

FROM: R FELLGETT
DATE: 7 April 1988

1. MR PHILLIPS *See separate note. HP 3/4*
Copies attached for:
PS/Chancellor
Sir P Middleton

2. CST

cc Mr Anson o/r
Mr Hawtin o/r
Mr Turnbull
Mrs Case
Miss Peirson
Mr Gieve
Mr Potter
Mr Burns

1989-90 RATE SUPPORT GRANT SETTLEMENT FOR ENGLAND

This submission offers advice on the approach you might take to the forthcoming discussions of the RSG settlement for England for 1989-90. It discusses the main elements of the settlement - Aggregate Exchequer Grant (AEG), provision for relevant public expenditure and aggregate GRE. When you have considered it, I expect you will wish to discuss it with us.

Background

NB | 2. At Annex A is a short history of RSG settlements since 1979 and trends in local authority spending. The 1988-89 settlement involved an announced increase in AEG of £750 million. But with higher grant penalties than in 1987-88 (mainly because the level of expenditure provision, against which overspending is measured, was less realistic than for the earlier year) the increase in grant at outturn is now estimated to be around £550 million. This is a significantly tougher settlement than for 1987-88. Partly as a result, there are encouraging signs that the rapid rate of growth of local authority spending has started to slow down a little.

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3. The settlement for 1989-90 will be the last one under the present RSG system. From 1990-91, with the introduction of the Community Charge system, local authorities will lose just over half their independent taxing powers, because business rates will be indexed to the RPI. The consequent shortfall in business rate revenue will have to be met by a combination of slower growth in spending, higher increases in grant, and higher increases in Community Charges (CCs).

4. A steady increase in grant, with a small increase in real terms each year, seems the right medium-term approach after 1990. Larger increases in grant would undermine the accountability link between the level of CC and expenditure, which the new system is intended to promote, whereas smaller increases in grant would create intolerable pressures on the CC. If it can be achieved, despite all the pressures to subsidise CCs with generous increases in grant, this approach should moderate the growth in local authority expenditure after 1990. The 1989-90 settlement could form a useful precedent.

Objectives

5. The general objective of the RSG settlement for 1989-90, should be to encourage a further fall, and certainly avoid any rise, in the underlying rate at which local authority current spending is increasing. It has recently risen faster than money GNP, requiring tougher constraints on other expenditure to achieve a fall in the GGE:GNP ratio. In the longer term, it would be helpful to get the growth rate in LA current spending down to that in money GNP, and ideally reduce it further so that local authorities made a contribution to reducing the GGE:GNP ratio, in line with the overall objective for public expenditure.

essential
(though diff)

Aggregate Exchequer Grant

6. Grant is the main tool available in the RSG system to influence spending. I therefore suggest that your objective in discussions with colleagues should be to aim for an increase in AEG at outturn

of no more than £550 to £600 million. The lower figure would be similar to the cash increase expected under the 1988-89 settlement; the higher one could be justified by the extra costs local authorities face in preparing for the CC. These figures would (on the latest FSBR GDP deflator) represent a real increase in grant of about $\frac{1}{4}$ - $\frac{3}{4}$ %.

7. We could aim for an even tougher settlement on the grounds that 1989-90 is the last chance to cut grant in real terms before the CC system comes into operation. A real cut would be a firmer signal to local authorities to control their spending under the CC regime. To the extent that it meant higher rates that could make the subsequent CC more attractive and it would increase the starting poundage for the National Non Domestic Rate. You might use this as the basis of your opening stance in negotiations.

8. However, it does not seem a realistic objective for the outcome of the negotiations. There are no overriding difficulties with public expenditure control, or economic conditions generally, that would support such a line. It would appear inconsistent with Government priorities for education, law and order and other local authority services. It would be difficult to apply to Scotland, where the CC is to begin in 1989; and a noticeably more accommodating RSG settlement for Scotland than for England in 1989-90 would be an awkward precedent. A real cut in grant would be seen as a one-off settlement before the CR regime; an offsetting large increase in 1990-91 would be hard to avoid and, as a precedent for later settlements under the CC system, that would not be in the longer term interests of public expenditure control (or the credibility of plans for grant in the new planning total).

9. Indeed, we do not underestimate the difficulties of securing an agreement along the lines proposed. It would be seen (and attacked in some quarters) as a tough settlement. It would involve a reduction in the announced grant percentage (the ratio of AEG to all relevant expenditure announced in the settlement) of about $1\frac{1}{2}$ percentage points. In contrast, for 1987-88 and 1988-89 the

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is

percentage barely changed. For reasons explained below, an increase in AEG of £550-£600 million for 1989-90 at outturn will require the same increase to be announced in the settlement significantly less than the equivalent increases of £750 million for 1988-89 and £1.2 billion for 1987-88.

10. DOE will no doubt advise Mr Ridley to argue strongly for AEG to be based on the same percentage announced in the 1987-88 and 1988-89 settlements, mainly on the grounds of stability in the RSG system in its last year and to set a high base for grant under the new planning total and CC system, where the safety net from 1990-91 to 1993-94 will be based on grant and rate income in 1989-90. This grant percentage would lead to an increase in AEG of around £1 billion, or 8%. We cannot see anyway of squaring an unchanged grant percentage with an increase in AEG of £550 to £600 million; expenditure provision would have to be set so unrealistically low that it could be subject to legal challenge. The arguments in favour of an unchanged percentage will therefore have to be faced and argued against in the following terms:

i. an increase of £1 billion - twice the forecast GDP deflator - would give totally the wrong signal to local authorities in the last year before CC, and would encourage them to increase the rate of growth in their spending again, and would thus make the CC policy harder to implement;

ii. it amounts to financing (albeit about one year in arrears) a predetermined proportion of whatever local authorities decide to spend, to which there are public expenditure policy objections, pay policy objections (because 80% of spending is pay), and perhaps political objections (as many local authorities are controlled by the Government's political opponents);

iii. the grant percentage will in fact change anyway, because with the transfer of polytechnics from local to central government control, their full cost of about £800 million (and not a percentage of their cost) will be deducted from AEG.

You will recognise much of the first two arguments from last year's discussions. It may again prove difficult to persuade colleagues of their force, if they take the view that an unchanged grant percentage is necessary for the stability of the RSG system in its last year, and to set a higher base for levels of AEG and the safety net under the CC system.

11. On the other hand, much of the political difficulty with reducing the grant percentage comes from consequent higher increases in rates; a firm grant settlement not only reduces expenditure but results in higher rate rises. But uniquely in 1989-90, rates are unlikely to be greatly affected by the RSG settlement. Labour authorities (as Strathclyde have done in Scotland for 1988-89) may decide to freeze rates to make the subsequent Community Charge look relatively less attractive. Shire county elections in May 1989 may also help keep rates down. Conversely, high increases in rates would presumably cause the Government less political difficulty than in other years. It may therefore be easier to secure the agreement of colleagues to a cut in the grant percentage, particularly if that meant in reality the same increase in the quantum of grant as for 1988-89. (Average increases in rates should then be roughly 8%, although, as already noted, rates increases in 1989-90 may bear little relationship to underlying changes to grant and expenditure).

Expenditure Provision

But main impact via grant %
12. Provision for local authority current expenditure has no direct effect on local authority spending, although it may have some effect as a signal. We anticipate that English local authorities will set budgets around £1¼ billion above the PEWP plans in 1988-89; this will be a claim on the Reserve. A transfer from the Reserve of about £1½ billion will be necessary for 1989-90, if provision is set equal in real terms to budgets for 1988-89 plus a small addition for CC costs.

13. There are arguments for a larger transfer from the Reserve to allow for a small real increase in local authority expenditure

in 1989-90. It is unrealistic to plan for local authority spending to show no real rise over the two years, when it has been increasing 4-5% per annum in real terms recently and, at least for some local authority services, there are a pressures to accommodate new demands and new policies. However, higher and more realistic provision would lead to smaller grant penalties in 1989-90 than in 1988-89, because penalties are broadly based on the excess of expenditure over provision. To achieve an increase in AEG at outturn of £550-600 million, the increase announced in the settlement would have to be even less. We doubt if this could be agreed. Provision will therefore have to be based on a transfer from the Reserve of only about £1½ billion. In that case, the figures for AEG would be:

	1988-89	objective for 1989-90	£ billion
announced:	13.00	13.55 - 13.60	
outturn:	12.45	13.00 - 13.05	

14. A transfer from the Reserve of £1½ billion, which allowed for no real growth in spending compared to 1988-89 local authority budgets, is unlikely to be welcomed by colleagues in spending departments; you will recall the difficulty last year in agreeing provision for DHSS. However it would allow for an average increase in departmental plans, compared to the plans in Cm 288 (not LA budgets) of about 8%. That should be defensible.

GRES

15. Finally, I suggest that you argue for the minimum possible increase in GRE. This is widely regarded as an expenditure norm and the point at which an authority "goes into grant penalty". (In fact, unlike the old target and penalty system, grant is withheld in response to an increase in spending at all levels of expenditure, not just those above GRE; and the rate of loss increases at GRE + 10%). GRE does form the basis of selection for rate capping. A low increase in GRE will therefore help moderate the rate of increase in expenditure. It should be possible to secure an

increase for the majority of services close to the GDP deflator, with extra as necessary for some services like the teachers and police where pay (and manpower for the police) are approved by central government, and some addition to allow for the costs of preparing for the Community Charge.

Other options

16. For completeness, I should mention that we have considered and rejected the option of proposing the reintroduction of target and penalties. However attractive in expenditure control terms, we conclude from the last RSG round that they are not, in political terms, a credible option.

17. We also doubt if you could propose any option involving further complicated and controversial local government finance legislation without Mr Ridley's backing; the business managers would undoubtedly be strongly opposed. It therefore seems that the "frozen grant" idea, which was discussed briefly before the last round, is not a serious option for 1989-90. DOE officials have indicated to us that it is not part of their thinking, or Mr Ridley's. In any case, one of the attractions of the frozen grant idea was that it would involve closing down the present RSG system and ceasing to make grant adjustments in respect of earlier years: this point is being pursued separately.

Polytechnics

18. If has been agreed and announced that, when the polytechnics and other colleges are transferred out of local government control in April 1989, a sum equal to pooled expenditure on these colleges will be deducted from AEG. This is to ensure that the transfer has no direct effect on either ratepayers or central taxpayers. For simplicity, all the figures above exclude an equivalent amount for all years: thus, for example, the announced total of AEG for 1988-89 is taken as £12,966 million and not the £13,775 million actually announced for the year, because £809 million has been subtracted for the polytechnics. (The precise adjustment has still to be calculated and agreed with DES; and there will be

complications in Scotland, where the equivalents to polytechnics are already a central government responsibility and in Wales, where the polytechnics will remain in local government.)

The figures

19. Many of the figures quoted in this submission are still uncertain; we will not be able to estimate local authority budgets for 1988-89 or any projections based on them with more precision until the full budget returns have been received by DOE, hopefully during May.

Tactics

20. Agreement will need to be reached in E(LA). This is not, however, a Committee on which you will find many natural allies. Mr Ridley may wish to see a tougher settlement than colleagues with spending responsibilities. You may therefore feel that there would be advantages in trying to secure the maximum possible agreement with Mr Ridley before the formal E(LA) sessions start, probably in late May. Although we have received no approach yet from DOE, in previous years Mr Ridley was inclined to seek agreement with you or your predecessor bilaterally, or at least explore options, beforehand. He may prefer to avoid a protracted haggle in Committee.

21. If you decide to meet Mr Ridley during April, you might explore whether he was interested in a grant settlement along the lines we have suggested above. If you decided to reveal your hand, you could describe it to him as an offer to increase grant in line with the GDP deflator, plus an addition of (say) £50 million (giving £570m in all) towards the cost in current expenditure of preparation for the Community Charge.

22. Any private discussions would obviously have to be on the basis that, unless they produced an agreement that you could take jointly to E(LA), you would withdraw any offer that you made and start from a tougher position in Committee. One option for

E(LA) would be to base your position on the announced baseline for expenditure provision for 1989-90 in the latest White Paper, and the arguments for a very tough line set out in paragraph 7.

23. You may also feel that it would be worthwhile discussing your objectives in broad terms with Mr Parkinson (who will be chairing E(LA)). And in the light of discussions with Mr Ridley and Mr Parkinson, it might be worth acquainting the Prime Minister with the approach that you decide to take.

Conclusion

24. The preliminary conclusions of this submission, which has been agreed with GEP, are therefore:

i. the overall Treasury aims should be a firm settlement to encourage a further reduction in the underlying growth rate of local authority current spending in 1989-90 and later, and to set a useful precedent for the Community Charge regime from 1990-91;

ii. more specific objectives for the outcome of discussions with colleagues are: an increase in AEG of no more than £550-600m, an increase in provision involving a claim on the Reserve of about £1½ billion, and an increase in GRE for most services of about 4% (the GDP deflator). We do not underestimate the difficulty of securing such an agreement, which would be seen as a tough settlement. Tactically, however, you will wish to start from a tougher position;

iii. it would probably be worthwhile discussing the options privately with Mr Ridley before E(LA) begins its discussions; and it could be useful to talk also to Mr Parkinson (and, in the light of those discussions, possibly briefly to the Prime Minister).

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History

A1. In the first two years of the present Government up to 1980-81, the RSG system inherited from the previous administration contained a presumption that the Government would finance a given percentage of local authority spending. In fact, some reductions in this "grant percentage" were made, with a view to discouraging local authority public expenditure. Over the 2 years, the percentage fell by about 2½ percentage points from 59.8% to 57.2% of expenditure. Continuing real growth in local authority current spending of about 2½% a year in real terms dragged grant up by £2.7 billion in cash over the two years, although with high inflation this represented a real cut of 2%.

A2. The introduction of the new block grant system for 1981-82, the application for targets for local authority spending and penalties for exceeding them for 1982-83, and a series of tough grant settlements contributed to a slow down in the rate of increase in local authority current spending to just ½% a year in real terms from 1981-82 to 1985-86. Over these 4 years grant increased by only £0.9 billion, the grant percentage fell by 8½ points, and there was a reduction in the real value of grant of 13%.

A3. The Settlement for 1986-87 was designed to place constraints and incentives on authorities which would result in a claim on the Reserve for no more than £½ billion. Targets and penalties were abandoned, but the slope of the poundage schedule steepened so that a majority of authorities were entitled to less grant if they spent more. Grant was planned to increase at outturn by around £½ billion. In the event, this proved unsuccessful. The claim on the Reserve was for £2 billion. The abolition of targets and penalties not only removed a significant constraint on spending, but allowed authorities to manipulate their books to reclaim around £½ billion of penalties paid in earlier years (with the consequence that grant for 1986-87 was not, in fact, higher than outturn for 1985-86).

A4. Since 1986-87 local authority current spending has been increasing in real terms by around 4-5% a year. There is

Therefore a strong argument that the abandonment of targets and penalties, and the subsequent more generous RSG Settlements for 1987-88 and 1988-89, have removed a major constraint on local authority expenditure. On the other hand, some part of this real growth will have been a "catching-up" following up the earlier tougher financial regime, which arguably would have happened anyway at some stage. And because lower inflation has not been accompanied by equal reductions in nominal increases in earnings, real increases in pay have placed local authority spending under pressure - around 80% of net current spending by local authorities is pay and similar items.

A5. The 1987-88 Settlement was the most generous since, at least, the early years of the present Government. The amount of grant available was increased by £1.2 billion, including extra sums for teachers' pay, based (I believe for the first time under the present Government) on an unchanged grant percentage. However with the abolition of "grant recycling" which paid back to all local authorities grant withdrawn from high spenders, the increase in grant at outturn is likely to be around £950 million.

A6. The Settlement for 1988-89 was also notionally based on a little-changed grant percentage, with an increase in the grant available of £750 million. In practice, provision for spending was set (artificially) even lower than a realistic estimate, which both reduced the increase in grant at a fixed percentage and increased the amount of grant recovered as a consequence of authorities in aggregate overspending this plan. At outturn, grant is likely to rise by around £550 million.

A7. There are now some preliminary indications that the rate of growth in local authority spending may be slowing down a little in 1988-89. This has yet to be confirmed, and the rate of growth will fall by no more than a percentage point. If a slowing down is taking place, it is likely to be the consequence of: a tougher RSG Settlement for 1988-89 than for 1987-88; the effects of rate-capping, which are finally being seen in lower expenditure policies in a number of previously very high spending areas; the Government's additional control on teachers' pay through the Interim Advisory Committee; and less need for "catching up" now that targets and penalties have been abolished for some years.

FROM: H PHILLIPS
DATE: 8 April 1988

CHIEF SECRETARY

Ch

*It is essential to be tough on provision (even though this is partly illusory). cc
Lower provision means, for any given level of grant, a higher grant percentage, which Mr Ridley cares about a lot.*

PS/Chancellor - 2nd
Sir P Middleton
Mr Anson o/r
Mr Hawtin o/r
Mr Turnbull
Mrs Case
Miss Peirson
Mr Gieve
Mr Potter
Mr Burns

1989-90 RATE SUPPORT GRANT SETTLEMENT FOR ENGLAND

The attached submission from Mr Fellgett recommends that the Treasury should aim for another firm settlement in this year's E(LA) negotiations on grant and provision for local authority current expenditure in England. The following are considered to be realistically achievable targets for the negotiations:

- a very small real increase in Aggregate Exchequer Grant (AEG) at settlement of £550-600 million (cf £750 million for 1988-89 and £1.2 billion for 1987-88);
- an increase in provision for LA relevant public expenditure leading to a claim on the Reserve of about £1½ billion; and
- aggregate GRES set broadly constant in real terms.

2. I agree with Mr Fellgett that this package represents an achievable and acceptable settlement for the Treasury. Following the 10% real increase in LA spending over the preceding two years, a tougher settlement was negotiated in E(LA) last year. The indications from local authorities' budget information for 1988-89 are that this has resulted in a slower

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projected rate of increase in LA spending. Our aim should be to build on this year's improvement and reach an equally tough settlement that will reinforce the downward pressure on the underlying rate of growth in LA expenditure.

3. We considered taking a more aggressive stance and seeking real cuts in grant with the aim of inducing nil growth or even a real fall in LA expenditure. But in the last year of the present system it is unlikely that Ministers in E(LA) would be prepared to risk a major confrontation on grant and spending with local government - especially since local authorities' acquiescence, if not their full support, will be necessary next year in preparing for the Community Charge and in introducing major new policies, particularly on education. Nor would a real cut in grant necessarily be in the Treasury's medium-term interests. It would be widely seen as a last ditch attempt to cut LA spending before the new system was introduced. The cut in grant would almost certainly then have to be reversed for 1990-91 to keep Community Charges down to politically tolerable levels. Starting the new system with a major injection of grant, which would then form the base for the safety-net grant up till 1993-94, would give wholly the wrong signals to local authorities and to chargepayers.

4. But the difficulties in achieving even the firm settlement we have in mind are formidable. We expect the Secretary of State for the Environment and other Departmental Ministers to argue for "stability" and a "quiet settlement" in the last year of the present system. They will seek to interpret that as requiring the current grant percentage (broadly the ratio of AEG to provision for LA relevant expenditure) to be maintained, following the near-stability attained in the last two settlements. Such a settlement would add about £1 billion to grant compared to our target of £550-600 million - and there is no real scope to narrow that gap by squeezing provision.

5. There is therefore very little choice but to move colleagues off the concept of a stable grant percentage. As you are already

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But must squeeze as much as possible.

aware, there are powerful arguments which you can adduce against a fixed percentage: it amounts to a Government commitment to meet a constant proportion of LA expenditure - including overspends against provision. But convincing colleagues of this, even in the last year of the present system, will be a difficult task.

6. Moreover E(LA) contains few natural Treasury allies. Indeed past experience suggests that Mr Ridley may well wish to see a tougher settlement than others at E(LA); he also has a strong personal dislike for set-piece battles in the Survey and E(LA). We therefore recommend that, as a first step, you see how far a settlement can be reached bilaterally beforehand. You may wish to await the first contact from Mr Ridley or consider a pre-emptive strike. And, since any settlement will have to be approved by E(LA), we suggest it would be helpful to make Mr Parkinson aware early on of the Treasury's objectives for this year's E(LA) settlement.

7. You will now wish to consider both the substance of the recommendations and the proposed tactical handling contained in the submission and perhaps then discuss them further with us.

HP.

HAYDEN PHILLIPS