

PERSONAL AND CONFIDENTIAL**DRAFT LETTER TO SECRETARY OF STATE FOR THE ENVIRONMENT****LOCAL AUTHORITY CAPITAL: CONSULTATION DOCUMENT**

Following discussions on the RSG settlement for 1989-90 earlier this week, officials have brought to my attention the risk of a surge in local authority capital expenditure between next week, when the capital consultation document is to be issued, and the introduction of the new control regime in 1990. Even though I understand the consultation paper is already at the printers, we need to meet urgently to discuss whether this risk can be reduced satisfactorily or eliminated by changes to the transitional proposals.

I should emphasise that the changes I have in mind would be to details of the transitional arrangements before 1990, not our substantive proposals on how the new regime should work. I am well aware of the difficulties any further delay in publishing the consultation document will cause: but the sums at risk are so large, that if changes are found to be necessary, we must be ready to hold up publication for a few days.

2. The problem is the existence of some £7 billion in cash-backed capital receipts, mostly in the form of money on deposit. Around £5 billion is held by the Shire Districts. Under the proposals in the capital consultation document, 75% of cash-backed housing receipts and 50% of other cash-backed receipts held on 31 March 1990 must be used

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to redeem outstanding capital debt or set aside to meet future capital commitments. Local councils will therefore have an incentive to use cash-backed receipts before 31 March 1990, while they are available to be spent, rather than after that date, when more than half of them must be used to redeem outstanding debt.

3. Of course, our present controls on the proportion of capital receipts which can be used to finance prescribed expenditure should help to prevent excessive prescribed spending. But there are no such controls over non-prescribed spending - the bulk of which comprises capitalised current expenditure on repairs and maintenance. So we will be at risk of cash-backed receipts being used on a major scale to finance such repairs and maintenance between next week and 1990. Your own officials have estimated that up to about £1 billion of cash-backed receipts might be used this way; and up to a further £700 million used to substitute capital receipts for due debt repayments rather than meeting these out of revenue account.

4. Moreover the incentives to use capital receipts in these ways are considerably enhanced by the present RSG system. Capitalising current expenditure allows local councils to reduce their recorded total expenditure and increase their entitlement to block grant. Indeed there has always been an incentive in grant terms to capitalise current spending: but that incentive will also disappear from 1 April 1990, with the introduction of the new Community Charge regime.

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5. So, from the date the consultation document is issued, local councils will have an incentive to use outstanding cash-backed receipts over the next eighteen months rather than see more than half of that spending power lost after 1 April 1990. They will have the opportunity to use, in principle all though in practice considerably less, of the receipts to finance capitalised current spending which scores as non-prescribed (uncontrolled) capital expenditure. And to the extent they do use them in this way they will have the added financial benefit of extra block grant payments.

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maintenance
etc.

6. We must be at serious risk of a surge in expenditure; and that risk cannot be closed off, just by removing one element in the picture, eg the grant incentive. Difficult though any delay would be at this stage, my officials consider that the detailed transitional proposals in the consultation paper must be revised so as to prevent or at least strongly discourage local councils from excessive drawing down of the money held on deposit from cash-backed receipts. I suggest our officials meet urgently to consider how this could best be done.

7. In view of the possible implications for the publication date of the capital consultation paper, I am copying this letter to the Prime Minister.

JOHN MAJOR

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CHIEF SECRETARY

FROM: B H POTTER

Date: 20 June 1988

cc: Mr Anson
Mr Phillips
Mr Edwards
Mr Fellgett*cc Mr Tyrie*

CLOSEDOWN OF RSG SYSTEM

DOE officials have now produced another version of the paper on options for closing down the RSG system (attached)*. The Environment Secretary is anxious to discuss the paper further with you; and, following that discussion, he wishes to write to the Prime Minister recommending one particular option.

2. The option favoured by DOE officials is a closedown of the RSG system in July this year (option 1 in the attached paper). For the reasons set out in the minutes of 10 June from Mr Edwards and Mr Fellgett, we remain convinced this is not attractive. In our view the important considerations of financial and political (as well as Parliamentary) propriety mean that a closedown could only be sold in the context of a generous RSG settlement. It would also expose us to a further risk of a surge in local authority expenditure in both 1988-89 and 1989-90, because grant pressures at the margin had been removed, before the greater accountability under the Community Charge was in place.

3. Option 2 has been developed by DOE officials in an attempt to keep grant pressures in being for 1989-90: this would "cap" the grant available at settlement but, to the extent that expenditure exceeded the settlement spending assumption, local authorities would lose grant. In other respects, the option is similar to option 1. Accordingly many of the same objections of propriety apply: indeed they are worse in the sense that this is a "no reward for underspend but penalties for overspend" arrangement. Moreover the scope to switch expenditure a year

* Not to copy recipients.

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forward or back from 1989-90 might in practice mean that no overspend on reported total expenditure would arise and therefore no grant penalty. We are considering a variant of this option which would work on relevant current expenditure ie public expenditure on services rather than total expenditure. It is a technical possibility: but it would require more complex legislation and it might be difficult to persuade Mr Ridley and colleagues that a new approach, which would be characterised by local authorities as a targets and penalties system, should be introduced for the last year of RSG.

4. We believe option 3 remains most promising. This would leave closedown of the RSG system till about this time next year, once local authorities budgets for 1989-90 had been reported to DOE. Closedown would then take place in the inevitably more propitious circumstances of the 1990-91 settlement. And hence the last RSG settlement would go ahead now on a conventional basis.

5. The risk, of course, is that until next July local authorities would be able to play 'creative accounting' games - with their accounts for 1987-88; their reported expenditure for 1988-89; and their budgets for 1989-90. DOE officials have helpfully tried to identify the main areas of risk and to quantify them: their latest results are at Annex A. Two points stand out: first, the scope for using special funds to increase grant entitlement in 1989-90 must be taken fully into account in the RSG settlement; second the other main areas of risk are related not just to the closedown of the RSG system but also the shift to the new capital control regime in 1990.

Capitalisation

6. The particular worry is capitalisation of revenue expenditure. Local authorities already have a grant incentive to do this: if spending on repairs and maintenance is not scored as revenue expenditure, it reduces total expenditure and increases grant. Such capitalised repairs and maintenance spending scores as non-prescribed capital spending and is usually paid for (directly or indirectly) by capital receipts. However, under the new capital

control regime, on 1 April 1990 at least 50% of all outstanding cash-backed capital receipts must be used to redeem outstanding debt. So the problem is that over the next eighteen months, councils have a very strong incentive indeed to capitalise such expenditure because:

- it will reduce total expenditure and raise grant entitlement (last chance in 1989-90);
- it will allow them to use their cash-backed receipts to finance extra spending in 1989-90, rather than allow them just to extinguish part of their debt in 1990-91.

7. DOE officials do not dispute the above analysis: it is based on their figures in Annex A. They see the grant at risk from the move to the new capital control system as an additional argument, developed since your last meeting with Mr Ridley, in favour of option 1 on closedown. On the other hand, we believe that if a way of discouraging such excessive capitalisation could be found that would considerably strengthen the attractions of option 3. For, if capitalisation and special funds were broadly taken into account and other schemes like interest swaps and factoring dealt with directly - work is in train on those - we would have gone a long way to reducing the risks of creative accounting games being played over the next year.

8. But there is an important snag. Our ideas for tackling the creative accounting abuses directly were formulated only at the weekend. Ways of taking into account the scope and likely use of capitalisation (which is not easily measured and which, to a degree, the Government has encouraged) are difficult to specify. Our best thought is that we should require councils to identify all cash-backed receipts on 31 March 1989 and 31 March 1990. The Government would make it clear that, to the extent those receipts had been run down in 1989-90 by excessive non-prescribed expenditure in any authority, it would be required to use a higher prescribed proportion of its remaining receipts to redeem outstanding debt on 1 April 1990.

9. DOE officials are hostile: it is administratively complex; it undoubtedly (if successful) makes option 3 more attractive relative to option 1; and it means revising (yet again) the capital consultation document which has just gone to the printers.

Conclusion

10. We need a few more days to work up option 3 and see whether some such measures to reduce the risks of higher grant being claimed can be made to work satisfactorily. Once that is done, we suggest you should discuss the DOE paper with Mr Ridley - probably Thursday or Friday. But it is essential to let Mr Ridley know immediately that we wish to consider an option which quite probably means delaying the capital consultation paper. That will be difficult for him - he is due to speak about it on Wednesday 29 June - and to you, because you intended to cover it on 1 July at your speech to the ADC. But there is a risk which DOE officials have only just identified, to the Exchequer from issuing the consultation paper in its present form; this would exist whether or not the RSG system was also coming to an end. And the delay should only be two days or so: and if it results in a workable option 3, I imagine Mr Ridley would agree it was worthwhile.

11. I attach a draft letter for you to send to Mr Ridley.

Barry H. Potter

BARRY H POTTER

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DRAFT LETTER TO THE SECRETARY OF STATE FOR THE ENVIRONMENT

CLOSEDOWN OF RSG SYSTEM

I have now seen a copy of the paper prepared by your officials setting out options for closing down the RSG system. We will need to meet very soon for a further discussion of the options.

As you know, I am not attracted to an early closedown of the RSG system next month (options 1 and 2) and would prefer to aim for closedown in the summer of 1989 (option 3). However I am very conscious that, if we pursue an approach based on option 3, that could leave the Exchequer open to a potentially large claim on grant. The annex to the paper helpfully identifies the main mechanisms and abuses through creative accounting which can be used and puts an inevitably broad-brush but nonetheless worrying figure on the maximum sums at risk.

If it were possible to act directly on these abuses, then we could be much more confident that option 3 was an acceptable way forward. Our officials take the view that the main potential risks arise not just from the end of the RSG system but from the combined

effect of that, and the change in the capital control regimes. Together they create a particularly strong incentive to capitalise expenditure; and that poses serious risks to the Exchequer. Local authorities will perceive the opportunities once the capital consultation document is issued.

I have asked my officials to pursue with yours as a matter of urgency whether some satisfactory arrangements for discouraging excessive capitalisation might be devised. On that basis, we might be able to build up and describe in more detail how option 3 would work. But I understand that the sort of arrangement for discouraging capitalisation my officials have in mind would quite probably require changes - albeit relatively minor - to the capital consultation document. I appreciate we cannot hold back for more than a few days on publishing the consultation document - we are both committed to speaking about the proposals next week. But I hope we can agree to keep open the option of a last minute change to the consultation document, until we meet at the end of the week.

[J.M]

ON 23.6.88

x4339.

- 1 Mr Osborn
- 2 PS/Secretary of State

cc Mr Tyrie

MA

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1989/90 RSG SETTLEMENT

1. Following the Secretary of State's discussions with the Chief Secretary earlier in the week I attach a note setting out the background to the problem of closing down the RSG system, and the options for dealing with it. I also attach a draft minute for our Secretary of State to send to the Prime Minister. These papers have been discussed with Treasury officials and are being put up to the Chief Secretary.

2. I have included the three options we identified. The first is essentially the option that the Secretary of State discussed with the Chief Secretary on Tuesday. It involves closing down on total expenditure information in July for all years. It is therefore simpler than the proposal we put forward last week. It addresses more directly the problem of authorities manipulating expenditure to increase grant claims. But it would not prevent authorities from challenging aspects other than total expenditure in the Settlement the Supplementary Reports. Nor would it stop us from introducing further Supplementary Reports should we find errors in any of the forthcoming Reports.

3. The second option is the one whereby we set a maximum amount of grant that can be claimed in 1989/90 but close down on earlier years as under the first option.

4. And, finally, the third option is to delay closing down until 1989.

5. I have tried to assess the potential risk of our exposure to manipulations of total expenditure. As we anticipated, it is not possible to produce any firm figures. But I have put together in an Annex to the paper those numbers that I have been able to identify. I should stress that these are the scale of the risk. They are not an assessment of the likely level of manipulation.

6. I have consulted our lawyers on the three options. Their view is that the first option to close down simply on total expenditure information would be relatively easy to draft. The second option would involve a more fundamental change to the grant system and would therefore be more difficult. But option two should still be possible.

7. Treasury officials have also identified a variant to Option 2 whereby we would determine grant entitlements on the basis of current expenditure rather than total expenditure. Our view is that we could not resolve the difficulties with this approval and pass the legislation in time for the 1989/90 Settlement.

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8. My view is that Option 1 is preferable to the other options. Option 2 would be much more difficult to sell to the backbenchers and given the scope for manipulation of expenditure I doubt that it would be more effective than Option 1 at restraining expenditure. Option 3 is simply too high risk.

9. The Secretary of State may wish to discuss.

D L H ROBERTS

FDGR

17 June 1988

cc. PS/Mr Howard
PS/Permanent Secretary
Mr Breakley
Mrs Phillips
Mr D Roberts
Mr J Roberts
Mr Serjeant
Mr Rowsell
Mr Whaley
Mrs Ramsey
Mr Chope

1989/90 RSG SETTLEMENT

1. The 1989/90 RSG Settlement is the last under the present system prior to the introduction to the community charge in 1990. The central feature of the present system is that a local authority's grant entitlement varies with its expenditure. For almost all authorities higher expenditure means lower grant. From 1990 onwards, however, grant entitlement will be fixed at the beginning of the year and will not vary with expenditure.

But in 1990 there will be strong downward pressure on expenditure since all additional expenditure will fall to be met by community chargepayers whereas under the present arrangements it is met by both domestic and non domestic ratepayers.

2. The change to the new grant arrangements gives local authorities an opportunity to reduce reported expenditure in the last years of the present system and thereby increase grant entitlements. In 1990 the capital control system will also be revised. This will provide incentives to local authorities to manipulate total expenditure to increase grant. Some reductions in expenditure will be genuine and rightly should lead to higher grant receipts. Others will be bookkeeping adjustments - such as use of special funds - that we have accepted over the years should reasonably lead to additional grant. But some adjustments will be more dubious simply taking advantage of this unique opportunity to increase grant.

3. Recent experience suggests that there is considerable scope for achieving reductions in reported expenditure through such accounting arrangements. The effect of some such manipulations would be to increase the total grant claim on the Exchequer without having achieved the real reductions in expenditure that would make such increases in grant acceptable. This note considers the risks of such higher grant claims and discusses options for reducing the risks to the Exchequer.

ASSESSMENT OF THE RISK

4. Since 1987/88 the amount of RSG available to local authorities has been open ended although the expectation has been that the actual claim would be lower than allowed for in the RSG Settlements. In practice local authorities have indeed spent higher than allowed for in the RSG Settlement and have forfeited grant. On present information in 1987/88 authorities overspent by £811m and consequently lost £298m grant. In 1988/89 authorities have budgeted to spend £1035m more than allowed for in the settlement and the grant claim is £521m lower.

5. In the normal cycle of events we would update our information on actual expenditure and revise grant claims accordingly. Final calculations of grant would not be made until at least two years after the end of the relevant financial year.

6. The particular risk to the Exchequer arises now because of the potential local authorities to use various accounting adjustments either to reduce reported total expenditure or to switch reported total expenditure from years in which it would reduce their grant entitlements to years where it has no impact on grant.

7. Throughout the 1980s local authorities have used various devices for reducing reported total expenditure in order to maximise grant. Common methods have been thorough use of special funds, and classifying expenditure on repairs and renewals as capital rather than revenue. Many rate capped authorities have indulged in a much wider range of creative accounting arrangements.

8. We already know that many local authorities are actively considering how best to take advantage of the forthcoming opportunity; and we know that experts in the City are working up schemes to sell to local authorities. Amongst the arrangements being considered are factoring - which involves "selling" future expected capital receipts - use of special funds, capitalising revenue expenditure, and reducing repayments of outstanding debt from revenue.

9. We can anticipate the use of some of these schemes and take account of them in fixing our assumptions for the 1989/90 Settlement. In particular we

can allow for use of special funds to reduce expenditure in 1989/90 (though we cannot now allow for further use in earlier years as local authorities have rated on the basis of the Settlement arrangements approved by Parliament. We may also be able to prevent some abuses - such as factoring - using existing powers. But we cannot allow for other dubious accounting practices in the 1989/90 Settlement without effectively condoning them and thereby encouraging authorities to indulge them.

10. We cannot quantify precisely the extent to which the Exchequer may be at risk. We estimate that in recent years rate capped authorities have understated true expenditure by around 12%. If all authorities were to understate expenditure to this extent the grant claim would rise by around £1700m in 1989/90. This certainly exaggerates greatly the extent to which grant might be manipulated. But we can expect considerable manipulation even from authorities that would normally avoid such arrangements. In particular we can expect a herd instinct to develop as it becomes clear that many authorities are manipulating the system particularly as these accounting arrangements are all within the law. Moreover the proposed changes to the capital control system, which require at least half of cash-backed capital receipts to be applied to redemption of debt in 1990, will encourage local authorities to make maximum use of capital receipts to reduce revenue expenditure in the years up to 1989/90. The risk to the Exchequer is at least £350m in respect of 1987/88 and 1988/89. For 1989/90 an expected grant underclaim of several hundred million pounds could easily become a grant overclaim. Annex A sets out the available information on the scope for manipulation.

11. The amounts at risk are so large that it is almost inevitable that steps will have to be taken to reduce the exposure of the Exchequer. This inevitably means further legislation either to pre-empt the danger or in response to some of the more dubious accounting arrangements. The following sections consider what action might be taken to reduce the risk to the Exchequer.

12. In considering what might be done we have taken account of the situation regarding determination of grant for the forthcoming year in the next RSG Settlement, the present year (1988/89) and, past years. Grant

entitlements for 1988/89 and all outstanding earlier years are due to be revised in Supplementary Reports later this year. These reports will take account of outturn expenditure for 1985/86 and 1986/87, of revised budgets for 1987/88 and budgets for 1988/89. Full sets of expenditure data for these Supplementary Reports are being put together now. This therefore provides a good opportunity for changing the present system to reduce the risk to the Exchequer. The next such opportunity when we will have full sets of expenditure data for all outstanding years is July 1989.

OPTIONS FOR REDUCING RISK TO EXCHEQUER

13. We have identified three options for reducing the opportunities to manipulate the system to increase grant claims. The first two require legislation in the next session to change the basis on which grant will be distributed in 1989/90, and to limit grant claims in respect of earlier years. The third option is to delay action until summer 1989 and then legislate to close down the present system.

OPTION 1 : Immediate closedown of the present RSG system

14. The main features of this proposal are:-
(a) grant entitlements for 1989/90 would be fixed in the forthcoming settlement and would not be linked to actual expenditure. This means that there would be no grant underclaim as in 1987/88 and 1988/89, but nor would there be any risk for grant overclaim.

(b) Final grant entitlements for 1988/89 and all outstanding earlier years would be determined on the basis of reported expenditure available on the date of the announcement in July of this year. These grant changes would be made through supplementary reports at around the end of this year, these would be the last reports under the present system.

15. Fixing grant in this way would remove the risks to the Exchequer on the grant side. But it would also reduce pressure on local authority expenditure

since higher expenditure would no longer lead to lower grant. We do not know what effect there would be on expenditure in this transitional period before the discipline of the community charge system is introduced. But every 1% increase in expenditure is equivalent to £300m. Account would have to be taken of such grant and expenditure implications when determining the 1989/90 RSG Settlement.

16. If this option is pursued an early announcement is desirable to minimise both the risk to the Exchequer and the possibility of authorities getting wind of the proposal and adjusting the accounts before we act. A simple short Money Bill would be required in the autumn to achieve Royal assent by March in order to pay grant in 1989/90 on the correct basis. Apart from this the 1989/90 Settlement and the series of supplementary reports planned for the autumn would proceed as planned other than that no account would be taken of expenditure data reported to us after the date of announcement.

OPTION 2 : Removing the opportunity for authorities to gain grant from reducing expenditure

17 This option is similar to the previous option but retains grant penalties for increased expenditure in 1989/90. The main features are : -

a) for 1989/90 the RSG Settlement would set a maximum grant entitlement for 1989/90 equivalent to the grant entitlement determined in Option 1. Unlike Option 1, however, increases in expenditure would lead to reductions in grant entitlements.

The maximum grant claim in respect of 1989/90 would therefore be the sum determined in the forthcoming Settlement.

b) grant claims in respect of all earlier years would be determined as in Option 1 i.e. they would be calculated on the basis of information on expenditure at the time of the announcement.

18. As with Option 1 the maximum amount of grant to be paid in respect of all years would be determined at the time of the announcement. But with this

option there would be a grant incentive to authorities to restrain expenditure. The legislation to effect this would, however, be more complex than with Option 1. And, unlike Option 1, subsequent steps would have to be taken to closedown on grant claims early to avoid running the present system until at least 1992.

19. Ideally the expenditure pressure imposed by this option would be on underlying current expenditure rather than total expenditure which is more susceptible to manipulation. However, this would require very considerable legislative changes and it is doubtful that these could be introduced in time for the 1989/90 RSG Settlement. We are investigating this further.

OPTION 3: Delay closing down until 1989

20. With this option we would run the system for another year and announce the revised arrangements in July 1989. At that time we would have information on expenditure for all outstanding years under the present system. The legislation at that time would therefore simply state that for the purposes of calculating grant entitlements no account would be taken of later information on expenditure in respect of any years.

21. The risk here is that much of the potential undesirable manipulation of expenditure will have already taken place. We would then either have to accept the grant consequences for the Exchequer or make the legislation retrospective to allow us to ignore information available to us. Aside from the normal undesirability of retrospective legislation this would pose particular difficulties in that local authorities would have rated on the basis of an expectation of receiving grant entitlements due under the RSG Settlement. It would be a very serious step to go back on such undertakings.

22. There is some prospect that authorities might delay manipulating expenditure until after details of the transitional arrangements to the community charge system have been announced. But there must be a serious risk that many authorities will act well before July 1989 to maximise grant.

ASSESSMENT OF OPTIONS

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23. The first option provides the greater certainty on grant as Treasury would know exactly how much grant has to be paid out under the present system in July. The change could be presented as an orderly transition to the new system where grant will also be fixed in the Settlement. By acting swiftly we minimise the risk to the Exchequer. Local authorities would also know precisely how much grant they would be entitled to and can concentrate on setting up the new system rather than expending energy trying to manipulate the present system.

24. The main disadvantage of the first option is that there would be less downward pressure on expenditure following the July announcement which may lead to higher local authority expenditure in the period up to March 1990. We cannot predict how much expenditure might rise. Some authorities will probably take the opportunity to spend more. But as expenditure has been rising in recent years there is no pent up pressure to suggest that it will rise substantially. Nevertheless every 1% rise means £300m additional expenditure.

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24. Option 2 would put greater pressure on expenditure in the last year of the present system. But a harsher grant penalty system with no rewards for lower spending would be much more difficult to sell to our supporters. Nor could we claim that with this option there would be no grant underclaim so it would not be such a smooth transition to the future fixed grant system. It is also questionable how effective it would in practice be in restraining expenditure. This depends in part on the 1989/90 Settlement. But introducing fixed grant for 1989/90 and having a fixed grant system in 1990/91 would introduce very considerable scope for artificially reducing expenditure in the middle year. Consequently both the total grant claim and expenditure may be very similar as under Option 1. In practice therefore Option 2 may in effect be very similar to Option 1 but would be presentationally worse involve more complex legislation and require a second go to close down the system for 1989/90. An option based on current expenditure may be more effective but legislation would be very complex and we may not be able to deliver it in time for the 1989/90 Settlement.

25. Option 3 has the advantage that pressures to restrain expenditure are retained in 1989/90 at least until authorities have set their budgets. But we run the risk that by the time we come to close down the system next summer the

Exchequer will already have had to pay out higher grant claims arising from creative accounting.

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PUBLIC PRESENTATION

26. Any option for early closedown of the RSG system will inevitably result in a good deal of complaint from local authorities. They will claim that central government has withheld grant on the basis of high budget figures but not giving them credit for reductions in expenditure. And of course they will complain that once again the goal posts are being moved.

27. Our justification for making the change under the first option would be that it is necessary to do so to avoid high grant claims arising from dubious accounting practices: that it is necessary to achieve a smooth transition to the new system; that it provides local authorities with certainty over grant entitlements: and that it avoids a grant underclaim in 1989/90. This option therefore has advantages and disadvantages for local authorities.

28. With the second option the presentation would have to be much more in terms of being necessary to deliver the Government's public expenditure objectives, and to counter dubious accounting arrangements. It would neither provide certainty over grant nor avoid a grant underclaim. There would be no advantages for local authorities.

29. Presentation under the third Option would need more consideration next summer but would be justified more in terms of providing an orderly closedown to the present system.

ANNEX A

Scope for Manipulating Total Expenditure

Special Funds : £1.1bn of special funds available at April 1989. Use of up to £900m could be allowed for in 1989/90 settlement. Remaining £200m could be used in earlier years to increase grant claims by around £200m

Capitalisation of repairs and renewals:

LAs have around £7bn of cash backed capital receipts that could be used to finance repairs and renewals. In practice the scope is much lower as around £5bn receipts are held by shire districts. But as much as £1bn might be used to reduce total expenditure thereby increasing grant claims by £500m.

Factoring : This scheme is specifically designed to reduce total expenditure and increase grant. It involves "selling future capital future receipts" for a lump sum which is then invested. The resultant interest receipts count as a reduction to total expenditure and hence increase grant. The future capital receipts are "repurchased" post March 1990. One London Borough is already planning to increase RSG entitlements by £1m in both 1988/89 and 1989/90 through this arrangement. The total RSG at risk in 1989/90 might be over £100m. Consideration is being given to ways of stopping this abuse of the system.

Capitalisation of debt servicing :

LAs could reduce repayments of outstanding debt from the revenue account by substituting repayment through capital receipts. At risk here is around £700m of expenditure and hence around £350m of grant, though in practice the amount involved is likely to be smaller.

Short term delaying of expenditure :

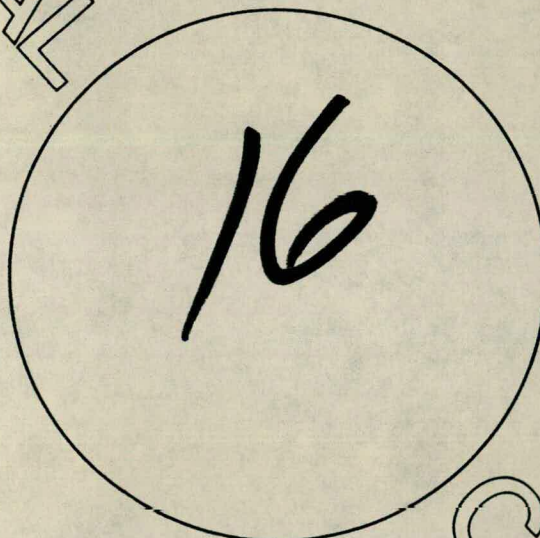
There is scope for authorities to holdback expenditure from the early part of 1990 and have a surge of expenditure in April 1990. We have seen evidence of this when targets and holdback were abolished in 1986. Perhaps 2% of expenditure might be so delayed. This would increase grant claims by around £300m.

Interest rate swaps :

This involves swapping a low interest loan for a higher interest loan with an outside body for an up front premium. This premium is then invested and the interest receipts used to reduce total expenditure. Although the amounts swapped are large the effect on total expenditure is relatively small.

Other schemes : We know of a number of other schemes for reducing total expenditure but these all appear to be relatively small scale. It is possible however tht new large scale schemes may be devised.

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DRAFT MINUTE FROM THE SECRETARY OF STATE FOR THE ENVIRONMENT
TO THE PRIME MINISTER

1989/90 RSG SETTLEMENT

We have identified a potentially serious risk that in the last years of running the present RSG system local authorities could manipulate the system to attract large additional sums of grant from the Exchequer. The risk arises because block grant is open-ended and the amount payable depends on an authority's reported total expenditure. If authorities manipulate their accounts to reduce reported expenditure the grant claim on the Exchequer increases.

We cannot accurately predict the extent to which authorities might so manipulate expenditure but experience of recent years suggests that the risk to the Exchequer could run to 100s of millions of pounds.

To an extent we can allow for this potential claim on the Exchequer in the forthcoming RSG Settlement for 1989/90. But only by allowing for an unrealistically low increase in local authority expenditure, or by a substantial reduction in the grant percentage. Neither of these would be easy to sell to our supporters. The former may be subject to successful judicial review and might also implicitly condone dubious accounting practices. A much reduced grant percentage would be read as implying that having passed the community charge legislation we are prepared to push up community charges to a much higher level than has so far been suggested.

I have therefore considered with the Chief Secretary other options for reducing the risks to the Exchequer. One that has some merit is to act early to remove the present open-ended commitment on grant and to close down the present system in an orderly way before we introduce the new grant system in 1990. If we do not act to close down the system early it will continue to operate until spring 1992.

There are a number of ways of closing down the system early. The one I favour would be to make an early announcement - in July - that grant entitlements for 1989/90 would be fixed in the RSG Settlement and would not vary with an authority's expenditure. At the same time, to avoid manipulation of grant in earlier years, we would make final determinations of grant entitlements for all outstanding years including 1988/89 taking account only such information on expenditure available to us at the time of the announcement.

This option has the advantage of minimising the time at which the Exchequer is at risk to higher grant claims. But by abolishing grant penalties it reduces the pressure on authorities to restrain expenditure before 1990. The alternative is to wait until next summer before closedown. But by then much of the grant at risk may have already have been claimed. I have also considered an option of changing the grant system for 1989/90 so that authorities would still lose grant if they spend up but would not gain additional grant if they reduced expenditure. I do not believe, however, that we could sell this to our supporters. Details of the options with the assessment of advantages and disadvantages are set out in the attached paper.

My preferred option requires an additional Bill next session. This is regrettable. But primary legislation will be necessary at some stage if we are to close down the present system before 1992. And if we continue with the present system further legislation may be necessary to closedown new dubious accounting practices that may come to light.

In we are to act on this we must do so quickly. This will reduce the chance of local authorities getting wind of our proposal and acting to circumvent it. And we must know the basis on which grant will be paid in 1989/90 before we can reach any conclusions on the 1989/90 RSG Settlement.

[I would welcome an opportunity to talk this through with you and others].

I am copying this letter and enclosure only to Nigel Lawson, Cecil Parkinson, John Major, John Wakeham and Sir Robin Butler.