in practice, any substantial spending financed in this way would require significant increases in community charge.

7. We agree that restriction is needed on capital spending financed from the £10 billion accumulated receipts, so as to preserve some room within the expenditure plans for new borrowing permissions. But this is likely to be contentious and may well

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lead the Local Authority Associations to contest the proposals. At present, the principle is that all capital receipts can be used eventually; under this scheme, some proportion (probably 50%) will be used to redeem debt. It will be difficult to get this accepted: but it is an essential feature, if the 'cascade' problem is to be overcome.

(ii) Control over LABR

8. The new proposals will affect the LABR in five ways:

- (i) new capital borrowing will be annually controlled and the permissions issued by central government are likely to be used in full, so this element of the LABR will be predictable. If a local authority has a surplus on revenue account in one year it will be allowed to lend those revenue balances to its capital account provided this 'internal lending' scores against the borrowing limit.
- (ii) repayment of outstanding loans. Local authorities are required to make provision for debt repayment from their revenue accounts, and those payments help reduce the LABR. The size of these provisions will now be regulated to stop creative accounting devices. This will help improve our ability to forecast these flows.
- (iii) capital receipts will be controlled. We will need to forecast in-year receipts as at present. We will also have to forecast the likely use of capital receipts to increase spending; but this second source of error in the LABR forecast will become of less significance as the stock of accumulated receipts falls.
- (iv) revenue balances. Local authorities will remain free to draw on revenue balances.

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- (v) temporary lending for revenue spending. Local authorities will retain some ability to borrow in lieu of revenues receivable in year but not received, though we are aiming to ensure this borrowing is repaid when the revenues are received.

9. The proposals should help improve understanding of the relationship between constraints on local authority spending and the LABR. We expect significant improvements on items (i) (ii) and (iii) above. Local authorities will retain flexibility on (iv) and (v). But if we removed that flexibility local authorities would end up sending all unexpected bills to central government.

(iii) Matching Resources and Needs

10. Ministers will be allowed to take account of spending power from receipts when distributing borrowing permissions. This will improve the match of needs to resources and should command support from Departments and local authorities. It will also help to resist pressures for higher spending eg as advanced by Mr Baker in the Survey.

(iv) Asset Sales

11. Any improved matching of resources to needs, however, means that local authorities will tend to have less incentive to generate receipts (it will lead to fewer borrowing permissions). But so far as housing is concerned, sales are in any case largely driven by tenant demand. Moreover, if only a proportion of receipts is taken into account, LAs will retain some incentive to sell assets. And other manipulations like taking account of potential rather than actual receipts could help sustain the incentive. But the biggest disincentive to sales is the intention to set aside around 50% of receipts for debt redemption. On balance, the new scheme must involve rather less incentive for the LA to generate asset sales.

(v) Creative Accounting

12. Creative accounting deals will score against the annual

borrowing limit or be banned. Officials are making good progress on a suitably wide definition that catches all such deals. This work needs to be completed so the results can be reflected in the proposed consultation paper.

Housing

13. It is intended that housing should be outside the scope of this system. DOE are revising their proposals for a separate local authority housing regime. For central government planning and control purposes it would be possible, if necessary, to split housing from other local authority capital spending and run the two regimes separately. But we shall need to look carefully at the implications of a separate ring fenced housing system. For example, if local authorities' freedom to vire housing receipts to other services were ended, this would increase pressure for more borrowing permissions for education and "other services".

Conclusion

14. We recommend that you endorse the broad outline of the scheme. The next step will be the preparation of a consultation paper. We will need to be involved at official level.

Barry H. Potter

B H POTTER

THE PROPOSED SYSTEM

The details are set out at paragraphs 5-9 and Annex A to E(LF)(87)41.

Annual approvals for borrowing to finance capital spending

2. Local authorities will be given annual borrowing approvals. But if a local authority is running a surplus on revenue account it will remain free to lend that money to capital account, provided that 'internal lending' scores against the borrowing permission. If the revenue balance is run down in subsequent years, the authority will be able to externalise the lending - increasing the LABR. This basic approach is favoured by local authorities which generally accept the need for central government control on borrowing.

Creative accounting

3. Creative accounting deals will score against the annual borrowing limit or be banned. Officials are making some progress on a suitably wide definition that catches all such deals. This work needs to be completed so the results can be reflected in the proposed consultation paper.

Capital receipts

4. Spending power from capital receipts will be tackled in three ways:

- (a) the notional spending power from non-cash backed receipts will be abolished - reducing the level of accumulated receipts by around 40 per cent. This spending power can only be used if cash is found from new in-year receipts or revenue account and both these sources of cash can be used to increase capital spending under these proposals.

- (b) It is proposed that 50 per cent (or so) of all cash backed receipts will have to be set aside to repay debt; otherwise the receipts can be freely used for capital spending. This is a broadbrush way of ensuring that when assets are sold a proportion of the receipts are used to repay the loans incurred when the assets were created. It will also stop the cascade of accumulated receipts and ensure the backlog is quickly run down.
- (c) Ministers will be allowed to take account of spending power from receipts when distributing borrowing permissions. This will help match needs to resources. The drawback is that it will reduce the incentive to generate new receipts. So far as housing is concerned sales are largely driven by demand from the tenant. And Ministers will be able to ensure that some incentive is retained by not reducing borrowing permissions by 100 per cent of spending power from receipts.

Debt redemption

5. Regulations will be introduced to ensure local authorities do make adequate provision for debt redemption from revenue account. A few local authorities have been manipulating the provision they are presently expected to make to reduce spending for RSG purposes.

Calculation of borrowing approvals (Paragraphs 10-11 of E(LF) paper).

6. Initial calculations suggest borrowing permissions under this system will be slightly higher than allocations would be, largely because the category of non-prescribed (uncontrolled) capital spending will be abolished. However, the growing spending power from receipts under the present system will probably squeeze the room for borrowing permissions in 1990 below current levels of allocations (unless provision is increased). Once the proposed system is in place, spending power from accumulated receipts

is likely to be used up more quickly than new spending power is generated. This will increase the level of new borrowing permissions consistent with a given level of provision, easing the Survey pressures on local authority capital.

7. Spending departments may be eager to discuss how the proposals will affect them. Officials have had a preliminary discussion of the Survey arrangements and no difficulties have emerged - however decisions are not needed until 1989. Three points are clear:

- (i) the larger the percentage of receipts set aside to repay debt, the greater the room for borrowing permissions;
- (ii) if 50 per cent of capital receipts have to be set aside for debt redemption as now assumed, the room for borrowing permissions will be higher than it would be for allocations (for a given level of provision and receipts);
- (iii) It will be possible for departments to take account of a proportion of spending power from receipts. So each department could determine a gross needs figure that included an element of spending power from receipts, as well as new borrowing permissions. This will substantially increase the scope for matching needs to resources.

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From The Secretary of State for Wales

The Rt Hon Peter Walker MBE MP

26 October 1987

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E(LF)(87)(41): FUTURE OF LOCAL AUTHORITY CAPITAL CONTROLS

I thought it might be helpful if I set out my comments on this paper in writing in advance of Tuesday's meeting.

I am somewhat unhappy that we are discussing the capital control system in isolation from new proposals on housing finance when, after all, housing and in particular housing receipts is the most significant single component in the local government capital package. Certainly by the time any consultation paper is issued to local government I think we need to be in a position to describe at least in general terms the linkages between the proposed capital control system and changes to housing finance.

That apart I am content for Nicholas Ridley to work up these proposals and to draft a consultation paper. Clearly though there are a number of points which will need to be explored more fully during that process; I see the following as amongst the more important:

Papar para 4; I am not sure that local authorities' judgements on community charge levels will necessarily lead to the level of capital expenditure which we want. I would prefer a more direct control on revenue contributions to capital expenditure;

Papar para 11; I would prefer to continue to issue approvals on the basis of service blocks ie "housing" and "non housing" in the case of Wales as well as being able to link specific elements with specific projects. I am therefore happier with the description at para 5 of the annex than with the rather ambivalent phrasing on para 11 of the main paper;

/...

The Rt Hon Viscount Whitelaw CH MC
The Lord President of the Council
Privy Council Office
68 Whitehall
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Annex para 20; The treatment of receipts will have to be looked at carefully. There must be some incentive to authorities to raise receipts, there may be a case for taking only a proportion of their receipts capacity into account when making borrowing approvals, or for allowing a 100% addition to their approval level. As at present I would need to have the power to set different proportions in Wales;

Annex para 25; I do not think that, politically, we can simply wipe out existing accumulated receipts which do not happen to be backed by cash. Local authorities, rightly or wrongly, would simply represent this as a seizure by central Government of their money.

Annex para 27; It seems to me that repair and maintenance should continue to be treated as capital expenditure. The 'wider consents' would need to be exercisable separately in Wales.

/ I am copying this letter to other members of E(LF) and to Sir Robert Armstrong.

A large, stylized handwritten signature in black ink, consisting of several sweeping loops and a final flourish.