

CHIEF SECRETARY

FROM: B H POTTER

Date: 3 June 1988

cc: PS/Chancellor
 Sir Peter Middleton
 Mr Anson
 Mr Phillips
 Mrs Case
 Mr Edwards
 Miss Peirson
 Mr Turnbull
 Mr Fellgett
 Mr Call

**MEETING WITH SECRETARY OF STATE FOR ENVIRONMENT: DISCUSSION
 ON 1989-90 RSG SETTLEMENT**

I attach two briefing notes for your meeting next Tuesday with the Secretary of State for Environment on the 1989-90 RSG Settlement.

2. The first from Mr Fellgett provides a brief on the key features of the RSG Settlement, the quantum of grant and the provision for relevant public expenditure. My separate brief covers rate capping in 1989-90, in case this is raised in the discussions.

Tables for meeting

3. Attached are two tables, prepared by DOE officials and agreed with us, as the factual basis for your meeting with Mr Ridley. Table 1 describes the options as follows:

- on provision: options 1-4 (+ £1.6 billion; + £1.3 billion; + £1.1 billion; + £0.8 billion respectively above PEWP provision)

*Review to all
 subject to all
 un-sure with Mr. Phillips
 before (LA) - He says on no
 direction of the, too, whatever
 his approach was in*

- on AEG: option A (DOE fixed grant percentage of 44.7%);
option B an addition of £520 million at settlement.

Table 2 describes the impact of different combinations of grant and provision options on rate increases and the levels of Community Charge in 1989-90, for given assumptions about local authorities' spending behaviour.

Briefing line from DOE officials

4. Since Mr Fellgett's brief was prepared we have a clearer understanding of the line Mr Ridley is being briefed to take at the meeting. This is as follows:

- not to reach an agreement with you on either grant or provision;
- to see whether an understanding can nevertheless be reached that "extreme" options - that is options 1 and 4 on provision and option B on grant - can be dropped before Mr Ridley's paper goes to E(LA);
- to give no ground on the grant percentage argument;
- to accept there may be flexibility on the financing items within relevant expenditure (so that a lower quantum of grant can be consistent with a fixed grant percentage); but not to offer any particular amounts;
- not to discuss GREs, unallocated margins or rate limitation.

5. DOE officials' strategy appears to be to get our options on provision and grant off the table and then to rely on pressure from the spending Ministers in E(LA) to force up the provision figure to option 2. With a fixed grant percentage, that would increase grant at settlement by over £1 billion. However DOE officials have hinted that Mr Ridley might be reluctantly persuaded to accept option 3 on provision.

Line to take

6. If Mr Ridley takes the uncompromising line suggested by his officials, the meeting will not prove very helpful. You will not wish to offer any movement away from option 4 on provision and option B on grant. You should draw on the key arguments in Mr Fellgett's brief against the big injection of grant under Mr Ridley's favoured option - option 2 on provision, and option A on grant. In particular why push more grant in now in pursuit of popular low rate rises just when rates are being abolished? The very best that might be achieved from such a discussion would be some understanding that Mr Ridley might be prepared to adopt option 3 on provision and agree that the scope for squeezing the financing items (to square a lower quantum of grant with a fixed grant percentage) should be explored by officials.

7. But, whatever his officials may advise, Mr Ridley may still be attracted to reaching a fairly firm understanding with you before E(LA) meets on 22 June. Time constraints have increased the pressure on him to get a swift agreement. Mr Fellgett's brief sets out the line to take but the way towards such an understanding is summarised below. However, how far you feel able to go must depend upon Mr Ridley's stance at the meeting.

- i) The starting gap on AEG between Mr Ridley's lowest bid - option 3, fixed grant percentage (AEG = £13,920 million) - and your grant figure (AEG = £13,495 million) is £425m.
- ii) You might offer another £110 million on AEG - but only on the non-committal basis that this is for the purpose of exploring how far the gap between you and Mr Ridley might be bridged. This £110m could be seen as grant to cover Community Charge preparation costs.

- iii) You could indicate that your officials believe it should be possible to increase the allowance for special funds (see paragraph 4 of Mr Fellgett's brief) so as to reduce relevant expenditure and hence the amount of grant consistent with a fixed grant percentage by a further £150m.
- iv) There may be room for some further minor adjustments on financing items to reduce the gap by up to a further £25m.
- v) The outstanding gap would then only be £140m on grant. You might seek some gesture on grant from Mr Ridley indicating that, on that basis, you would then reluctantly accept option 3 on provision.

8. While paragraph 6 above describes the minimum objectives we should secure the most that might be gained would be an understanding, as follows. You would indicate that you might be prepared to accept, albeit reluctantly, a fixed grant percentage in 1989-90; but only if Mr Ridley will support option 3 on provision and agree that officials should find ways of reducing the amount of grant consistent with the fixed grant percentage by more than £150 million below the figures included in the tables. Should any such understanding be achieved, we will then need to consider how the E(LA) meeting should be handled. I think DOE officials are right to take the view that too obvious or too early a joint approach from you and Mr Ridley might lead service Ministers to dig in for a more generous settlement.

Fixed grant

9. Finally Mr Ridley may refer to another idea which has suddenly re-emerged - a fixed grant settlement. The basic idea is that grant would be paid on a notional amount of

expenditure set at 1988-89 budgets + X%, rather than actual expenditure. So there would be no underclaim of AEG at settlement, because grant would not be lost if an LA's budget exceeded the notional amount set.

10. The advantages are that it provides a way of closing down the RSG system and avoiding the scope for creative accounting for the last (and all preceding) years of the present system. Such creative accounting could be expensive to the Exchequer in terms of additional grant claimed. But the disadvantages are that we would lose all grant underclaim in 1989-90. The balance between the two in terms of Exchequer cost is unclear and we will need to do more work before being able to advise on the merits. (It is not even clear yet whether Mr Ridley himself will want to pursue fixed grant.) I would not therefore advocate that you raise the idea on Tuesday: but if Mr Ridley does so you could express interest without any commitment.

Barry H. Potter

BARRY H POTTER

Changes in Provision and Grant

| <u>Provision Option</u> | <u>Grant Option</u> | <u>Increase in AEG</u> | | <u>(AEG % at Outturn)</u> |
|---|---------------------|------------------------|---------------------|-------------------------------|
| | | <u>At Settlement*</u> | <u>At Outturn**</u> | |
| 1. £29350m : GDP+1 £1.6bn above PEWP | A £14148m : 44.7% | £1173m | £1536m | (44.0%) |
| | B £13495m : 42.6% | £520m | £887m | (41.9%) |
| 2. £29100m : GDP £1.3b above PEWP | A £14036m : 44.7% | £1061m | £1295m | (43.6%) |
| | B £13495m : 43.0% | £520m | £760m | (41.9%) |
| 3. £28840m : GDP-1 £1.1bn above PEWP | A £13920m : 44.7% | £945m | £1039m | (43.1%) |
| | B £13495m : 43.3% | £520m | £621m | (41.8%) |
| 4. £28590m : GDP-2 £0.8bn above PEWP | A £13808m : 44.7% | £833m | £782m | (42.6%) |
| | B £13495m : 43.7% | £520m | £477m | (41.7%) |

* Change between AEG at 1988/89 settlement and AEG at 1989/90 settlement.

** Change between AEG at budgets in 1988/89 and AEG payable for spending at 3% above Option 2 Settlement Expenditure Assumption.

Background 1988/89 settlement (adj for polytechnics)

| | |
|-------------------|-----------------|
| Provision | £26836m |
| Budgets | £27866m |
| AEG at settlement | £12976m (42.7%) |
| AEG at budget | £12389m |
| Underclaim | £587m |

IMPLICATIONS OF OPTIONS FOR 1989/90 RATE SUPPORT GRANT SETTLEMENT

| | Spending at Settlement Expenditure Assumption | | Spending at 1.5% above Option 2 Settlement Expenditure Assumption | | Spending at 3% above Option 2 Settlement Expenditure Assumption | |
|--------------------------------------|--|------------------|--|------------------|--|------------------|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| PROVISION OPTION 1 (£29,350m) | <u>GRANT (A)</u> | <u>GRANT (B)</u> | <u>GRANT (A)</u> | <u>GRANT (B)</u> | <u>GRANT (A)</u> | <u>GRANT (B)</u> |
| AEG at Settlement: | £14,148m | £13,495m | £14,148m | £13,495m | £14,148m | £13,495m |
| | 44.7% | 42.6% | 44.7% | 42.6% | 44.7% | 42.6% |
| AEG + rebates at Settlement: | 49.1% | 47.1% | 49.1% | 47.1% | 49.1% | 47.1% |
| Grant underclaim | - | - | -£34m * | -£35m * | £157m | £153m |
| Average rate increase: | | | | | | |
| Non-rate limited | .3% | 4.1% | 1.5% | 5.2% | 4.9% | 8.6% |
| All authorities | -.5% | 3.0% | .6% | 4.0% | 3.6% | 7.1% |
| CC at need (CCSN) | £216 | £234 | £216 | £234 | £216 | £234 |
| CC at spending level | £233 | £251 | £237 | £255 | £247 | £265 |
| PROVISION OPTION 2 (£29,100m) | | | | | | |
| AEG at Settlement: | £14,036m | £13,495m | £14,036m | £13,495m | £14,036m | £13,495m |
| | 44.7% | 43.0% | 44.7% | 43.0% | 44.7% | 43.0% |
| AEG + rebates at Settlement: | 49.2% | 47.4% | 49.2% | 47.4% | 49.2% | 47.4% |
| Grant underclaim | - | - | £91m | £88m | £287m | £280m |
| Average rate increase: | | | | | | |
| Non-rate limited | -.6% | 2.5% | 2.8% | 5.9% | 6.2% | 9.3% |
| All authorities | -1.2% | 1.7% | 1.8% | 4.7% | 4.9% | 7.8% |
| CC at need (CCSN) | £212 | £227 | £212 | £227 | £212 | £227 |
| CC at spending level | £230 | £244 | £240 | £255 | £251 | £265 |
| PROVISION OPTION 3 (£28,840m) | | | | | | |
| AEG at Settlement: | £13,920m | £13,495m | £13,920m | £13,495m | £13,920m | £13,495m |
| | 44.7% | 43.3% | 44.7% | 43.3% | 44.7% | 43.3% |
| AEG + rebates at Settlement: | 49.2% | 47.8% | 49.2% | 47.8% | 49.2% | 47.8% |
| Grant underclaim | - | - | £223m | £219m | £427m | £420m |
| Average rate increase: | | | | | | |
| Non-rate limited | -1.6% | .9% | 4.2% | 6.6% | 7.6% | 10.1% |
| All authorities | -2.0% | .3% | 3.2% | 5.4% | 6.3% | 8.5% |
| CC at need (CCSN) | £208 | £220 | £208 | £220 | £208 | £220 |
| CC at spending level | £226 | £237 | £243 | £255 | £254 | £265 |
| PROVISION OPTION 4 (£28,590m) | | | | | | |
| AEG at Settlement: | £13,808m | £13,495m | £13,808m | £13,495m | £13,808m | £13,495m |
| | 44.7% | 43.7% | 44.7% | 43.7% | 44.7% | 43.7% |
| AEG + rebates at Settlement: | 49.2% | 48.2% | 49.2% | 48.2% | 49.2% | 48.2% |
| Grant underclaim | - | - | £354m | £349m | £572m | £563m |
| Average rate increase: | | | | | | |
| Non-rate limited | -2.5% | -.7% | 5.5% | 7.3% | 9.1% | 10.8% |
| All authorities | -2.7% | -1.1% | 4.5% | 6.1% | 7.6% | 9.3% |
| CC at need (CCSN) | £205 | £213 | £205 | £213 | £205 | £213 |
| CC at spending level | £222 | £230 | £246 | £255 | £257 | £265 |

* Grant overclaim

OPTIONS FOR 1989/90 RATE SUPPORT GRANT SETTLEMENT

NOTES TO TABLES

A. PROVISION: Option 1 is based on a 5% increase on 1988/89 budgeted current expenditure for non rate limited authorities plus current expenditure consistent with ELs for rate limited authorities and 1989/90 budget for Metropolitan Police. In options 2, 3 and 4 the increase for non rate limited authorities is 4%, 3% and 2% respectively. In all cases £110m has been added for the set up cost of community charge collection.

B. EXPENDITURE ASSUMPTION: Columns 1 and 2 of the table assume that authorities spend at the relevant settlement expenditure assumption described below. Columns 3 and 4 assume for all options that non-rate limited authorities spend at 1½% above the Option 2 Settlement expenditure assumption and rate limited authorities spend at EL. Columns 5 and 6 assume for all options that non-rate limited authorities spend at 3% above the Option 2 Settlement expenditure assumption and rate limited authorities spend at EL.

SETTLEMENT EXPENDITURE ASSUMPTION

| | <u>OPTION 1</u> | <u>OPTION 2</u> | <u>OPTION 3</u> | <u>OPTION 4</u> |
|------------------------------|---------------------------------------|------------------------------|------------------------------|------------------------------|
| Rate-Limited authorities | EL | EL | EL | EL |
| Metropolitan Police | assumed 1989/90 budget | assumed 1989/90 budget | assumed 1989/90 budget | assumed 1989/90 budget |
| Non-rate limited authorities | 1988/89 budgets +5% | 1988/89 budgets +4% | 1988/89 budgets +3% | 1988/89 budgets +2% |
| | + community charge set up costs | + c c set up costs | + c c set up costs | + c c set up costs |

C. USE OF SPECIAL FUNDS AND BALANCES: The Settlement spending assumption assumes that special funds are reduced by £567m, as in 1988/89, and there is

no change in balances. At higher spending levels we assume that £900m of special funds are used to reduce total expenditure, but £430m is added to balances.

D. RATES: At all three spending levels, rate and precept limited authorities are assumed to levy a rate equal to their rate/precept limit.

Rate changes shown are for general rates: increases in domestic rates would be about 1% higher.

E. BLOCK GRANT MECHANISMS AND GRE: These are as in 1988/89 except that there is no cap on grant gains.

F. IMPLIED COMMUNITY CHARGE FOR SPENDING AT NEED is lower than community charge at settlement spending assumption because total GRE is lower than total provision.

G. SENSITIVITY TO GRANT: For every extra £100m of AEG rate increases would be about 1% lower than shown, for any given spending assumption.

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1. MR POTTER *RHP 3/6*
 2. CHIEF SECRETARY

FROM: R FELLGETT

Date: 3 June 1988

cc: Chancellor
 Sir P Middleton
 Mr Anson
 Mr Phillips
 Mr A J C Edwards
 Mr Turnbull
 Mr Burns
 Mr Call

1989-90 RSG SETTLEMENT FOR ENGLAND

You are meeting Mr Ridley on Tuesday 7 June. There is much to be said for reaching an understanding with him if possible. In E(LA) spending colleagues will press for high expenditure provision; Mr Hurd and Mr Moore have already put down markers. If Mr Ridley sticks to an unchanged grant percentage, that will drive up the quantum of grant, which really matters. On the other hand, I would not advocate an agreement with Mr Ridley at any price.

Line to take

2. I therefore recommend the following general line on the main items to be settled:

- Aggregate Exchequer Grant. The actual increase in grant being paid in 1988-89 is £500 million (4%). It would be a backward step to provide a bigger increase; that would simply fuel a higher increase in LA spending. Therefore support option B; an extra £520m to increase AEG in line with inflation. If pressed: accept option B £520m plus £110m to fund the full cost of Community Charge preparation.

- Expenditure provision. Bids submitted in Survey, including those by Mr Ridley himself, are very large. Nevertheless can be flexible about the options provided the higher options do not imply more grant. Colleagues may want option 1 or 2, and a bigger increase would deflect criticism that the plans were unrealistic. But options 3 or 4 would avoid the presentational difficulty of a large increase on the Survey baseline, and would keep up the grant percentage for any quantum of grant. Therefore prepared to argue for option 4 (£28,590m - an increase of £0.8bn) or option 3 (£29,840m - an increase of £1.1bn) if that would help Mr Ridley.

- Unallocated margin. Total of GREs is an important signal to LAs; it therefore should, as in 1987-88 and 1988-89, rise by no more than inflation (4%) plus adjustments for pay rises endorsed by the Government (teachers, police etc). Mr Ridley's proposed 8% increase in GREs would give completely the wrong signal that the Government believes LA spending needs have risen by twice the rate of inflation.

3. The key messages such a line should give Mr Ridley are:

- You will oppose most strongly any increase in the quantum of AEG much above option B. You are concerned about the likely actual increase at outturn, as well as the increase announced at settlement, because the outturn increase is the actual cost to the taxpayer and represents the actual financial pressure on LAs to control their spending.

- You are prepared to help Mr Ridley keep up the grant percentage, by holding down provision, notwithstanding the expenditure control and pay policy arguments against endorsing LA spending decisions through the signal of a broadly unchanged grant percentage.

- You will oppose a substantial increase in GREs because they are an important signal, but are not as concerned about this signal as about the actual financial pressure through AEG. (Indeed, I would not completely rule out Mr Ridley's GRE option, provided that secured a good firm agreement on AEG.)

4. We believe that it may be possible to square option B for AEG and option 3 for provision with a broadly unchanged grant percentage. This would involve squeezing the assumed level of those items of LA's relevant expenditure which are not classified as public expenditure, especially by making a realistic assumption about likely transfers from LA special funds to their general rate funds. Such transfers reduce relevant expenditure, although they are only book-keeping transactions, and LAs are likely to make full use of them to maximise their grant entitlement before April 1990, when such transfers will cease to affect grant. DOE officials must be aware of this possibility, but we have no hint about whether Mr Ridley would accept it.

5. I attach more detailed notes on:

- the key arguments;
- Mr Ridley's options and objections to them;
- various detailed or defensive points;
- an outline of a possible compromise.

6. Following your meeting, you will wish to consider further the terms in which you might write or speak to Mr Parkinson (a draft was attached to my submission of 7 April) and whether you want to write to E(LA) before the meeting on 22 June.

p.p. Barry H. Potter

R FELLGETT

KEY POINTS

1. LA current spending remains the threat to our pledge to reduce government expenditure (central and local together) as a proportion of national income. Over the 3 years to 1988-89 LA current spending has increased by 29%, compared to inflation of 13% and 16% for public expenditure as a whole and growth in GDP of 26%.
2. Much of the problem is pay - with both management and union sides dominated by the Labour party - and manpower growth.
3. 1988-89 nevertheless a welcome improvement, with growth in spending cut back from 9½% in 1987-88 to 7½%. Firmer RSG settlement an important factor. At outturn (comparing grant actually paid in all years) increase in AEG reduced from £950m in 1987-88 to £500m in 1988-89; we gave them £450m less and that helped reduce the rate of increase in cash spending from 9.7% to 7.7% - a difference of £520m.
4. All this without big rates rises; up only from 6% in 1987-88 to 7½% in 1988-89, well below the 10½% that DOE forecast in July 1987.
5. Helpful signs on the pay front too. In 1987-88 LAs, buoyed by nearly £1 billion more grant, gave the manual workers 10½%. In 1988-89, with only a little over £½ billion more grant to spend, white collar workers have been offered just 4½%.
6. Therefore essential to stick closely to an increase in AEG in line with inflation, as it actually is in 1988-89. (Even that would be pretty generous compared to real cuts in AEG from 1979 to 1986.) Retrograde to fuel higher LA spending with more grant in 1989-90; must keep the trend in LA spending coming down ahead of the Community Charge.
7. Time to consider (no promises) more grant in 1990-91 when CC is introduced. Pointless to try and engineer popular low rate rises in 1989-90, just as the rates are about to be abolished.

MR RIDLEY'S OPTIONS

1. Option 2 for provision in 1989-90 means:

- an increase of $4\frac{1}{2}\%$ compared to LA budgets, more than equivalent increase of 3.8% in 1988-89 settlement.
- claim on Reserve of £1.3 billion (5%), more than equivalent claim of £1.0 billion in 1988-89 settlement.
- increase of $8\frac{1}{2}\%$ compared to provision made for 1988-89, more than equivalent increase of 7% in 1988-89 settlement.

Option 3 (but perhaps not option 4) should be defensible, notwithstanding acknowledged legal problem with any option that is too unrealistic.

2. AEG of £14,026m (an unchanged grant percentage of 44.7% with option 2 for provision) means

- an increase in grant at outturn of £1.3 billion on DOE's own figures, ie $9\frac{1}{2}\%$ in cash and 5% in real terms.
- biggest percentage cash increase since 1980-81, when inflation was $18\frac{1}{2}\%$, and the biggest percentage real increase since before 1979.
- and in practice LAs would manipulate their special funds to increase grant by up to another £325m.

3. AEG of £13,920m (an unchanged grant percentage of 44.7% with option 3 for provision) means:

- an increase at outturn of £950m on DOE figures, ie $7\frac{1}{2}\%$ in cash and $3\frac{1}{2}\%$ in real terms.

- still biggest percentage cash increase since 1980-81 (apart from pre-Election 1987-88 settlement, which involved 8% rise), and still biggest percentage real increase in any year since before 1979.

- and in practice will be up to £325m higher.

4. Comparing a settlement based on Mr Ridley's option 2 and unchanged 44.7% grant percentage with actual LA budgeted spending and grant in 1988-89:

- grant goes up by £1,584m, to finance extra spending of £1,224m and leave rates to fall by 1.3%. This is because the grant percentage at outturn is actually increasing.

No one would believe that. If Mr Ridley really wanted to endorse £1.2bn of extra expenditure he should pay grant at 44.7% of £1.2bn, ie £540m more grant. His approach pays grant on £1.2bn and on the overspend in 1988-89.

5. Policy objections to an unchanged grant percentage are:

- undermines expenditure control policy. By paying grant at a fixed percentage of provision, based on LAs own budgeted spending in 1988-89, effectively finances half what they choose to spend one year in arrears. Allows LAs to dictate financing to the Government.

- undermines pay policy. Allows LAs to concede big pay rises and pass half the cost to the taxpayer, one year in arrears. Mr Ridley has often said that Government will not finance excessive pay rises; need to maintain credibility of such statements.

DETAILED AND DEFENSIVE POINTS

1. Quantum of AEG has no effect on LA spending/lower increase in spending in 1988-89 entirely due to rate capping.

No. Rate capping important; Community Charge capping will be useful too. But non rate-capped LAs cut their increase in spending from 10.2% in 1987-88 to 9.0% in 1988-89. (DOE claim this is entirely due to lower price rises for LAs in 1988-89 - but that confirms our point, because prices (normally pay) are partly under LAs own control and lower pay rises are a response to greater financial pressure.)

2. Quantum of AEG affects only Conservative authorities, Labour just put rates up.

No. Tory and Labour authorities (apart from rate capped) both put spending up by 8% in 1988-89.

3. 7½% rates rises in 1988-89 too high - should have had more grant this year.

No. Nothing odd about 7½% rates rise for 7½% spending increase. But spending increase of 6% would have reduced rates rise to 4-5%.

4. DOE forecast rates rise for 1988 too high.

Yes. Figures from annex B to Lord Whitelaw's letter of 15 July 1987 compared to recent DOE rates monitor.

| | DOE forecast | Actual |
|-----------------|--------------|--------|
| English average | 10.4% | 7.6% |
| Cambridgeshire | 17% | 4% |
| Gloucestershire | 20% | 12% |

Fact is that LAs have reacted to lower increase in AEG in 1988-89 by moderating spending and rates.

5. Transition to Community Charge requires low rates rise in 1989-90/safety net means grant for 1990-91 fixed by 1989-90

No. Quite the opposite. No point in trying to make rates popular in their last year - Labour authorities would welcome that (Strathclyde have a rates freeze in 1988-89 in the last year before Community Charge in Scotland).

May be scope for greater increase in grant to ease safety net in 1990-91. No promises; consider it on its merits in 1989 E(LA).

6. New planning total (excluding LA self-financed expenditure) means LA spending no longer matters/claim on Reserve irrelevant.

No - objective remains that general government spending (including all LAs) should absorb a declining proportion of national income. Taxes raised by local authorities still part of the tax burden which Government is pledged to reduce.

Claim on Reserve exists under existing planning total and creates a presentational problem; just as valid as any presentational problem with the grant percentage, which will also disappear under new system from April 1990.

7. Government objective to maintain financing of 50% of LA spending, through AEG and rebates, into new system.

No - 50% simply roughly what happens now. "Objective" not even discussed collectively, let alone agreed.

Meaningless. 50% ratio depends, like the grant percentage, on definition of AEG (which will change in new system) and relevant expenditure (which is a creation of the 1980 Act, and will no longer exist in new system).

SQUARING OPTIONS 3 AND B WITH 44.7%

1. On the DOE grant percentage approach, AEG is 44.7% of an assumed level of relevant expenditure (ie provision for "relevant current" plus other items which are mostly not classified as public expenditure and do not therefore appear in the PEWP). Squaring therefore involves:

- a lowish provision for "relevant current";
- a low assumption for other items.

2. Within the other items, the main issue concerns special funds. LAs will, with minor exceptions, undoubtedly draw down before April 1990 all of the £1.9 billion special funds that they are believed to have on 1 April 1988. Up to 1990 each £100 million draw down will increase the grant paid to LAs by about £50 million; after 1990 there is no such incentive. They have budgeted for a draw down of £567 million in 1988-89, leaving a £1,333 million to be drawn in 1989-90. DOE initially assumed a draw down of £567 million again in 1989-90, but officials have already acknowledged that it could be £900 million.

3. It may not be realistic to assume that every £1 in special funds is withdrawn. A draw down in the range of £900 million-£1,250 million may be better. This could still be squared by either (or both):

- some reduction in the other items apart from special funds; and
- assuming a broadly unchanged grant percentage of, say, 44.5%. (The grant percentage at settlement did drop by 0.2% in 1988-89.)

The precise arithmetic can be a matter for DOE, consulting Treasury, provided that the answer is Option B for grant.

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CHIEF SECRETARY

FROM: B H POTTER

Date: 3 June 1988

cc: PS/Chancellor
Sir P Middleton
Mr Anson
Mr Phillips
Mr Edwards
Mrs Case
Miss Peirson
Mr Turnbull
Mr Fellgett
Mr Call

RATE LIMITATION 1989-90

Although your discussion with the Secretary of State for the Environment next Tuesday will focus on the Rate Support Grant Settlement, he may also wish to cover rate capping. (The list of authorities selected for rate limitation in 1989-90 must be announced by end July.)

2. DOE officials have now confirmed that Mr Ridley will propose only seven authorities should be rate capped in 1989-90 under the selective provisions (c.f. seventeen in 1988-89). In addition, a number of Joint Boards, single purpose authorities formed after abolition of the metropolitan counties and the GLC and automatically selected up until 1988-89, are also likely to be rate-capped next year under the selective provisions. Specific proposals on these will be put forward by the Home Secretary and Secretaries of States for Education and Transport.

Line to take

3. Attached at annex A is a note on the recent history of rate-capping in England and at annex B a description of the options for 1989-90. I recommend the following line to take, if rate-capping is raised;

- too early to give any commitment; can only indicate a preliminary view;

- must certainly select for rate-capping all seven authorities proposed: but should not rule out going beyond this to include other authorities where spending is well above GRE;
- concern about large number of authorities which will escape rate-capping next year, not by reducing their underlying expenditure but by getting their total expenditure under the critical threshold by artificial means;
- points to the importance of ensuring that the Community Charge capping provisions are not fettered in a similar way, so that account can be taken of all sources of income to finance current expenditure when determining which authorities should be capped.

Barry H. Potter

BARRY H POTTER

RATE-CAPPING SINCE 1985/86

1. Under the Rates Act 1984, the Secretary of State for Environment can select for rate limitation any local authority whose expenditure is excessive. Section 2 of the Act requires that excessive must be measured in terms of total expenditure (as defined in part VI of the 1980 Act). In practice, the criteria on total expenditure have referred to absolute levels of total expenditure above a threshold and year on year growth in total expenditure. Each authority selected is given a maximum Expenditure Level (again defined in terms of total expenditure) to which the rate-cap is linked.

2. Very broadly the picture over the first three years was of rate-capped local authorities getting around their Expenditure Levels, by a combination of creative accounting measures:

- the use of accumulated reserves and balances (which made the largest contribution);
- reclassification of revenue spending as capital (housing repairs but also other expenditure) mainly paid for by capital receipts; and
- sale and leaseback and other creative financing devices.

So actual current expenditure exceeded the current spending set at Expenditure Level.


3. Indeed a distinction needs to be drawn between the total expenditure of rate-capped authorities as formally defined and underlying actual current expenditure. Thus the 17 authorities selected for rate limitation this year had budgets in 1987-88 which showed total expenditure at levels between 15 and 30% above GRE, over a selection threshold of GRE + 12½%. But their underlying expenditure ie total expenditure plus other current expenditure financed from non-rate sources was even greater - in the range of some 30-50% above GREs.

Up to 1987-88, creative accounting allowed most authorities to sustain their underlying spending. But in 1988-89 there have been two interesting developments. First we agree with DOE's view that there is now real evidence that some authorities are cutting back on their expenditure. In 1988-89 rate capped authorities budgets showed a cash increase of just 1.7%; non rate-capped authorities increased budgets by 9.0%. But it is not only their total expenditure but also underlying spending which is being curtailed. For example, material gathered by the monitoring group suggests underlying spending has been cut by £4 million in cash terms this year in Tower Hamlets, by £3.5m in Camden; and held constant in Manchester. Elsewhere the rate of growth has generally been reduced - although in one or two authorities like Brent it continues to escalate alarmingly.

5. Secondly, however, authorities have become much more skilful at playing the rate-capping game. Following various legal cases, local councils have a fairly astute idea of the constraints on DOE in setting its selection criteria (see legal advice at attachment A). The most important criterion is the threshold on absolute spending, ie only those with higher total spending can be selected. This has been set at GRE + 12½% for several years. Counsel advised again only yesterday (2 June) that this criterion cannot safely be tightened further. And, although we have narrowed the scope for creative accounting, there remains sufficient flexibility for many councils to get budgeted total expenditure under the critical GRE + 12½% threshold and thus escapes the ratecapping net - while underlying expenditure remains much higher.

6. As you are aware we are taking steps to tighten the regime under Community Charge capping which takes over in the year after next:

- i) the system will operate in-year; so the criteria can be set after we have local authorities' budgets not on the basis of the preceding years' budget;
- ii) we are seeking to ensure that the proposals allow DOE to take into account all sources of local authority



finance, ie including the likely use of creative accounting. We are still pressing Parliamentary Counsel to amend the Local Government Finance Bill to ensure this is allowable - even though Counsel's advice is that the present clauses are sufficient to do this.

RATE CAPPING IN 1989-90

For next year Mr Ridley is proposing to continue with a two category approach:

- a) for local authorities previously selected, there will be a single selection criterion - total expenditure in excess of GRE + 12½%;
- b) for those not previously selected, the criteria will be total expenditure of GRE + 12½% and a 6% year on year increase in total expenditure.

2. All seven of those proposed for rate capping come under the first category (see table B). And all but one of the other ten authorities rate capped this year have escaped by getting their total expenditure under the critical GRE + 12½% threshold. (The other one - Basildon - escapes essentially on a de minimis expenditure point). However many of these ten are still spending in underlying expenditure terms well over their GREs. Moreover, even if the legal advice had allowed a tighter limit down to the theoretical maximum of GRE + 10% (ie the point at which the slope of the grant schedule becomes steeper) we would only capture one further authority - Middlesborough - and even then only just.

3. There is possible scope to select authorities next year not previously selected in 1988-89. If we were to adopt only the a) criterion rather than b) for new candidates, a further four authorities would come within the net - the City of London, Blackburn, Bristol and Leicester. While we could propose that only the single criterion would apply, we cannot select the other three authorities without also including the City. And quite apart from any other considerations, the special nature of the City is thought to mean that its GRE is not a fair measure of its assessed need to spend. Again we might face legal challenge.

4. In practice, given the legal advice, the choice lies between the 7 authorities proposed by Mr Ridley or taking in the extra 4 identified in paragraph 3. The position is unsatisfactory: but it would not be possible to persuade Mr Ridley to take the legislative action necessary to capture any of the authorities escaping this year. It does highlight the need for the Community Charge capping power not to be restricted in this way.

Extract from legal Advice to DOE.

- a) a single "GRE-only" criterion for previously selected authorities should be satisfactory, but it is important that the Secretary of State has reasoned arguments (eg, effects of previous rate limitation on authorities' present total expenditure) for so determining;
- b) fixing the criterion at "12% over GRE" should be satisfactory: this was primarily a matter for the Secretary of State's judgement and, notwithstanding the existence of an unallocated margin, it was hard to envisage a successful challenge being mounted;
- c) going below 12% down towards 10% would be much riskier, and it would be absolutely essential to have a reasoned basis for such a determination which fully thought through such factors as the approximation of GRE's and the justification for the 10% threshold nationally;
- d) "threshold" is not really a starter if it would mean selecting authorities below the average threshold level (GRE + 10%). The Secretary of State would have to be satisfied that the mechanisms producing individual thresholds were not imperfect or unfair in themselves, and that the effects of such a selection criterion would not produce unreasonable designations of individual authorities (eg, when compared with their GRE);

SELECTION OF AUTHORITIES FOR RATE LIMITATION 1989-90

| | OVERSPEND ON GRE % | SPENDING GROWTH 1987-88 TO 1988-89 |
|---|--------------------------|---|
| A. re-selected authorities | | |
| THAMESDOWN | 69.0 | 3.8 |
| GREENWICH | 39.6 | 1.6 |
| CAMDEN | 29.7 | -3.3 |
| LEWISHAM | 29.2 | -1.8 |
| TOWER HAMLETS | 23.1 | 2.5 |
| HACKNEY | 19.7 | -10.2 |
| SOUTH-WARK | 13.1 | -10.2 |
| B. authorities not reselected | | |
| BASILDON | 62.8 | -25.9 |
| MIDDLESBROUGH | 10.7 | -1.7 |
| KINGSTON-UPON-HULL | 9.4 | -16.0 |
| NEWCASTLE-UPON-TYNE | 9.2 | 1.7 |
| LAMBETH | 8.9 | -0.1 |
| MANCHESTER | 8.5 | 0 |
| LIVERPOOL | 8.3 | -1.7 |
| WALTHAM FOREST | 3.3 | -7.0 |
| HARINGEY | 3.2 | -0.1 |
| EALING | 3.2 | 1.1 |
| C. authorities not selected but spending more than 12.5% over GRE | | |
| CITY OF LONDON | 97.3 | 2.7 |
| BLACKBURN | 25.2 | -3.4 |
| BRISTOL | 23.3 | 2.7 |
| LEICESTER | 17.9 | -18.2 |