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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Viscount Whitelaw PC CH MC
Lord President of the Council
Privy Council Office
Whitehall
London
SW1A 2AT

25 July 1986

Dear Lord President,

LOCAL AUTHORITY CAPITAL CONTROLS

FILE WITH DRN

I have seen a copy of Nicholas Ridley's letter of 21 July.

In the last three years overspending on the local authority capital cash limit has exceeded £700 million a year. Clearly we must take action to bring this expenditure under proper control. Personally, I remain attracted to the idea of a comprehensive package of reform for local authority capital spending of the sort proposed by Nicholas Ridley. Such a package would contain elements that were favourable to local authorities as well as improvements in control. The package would, however, have to be got through Parliament on a very tight timetable. The legislation would also be controversial. If colleagues consider the Parliamentary difficulties are overwhelming we will have to consider the alternatives.

One way forward would be to impose a cash limit penalty. That would mean that the forward commitments given to local authorities on the minimum size of their housing and 'other service' allocations in 1987-88 did not apply. Allocations could then be constrained to restrict spending. However, now that the final overspend for 1985-86 has been announced we need to take a quick decision on this before the holidays. I understand this option may not be open to us in the autumn because of the danger of judicial review on the grounds of unreasonable delay in giving notice.

As an alternative, we could assemble a smaller but viable package of changes that will create nearly as much room for allocations as the proposal for total reform. We have already agreed and announced action on advanced and deferred purchase

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schemes. That will require primary legislation. I believe that at the same time we should tackle three other areas of uncontrolled spending:

- (i) At present capital spending on leasing of assets (e.g. plant and vehicles) is non-prescribed (uncontrolled). I suggest we prescribe this spending so that it is brought within the control system. This will not stop local authorities leasing assets if they wish as long as they have the necessary spending power. But it will remove a distortion in the choice between purchase and leasing. This change would require secondary legislation.
- (ii) Housing repairs financed other than by borrowing are also non-prescribed at present. Some authorities are using capital receipts to finance housing repairs without using up any spending power. Under the existing rules the spending power from these receipts - now not backed by cash - can then be used again for another purpose altogether. I suggest we prescribe all capitalised housing repairs to ensure that this capital spending uses up spending power.
- (iii) We also need to ensure local authority companies are properly controlled. This has been done for local authority bus and airport companies but not yet for other local authority companies - some of which are simply devices to evade our controls. For example any local authority can set up a nominal "company" to borrow from a bank on the basis of a local authority guarantee. That money can then be spent by the company regardless of any public expenditure controls. This change would require primary legislation.

Tackling leasing and housing repairs would help create room for around an extra £400 million allocations for any given level of PES provision. That would considerably help our Survey discussions.

Clearly it would be helpful if we could also tackle at least some of the problems which arise on receipts. In particular I hope we could:

- (i) stop the use of non-cash backed receipts;
- (ii) take account of individual authorities' receipts when setting allocations. This would help to direct resources to where they are most needed - notably the inner cities;
- (iii) end the cascade. When the system was set up it was intended that no spending power would arise from the non-prescribed proportion of in-year receipts. But the legislation has turned out to be defective and it allows local authorities to spend the prescribed proportion of all accumulated receipts;

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(iv) take power to set different prescribed proportions for in-year and accumulated receipts. If we do end the cascade we may need to increase the prescribed proportion for in-year receipts. That cannot be done under present legislation without also changing the prescribed proportion for accumulated receipts.

Above all, we must reach a decision before the holidays to enable legislation to be prepared for the start of the session and to provide a basis for our Survey discussions.

I am copying this letter to the Prime Minister, to the other members of E(LA), to Patrick Mayhew, John Wakeham and Bertie Denham and to Sir Robert Armstrong.

Yours sincerely,

Jim Ruth

pp JOHN MacGREGOR

(Approved by the Chief Secretary
and signed in his absence)

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From The Secretary of State for Wales

The Rt Hon Nicholas Edwards MP

I. Ullie

NBP

25 July 1986

LOCAL AUTHORITY CAPITAL CONTROLS

We are to discuss Nicholas Ridley's proposals for reform of the capital control system (E(LA) (86)12) at the meeting of E(LA) on 28 July. Unfortunately I shall not be able to attend that meeting and I thought it would be helpful if I set out my own position in the light of Nicholas' letter to you of 21 July.

As I made clear in my letter of 15 July I was concerned that Nicholas' original proposals would lead to very significant shifts in individual authorities' allocations (and hence borrowing approval) and spending power. While this may be acceptable as an ultimate aim it would be very difficult to defend in the time scale we are talking about. It would be advisable, therefore, to look at the specific measures which could achieve the changes we want and to implement them gradually. Otherwise we are driven to some sort of safety net system which as Nicholas points out would be complex and open to criticism.

The major areas which we might consider are:

Treatment of receipts. - I am quite sure that a power to allow allocations to take some account of individual authorities' receipts would be very useful, though the allowance would need to be fairly small to maintain the incentive to generate receipts. It would improve the focussing of resources on areas with highest needs. Authorities could continue to have access to the balance of receipts but over a period of time, and only after the year in which they were generated. If authorities were eventually allowed to use 100% of receipts none need be built into allocations and the 'cascade' effect would automatically be eliminated.

/...

Viscount Whitelaw PC CH MC
Lord President of the Council



Forward indications - If some allowance was thus made for individual authorities receipts then it would be easier to stick to existing forward indications. Formal indications in Wales present less of a problem now than in England, because they are set at 80% of likely allocations for the relevant year, rather than 80% of a previous year. This may be an approach which might be adopted generally in future. It would not involve legislation.

Spending power of receipts. - There is a good case for removing the spending power associated with 'notional' receipts from leasing disposals and from receipts already used to finance capitalised housing repairs. This would bring overall spending power closer to the level of cash backed receipts, but would be far more defensible to our supporters than a tight restriction to cash backed receipts alone.

Non prescribed expenditure. - I can see the argument for removing vehicle and plant leasing from non-prescribed expenditure but fear that it would simply lead to an increase in operational leasing and thus revenue spending. We need to consider this carefully.

On the question of **revenue contributions** I agree that the present proposal is an improvement on that in the consultation document but still have the reservations expressed in my earlier letter.

To proceed with the changes suggested above would only be defensible if the package also included some of the positive features Nicholas advocates. ... The attached note sets out these issues in greater detail. It is a fine point whether a package along these lines is essentially a modification of the present system or effectively a new one. It could be presented either way. I suggest that it would be more defensible than minor patching which only closed up loopholes and did not begin to deal with the longer term. Equally it would not produce the problems which would arise from the more sweeping changes Nicholas proposes.

/ I am copying this letter to the Prime Minister, to the other members of E(LA), to Patrick Mayhew, John Wakeham and Bertie Denham, and to Sir Robert Armstrong.

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POSSIBLE MODIFICATIONS TO THE CAPITAL CONTROL SYSTEM

Background

1. Responses to the Green Paper proposals have made it clear that authorities consider they should have full use of any receipts they accrue. The original intention of the 1980 legislation was to allow authorities to use only a proportion of their receipts and to build the balance into allocations. Omissions in drafting meant that individual authorities were able to make use of the balance as well, allowing double use of the associated spending power. This led to a build up of a large reserve of accumulated receipts and the associated spending power represents a major threat to the cash limit unless it is properly allowed for in setting the level of allocations. This in turn results in a very low level of allocations, though authorities overall spending power is unaffected.

Access to Receipts

2. The introduction of a prescribed proportion to restrict the use of receipts was intended to share out the spending power of the balance in order to smooth out the uneven distribution between authorities, particularly of housing receipts. This was appropriate at the beginning of the new system when it was not certain where the receipts would arise. Now that there is good information on accumulated receipts the same kind of result can be achieved by making an offset against a 'needs assessment' in calculating individual authorities' allocations. The offset would be based on the level of receipts in the authority but would have to be fairly small to maintain incentives to generate receipts (perhaps 20% for housing and nothing for 'other receipts' although higher proportions could be used in England). It would be assumed that authorities would certainly use at least this proportion of their receipts but they would be allowed to use a rather higher proportion overall (perhaps 25% in Wales and higher in England for housing receipts) if they wished to increase their spending power. The precise proportions would need to be set eventually to reduce the level of accumulated receipts and no addition would be made to allocations to allow for the 'non-prescribed' proportion of receipts. There would be no access to receipts in the year in which they were generated, in order to improve stability.

3. Borrowing approval for individual authorities would be equal to their 'residual' allocation ('needs assessment' less offset for use of receipts). But it would not necessarily be assumed that authorities used the receipts built into allocations before they made use of the borrowing approval.

4. For authorities with a very high level of receipts the reduction in borrowing approval between years may be too severe, even using only 20% of accumulated receipts, and some transitional arrangements may be necessary to increase borrowing power and thus reduce changes in the level of block grant.



An individual authority's spending power would thus be

$$\begin{array}{l} \text{Residual Allocation} = \text{Borrowing Approval} \\ + \text{Receipts Offset} \\ \hline \text{Total needs assessment} = \text{Allocation} \\ + \text{Additional proportion of receipts} \\ \hline \text{Total spending power} \end{array}$$

The allocation would be the figure to be compared with forward indications and would allow a better focussing of residual allocations to areas of greatest need.

Forward Indications

5. For future years authorities can plan with far greater certainty and more efficiently if they are given forward indications. If these are calculated as a proportion (70 or 80%) of the figure **anticipated for the year**, rather than in relation to an earlier year, they are less likely to be a constraint on the final figures. The main purpose of forward indications is to allow authorities to produce long term plans which they can be certain of achieving and even a figure which they consider to be low is vastly preferable to none at all.

Non prescribed expenditure

6. The other major area to consider is non-prescribed expenditure. This has grown rapidly during the life of the present system. It is possible to make appropriate allowance for the use of non-prescribed expenditure when setting allocations and thus minimise the threat to the cash limit. However levels are now so high that consideration needs to be given to closing down some options.

7. **Leasing** of vehicles and other plant is the major item of non-prescribed expenditure. Responses to the consultation paper, however, have noted that the distinction between finance and operating leasing proposed in the consultation document would shift the balance of advantage to the latter, increasing revenue expenditure. The introduction of bus companies under the Transport Act should remove a substantial proportion of vehicle leasing.

8. Capitalised **housing repairs financed directly by receipts** (Schedule 12) is another major non-prescribed item. At present receipts used in this way retain their 'spending power' and thus pose a threat to the cash limit, though they are no longer actually available.

9. Removal of this 'spending power', combined with the measures to increase use of receipts described above, should considerably reduce the incentive to use this loophole.

10. Consideration could also be given to removal of the 'notional spending power' associated with disposal of leases from a local authority (as in the DOE proposals). At present the full value of the leased asset counts as a receipt, in the same way as the full value scores as prescribed expenditure when leased by the authority. In practice, though, no actual cash is received.



11. Removal of these two anomalies from the total of authorities' spending power would be readily understood by local authorities and would bring spending power from accumulated receipts closer to the 'cash-backed' level.

12. The possibility of an outright move to 'cash-backed' receipts alone has been severely criticised in the responses to the consultation document. A number of authorities, for example, have virtually no cash-backed receipts but a high level of spending power and so would suffer a major reduction in spending power if the full change were implemented. These smaller changes should prove more acceptable.

Other Changes

13. The consultation document proposed a number of minor changes in the treatment of certain receipts, for example, those arising from Compulsory Purchase Orders. Most of these could be effected by regulations. They were generally welcomed and their introduction should make other changes more acceptable to local authorities.

Relations: LOCAL GOV

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My ref:

Your ref:

21 July 1986

DAN SEN

Dan Laine

LOCAL AUTHORITY CAPITAL CONTROLS

Prior to our discussion at E(LA) on 28 July, I have looked again at my proposals in E(LA)(86)12 in the light of our last discussion (E(LA)(86)9th) and of the letter of 15 July from Nick Edwards.

My proposals are based on the form of system which we proposed in the Green Paper and the associated consultation paper, which was itself the product of long consideration both internally and with the local authority associations, but they have been modified in the light of the comments we have received. Both the proposal to allow an unlimited addition to spending from revenue contributions and the proposal to allow full use of cash-backed receipts, new and accumulated, are substantial improvements on the Green Paper from a local authority viewpoint, reflecting the concerns which were expressed. The revenue proposition helps to put more of the burden of local spending where we want it to fall - directly on ratepayers and tenants - and fits well with the proposals for strengthening accountability in the rest of the Green Paper.

Provided that we allow a reasonable level of receipts to be used each year, I do not see that authorities with high receipts - shire districts in England and the Welsh authorities to which Nick refers - can reasonably complain at getting lower allocations than under the present system. I think it may be worth raising the prescribed proportion as high as 50%; and I would not envisage taking account of more than say 50% of permitted receipts when setting housing allocations; I agree that a one-for-one offset would be destructive of the incentive to generate receipts. It would be possible to damp the immediate effect of the new system on individual authorities by introducing some form of safety net into housing allocations for a transitional period. This would be complex and may not be necessary, but it might help in convincing our own supporters of the merits of the system. Other colleagues will need to consider what use if any they want to make of the new facility.

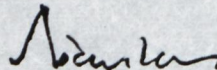
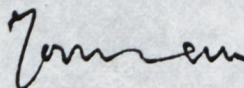
I shall also of course be happy to discuss the RSG consequences which Nick has rightly identified. But I am sure that they are not such that we need be deterred from deciding now on comprehensive reform of the system next session, which I still think is the right way forward.

I have considered whether a package of small legislative measures, to be added to the stopping of advance and deferred purchase, could be put together which would achieve much of what we are looking for from a new system while at the same time being less unpopular with local government and with our own supporters. I attach a list of candidates for such legislation, grouped according to whether their primary benefit is for central or for local government and listed in approximate order of their significance to the two sides. Apart from ending the cascade, which is not appropriate to the new system I have proposed, all the items listed would be part of the new system set out in E(LA)(86)12 and were covered in Annex A to that paper.

To stand any chance of keeping within reasonable bounds the unpopularity of these proposals with our supporters, such a package would need to include positive features for them - in particular, the addition of revenue contributions, which I regard as fitting well with the Green Paper philosophy - as well as items to improve control for us. It would have the disadvantage, which would not apply to the full new system, that the 80% assurance given by my predecessors for 1987/88 allocations for my blocks would not be automatically invalidated. As I made clear in E(LA)(86)12, I believe it would be both dishonourable and politically unacceptable, as well as legally uncertain, to renounce that assurance unless the legislation we introduce offers a substantive new system. We could not claim that a selective package did amount to a new system. But we should have just as much difficulty with the Parliamentary timetable in passing a significant package of amendments as with a whole new system. Indeed, we could not be sure that the legislation would pass at all if it became clear that I intended to go back on the 80% assurance.

I hope therefore that E(LA) will give serious further consideration to having full legislation in the early part of next session. I do believe that it will prove preferable to a package of lesser measures in what it will offer both to us and to local government; the measures dealing with revenue contributions and receipts will remove features to which authorities object in the present system, while from our viewpoint a new system must be better than continued patching. Full legislation, though certainly not without difficulties, is the best option available to us.

I am copying this letter to the Prime Minister, to the other members of E(LA), to Patrick Mayhew, John Wakeham and Bertie Denham, and to Sir Robert Armstrong.



NICHOLAS RIDLEY

POSSIBLE CAPITAL LEGISLATION

Good for central government

1. Nullify advance and deferred purchase (already agreed).
2. Take power to take account of individual authorities' receipts when setting allocations (only beneficial in first year if 80% assurance dropped - legally uncertain unless indemnity clause included in legislation)
3. Reduce overhang of receipts:
 - a. End cascade (no benefit in first year; possible corollary: take power for separate prescribed proportions for in-year and accumulated receipts)
 - b. Stop use of non-cash-backed receipts
4. Close other loopholes:
 - a. Tighten definition of non-prescribed expenditure, including leasing
 - b. Bring companies under control
5. Improve administration of system:
 - a. Clearer "national or regional importance" provision
 - b. Better drafted sanctions for over-spending
 - c. Statutory duty to make capital returns.

Good for local government

1. Make extra spending power from revenue limited only by pre-year budgets
2. Allow use of all receipts over time, at reasonably high (eg 50%) annual rate (incompatible with ending cascade).
3. Allow extra spending power from ERDF and other community grants.
4. Minor measures, particularly:
 - a. End disincentive for "back-to-back" schemes
 - b. Help authorities subject to Government CPOs.

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From The Secretary of State for Wales

NBN

The Rt Hon Nicholas Edwards MP

Prime Minister 2

15 July 1986

*Dr Edwards is strongly
opposed proceeding with the proposed new
regime for capital controls from April 1987.*

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from Lord President

at 11.45

*DLN
15/7*

When I wrote to Nicholas Ridley on 10 July I was not aware of his proposals in E(LA) (86)12 which was circulated on the same day for discussion at yesterday's meeting of E(LA). Legislation on local government finance is, as you know, common to both Wales and England and proposals for change therefore need to take account of the position in both countries. I do not dissent from the view that the present system for controlling capital expenditure needs to be improved but having examined the changes Nicholas has put forward for consideration I am quite sure that it would not be wise to legislate as proposed in the next session for implementation in 1987/88.

I have reached this view for the following reasons:-

1. The proposals have not been subjected to careful scrutiny either by colleagues or by local government. We know to our cost that systems which are introduced without a full understanding of their operation and their effect can only lead to trouble. We must be sure that our ideas are well thought out and have, as far as possible, the support of the practitioners in local government who would be expected to operate any new arrangements we might introduce.
2. As they stand the proposals would lead to significant shifts in individual authorities' allocations (and hence borrowing approval) and spending power. No proposal would be acceptable to local government which involved sizeable changes in spending power between years without reasonable advance warning. We would be laying ourselves open to serious criticism if we were to ask local government to make the adjustments to their present plans for 1987/88 which these proposals would require. Authorities already have schemes under way for 1987/88 on the assumption that they can use forward indications and a reasonable proportion of receipts. It would not be possible to issue even provisional figures under the new system for some months and firm figures would have to await the passage of new legislation. This is clearly not conducive to careful forward planning or efficient use of resources.

/ 3. The ...

The Rt Hon Viscount Whitelaw CH MC
Lord President of the Council



3. The proposals do not address the question of incentives for asset sales - one of the criteria in our original Green Paper proposals. If an authority's allocation is reduced directly in proportion to the level of its capital receipts there would clearly be little incentive to generate them. Right to buy sales, where there is a statutory basis, would probably be relatively unaffected, but other asset sales would almost certainly fall.

4. One of the arguments advanced in favour of the proposals is the greater freedom to use revenue contributions to increase capital spending. In the case of the Housing Revenue Account this is probably less of a benefit than it first appears. Authorities already have considerable freedom in deciding whether to capitalise repair and maintenance expenditure or not and can increase rents to pay for increased revenue spending if they wish. The requirement to declare their intentions on revenue contributions in advance and to stick to those intentions would certainly inhibit authorities' use of this new freedom and would distort the financing decisions which are normally left to the end of the year.

5. Pressing problems would also arise on the RSG front. The provisional RSG proposals we have been considering for 1987/88 are based on relevant expenditure including loan charges, revenue contributions and interest receipts under the present capital control system. At national level the proposed arrangements may result in broadly the same level of expenditure, though Nicholas's paper does not address this point. At the individual authority level they certainly would not and, additionally, they almost certainly would result in significant shifts in GREs and therefore block grant entitlements.

6. A major component of relevant expenditure relates to the financing of capital expenditure. At present the GRE for this component ('capital charges' GRE) is based on the assumption that authorities spend their allocations and most of that spending is financed by borrowing. This adds to outstanding debt and the associated principal and interest repayments are used in calculating GRE. The proposals suggest a major change in the level of allocations for individual authorities and, therefore, for their capital charges GRE and ultimately block grant entitlements. In the time available it has not been possible to calculate detailed figures for individual authorities but I estimate that a £1 million reduction in an authority's allocation may reduce its GRE by £200,000 and block grant by £130,000. It is possible that some authorities would no longer have a housing allocation at all, so their grant entitlements might well be severely affected.

7. Any changes to capital charges GRE would need to be discussed with the associations and therefore could not be incorporated in the provisional announcement of the 1987/88 RSG Settlement set for 23 July. This would mean that I could not proceed with plans to announce details of individual authority grant entitlements this summer. This would, of course, make the provisional announcement much less useful and leave me open to severe criticism. This is not such a problem in England, where no detailed figures are released for individual authorities in July.



8. A decision to proceed with any new proposal would certainly extend consultation and could well delay the RSG Settlement beyond mid November.

9. In November, any legislation would only be beginning its progress through the House. It may well be subject to major changes which in turn would have an impact on capital charges. GREs, however, could not be changed at that late stage and consequently the 1987/88 RSG Settlement would, to say the least, be very difficult to manage. I referred to this and the problems it would generate in my letter of 7 May to Nicholas Ridley.

The calculations we have made in Wales show some very severe reductions in allocations and spending power in areas represented by Conservative MPs. My own constituency is one of these. I am quite certain that the balance of advantage clearly lies in living with the present capital control system for a further year. It would be most unwise to proceed with major changes for implementation in 1987/88 and I strongly advise that no change should take place without full and close examination in Whitehall nor without consulting local government.

/ Copies of this letter go to the Prime Minister, members of E(LA) and to Sir Robert Armstrong.

Your sincerely
W. G. A. Williams

Approved by the Secretary of State
and signed in his absence

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From The Secretary of State for Wales

The Rt Hon Nicholas Edwards MP

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NBRN

10 July 1986

LOCAL AUTHORITY CAPITAL EXPENDITURE CONTROLS

FLAP PT 29

Kenneth Baker's letter to John MacGregor dated 14 May 1986 summarised the responses to the consultation document in England and expressed his views on the way forward.

Responses in Wales have been in much the same vein but have emphasised that the proposals are at variance with the general approach in the rest of the Green Paper which seeks to improve local accountability. The responses seriously question the need for change in Wales given the fact that expenditure has been kept broadly in line with plans using existing rules. (The average excess over gross capital provision for the services within my responsibility in Wales for the three year period 1983/84 to 1985/86 is under 3%). In the light of this I can only endorse Kenneth's conclusions that we should not proceed with either of our Green Paper proposals in their present form.

Although the problem is not so acute in Wales I support the general consensus that there is a need to prevent the abuse of deferred purchase while making provision to allow the "sensible" use of deferred purchase arrangements to finance major schemes. Our main problem, however, is clearly the very large build up of capital receipts. Proposals for any new capital control system will need to ensure that this does not happen again, while maintaining some incentive to authorities to continue to generate receipts. During a transitional period we shall need to allow existing accumulated receipts to be used by authorities over a reasonable timescale, in line with our earlier promises, but not at a level which could damage planning totals. Above all we must seek a solution which has the confidence of local government and which will endure in the long term.

We clearly need to consider urgently the way forward. It is too late to introduce radical changes for 1987/88 and the most we could reasonably achieve would be some modest improvement to the present system.

/We therefore ...

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment



We therefore need to concentrate on workable proposals or legislation in the next session, for implementation in 1988/89. These could either be fairly substantial modifications to the present system (in particular undoing the "cascade") or a new approach. In either case there is a strong argument for placing more emphasis on the importance of overall spending power, including the use of receipts, and less on the value of allocations.

We shall need to consider proposals soon if we are to legislate in the next session. I suggest that our officials be asked to set out the options for both 1987/88 and 1988/89 for our consideration.

/ I am copying this letter to the Prime Minister, Willie Whitelaw, members of E(LF) and E(LA), John Biffen, John Wakeham, Bertie Denham and Sir Robert Armstrong.

J *es*
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