

cc BE

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

The Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

My ref:
Your ref:

26 June 1987

NBRM

Dear Chief Secretary,

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

John MacGregor wrote to me on 8 May, in reply to my letter of 1 May in which I outlined some of the work which was in hand to devise a prudential financial regime for local authorities. A copy of this correspondence is attached, for ease of reference.

As John suggested, Sir Peter Middleton, Sir Terence Heiser and the Deputy Governor of the Bank of England subsequently met on 1 June to discuss the progress that has been made in working up a comprehensive package of measures in this area, and the prospects for further development. One outcome of this meeting was a decision to set up a high-level official Working Group to consider these issues in more detail.

The Group has now produced an interim report, a copy of which is enclosed. This provides a round up, following the Election, of progress in developing a prudential regime. It describes, in greater detail than in the earlier correspondence, the state of development of the principal measures envisaged and sets out the work in hand (paragraph 31 of the report summarises the position of this). I am not seeking any decisions at this stage. The Group will produce a second, substantive report by the end of July, and we may wish to meet to discuss the direction of work at that stage. In the meantime however, I will be coming to colleagues separately about particular aspects of the policy on which we need to legislate. The first of these will be the auditors' stop power on which I shall be writing soon.

I am copying this letter, with the Working Group's report to the Prime Minister, to members of E(LA), and to Sir Robert Armstrong.

Yours sincerely,

Nicholas Ridley

NICHOLAS RIDLEY

(Approved in draft by the Secretary of State and signed in his absence.)

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES
REPORT BY THE WORKING GROUP ON LOCAL AUTHORITY FINANCIAL
PRUDENCE

BACKGROUND

1. Mr Ridley's letter of 1 May to the Lord President (Annex A) set out some of the measures in hand to tackle the problems of creative accounting and financial irresponsibility in a minority of local authorities. On 1 June Sir Peter Middleton (HMT), Sir Terence Heiser (DOE) and the Deputy Governor of the Bank of England met to discuss the issues raised in this letter, and in earlier correspondence.

2. The principal aim of the meeting was to review the work currently in hand to deal, through a comprehensive package of measures, with local authorities who persist in acting in a financially irresponsible manner; the state of development of the various measures proposed, and their likely efficacy; and what role the Bank of England might play.

3. It was agreed at the meeting that a high level official Working Group should be set up under DOE chairmanship to develop these issues further, and to report to Ministers. This group has now been convened, as the Working Group on Local Authority Financial Prudence (WGFP); a list of members is attached at Annex B. This first report of the Working Group is intended primarily to set out the current situation for Ministers. The Group is now examining the issues in more detail, and will provide a second substantive report before the end of July.

4. The rest of this report:

- summarises the scale of the creative accounting problem and the position of authorities;
- considers the role of the Bank of England;
- sketches out the counter measures that look worth pursuing and the overall prudential framework into which they might fit.

Ministers are not being asked to take any decisions at this stage.

THE SCALE OF THE CREATIVE ACCOUNTING PROBLEM IN LOCAL AUTHORITIES

5. In recent years a minority of local authorities have adopted a number of financial devices in order to reduce the impact on their spending of Government policies designed to restrain local government expenditure. These devices are not only of concern because their purpose is to circumvent Government controls over current and capital expenditure, and in some cases to gain a block grant advantage. Their use may also involve financial impropriety or inefficient methods of financing, and is likely to store up problems for the future, either by creating liabilities or by disguising a growing difficulty in balancing the authority's books.

6. The devices that have been employed include the use of special funds, deferred purchase schemes, and sale/leaseback and lease/leaseback deals. The Government has taken various steps in recent legislation to restrict local authorities' scope for entering into creative accounting deals. Measures have been taken in the Local Government Act 1986, the Local Government Finance Act 1987 and the Local Government Act 1987 to block some of the available routes. Nevertheless, authorities still have considerable room for manoeuvre, and some have already accumulated very large commitments for future years; it has been estimated that authorities have forward commitments of £2bn, mainly on deferred purchase schemes. Some information on the scale of authorities' use of the principal devices that have been identified has already been considered by the Group. This is now being reviewed and updated by a monitoring sub-group, involving officials from DOE, the Treasury, the Bank, the PWLB and the Audit Commission, that has been set up to pool information, and a detailed analysis will be incorporated in the Group's next report.

AN ASSESSMENT OF THE POSITION OF THE AUTHORITIES MOST AT RISK OF FINANCIAL COLLAPSE

7. The information available to the Government on the position of individual authorities is inevitably incomplete and sketchy. However, the sub-group of the WGFP is now reviewing the available figures, and the Group's next report will include a more detailed assessment.

8. In order to provide a flavour of what is currently known about the position of authorities, the notes at Annex C set out a brief summary of the position of seven major authorities most at risk (Manchester, Sheffield, Haringey, Camden, Islington, Lambeth, Hackney). They are ranked by size of funding gap, which is the difference between actual revenue spending and expenditure consistent with the rate levied. These seven authorities have the largest gaps between revenue spending and income but ratecapped Greenwich, Lewisham, Southwark and Brent are not far behind. Other major authorities are engaged in major deals which enable spending in excess of income and could spell trouble ahead, eg Ealing, Liverpool and Hammersmith and Fulham.

9. As a further indication, the table at Annex D shows the funding gap for the 20 ratecapped authorities in 1987/88. The effective expenditure level is the expenditure the authority should be able to finance with its permitted rate, and the underlying expenditure is the actual expenditure it is believed the authority will undertake. It appears that the total underlying expenditure of these authorities, at £2.824bn, exceeds the total of their effective expenditure levels by some £513m, or 22%.

THE ROLE OF THE BANK OF ENGLAND

10. The Group has considered with the Treasury and the Bank of England whether there are any steps which the Bank could take to discourage financial intermediaries from marketing creative financing schemes to local authorities.

11. The Bank supervisors have already circulated the Secretary of State for the Environment's statement on local authority creditworthiness to the British Bankers Association and the discount market, who between them cover those institutions most involved in local authority lending. As it happens, the Bank has recently issued in its supervisory capacity proposals of general application on capital adequacy and large exposures, which attach a higher credit risk to local authorities than to central government; also lending to local authorities is treated in the large exposures rules in the same manner as exposures to private sector borrowers. This should be of some further help in bringing home the message in the press release.

The Bank have carefully considered what more they could do. Any general statement by the Bank about lending to local authorities would go beyond the Bank's statutory supervisory responsibilities and it is unlikely that it would have much practical effect. Nor could the Bank comment on individual funding techniques in the absence of any evidence that these carried a particular high risk per se for lenders. What the Bank can do, where specific details can be obtained of facilities which are causing concern and if the details throw up unusual features, is to raise questions at its regular supervisory interviews with banks if it appears that lenders may be implicitly - and unrealistically - relying on central government backing in making large or certain types of facilities available to local authorities. The monitoring group may be able to identify facilities about which the Bank might be able to raise questions.

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

13. The Group has reviewed the principal measures which are currently being developed to combat creative accounting and financial imprudence. The work of the Group starts from the point that what is now needed are not further isolated legislative provisions, designed to deal piecemeal with individual problems as they are identified, but a more comprehensive package of interrelated measures which will together encourage authorities to act prudently, and will provide the Government with a system of "graduated response" to those authorities which persist in courting financial disaster. Some of these measures, however, are urgently needed and need to be worked up quickly if they are to be included in legislation in the next session. Others will need to be developed over a slightly longer time-scale, and some may not require legislation at all.

14. The main issues the Group is proposing to tackle are:

General measures

i. Prudential Ratios

15. An effective system of prudential ratios by which the prudence and financial standing of local authorities could be judged would be a significant step forward. Other actions, such as those developed below, might then flow if certain adverse ratios were approached or passed. The proposal for prudential ratios is being worked up by the Audit Commission in consultation with DOE. Current thinking is that the ratios might relate commitments and liabilities to likely income. There might be two levels of ratios:

- authorities judged to be in breach of the first could expect to find that they were treated with special caution when seeking loans or grants. The Council's cashflow could be threatened; and their councillors' pet projects endangered.

- authorities judged to be in breach of the second ratio would be completely beyond the limits of normal prudence. Auditors taking them to court could quote the breach as strong evidence of unlawfulness. Risk of breach could be grounds for a 'Stop' order. (see para 18-20 below).

16. Further detailed study is needed before it will be clear whether the development of these ratios is practicable and will match on an empirical basis the authorities likely to be at risk, but the Group hopes to be in a position to report further in its next report.

ii. Definition of "Borrowing"

17. It will be very difficult to work ratios effectively or shut off creative accounting unless an appropriate definition of borrowing can be devised. At present the legislation does not define the term "borrowing" and legal advice is that it should therefore be taken to have its natural meaning and relate to purely financial transactions. Creative accounting devices such as lease/leaseback are thus not caught by the control system: these have the effect of borrowing, but are technically not borrowing because the financial transactions are linked to property transfers. Finding and enacting definition which would bring a range of creative accounting methods within the control system would be a major step forward. However, it will be very difficult to frame a definition which is effective and does not also catch legitimate arrangements such as building and employment contracts. The Group is discussing some possible solutions to this problem, and will return to the question in its next report.

iii. Stop Power

18. Widdicombe recommended that the Audit Commission should have a power to seek a restraining injunction to stop a local authority incurring or authorising unlawful expenditure and a power to seek an order to compel councils to

undertake a duty where that failure would result in financial loss. Under the alternative 'stop' power proposal which DOE is working up the auditor would not have to go through the courts but could issue an order directly subject to rights of appeal to the courts. The effect of a stop notice would be to bring an immediate halt to a particular course of action by a council which in the auditor's opinion would be likely to lead to significant and unreasonable loss, significant unlawful expenditure, or a significant breach of fiduciary duty to ratepayers. The effect of a notice could also be to enjoin an authority against sliding into these difficulties through its failure to take action. Thus the power would be capable of preventing illegal action by councils which can now only be redressed, after the event, through the penalties of surcharge and disqualification against individual councillors.

19. The power may need to be buttressed with further provisions, notably a clarification of local authorities' fiduciary duty to balance the interests of current and future ratepayers amongst other considerations. This could then help the auditor in preventing authorities becoming rashly over-committed. A 'stop' notice would remain in force unless and until successfully appealed against to the courts, or withdrawn by the auditor. Appeal to the courts would be by way of judicial review. The auditor could seek enforcement of a breach of a notice through the courts by way of judicial review and/or take action subsequently to surcharge and disqualify those responsible.

20. The Audit Commission has recently reconsidered its response to Widdicombe and expressed its support for the development of this measure. DOE officials are developing a scheme urgently, for possible legislation this Session. However, considerable practical difficulties, especially regarding the definition of fiduciary duty, remain to be overcome before these proposals can be finalised.

iv. Role of Treasurer

21. The Green Paper "Paying for Local Government" included proposals for strengthening the position of local authority Treasurers in relation to the legality and propriety of the expenditure of their authorities. It is now proposed to introduce such provisions, with some modifications. The key points in the proposals are:

- the Treasurer (or Chief Finance Officer) would be placed under a statutory duty to report to the authority on any decisions, acts or omissions of the authority which would in his opinion lead to unlawful payments, deliberate loss, or expenditure in excess of available resources;
- the authority would, conversely, be required to refrain from actions which were the subject of a report until it had considered the report;
- in order that these procedures were not emasculated by political appointments, principal councils and joint authorities would be required to appoint to this post only members of the recognised professional accounting bodies (or persons already holding this office at the time the provisions come into force).

22. This measure would not alter the legal boundaries of what an authority may or may not do, nor would the authority be prevented from proceeding to act unlawfully once it had considered the Treasurer's report. Nevertheless, it would exert some further restraint on authorities, and - most importantly - provide the auditor (who would receive a copy of any report) with firm grounds for action, possibly including the issuing of a "Stop" notice in appropriate circumstances.

23. Instructions have been sent to Counsel on this matter, for inclusion in the Local Government Finance Bill.

v. Good Practice Certificate

24. Some authorities repeatedly fail to take action to remedy unsatisfactory financial management practices drawn to their attention by the auditor in management letters, qualified accounts and public interest reports. Yet there is generally insufficient evidence of malpractice to establish a case at law for central government discriminating against them through, for example, instituting more rigorous grant procedures or borrowing restrictions. The aims of this proposal would be to require local authorities to be in possession of a current certificate from the auditor attesting to the good order of their financial management systems and procedures. Lack of a current certificate could make the authority liable to central government sanctions and might serve to deter potential lenders. A certificate would normally be renewed annually at completion of audit but could be withdrawn or renewed at any intervening time.

where the auditor's dissatisfaction was limited to specific matters he would have discretion to qualify a certificate, in which case any sanctions imposed might be confined to the area of qualification.

25. Only preliminary consideration has so far been given to this possibility. A full appraisal will be included in the Group's next report.

iv. Differential Interest Rate Scheme for PWLB Lending

26. The Treasury has been considering the possibility that the PWLB should charge local authorities differential interest rates, reflecting their financial standing. Such "tiering" of interest rates appears to be both feasible and desirable. The difficulty lies in establishing objective tests of local authority creditworthiness that would withstand legal challenge. At present it appears that this might best be done by reference to the proposed prudential ratios. The timing of any further development on this front is therefore dependent on progress in working up prudential ratios, as discussed above.

27. The Group is also examining how the role of the PWLB might be adapted, to enable it to play a part in the contingency measures discussed below. Such changes would require legislation, and would therefore take a couple of years to implement.

CONTINGENCY PLANNING

28. In addition to reviewing progress on measures that are aimed to prevent authorities getting into financial difficulties the Group is also taking stock of the proposed contingency measures for dealing with authorities that may (through incompetence or deliberately) bring themselves to the brink of financial collapse. Work is in hand in the two areas described below. These represent the last stages in any system of graduated response.

i. Overseers

29. Overseers are seen as one means of avoiding the appointment of Commissioners, in certain circumstances. The key points in the proposal are:

- an overseer would be appointed in cases where an authority was likely to co-operate in the actions necessary to restore its financial standing;

- his role would be primarily advisory, requiring him to approve a recovery plan prepared by the authority, and to advise on the conduct of business within the plan.

The precise role powers and sanctions of the overseer are being examined by the Group and will be dealt with in our next report.

ii. Commissioners

30. It will also be necessary to make provision for those cases where an authority comes to the brink of collapse but is not prepared to co-operate in the measures necessary for recovery. The least unattractive solution in these extreme circumstances is still seen as the appointment of Commissioners to take over responsibility for running all the authority's services. An emergency Commissioners Bill is already drafted, and DOE officials are reviewing this, to see how far it needs updating in the light of more recent developments, and whether the financial arrangements require amendment.

CONCLUSION

31. Progress on the various measures described above can be summarised as follows:

- i. Prudential Ratios - the Audit Commission is taking forward detailed studies, and the Group should be able to report further in July;
- ii. Definition of "Borrowing" - possible solutions are being considered by the Group, which will report further in July;
- iii. "Stop" Power - a scheme is being developed for possible legislation this Session, and the Secretary of State will be writing to colleagues shortly;
- iv. Role of Treasurer - it is proposed to legislate in the Local Government Finance Bill this Session, and Instructions have been sent to Counsel;
- v. Good Practice Certificate - proposals are being worked up, and the Group will report further in July;

- vi. Overseers - detailed proposals have been worked up in DOE, and officials in other interested departments are now being consulted;
- vii. Commissioners - an emergency Bill is already drafted, but is being reviewed by DOE officials.

32. Ministers are invited to note the contents of this report, which sets out what is currently known about the scale of the creative accounting problem and outlines the work now being undertaken to tackle the problem, together with an indication of the timetable for further development of the various measures described. A further report will be circulated before the end of July, describing the progress that has been made in the evolution of a prudential regime for local authorities, and setting out the Working Group's proposals for further action.

WGFP

June 1987

WORKING GROUP ON LOCAL AUTHORITY FINANCIAL PRUDENCE

Department of the Environment Mr K F J Ennals (Chairman)

Mr C J S Brearley

Mr D A C Heigham

Mr I C McBrayne

Mr A C B Ramsay

Mr A C Wyatt

(Secretariat)

H M Treasury

Mr M V Hawtin

Mrs J R Lomax

Scottish Office

Mr G Robson

Welsh Office

Mr C L Jones

Bank of England

Mr I Plenderleith

Mr R I McConnachie

Audit Commission

Mr J C Nicholson

No. 10 Policy Unit

Mr P J Stredder

THE POSITION OF AUTHORITIES AT RISK

1. Manchester - Funding gap £70m in 1987-88

- have undertaken £200m lease/leaseback, using wholly-owned Manchester Mortgage Corporation, to bring in £15m in 1987/88 and £33m in 1988/89, at a cost of £5.4m annually until 2007.
- deferred purchase deal of £100m with Mercantile House.

2. Sheffield - funding gap £68m in 1987-88

- most of the funding gap bridged by capitalisation charged to £110m deferred purchase deal with Banque Paribas. £20m gap still unaccounted for.
- Council estimate initial annual repayments on deferred purchase of the order of £20-25m starting in 1989-90 and continuing until 1996-97

3. Haringey - funding gap £55m in 1987-88

- critical element of strategy involves £180m interest rate swap recently called into question by the District Auditor. The benefit amounts to £17m and the Council could be in trouble without it.
- have also undertaken significant capitalisation and are involved in lease/leaseback deals (a recent Press report suggests they may be in difficulty with this).
- deferred purchase facility of £60m with Guinness Mahon.

4. Camden - funding gap £56m in 1987-88

- recently been taking steps to curb expenditure but are still heavily reliant on capitalisation funded by sales of property, sale/leaseback of household fittings and deferred purchase.

deferred commitments with Banque Paribas and Mercantile House estimated at £113m, repayments believed to commence in 1988-89.

5. Islington - funding gap £47m in 1987-88.

- major capitalisation scheme linked to SATMAN 30. Total deferred commitments estimated at £250m, including a £150m lease/leaseback deal to generate £48m interest over the next three years.

- repayments due to begin in 1989-90.

6. Lambeth - funding gap £46m in 1987-88.

- Council appear to be capitalising close to the maximum available, financed by capital receipts and lease/leaseback using wholly owned LAMSAT as an intermediary.

- committed to an £11m deferred purchase deal, costing £33m in total repayments over the period, which could possibly be expanded.

- have suspended payments into superannuation funds in 1986-87 and 1987-88, saving the revenue account £13m.

7. Hackney - funding gap £31m in 1987-88

- appeared to be in serious trouble six months ago, but have staved off collapse with a major shift to capitalisation of repairs and maintenance.

- also involved in interest rate swaps.

- believed to have a £36m deferred purchase arrangements.

RATE LIMITED AUTHORITIES-ESTIMATED FUNDING GAPS 1987/88

	(i) UNDERLYING EXPENDITURE £m	(ii) EFFECTIVE EXPENDITURE LEVEL £m	(iii) FUNDING GAP £m	(iv) GAP AS % OF UNDERLYING EXPENDITURE %
Gateshead	111.000	102.521	8.479	7.6
Newcastle upon Tyne	169.000	155.494	13.506	8.0
North Tyneside	110.000	96.150	13.850	12.6
Sheffield	335.400	267.373	68.027	20.3
Camden	197.918	141.917	56.001	28.3
Greenwich	128.718	95.333	33.385	25.9
Hackney	163.339	132.691	30.648	18.8
Islington	154.012	107.085	46.927	30.5
Lambeth	198.175	152.336	45.839	23.1
Lewisham	145.400	115.550	29.850	20.5
Southwark	160.100	134.529	25.571	16.0
Tower Hamlets	141.000	125.608	15.392	10.9
Brent	207.600	183.286	24.314	11.7
Haringey	210.000	154.810	55.190	26.3
Hounslow	124.000	117.856	6.144	4.9
Newham	196.000	167.193	28.807	14.7
Basildon	20.000	13.897	6.103	30.5
Brighton	19.000	14.954	4.046	21.3
Middlesbrough	17.428	17.428	NIL	NIL
Thamesdown	15.500	14.557	0.943	6.1

LONG COVE

RELATIONS

PT 32



CONFIDENTIAL



COBG

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
London
SW1P 3EB

NBM

Dear Nick,

20 July 1987

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

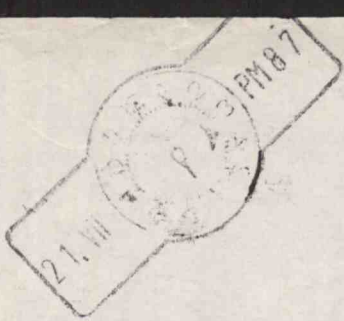
Thank you for your letter of 26 June covering the interim report by the Inter-Departmental Working Group on Financial Prudence.

I was interested to read the Group's report and the discussion of the individual measures which might form part of a package to establish a prudential regime for local authorities. I recognise however that there are still serious practical issues to be overcome if an effective regime is to be developed. We should be better placed to assess the prospects once we have the Group's further report at the end of this month.

I am copying this letter to the Prime Minister, to members of E(LA) and to Sir Robert Armstrong.

Yours Ever,
John

JOHN MAJOR



LOCAL GOVT
RELATIONS
PT 32

cc BCL

From: THE PRIVATE SECRETARY



CONFIDENTIAL

HOME OFFICE
QUEEN ANNE'S GATE
LONDON SW1H 9AT

18 May 1987

NBPM

Dear Robin

"A PRUDENTIAL REGIME FOR
LOCAL AUTHORITIES"

The Home Secretary read with interest the proposals in your Secretary of State's letter of 1 May, which the Chief Secretary supported in his letter of 8 May.

attap

He looks forward to discussion in MISC 109 of worked up proposals for legislation when they are ready. In the meantime he would be grateful if your officials would keep ours and those of the other service Departments in touch as the ideas are developed.

I am copying this letter to the recipients of your Secretary of State's letter.

Yours sincerely
William Pitt

W R FITTALL

✓

R U Young, Esq.,

CONFIDENTIAL

LOCAL GOVT Relations PT32



CONFIDENTIAL

C/BG



Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley AMICE MP
 Secretary of State for the Environment
 Department of the Environment
 2 Marsham Street
 London
 SW1P 3EB

NRBM

8TH May 1987

Dear Nick,

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

Thank you for sending me a copy of your letter of 1 May to Willie Whitelaw, setting out a range of possible new measures designed to improve prudential controls over local authorities. *at hand*

I very much welcome your general approach and I agree that these ideas are well worth further and more detailed examination.

I understand that since your earlier letter of 13 March, our officials have had a number of useful discussions about this area, including any action through the Bank of England. What I would like to suggest now is that our Permanent Secretaries should make arrangements for all the issues covered by your two letters to be considered together, with a view to reporting back to Ministers as quickly as possible. Peter Middleton will accordingly be in touch with Terry Heiser to arrange a very early meeting, to which he will also invite the Deputy Governor of the Bank of England.

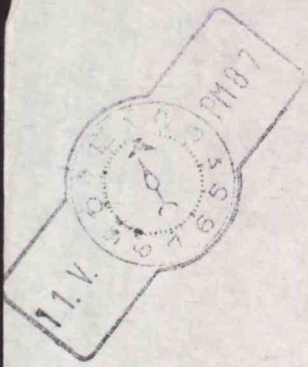
I am copying this letter to the Prime Minister, Willie Whitelaw, members of E(LA) and E(LF), and to Sir Robert Armstrong.

Yours ever,

JH

JOHN MacGREGOR

LOCAL GOVT : Relations PT32





The Rt Hon Viscount Whitelaw CH MC
 Lord President of the Council
 Privy Council Office
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2 MARSHAM STREET
 LONDON SW1P 3EB
 01-212 3434

My ref:

Your ref:

Prime Minister 2

1 May 1987

Potentially some very
~~useful~~ useful ideas here.

JKV

6/6.

Dear Lord President,

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

We had some discussions in MISC 109 earlier in the year about contingency measures that might be necessary to deal with the situation in a few authorities who may have set themselves on a financial disaster course. Other local authorities are not in anything like the same position, but there are signs that creative accounting is contagious. I believe it is appropriate to be taking steps to prevent authorities getting into such deep financial waters in future. Effective measures on the lines I sketch out below will also remove the need for constant legislation to block creative accounting loopholes; such as that on lease/leaseback about which I wrote recently.

The present sanctions act on councillors, not on the authority itself. They work in retrospect, they are slow and they are too narrowly focused. The militant leadership in Liverpool spun out nearly half of their four-year term in office under threat of disqualification, despite extraordinary audit and expedited hearing procedures. The ingredients needed to reinforce these sanctions are:

(a) timeliness; powers that can stop the rot as it is beginning;

(b) effective sanctions on authorities as well as on councillors as individuals; and

(c) a change of climate in the town halls, and amongst the City suppliers of finance, backed with a solid respect for prudence.

Local authority accountants show some signs of beginning to reassert professional standards. Under threat of a prescribed code of accounts which would issue from my Department, they and the Audit Commission have produced an improved voluntary code for revenue expenditure accounting. I expect the local authority associations to commend it to me shortly. I understand that it is already beginning to operate. Further work is going ahead on capital accounting, which is due to report in the autumn.

This contribution is something to build on; it is certainly not enough in itself. I have a range of new measures in mind, some or all of which will be needed to produce a comprehensive regime. At present the most promising seem to be:

A Stop Power

(i) Colleagues in MISC 109 reacted favourably to the idea of giving the Auditor a power to step in and issue an order pre-empting courses of action or inaction by a local authority which are likely to have illegal consequences. This is developing favourably. It may need to be buttressed with one or two further provisions; notably a clarification of local authorities' fiduciary duty to balance the interest of future and present electors and ratepayers. The 'stop' power should help the Auditor prevent authorities becoming rashly over-committed, and from entering into possibly illegal deals.

Prudential Ratios

(ii) Banks and building societies maintain prudential ratios between their means and their commitments. Similar ratios are being explored for local authorities. If this effort does prove successful, there would be likely to be two levels of ratios:

(a) Authorities judged to be in breach of the first could expect to find that they were treated with special caution when seeking loans or grants. The Council's cashflow could be threatened; and their councillors' pet projects endangered.

(b) Authorities judged to be in breach of the second ratio would be completely beyond the limits of normal prudence. Auditors taking them to court could quote the breach as strong evidence of unlawfulness. Risk of breach could be grounds for a 'Stop' order.

Good Practice Certificate

(iii) At present, the onus of proof lies on the Auditor if he thinks that an authority's financial practices are misguided or inadequate. Even where he demonstrates dissatisfaction, and qualifies the accounts or makes a report in the public interest, the authority may take no remedial action. This position might be reversed if it became normal practice for the auditor to issue a certificate to the authority that he was satisfied with its financial practices and management. Withdrawal or qualification of that certificate could trigger consequences similar to those for breach of the first level of prudential ratios. The certificate would re-inforce the other powers: and in particular act against cutting of financial corners.

Strengthening the Treasurer

(iv) Our Green Paper on "Paying for Local Government" looked at strengthening the legal duties of the Treasurer. Even if we strengthen the position of the auditor as I have suggested above, the Treasurer's proposed duty to report to the Council breaches of legality or propriety would still be essential. However, he would not have to certify his Council's taxing resolutions. He could rely on the auditors to act promptly if breaches were likely.

The Definition of Local Authority "Borrowing"

(v) The present legal definition of local authority "borrowing" does not extend to all the relevant forms of raising finance now in order to pay later for present benefits. Arriving at a more satisfactory legal definition looks difficult. Nonetheless, I think it should be attempted. If the definition can be materially widened, that could be an effective additional barrier against over-commitment and link with improved capital controls.

I am confident that new measures are needed; and I look forward to the support of colleagues. The effectiveness of all of the measures will be enhanced insofar as we can marshal responsible professional opinion behind the proposals. Some of the proposals are bound to require legislation. Our objective should be to make a start next session.

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

Yours sincerely,

Nicholas Ridley

NICHOLAS RIDLEY

PP (Approved in draft by the Secretary of State and signed in his absence.)

Advance copies to ^{ccBxp} ~~David Norgrove~~ - No 10 1
Anthony Langdon - Cabinet 2
Margaret Pierson - Treasury 3
Philip Ward - Environment 4

SECRET

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

COPY NO 1

CABINET

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY
SUB-COMMITTEE ON LOCAL GOVERNMENT FINANCE

—
ADDENDUM TO E(LF)(87)9
—

The paper referred to in paragraph 8 is attached.

SECRET

Department of Health and Social Security
29th April 1987

MINIMUM CONTRIBUTION TO DOMESTIC RATES

Additional Memorandum by the Secretary of State for Social Services

1. As foreshadowed in my Memorandum, E(LF)(87)9, I attach a separate note setting out:

(a) the main effects on disposable income in April 1988 of the social security reforms alone and of the combined effect taking the 20 per cent minimum contribution to domestic rates into account (Part 1). These figures are taken from the Technical Annex published in December 1985 with the Social Security White Paper. They are being re-costed to bring them up to date in preparation for decisions later in the year on the actual benefit rates in the reformed schemes from next April.

(b) the financial implications of the decision to require a minimum contribution to rates (based on the illustrative figure of 20 per cent) and of the options identified in the Memorandum for easing the burden of this new liability on the poorest social security beneficiaries (Part 2)

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Department of Health and Social Security
30th April 1987

This will be available
to others only at the
meeting.

NOTE

PART 1: EFFECTS ON DISPOSABLE INCOME: CASH POSITION AT POINT OF CHANGE

	Col (1) without 20% contribution	Col (2) with 20% contribution
(a) <u>Income support beneficiaries</u>		
* total gainers/no change	4.3m	3.3m
* total losers(transitional protection)	0	970,000
- pensioner losers	0	540,000
- pensioner losses	-	Up to £1:290,000 £1-£2:250,000
- sick/disabled/lone parent losers	-	140,000
- unemployed (and others) losers	-	280,000
- unemployed (and others) losses	-	Up to £1: 90,000 £1-£2:190,000
(b) <u>All recipients of income-related benefits</u>		
* total gainers/no change	7.6m	6.0m
* total losers	590,000	1.96m
- pensioners: losers	210,000	1m
- pensioners: losses	up to £1 80,000 £1-£2 50,000 over £2 80,000	450,000 450,000 100,000 *
- sick/disabled/lone parent: losers	60,000	210,000
- couples with children: losers	60,000	120,000
(in full-time work)	50,000	70,000
(not in full-time work)	10,000	50,000
- Other (including unemployed): losers	270,000	640,000
- Other (including unemployed): losses	up to £1 30,000 £1-£2 50,000 over £2 190,000	140,000 290,000 220,000 *

* how much over £2?

PART 2: FINANCIAL IMPLICATIONS

	<u>Savings (-)/Cost (+)</u>	<u>£ million</u>
	<u>Supplementary Ben)</u> <u>Income support)</u>	<u>Housing Benefit</u>
(a) <u>Present plans</u>		
Effect of introducing a minimum 20% contribution to rates	-	-350 (non-PE)
 (b) <u>Options in E(LF)(87)9 compared with £350m saving above</u>		
(i) para 7.1 - retain maximum rebate at 100 %	-	+350 (non-PE)
(ii) para 7.2 - retain maximum rebate at 90%	-	+180 (non-PE)
(iii) para 8.1 - <u>blanket</u> increase of £1.30 a week in all income-related benefits	+270 (PE)	+ 90
(iv) para 8.2 - <u>selective</u> increased £1.30 a week on all premium rates	+210 (PE)	+ 80
(v) para 8.3 - <u>selective</u> increase of £1.30 in certain premium rates (pensioners and families with children)	+160 (PE)	+ 65

(c) Average rate bills/liability based on 20% minimum contribution

	<u>Average rate bill</u>	<u>Average 20% contribution</u>
(i) Reflected in 1985 Technical Annex	£5 a week	£1 a week
(ii) Now - all ratepayers	£8 a week	£1.60 a week
highest average (Westminster)	£15 a week	£3 a week
lowest average (York)	£4.20 a week	84p a week
(iii) Now - supplementary benefit claimant ratepayers	£6.60 a week	£1.32 a week