File

10 DOWNING STREET

From the Private Secretary

Mr Redwood.

You may like to see the attached letter and note. Subject to Ian Gow's reaction, Treasury will give the note under circulation.

I agree with the hard Treasury 'line'.

(i) it is logical in terms of economic management

(ii) by denying public enterprise access to ~~public~~ private finance and by subjecting them to Treasury discipline, we give the managers more incentive to seek a full private sector solution.

AT

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AT.

I agree

JR.

CONFIDENTIAL

218/2

JR.
27/2/85

Treasury Chambers, Parliament Street, SW1P 3AG

Ian Gow MP
Minister for Housing and Construction
Department of the Environment
2 Marsham Street
London SW1P 3EB

25 February 1985

Dear Ian

SALE AND LEASEBACK AND INTEREST SWAPS
WATER AUTHORITIES

Thank you for your letter of 21 November. I am sorry not to have replied before now. Your proposals raise fundamental issues, and I wanted to give them careful consideration.

I understand, and sympathise with the water authorities' wish to act commercially. If they were private sector organisations it would not be for me to object to what they propose (although for some of the proposals I suspect their finance directors would). But at present they are public sector businesses; and their financial transactions have a direct impact on public spending and borrowing. This means that there have to be limits to the freedom they can enjoy in raising finance. All other nationalised industries are in the same position.

I will start with the question of sale and leaseback, setting out first the general policy considerations which apply equally to related proposals. A number of transactions - including asset sales, indiscriminate local authority mortgage book sales and sale and leaseback arrangements reduce public spending and borrowing, but, unlike a reduction in spending on goods and services, they do not reduce the demand for money; and do nothing to help us achieve our macro- economic objectives of lower inflation, interest rates and taxation. Indeed, to the extent that these devices generate paper "savings" which are nevertheless used to provide room for new spending, they increase the overall demand for money, and positively hinder progress towards our macro economic goals. There is not even much of a presentational gain in lower (net) totals because the Treasury Select Committee and other informed commentators are quick to point to these effects.

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In practice, I think our approach has to be pragmatic and undoctrinaire. On the macro-economic grounds indicated above we should reject all proposals to enter into transactions of these kinds. However, we do allow some such transactions to go ahead because they bring with them sufficient benefits in terms of the achievement of other government policy objections. Council house sales, for example, improve financial conditions little if at all; but they are worth doing because of the far reaching economic, social and political benefits of increased home ownership. The case of local authority mortgage books is explained in the Annex to the enclosed paper, but except in unusual circumstances, the sale of mortgages will not be instrumental in achieving a council house sale. We have to make an assessment of the overall costs and benefits of all such proposals, whether they involve new schemes or extensions of existing arrangements not reflected in plans and decide on balance whether they should be allowed to go ahead or not. In order that the basis of this judgment is clear, I am enclosing a note by officials which sets out the arguments at greater length, and describes precisely how we should aim to reach conclusions in these cases.

The enclosed paper includes an explanation of why we do not think water authorities' sale and leaseback proposals will improve financial conditions. If therefore they were used to make room for increased expenditure, it would make it more difficult to achieve our overall goals for inflation, interest rates and taxation. In this case I do not think there are other policy objectives which sale and leaseback will bring nearer - it will not, for example, lead to an advantageous change in the management of the assets, in which case I would have been more sympathetically inclined to the proposal. If you felt there were other specific benefits that outweighed the costs associated with the transaction I would be happy to discuss them further. But as matters stand, for the reasons given above, I cannot accept the water authorities' proposal.

On the use of the National Loans Fund (NLF) I should make it clear that I do not see a case for allowing nationalised industries to borrow long term in sterling from the private sector as long as they remain in the public sector. The market regards nationalised industry debt as broadly equivalent to government debt, because it assumes an implicit Government guarantee. Nationalised industries do not borrow on the strength of their own credit standing, but on that of the Government's. It makes sense, therefore, for their borrowing to be raised by the Government itself and channelled through the NLF because:

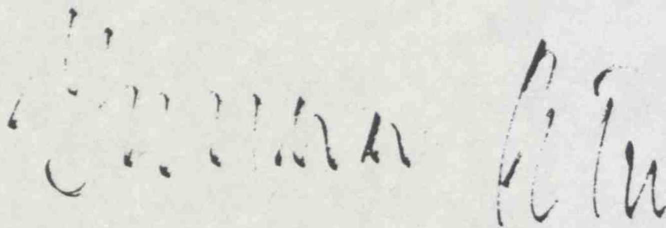
(a) it enables the funding of nationalised industries and of the Government itself to be co-ordinated through the Government's operations in the gilt-edged market and avoids the conflicts which would be likely if separate operations were going on;

(b) it avoids the extra cost that would be likely because nationalised industry debt, though almost equivalent to Government debt, would not command quite such fine terms.

So we cannot approach this as though borrowing by nationalised industries and private sector bodies were on all fours.

I fully understand that the water authorities may want to adjust the balance between their fixed and floating rate debt. But I do not accept that early repayment of fixed rate borrowing from the NLF is as difficult, or as expensive, as you suggest. In any case, my officials are considering at present how the NLF's floating rate facility might be improved - which might help to meet the water authorities' objective. But as I am sure you are aware, there are statutory constraints on what the NLF can do, which means that it can never be quite as flexible as a bank. The greater flexibility in obtaining finance is of course one of the attractions of privatisation.

Our approach to interest rate swaps is also being reconsidered generally at present and I will write to you separately about this in due course.



PETER REES

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PUBLIC EXPENDITURE CONTROL: THE SALE OF ASSETS AND OTHER FINANCIAL TRANSACTIONS

One important general objective of government policy is to roll back the boundaries of the public sector so as to enlarge the area within which free enterprise and a competitive market economy can function. Sales of public sector assets however also have an impact on other government objectives in the economic field. This note therefore examines the implications of the sale of public sector assets and analogous financial transactions (such as leasing) for the government's economic and public expenditure control policies. It discusses the varying effects of such transactions in relation to the government's objectives, and sets out guidelines by which proposed transactions can be assessed.

Macro-Economic Objectives and Asset Sales

2. A central element of the government's economic policy, as set out in the Medium Term Financial Strategy, is to hold down the growth of public expenditure and borrowing, in order to reduce inflation and also, without crowding out private sector expenditure, to create room for lower taxation. Lower expenditure is important at the micro-economic level in helping to create opportunities for the private sector to develop and expand its supply of goods and services; but it is in relation to the wider macro-economic goals that public expenditure and the PSBR are especially important. The public expenditure measure on which most attention is focussed for both planning and control purposes is the planning total. However the monetary and macro-economic effects of various elements of the planning total differ, and thus the composition of public expenditure (and of government revenues) has to be taken into account in setting the PSBR target that is consistent with the government's macro-economic objectives.

3. In general, an increase in public expenditure financed by a higher PSBR will, by raising activity and prices, increase the demand for money and hence make it harder to finance the borrowing requirement in a non-inflationary way. Similarly an increase in current receipts will reduce the demand for money. But a financial transaction such as a sale of assets, although reducing the public expenditure planning total (because the sale receipts are classified as negative public expenditure), will make little difference to the demand for money since it will simply represent an exchange of claims (eg shares for cash) between the public and private sector. Thus where an increase in gross expenditure is offset by higher asset sales so that there is no net change in the planning total, there will be an increase in

the demand for money just as if the PSBR had been increased; and if this is not to put further pressure on interest rates or money supply (and hence future inflation) it will require a lower PSBR.

4. The monetary impact of different types of asset sales, although generally weak, varies somewhat. Share sales, eg as part of the privatisation programme, have little impact, especially where the paper on offer is likely to be a close substitute for gilt-edged stock. The asset sale reduces the demand for gilts, at given interest rates; so a reduction in the supply of gilts, to match the lower PSBR, does little or nothing to ease the difficulties of financing the PSBR in a non-inflationary way. Similarly, refinancing existing public sector loans, such as local authority mortgages or export credit, is likely to be offset in monetary terms almost entirely by increased lending by the private sector, especially the banks and building societies who take over the loans. Again this would do little if anything to reduce the demand for money. Sales of real assets, such as land or council houses, are rather different, and involve the private sector in raising new finance. But they still probably do little or nothing to reduce the demand for money.

5. There are further difficulties where the asset sales add directly or indirectly to bank lending. Where the sales offset on increase in spending (ie net public expenditure and the PSBR are unchanged), the proportion of the PSBR that is financed by sales of gilts to institutions and the public has to rise if the increased bank lending is not to add to monetary growth. These additional sales of gilts increase the pressure on interest rates, crowding out other forms of borrowing.

6. The increase in bank lending is likely to be greatest in the case of refinancing of existing public sector loans (eg refinancing of fixed rate export credit or LA mortgages) or sales of real assets (eg land and council houses). Since higher gross spending is itself likely to add to bank lending, there is a strong presumption that higher gross spending financed by asset sales will exacerbate the management problem which the monetary authorities already face in the money markets.

7. To summarise: public expenditure objectives are defined in terms of the planning total which, consistently with international conventions, is defined net of sales of assets. But the extent of asset sales within the composition of the total has important implications for the fiscal stance and monetary conditions, and thus the government's objectives for inflation. Using higher sales of real or financial assets to finance higher gross spending will require a reduction in the PSBR to leave the fiscal stance unchanged. Hence, higher expenditure associated with higher asset sales either reduces the scope for tax cuts, or means tighter financial conditions for a given PSBR.

Other Objectives

8. From a purely macro-economic point of view, therefore, it would be helpful if the

government's expenditure objectives could be defined in terms of gross expenditure. But the government has other important economic objectives in relation to asset sales, including:

1. the transfer of public sector enterprises and trading activities to the private sector (privatisation); and otherwise encouraging the private sector to take on, unaided, responsibilities formerly borne or assisted by the public sector.

2. the transfer of physical assets to the private sector where there are management, efficiency, social or other micro-economic benefits (eg council house sales).

3. The disposal of surplus public sector fixed assets as part of the efficient management of public sector resources (eg the initiative to set targets for the disposal of surplus land and empty buildings).

9. Sales of assets can thus provide an important contribution to the Government's wider objectives, particularly in relation to the micro-economic, political and social benefits of reducing the role of the state. Sales have therefore been included in the planning total on two bases:

i. counted against the planning total as a whole, but not individual programmes, ie receipts from the privatisation programme, classified as special sales of assets (SSA);

ii. counted against programme expenditure, ie other sales of assets.

10. The treatment of non-SSA sales receipts gives departmental Ministers an incentive to generate such receipts. The Survey discussions generally focus on net expenditure, and to the extent that receipts are increased a given net target is consistent with higher gross spending. The incentive operates differently in-year, partly because the scope for generating additional receipts is more limited and partly because in some areas the rules governing the treatment of unanticipated additional in-year receipts constrain the extent to which they may finance additional gross expenditure. But, to the extent incentives do have an effect, the present definition of the planning total operates consistently with the full range of the government's objectives only if account is taken of the changing composition of public expenditure in macro-economic decision making.

11. In some cases, however, sale of an asset will bring no net advantage to other (non macro-economic) objectives. Some transactions involve nothing more than the transfer of title from the public to the private sector; while the management and use of assets remains within the public sector (or as though it were in the public sector). For example, the sale

and lease back of physical assets will typically involve only a transfer of title with little or no managerial or operational changes. In such cases there will often be a net disadvantage. There may be a financial cost, in that the annual rental or leasing charge would be greater than the cost of equivalent public sector borrowing. The problems for money market management, mentioned in paragraph 5 above, may also arise if the transaction involves the purchaser borrowing from the banks or building societies.

12. It is sometimes argued that any reduction in public spending or borrowing is ipso facto advantageous to the government in that it creates a favourable impression in financial markets. But there is no benefit in a purely cosmetic reduction in public expenditure or the PSBR. Parliament (most recently the TCSC in their report on the Autumn Statement), the financial markets and other commentators are increasingly making their own adjustments to the government's expenditure and PSBR objectives and achievements to make allowance for the type of financial transactions discussed in this note. Indeed cosmetic expenditure reductions, where they lead to increases in gross expenditure, damage the long term integrity and credibility of expenditure control.

Direct Private Sector Financing of Public Sector Activities

13. A financial lease, whether or not associated with a sale of the asset, is one way in which private sector capital may be directly introduced (ie rather than by the government itself borrowing from the private sector by eg selling gilts) into the financing of public sector activities or projects. The injection of private finance might be used to achieve a PSBR lower than otherwise, but will probably take the form either of increased bank lending, or of finance raised from the capital markets. In the case of bank finance, this will directly offset the beneficial effect of a lower PSBR on the demand for money. If the finance is raised from the capital markets - either equities or debentures - this will tend to displace gilt sales, to an extent which will depend on how close a substitute the newly issued company securities are for gilts. It is likely, whatever the source of private finance, that any net effect on the demand for money will be small.

14. The arguments of the previous sections may therefore be extended to the private financing of public projects or activities, which are seen as analogous to the sale of assets. If there is no offsetting reduction in the PSBR, there will be an increase in activity and prices, and upward pressure on interest rates. In some cases there may still be a micro-economic benefit from private sector participation in the management of the public sector project and activity. Any such benefit will need to be set against the costs to the public sector, in particular any difference between the implied cost of finance and the cost of the public sector itself financing the activity, ie the cost of borrowing in the gilts

market. Thus the "Ryric Rules" governing the use of private sector finance (for nationalised industries investment) require that the net yield of the project should be greater than if it were publicly financed by at least enough to cover the increased cost of raising risk capital from the financial market. These rules also require that the competition with other private sector borrowers be fair; if the lender is in effect being offered a risk free security eg because it is explicitly or implicitly guaranteed by the public sector, there is a clear comparison with investment in gilts, and a direct substitution of finance with no scope for macro or micro advantage. They also apply in the special case of private financing of housing association activities. Although classified to the private sector, housing associations receive the majority of funds for capital projects and subsidy to meet their revenue deficits as public grant.

15. Similar principles apply to sale and leaseback, or other leasing proposals. There is no advantage to such schemes when their only effect is to reduce (or avoid an increase in) the planning total, PSBR or other control total (eg, in the case of a public corporation, its EFL). This consideration is reflected in the requirement for financial leases to be capitalised for expenditure control purposes by nationalised industries and local authorities (a principle now followed in the private sector with SSAP 21). The implied cost of finance (or rental or leasing charge) is also likely to be greater than the implied cost of government borrowing (taking account of any leakage of tax allowances to the private sector). On the other hand there may be micro advantages. Some leasing deals can bring operational flexibility or other managerial benefits that could not be available if the assets were purchased, and implementation may be justified on that basis (the capitalisation rules do not apply to operational, as opposed to financial leases). Alternatively the involvement of private sector lenders may be part of a policy of switching from a grant-based scheme within the public sector to a loan-based scheme, which in some circumstances might be more efficiently managed if based on private finance. The key yardstick for any private financing scheme is its justification in terms of cost, efficiency and related (micro) criteria, and not as a means of circumventing public expenditure controls.

Expenditure Control Arrangements

16. These macro-economic and other effects are complex and cannot be readily be measured against each other. For the purpose of expenditure control the issues need to be separated and clear rules and guidelines given to departments.

17. Two rules are proposed; they apply to all new schemes involving financial transactions that have not been previously agreed, and to any action to extend or widen the use of a previously agreed scheme:

A. Financial transactions (ie transactions which have negligible effects on activity,

prices and the demand for money) should only be undertaken where they bring micro-economic benefits in terms of the management and use of real assets (para 8).

B. In a case where a financial transaction can be shown to bring significant micro-economic benefits, approval can only be given where these benefits outweigh the costs. These costs will include the direct additional cost of raising finance from the private sector, by comparison with the government itself financing the activity by borrowing in the gilts market.

18. The Treasury must be consulted in any instance where, in the view of the department, there is a case for proceeding under these rules. There are three options:

(i) not to go ahead with the transaction;

(ii) to go ahead but not to count it against the departmental programme (or related control total), ie to count it within special sales of assets:

(iii) to allow the transaction to offset expenditure within a departmental programme.

19. Where there is judged to be no net benefit, option (i) will be appropriate. In a few cases, established practice or previous Treasury agreement may point to option (iii); for example, new efforts to encourage council house sales, for which the present arrangements (which are given statutory force, but which are currently under review) allow the use by local authorities of a prescribed proportion of receipts; and disposals of surplus land and empty housing following Ministers' recent initiative. But for the balance of cases, there is a presumption that the middle course (SSA treatment) will be appropriate. This treatment will properly allow the Treasury to decide whether the macro-economic implications should be reflected in a lower PSBR or, to the extent they are not, to judge whether (and where) spending should be increased or taxes reduced. Where the incentive effect of any proposal in relation to the range of government's objectives (para 10) is weak, or where there is uncertainty about the scale of receipts so that unplanned increases would otherwise finance increases in expenditure not allowed for in setting the PSBR target, SSA is more likely to be appropiate.

20. The attached annex briefly assesses against these rules three proposals that have been made recently.

ANNEX

Recent Proposals

1. This annex briefly assesses three proposals that have been made by the Department of the Environment in recent months:

i) the sale and leaseback of assets by the water authorities would involve only a transfer of title. It would thus bring no micro benefits (and possibly a financing cost). It clearly fails against the criteria in paragraph 17.

ii) Sales of local authority mortgages to banks or building societies (where this is not necessary to secure the sale of the underlying real asset) similarly fails. To the extent that some mortgage sales have already been accepted in the context of steps to reduce cash limit overspending in 1984-85 and in the Survey decisions for 1985-86, this will have been reflected in public expenditure plans and judgements on the fiscal stance. In this case the Treasury's concern applies to any increase in the amounts involved in those years, and to the use of this method of finance in future years.

iii) the refinancing of housing association loans would allow a nominal reduction in expenditure which, on present DOE propoals, would be offset by higher spending elsewhere. This nominal reduction would arise as Housing Corporation loans were repaid, but it would represent no more than a transfer of financial claims from the public to the private sector, with no accompaning benefit of any kind - indeed there would probably be costs rather than benefits, because the private sector finance would almost certainly be more expensive. It should also be noted that Housing Corporation guarantees of (private sector) associations' borrowing would have similar effects overall. Such schemes are therefore not acceptable in their present form.

2. All three schemes fail in the first instance because they do not transfer assets to the private sector in any effective sense, ie in terms of the management and use of the asset, as opposed to the transfer of title. There are thus no micro benefits to set against the costs. Indeed, without any transfer of management initiative, there is unlikely to be any chance of micro benefit.

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