24/1/337/08

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BF to ACSA

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CHIEF SECRETARY

FROM: B H POTTER

Date: 23 June 1988

cc: PS/Chancellor
Mr Anson
Mr Phillips
Mr Edwards
Mr Fellgett
cc Mr Tyrie

MEETING WITH THE ENVIRONMENT SECRETARY

I attach a revised speaking note and further background briefing for your meeting with Mr Ridley this evening. I suggest that our main objectives for the meeting might be as follows:

(i) to secure agreement in principle that some way needs to be found to prevent the anticipated surge in the use of cash-back capital receipts; the consultation document cannot be released until this is found;

(ii) agree that whatever approach is adopted any consequentials for the RSG settlement in terms of the estimated size of the loan charges and rccos items within relevant expenditure also needs to be taken fully into account.

2. I doubt if it will be possible to reach a firm conclusion on closedown. But to the extent that agreement is reached on blocking the capital loophole, it will improve the attractiveness of option 3 (closedown July 1989) over option 1 (closedown next month). Once a solution to the capital problem is found, it will be appropriate for DOE to recast the paper setting out the options again and reaching a view on the balance between them. Only at that point should the paper be submitted to the Prime Minister and other senior colleagues. This would suggest that it is unlikely the paper could be forwarded to the Prime Minister until after next week's E(LA) discussion.

Barry H. Potter

BARRY H POTTER

SPEAKING NOTES FOR MEETING WITH ENVIRONMENT SECRETARY

Tasks for Meeting

Treasury most concerned to avoid a surge of LA expenditure (or Government grant) as we move from existing current and capital control systems to the new systems. Hence two inter-related problems we need to resolve:

i) how to close down existing capital control system (and in particular deal with problem of large overhang of accumulated cash-backed capital receipts),

ii) how to close down existing RSG system, without relaxing restraints on LA spending or incurring an obligation to pay out large extra amounts in block grant.

Capital Receipts: The Problem

Officials are agreed that, if nothing is done, LAs will have the ability and the incentive to increase their expenditure and grant entitlement between now and April 1990 by drawing on their accumulated cash-backed capital receipts of some £7 billion.

The reason is that, from April 1990, LAs will be obliged to use half of all their capital receipts, past and future, to redeem debt. In April 1990 they will have to use half their outstanding accumulated receipts for this purpose and these receipts will no longer be available to finance expenditure.

A further reason is that LAs can increase their block grant entitlement by using cash-backed capital receipts to finance:

i) expenditure on repairs and maintenance (amount of expenditure involved: up to £1 billion); and/or

ii) the repayments of principal on past borrowing which LAs are obliged to make (amount of expenditure involved: up to £700 million); and/or

iii) capital spending which they would otherwise have financed from revenue (total amount involved uncertain).

All these devices would increase LAs' entitlement to block grant by reducing the total expenditure aggregate to which grant is (inversely) related.

Aware that your officials are reconsidering the numbers in Annex A of your paper. But not in doubt, I think, that sums involved, both for grant and expenditure, run into hundreds of millions of pounds.

Capital Receipts: Possible Solutions

Clear we must act to solve this problem. Main options which officials have identified are:

i) discourage LAs from using capital receipts by saying in consultation paper on new capital control system that LAs making excessive use of capital receipts between now and April 1990 will be required to use a higher proportion of their accumulated receipts to repay debt in April 1990 (my officials suggested this approach but I am by no means wedded to it);

ii) using powers under section 12 of 1980 Local Government Act, withdraw the consent which LAs now have to use capital receipts to finance repairs and maintenance; and deal with the other possible uses of capital receipts by means of offsetting reduction in the 1989-90 block grant and/or settlement spending assumption (in the latter case by including the allowance for use of capital receipts to finance repayments of principal on past borrowing and capital spending otherwise financed by revenue contributions). Reduction in spending assumption would increase grant under-claim.

Believe your officials see the second option as more promising. Could be presented as a measure to prevent surge of additional LA expenditure and block grant entitlement during transition to the new system.

Would presumably be best to announce this in, or at the same time as, consultation paper on new capital controls system, to take effect from midnight on the night of announcement.

CLOSEDOWN OF RSG SYSTEM

Grateful for further work by DOE officials. Paper very helpful in setting out nature and scale of the problem.

2. Choice is essentially between closedown of RSG system next month (options 1 and 2) and closedown next year (option 3).

3. Appreciate that you have had Treasury interests very much in mind in considering option of closedown next month. We do however remain unhappy about option 1 for reasons explained before:

(i) it would gravely weaken the restraints on LAs' expenditure between now and April 1990 by removing their grant incentives to contain spending;

(ii) it would breach several principles of good financial practice by changing the rules in mid game, being inequitable as between authorities, and by rewarding vice penalising virtue.

In view of expenditure worries in particular, still reluctant to go down that route.

4. Option 2 would be better; but probably not much better. Appreciate that it is designed to retain a degree of punishment for overspending; but understand that the view of your officials is that scope for fiddling figures is such that authorities could probably find ways of avoiding penalties for overspending.

5. An approach which related block grant to current expenditure on services rather than total expenditure, would, I believe, have considerable attractions. It would in principle get rid of most of the scope for increasing grant through creative accounting, while retaining the existing restraints on local authority expenditure. But have to accept that it would be difficult to make such a change for one year only. LAs would no doubt complain bitterly.

6. Against this background we would still be inclined to favour an approach which would combine option 3 (normal settlement this followed by closedown in July of next year) with action in meantime to pre-empt possible abuses of system, in particular:

(i) action on cash-backed capital receipts as discussed early (see previous speaking note);

(ii) allowing fully in the RSG settlement for the likely use of special funds and switching of payments between years; and

(iii) direct action, as DOE intends anyway, to deal with other abuses such as factoring and interest rate swaps.

7. This approach would not set an absolute limit on the amount of block grant payable next year but would have the powerful advantages that:

(a) the grant restraints on total LA expenditure would continue; and

(b) since closedown would take place in the context of the new Community Charge system, there would be much less ground for complaints about changing rules in mid-game, inequity between authorities and so on.

BACKGROUND BRIEF ON CASH-BACKED CAPITAL RECEIPTS

The problem

Local authorities have approximately £7b in cash-backed capital receipts ie money held on deposit mainly with banks and other financial institutions. About £5b is held by Shire Districts; only around £½b is held by Shire Counties.

2. 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 to redeem outstanding debt or set aside to meet future capital commitments (ie it substitutes for new borrowing). Councils therefore have an incentive to use cash-backed receipts before then, while they can still be spent in full, rather than after that date when more than half of them must be set aside for debt redemption.

3. Controls over the proportion of receipts which can be used for prescribed (ie controlled) capital spending should prevent excessive growth in such prescribed spending. But LAs are in principle able to use 100% of their cash-backed receipts on non-prescribed capital expenditure. In particular they can use them:

i) to capitalise current expenditure on repairs and maintenance;

ii) to replace revenue contributions to capital outlays (rccos);

iii) to finance the principal element of debt repayments due to be met out of revenue.

4. But there is an additional incentive to spend in any of these ways: because they reduce recorded total expenditure (TE), local authorities increase their block grant entitlement (which is determined by TE).

5. So we believe that LAs have a double incentive to use cash-backed capital receipts to finance non-prescribed spending and substitute for other spending:

- to use up cash-backed receipts before more than half the spending power is lost;

- to increase block grant entitlement while opportunities still exist under present RSG system.

Scale of the problem

6. DOE officials are in some disarray over this. In Annex A to the draft paper, they quoted £1b as the sum at risk from additional capitalisation and £700m as the amount which might be used to substitute for due debt repayments. They now say that the figure on capitalisation may be nearer £500-£650m and that the £700m is "too high". But what is accepted, however DOE officials may wish to qualify their estimates, is that at least £500m is at risk on expenditure and £250m in extra grant.

7. In practice, neither DOE officials nor ourselves can make a reliable assessment of the sums at risk. But they do run into hundreds of millions: and it is worth bearing in mind the economic effects:

i) all forms of spending cash-backed receipts tend to increase Exchequer costs and can also add to total public expenditure and to the PSBR (unless the money is used to repay debt);

ii) If cash-back receipts only substitute for revenue expenditure, they do not increase public spending directly; but as a result of the extra grant received they increase Exchequer costs - and when the extra grant is eventually spent add to public expenditure;

iii) If spending from cash-backed receipts is additional, it adds both to public expenditure and the PSBR directly.

Possible solutions

8. Our proposed solution was to change the transitional arrangements in the capital consultation document. Specifically, we had in mind a form of words that would discourage LAs from running-down their cash-backed receipts excessively. Some formulation along the following lines was proposed:

> "The Government will take into account the extent to which the amount of cash-backed capital receipts held by an authority changes between the date of this consultation paper and 1 April 1990, when a proportion of outstanding cash-backed receipts must be set aside to repay debt."

9. The implied threat was that if an authority ran down its cash-backed receipts excessively, they would be required to set aside a higher proportion of their receipts to redeem debt. DOE officials are not attracted to this solution because:

- if challenged, they would have to show how any such arrangement would work; and this is not yet thought through;

- there are data problems - information on cash-backed receipts is difficult to define and there are lesser problems in defining non-prescribed spending (an alternative option would be to take into account changes in non-prescribed spending);

- it is holding up publication of the consultation document.

We are by no means convinced these problems are insuperable. But neither are we wedded to that solution.

10. DOE have (reluctantly) floated an alternative. This would involve taking adminstrative action - in the form of a Departmental circular - to withdraw the Secretary of State's present consent in circular 5/87 to use capital receipts in order to finance repairs and maintenance. Ideally such a circular would have to be issued at the same time as the consultation document.

11. This approach would remove the option of running down the cash-backed receipts to pay for non-prescribed spending: but the receipts could still be used to finance due debt repayments. Thus if we pursued the DOE option, it would also be necessary to reduce the estimate of debt repayments within total expenditure (to the extent, we expected them to be financed out of capital receipts rather than as revenue expenditure); and we would have to accept that rccos to pay for capitalised repairs would be higher. So adjustments to the financing elements within relevant (and total) expenditure would be necessary. But this is a second order effect which can be pursued amongst officials.

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CLOSEDOWN OF THE RATE SUPPORT GRANT SYSTEM: BACKGROUND BRIEFING

1. We agree with DOE officials that, at some stage, it will be necessary to closedown the present RSG system. There is little point, and it may be administratively impracticable, to go on making adjustments to the grant due to authorities under the present system for many years into the 1990s. (The final "conclusive calculation" for 1981-82 is just about to be made in 1988.) The issues are when and how closedown should take place. Whenever it happens, primary legislation will be needed.

The options

2. Under option 1 Mr Ridley would announce in July 1988 that "from midnight" he would take account of no new information about authorities expenditure in calculating their grant entitlements for any year up to 1989-90. Adjustments to grant for years up to 1988-89 would take account only of information he had already received. And in 1989-90 grant would be paid on the assumption that authorities would spend at the RSG Settlement spending assumption (ie in line with provision).

3. Option 2 is a variant on option 1. Rather than simply paying the whole amount of grant available for 1989-90, an ad hoc system of withdrawing grant for overspenders would be used. To work effectively, this would have to act on public expenditure, and not on so-called total expenditure which is open to so much manipulation. Technically, we think this could probably be done, although the legislation could not be as straightforward as option 1. Politically it would open the Government to the accusation that they were introducing a new target and penalty system for just one year.

4. Option 3 would mean closedown "from midnight" in July 1989, one year later. In the meantime, the pressures in the present RSG system that penalise authorities for putting up spending would continue, but so would the opportunties for authorities to manipulate their expenditure figures to claim extra grant for no good reason.

General considerations

5. In our view (although this is primarily a political judgement) any "midnight tonight" closedown would provoke loud complaints from local authorities. It would involve removing a legal obligation on the Government to pay extra grant if authorities reduce their spending (and indeed to withdraw grant if they increased it). Authorities who had not declared lower expenditure in 1988-89 and earlier years until they were sure they could deliver would get no reward. And authorities that had declared artifically low expenditure to obtain a cash flow advantage would keep extra grant for ever. There would undoubtedly be genuine hard cases, and a good deal of exaggeration in the complains. Treasury, as well as DOE, Ministers would be accused of behaving improperly and breaching several principles of good financial practice. The Government would be seen to have offered a reward (more grant) if authorities kept their spending down, and then to have withdrawn the reward when it was rightfully claimed.

6. We therefore believe that closedown could only reasonably be announced in the context of good news for local authorities, such as a more generous RSG settlement. Indeed, the quantum of AEG available may need to be topped up to explicitly cover an extra payment to all authorities in recompense for withdrawing their rights. The price of option 1 may therefore be something closer to Mr Ridley's option for AEG for 1989-90 - an increase of around £1 billion - than your option of £520 million more grant. On the other hand, the RSG settlement for 1990-91 may anyway have to be more generous.

Exchequer costs and savings

7. Leaving aside the possibility that closedown would imply more generous RSG settlements, the grant effect of option 1 is broadly the same as the grant effect of never closing down the system. The latest (but inevitably very broad-brush) figures are as follows. Option 1 would means a saving to the Exchequer of:

(i) £200 million from the potential use of special funds in years up to 1988-89;

(ii) £150-300 million from short term delays in expenditure from 1989-90 into 1990-91;

(iii) an unknown sum from any other schemes that DOE have not thought of.

The total saving is therefore about £350-500 million, or possibly a little more.

8. The cost of option 1 to the Exchequer is estimated as:

(i) £250-650 million if there is no grant underclaim in 1989-90; and

(ii) rather more, if Mr Ridley does not agree to allow fully in the RSG settlement spending assumption for at least £900 million drawing of special funds in 1989-90, and make full allowance for any capitalisation (particularly of loan charges) that cannot be covered by the transitional arrangements to the new capital control system.

The grant underclaim figures assume that authorities will spend in 1989-90 7½% more than they spend in 1988-89, ie the same percentage increase as in the previous year. If they spend less, the underclaim will be less, but that would be welcome. The range of figures reflects the options for provision to be discussed in E(LA); the underclaim of £250 million is consistent with the highest option 1 for provision, an underclaim of £650 million with the lowest option 4 for provision.

9. In summary, there are therefore substantial uncertainties about the Exchequer costs and savings. Only early closedown in July 1988 will place a cash limit on the amount of grant to be paid out before 1990. But option 1 looks very broadly equivalent to no closedown provided Mr Ridley agrees to make full allowance, through a lower settlement spending assumption, for the use of special funds and capitalisation in 1989-90. And option 3 should secure some savings without the cost of foregoing the grant underclaim in 1989-90.

Public expenditure

10. In public expenditure terms, option 3 looks clearly better than option 1. The marginal pressures on authorities to keep down spending in order to claim more grant would continue for another 12 months. And, crucially, authorities would set their budgets for 1989-90 in the knowledge that those pressures were still in place. It is very difficult to quantify the amount of additional public expenditure which authorities might incur in 1989-90 under option 1, if they thought they had a "window of opportunity" to spend up without grant pressures before the extra financial discipline of the Community Charge system comes into effect. But our best guess remains that additional expenditure of 1-3%, or £300-800 million covers the likely range.