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CC (B)
B/UP.

P 02484

PRIME MINISTER

Local Authorities
Creative Accounting and Financial Prudence

Ag A - MISC 109(87) 1

DECISIONS

1. The meeting provides an opportunity to discuss the Government's strategy towards those local authorities facing possible financial collapse. In particular, the Group will wish to consider whether:

a. In the Immediate Future:

i. The Government should indicate (and if so, how) that it does not underwrite local authority debt;

ii. the Law Officers should consider launching test cases against imprudent authorities; and

b. For the longer-term

iii. to commission work on the possibility of appointing "overseers";

iv. to study other longer-term measures to close off creative accounting and to stop authorities getting into dangerous situations.

BACKGROUND

2. On 11 December the Secretary of State for the Environment reported to the Cabinet that two or three dozen local authorities

had borrowed significant amounts of money through various 'creative accounting' devices designed to avoid the financial disciplines that the Government had imposed. The servicing of these debts would cause problems for the future. He anticipated that the situation might become unmanageable in about the Spring of this year. You therefore invited him to bring forward a paper (CC(86)41.2).

THE ISSUES

3. The Group will wish to assess first how serious the problem has now become, and establish the most likely timescale for further developments. It will then be necessary to consider

- first any action which the Government should take immediately to seek to prevent any further deterioration;
- second, what actions the Government might take when the collapse of an authority is imminent; and
- third what improvements can be made in the local government finance system to prevent such situations arising again.

The Problem

4. The Secretary of State has identified eight London authorities facing substantial funding gaps which have been financed in the past by creative accounting. These are the same authorities identified as 'Group A' in the recent Audit Commission Report, which were found to be set on a course which will lead to financial and management breakdown, and whose internal management and efficiency was contrasted unfavourably with other similar London and Metropolitan boroughs (most Labour controlled). The Audit Commission found that the Group A authorities were spending well above their income from rates, grants and charges, and that this gap had been financed by drawing down financial reserves, borrowing to meet maintenance costs which would traditionally have been treated as revenue expenditure, and by deferred purchase

schemes amounting to £550 million. They estimated the extent of the funding gap in 1987/88 to be close to £300 million, representing some 30 per cent of their 1985/86 revenue expenditure.

Timing

5. This is still very uncertain. The first collapse could occur in Spring 1987 when a budget has to be drawn up; or later during 1987/88 when an authority might run out of money; or not until 1988. The Government must obviously be ready for the worst, but, the experience in Liverpool in 1985 suggests that authorities can get by for many months despite not having a balanced budget, and Mr Ridley's assessment, which appears to be shared by some of the Labour authority leaders, is that the crisis is more likely to be later than sooner. The Group will wish to explore this with him, but if his judgement is accepted then there is some time to prepare contingency measures.

Immediate Steps

6. The Government will, however, need to consider whether any immediate action is necessary. Mr Ridley suggests first that the Government should close loopholes in the accounting system (paragraph 6). You will no doubt wish to endorse this as a general objective, though Mr Ridley may be too optimistic in suggesting that it may be feasible to enact a widely-drawn power that then operates through subordinate legislation. So far, the definitional problems of this idea have proved insuperable. But there is clearly no harm in looking at the matter again.

7. Beyond that, he has two proposals (paragraph 8 and 9):-

(i) First, he suggests that he should issue a clear statement that the Government does not stand behind local authority debt. The Government has never previously done so (although the issue has probably never been in question before), but it can be argued that this would fire a

warning shot to attract the attention of some potential lenders. In practice, the authorities would still be able to borrow, but probably at a higher price. A declaration might therefore have limited practical effect, but would help to focus public attention on the responsibility of the councils for managing their own affairs. On the other hand, in so far as it did bite, it would enable the authorities to argue that the Government had raised the cost of money for them and thus exacerbated their difficulties. You will in any case need to decide whether the Environment Secretary should deliberately take the initiative in making such a statement or whether he should, so to speak, just "let it out" if a suitable context arose.

(ii) Mr Ridley also suggests that the Law Officers might bring test cases against authorities that are in breach of their fiduciary duty to their rate payers. This would need to be on a particular issue (eg an unrealistic budget, or an imprudent loan) and would bring into sharp focus the confrontation between Government and the authority concerned. So long as the Government's case was successful (and there could be no guarantee of this) such a manoeuvre would serve either to force the council concerned to back down on that issue, or alternatively to defy the Court and face the penalties for contempt. It would therefore serve to bring the issues to a head, and the Government would have to be careful to choose a test case on which it could clearly demonstrate to the public the rightness of its position.

8. I understand that the Law Officer can envisage circumstances in which it might be right to undertake such action, although no concrete cases have yet occurred. You will wish to hear the Solicitor General's views on this in more detail.

The Longer Term

9. The Government will need to have plans made in case a crisis does occur.

10. The ultimate response to the failure of a local authority would have to be the imposition of Commissioners. However, as the Group recognised in the Liverpool context this is very difficult: emergency legislation would be needed; local democracy would be removed; and considerable chaos could follow, which rightly or wrongly would be blamed on the Government. Mr Ridley has therefore considered measures short of installing Commissioners which might avoid the ultimate collapse. He has two proposals:-

(i) First, he suggests that a tighter statutory framework might be set up, under which authorities acting in an imprudent way - as defined by a system of financial ratios - would lose some of their powers - eg they might require the Secretary of State's consent for each tranche of borrowing. This would result in the responsibility for ensuring credit worthiness being shared between the local authority and the Secretary of State. The Group will need to explore whether it is practicable to define the necessary framework, given the proven scope for creative accounting, and for the Secretary of State to exercise the controls. This is an area which would be fraught with judicial challenges,

(ii) Second, he suggests the Government should take a power to appoint a sort of IMF overseer empowered to investigate an authority's financial position, draw up a retrenchment budget, and oversee the authority's performance in implementing it. There is, of course, nothing to prevent an authority doing this voluntarily now. New powers would only be needed where a local authority was reluctant to cooperate. But in such a case, it is doubtful whether an overseer could have much influence, unless he

were to take full powers himself and effectively become a Commissioner. As Mr Ridley's paper makes clear, the sort of measures which an overseer would need to implement - increased rents, cuts in services and staff - are issues on which it is unlikely that the most extreme authorities would be prepared to compromise. To the extent that they did, the Government would no doubt be blamed publicly and directly for all the alleged consequences (shades of IMF riots?) The Group will therefore need to consider very carefully indeed whether there is a genuine role which a statutory overseer could usefully fulfil.

11. The Government probably has until the autumn to draw up any specific new plans in this area, so that legislation could, if necessary, be in place before the 1988/89 financial year. You will therefore wish to identify which, if any, of the various proposals made by Mr Ridley and by the other members of the Group should be worked up for consideration at a further meeting in the spring.

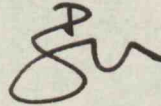
12. As indicated above, the essential question on the more radical suggestions is whether there is any middle-ground that can be occupied between the Government and a set of local authorities that presently seem set on a deliberate collision course. At first hand, it seems very doubtful whether there can be and, if that is the judgement of the Group, there will be no point in pursuing ideas of overseers and graduated intervention. The alternative, on the other hand, is simply to wait for collapse and be prepared with Commissioners, and one can well see why Mr Ridley wishes to discuss with colleagues if anything less drastic is attainable.

HANDLING

13. You will wish to invite the Secretary of State for the Environment to introduce the discussion. The Chancellor of the Duchy of Lancaster will wish to give a political appreciation. The Chancellor of the Exchequer will wish to comment on the question

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of solvency and the extent to which Government stands behind local authorities, and The Solicitor General on the proposal that legal action might be taken. Other Ministers will wish to contribute generally.



J B UNWIN

Cabinet Office
6 February 1987

CC B/UP

PRIME MINISTER

9 February 1987

MISC 109

You are meeting to discuss Nicholas Ridley's paper about what the Government should do now faced with the likelihood that a number of local authorities will become insolvent in the next two years.

Background

A number of Labour Local Authorities are managing to maintain expenditure levels only by using creative accounting devices such as deferred purchase, sale and lease back, and capitalisation of maintenance expenditure. The full revenue consequences of these devices do not flow through into the rates for some years but when they do these authorities will face collapse because rate capping will not allow them to levy a sufficient rate to meet their obligations. The first collapse could come this Spring but is more likely in 1988-89. Nicholas Ridley's paper considers what the Government should do in the period up to collapse and in the event that it occurs in one or more.

Tactics

The Government would be playing into the hands of its opponents if it was seen to be actively promoting the collapse of these local authorities. It needs to tread a careful path between, on the one hand, refraining from action which deliberately promotes collapse whilst on the other hand protecting the interests of the ratepayers and lenders to the local authorities concerned. It also needs realistic proposals for tackling the position when the crisis eventually materialises. Nicholas Ridley's proposals appear to meet these requirements.

Proposals

The most important element in these is to prepare realistic arrangements for dealing with a crisis when it occurs. At present, the only mechanism is to put Commissioners in. This is an unsatisfactory remedy both because the Commissioners would face a difficult task in the face of opposition from staff and trade unions and because their appointment would encourage continued irresponsibility by the local politicians. We therefore strongly support Nicholas Ridley's proposal to develop an alternative mechanism, on the IMF model, which would appoint "overseers" to prepare with the local authority a stringent plan for recovery, in return for some easing of Government constraints. If local authorities refuse to co-operate there is no alternative to eventual imposition of Commissioners but there are clear advantages in trying to see local authorities themselves to put their own house in order.

In particular we support the proposal to close off new creative accounting devices and prepare longer term measures to prevent a similar situation arising in future. It is also right that the Government should make clear that it does not stand behind local authority debt. Whilst we doubt the wisdom of the Attorney General initiating proceedings for breach of fiduciary duty against the worst offenders for the reason stated above and because of the outcome would be uncertain, we see no objection to the Attorney considering this proposal further.

Conclusion

We support the measures set out in Nicholas Ridley's paper.

Peter Stredder

PETER STREDDER

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P 02498

From: J B UNWIN
11 February 1987

SIR ROBERT ARMSTRONG

cc Mr Langdon
Mr Monger
Mr Roberts

LOCAL AUTHORITIES: FOLLOW-UP TO MISC 109

For the record, I have discussed the follow-up to yesterday's MISC 109 meeting with Mr Heiser and his team.

2. We agreed that:-

(i) DOE would prepare a minute on Liverpool for Mr Ridley to send to the Prime Minister as soon as possible. It seems sensible to handle this separately;

(ii) DOE will prepare a wider ranging paper for consideration by MISC 109 in about a month's time. This will pick up the points in the MISC 109 discussion, concentrating on the Northern Ireland analogy, particularly in relation to key services like housing, personal social services and education (although the last is not, of course, relevant to the London boroughs). In practice this will be another variant of putting in Commissioners, but we agreed that it would be sensible to devise a scheme that could either be introduced after financial collapse (the "5 minutes past midnight" situation), or prior to such collapse if particular services were seen to be breaking down. The paper should also include some facts and numbers so as to give Ministers a better idea of the financial and other implications of what might be involved.

bc Mr Naisome

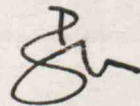
cc Peter Skredder
and pa.

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3. The responsibility is squarely on the DOE, in consultation with the other Departments mainly concerned, to produce this material, but we shall keep closely in touch with them.



J B UNWIN



CC Blyth

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P 02487

MR NORGROVE

MISC 109(87) 1st Meeting:
Local Authorities' Solvency

There is a further point on Mr Ridley's paper that I should draw to the Prime Minister's attention.

2. Paragraph 17(ii) invites the Group to agree that the Attorney General should consider bringing one or more test cases against authorities who could be in breach of their fiduciary duty to their rate payers. The Law Officers' Department have contacted us today to stress that in considering public interest cases the Law Officers act independently, and are not subject to collective responsibility. The Solicitor General believes that it would be quite inappropriate for the Group to seek to guide him on the desirability of action being taken against local authorities, or to discuss particular cases. The furthest he is likely to be prepared to go is to indicate to the Group as a matter of information the general principles which the Law Officers would apply in considering any cases which Ministers (or indeed ratepayers) might draw to their attention.

3. The Prime Minister will wish to bear this in mind in conducting the discussion. I suspect, however, that the Law Officers' Department are being a little oversensitive. Of course their judgement on whether to bring a case must be independent and seen to be so; but equally there is nothing to prevent Ministers individually or collectively making their own views and conclusions known to them.

J B UNWIN

9 February 1987
Cabinet Office

cc: BG/
BLUP

Prime Minister

MINISTERIAL GROUP ON LOCAL AUTHORITY CONTINGENCIES

I am sorry that I cannot be present tomorrow to consider MISC 109(87)1.

2. The situation created by these highly irresponsible hard left councils is worrying and I am interested in the Secretary of State for the Environment's proposals to deal with the financial imprudence of some local authorities. Taking account in particular of my interest in inner city policy and public order, I should want Home Office officials to be closely involved in their further development. I have no comments at this stage to make on his proposals.

3. I am copying this to the other members of MISC 109.

Douglas Hurd.

9 February 1987

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File SH

cc BG

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

SIR ROBERT ARMSTRONG

CABINET OFFICE

SOLVENCY OF LOCAL AUTHORITIES

The Prime Minister has seen your minute of 5 January to Mr. Wicks, and is content with the proposed ministerial arrangements for considering the solvency of local authorities described in your second paragraph, except that she would not think it necessary for the Secretary of State for Trade and Industry to be a member of the group.

I shall ask the diary secretaries to be in touch to arrange a meeting for the last week of January.

DN

DAVID NORGROVE

7 January 1987

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OA



Prime Minister 1

Content with the arrangements set out in paragraph 2?

DLW 6/1

Ref. A087/18

MR WICKS

Solvency of Local Authorities

attached

At Cabinet on 11 December (CC(86) 41.2) the Secretary of State for the Environment was invited to bring forward a paper soon after the Christmas Adjournment about the local authorities that appear to be on course to run out of money next year. I understand that, although the Secretary of State is awaiting a report from the Audit Commission, he should be able to bring forward a paper by the end of January.

2. In the meantime, we should consider which Ministerial group is most appropriate for this business, I should be grateful to know if the Prime Minister agrees that MISC 109 would be the best choice. This group, under the Prime Minister's chairmanship, was set up in 1984 to keep the Liverpool situation under review, though its terms of reference extend more widely. The membership is set out in my minute to Mr Turnbull of 13 November 1984, --- of which I attach a copy for ease of reference. The membership still seems appropriate, though I would recommend that Mr Tebbit should now be brought on to the group - instead of the ~~present~~

present P.A.S.T.I.

3. If the Prime Minister is content, we shall arrange a meeting, including Mr Tebbit, in the last week of January.

RA

ROBERT ARMSTRONG

5 January 1987