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SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

The Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CHIEF SECRETARY
REC. 23 JUN 1988
Mr Potter
Cx
Mr Anson Mr Edwards
Mr Fellgett,
Mr Call.
cc Mr Tyrie

23 June 1988

Dear John

I have received your letter of 22 June about the consultation paper on local authority capital expenditure and finance. The consultation paper had been the subject of extensive discussions by officials and by E(LF) and the version sent to the printer on 20 June had been cleared by your officials and incorporated amendments to meet the points in your letter of 17 June.

The issues which you have identified are not new. Local authorities have been free throughout the present system to use capital receipts to finance repairs and maintenance which would otherwise be carried out over time and charged to revenue account. This practice has had a fair measure of encouragement from Ministers. We have frequently drawn attention to it when responding to criticisms from our supporters about restrictions on the use of capital receipts, and we allow for it when deciding what level of capital allocations would be consistent with the cash limit for local authority capital expenditure. Your officials have long since been involved in discussion about the estimate to be made for 1989-90. The new capital control system proposed in the consultation paper has likewise always included the proposition that a proportion of capital receipts should be applied to debt redemption.

You mention what you describe as estimates by my officials of the amount of cashbacked receipts which might be applied to the capitalisation of repairs and maintenance and of the use of receipts as a substitute for revenue account contributions to debt repayments. There has clearly been some misunderstanding as to the nature of these figures. Neither was an estimate or forecast of additional expenditure that would be financed by these means. They were assessments of upper or outer bounds within which (and probably far within which) the reported total expenditure subject to reclassifications would necessarily be constrained. They were not estimates of what would necessarily occur nor of levels of actual additional expenditure. Moreover, they relate to the three open-ended grant years 1987-88 to

100% RECYCLED PAPER

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1989-90. The £700m which you mention appears on reflection not to be an indication of the scope for reducing debt repayments from revenue. It assumed that authorities could use capital receipts in lieu of such repayments. But this is not possible under present legislation. £50m to £100m per annum at most would be a more realistic estimate of the scope for reducing total expenditure by adjustment of loan repayment profiles. In any event, it would be perverse to penalise authorities for repaying debt from capital receipts when that is what we propose to require them to do in the new system. The figure of £1 billion on capitalisation was likewise an upper limit of the bookkeeping adjustments that might be possible over the 3 year period. The actual sum could be less. But this would not be additional expenditure but simply a post hoc reclassification of expenditure in the revenue account to capital.

We do have a precedent. In 1986-87, local authorities in general faced for the first time negative marginal grant rates. At the same time, they had been presented with our previous proposals for a new capital control system, which envisaged restrictions on the future spending of receipts in some ways harsher than those we now propose. The effect on capitalisation appears to have been less than £100m.

Your officials have explained to mine what they had in mind by way of changes to the transitional arrangements set out in the consultation paper. My officials are not persuaded that the changes would be feasible. The financing of capital programmes is settled on an annual basis after the event rather than day to day as expenditure is incurred. (This issue was, as your officials will know, once exhaustively explored in the context of proposals that the prescribed proportion should be changed in mid-year.) Thus, because we are well into 1988-89 and because the relevant accounts for 1987-88 are still open, the changes would have to be retrospective for 15 months if they were to be fully effective. Nor would we have the data necessary to enforce them.

There is, however, a larger objection to the changes proposed by your officials. Because they would take immediate effect, and because of the penalties that capitalisation would be liable to attract, they would have to be specifically drawn to the attention of local authorities when the consultation paper was published. They would be perceived by our supporters, particularly in the Shires, as a further attack by the Government on the ability of local authorities to use their capital receipts under the present system. We would be seen as going back on what we have said about their freedom to use receipts to pay for repairs. This would create the worst possible climate in which to conduct the consultation on the new capital control system which otherwise offers the prospect of removing many of the difficulties which we have faced in recent years over local authority capital expenditure.

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I do not think that it would be right to use the new capital control system as a means of offsetting the effect of capitalisation of repairs and maintenance (or other revenue expenditure) on local authorities' entitlements to revenue support grant. You and I are considering separately options that would address this issue on a wider front.

I propose that we should proceed as follows.

For the reasons already set out, it would be wrong to delay or amend the consultation paper. It is still possible for it to issue on Tuesday, and it should be published then.

We then need to consider 1988-89 and 1989-90 separately.

In 1987-88, it is clear that there was a substantial underspend on the cash limit. That was attributable to a surge in housing receipts and led to criticism of the Government from those concerned with homelessness. Right-to-buy applications continue to be buoyant and the assumptions underlying the 1988-89 cash-limit already appear pessimistic. (This was drawn to the attention of your officials in connection with my announcement last week of the second tranche of EYF allocations.) We are already forecasting an underspend for the current year of £230m. As the cash-limit applies to net expenditure, I see no reason to be concerned by any increase in capitalisation of up to that amount.

For 1989-90, our officials have already adopted a provisional assumption about the level of non-prescribed expenditure. That assumption was made in light of both the proposals for the new capital control system and the effects of the present RSG system. It stands to be reviewed during the remainder of the Survey in light not only of any later information about historic levels of capitalisation but also of the response to the consultation paper and of our decisions (when reached and announced) about close-down, on which it is within our power to remove the RSG incentive to capitalisation.

We have in reserve for 1989-90 the possibility of amending the general consent for the use of capital receipts to finance repairs and maintenance within specific Ministerial control. (This again is something that would have to be done in relation to a whole year.) This would, however, be a significant and controversial step, which might well be as badly received as the measures which we had to take on 9 March this year. I do not think that we should commit ourselves to such a step now.

I am sending a copy of this letter to the Prime Minister.

Yours ever

Nicholas

NICHOLAS RIDLEY