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P 02670

PRIME MINISTER

Abolition of ILEA and Financial Arrangements for
Opting Out by Schools

You are meeting with Ministers at 5.30 pm tomorrow to discuss both the above issues on the basis of Mr Baker's minute of 5 May and the paper on Financial Arrangements with my earlier minute to you of today's date.

DECISIONS

2. You will need to decide:-

(i) on ILEA, whether to accept Mr Baker's proposal for including the abolition of ILEA in the legislation planned for the first session of a new Parliament, and what should be said about this in the meantime;

(ii) on the financial arrangements for opting out, which of the Options in the Cabinet Office paper to accept to remove the disincentives problem and for adjusting local authority grants, and how this should be taken further forward.

ABOLITION OF THE ILEA

3. Mr Baker's earlier proposal was to announce in a manifesto the intention to set up a formal review under the 1985 Local Government Act after the election. His preferred course of action after this was to allow individual boroughs to opt out. You had doubts about this, however, not least because those authorities within the Association of Labour Authorities would form themselves into a rump ILEA which could prove worse than the present ILEA.

4. Mr Baker's present proposal differs only from his previous approach in that he recommends moving directly to the break-up option by legislation in the first session of a new Parliament without going through the motions of a 1985 Act review. The latter would delay matters and preclude legislation before the 1988-89 session which would then get tied up politically with the run-up to the ILEA direct elections in 1990. Mr Baker is influenced by the Lord President's belief that it might now be easier to get the legislation through the House of Lords.

5. There is little detail or analysis in this new paper. The main objections to the course proposed still stand. There is still a risk of an objectionable rump ILEA; and simply giving authorities the right to opt out would not in itself do anything about the present overspending problems, the quality of education in the London boroughs, or the problem identified last time of the effects on the Community Charge. It remains the case that, despite the formidable difficulties, the only direct way of influencing spending and other policies would be for the Government to take over control.

6. Adoption of the course proposed by Mr Baker will make it even more urgent to get on as quickly as possible with the range of reforms designed to give schools greater autonomy and parental choice; and to get the new local government financing arrangements, with an appropriate London safety net, in place. Mr Baker's minute is somewhat optimistic on the timing (it is unlikely, as paragraph 6 claims, that all these reform measures "will be in place by the time we bring forward legislation on ILEA"); but clearly no time must be lost in pressing them forward.

7. If your colleagues are content in principle with Mr Baker's proposal, you may wish to ask him to work up detailed proposals (on the basis of which Instructions could be prepared) for further consideration as soon as possible. In the meantime, he should prepare a shorter and more general form of words for use in the coming weeks.

[J B Uwin]

FINANCIAL ARRANGEMENTS FOR OPTING OUT

8. The paper attached to my minute to you of today's date (which I have copied to the other Ministers attending your meeting) has been agreed with the key officials in the Treasury and DOE and DES. I understand that Mr Baker endorses both its main recommendations; and that Mr Ridley endorses the proposal on disincentives, but (as his minute of yesterday to you makes clear) he does not think it necessary at this stage to decide how local authority grants should be adjusted. Treasury officials are advising the Chief Secretary broadly to endorse both the main recommendations.

Disincentives to Opting Out

9. This is discussed in paragraphs 3 to 7 of the paper. In brief, we examined a range of possibilities, and were not able to find a formula that would meet all the Government's policy objectives. On the basis, however, that your top priority is to get the opting out arrangements successfully launched, and to remove any disincentives, we have recommended the course entitled Option 3, and described in paragraph 6. This would simply apply to opting out schools the local authority's own financial delegation formula, as approved by the Secretary of State, rather than a national formula as originally proposed by Mr Baker. As the note makes clear, this would have the somewhat anomalous result of the Government funding different opted out schools at different levels for similar needs; but if it is envisaged essentially as a transitional measure, to get the scheme off to a good start, it should meet your immediate objectives.

10. If this proposal commands general support, you will wish to ask Mr Baker to build it into his wider proposals.

Adjustments to Local Authority Grants

11. Paragraphs 8 to 11 of the Cabinet Office paper explore the three options that came up at your last meeting:-

Option A: reducing the authority's own grant by the GRE attributable to that school, but reducing aggregate grant to all authorities by the actual spending on that school;

Option B: reducing both the authority's grant and aggregate grant by the GRE figure;

Option C: reducing both the authority's own grant and the aggregate grant by the actual expenditure on the school.

12. On grounds of financial neutrality we favoured Option C. It would avoid all changes in the financial position of central and local taxpayers, both in aggregate and in each area. In high spending areas, community charge payers would meet the full cost of the high spending on schools in their area, albeit at the cost of taking these particular arrangements outside the basic grant mechanisms of the new local government finance system. In practice, it would amount to a direct levy on community charge payers for opted out schools, and if this course were adopted it might be preferable presentationally to establish it as such.

13. However, it is not necessary to take a final decision on this point now and you may be content to accept Mr Ridley's suggestion that it should be deferred for consideration in the wider context of the grant arrangements generally. You will, however, want to urge him to bring these forward as soon as possible.

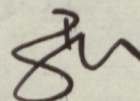
Ring fencing Education Expenditure

14. Paragraph 14 deals very briefly with this. DOE officials have put detailed papers to Mr Ridley, but I understand that he is now very doubtful whether this proposal is workable. There are considerable problems of definition, and the housing analogy is a misleading one. You will, however, want to ask Mr Ridley how he now proposes to take this forward.

HANDLING

15 You will want to ask the Education Secretary to introduce his proposal on ILEA, and to seek the comments of other Ministers generally - not least, the Lord President's comments on the possibility of legislation in the first session of a new Parliament.

16. On the financial arrangements for opting out, unless you want me briefly to introduce the Cabinet Office paper, you will want to hear the view in particular of the Education Secretary, the Environment Secretary, and the Chief Secretary, Treasury on the proposals put forward.



J B UNWIN

Cabinet Office
6 May 1987

CONFIDENTIAL

P 02666

PRIME MINISTER

Better Schools: Financial Arrangements for Opting Out

When you discussed the Secretary of State for Education and Science's proposals for allowing individual schools to opt out of the local authority sector with some of the Ministers most directly concerned on 8 April you were particularly concerned at the potential disincentives to schools to opt out in high spending local authority areas. You instructed officials to consider this further, together with the options for adjusting local authorities' grant entitlements and their implications for central and local taxpayers.

2. I attach a paper covering these issues prepared by the Cabinet Office in conjunction with the Treasury, the Department of Environment, and the Department of Education and Science. I understand that you propose to discuss this after the Education Secretary's minute of 5 May on ILEA at your meeting tomorrow afternoon. I am therefore sending this paper to all those Ministers attending the ILEA discussion, although not all of them will wish to stay for this item.

3. The essence of the main proposals in the attached paper may be summarised as follows:-

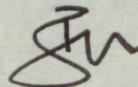
(a) Incentives and Disincentives (paragraphs 3 to 7): we reject the ideas of a more flexible national formula, or no formula at all, and instead recommend applying to each opting out school the local authority's own financial delegation formula, as approved by the Secretary of State (Option 3 in paragraph 6). This is not a perfect solution, since it would have the somewhat anomalous result of the Government funding different Grant Maintained (GM) schools

at different levels for similar needs; but at least as a transitional measure it would effectively deal with the disincentives problem at the handover point, and I understand that the Education and Environment Secretaries support it;

(b) Adjustments to Local Authority Grants (paragraphs 8 to 11): the choice of options determines how local and central taxpayers are affected. On balance we favour complete financial neutrality by reducing both the authority's own grant and the aggregate grant by the actual expenditure on the opting out schools (Option C in paragraph 11). In his minute to you of 5 May, however, the Environment Secretary has suggested that this decision should be postponed until Ministers have considered in detail the options for grant arrangements in the new local finance system.

4. The longer term answer to the disincentive and other problems clearly lies in constraining high spending authorities. The separate note on ILEA is crucial to this, and paragraph 14 of the attached paper briefly discusses the possibility of ring fencing local authority education expenditure. There are, however, some formidable difficulties (it would not work in the same way as is proposed for housing) and much more work would need to be done on this.

5. I am sending copies of this minute and enclosure to the Lord President, ^{the Chancellor of the Exchequer,} the Foreign and Commonwealth Secretary, the Home Secretary, the Secretary of State for Wales, the Chancellor of the Duchy of Lancaster, the Secretaries of State for the Environment, Employment and Education and Science, the Chief Secretary, the Secretary of State for Scotland, the Chief Whip, and to Sir Robert Armstrong.



J B UNWIN

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Lambeth

Better Schools: Financial Arrangements for Opting Out

Memorandum by the Cabinet Office

At the Prime Minister's meeting with Ministers most directly concerned on 8 April, officials from DES, DOE, Treasury and Cabinet Office were asked to give further consideration to the financial arrangements for schools to opt out of the local authority sector, and in particular:

- i. the incentives and disincentives to schools to opt out, arising from variations in the level of spending by different education authorities;
- ii. the options for adjusting local authorities' grant entitlements, and their implications for the burden on central and local taxpayers.

This Memorandum records the outcome of consultation between the Cabinet Office and the Departments concerned.

INCENTIVES AND DISINCENTIVES: SCALE OF THE PROBLEM

2. The problem of disincentives for schools to opt out arises because some local education authorities (LEAs) spend well in excess of the levels which a per capita funding regime for Grant Maintained (GM) schools would support. The note by DES at Annex A assesses the scale of the problem. It estimates that perhaps 300 out of the 4,000 secondary schools, and 150 out of the 2,000 large primary schools which would initially be allowed to opt, have unit costs more than 10 per cent above average. This suggests that there might be a serious problem with about 450 schools. But of course these would be concentrated in a small number of high spending Labour controlled authorities, and particularly in the

ILEA's area. They are therefore just those schools which might be most attracted to opting out of local authority control.

INCENTIVES AND DISINCENTIVES: POSSIBLE SOLUTIONS

3. Officials have considered three options which might reduce or remove these disincentives:

Option 1: making the national per capita formula more flexible and lengthening the transition period;

Option 2: moving away from the formula approach entirely, and making each school's budget subject to an annual review;

Option 3: applying to each school, instead of a national formula, the same formula which would have applied under the financial delegation proposals if it had remained in the local authority sector.

Option 1

4. The first approach, a more flexible formula, would rely on extensive use of special needs allowances to reflect the high levels of spending in inner city areas. It could narrow the differences between the formula and existing spending levels in these areas, and therefore reduce disincentives for opting out. A longer transition could also help. But this approach has some substantial disadvantages:

i. it would appear to validate spending levels in these areas - there would no doubt be pressure to use the new formula to calculate needs grant for local authorities under the new local government finance system;

ii. it is unlikely that any formula could cater for ILEA's very high spending levels, so the disincentive for ILEA schools to opt out would remain;

iii. it would give high grants to schools in areas like Birmingham where the existing level of spending is not high.

For these reasons we do not recommend this approach.

Option 2

5. The second option, an annual budget review, would involve setting each GM school up at its existing spending level, and reviewing the scope for reductions individually each year. This would remove the automatic disincentives to opt out. But it would involve very high administrative costs for DES, and conflict with the financial delegation proposals for schools remaining in the local authority sector. We do not therefore recommend this approach.

Option 3

6. The third option, applying the local authority's own financial delegation formula, under a scheme approved by the Secretary of State, as opposed to a national formula (as originally proposed by the Secretary of State for Education and Science), would mean that each school would continue to get exactly the same level of funding as if it had remained under local authority control. This would apply in both the first year and subsequent years: if the authority increased its expenditure, grant to all the GM schools in its area would rise, and if it cut spending grant would fall. This option would certainly achieve financial neutrality for the school, and remove any possible disincentive to opting out, which primarily concerned Ministers. But the level of spending and grant for each school would continue to be determined by decisions of the relevant local authority, not by the Government; and pressures might arise from GM schools in low spending areas to be brought up to the level of those in high spending areas. In the early years (between 1990 and 1993) the financial delegation arrangements will not be in place in all authorities, and a more rough and ready interim system of relating grant to the overall

level of the relevant authority's expenditure would have to be adopted.

7. If Ministers still attach priority to removing any disincentives to opting out, we recommend Option 3 above. It is the only approach we have been able to identify which offers a real solution to the problem of disincentives identified at the Prime Minister's meeting. But Ministers will wish to consider the disadvantages carefully before agreeing to this option.

ADJUSTMENTS TO LOCAL AUTHORITY GRANTS: FINANCIAL NEUTRALITY

8. Ministers were concerned about the financial implications of opting out as between central and local taxpayers, and as between local taxpayers in the area where a school opted out and those elsewhere. We have therefore considered the effects of three options to deal with the situation where a school opts out in a particular authority's area:

Option A: to reduce the authority's own grant by the GRE attributable to that school, but to reduce aggregate grant to all authorities by the actual spending on that school (which would be the amount it would get from the Exchequer as a GM school);

Option B: to reduce both the authority's own grant and the aggregate grant by the GRE figure;

Option C: to reduce both the authority's own grant and the aggregate grant by the actual expenditure on the school.

Option A was originally favoured by the Education Secretary, and Option B by the Environment Secretary. Option C is new, and is designed to achieve complete financial neutrality, but at some cost to the integrity of the new local government finance system.

9. Option A is neutral as between central and local taxpayers, because aggregate grant is reduced by the full amount of spending on each GM school. But it reduces the individual authority's grant by the GRE amount, which might be more (in a low spending authority) or less (in a high spending authority) than actual spending. The rationale for this is that the GRE figure is the amount in respect of which the Exchequer pays grant support for the school - any additional spending has to be met entirely by community charge payers and is not covered by grant. Where a school opts out, community charge payers will be relieved of this additional burden under this option. But because aggregate grant will be cut by the actual spending on the school, all authorities would lose some extra grant when a high spending school opted out, and gain when a low spending school opted out.

10. Option B is similar, but prevents these gratuitous increases and decreases for all authorities by cutting aggregate grant by exactly the same amount as the grant entitlement of the individual authority. This means that it is not neutral as between the Exchequer and local authorities. Where a high spending school opts out the Exchequer (ie the taxpayer at large) will lose, and where a low spending school opts out it will gain. But at the national level the effect would depend on the balance between low and high cost schools opting out.

11. Option C avoids all changes in the financial position of central and local taxpayers, both in aggregate and in each area. But this is achieved by reducing a high spending authority's grant by more than GRE, ie by more than the amount recognised for Exchequer support to the school in question. Conversely a low spending authority's grant is cut by less than GRE. The result is that community charge payers continue to pay for the high spending policy of their authorities in respect of opted out schools as well as those which they still control. In effect it amounts to a continuing levy on those community charge payers for opted out schools. Ministers might wish to consider whether in such circumstances it would be preferable, if only for reasons of

transparency, to impose a direct levy instead of individual adjustments to grant which would conflict with the aims underlying the new grant system (in particular, that grant should be stable and predictable, and that there should be clear and transparent accountability). However this option does have a certain logic if it is taken alongside the proposal in paragraph 6 above that funding for GM schools should allow the local authority's decisions. It would then be consistent for community charge payers to meet the full cost of high spending on schools in their area. This is therefore on balance the option we recommend.

RECOMMENDATION

12. No option which we have been able to identify meets all the problems. Nevertheless if Ministers wish to put in place arrangements which will encourage schools in all areas to opt out of the local authority sector, we recommend:

- Option 3: in paragraph 3 above, which will link funding for GM schools to the level they would receive under their local authority's own approved formula for financial delegation;
- Option C: in paragraph 7 above, which will reduce both individual and aggregate grant by the actual expenditure on schools which opt out. (Alternatively the same result might be achieved by leaving grant unchanged but imposing a levy or precept on each local authority to meet the cost of GM schools in its area.)

13. Such a system will, however, have the effect that decisions by local authorities about the schools they control will directly affect the funding of GM schools in their areas. This could attract criticism, especially if a large number of schools opt out. It therefore seems unlikely to be a long term solution to the problem of GM schools, and may need to be reviewed within a few years of a 1990 start.

RINGFENCING EDUCATION EXPENDITURE

14. The Prime Minister's meeting also touched on the possibility of ringfencing local authority education expenditure as a way of reducing the budget of high spending education authorities. If ring fencing could be used radically to reduce the budgets of high spending education authorities, it would of course reduce the problem of disincentives to opting out, although it might not remove them entirely. We have not considered this possibility in detail. But it is clear that ringfencing could not work in the same way as is propoed for council housing. Housing is a trading service with large amounts of income from rents and other sources, and it could be ringfenced by simply preventing authorities from making rate fund subsidies. In contrast education is a service where the majority of expenditure is funded from local sources of finance, supported by block grant. Ringfencing would have to work by limiting the amount of money spent on education. This would raise very considerable problems of defining what counted as education spending and designing a mechanism to control it.

Cabinet Office

6 May 1987

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ANNEX A

THE SCALE OF THE PROBLEM OF DISINCENTIVES

1. The number of schools likely to face significant financial incentives or disincentives to opt out depends on the numbers which are currently resourced well below or above the level which would result from the application of a national formula. The formula proposed in earlier papers builds in a degree of variation between schools in per capita grants. Smaller schools would receive some compensation for diseconomies of scale; schools in poor areas would receive an allowance for socio-economic factors; schools with sixth formers would receive a premium for these pupils. The resulting range of unit funding in the formula could vary from £1050 for a large 11-16 school in a good area to £1400 for a small 11-16 school in a poor area; whilst for each sixth former the school would receive £1600.

2. DES does not have information about unit costs for individual schools. We do however have figures for pupil teacher ratios, from which costs can be estimated. Analysis of the available data for secondary schools suggests that a significant financial disincentive will arise only for a small minority. Most schools are clustered close to the average:

- about 50% of schools have estimated unit costs within +5% of the average
- about 90% of schools have estimated unit costs within +10% of the average.

Only about 300 of the 4,000 secondary schools appear to have unit costs more than 10% above the average; a quarter of these are in the ILEA (representing about half of ILEA secondary schools).

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3. The range is greater for primary schools, but much of the variation arises from differences in school size. It is proposed that, initially at least, only primary schools with more than 300 pupils should be able to opt out - about 2,000 out of the total of 19,000 primary schools. We estimate that, amongst these schools:

- about 40% have unit costs within $\pm 5\%$ of the average
- about 75% have unit costs within $\pm 10\%$ of the average

Of the quarter outside the $\pm 10\%$ range, more have below average costs than above. Only about 150 schools are estimated to have unit costs more than 10% above the average. A quarter of these are in the ILEA.

4. This analysis suggests that in total some 450 schools might be at risk. The number may be an underestimate, in that it is based on pupil teacher ratios and takes no account of above average non-teaching costs - this is likely to be particularly significant for ILEA, which has very high non-teaching costs. On the other hand the 450 will include some schools which have higher costs because of special factors (small size, many disadvantaged pupils or a large sixth form) which would be allowed for in the formula. Overall 450 is probably a reasonable estimate. These schools are for the most part concentrated in ILEA and a small number of other high spending authorities (for example Brent and Haringey).

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5 May 87

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PRIME MINISTER

BETTER SCHOOLS: OPTING OUT

We are to meet on Thursday to discuss officials' advice on the financial consequences of the opting out proposals.

While we obviously must reach a decision on the level of funding for opted out schools, it is not necessary for us to reach firm conclusions on the consequential adjustments to the grants for individual authorities; although I accept that we shall have to make it clear that we intend to make offsetting adjustments to local finances for the extra cost of central funding.

I am worried that we are being pushed towards accepting option C, on the grounds that it meets immediate concerns in this context, before we have considered in detail the options for grant arrangements in the new local finance system. My officials are considering options for a radical simplification of the grant which Option C would cut across, unless we decided to go for direct levy on LEAs instead of adjustment to grant. I would be grateful if we could defer detailed decisions until they can be considered in the wider context of the grant arrangements generally. I hope that I will be able to put proposals forward for grant relatively soon.

I am copying this to the Chancellor, Kenneth Baker and Sir Robert Armstrong.

NR

5 May 1987