FROM: A C S ALLAN
DATE: 11 JULY 1989

MR SEDGWICK

cc Sir P Middleton
Sir T Burns
Mr Monck
Mr A J C Edwards
Mr D J L Moore
Mr Bent
Mr Hibberd
Mr M L Williams
Mr O'Brien
Mrs Chaplin

RPI

The Chancellor would be grateful for a note setting out the forecast increases in the RPI attributable to water privatisation, electricity privatisation, and the introduction of the community charge, based on the following assumptions:

(i) For water privatisation, the increases should be restricted to those directly attributable to privatisation itself: ie the net effect (if any) of moves to a new capital structure should score, but not the funding of investment that would take place with or without privatisation.

(ii) The same assumptions should be used for electricity privatisation.

(iii) For the introduction of the community charge, no assumptions should be made about whether local authority spending or revenue raising would be higher or lower if rates had been retained. The impact on the RPI should be confined to the 'index household effect'.

2. In each case, he would be grateful to know the forecast increase in prices for the service as a whole (ie the forecast percentage increase in water prices etc); and the portion

6/11/7

attributable to privatisation and the introduction of the community charge. In addition, he would like figures for the corresponding contributions to the total increase in the RPI. Quarterly figures up to Q4 1991 would be helpful.

3. I should be grateful if you could let me have this information by close of play on Monday 17 July.

ACSA

A C S ALLAN

B10a

FROM: J S HIBBERD (
DATE: 14 JULY 1989
EXT : 4590

CHANCELLOR

cc : Sir Peter Middleton
Sir Terence Burns
Mr Monck
Mr A J C Edwards
Mr D J L Moore
Mr Sedgwick
Mr Bent
Mr M L Williams
Mr O'Brien
Mrs Chaplin

RPI:

You asked (Alex Allan's minute to Peter Sedgwick of 11 July, copy attached) for RPI inflation forecasts adjusted specifically for privatisation effects as they may affect water and electricity charges. You also asked for the impact of the Community Charge, assuming that its only impact was due to the index household effect.

see para 6 & table

Water and Electricity Privatisation

2. I have discussed privatisation effects with PE division and paras 2-5 reflect their views. They are satisfied that it is reasonable to assume that the forecast price increases for Water and Electricity are no higher than if the industries were remaining in the public sector. Whatever their ownership, both industries, and Water in particular, face large investment programmes. If the industries had been continuing in the public sector the Treasury would have argued for an 8 per cent return on this new investment and for increases, so far as was practicable, in their present financial targets (Electricity (England and Wales) 4.75 per cent for 1989-90; Scottish Electricity 2.7 per cent for 1989-90; and Water 2¼ per cent for 1988-89).

3. In practice, and particularly for the next two years, the debate would have been over what were the maximum politically acceptable price increases. It may be that for Water, ministers collectively would have settled on lower increases than those implied by the privatisation Ks, and accepted even larger EFL bids. But it is of course impossible to say how they would have decided.

4. In the longer term we would expect lower price increases to result from privatisation because of increased efficiency stimulated by privatisation and, in the case of Electricity, by competition. Electricity prices are also lower because of the more rigorous and commercial approach to coal prices with the financing burden shifted

from Electricity to the Coal industry; though this could also have happened under a public sector regime and indeed it would be a necessary percursor to the privatisation of BC. (An offsetting factor in the case of Electricity is the sharp increase in nuclear costs thrown up by the privatisation work; but that would have emerged sooner or later under any regime.)

5. For public consumption the safest generalisation is that the price increases are no higher in the short term than if the industries were staying in the public sector and that for the medium term and beyond, as the benefits of privatisation come through, price increases should be lower than otherwise.

Community Charge

*

6. The community charge indicator in the RPI is projected to rise by 20.8 per cent in April 1990. Of this, 3.5 per cent is due to the index household effect. For given local authority revenue spending plans, therefore, this is the only effect directly associated with the introduction of the community charge. It is worth 0.15 per cent on the all-items RPI inflation from April 1990 to March 1991. Thereafter even this effect drops out of the annual inflation rate calculation.

Conclusions

7. The attached table shows the quarterly path of inflation for water, electricity and community charge separately and their respective contributions to the RPI over 1989Q1-1991Q4. The forecast figures are based on the June forecast. The forecast for water charges is due to be updated in a few days; it is likely to be a little lower than we assumed in the forecast. Given that privatisation of itself is deemed to have no direct effect on inflation, the only factor to adjust for in the light of your request is the index household effect; this is also shown in the table.

JH

J S HIBBERD

Assumes 8¼% increase in LA spending (GB) in 90-91 & average charge of £319

Movements in Water, Electricity and Community Charges and their contributions to RPI inflation

	1989				1990				1991			
Charges	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Water												
Increase on year earlier	8.0	14.3	13.7	13.7	13.1	12.1	12.7	12.7	12.7	11.7	11.7	11.7
Contribution to RPI inflation	0.06	0.10	0.10	0.10	0.09	0.09	0.09	0.09	0.08	0.08	0.08	0.08
Electricity prices												
Increase on year earlier	8.6	7.4	6.5	6.5	6.5	6.6	7.2	7.2	7.2	5.5	3.8	3.8
Contribution to RPI inflation	0.22	0.20	0.17	0.17	0.17	0.17	0.19	0.19	0.19	0.14	0.10	0.10
Rates Community Charge (exl index household effect												
Increase on year earlier	8.4	9.6	9.6	9.6	9.6	17.3	17.3	17.3	17.3	9.4	9.4	9.4
Contribution to RPI inflation	0.35	0.40	0.40	0.40	0.40	0.73	0.73	0.73	0.73	0.39	0.39	0.39
Index household effect*												
Increase on year earlier	-	-	-	-	-	3.5	3.5	3.5	3.5	-	-	-
Contribution to RPI inflation	-	-	-	-	-	0.15	0.15	0.15	0.15	-	-	-
All items RPI inflation	7.7	8.2	7.6	6.7	6.2	6.2	6.0	5.7	5.6	4.9	4.8	4.7
All items RPI inflation excluding index household effects**	7.7	8.2	7.6	6.7	6.2	6.0	5.8	5.5	5.4	4.9	4.8	4.7

** There is an index household effect in April 1989 associated with the introduction of community charge in Scotland. But it is minuscule, about 0.01 on the all-items inflation rate.

** Rounding 0.15 per cent index household effect to 0.2 per cent.

Ch/ This has just arrived from DOE.
DJS

1990/91 LOCAL AUTHORITY GRANT SETTLEMENT - MAIN POINTS

19/7/89.

* Total support for local authorities from the taxpayer (in revenue support grant and specific grants) and from business rates will rise by 8.5% in 1990/91. This is a fair settlement which will help meet the cost of local spending next year at a time when inflation is expected to be falling.

* This settlement will ensure that next year each council in the country is able to charge £275 per adult for a standard level of service. If the council charges more, after allowing for the safety net, it will be because of its overspending. And every voter will know because this will be clearly set out on his bill.

* There is no guarantee that extra grant would feed through to lower community charge levels. Exchequer grant to Scotland rose by 10% in 1989/90 but local authority spending rose by 12% producing no gain to the community charge payer.

* At the present time areas with high rateable values subsidize areas with low rateable values. This is reflected in people's rate bills, ~~clearly~~. The safety net is therefore not a new imposition. It is merely a means of phasing out this unfairness to avoid sudden disruption to loser areas.

* New proposals for the safety net will ensure that gainer areas get between 40% and 50% of their gains in 1990/91. The remainder will go to loser areas to give them time to adjust spending levels. Gainer areas would not gain a single penny if the Government's reforms were not being introduced. They would continue to suffer from the unfairness of transfers of resources to areas with lower rateable values.

* There will be about £100 million of extra help to Inner London boroughs to give them time to reduce the overspending which they will inherit from ILEA next year.

* There will also be £100 million of additional support to areas with particularly low average rateable values. Those areas with average rateable values of £130 or less will receive up to £25 per adult. This will reduce to zero where average rateable values are £150 or more. Almost all this money will help areas in the North.

1989/90 COMMUNITY CHARGE FIGURES - AND THE ALTERNATIVES

* The 1989/90 figures are an estimate of what the community charge would have been in each local authority area with and without the safety net if it had been in force this year. They are not in any sense a forecast of next year's community charge. This will depend both on the level of grant and business rate income for each authority and on the spending of that authority next year.

* These figures are not related to the provision of Government grant for next year. Individual grant allocations for next year have yet to be decided.

* The calculations have been done on a similar basis to last year's except that spending has been measured by estimated income from rates and government grants instead of using reported local authority expenditure. This method of calculation is more closely in line with the way actual charges will be determined in 1990/91.

* The new decisions on the safety net have been incorporated into the figures.

* Each council in the country could have charged £240 per adult, not taking account of the safety net if the system had been introduced this year.

* The figures contain some estimates of the benefit to those local authorities gaining from the £100 million to Inner London and the £100 million to low rateable value areas.

* The figures for Labour's two tax alternative and for the SLD policy of a local income tax are comparable to the community charge figures without the safety net.

* The figures assume an 80/20 split between capital value rates and local income tax. They also assume an equalization of resources between authorities. This means that £1 per £1000 of capital value and 1p in local income tax raises the same amount everywhere in the country and that each authority gets an equal share of business rate income.

* The figures are for a single person on male average earnings and entitled to the single person's allowance - about £14,000 gross. Ward sisters earn around this figure in many parts of the country.

* Figures are given for a range of different property values. Constituencies can pick the figure most realistic for their area. Both council and private tenants ~~will~~ would have to pay capital value rates.

Background

The background to the settlement is one of continued local authority over-spending.

- Budgets in 1989-90 are £1.9 billion more than the Government's assessment of a reasonable level of spending (the aggregate of all grant-related expenditure assessments - GREAs).

- On the basis of this year's budgets, Conservative authorities as a group spend below their GREA. But nearly 90% of Labour authorities spend above their GREA.

There is still enormous scope for savings. The Audit Commission has identified potential savings of over £2 1/2 billion for local authorities as a whole from contracting out, efficiency improvements etc. District auditors have identified £900 million savings for individual local authorities. Only £300 million of this has been realised.

Reducing public expenditure as share of national income is a central element of economic policy - the only way to create the conditions for sustained growth and the defeat of inflation. Local authorities must play their part.

New System of Local Government Finance

The new system of local government finance to be introduced from April 1990 is:

- simpler,
- fairer, and
- will lead to greater accountability of local authorities to the people they serve.

Its key features are:

- the community charge replaces domestic rates;
- a national uniform business rate replaces local business rates set by councils;
- a new grant system, once fully introduced, will distribute grant so that if all councils delivered a standard level of services, the community charge would be same everywhere.

Under the new system, some 70% of total standard spending will be met by the taxpayer and the business ratepayer. So the community charge only pays for part of the total.

The community charge system:

- spreads the burden of paying for local government over almost all those benefiting from local authority services;

- promotes accountability, since all electors will understand how much the council is spending compared with what it could spend; and

- ensures that over one in four will receive rebates.

Under the new system of business rates:

- all businesses will pay the same business rate poundage, set by central government;

- business rate revenue will be distributed to all councils on a per adult basis;

- in future the business rate poundage will rise no faster than inflation;

- transitional provisions will ensure that large increases are phased in; and

- the Midlands and the North will gain £850 million.

New grant system. The principle is that, if authorities spend at the level needed to provide a standard service, the community charge should be the same everywhere. This is a much simpler and fairer system.

- The Government starts by deciding the total amount local authorities need to spend to deliver a standard service - Total Standard Spending (TSS).

- Then it decides how much of this falls to each authority.

- It deducts the authority's share of business rate income.

- It then pays grant so that the cost of the remaining standard spending works out at the same amount per adult everywhere - community charge for standard spending (CCSS).

- Authorities with greater needs therefore get more grant.

- Any variations in spending from the standard level will feed through £1 for £1 into the level of community charge - up or down.

Grant Settlement for 1990-1

The Environment Secretary announced that government support for current spending for 1990-91 would be £23.1 billion, £1.8 billion more than in the current year. This increase of 8.5% is well above projected levels of inflation for next year.

This support (known as Aggregate Exchequer Finance (AEF)) includes Standard Spending Grant (the old rate support grant, now technically known as revenue support grant), and the payment to local authorities from business rates. It also includes most specific grants. So most of the current grants which used to form part of Aggregate Exchequer Grant (AEG) are within AEF, such as police grant, and education support grants. But grants which pay for all or almost all of spending on a particular service - such as housing benefit, or mandatory student awards - are paid <u>in addition</u> to AEF.

The division of AEF between Standard Spending Grant, business rate payments, and specific grants will be made in the Autumn.

The Environment Secretary also announced <u>Total Standard Spending</u> - the amount authorities could spend in aggregate, to deliver a standard level of services. <u>For 1990-91, this will be £32.8 billion</u>. This is an increase of £1.2 billion on local authority budgets for 1989-90 - a challenging, but realistic target. Those authorities which stayed within their old grant-related expenditure assessment (GREA) should have no difficulty in spending at standard spending - and Conservative authorities as a whole spent <u>below</u> their GREA. However, the standard spending figure will impose a squeeze on overspending authorities, particularly high-spending Labour authorities. It thus maintains the Government's ten-year policy of getting down local authority overspending - a policy which the community charge will help achieve.

The <u>community charge for standard spending</u> (CCSS) depends on the level of TSS and grant (AEF). The figures above mean that, if local authorities spent in line with the standard assessment, the community charge for standard spending would be about £275. This is the <u>benchmark for accountability</u> in the new system. It is the community charge payer's ready reckoner and will be put on his bill alongside the figure he is asked to pay. After taking account of the safety net (see below) chargepayers will know that if their local authority is charging more than the CCSS they are overspending.

Actual community charges will depend partly on the safet net, and partly on each local authority's own decisions on spending. . If local authorities spend more, the money will have to come from the community charge.

This is a fair and balanced settlement. Reasonable, well run authorities will be well able to set community charges in line with the CCSS (after taking account of any contribution to or from the safety net). But overspending councils will have to account to chargepayers for their overspending.

Safety Net

The Environment Secretary also announced changes to the safety net, to enable gainers to get more of their gains sooner.

Not surprisingly, with such wide-ranging changes to the local government finance system, there will be substantial changes in domestic tax bills. In some authorities, the community charge is likely to be lower than the average domestic rate bill per head; in others, it will be higher.

One of the main reasons for this is that the old system distributed grant on the basis of rateable value. Where both spent at need, an area of low rateable value would get more grant than an area of high rateable value. So community charges will tend to be higher than average rate bills in areas of high rateable value. Charges are also likely to be high in some parts of Inner London because ILEA's overspending will now fall wholly on the chargepayer and not on the business ratepayer.

The Government has decided that it would not be right for the full impact of the changes to come through straight away - that would mean community charges in some authorities might be £100 above this year's average rate bill per head, or in some cases more. Where these increases would result from overspending, the accountability of the community charge will help to bring this down. But this is bound to take time, and it would be unreasonable to expect chargepayers to bear the full burden straight away. So some form of safety net is essential.

The original proposal for the safety net was:

- losing authorities would see no increase in domestic tax bills in the first year: if they maintained their spending in real terms, the community charge in the first year need be no higher than the average rate bill per adult in real terms;

- this was to be paid for by gaining authorities subject to a maximum of £75 per adult for any authority.

The Government has reviewed the safety net in the light of representations. The new proposals are:

- charge payers in losing authorities will bear the first £25 of their loss;

- there will be special protection for two particular sets of authorities (see below);

- gainers will get between 40% and 50% of their gains in the first year;

- the £75 ceiling on contributions will be maintained.

This is a <u>much better package for the gainers</u>.

- Previously, only the larger gainers saw any benefit at all in the first year. Now all of them will get around 45% of their gains straight away.

- Previously, charge payers in some authorities had £75 of their gain deferred. Now, fewer will do so.

- For the great majority of gainers, the amount deferred by the safety net arrangement will be lower than previously expected, in some cases subtantially so.

The new package is also <u>a fair deal for the losers</u>. On average, the community charge in losing areas need be no more than 50p a week above the average rate bill, if local authorities spend in line with the standard spending assumption. And in two particular caes, there will be special protection.

- Areas with the lowest domestic rateable values are among the heaviest losers. So there will be additional support of about £100 million to give these authorities more time to adjust to a higher level of charges.

- In Inner London, the boroughs are taking responsibility for education for the first time with the abolition of ILEA. It will undoubtedly take time for them to bring down ILEA's overspending. In the short term, a specific grant of £100 million will be paid to reduce the burden falling on the chargepayer. For the first year, much of this serves to reduce the cost of safety net protection for Inner London and thus reduce further the cost of the safety net falling on gaining authorities.