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Leakes
Legal
How do we rum
to this?

FROM: A J C EDWARDS
DATE: 27 June 1988

CHIEF SECRETARY

cc Chancellor 12/2
Sir P Middleton
Mr Anson
Mr Phillips
Mr Potter
Mr Fellgett
cc Mr Tyrie

RSG SETTLEMENT AND RELATED MATTERS

At your meeting on Thursday with Mr Ridley you commissioned a paper by officials about the problems of winding up the existing RSG system, and the related problem of capital receipts, as the basis for an early discussion with the Prime Minister. DOE's first draft of this paper did not seem to us satisfactory, and we are still discussing this intensively with them. The paper will not, however, be able to deal adequately with some of the more delicate issues at stake, and it may therefore be helpful if I try in this minute to summarise how we see things in preparation for your discussion with the Chancellor.

The Problem

2. The problem is, in a nutshell, that, if we are not careful, there could be a surge in local authority spending and in government grant to local authorities as we move from the exisiting control systems for local authority current and capital expenditure to the new systems.

3. The immediate area where we are vunerable is government grant. Under the existing system (but not the new system from April 1990) most local authorities lose grant if they increase their total expenditure and gain grant if they reduce it. This feature of the system has the merit of strengthening local authorities' financial incentives to restrain their expenditure. Unfortunately, however, authorities are able to massage their reported expenditure totals downwards by means of various creative accounting devices and thus claim extra government grant. The main such devices,

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and our best guesses as to the extra amounts of government grant potentially claimable by the authorities between now and April 1990, are shown in the accompanying table. There are other manipulative devices as well, including factoring and interest swaps. Yet another device, just invented, is advance maintenance deals, which would enable authorities to use capital receipts this year or next to finance maintenance and repairs in future years when the restrictions on the use of capital receipts will be tighter. DOE are confident, however, that they can block off these additional manipulative devices, which are not reflected in their table.

4. There are four important points to note about the expenditure/grant manipulation devices in the table. First, local authorities will have an immense incentive to draw on their accumulated 'special funds' and some of the other devices for reducing reported expenditure during the rest of this year and next year so as to gain extra government grant; for under the new system from April 1990 these grant advantages will no longer be available.

5. Second, authorities will anyway have an incentive quite apart from increases in their grant entitlement, to maximise use of capital receipts to finance expenditure before April 1990 when they will be required to use more than 50% of their accumulated stock of receipts to retire debt.

6. Third, the most significant of the devices listed are in fact legitimate in terms of the existing system. The special funds device, in particular, is legitimate. For grant purposes payments into a special fund have scored and continue to score as expenditure while drawings on such funds score as negative expenditure. Local authorities lost grant when they built up the existing £1.1 billion of special funds in the expectation that on some future occasion they would be able to gain grant correspondingly. The use of capital receipts to finance repairs and maintenance is similarly legitimate within reason.

7. Finally we have to beware of the danger that in the process of solving the problem of vulnerability on grant, we do not

simultaneously reduce the general restraints on total local authority spending.

Options for action

8. The paper by officials will identify two broad options for action to protect the government against a surge of claims for extra grant.

- Option 1: 'a fixed grant for 1989-90, with immediate 'closedown' of earlier years. Mr Ridley would announce at the end of July that the grant for 1989-90 would be a fixed sum, not related to expenditure, and that no further adjustments would be made to grant, in respect of either the current year or earlier years beyond those flowing from changes already reported to the DOE.

This is the old 'option 3'

- Option 2: expenditure-related grant to continue for 1989-90, with action as necessary to wind up the existing system next year. Mr Ridley would announce a 'normal' settlement this year and would wait until next year before completing the unfinished business of the existing system. In the meantime all foreseeable loopholes would be either blocked or offset in the amount of the grant settlement.

Certainly under Option 2, and preferably under Option 1, it would be important to take action as well on the capital side to prevent a surge in repairs and maintenance expenditure financed by capital receipts and to preclude 'advance maintenance deals'.

Options compared

9. In comparing the options there are 5 main factors to consider, effects on government grant, effects on total local authority expenditure, stage management, financial propriety and legislative implications. It is convenient to take these in reverse order.

10. First, the legislative implications. A Bill will be required to close down the existing RSG system. Option 1 would require

short but highly contentious bill at the beginning of the 1988-89 session, the pressures on which are already intense. Option 2 would require a much less contentious bill at the beginning of the 1989-90 session.

11. Second, financial propriety. We have to assume that Local Authorities would complain loudly and stridently about option 1, which can justifiably be described as changing the rules and the goal posts in mid-game. Local authorities who have accumulated 'special funds', at the cost of reduced grant, in previous years would complain vigourously. There must inevitably be some doubts as to whether the government could sustain its position. Option 2 would not involve this problem in anything like the same degree. It would be quite natural for the government to announce arrangements for winding up the existing system in the context of the proposed grant settlement for the first year of the new system. By that stage it may well be possible to proceed on the basis that all grant claims arising from special funds already ? how accumulated would be met provided that the funds are run down before the end of 1989-90.

12. Third, stage management. Option 1 would only achieve its intended objective of blocking claims for extra grant if the government suceeds in keeping its intentions secret up to the time of announcement. If local authorities guess what is afoot, they will draw on special funds straight away and report lower expenditure immediately so as to avoid being caught out. The problems of preserving confidentiality up to the last moment should not be underestimated. It would be difficult to avoid warning the other ministers and department's concerned with local authorities in advance - and some time in advance, too. The difficulties of maintaining complete confidentiality in such circumstances are well known. If the governments intentions were leaked or widely guessed the DOE would probably call off the whole plan. Option 2 does not raise any comparable problems.

13. Fourth, the effects on government grant. This aspect of the comparison between the two options is less than clear-cut. Option 1 has the considerable advantage of certainty. Under Option

1 grant, once settled would be a fixed and known amount, whereas under option 2 we would have no comparable certainty.

14. The comparative amounts of grant which the government might expect to have to pay out under the two options are more difficult to predict. Under option 1 we would not be at risk on creative accounting devices (provided that secrecy had been maintained up to the time of announcement). The government would in effect serve notice that it was not prepared to meet the extra grant claims which the authorities thought they were entitled. Option 2 could not deliver similar certainty about the outcome on grant. Under option 2 the aim would be to set the level of grant lower than in a normal settlement so as to offset the use of special funds by the authorities. We would also shut off the grant gains from delaying expenditure to 1991-92 in the context of next years settlement. We would limit the repairs on maintenance route to extra grant by separate and specific administrative action to limit the ability of authorities to finance repairs and maintenance from capital receipts. In short, therfore, Option 1 would more comprehensively and dependedly deal with manipulative devices leading to extra grant claims. But the government could take action under option 2 to offset the likely effects of special funds claims and to block off or contain most but not all of the other main possibilities for manipulation.

This is critical

Can we really offset this?!

15. A major disadvantage of option 1, in grant as well as expenditure terms, however, is that the government would lose the 'grant underclaim' resulting from the fact that many local authorities will in practice establish their budgets at levels above the Governments settlement spending assumption and will thus have their grant entitlements reduced under the existing system. The amount involved here could be of the order of £250-£600 million depending on the levels of the settlement spending assumption and the authorities budgets.

16. Mr Ridley has said in discussion with you that he would be prepared to have a lower grant settlement under option 1 than under option 2. We do not know, however, exactly what he has

in mind. We do wonder, moreover, whether this would in fact be the reality. As described above, option 1 would, we think, provoke the strongest criticism from local authorities on the basis that the goal posts had been shifted in mid-game. Especially incensed would be the authorities with special funds who had been planning to draw on them next year or in the remainder of this year. They would feel totally cheated. Even if Mr Ridley started out with a tough grant settlement, therefore, we would expect him to come under intense pressure when the closedown Bill was before the house to make concessions, and in particular a concession whereby authorities could obtain grant relief in respect of drawings on their existing special funds. Such concessions could be enormously expensive unless Mr Ridley acted simultaneously to remove the exemption from grant underclaim in which case we would be back with Option 2. From the Treasury's point of view, despite what Mr Ridley has said we risk in practice ending up with an extremely expensive settlement this year followed by another expensive settlement next year. In other words, we risk ending up by paying twice over for the transition to the new system. When these risks are weighed in the balance, option 1 arguably looks less attractive even in terms of grant than option 2.

17. Finally, the effects on total local authority expenditure. There is no doubt, that on this criterion, option 2 is superior to option 1. It would retain the grant incentive to local authorities to keep their total spending down during a period which local authorities may see as their last chance for milking business rate payers and setting a high starting level for the national non domestic rate.

18. DOE claim to believe that the financial disincentives at the margin provided by the existing RSG system have little effect on Local authority expenditure. We do not share this view, which incidentally implies that the disincentives to expenditure from the community charge are likely to be similarly ineffective. For an average authority which has to raise an extra £150 from rate payers for every £100 of extra expenditure, the marginal impact of extra expenditure on the domestic rate payer would be about 40% under option 1, compared with about 70% under option 2 and 100% under the community charge system.

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Conclusions on Option 1 versus Option 2

19. Mr Ridley and DOE seem extremely attached to Option 1, despite the furore which it would undoubtedly cause. They say, doubtless sincerely, that they are concerned to protect the exchequer from extreme vulnerability over grant. We think that they are also anxious to get rid of the complications of the existing RSG system just as soon as possible.

20. For all the reasons discussed above Treasury officials would go for Option 2 rather than Option 1, provided that a reasonable overall settlement on grant and provision can be obtained. If option 1 were chosen, we would think it better to allow individual authorities to have the grant benefit of existing special funds but to offset this fully in the grant total. We would not see maintenance of the existing grant percentage as a desirable policy objective. Preserving this percentage is equivalent to underwriting past excesses by local authorities.

how can this be done?

Capital receipts

21. As mentioned earlier local authorities will have both the incentive and the ability to use cash backed capital receipts between now and 1990 on repairs and maintenance, since they will 'lose' more than 50% of their accumulated receipts on 1 April 1990 (they will have to use them to retire debt). Under option 2, authorities will have a grant incentive as well to substitute capital receipts for revenue wherever possible in the financing of repairs and maintenance. Under either option they will have an incentive both to spend more on repairs and maintenance (thus intensifying in some degree the pressures on the construction industry) and to finance all the repairs and maintenance they do to the greatest possible extent from capital receipts, thus enabling themselves to spend more elsewhere for any given level of rates.

22. The conclusion we would draw is that DOE must take action to control the financing of repairs and maintenance through capital receipts in any event as well as cutting of further devices such

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s forward maintenance deals. DOE say that they can do this without legislation. The best time would probably be January/February of next year. In the meantime, we suggest that you should now agree that the capital controls consultative paper should issue tomorrow as originally intended.

Next Action

23. The next action as we see it should be:

i. agreement as soon as possible on the official paper about options 1 and 2 for Mr Ridley to send to the Prime Minister;

ii. we should stand ready to give you a draft minute to the Prime Minister if that seems appropriate;

iii. in the meantime you may like to authorise us to let DOE issue the consultative paper on the future capital control system (we need to pass the word to DOE immediately after discussion with the Chancellor);

iv. subject to the outcome of your discussion with the Chancellor, you may also wish to ask us to confirm to the Cabinet Office your wish to cancel this weeks E(LA) meeting.

24. We shall be minuting separately on rate-caping and dual-running.

p.p. Barry H. Potter

A J C EDWARDS

CLOSEDOWN: GRANT AND EXPENDITURE AT RISK

	£ million at risk on: Expenditure	Grant
(i) Drawings on previously accumulated 'special funds', which score as negative expenditure		
[(a) 1989-90	c900	c450]*
(b) Earlier years	c200	c200
(ii) Postponement of expenditure from 1989-90 to 1990-91, when there will be no grant penalty	?300	?150
(iii) Reductions in reported expenditure through scoring repairs and maintenance as capital expenditure		
(a) extra expenditure	?200	?100
(b) switch of financing to capital receipts	700	350
(iv) End-loading the profile of debt repayments which LAs are obliged to make	?200	?70
(v) Reductions in reported expenditure through reduced revenue contributions to capital expenditure	?50	?25
		900

* Not included in total: can be taken into account in 1989-90 RSG settlement.