

PROSPECTS FOR LOCAL AUTHORITY FINANCES**Introduction**

The Community Charge (CC) will be introduced in Scotland in April 1989 and in England and Wales in April 1990. This note explores the prospects for CC in the context of projections of local authority income and expenditure for the next 3 years. The focus is on both the prospects for CC income in aggregate and also on implied year-on-year changes in the average per capita charge. Most of the figuring is for Great Britain as a whole, but where necessary separate assumptions are made for Scotland on the one hand and England and Wales on the other. As far as we know this is the first attempt to examine the level of CC in 1990-91 - other analyses, for example by the DOE, merely illustrate the level of CC implied by current levels of LA spending.

2. The results depend on a number of crucial assumptions and are very uncertain. The uncertainties relate not just to the period after CC is introduced but also to behaviour beforehand. In view of this, one possible alternative scenario - involving different behaviour in 1989-90 and 1990-91 - is presented. In addition some calculations at the end of the note show the sensitivity of the prospects for CC to various changes in assumptions about behaviour in 1990-91.

Current income and expenditure

3. The future course of CC depends mainly upon the future course of

LA current expenditure,

income from business rates

and grant (AEG) receipts from central government.

It also depends on the extent to which current expenditure is covered by current income ie from grant, rates and the CC. Any shortfall (or longfall) involves a running down (or up) of rate fund balances. Changing balances is only a temporary expedient income and expenditure. The outcome is also dependent on LAs' use

of special funds. These funds lie outside the rate fund account and can be used by authorities as a creative accounting device to change the level of relevant expenditure for grant purposes, without changing actual expenditure.

4. The projection of LA expenditure is built-up from separate assumptions about numbers employed, earnings increases -75 per cent of current expenditure goes on pay - procurement expenditure, interest payments etc and then checked for overall plausibility. Within this, it is assumed that the additional manpower to implement CC adds some £100 million to LAs' pay bills from 1989-90. This increase is consolidated in the first year of CC when there will be additional costs from other initiatives such as the national curriculum and abolition of ILEA. One factor, which this work has not attempted to allow for, is the effect of competitive tendering. It is possible that this could result in the provision of LA services at lower cost, thereby holding down the growth of expenditure in real terms.

5. The projection assumes full indexing of business rates in line with the RPI and that the business rate base will be rising somewhat faster than over the recent past, reflecting strong growth of business investment in property.

6. The proportion of LA expenditure financed by central government grant has been falling in recent years as a result of the Government's attempts to rein back LA spending. Under the present system grant is withheld if authorities overspend, but there is no provision in the new system for grant penalties. The Government's commitment that the level of CC per household in each local area in 1990-91 will be broadly no higher in real terms than rates per household in 1989-90 if the local authority expenditure is unchanged in real terms, effectively means that the level of AEG in 1990-91 should not rise in real terms from outturn (after grant penalties) in 1989-90. However, the projection assumes that the amount of grant paid in 1990-91 is such that the grant percentage in that year will be at least as high as in 1989-90 before penalties. As grant penalties are expected to reduce the actual grant percentage by about one percentage point in 1989-90 an unchanged percentage before penalties implies a one point rise in the actual grant percentage in 1990-91. But at the moment the

risk appears to be that if anything the grant percentage could be higher than assumed. A small further rise in the grant percentage in 1991-92 is assumed.

7. Some attempt has also been made to allow for the effect of the distribution of grant among individual authorities on the levels of aggregate expenditure and CC. Under the transitional arrangements for England which last from 1990-91 to 1994-95, and simplifying a little, authorities in the "south" gain grant at the expense of those in the "north and inner London". This redistribution could well push up aggregate levels of both expenditure and CC. Authorities in the "south" rather than maintaining spending and having a lower CC than otherwise would be able to boost spending without having to raise more CC to finance it. Authorities in the "north and inner London" might maintain expenditure, rather than cutting it to match the lower grant, by increasing the CC and blaming central government.

8. There could well be significant shortfalls in **CC receipts** due partly to evasion and partly to LAs' inability to collect receipts from people on the register. It is assumed that the authorities' anticipate a 5 per cent shortfall when setting the charge for 1990-91 but that in the event the shortfall is larger at 10 per cent. The unexpected additional 5 per cent shortfall is assumed to be financed by a run down in balances. It is assumed that the unexpected shortfall is a little smaller in 1991-92 and that the authorities again run down balances.

9. The future course of local authority current expenditure and receipts, on the various assumptions stated above, is summarised in table 1. Current expenditure grows at around 4 per cent a year in real terms from 1989-90, more than the unusually low increase which seems in prospect for 1988-89, but not very different from earlier years. In 1990-91 grant income rises more, and CC income less, in real terms than expenditure. In 1991-92 grant rises a little faster than expenditure but with business rates rising by less than 2 per cent in real terms there is a relatively large increase in real CC income.

Table 1: Local Authority Current Account Expenditure and Receipts

<u>PES terms, GB</u>	<u>£ billion</u>				
	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Expenditure</u>					
Total relevant expenditure	35.0	37.3	40.7	44.2	48.0
Total current expenditure	35.3	37.6	41.1	44.6	48.4
<u>Receipts</u>					
Grant (cash)	16.3	16.7	18.1	20.1	22.1
Rates	18.8	20.5	22.0	13.6	14.3
of which:					
Domestic	8.8	9.6	9.7	0.4	0.3
Non-domestic	10.0	10.9	12.2	13.2	14.0
Community charge	-	-	1.0	10.6	11.6
Drawings from balances	0.3	0.4	0.0	0.3	0.5
Total finance	35.3	37.6	41.1	44.6	48.4
Grant percentage (accruals)	45.6	44.8	44.5	45.5	46.0
	<u>Annual percentage changes</u>				
<u>Cash</u>					
Total current expenditure	8.8	6.5	9.3	8.5	8.6
Grant	9.4	2.9	8.4	11.0	9.8
Rates & community charge	8.0	9.3	11.7	5.4	6.9
of which:					
Domestic	8.0	9.3	10.9	2.4	8.0
Non-domestic	8.0	9.3	12.4	8.1	6.0
<u>Real terms</u>					
Total current expenditure	3.4	0.8	3.8	4.3	4.3
Grant	4.0	-2.7	3.0	6.7	5.5
Rates & community charge	2.7	3.4	6.2	1.4	2.7
of which:					
Domestic	2.7	3.4	5.4	-1.5	3.7
Non-domestic	2.7	3.4	6.8	3.9	1.8

Capital Account and Borrowing

10. The main feature of the recent past is the unexpectedly high level of capital receipts - for example from council house sales and repayment of LA mortgages - in 1987-88. It is assumed that receipts are maintained at the 1987-88 level in real terms. Gross capital expenditure - ie. acquisition of capital assets - is assumed to rise by 1 per cent a year in real terms.

11. The projection of LA borrowing - the LABR - in 1988-89 gives weight both to the projections of LA income and expenditure and to the outturn for borrowing in the first two months of the year. The latter suggests higher borrowing than the former. Thereafter, the LABR merely mirrors projected movements in the balance of income and expenditure.

LABR - £ billion

1987-88	1988-89	1989-90	1990-91	1991-92
1.5	2.0	1.5	2.1	2.4

The rises in borrowing in 1990-91 and 1991-92 can be seen as partly reflecting the assumed unexpected shortfall in CC receipts. It also reflects the assumption that net capital spending will rise in real terms.

Rates of Increase of Domestic Rates and CC

12. Table 2 shows the growth of domestic rates and CC, taken together, expressed in three different ways:-

- a. the growth in aggregate LA receipts from domestic rates and CC, as in table 1;
- b. the growth in domestic rates and CC per (non-exempt) adult; ie as if domestic rate prior to 1990-91 had been distributed equally among those liable to CC;
- c. the growth in domestic rates and CC per household; ie as if CC payments were distributed equally among only those liable to rates.

Table 2: Domestic Rates and CC

	<u>annual percentage changes</u>				
	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
Total LA income	8.0	9.3	10.9	2.4	8.0
Per household	6.6	7.8	9.3	0.8	6.2
Per adult	7.2	8.7	10.3	1.9	7.4
Memo: increase in total RPI (%)	4.0	5.0	5.8	4.1	4.0
Average level of CC per head*(£)	-	-	279	279	300

* Assuming that it is set on the assumption of 5 per cent non-payment; 1989-90 is average for Scotland only - other years are averages for GB.

13. The per capita figures are based on the forecast of the adult population provided by the Government Actuary's Department (GAD). It is assumed that a constant 3 per cent of the adult population is wholly exempt from the charge (treating partly exempt persons as four-fifths exempt).

14. The treatment of the CC in the RPI is not yet decided. Lines 2 and 3 of table 2 gave some indication only of how the CC component of the RPI might behave, if it were decided to include it. They suggest real reductions in 1990-91, when the charge is introduced in England and Wales but sizeable real increases in 1991-92. But it is important to note - see table 4 below - the transitional effects on the RPI of the ending of domestic rates and introduction of CC. These are likely - if the CC were included in the RPI - to increase the RPI because the burden of rates falls more on richer households excluded from the RPI while the burden of CC is more evenly distributed and therefore higher on households whose expenditure is used for compilation of the RPI.

Variant

15. This variant explores what might happen if authorities make greater attempts, through creative accounting in the run-up to CC, to maximise their grant entitlement, with the effects being unwound in 1990-91, increasing expenditure in that year. Although most creative accounting devices have been blocked, one that remains is the use of so-called special funds. When an authority

runs down its special funds the effect is to reduce relevant expenditure in PES terms for given purchases of goods and services, which may reduce grant penalties. But under the new grant system there will be no grant penalties and therefore no incentive for authorities to use special funds in this way.

16. Special funds are currently estimated at about £1.1 billion. If authorities respond to the reforms by running these down over the next two years the effect will be to reduce relevant expenditure in the period before CC but then to produce a step-up in relevant expenditure in 1990-91. The magnitude of these effects is highly uncertain. For illustrative purposes table 3 shows the result of £400 million less relevant expenditure in 1989-90 and £1 billion more in 1990-91 and 1991-92, with the remaining assumptions unchanged.

Table 3: Summary of Variant

	<u>Annual percentage changes in real terms</u>				
	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Current expenditure</u>					
main case	3.4	0.8	3.8	4.3	4.3
variant	3.4	0.8	2.8	7.7	4.1
<u>Grant</u>					
main case	4.0	-2.7	3.0	6.7	5.5
variant	4.0	-2.7	1.9	10.2	5.3
<u>Domestic rates & CC</u>					
main case	2.7	3.4	5.4	-1.5	3.7
variant	2.7	3.4	4.3	5.2	3.4

Sensitivity of CC to Alternative Assumptions

17. As a further indication of the sensitivity of the figures in table 2 to the underlying assumptions, table 4 gives changes in rates/CC in 1990-91 under a range of alternative assumptions about behaviour in that year:

1. reduction in balances of £500 million instead of £250 million;
2. no change in balances (ie. £250 million less drawing);

3. increase in balances of £250 million compared to a reduction of £250 million in the main case;
4. 1 per cent faster growth in current expenditure (for given grant);
5. grant one per cent higher.

In each case only one assumption is changed. For example case 5 shows the effect of higher grant for given expenditure and balances.

Table 4: Community Charge in 1990-91 - alternative cases

	<u>Annual percentage change</u>					
	Main Case	Case 1 (Variations in balances)	Case 2	Case 3	Case 4 (more expend)	Case 5 (more grant)
Total income	2.4	0.2	4.6	6.8	6.1	0.6
per household	0.8	-1.4	3.0	5.2	4.4	-1.0
per adult	1.9	-0.3	4.1	6.3	5.6	0.1
CC per head*(£)	279	273	285	291	289	274
RPI inflation 1990-91 on 1989-90						
(i) Excluding rates and community charge from RPI**	3.8	3.8	3.8	3.8	3.8	3.8
(ii) Replacing rates by community charge***	4.0	3.9	4.1	4.2	4.2	3.9

* Assuming 5 per cent non-payment

** In this case rates are dropped from the RPI and are not replaced by community charge. It is assumed that rates are removed from the RPI in the January preceding April 1990, in order to avoid a spurious drop in the RPI when rates are abolished (and their "price" apparently falls to zero). Were this not done, there would be negative inflation in 1990-91.

*** Replacing rates by the community charge increases the rate of inflation in all cases, even in Case 1. This is because of the "index household" effect. A given increase in LA income impacts more heavily on the particular households covered by the RPI if it is raised by community charge rather than rates. This adds 5 per cent to the increase in the rates/community charge indicator in the year community charge is introduced.

18. Variations in balances (cases 1 to 3) come through one for one on CC in absolute terms. A £250 million difference in balances is worth about 2 percentage points on the growth of CC. The more authorities run down balances to finance expenditure (cf case 1 with main case) the smaller is the increase in the CC. Running down balances is however not a long term option, only a temporary expedient. Over time LAs have by law to balance income and expenditure.

19. Table 4 shows also the high gearing between changes in expenditure and grant and changes in CC ie. given proportionate changes in expenditure and grant have larger proportionate effects on CC. In the case of changes in expenditure (for given grant) the gearing is about 1 to 4 because CC finances about 25 per cent of expenditure. In other words a 1 per cent increase in expenditure produces a 4 per cent increase in CC.

20. The gearing between changes in grant and CC is 1 to 2; a 1 per cent increase in grant produces a 2 per cent reduction in CC. This is because grant income is roughly twice CC income.

Conclusions

21. There are perhaps two main conclusions:

- (i) due to transitional effects the rate of increase of the burden of domestic rates and CC could be quite different in 1990-91, the year CC is introduced in England and Wales, from subsequent years. It is possible that the burden could rise by a relatively small amount (or even fall) in the first year of CC in England and Wales;
- (ii) all the assumptions are uncertain and the figuring is very sensitive to changes in assumptions. Sensitivity analysis shows that it is possible, by varying the assumptions in not unreasonable ways, to produce projections which range from a large real increase in the burden of domestic rates and CC to a sizeable real reduction. These projections largely turn on decisions

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which will be made by Ministers and by local authorities over many years which cannot, by their nature, be forecast at this stage.

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