

PERSONAL AND CONFIDENTIAL

1. MR POTTER *BHP 10/6*
2. CHIEF SECRETARY

FROM: R FELLGETT

Date: 10 June 1988

cc: Chancellor
Sir P Middleton*
Mr Anson*
Mr Phillips
Mr A J C Edwards
* without attachment

1989-90 RATE SUPPORT GRANT SETTLEMENT

We have now discussed with DOE officials the fixed grant proposal which Mr Ridley put to you earlier this week.

The Fixed Grant Proposal

2. As Mr Potter foreshadowed in his submission of 3 June, Mr Ridley is not thinking of the frozen grant idea which was discussed briefly last year. That would involve an impracticable Parliamentary timetable. His approach does not, therefore, have the political attraction of being able to offer, say, Essex the same percentage increase in block grant as, say, Cleveland.

3. Instead, the RSG settlement would proceed as normal in July. But when the details were published in the autumn, the Government would announce that it would take legislation to prevent any authority losing grant in 1989-90 as a result of overspending (or gaining grant from underspending the settlement assumption), and as a quid pro quo that no further grant would be paid out for 1988-89 or earlier years if authorities declared lower expenditure. This would require a Bill, but DOE currently believe that it would be a short money Bill, to be introduced in December after the RSG settlement.

Assessment

4. The attached DOE paper describes their proposal, together with some assessment of the costs and benefits and other

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disadvantages and advantages. It has been prepared in consultation with us. We agree that it covers the main points and that the costings are adequate for their immediate purpose, although there are inevitably considerable uncertainties and the financial assessment could be refined. The scheme is still only an outline, and if you and Mr Ridley were attracted to developing it further a good deal of work would be needed.

5. We do not believe the proposal represents a good deal for the Treasury. The public expenditure argument points strongly against this proposal. Local authorities would have over a year in which they knew that additional spending incurred no grant penalty (for the first time in recent years). They would very likely be tempted to push up their spending during this "window of opportunity", while they could, for a final time, finance it in part from higher business rates. Grant pressures were last relaxed in 1986-87, with the abolition of targets and penalties, and the trend growth in local authority spending increased by about 5% or more than £1 billion. On this occasion, the additional expenditure is likely to be rather less because the relaxation in grant pressures is not so great. Our guess (and it is only a guess) is that additional expenditure of 1-3%, or £300-£800 million, covers the likely range.

6. In Exchequer grant terms, the argument is more finely balanced. Paragraph b on pages 2-3 of the paper estimates that the cost of adopting the proposal would be around £350 million, because there would be no grant underclaim in 1989-90. This figure is subject to considerable uncertainty, and indeed might be significantly higher if we do not secure a firm settlement that would reduce local authority overspending.

7. Paragraph a on page 2 sets out the extent to which the Exchequer is at risk to claims for additional grant (because of later information showing lower total expenditure) in respect of 1988-89 and earlier years if the proposal is not adopted.

This figure is even more speculative than the costs of the proposal, but is also about £350m. Of the total, about £140 million could legitimately be due to authorities if they genuinely reduce their spending, and the remaining £210 million represents the cost of possible accounting fiddles, mainly by just one authority - Westminster. However, some of this risk of additional grant could also be avoided if the present RSG system were closed down after local authorities had set their 1989-90 budgets, perhaps in July 1989, although the longer we leave close down the longer authorities have to fix their books. Closedown in July 1989, after a grant underclaim for 1989-90, is nevertheless an alternative approach which we have already discussed with DOE, without reaching any conclusion.

8. DOE officials are seeking to present the proposal as broadly neutral in terms of Exchequer grant. However, the costs look more certain than the savings, and the balance is more likely to be against the Exchequer than in its favour if the proposal is adopted. On the other hand, the proposal undoubtedly has the advantage of ensuring certainty in grant payments.

9. Apart from these expenditure and grant arguments, we have some additional concerns about the DOE proposal:

(i) by curtailing local authorities' rights through retrospective legislation, there will undoubtedly be a chorus of complaints (some invalid, but some genuine hard cases) that will be directed to Treasury as well as Environment Ministers. One cannot rule out the possibility that in certain cases we will feel compelled to make ex-gratia payments to recompense local authorities that have lost out from curtailing their ability to gain grant by reducing expenditure;

(ii) from a wider financial prospective, we do doubt the propriety of withdrawing financial rights and obligations in this way without notice or recompense, when there is no overriding economic or financial reason for doing so;

(iii) these sorts of concerns may be expressed quite vociferously in Parliament.

10. DOE do not think that it will be possible to take a final decision until the autumn, when they would know whether authorities had in fact already manipulated their accounts for earlier years or still had scope to do so at some later date. They are therefore envisaging simply a contingency plan to proceed in this way. This must be right; knowledge of such a plan must be restricted to very few people here and in DOE and it would be awkward to go through a whole E(LA) round with colleagues if there was simultaneously a firm decision of which they could not be aware.

11. I accordingly recommend that you meet Mr Ridley again briefly to discuss the proposal, and say that you see substantial disadvantages for the Treasury in it. You also have some wider reservations. On the other hand, there is something to be said for having more than one approach to the settlement in play, in case, despite the disadvantages we have identified, some version of the scheme may be needed in due course. No firm decision on the scheme, which exists only in outline, is needed now. At some stage, it will be appropriate to close down the present RSG system, although not necessarily in the way now proposed. We further understand that Mr Ridley is attracted to the scheme; it could be counter-productive to be too unreceptive. If he presses it, you could therefore accept further work on the scheme, on a contingency basis; although there would need to be a clear presumption that the RSG settlement should go ahead in the normal way.

E(LA) Meeting

12. The first meeting of E(LA) is to take place on 22 June. DOE will circulate their first paper - which will of course give no hint of the fixed grant option - no later than the middle of next week. We need to decide now on the Treasury's opening proposals on provision and grant and how best to present these proposals to colleagues in E(LA).

13. In your private discussions with Mr Ridley, you have indicated your position on provision (option 4 in the DOE table: roughly 2% above LA 1988-89 budgets) and grant (option B: +£520m). There remains the possibility of now taking a firmer (or a more generous) line for the first encounter at E(LA). But, quite apart from the difficulty in shifting your stance after the discussions with Mr Ridley, we believe - bearing in mind the experience of starting from a very tough position last year - that there could be advantage in putting forward option 4B as a credible opening package (and dressed up as a generous offer). Given that Mr Ridley has not moved from option 2A, we would recommend against a more generous starting position on provision or grant at this stage.

14. We will provide full briefing for the E(LA) meeting in due course. Our present views are:-

- i) that the Treasury option 4 on provision and option B on grant should be included in the DOE paper for E(LA). We do not want option 3 to appear as the 'extreme' case. It also facilitates the discussion if E(LA) can work on one set of tables which describe the options and their impact on rates and grant underclaim;
- ii) that you should write to colleagues arguing for option 4 on provision and option B on grant - probably in the form of a paper to E(LA); the paper would
 - first display the principal arguments against the profligate settlement proposed by Mr Ridley: in particular it would question the need for high grant in pursuit of popular low rate increases in the last year of rates and, because of its longer-term significance, present our familiar arguments against a fixed grant percentage and in favour

of pressure on local authorities to restrain their excessive spending;

- second indicate that, despite those strong arguments, you are reluctantly prepared to provide a full £520m in order to maintain grant in real terms in 1989-90 (option B); the paper should suggest this was a break from past unrealistic Treasury negotiating stances on grant; you would also support option 4 on provision - but perhaps hint that you recognise there are arguments for being a little more generous on provision but not on grant.

We therefore envisage that you would make very little movement if any on grant in the first E(LA) discussion; but it may be possible to move to option 3 on provision, in response to the pressure from Departmental Ministers.

15. If you are content, we will provide a draft paper for you to circulate to colleagues early next week.

Robert Fellgett

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1989/90 RSG SETTLEMENT : CLOSING DOWN THE RSG SYSTEM

This paper describes an option for closing down the RSG system at the time of making the 1989/90 RSG settlement. The paper is divided into 5 sections. The first describes how the arrangement would work and the timetable for its implementation. The second describes the main policy points on grant and expenditure. The third section discusses the legal and parliamentary issues. And the final two sections describe the advantages and disadvantages associated with this option.

DESCRIPTION OF CLOSING DOWN OPTION

The main feature of this proposal to close down the RSG system is that grant entitlements for 1989/90 would be calculated on the basis of the settlement spending assumption rather than on the basis of local authority reported expenditure. This means that the amount of grant paid out would be the amount specified in the settlement : there would be no grant under claim as in 1987/88 and 1988/89 but nor would there be any risk of a grant overclaim. Having fixed grant entitlements before the beginning of the grant year there would be no subsequent revisions.

Final grant entitlements in respect of all earlier years would also be calculated before April 1989. These would be determined on the basis of Supplementary Reports due to be made around the time of the 1989/90 settlement. It is in a way fortuitous that SRs are due to be made in respect of all outstanding years at this time and this option seeks to capitalise on this.

No further changes to grant entitlements under the present system would be made after March 1989 in respect of any years.

The key steps would be : -

- a. July : announcement on settlement as usual;
- b. October : Consultation paper on settlement as usual;
- c. October : Closedown on data for settlement and 1987/88 and 1988/89 SRs;

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- d. November : Closedown on data for 1985/86 and 1986/87 SRs 9 (later for these reports as they are not being laid until January);
- e. November/December : announcement on Settlement Day that a Bill will be introduced to closedown system taking account only of information used (or to be used) in the settlement and supplementary reports : grant entitlements for 1989/90 to be based on settlement spending assumption so full AEG to be paid out.
- f. December : debate and approve RSG Report and SRs for 1987/88 and 1988/89;
- g. December : introduce (Money) Bill;
- h. December : make provisional Rate limits;
- i. January : lay and debate SRs for 1985/86 and 1986/87;
- j. February : determine final Rate limits;
- k. March : Royal assent to Bill allowing payment of grant in April to be on basis of settlement spending assumption;
- l. April : implement final grant changes in respect of all years prior to 1989/90 and commence payment of 1989/90 grant entitlements based on settlement spending assumption.

GRANT AND EXPENDITURE IMPLICATIONS

The main grant implications are :

- a. Grant claims in respect of 1987/88 and 1988/89 are likely to be lower with this option because authorities will not have further opportunities to manipulate total expenditure to increase grant claims after October 1988. Experience with ending of the targets and holdback regime indicates that there is considerable scope for such manipulation of total expenditure. Early closedown could save the Treasury around £70m each year arising from normal reductions in current expenditure between budgets and outturn; £155m from use of special funds by Westminster, and £55m from use of special funds by other authorities. The total sum at risk for these reasons is thus around £350m. Treasury would also be at risk from further increases in the grant claim arising from other manipulations of total expenditure in respect of these years.
- b. The grant claim in respect of 1989/90 will be fixed at the settlement level. This means that Treasury forgo the potential underclaim which might arise if authorities spend above the settlement spending assumption. On the basis of option 2A (Mr

Ridley's option) and for spending at 7½% above 1988/89 budgets the underclaim would be £287m and on option 4B (the Chief Secretary's option) and for spending at 6% above 1988/89 budgets the underclaim would be £349m. But the grant underclaim could be £90m lower if Westminster were to make full use of special funds in 1989/90. The grant claim could also be increased through other manipulation of total expenditure such as factoring, capitalisation of expenditure, interest rate swaps, use of other funds such as the HRA, and other forms of creative accounting not yet dreamt of. For every 1% reduction in expenditure the grant claim would increase by around £150m.

Much of this assessment of additional grant claims is necessarily speculative but the risk of higher grant claims under the present grant system is very real. Over the three year period the scope for such manipulation to increase grant is certainly greater than the likely grant underclaim in 1989/90. With a later closedown of the system it might still be possible to cut off some of the potential higher grant claims in respect of 1987/88 and 1988/89 but by then authorities may have taken the opportunity to increase considerably the grant claim for 1989/90.

There are also potential implications for local authority current expenditure in 1989/90. Local authority public expenditure is likely to be higher in 1989/90 (and to a much smaller extent in 1988/89) if this option is adopted. Authorities will be able to finance additional expenditure without losing grant, as they could not have done in any other recent year. Of course, some part of the cost of any extra spending would fall on domestic local tax payers but local authorities would for the last time be able to finance just over half the higher spending from higher business rates. Authorities would be aware of this window of opportunity for additional expenditure when they set their budget for 1989/90. Each extra 1% of spending would be about £300m.

LEGAL AND PARLIAMENTARY ISSUES

There are a number of legal and parliamentary implications with this option. First it requires an additional Bill to implement closedown before April 1989 so that grant can be paid out on a correct basis in 1989/90. We believe that it will be a short Bill and on past precedent that it should be a Money Bill. It should therefore be possible to obtain Royal Assent by March if the Bill is introduced in December.

The Bill will be introduced at the same time as the settlement. This means that Parliament will be asked to debate and approve the RSG settlement when it has before it a Bill that will change the basis on which grant is calculated. However, our lawyers advise that this is reasonable since all the determinations in the Report stand irrespective of the Bill. All that the Bill will change is the total expenditure figure to be used in the Section 66(1) calculation of grant entitlements.

As set out here this closedown arrangement would not be announced until Settlement Day. This means that all consultation on the Settlement with local authorities will arguably have been carried out on a different basis to the actual Settlement. We could avoid this by announcing the closedown option at the time we go out to formal consultation on the Settlement : but we need to consider how this would fit with our proposed closedown dates for information for the Settlement and SRs, and with the Parliamentary timetable. If we do make the announcement on Settlement Day we may have to take powers in the Bill to validate the consultation process.

There is also the question of whether we should use the Bill to prevent any further legal challenges to the Settlement and the Supplementary Reports being made in the autumn. There are obvious attractions in doing so in that we would be certain that the system was properly closed down. But it would make passage through the House more difficult. This matter and similar issues will need to be considered when we have worked up the options in more detail.

If Ministers agree that this option shall be pursued we will need to obtain the advice of the Attorney General urgently on the proposed legislation and the proposed timetable.

ADVANTAGES

The main advantages for Central Government are : -

- a. Treasury would know in November (and pretty accurately in July) how much grant has to be paid out under the present system for all years;
- b. The present system would be closed down in an orderly fashion well before the introduction of the new system;
- c. It would prevent authorities from manipulating expenditure to increase grant claims from October onwards;
- d. On settlement day Ministers would be able to announce that the full amount of AEG would be paid out in 1989/90.
- e. It reduces the risk of further emergency legislation to patch up the present system e.g. to outlaw new creative accounting arrangements;
- f. it would avoid the need for further supplementary reports and debates after the forthcoming round.
- g. There would be no overhang of the present system during the early years of the new system which otherwise might lead to some loss of accountability in the new system;

The main advantages for local authorities are : -

- a. Certainty about grant entitlements in 1989/90 and all later years i.e. no grant changes in 1990/91 and later years arising from the old system;
- b. Unlike recent years local authorities would receive the full amount of grant being made available in the settlement;
- c. Local authorities will be free to direct their resources to setting up the new system rather than worrying about the present system;
- d. There will be an orderly closedown of the present system and a smooth transition to the certainties of the new system.

DISADVANTAGES

The main disadvantages for Central Government are : -

- a. The removal of grant penalties means lower pressure on local authority expenditure during 1989/90; this means that local authority expenditure might be higher than it might otherwise be;
- b. An additional Bill, albeit probably a short Money Bill, would be required so that grant payments on the correct basis could be made from the beginning of the 1989/90 financial year;
- c. There would be no grant reduction in 1989/90 in the event of overspending by local authorities;
- d. The Secretary of State would have to announce the RSG settlement to LAs and Parliament on one basis in mid-July and on a different basis in the outturn settlement;
- e. Information on the proposal to legislate would have to be restricted on a strict "need to know" basis to avoid the proposal leaking; any premature release would alert local authorities to need to act quickly in order to manipulate the system to their advantage;
- f. Ministers can expect a good deal of flack from local authorities claiming that basing closedown on 1988/89 budgets was unfair to them. Some of these complaints would be justified. (This is, of course, inherent in any early closedown arrangement).
- g. Local authorities have until October to manipulate expenditure to increase grant entitlements in respect of 1987/88 and 1988/89.

- h. Rate limitation would be less severe for authorities with redetermined expenditure levels. This arises because the grant entitlements used in the calculation of rate limits could not take account of the proposed legislation so would be assumed to be lower than provided for in the Bill.

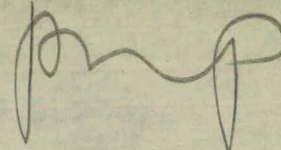
For local authorities the main disadvantages are : -

- a. They would not gain additional grant for genuine reductions in expenditure below the settlement spending assumption;
- b. They would be unable to manipulate total expenditure after October to maximise grant entitlements;
- c. The proposal would benefit local authorities that used accounting arrangements, such as use of special funds, to increase grant in 1988/89 and disbenefit authorities that were planning to use such arrangements in 1989/90;
- d. There would be hard luck cases about how 1988/89 total expenditure, which underlies the 1989/90 settlement assumption, is "exceptional" and authorities are therefore being unfairly treated over grant entitlements in the last year of the present system.
- e. Depending on the precise form of the legislation it may not be possible to correct any "errors" in the 1989/90 Settlement though of course we hope that there will be no such errors;

Department of the Environment
10th June, 1988

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FROM: MR A J C EDWARDS

DATE: 10 June 1988

CHIEF SECRETARY

cc PS/Chancellor
 Sir P Middleton
 Mr Anson
 Mr H Phillips
 Mr Turnbull
 Mr Potter
 Mr Fellgett

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1989-90 RSG SETTLEMENT: 'FIXED GRANT' PROPOSAL

I agree with the minute submitted by Mr Potter and Mr Fellgett, which reflects discussion between the three of us.

2. We understand that Mr Ridley is much attracted (as are some, but not all, of his officials) by the idea of a 'fixed grant' RSG deal for 1989-90. In our view, this is a bad idea. We hope therefore that it may be possible for you to see Mr Ridley on Tuesday, as earlier envisaged.

3. What the fixed grant proposal means, in simple terms, is that Mr Ridley would simultaneously in the autumn -

- a. announce the level of grant for each local authority in 1989-90, and
- b. introduce primary legislation to preclude any adjustments to the 1989-90 grant figures and any further adjustments to the grants for earlier years.

The effect of element (b) would be to bring the existing RSG system by diktat to a premature end ('from midnight tonight').

4. As explained in the accompanying minute, fixed grant looks to be a bad financial deal from the Treasury's point of view. Element (a) would gravely weaken the restraints on total local

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authority spending in 1989-90. It would also require the government to provide an extra amount of grant tentatively estimated at £350 million resulting from the loss of grant underclaim.

5. Element (b) would in principle produce a saving in government grant to set against the loss of underclaim. On DOE's own admission, however, there is no solid basis for supposing that the saving would exceed the loss on underclaim. It would moreover be partly bogus in that we would reckon to obtain a considerable saving under whatever scheme is introduced for closing down the existing RSG system. The DOE estimate also assumes, unrealistically, that local authorities would not anticipate the possibility of such a pre-emptive strike by the DoE and would not therefore arrange their accounts so as to pre-empt the pre-emptive strike.

6. The other great difficulty with the fixed grant proposal, as I see it, is that it would breach so many principles of good financial practice. The government would be accused of (a) altering the rules unilaterally in mid-game, (b) doing so in a way which would not only be profoundly inequitable as between local authorities but would actually reward the wicked while penalising the virtuous, and (c) misleading local authorities and Parliament. DOE would doubtless take most of the flack. But we as Treasury would, I think, be much embarrassed if asked whether we had approved this way of conducting financial business. Moreover, DOE would I suspect be likely to come to us with requests for extra grant to cover 'hard cases'.

7. Mr Ridley will doubtless be unwilling to drop the fixed grant idea completely at the first whiff of grapeshot. For the reasons discussed above, however, I endorse the advice that you should make clear to him your severe misgivings about the idea. We would advise you likewise against any kind of pact whereby our two departments would secretly have a fixed grant scheme in mind during the forthcoming E(LA) discussions and against accepting (as DoE protagonists would like us to do) that a fixed grant solution can be regarded as 'grant-neutral' or 'expenditure-neutral' compared with the existing system.

8. Looking ahead, there is undoubtedly an important policy question as to how the existing RSG system will best be wound up. My instinct is that a far better approach would be -

a. to complete the unfinished business of the existing system in the context of next year's grant settlement (when Mr Ridley and others will be arguing for a generous settlement to lighten the impact of the community charge) and

(b) to avoid charges of retrospection, inequity and misleading Parliament by giving local authorities a couple of months to make their final grant claims under the existing system, on the basis that all these will have to be settled within the total grant figure for 1990-91 (which will be higher than it would have otherwise have been).

We shall need, obviously, to think a great deal more about all this.

X 9. In the meantime, the Treasury arguments continue in our view to point to a robust grant settlement this year. We would not accept Mr Ridley's argument that leniency is needed this year in order that local authorities should not run down balances which could help to keep the community charge down in 1990-91. There would be no guarantee that the authorities would maintain balances. They might well choose to spend more. A more efficient way to lighten the financial burden on local authorities next year (if the government should so decide) would be to set next year's grant with that in mind.

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