

CUBG



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10 August 1987

Dear Jim,

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

My Secretary of State wrote to the Chief Secretary on 26 June covering the interim report of the Working Group on Local Authority Financial Prudence, and he replied on 20 July.

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I now enclose a copy of the Working Group's further report. Section 1 provides a summary. The report sets out a detailed analysis of the principal creative accounting devices employed by local authorities, and of the financial position of the 20 authorities which appear to have become most heavily embroiled in creative accounting. It also provides an up-to-date report on the development of the prudential regime, and indicates the direction which the Group believes further work should take.

AT BACK OF FILE

The Group's work is relevant to the forthcoming discussion of our proposals for a "stop" power for the auditor, which the Lord President suggested in his letter of 23 July. It also relates to the proposal for "overseers" on which my Secretary of State is due to report to MISC 109.

I am copying this letter and enclosure to David Norgrove at No 10, Mike Eland in the Lord President's office, the private secretaries to other members of MISC 109 and E(LF), and Trevor Woolley in Sir Robert Armstrong's office.

Yours,

Robin

R U YOUNG
 Private Secretary

LOCAL GOVT

RELATIONS

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A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

FURTHER REPORT BY

THE WORKING GROUP ON LOCAL AUTHORITY FINANCIAL PRUDENCE

August 1987

CONFIDENTIAL

A PRUDENTIAL REGIME FOR LOCAL AUTHORITIES

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AUGUST 1987

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1. INTRODUCTION TO THE REPORT

1.1. BACKGROUND

1.1.1. The Working Group on Local Authority Financial Prudence was set up to examine the use of creative accounting devices by local authorities, and to review the various measures being developed to encourage prudent financial behaviour in local government. It is chaired by DOE and has represented on it the Treasury, the Scottish and Welsh Offices, the Bank of England, the Audit Commission and the No. 10 Policy Unit.

1.1.2 The interim report of the Working Group, circulated under cover of the Secretary of State for the Environment's letter of 26 June to the Chief Secretary, described progress with current work and the timetable for the future. The contents of this further report are summarised below.

1.2. SUMMARY OF THE REPORT

Section 2

1.2.1. A number of distinct "creative accounting" devices can be identified, and a distinction drawn between "creative accounting" and "creative financing". The former is the exploitation of accounting practices to gain financial advantage, the latter the use of means of raising finance which are generally forms of pseudo - borrowing. Both erode Government expenditure controls; the latter also undermines authorities' creditworthiness, if used to excess. The report sets out the nature and where known the scale of each device; these are listed in paragraph 2.1.1, and include the use of special funds, deferred purchase, advance leasing, lease/leaseback, and others. Where appropriate, the report describes the Government counter-measures taken. However, local authorities and the City have continued to identify new devices as the old ones are blocked off, and there is an evident need to move

away from piecemeal action on individual devices as they come to light, towards a more general solution to the underlying problem of creative accounting. This section of the report also describes the aggregate effects of creative accounting, and notes the importance of keeping up to date with new devices as they become available. Authorities will probably be incurring substantial costs by 1990/91 as a result of arrangements already entered into, but it is thought that they have considerable scope for re-financing.

Section 3

1.2.2. Examination of the available information about the 20 authorities which have indulged to the greatest extent in "creative accounting" suggests that these authorities should get through 1987/88 without breakdown. There is however some uncertainty, in particular about Haringey. It is too early to be confident about the position in 1988/89. Many of the authorities face large "funding gaps", which together total some £982m. They may negotiate creative accounting deals to cover these, but (possibly in response to Mr Ridley's statement on local authority debt) the City appears to be becoming more wary of financing authorities in apparent difficulties. The alternative, if financial collapse is to be avoided, is the adoption of measures to secure substantial savings in the short term.

1.2.3. Recent statements by the Association of London Authorities have suggested a new realism in facing financial problems, and some options for greater economy and efficiency can be identified. These, although they do not provide a complete solution, could enable the authorities concerned to reduce their net expenditure considerably. If the will is there the authorities may thus be able to take steps to improve their position in 1988/89, but the scale of their difficulties should not be underestimated. Even if the flow of new creative accounting is slowing down, the worst affected authorities already have significant deferred liabilities to cope with in 1989/90 and beyond.

1.2.4. A critical element will be the rate increases levied by non-rate-capped authorities (which include some of those previously rate-capped with the most substantial "gaps" such as Islington, Brent and Sheffield) and the extent to which the rate limits set by the Secretary of State make an allowance for "funding gaps". There is, however, a need to get better information on financing deals entered into by individual authorities and their future costs, as well as general information about the types of deal available (referred to in paragraph 1.2.1 above).

Monitoring

1.2.5 Both sections 2 and 3 of the report draw heavily on the work of the Working Group's monitoring sub-group (on which the PWLB is also represented). It is intended that this sub-group should remain in being and continue to act as a forum for the exchange of information about developments in creative accounting and creative financing, both in general and as they affect the position of individual authorities. Profiles of the kind shown at Annex A to the report are available for the 20 authorities thought to be most heavily engaged in creative accounting, and will be maintained and updated on a regular basis.

Section 4

1.2.6. If a more comprehensive solution to the problem of creative accounting can be found, it is likely to lie in a package of inter-related measures which, supporting the forthcoming reforms of local government finance and the capital control system, will together act to encourage financial prudence amongst that minority of local authorities who at present neglect it. This package would comprise what has been called the "prudential regime", and would ideally permit a graduated response by Government to authorities behaving imprudently. This would involve the tightening of the screws on an authority as it moves further into the area of imprudence - from signals to lenders that an authority is an increasing risk; through restraints, or in the end prohibitions, on action by the authority; to direct intervention by Government in the form of appointing overseers or Commissioners. However, much work remains to be done before we can be sure that an effective regime of this kind can be put in place. This section of the report describes progress in developing the component elements of the prudential regime, which are listed in paragraph 4.1.5. It also comments on the likely impact on local authorities of the proposed regime, and their probable reaction to it.

1.2.7. On the elements of the regime the findings and recommendations of the Working Group can be summarised as follows:

- i. Definition of borrowing: it will be very important to continue to develop a definition which encompasses 'pseudo-borrowing' (deferred purchase, lease/leaseback) and brings it within the capital control system. The Group recommends that work should continue on a statutory definition of borrowing, for inclusion in legislation on the capital control system in 1988/89 (para 4.2.10).

ii. Prudential ratios are worth pursuing as an element in the new regime to provide signals to lenders and a framework for other elements of the regime. A good deal of further work needs to be done before it is clear that acceptable and workable ratios can be identified. The Group recommends that this work, which is principally for the Audit Commission, should be progressed urgently. Considered proposals should be available in October (para 4.3.10).

iii. The auditor's stop power will be a useful component of the overall prudential package, enabling the auditor to prevent unlawful acts and, if the proposed new statutory definition of local authorities' fiduciary duty is accepted, highly imprudent ones also. The Group notes that it is intended to legislate on the first element of this proposal (and the second also, if Ministers agree that this should be proceeded with) in the Local Government Bill (para 4.4.5).

iv. Role of the Treasurer: Giving the local authority Treasurer a strengthened role in relation to the legality and propriety of his authority's expenditure will also play a useful part in the prudential regime, especially in conjunction with the proposed stop power. The Group notes that it is proposed, subject to Ministerial agreements, to legislate in the Local Government Finance Bill (para 4.5.2.)

v. Exchequer Grant: Under present legislation, central Government would only be able to withdraw mandatory grants such as RSG if an authority was acting illegally. The Group recommends that no new powers should be taken to allow Ministers to withhold grant where they considered an authority was financially imprudent (para 4.6.7).

vi. Good practice certificates are concerned more with the financial management systems needed for prudent management with than imprudence directly. The Group recommends that they should be developed separately by the Audit Commission in due course and not considered as part of the prudential regime (para 4.7.5).

vii. The proposal for the appointment by the Secretary of State of Overseers for authorities in financial difficulties has merit but needs further working up, together with an associated proposal by which authorities would themselves appoint consultants to assist in the

formulation and/or monitoring of a recovery plan. The Group recommends that a detailed paper exploring the options, and taking account of the question of the standard of service provision embodied in a recovery plan, should be put to Ministers in September (para. 4.8.5).

viii. Role of the PWLB: The charging by the PWLB of differential interest rates would be desirable, but the viability of such a scheme depends on success in developing prudential ratios which can provide a satisfactory test of creditworthiness, and would almost certainly require new legislation. The Group recommends that other options for regulating Government lending to authorities close to collapse should be worked up for its consideration.

1.2.8 Finally, sub-section 4.10 notes that some updating of the draft Commissioners legislation is being undertaken.

1.3. THE POSITION IN SCOTLAND AND WALES

1.3.1 This report is principally concerned with the consequences of action by a small number of English authorities. Creative accounting by Welsh or Scottish authorities is thought at present to be on a significantly lesser scale than that in England. However, a recent report by the Commission for Local Authority Accounts in Scotland says that Scottish authorities' accounts for the last two years show around 200 cases of questionable accounting practices (eg wrong classification of expenditure as between capital and current, apparently undertaken for the purposes of evading Government controls) but the amount of money involved totals around £55 million, or less than 1% of local authority current expenditure in the period. As regards the more novel creative financing devices which are a principal cause of concern in England, the only signs in Scotland are of a number of covenant schemes (a form of deferred purchase) to a total value of around £400 million; 26 authorities are known to have entered into such schemes. In some cases these have been entered into to facilitate lumpy investment programmes by small authorities, and are unexceptionable. Three authorities stand out -Edinburgh District which is known still to be active in investigating creative accounting options, Glasgow District which has borrowed £75 million for house improvements, and Lothian Region which has borrowed £45 million, originally for new road construction but now diverted to other purposes. Except possibly in the case of Edinburgh, which auditors are now examining, none of these schemes are thought to give rise to difficulties about future repayment. Moreover, the Secretary of State has now brought covenant schemes firmly within his capital control system. Nevertheless, there can be no guarantee that English practices will not prove contagious.

2. METHODS OF CREATIVE ACCOUNTING EMPLOYED BY LOCAL AUTHORITIES

2.1 INTRODUCTION

2.1.1 This section describes the principal creative accounting devices employed by local authorities, giving an assessment of the scale and nature of the problem and outlining the counter-measures already taken by central Government. The final paragraphs summarise the aggregate effects of "creative accounting" on both the capital and revenue sides. As will be clear from the text, "creative accounting" is a loose term which covers not only the exploitation of accounting practices to gain financial advantage (the use of special funds, capitalisation etc) but also creative financing, primarily of the "spend now, pay later" kind (deferred purchase, lease/leaseback etc)- effectively borrowing by another name. Both types are designed to circumvent Government expenditure controls; the latter also undermines authorities' creditworthiness. The text separately identifies accounting and financing devices.

2.1.2. The following devices are discussed:

Sub-section 2.2 Use of Special Funds

2.3 Capitalisation

2.4 Use of Superannuation Funds

2.5 Changed Sinking Fund Rate

2.6 Deferred Purchase

2.7 Sale/Leaseback and Lease/Leaseback

2.8 Sale of Mortgages

2.9 Advance Leasing

2.10 Diversification of Rented Housing

2.11 Interest Rate Swaps

2.12 Parallel Loans

2.1.3. The advent of the community charge and the new grant system will make redundant those devices which rely for their effect on the relationship of spending to grant, but it will not remove the desire by some authorities to

spend now and pay later. What follows is therefore of relevance both to the current and to the new systems of local government finance. This section of the report also indicates the piecemeal nature of the approach which Government has so far adopted, acting against individual devices - sale of mortgages, deferred purchase, leasing - as they become established, and the ingenuity of the City/Local Government in devising new ones. It thus underlines the case for replacing this piecemeal approach by a general attack on the philosophy behind "creative accounting", and authorities' ability to indulge in it. It also makes it clear that the Government will continue to need to keep up with the development of new financing devices as they emerge.

2.2 USE OF SPECIAL FUNDS (ACCOUNTING)

The Methods Used

2.2.1 Contributions made by an authority to a special fund set up under Schedule 13 of the Local Government Act 1972 have been counted as "total" expenditure for the purpose of calculating block grant entitlements, whilst the spending of sums out of such funds has not. As block grant mechanisms became tougher each year local authorities began to make notional payments into special funds, in years when the grant penalties for extra expenditure were relatively mild, to draw down in later years to reduce expenditure and minimise grant losses. Some authorities have manipulated their balances to such an extent that notional contributions to special funds are sufficient to result in a deficit on the rate fund. This has become known as deficit financing of special funds.

2.2.2 Special funds have been drawn on by rate-limited authorities to enable spending in excess of their expenditure level. Capital funds, housing revenue account balances, trading services account balances and others have all been used for this purpose.

The Scale of the Problem

2.2.3 In order to avoid the increasing severity of the block grant regime from 1981-82 onwards local authorities made unallocated contributions into special funds of £1.5 bn in the years 1981-82 to 1984-85, which have been drawn down to the tune of £0.8 bn in 1985-86 and 1986-87 (see Table 1). The impact of changes in the marginal rates of block grant loss for increases in total expenditure

has thus been considerably mitigated. Nottinghamshire, for example, have gained £141m block grant by making net withdrawals of £46m from special funds over a period of five years (see Table 2).

2.2.4. In practice, many authorities have now exhausted their funds, though some £1bn of special funds still remain. The main concern now is that by drawing down their funds rate-capped authorities have been able to avoid the real cuts in spending which they were intended to have to make. As the scope for drawing down special funds decreases the authorities will have to make acute reductions in expenditure in future years, if they are not permitted to raise their rates to bridge the gap.

Counter-Actions Taken

2.2.5 The Local Government Finance Act 1987 put the established uses of special funds on a firm statutory basis. It did however also provide the means to outlaw deficit financing of special funds, through the making of specifications which would have the effect of excluding certain transfers from relevant and total expenditure, so preventing authorities from gaining any block grant advantage from this sort of transfer. The use of special funds as a device to maximise grant entitlements between years will end with the new system of local government finance to be introduced in 1990, when grant entitlement will be divorced from an authority's actual spending.

2.3. CAPITALISATION (ACCOUNTING)

The Method Used

2.3.1. There are a number of categories of expenditure which an authority has discretion to classify as either revenue or capital. The most significant of these is housing repairs and maintenance. This is traditionally a revenue item, but authorities can if they wish charge it to their capital account and finance it by borrowing, capital receipts or deferred purchase rather than by revenue. If it is financed by borrowing, it is prescribed expenditure and scores against the authority's capital spending limit, making it of less interest to many authorities as a creative accounting device. But if it is financed by capital receipts the expenditure is not prescribed, and by doing this an authority can use up receipts faster than would normally be allowed by the prescribed proportion rules, which limit the rate at which receipts may be used for

prescribed expenditure. Finally, if it is financed by a deferred purchase scheme it is again not prescribed and so is not affected by the new rules contained in the Local Government Act 1987 (see paragraph 2.6.5 below).

2.3.2. Some local authorities have been capitalising for several years as a means of increasing the overall level of repair and maintenance work, and in some cases the treatment of major repairs or renovation as a capital item is entirely justifiable. But increasingly authorities are using the device to reduce the level of revenue expenditure on repairs and thus the size of their rate fund contribution to the housing revenue account and in turn their total rate-borne expenditure. Some authorities have carried this to the point of entirely eliminating revenue expenditure on repairs and maintenance. The authority in the past gained both a block grant advantage from this arrangement and extra housing subsidy.

The Scale of the Problem

2.3.3. Table 3 shows examples of authorities where capitalised housing repairs are around £10m or above. The figures show that these authorities have capitalised about £89m more spending in 1986-87 than in 1985-86. It is thought that capitalisation deals account overall for a very large part of the creative accounting undertaken by local authorities.

Counter-Actions Taken

2.3.4. Ministers have tackled the implications of capitalisation for housing subsidy. Authorities benefitted because payments were previously based on notional levels of uncapitalised housing maintenance, which were not reduced if the authority had capitalised expenditure, plus actual levels of capital expenditure. In February 1987 a general determination was issued to the effect that entitlement to housing subsidy would be based on either actual revenue expenditure or the notional level, whichever was lower.

2.3.5 It might be possible to introduce legislation to tackle the capitalisation problem more fundamentally from 1988/89. However, the Government plans in any case to bring in legislation in 1988/89 to reform the capital control system, with effect from 1990/91. Although present work is focussing on borrowing controls and the concept of prescribed expenditure may therefore no longer be relevant, the opportunity could be taken then to tighten up the grey area of what is and is not capital, and for what purposes authorities may or may not borrow or use capital receipts.

2.4 USE OF SUPERANNUATION FUNDS (ACCOUNTING/FINANCING)

The Methods Used

2.4.1. The local government superannuation scheme (LGSS) is contained in detailed statutory regulations made by the Secretary of State under powers provided by the Superannuation Act 1972. There are 88 administering authorities in England and Wales (mainly County Councils and London Borough Councils) who are required by the regulations to establish and maintain superannuation funds. The market value of these funds is now estimated to be about £25bn. Of this, the funds of the 32 London Boroughs and the City are worth about £3bn in total.

2.4.2. An administering authority might use superannuation funds to evade expenditure controls. Employers' contributions might be suspended in anticipation of an actuary's favourable interim or regular revaluation of the fund. This results in immediate revenue savings, but possibly at the expense of increased expenditure in later years if it becomes necessary to replenish the superannuation fund from the rate fund. Another device centres on the use of funds. Under the present regulations up to 10% of the fund can be used by the administering authority or lent to other authorities, for purposes for which they have statutory borrowing powers. However, funds might also be invested in companies set up and controlled by the administering authority, which could by this route carry on activities outside of the normal constraints on expenditure provided that there was a reasonable expectation of a return on the superannuation fund's capital. (Although concern about superannuation funds has centred recently on the "News on Sunday" case, where a number of authorities put money (arguably for political reasons) into the newspaper which is now in receivership, these unsound investments cannot really be classed as creative accounting.)

The Scale of the Problem

2.4.3. It is not clear that use of superannuation funds yet represents a significant problem from the creative accounting perspective. However, a number of authorities including Liverpool and Lambeth have used a reduction in contributions to their funds to assist their financial position.

Counter-Actions Taken

2.4.4. The regulations governing the management of superannuation funds were significantly relaxed in 1983, to give administering authorities greater freedom in their investment decisions. Largely in response to the "News on Sunday" case DOE Ministers are currently considering the arguments for making further changes, for example in order to restrict the proportion of a company's unlisted share capital that can be held by local government superannuation funds, or to remove responsibility for the management of funds from London Boroughs. The Audit Commission's present view is that there is no power to make interim revaluations of a superannuation fund. This will constrict the scope for reducing or suspending employers' contributions.

2.4.5. The use of investment in companies controlled by the authority as a means of avoiding constraints on expenditure is being considered in the context of the review of capital controls. The question of local authorities' interest in companies is also being examined, in response to a recommendation of the Widdicombe report, by an interdepartmental study group on which consultants are represented, and which should report in November.

2.5. CHANGED SINKING FUND RATE (ACCOUNTING)

The Methods Used

2.5.1 Authorities have a degree of discretion as to the way in which they make provision in their accounts for meeting future loan charges. Some use a sinking fund. A number of local authorities have chosen to increase their sinking fund rates, often from 5% to 10%. Repayments of principal are thereby lower in the early part of the loan. This has the effect of reducing revenue contributions in the short term, at the expense of higher costs over the loan as a whole, but did not in the past reduce entitlement to housing subsidy which was paid on the basis of a notional 5% sinking fund rate.

Counter-Actions Taken

2.5.2 The main constraint on this and other creative accounting for loan charges is that the auditor would object if manifestly inadequate provision were made. The housing subsidy anomaly has been partly removed by increasing the sinking fund rate on which entitlement is based to a notional 8% (or an actual lower rate if applicable).

2.6 DEFERRED PURCHASE (FINANCING)

2.6.1 A deferred purchase arrangement is one in which a financial institution agrees to finance capital work to be carried out for an authority now but does not require payment from the authority until a future year. The Government accepted the existence of such schemes for many years, because at that stage they were limited to relatively few authorities, usually small districts, which used the device to achieve a one-off capital project which was difficult to accommodate within their spending ceiling for a single year. During 1985 and 1986, however, a number of major authorities undertook such schemes on a large scale. In most cases they were used to avoid capital controls but some were undertaken as a way round rate limitation. By financing, or releasing other funds to finance, capitalisation (see sub-section 2.3 above) they helped authorities to spend up despite rate limits.

2.6.2. Conversely, during periods when revenue and capital control systems are becoming progressively tougher it may be attractive to an authority to incur expenditure in advance of its need for a particular project. An advance purchase deal involves payment to a financial institution covering work to be carried out in a future year. Although the nature of this device is such that it is less attractive to authorities when pressures on spending are severe, there have been occasions - notably before the reduction in prescribed proportions at the beginning of 1985-86 - when imminent capital control changes have led to a spate of such schemes.

The Scale of the Problem

2.6.3 Many authorities have entered into significant deferred purchase deals. Our evidence is probably incomplete. However, Table 4 lists 35 authorities (four of them in Scotland) who are known to have entered into deferred purchase schemes to arrange works to the value of £1.8 bn. The works will be carried out

over the next few years but the payments by the authorities will be spread over a much longer period. The total cost will eventually be much higher than £1.8bn because it will include substantial interest payments.

2.6.4 As an example, Sheffield City Council has entered into deferred purchase agreements worth £110m to cover projects to be undertaken in the financial years 1986/87 to 1988/89. Repayments do not begin until 1989/1990, with fairly short redemption periods ending in 1996/97. The initial annual repayments will be £20m/£25m. At present the Council enjoys the use of what is in effect borrowed money without suffering block grant penalties or incurring any costs to be met from the rate fund. In the 1990s, however, the cost to ratepayers of these arrangements would be the equivalent of at least 100p in the pound on local rates - and under the existing block grant regime would be several times higher, because of grant penalties.

Counter-Actions Taken

2.6.5 In view of the increasing use of these schemes, the Government announced last July that it would take powers to inhibit the use of advance and deferred purchase as a means of avoiding the Government's capital expenditure controls. The Local Government Act 1987 contains provisions to put this into effect. The timing of prescribed expenditure is now determined by reference to the year in which works are carried out by or for an authority, rather than the year in which the payments are made, thus making these schemes considerably less attractive to authorities. The legislation applies retrospectively to contracts and other arrangements to which authorities have become committed on or after 23 July 1986. Most of the deals listed in Table 4 were arranged before this date but there are indications that some authorities at least might not have been legally committed to the arrangements to a sufficient extent to escape the provisions of the 1987 Act.

2.6.6. Ministers have announced that there will be a de minimis general exemption to enable authorities, particularly the smaller ones, to spread the cost of an occasional one-off project which is large in relation to their annual spending ceiling. There will also be a specific exemption to enable authorities to continue carrying out their building and improvement under licence housing schemes. This exemption will be backdated to 23 July 1986, so as not to disadvantage authorities who may have continued to enter such schemes in good

faith on or after that date without realising the impact of the 1987 Act. Regulations are needed to bring the exemptions into force, and the local authority associations are now being consulted on these, with a view to introducing them on 1 September 1987.

2.7 SALE/LEASEBACK AND LEASE/LEASEBACK (FINANCING)

The Methods Used

2.7.1 The Government encourages local authorities to secure the genuine disposal of surplus assets, and to this end permits a proportion of the capital receipts generated to be invested in new capital expenditure. However, some authorities have increasingly looked for ways of generating capital receipts without effecting a true disposal.

2.7.2 A number of authorities have entered sale/leaseback or lease/leaseback agreements. These deals:

- consist of the freehold disposal of an asset followed by its immediate reacquisition by lease (sale-leaseback); or a leasehold disposal and reacquisition by lease (lease/leaseback);
- may involve land or buildings but not equipment (the new regulations bringing finance leasing within the control system - see paragraph 2.9.4 below - mean that the reacquisition of equipment would involve prescribed expenditure and so be unappealing to authorities);
- are on terms which provide for a substantial up-front premium for the disposal but annual rental payments for the reacquisition. They often include a holiday from rental payments in the early years of the scheme.

An authority therefore obtains a substantial lump sum which has to be repaid over a number of years - giving a short-term cash-flow advantage but adding to future commitments every bit as much as conventional borrowing. It can use the receipt for capital spending (subject to the prescribed proportion) or to relieve the revenue budget through capitalisation. But in most cases the main purpose of the deal is to earn interest on the capital receipt so as to help the revenue budget. Although sale/leaseback and lease/leaseback are themselves

perfectly acceptable financing techniques in the commercial world, their use by local authorities to gain short-term support for unrealistically high current expenditure, at the expense of substantial future liabilities, is a cause of concern.

The Scale of the Problem

2.7.3. The information available about the amounts involved in deals of this sort is probably incomplete. However, Table 4 lists 7 authorities who are between them known to have secured or to be considering leaseback deals to a value of £534m. There are indications that some of the authorities are having difficulty obtaining the necessary finance.

Counter-Actions Taken

2.7.4. The Government has made clear in answer to an inspired PQ and on several other occasions that it does not stand behind local authority debt and that debt arranged through unconventional financing deals is less secure than debt from conventional borrowing. This appears to have had some effect and to have contributed to the difficulty in securing deals mentioned above. In the long term a new system of controlling local authority borrowing for capital, which redefines borrowing to include these deals, offers the best solution to the problem.

2.8 SALE OF MORTGAGES (FINANCING)

The Methods Used

2.8.1. The sale of mortgage books has been a particularly attractive form of creative accounting. An authority would sell its mortgage book to a financial institution, sometimes without informing the mortgagors and sometimes retaining the risk attached to the mortgages. Such a transaction would provide the authority with immediate cash and capital spending power, although it would be deprived of regular payments in the future and might still have to meet loan charges on the mortgages for years to come. The capital spending power could be used to relieve the revenue budget by capitalisation.

Counter-Actions Taken

2.8.2 The Government acted in the Local Government Act 1986 to tighten up the rules relating to the sale of mortgages. Mortgagors must now always be informed of the sale in advance and give their consent: this will make it harder for authorities to rush through sales in order to generate cash. Moreover, unless the buyer takes all the risk attached to the mortgage as part of the sale, no capital receipt will be scored.

2.9 ADVANCE LEASING (FINANCING)

The Methods Used

2.9.1 Up to 1986/87 the finance leasing of vehicles, plant etc did not count as prescribed expenditure. Tax allowances were also available to lessors of capital assets. These incentives led to a rapid growth in leasing. Ministers decided that as this growth reduced the scope for adequate capital allocations, finance leasing should count as prescribed expenditure.

2.9.2. As authorities were aware of this change a large number of them entered into advance leasing deals, before 1 April 1987, for the acquisition of vehicles, plant etc. The deals involve an authority in acquiring assets over a number of years (anything from 2 to 10 years). However as the agreements they entered into gave them an interest in the future use of the asset at the date of the agreement the present rules allow an authority to score the capital value of the asset at that date. As this was before 1 April 1987 the acquisition of these assets did not count as prescribed expenditure.

The Scale of the Problem

2.9.3. Although we have no firm figures on the scale of advance leasing it appears that authorities have entered into advance leasing commitments, before 1 April 1987, amounting to well over £1 bn. However there is no way of saying whether all these arrangements will be used. There is some evidence that because of the interpretation by the Inland Revenue of the law relating to capital tax allowances many of these arrangements will not proceed.

Counter-Actions Taken

2.9.4. As the incentive to enter into advance leasing on a large scale to evade capital controls arose only once, there is no specific counter-action that could and need be taken. All finance leasing is now prescribed expenditure. However the total for capital allocations for 1988/89 and subsequent years will take account of the assets acquired during the relevant year under advance leasing schemes arranged in 1986/87. Ministers are also considering the possibility of taking into account the level of advance leasing undertaken by individual authorities when making allocations for those authorities.

2.10 DIVERSIFICATION OF RENTED HOUSING (FINANCING)

The Methods Used

2.10.1 A new move devised by Sheffield City Council could provide considerable scope for creative accounting by many authorities. The scheme involves a partnership between the authority and the private sector to provide or renovate housing stock. The land is disposed of to, for example, a housing association which raises money for the development privately. The housing association then uses the Council as managers and gives them 100% nomination rights for tenants. The Council in turn gives the housing association a revenue deficit subsidy to make up the difference between the fair rents to be charged and the cost of finance. Therefore in practice the scheme will provide municipal housing but in such a way that capital expenditure does not score for control purposes.

Counter-Actions Taken

2.10.2 The Minister for Housing announced on 5 February 1987 proposals to give local housing authorities a new explicit power to provide financial and other assistance towards the provision of private rented accommodation. The assistance may be in the form of both capital and revenue contributions. The Secretary of State's consent is required for the giving of such assistance, whether under existing powers or the proposed power. The provisions enshrining these proposals were introduced in the Local Government Bill but were subsequently deleted in order to secure the Bill's passage before the dissolution. The provisions have been reintroduced in the new Local Government Bill.

2.11 INTEREST RATE SWAPS (FINANCING)

The Methods Used

2.11.1 Interest rate swaps basically involve the exchange of a fixed interest rate liability for a variable one (or vice versa). There are a number of different ways in which this principle can be put into practice. In the simplest form of arrangement the authority will be paying interest at a fixed rate on a loan (probably from the PWLB), and a bank will agree to pay the authority half-yearly amounts equal to these interest payments. In return, the authority pays the bank interest on the amount of the loan at a variable half-yearly rate. The local authority will benefit from any favourable differential between the fixed and variable rates. The main attraction is however the payment of a large front-end fee or premium by the bank, in lieu of part of the future interest payments; this lump sum will be discounted to take account of the interest that would accrue if it were invested. The authority will thus obtain a one-off capital receipt, but at the expense of higher revenue costs in the longer term, in the shape of the differential between its fixed payments on the loan and its abated future income from the bank.

The Scale of the Problem

2.11.2 Five London Boroughs are known to be involved in or to be finalising interest rate swaps. Haringey have arranged two deals involving interest on £180m of debt, with a front-end premium of £29m; Islington have a series of deals amounting to £125m, with a premium probably of around £20m; and Brent have been trying to negotiate a complicated scheme, involving up to £200m of debt, and using Harlow DC and other authorities as intermediaries. Hackney are thought to be benefitting by £3m from interest rate swaps, and Camden are reported to have an interest rate swap with a premium of £10m. This information is not comprehensive, and further schemes may exist. It is a matter of concern that the authorities concerned are probably exploiting the availability to them of borrowing on preferential terms from the PWLB, and lending on through these deals.

Counter-Actions Taken

2.11.3 No action has yet been taken to combat these schemes, which are a relatively new development in local authority finance, though well-known

elsewhere in the financial world. It is, however, arguable that the front-end premia are in law a form of borrowing, and thus subject to control.

The District Auditor is also now considering court action against Haringey's proposed use of the premium for revenue purposes.

2.12 PARALLEL LOANS

2.12.1 Another form of creative accounting known to be in use by local authorities is the parallel loan. An authority borrows a relatively small sum from a bank at an extremely high interest rate, whilst at the same time the bank places a much larger sum on interest-free deposit with the authority. The interest payments on the smaller sum provide the bank with an acceptable return on its capital, but the larger amount does not score as borrowing by the authority. No reliable information is available about the scale on which this device is being used.

2.13 THE AGGREGATE EFFECTS OF CREATIVE ACCOUNTING

2.13.1 It can be seen from the preceding paragraphs that local authorities can use creative accounting/financing either for capital or for current expenditure purposes. On the capital account side, the aim is essentially to find ways of financing capital expenditure which do not score as borrowing or as prescribed expenditure in any given year. On the current account side, the aim may be either to avoid the loss of block grant by supporting the provision of services in ways which do not count as total expenditure in the year in question, or else (for rate-capped authorities) to find alternative sources of income to make up for the loss of the rate income on which they would otherwise have relied to support their spending plans. In many cases the interrelationship between the capital and current benefits of a scheme or series of schemes may be complex. For example, the capitalisation of housing repairs may be undertaken to reduce the level of rate fund contributions to the Housing Revenue Account, with consequent block grant benefits; but the capitalisation may in turn (until the recent change in the rules) have been supported by a deferred purchase arrangement which would not have scored as prescribed expenditure.

2.13.2 Table 5 summarises the information presented in the preceding paragraphs, and shows the aggregate impact of each of the main types of creative accounting on the Government's local authority expenditure controls. For each

of the years 1987/88 - 1990/91 figures are given for the value of the assets acquired by authorities, the expenditure scored for block grant and capital control purposes respectively, and the net benefit to the authorities. It has been assumed that only a proportion of the advance leasing arrangements that have been secured will actually be used in future years, because of the loss of tax benefits; it has also been assumed that the revenue contributions to finance leasing will be made in five equal instalments starting in the year the asset is acquired. Small deferred purchase schemes arranged in the 1970s, of the scale that will still be exempt from control under the proposed new regulations, have been ignored.

2.13.3 The table suggests that the total net gain to authorities begins to decline steeply in 1989/90, and by 1990/91 has been converted into a net cost of £400m. Substantial costs will continue to be incurred as a result of existing commitments for several subsequent years.

3. ASSESSMENT OF POSITION OF INDIVIDUAL AUTHORITIES

3.1. INTRODUCTION

3.1.1 The previous section looked at the overall scale of the creative accounting problem. This section considers the position of individual authorities, and assesses both the magnitude of the commitments they have built up and the degree of risk that they will be unable to meet those commitments in future years.

3.2. INFORMATION

3.2.1. The Group has noted that information about creative accounting deals, and their future costs, is patchy. The monitoring sub-group has relied on such Council papers (some returned within the rate limitation process) and newspaper reports as are available, and informal contacts with the Audit Commission, the PWLB and the Bank of England. This is not satisfactory. DOE is therefore taking Counsel's opinion on whether the Secretary of State's general power to seek information from local authorities under Section 230 of the Local Government Act 1972 could be used in this context. The sub-group will in any case continue to update the information held about individual authorities, their use of creative accounting, and the alternative means available to them to balance their budgets.

3.2.2. On the basis of available information we do not therefore have a comprehensive picture of authorities' underlying budget strategies. However, the monitoring sub-group has drawn up detailed profiles of the 20 authorities thought to be most heavily engaged in creative accounting. These are:

+ * Basildon	* Islington
* Brent	+ * Lambeth
* Brighton	+ * Lewisham
+ * Camden	+ Liverpool
+ Ealing	+ Manchester
+ * Greenwich	* Newham
+ * Hackney	* Sheffield
Hammersmith and Fulham	+ * Southwark
+ * Haringey	+ * Tower Hamlets
+ * ILEA	+ Waltham Forest

Fifteen of these authorities, marked with an asterisk above, are rate - or precept-limited in 1987/88. The fourteen marked with a cross will be rate-limited in 1988/89.

3.2.3. The sub-group's analysis has concentrated on the revenue aspects of the problem, and in particular on the means by which the authorities are planning to bridge their "funding gap". (The funding gap is defined for these purposes as the difference between the authority's underlying expenditure commitments and the expenditure it can fund from its rate and block grant income; for a rate-capped authority the latter figure is its prescribed Expenditure Level.) Where possible an indication of the future costs of financing devices has also been included. Although considerable areas of uncertainty remain, these profiles demonstrate the sort of strategies being employed by these authorities to balance their budgets in the short term, and indicate some of the longer-term prospects. The following paragraphs summarise what can be learnt from them.

3.3. THE POSITION IN 1987/88

3.3.1 The 20 authorities examined have a total funding gap in 1987/88 of £633m, as shown in Table 6. This represents some 14% of their total underlying expenditure, ranging from 31% for Islington to 1.9% for Waltham Forest. For the most part the authorities appear to have been successful in setting up creative accounting schemes to bridge these funding gaps, although some (Haringey, for example) have apparently had difficulty in finalising the deals they were negotiating for. Following a statement by Mr Ridley that Government did not stand behind local authority debt, there have also been reports that the financial markets have been beginning to look more closely than hitherto at the possible risk attached to some of the more specialised deals proposed, and have either been declining to lend or have been lending at more expensive rates. Nevertheless, it is not thought that any of these authorities are in immediate danger of financial collapse. The most difficult case is Haringey, where the auditor has reported adversely on the propriety of some of the devices that have been adopted to balance the books this year; if these arrangements are not allowed to stand, the authority will have difficulty in meeting its commitments later in the year unless it can re-adjust its budget. This issue has yet to be resolved.

3.3.2. By far the largest part of this £633m revenue funding gap is being met by capitalisation of repairs (£315m), financed in part by deferred purchase. Drawing down of special funds accounts for a further £132m, and lease/leaseback or sale/leaseback for £71m. Other creative accounting devices, such as interest rate swaps, changed sinking fund rates and use of superannuation funds, provide £45m of benefits this year, and other, unrepeatable items of income (such as rate fund balances carried forward, Residuary Body receipts, and so on) amount to £37m. This leaves £33m unaccounted for, which must be attributed to unidentified creative accounting schemes if the assumption that all authorities have found means of financing their underlying levels of expenditure this year is correct.

3.3.3. One example is Hackney, where since a strongly-worded District Auditor's report in July 1986 on their financial difficulties, the Council have undertaken a major shift towards capitalisation of repairs and maintenance. The revenue

savings from £15m of capitalisation were taken forward in rate fund balances to help bridge their £35m funding gap in 1987/88. Further capitalisation of £14m in the current year, together with £3m drawn from special funds and benefits from interest rate swaps amounting to a further £3m, account for the rest of the gap.

3.4 THE POSITION IN 1988/89 AND BEYOND

3.4.1. The calculation of the 1987/88 funding gap can be rolled forward to 1988/89, by increasing underlying expenditure in line with recent trends for each authority and using either 1987/88 underlying income or, for rate-capped authorities, provisional Expenditure Levels. The resulting figure therefore represents a funding gap which can be bridged by reductions in expenditure, by rate increases (assuming no increase in block grant entitlement) for non-rate-capped authorities, by increases in other income, or by further creative accounting. This inevitably crude calculation, which takes no account of particular problems such as large loan repayments facing individual authorities next year, suggests an aggregate funding gap for these 20 authorities of £982m (or 20.7% of underlying expenditure) in 1988/89. The gap ranges from 36.4% of underlying expenditure for Basildon, to 11.6% for ILEA.

3.4.2. Of this £982m, only some £237m, at the most optimistic assessment, is covered by existing financing arrangements. In Camden, for example, it is thought that benefits amounting to approximately £28m may again be available in 1988/89 from the existing capitalisation arrangement and lease/leaseback scheme on which they are relying in 1987/88. This will leave a funding gap of £35m to be covered by other means.

3.4.3 In addition, the position is exacerbated for some authorities in 1988/89 by the need to accommodate new or increased repayments on existing deferred purchase deals. In Lambeth, repayments are due to commence on an £11m deferred purchase deal, with a payment of £2.4m. In Liverpool, repayments on deferred purchase deals are increasing from £3m in 1986/87 and £9m in 1987/88 to £16m in 1988/89. The problem of new repayments affects more authorities in 1989/90 and later years. In Brent payments on a lease/leaseback deal start in 1989 at a net cost of at least £6m a year until 2007, whilst in Sheffield repayments of the order of £20-25m are due on a deferred purchase scheme in 1989/90. Islington's

position becomes more difficult in 1990/91 and later years as deferred payments accelerate and the benefits of a lease/leaseback deal ran out. The extent to which such deals can be refinanced and their costs spread over a longer period is not known. In most cases where repayments count as prescribed expenditure for capital control purposes, it will be necessary to meet them from the prescribed proportion of capital receipts or borrowing allocations, at the expense of an authority's capital programme. If repayments are non-prescribed expenditure, then the full amount of capital receipts may be used.

3.4.4. For the 6 authorities out of the 20 who are not rate-capped in 1988/89, the funding gaps remaining after taking account of known creative accounting facilities total some £128m. If no further deals were entered into, and no other measures were taken to reduce net expenditure, substantial rate increases would be required to cover these gaps, as shown in Table 8. The 14 rate-capped authorities will not of course enjoy the same freedom to pursue this option of high rate increases. Average increases of 52%, ranging from 100% for Greenwich and other authorities to 12% for ILEA, would be required to meet these gaps. The extent to which any of the gap is met from the rates will depend on the Secretary of State's consideration of applications to redetermine Expenditure Levels, and of rate limits. If as a result of Government counter-measures to date, and increasing caution on the part of the financial markets, creative accounting deals become increasingly unattractive or difficult to secure these authorities will have to look to reductions in net expenditure as an alternative means of bridging their revenue gaps.

3.5. THE SCOPE FOR REMEDIAL ACTION

3.5.1. All 20 authorities are, by definition, high spenders. Their total underlying expenditure exceeds their aggregate GRE assessment by £1412m, or 47%, ranging from 113% for Basildon to 19% for Ealing. To the extent that the GRE methodology takes account of local authorities' differing needs to spend in order to provide a standard level of service, this excess itself implies that these authorities should have considerable scope for reducing their net revenue expenditure to more reasonable levels. It is, however, less obvious where in their budgets the authorities would chose to make major savings, or how quickly these could now realistically be expected to be delivered.

3.5.2. However, certain features stand out from the profiles of individual authorities' positions. For example, 13 of the authorities have budgetted to make rate fund contributions totalling £257m (or 11% of their underlying expenditure) to their Housing Revenue Accounts in 1987/88. 12 of the authorities have raised their rents by significantly less than the Government's guidelines between 1983 and 1986. 5 of them made rate fund contributions to their Trading Services Accounts totalling £4.2m in 1986/87. 15 of them had sold a significantly lower proportion of their housing stock than the average for their class of authority, and 15 also had significantly higher levels of manual staff than the class average.

3.5.3. Another point of interest is that all of these authorities, except Brighton and Hammersmith and Fulham (whose holdings at less than a hectare are negligible) and ILEA, have substantial portfolios of land suitable for residential or commercial development. Sites shown on the Land Registers as owned by these authorities total 824 hectares, and according to DOE have an estimated value (based on median figures for each local authority area without inspection of individual sites) of some £859m. There is, however, an inevitable mismatch between resources and funding gaps: Southwark, for example, have 54 hectares of development land worth over £306m compared with a remaining 1988/89 funding gap of £20m, whilst Hackney have a remaining gap of £32m but development land worth only £8.8m. And even if these assets could be promptly realised their relevance to the authorities' revenue funding gaps is indirect, as the receipts could not be used to meet current expenditure needs. The receipts could, nevertheless, in principle help to pay off existing debts, or could be invested to earn interest, in both cases removing some of the burden of repayments from the rate fund revenue account. In addition, the prescribed proportions of the receipts can be used for capital purposes in addition to authorities' approved borrowing, and thus help to ensure that genuine capital programmes are not entirely squeezed out by the future consequences of creative accounting.

3.5.4. A similar source of potential receipts might be increased sales of housing. Those authorities out of the 20 who have sold less than the appropriate class average proportion of their stock have fallen short of the average by, in total, some 49,000 dwellings. Were they to be able to dispose of these dwellings the proceeds might amount to some £800m.

3.5.5. We are not suggesting that the factors identified in the profiles add up to a solution for one or all of the individual authorities. They do, however, indicate that there are areas where action can be taken by the authorities to improve their financial position.

3.6. ATTITUDE OF AUTHORITIES

3.6.1. The major question is whether the authorities concerned are prepared to take the necessary steps to bring their finances back under control. We do not know the answer but there are some helpful signs. The Chair of the Association of London Authorities has pointed to the need for authorities to be more realistic in the policies they adopt given their financial circumstances. A number of authorities - eg Camden and Hackney - appear from press reports to be taking a hard look at the scope for economies. Two authorities, Islington and Hackney, are co-operating in reviews by consultants nominated by the Audit Commission. At present there is little of the mixture of defiance of Government policy and the courting of collapse which characterised the early days of rate limitation. On the debit side, the monitoring sub-group has noted the poor level of financial management in many of the authorities concerned, which is exacerbated by the very high turnover of senior staff and the delays encountered in filling vacant posts. The Audit Commission paper on the management of London Authorities showed in January 1987 that, in 8 London boroughs, on average 54% of senior officers had left over a three-year period. These factors could seriously affect the ability of the authorities to turn matters round, even if the desire is there.

3.7. CONCLUSION: 1988/89 AND BEYOND

3.7.1. It is too early to make any confident predictions about whether these authorities will get through 1988/89. While they do have substantial funding gaps to cover the outcome will depend on the further availability of creative accounting devices, the willingness of authorities to make economies and, importantly, the eventual level of rates.

4. PROPOSED PRUDENTIAL REGIME PACKAGE

4.1. INTRODUCTION

The Need for the Prudential Regime

4.1.1. As noted in paragraph 2.1.2 above, the Government's response to creative accounting in local government has hitherto been piecemeal in nature, and has consisted of countering individual devices as they have arisen. Over the last few months, however, attention has focussed instead on the desirability of tackling the problem in a more comprehensive way, which would discourage all forms of creative accounting that enabled authorities to spend now and pay later (except within the ambit of the Government's conventional borrowing controls), and generally encourage prudent financial behaviour. This might be thought of as addressing the disease rather than the symptoms. To some extent the incentives for creative accounting will in any case be reduced with the introduction of the community charge and new grant system from 1990/91, as there will no longer be grant advantages to be had from the manipulation of total expenditure figures. Nevertheless, one of the strengths of the community charge, compared with the present rating system, is the enhanced accountability it will bring to local government expenditure; and the converse of this greater accountability is that authorities may well find that there are electoral advantages in deferring large increases in charges for a year or two. It will thus still be necessary to continue with the development of this comprehensive approach to the creative accounting problem.

4.1.2. It is unlikely that there is any single measure that can be taken which will itself provide a complete solution. The answer is more likely to lie with a package of related measures, that would together provide a suitable framework of prudent financial behaviour within which local authorities could act. The aim of the package would be to provide a graduated response to an authority which was engaging in financially imprudent behaviour, whilst leaving the Government maximum room for flexibility and judgement at each stage. Such a system is likely to depend to a large extent on prudential ratios, and work on these is at too early a stage for the Group to be certain that workable and effective ratios can be devised. However, a preliminary view of how the graduated response might operate is as follows.

4.1.3. As an authority's financial position worsened it would receive warnings from its Chief Finance Officer, the auditor and, possibly, the PWLB. Breach of a first prudential ratio (see sub-section 4.3 below) could signal to lenders that higher interest rates were in order and put Government on warning to be particularly careful about approving new projects for grant and grant payments themselves. The auditor might use his stop power to prevent actions which would make the authority's position worse. Approach to, or breach of, a second ratio could suggest the cessation of lending by the PWLB, and the appointment of overseers. Commissioners would follow only as a last resort if the authority failed to act on its own initiative to put its finances in order.

Impact of the Prudential Regime on Authorities

4.1.4. The prudential regime, as described in this section, cannot be fully in place for at least 2 years. While some elements - the strengthened role of the Treasurer, the auditor's stop power - should be enacted by mid 1988/89, others - prudential ratios, the revised definition of borrowing - will be well behind. That said, the regime could affect authorities in the following ways:

a) Authorities already in financial difficulty: the prudential regime will not solve existing financial difficulties, but it should prevent these authorities entering into further deals which increase their difficulties. Conversely, however, authorities' inability to negotiate further deals could make it impossible for them to bridge funding gaps and so precipitate collapse.

b) Other authorities: the prudential regime should prevent the spread of imprudence to the generality of authorities, if indeed there is any risk of that happening. The main response of authorities to the regime, however, is likely to be that it is yet another example of centralisation and is an unnecessary across the board reply to the problems of a small minority of authorities. The success of the prudential regime will depend to a large degree on convincing authorities in general that these measures will enable them to demonstrate their own good management and continuing

creditworthiness, and on avoiding so far as possible the imposition of unnecessary new burdens on the majority of authorities.

4.1.5. The remainder of Section 4 of this report describes the progress which has been made in working up prudential ratios and the other component elements of the prudential regime package, as follows:

- Sub-section 4.2 Statutory Definition of Borrowing
 - 4.3 Prudential Ratios
 - 4.4 Auditor's Stop Power
 - 4.5 The Role of the Treasurer
 - 4.6 Payment of Exchequer Grant
 - 4.7 Good Practice Certificate
 - 4.8 Overseers
 - 4.9 Role of the PWLB
 - 4.10 Contingency Planning

4.2. STATUTORY DEFINITION OF BORROWING

4.2.1. Many of the forms of creative accounting discussed in Section 2 above - notably deferred purchase and lease/leaseback - which provide an authority with either money or money's-worth in the short term in return for a commitment to make a stream of payments in the future - are closely akin to borrowing. But they are not technically borrowing in the sense which it is taken to have in present legislation. If "borrowing" (or some other phrase more clearly reflecting a broader concept of the raising of local government finance) could be defined in such a way as to embrace the range of creative financing deals these could be made either impossible or at least much less desirable to local authorities, without the need for more piecemeal legislation. They could either be prohibited, or else caught by the limits imposed by central Government through the borrowing approval system.

4.2.2 The defining of borrowing could therefore be a key factor in tightening up on creative accounting/financing, and extremely helpful background to other elements of a prudential regime. An opportunity to introduce a new definition of borrowing exists in the review of the capital control system which is currently taking place. It is intended that the review should lead to legislation during 1988/89 on a new control system to be introduced in 1990/91.

4.2.3. At present the legislation does not define the term "borrowing". Legal advice is that it should therefore be taken to have its natural meaning, that is that it involves a purely financial transaction and does not involve, for example, the acquisition by the lender of any interest in an asset (other than a mortgage) as a consideration for the advance, or the passing of money from the lender direct to a third party who is providing goods or services for the authority. It therefore fails to catch devices such as lease/leaseback and deferred purchase, even though they have key features in common with borrowing.

4.2.4. Establishing a suitable definition of "borrowing" will not be straightforward. The difficulty is to extend the definition to make it wide enough to catch devices like lease/leaseback and deferred purchase without making it embrace too much. For example it is not possible simply to define borrowing as any transaction which leads to a commitment to future payments. Such a definition would catch a standard building contract and perhaps even such things as contracts of employment. Conversely, a redefinition which replaced the concept of "borrowing" by the concept of "raising money on security" would still be too narrow: in lease/leaseback the essential point is that the property concerned is theoretically disposed of and re-acquired, while in deferred purchase there is no specific security. Moreover, all of the devices currently in use are capable of variation at the margin, and other similar devices may be developed. Any definition should not therefore concentrate too closely on catching these devices in their present form, but should aim at more general applicability.

4.2.5. Two approaches to the construction of a revised definition have been identified: definition by inclusion or definition by exclusion. In the former case the definition would be built up from a number of specific items; in the latter case it would be arrived at by making exclusions from a more sweeping definition. Thus "fruit" might be defined as "apples and oranges and pears and...." or as "all food other than vegetables, meat, bread...."

4.2.6. The difficulty with the inclusive approach is its complexity. This arises firstly because of the need to distinguish between unacceptable devices and similar transactions which are unexceptionable; and secondly because of the need to try to catch a range of potential variant forms of the unacceptable devices. A complex provision is going to be its own worst enemy: despite our efforts to second-guess the next developments in creative accounting, ways will doubtless be found of sidestepping the letter of the law if it is too detailed. On these grounds, definition by exclusion looks the more promising approach at present.

Definition by Exclusion

4.2.7. A definition by exclusion, designed to prohibit deferred purchase and lease/leaseback, might be on the following lines:-

A local authority may not incur any liability to make payments in a future financial year other than by:-

(a) borrowing;

(b) entering into a contract of employment;

(c) entering into a contract for the carrying out for the local authority of works under which at least 90% of the amount payable by the local authority falls due within six months from the date of material completion of the works;

(d) entering into a contract for the acquisition of an interest in real or other property which has not been held by, or for the benefit of, the local authority within the preceding twelve months;

This is not a comprehensive list but is intended to show the type of transactions which might be excluded. The list of excluded, acceptable forms of transaction might indeed prove quite long, but because an acceptable transaction which fell outside the generally permitted categories could be the subject of a specific consent, the wording could be broader brush than under the other approach.

4.2.8. Further simplification might be possible if the exclusive approach were used to bring pseudo-borrowing activities within a general borrowing limit, rather than to define activities which were excluded from a general prohibition. This approach might work by issuing a limit on conventional borrowing and then making a provision that any other liability to make payments in a future year other than:

(a) under a contract of employment;

(b) in repayment of sums borrowed for periods of less than one year;

(c) etc;

should be deemed to score against that limit.

Any categories of activity left out of the exceptions would be intra vires but would be caught by the limit. There would be a trade off: the extent to which the definition could be simplified would depend on the degree of complexity which Ministers were prepared to contemplate in setting the limit.

Avoidance

4.2.9. The Group has also considered whether a provision similar to that in taxation legislation, preventing avoidance of the spirit of a statute by steering a careful course through its precise wording, might usefully be included in legislation on the new system. We note, however, that the Inland Revenue have in the past found such provisions difficult to apply, and that reliance on an anti-evasion clause of this kind would only be proof against judicial review if the definition itself were very tightly drafted. It nevertheless remains an avenue worth exploring further.

Conclusion

4.2.10. The Group recommends that :

- a) work should continue on the development of a statutory definition of borrowing to cover "pseudo-borrowing";
- b) this should be primarily directed to working up a definition by exclusion of transactions which would be deemed to score against a borrowing limit;
- c) the aim should be to bring the new definition into force as part of the wider reform of the capital control system, planned for legislation in 1988/89, and introduction in 1990/91.

4.3. PRUDENTIAL RATIOS

Background

4.3.1. It is commonplace, in assessing the financial viability of a company or institution or even a country, to judge the relationship between its forward commitments and its ability to meet them. The idea of seeing if this approach

could be adapted to local authorities is being worked up by the Audit Commission. The aim is to define ratios between liabilities and the means to meet them which it would be imprudent for authorities to breach.

4.3.2. As part of the pattern of graduated response, we envisage two levels of prudential ratio. The first of these will be, in effect, an amber light; crossing it would alert lenders, the Government, the authority itself and its local taxpayers to the danger of over-commitment. The second will be a red light, and transgressing it would require instant action to retrieve the position; it might lead to the cessation of lending or the appointment of overseers. When nearing the amber light, question of professional judgement over precisely what should be included within the authorities' liabilities and net income will become important. There will therefore be a need for some professional to exercise his or her judgement in saying whether or not the prudential ratios have been surpassed. For regulated financial institutions, this judgement is taken by the supervisor. For local authority prudential ratios, the corresponding judgement is likely to have to be given by their auditor.

4.3.3. The purpose of prudential ratios is to provide a framework to assist those interested in the financial standing of an authority to make judgements; they are not intended to be mechanistic in their operation. Ideally ratios should:

- a) warn members, electors and local taxpayers that their credit is being pledged recklessly by a body with taxing power over them. This links closely with the enhancement of local accountability through the new community charge;
- b) warn potential lenders about the desirability of (or at least make them consider the appropriate rate for) further lending to an authority showing signs of over-commitment. Lenders would have to judge the likelihood of an authority being able in the short term to impose the size of rate or community charge increase necessary to service its debts, especially given policy on rate-capping;
- c) warn Government to take extra care in giving project approval for grant purposes and in paying grant itself;
- d) give the auditor a benchmark against which to issue warnings/public interest reports to an authority, or to use his proposed stop power.

It may not, however, prove possible in practice to define ratios which will fulfil all these functions. Work to date has been primarily directed at a) and d) above; the ratios so far produced have not been specifically designed with objectives b) and c) in mind, although they should provide some assistance in these areas.

Progress on the Development of Ratios

4.3.4. The local authority ratio between income and liabilities needs to cover as much as possible on both sides of the equation. The development work on the income side has so far included incomings from rates, block grant, trading income (though not in full), interest from revenue balances, interest received on mortgages granted, rents, and subsidy under the 1980 Housing Act. Debt figures have been taken from the standard returns of outstanding external advances. The definition will need to be extended to include liabilities under creative accounting deals on the one hand, and the netting off of liquid assets on the other hand. Some interim examples of the ratios of income to debt now emerging are attached as Table 7; figures are quoted for these randomly selected, but not untypical, authorities.

4.3.5. Although present figures are incomplete some main features can now be discerned. One of the first of these is that there is some considerable stability through a period of four years from 1982/83 to 1985/86 in overall ratios for England and Wales as a whole, for classes of authority, and for most individual authorities. The ratio of observed debt to income for the totality of authorities was 118% in 1982/83, in 1985/86 it was 121%, while in the intervening years it had dipped slightly. In some individual authorities, however, the ratio changed markedly over this period.

4.3.6 Second, there are marked differences in the ratios observed for different classes of authority. These differences arise from the nature of the services provided by classes of authority, with districts typically providing services (such as housing) which require capital investment and counties, for example, typically concentrating on more labour-intensive services such as education. The highest ratios on average are for inner London Boroughs and the non-metropolitan districts, both of which average around 300%. However, the range of variation in the non-met districts is rather wider than for the inner London Boroughs; this partly reflects the larger number of non-met. districts, and partly the incompleteness of the data so far used. Outer London Boroughs and the metropolitan districts have average ratios between 100% and 200%. Shire county ratios are very much lower, averaging 20 to 25% of income. The outlier county (Cleveland) is around 80%; at the other end Dorset and Lincolnshire

County Councils appear to be running their debt down to zero. It appears from these figures that it may be necessary to set the ratios which will trigger concern and action at different levels for different classes. Inner London Boroughs and non-metropolitan districts might be grouped together, as might outer London Boroughs and metropolitan districts. Shire counties might have to be treated separately. Further consideration will need to be given to the justification for setting different ratios by class, given the fact that all authorities have (subject to Government actions on rate limitation) essentially the same taxing power to raise revenue to meet their commitments.

4.3.7. The present figures do not cover creative accounting deals in the statement of liability. Even so, boroughs and districts known to be engaged in creative accounting show at the top end of the ranges. The top three inner London Boroughs for instance are Islington, Southwark and Camden. It should be noted however that one or two other authorities that have been particularly economical (such as, for example, Kensington and Chelsea) appear in the upper middle range of these ratios. Low income and moderate debt figures, in combination, can produce a fairly high ratio. Amongst metropolitan districts, it appears likely that Manchester, Salford and Liverpool will have amongst the highest observed ratios. Sheffield's ratio has been growing fast. In outer London, Haringey is in the lead with a ratio close to that for Manchester.

Need for Further Work

4.3.8. The Group concluded that a considerable amount of work still needed to be done to be certain that ratios would be workable and produce worthwhile results. No view had yet been formed of the level at which the first and second prudential ratios might be set, for any class of authority. It would also be necessary to be certain that ratios could be devised in a form which was acceptable to the majority of authorities. Without such acceptance by local government, ratios would founder. Work was needed on:

- a) the collection and processing of data;
- b) the form in which the ratios were expressed, in order to provide a clearer signal to lenders about creditworthiness;
- c) the extent to which different ratios were required for different types of authority;

d) the maturity pattern of authorities' liabilities and the relation of interest plus repayment flows to available income. This would be of particular interest in assessing the risk of financial collapse;

e) the way in which the ratios would be monitored by the auditor and his views passed to interested parties;

f) the relationship between prudential ratios and any new capital control scheme, and the extent to which Government capital allocations to individual authorities should acknowledge the existence of ratios.

4.3.9. It is proposed that work on items a) - e) should be taken forward by the Audit Commission, with the aim of exposing initial proposals to the local authority associations in September; this might then lead to wider discussion and the issue of a full consultation paper in October. Work on f) will be principally for the Department itself to take forward.

Conclusion

4.3.10 The Group recommends that the work outlined above be progressed urgently, with a view to having considered proposals available in October.

4.4. AUDITOR'S STOP POWER

4.4.1. This proposal is similar to, but goes somewhat further than, one put forward in the Widdicombe report. It has two main features. First, it would enable the auditor to issue an order preventing an authority from incurring unlawful expenditure or losses due to wilful misconduct. At present the auditor can only act retrospectively. Secondly, based on a statutory extension of the concept of fiduciary duty, it would enable him similarly to pre-empt acts which appeared to him highly imprudent. The latter aspect is most relevant to combating "creative accounting".

4.4.2. The Secretary of State for the Environment has recently written to colleagues setting out his proposals in more detail. To provide a firm basis in law for the exercise of the stop power in cases of gross imprudence it would be necessary to create, in addition to the currently non-statutory fiduciary duty owed by an authority to its ratepayers, a new statutory duty on local authorities to act impartially as regards the differing interests of:

- a) present ratepayers/community charge payers;
- b) future ratepayers/community charge payers;
- c) those who currently pay fees/charges for services;
- d) those who in the future will pay fees/charges for services; and
- e) present beneficiaries from services; and
- f) future beneficiaries from services.

4.4.3. In particular the authority would be required to be satisfied that anything done by it would not favour unduly one or more of the groups mentioned above at the expense of one or more of the other groups, and that any financial burdens which are likely to arise as a result of such action and which are to fall on the ratepayers/community chargepayers in any future year are commensurate with the resulting benefits which it expects them to enjoy in that future year or thereafter. The auditor could intervene to issue a stop notice where he believed that an authority had not considered or, in the end, complied with this new duty. Where an authority failed to comply with an order the auditor could take rapid enforcement action through the courts, or initiate action to surcharge and disqualify those responsible for any unlawful expenditure or loss. There would be procedures for appeal to the courts against the auditor's decision to issue a stop notice.

4.4.4. The first part of these proposals, which has the support in principle of the Audit Commission, represents a fairly clear cut extension of the auditor's existing powers. If Ministers are content it is proposed to introduce clauses to this effect in the Local Government Bill. The second part, however, breaks new ground and is likely to prove highly controversial with local government; further discussions between Ministers will therefore be required before any decision is taken on whether to proceed with this measure and if so by what means.

4.4.5 The Group has noted these developments, and considers that although the second part of the proposed new duty would not eliminate creative accounting, it would be a worthwhile element in the overall prudential regime if it enabled the auditor to prevent those deals which would tip an authority from an acceptable

financial equilibrium between means and commitments to something which was highly imprudent. Such a case might be where an authority entered into a scheme to defer substantial liabilities, so placing a clearly unreasonable burden on future ratepayers. This part of the proposal would interlock closely with the proposals on prudential ratios - which would provide a useful indication of when an authority's future commitments were becoming excessive - and on the role of the Treasurer (see sub-section 4.5 below), which would similarly support the judgement of the auditor in these cases. The Audit commission has, however expressed some concern that the provisions will be difficult to draft in a way that does not lead to the auditor's judgement on the balance of interest between groups being frequently tested in the courts.

4.5. THE ROLE OF THE TREASURER

4.5.1. The Group's previous report noted the Department of the Environment's proposals for strengthening the position of local authority Treasurers in relation to the legality and propriety of the expenditure of their authorities. The key points in the proposals were:

- a) 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;
- b) the authority would, conversely, be required to refrain from actions which were the subject of a report until it had considered the report;
- c) in order to reinforce the professional status of the Treasurer, 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).

4.5.2. The Secretary of State for the Environment has now written to colleagues seeking their confirmation that they are content for legislation on these points to be included in the Local Government Finance Bill. The Group has noted these proposals, and considers that they will constitute a further useful component of the prudential regime package. They 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, this measure would exert some further restraint on authorities, who would be forced to consider the consequences of their decisions. Most importantly, it would 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. These proposals should thus be seen as closely related to those concerning the auditor's stop power, described in subsection 4.4 above.

4.6. PAYMENT OF EXCHEQUER GRANT

4.6.1. The Group has considered whether, as one of the measures in the prudential regime package, powers should be taken to allow Ministers to withhold grant - in particular block grant - from financially imprudent authorities on a basis more clear-cut than at present.

Background: The Position under Present Legislation

4.6.2. Advice obtained from Counsel by DOE in July 1985, focusing on the position of the Accounting Officer, was that:

- a. where discretionary grants (such as UP grants) are concerned, "firm evidence of improper conduct or illegality concerning financial matters" would constitute good grounds for withholding grant, but the Accounting Officer would have to exercise judgement in individual cases;
- b. in the case of mandatory grants (such as RSG), grant could only be withheld where there was "firm evidence that the making of a payment would constitute knowing assistance in the execution of dishonest or illegal design".

In certain unusual circumstances such as defiance of a relevant Court Order the Accounting Officer would be required to withhold payment of both discretionary and mandatory grants.

4.6.3. Counsel's opinion is broadly consistent with the requirement in Government Accounting that the Accounting Officer should take steps to avoid making any payment in circumstances in which the requirements of propriety or regularity of expenditure might be infringed.

4.6.4. Although examples of discretionary grants actually being withheld are few, DOE not infrequently acts to protect its Accounting Officer, in cases where there is concern about financial management within or by local authorities or where there is reason to suspect impropriety or illegality in the handling of funds, by suspending discretionary grant approvals so that no entitlement to grant arises. The circumstances in which mandatory grants (notably RSG) can be withheld are much more narrowly drawn than mere suspicion of impropriety or illegality. Unless there is firm evidence that RSG grant payments would constitute "knowing assistance in the execution of dishonest or illegal design", there is no power for the Department to stop payment. This has never yet arisen.

4.6.5. It is far from certain that the likelihood of default would in itself justify the withdrawal of mandatory grants. Although imminent default (or the breach of a second prudential ratio) might arouse doubts about the payment of certain discretionary grants, if the Accounting Officer could no longer satisfy himself that moneys would be applied to the purposes or projects for which they were granted, it would not necessarily constitute the evidence of "knowing assistance..." required before mandatory grants could be withheld. The withdrawal of grant would, on the other hand, have considerable repercussions in precipitating collapse. Means would also have to be found to ensure that creditors with legitimate claims on the authority's withheld grant revenues received payment. The Department concerned would therefore need to be absolutely certain that in any given case withdrawal of grant was both justified and necessary to protect the Accounting Officer. Further advice from Counsel would be required before action was taken.

The Case for Taking New Legislative Powers

4.6.6. A new statutory power could make it easier for the Secretary of State to withhold grant. This would enable greater financial pressure to be applied to authorities that persisted in acting irresponsibly, and might persuade them to accept the appointment of overseers rather than face a real threat of loss of grant. There are, however, strong counter-arguments:

- i. the Secretary of State's position would be strongest if the withholding of grant were linked to objective financial criteria, for example the proposed prudential ratios, but loss of RSG would be very likely to precipitate financial collapse and such a mechanistic approach would leave little room for discretion in taking this step;

ii. even if there were room for the exercise of discretion, once the power was in existence the Secretary of State might come under considerable pressure to withhold grant;

iii. the power would be a draconian measure, which could raise questions about the position of companies doing business with authorities in good faith, and would be likely to arouse considerable opposition from local authorities at large.

Conclusion

4.6.7 The Group recommends that no new powers are taken to withhold grant payments, and that Government should operate on the basis of existing Counsel's opinion, taking further advice when necessary. It may, however, be necessary to look again at this issue in the light of developments on prudential ratios.

4.7. GOOD PRACTICE CERTIFICATE

4.7.1. The Group considered whether the Government should proceed with the Audit Commission's proposal to introduce an auditor's good practice certificate as an element in the prudential regime package.

Background

4.7.2. Section 15(1) of the Local Government Finance Act 1982 places a duty on the auditor in auditing local authority accounts to satisfy himself that, inter alia, the authority has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources. The Code of Audit Practice which the auditor is obliged to follow makes it clear that the ability of authorities to achieve value for money depends upon the existence of sound arrangements for the planning, appraisal, authorisation and control of the use of resources. The auditor's responsibility is to verify independently that these arrangements are in place and are effective. Where the auditor is dissatisfied as to those arrangements he can issue a report in the public interest or report his concerns in a management letter.

Proposal

4.7.3. Some authorities repeatedly fail to take action to remedy unsatisfactory matters drawn to their attention by the auditor in management letters, qualified accounts and public interest reports. It was therefore proposed that it should become normal practice or a requirement for 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 would alert central Government departments to the need for special care and deliberations in financial dealings with the authority, and might serve also as a warning to potential lenders. Where the auditor was dissatisfied with the generality of an authority's financial management he could refuse a certificate. Where this dissatisfaction was limited to specific matters he would have discretion to issue a qualified certificate. If at any time after giving or renewing a certificate he became dissatisfied as to the financial systems and practices in operation in the authority he could withdraw or qualify his certificate.

Group's Consideration

4.7.4. The Group has considered in detail the proposals for certification which have so far been developed, and believes that if implemented these could lead to tighter financial management procedures in those authorities where systems have decayed. However, the good practice certificate will focus on the quality of financial management rather than on deliberately imprudent behaviour, and on consideration the Group believes that it would be preferable for the development of the good practice certificate to be taken forward separately by the Audit Commission in due course, and not as part of the prudential regime package to which it would add little. It is unlikely that this proposal, although of interest, will justify other than a relatively low priority.

Conclusion

4.7.5. The Group recommends that further work on the proposal for a good practice certificate should be taken forward by the Audit Commission in due course, but not as part of the prudential regime package.

4.8. OVERSEERS

4.8.1 At its meeting on 5 March MISC 109 considered a proposal for the appointment of overseers, as a means of tackling the imminent breakdown of local government in a particular area. The Secretary of State for the Environment was invited to work these proposals up further, in conjunction with other Ministers.

The Working Group has considered a detailed paper subsequently prepared by DOE, and the comments of departments (DHSS, DES and Home Office) who are not represented on the Working Group.

Background

4.8.2. The proposal put forward by DOE is that overseers would be appointed in those cases where an authority was on the brink of financial collapse, and the Councillors could see no other course open to them, if they were to avoid the appointment of Commissioners, but to acquiesce in the measures necessary to restore the authority's financial standing. The overseer would be appointed by the Secretary of State, who would have a wide discretion on whether or not to appoint, depending on the willingness of the authority to co-operate and the nature of its problems. The role of the overseer would be to provide advice and to create the conditions in which the authority could put its own house in order; he would approve, monitor and enforce (in particular through a control on an authority's ability to borrow) compliance with a financial recovery plan. He would also bring with him certain distinct financial benefits:

- a) so long as the authority produced and complied with an recovery plan acceptable to the overseer there should be no need for Government to contemplate the withdrawal of mandatory grants;
- b) it is proposed that the overseer should have a statutory power to authorise the levying of a substitute rate in-year, and to seek the Secretary of State's approval to disapply any rate limit in the first year of his appointment (he would also advise on the setting of rate limits in future years);
- c) there would also be a statutory power for the overseer to advise the PWLB on lending, and if necessary to secure special borrowing arrangements from the PWLB in circumstances in which it would not otherwise countenance further lending to the authority.

4.8.3. The Group has, however, questioned whether there is merit in a statutory scheme for the appointment of overseers by the Secretary of State at all. It has been argued that it would be equally satisfactory - and distance Government from the arrangement - if the authority itself was simply, on its own initiative, to appoint a private consultant to help it formulate a recovery plan. This might be put forward as part of an application, by a rate-limited authority, for determination of its Expenditure Level for the following year. Alternatively, in cases where financial collapse was more imminent than that, it might be feasible for the Secretary of State, once he had approved a recovery plan, to have power to provide some immediate relief in the form of authorisation of a substitute rate or special borrowing consents.

4.8.4. The Group has also considered whether the overseers proposal, however this is eventually framed, should be presented publicly as part of the prudential regime package, or (as hitherto envisaged) kept back as a contingency measure. The problem with the latter course is that if the option is not known about authorities will not be in a position to choose to take advantage of it. On the other hand, early announcement (and legislation if necessary) might stir up opposition to the proposal, create unnecessary hostility, and highlight the issue of authorities' financial difficulties in an unhelpful way. On balance the Group believes, however, that early legislation would be advantageous.

Conclusion

4.8.5. It is evident that further work is needed on both of the alternative approaches outlined above, and their respective advantages and disadvantages. The Group agreed that a further detailed paper, exploring the options, should be prepared for Ministers in September. This should also consider the question, raised in particular by DHSS, of the extent and nature of the involvement that Ministers would have, under either approach, in ensuring that any recovery plan embodied acceptable levels of service provision. Attention should also be given to the practical problems that may arise, for example if an authority's staff refused to co-operate with an approved recovery plan.

The Group therefore recommends that:

- a) a detailed paper setting out alternative schemes for the formulation of recovery plans by authorities in financial difficulties and their monitoring either by private authorities or by overseers appointed by the Secretary of State, should be presented to Ministers in September;

b) the proposal eventually adopted should be presented publicly as part of a prudential regime rather than kept in reserve as a contingency measure.

4.9. THE ROLE OF THE PUBLIC WORKS LOAN BOARD

4.9.1 The Group considers that a prudential regime of the kind now being developed would need to be supported by appropriate arrangements for central Government lending to local authorities. The existence of a class of authorities whose behaviour was publicly held to be imprudent, according to more or less objective prudential tests, or whose affairs were the subject of advice and scrutiny by Government-appointed overseers, would create unfamiliar and difficult problems for the PWLB as presently constituted. In addition, changes in lending arrangements may be a way of bringing a degree of market discipline to bear on the more extreme authorities.

4.9.2 The Group's work on differential PWLB rates is summarised in Annex B. The viability of such a scheme depends critically on developing prudential ratios into analytically satisfactory tests of creditworthiness. Even if that is possible, it is clear that differential PWLB rates could only be a partial answer to the problems posed by the most extreme authorities. The Group recommends that other options, including the setting up of special arrangements separate from the PWLB for regulating lending to authorities who are close to financial collapse, should be worked up for the Group's consideration.

4.10. CONTINGENCY PLANNING: COMMISSIONERS

4.10.1. There is no assurance that the prudential regime package will prevent authorities who have already accumulated large forward commitments from going over the brink. It is therefore necessary to continue to have contingency plans in hand to cope with this eventuality.

4.10.2. The Group has considered briefly the action which central Government might take in the event of financial collapse and/or the collapse of service provision in certain local authorities, and concludes that there is no realistic alternative to the appointment of Commissioners to take over the full range of the Council's functions and responsibilities. Such an approach offers both the simplest and most clear-cut course of action, which would enable central Government to intervene firmly and effectively to protect the interests of local people, and would offer the easiest route back to normality.

4.10.3. Draft legislation for the appointment of Commissioners was prepared in 1985, and is now being reviewed by DOE officials. Some amendments will be necessary, principally to take account of the creation of joint authorities in the metropolitan areas by the Local Government Act 1985. The Group notes that a further submission on the state of play on this will be made to DOE Ministers in September.

WGFP

6 August 1987

DOC474VM

Hammersmith and Fulham1987-88: funding gap of £15m

The Council's financial strategy for 1987-88 involves an assumption of £8.6m slippage in planned growth of £18.3m. However, by increasing rates by 127% they have built up balances by £25m for the eventuality that the slippage might not occur. The quoted funding gap of £15m is based on underlying expenditure of £101m and total expenditure met from rates and block grant of £86m which assumes that the £8.6m slippage does not in fact take place. If slippage was as much as the Council suggest the funding gap would fall to nil after taking account of increased block grant entitlement.

The existing gap is being met largely from capitalisation (£8m) and special funds (£3m). The Council are also believed to have a £100m deferred purchase facility arranged through Guinness Mahon.

On this basis we have no evidence to suggest that they will be unable to meet their commitments this year.

1988-89: funding gap of £22m

A roll-forward budget of £108m for 1988-89 has been estimated by Conservative councillors.

Rate arrears (£5.0m) 6.6% of rate collectable in 1985/86 compared with class average of 5.1%. If written off this could further increase expenditure.

Options

A further rate increase of about 75% would be required in 1988-89 to meet a funding gap of £22m.

At £101m their 1987/88 underlying total expenditure is £26.5m (36%) above their GRE of £74.5m

£1 per week on rents would increase the Council's annual income by £0.9m

Some private contractor use - window cleaning, catering and maintenance of entire vehicle fleet. (All entered into prior to Labour gaining control in May 1986). It is not known if the council now plan to pull out.

The Council has sold 1773 dwellings, 6.7% of its total stock. Class average - 11.4% of stock sold.

In November 1986 the Council owned 789 vacant dwellings - 4.2% of total - Class average 5.6%

THE ROLE OF THE PUBLIC WORKS LOAN BOARD

1. The Group has considered the scope for the PWLB to charge local authorities differential interest rates, reflecting their financial standing. The case for "tiering" is two-fold. Where there are demonstrable and significant differences in local authority creditworthiness, the Accounting Officers for the NLF and PWLB may feel they have a duty to charge higher rates, under the National Loans Act 1968, to compensate for assuming higher risks. Action by the PWLB to charge premium rates would also be a clear signal that the Government believed some authorities to be genuinely more risky than others. Arguably, indeed, official or semi-official warnings about the credit standing of the most extreme authorities are unlikely to be fully credible, in the absence of a more selective approach by the PWLB. Nevertheless, there are problems to be overcome in developing any scheme of differential interest rates, which relate above all to the criteria to be used in applying higher rates. The prudential ratios now being developed may offer a way forward. But this is by no means certain at this stage.

2. These problems arise because the PWLB is an independent statutory body and it is for the Public Works Loan Commissioners, not the Treasury, to decide whether or not they should lend to an individual authority. But, if the PWLB does lend, it is for the Treasury - and the Treasury alone - to decide what rates of interest should be charged. The Treasury's powers to set PWLB interest rates are set out in Section 5 of the National Loans Act 1968. Under the terms of this Act the Treasury must set a rate for any loan, or class of loans, at a rate at least sufficient to prevent a loss if it had itself to borrow to finance the loan and may "take into account any consideration justifying a rate higher than that [minimum rate]".

3. At first sight this seems to give the Treasury a wide discretion to set a higher rate of interest on loans to particular local authorities. And, in principle, it should be possible to introduce a rate or rates of interest on all PWLB loans to certain authorities, pitched at say 1 or 2 per cent above the lowest rates charged by the PWLB. In practice, however, the Treasury's discretion to operate such a scheme would be far from unfettered. And devising a scheme likely to be proof against legal challenge is far from straightforward.

4. Taking the National Loans Act as a whole, the courts can be expected to say that the Treasury's power to set a rate of interest above the statutory minimum for some authorities had to be exercised for prudential reasons and not simply to penalise authorities subject to Government disapproval. The Treasury would also have a duty to act reasonably, both in the selection of local authorities liable to higher interest rates and in the determination of those rates. This means that the criteria for charging a higher rate would have to be defined in a way that was not only unambiguous from the point of view of the PWLB and the local authority, but also clearly justifiable on grounds relating to the security for the loans in question, rather than the identity of the borrower. Finally, the Treasury would not be able to delegate its duties under Section 5 to anyone else, so the scheme could not involve any independent exercise of discretion by the PWLB, in selecting the appropriate rate of interest for a particular loan.

5. The prudential ratios now being developed may offer a suitably objective test of creditworthiness for these purposes. In principle the Treasury might be able to direct the PWLB to apply a higher rate of interest in cases where, for example, an auditor has certified that an authority is in breach of one or more published target prudential ratios. However, it is not yet clear whether the ratios can be developed to provide an analytical satisfactory test of creditworthiness. Nor, until this is resolved, is it possible to say whether a scheme for differential rates can be introduced on the basis of existing legislation: at this stage it seems prudent to assume that new legislation will be needed to put beyond doubt the Treasury's ability to rely on ratio tests of this kind.

6. Legal and technical considerations aside, the case for introducing differential PWLB rates would depend, to a large extent, on the judgement taken about the likely market implications. Here views have changed significantly since the question was last considered in 1981. The central issue is whether the market response would be confined to a deterioration in the terms on which "high risk" authorities could borrow, or whether there would be a more general loss of confidence in local authorities, pushing up the cost of funds to even the most creditworthy authorities. In 1981, the Bank of England saw a significant risk of destabilising the whole local authority market. While considerable uncertainty on this issue inevitably remains, the Bank of England

now take the view that, provided it is made clear to the market which local authorities are having to pay higher rates and why, the most likely outcome would be a "tiering" of market rates, leaving rates to those authorities not regarded as "high risk" largely unaffected. Underlying this change of view are marked changes in the market's perception of the extent of central Government's responsibility for local authority debts; a growing sophistication about the differences between local authorities; and a sharp reduction in local authorities' dependence on the market for funds.

DOC474VM

TABLE 1

SPECIAL FUNDS

Unallocated contributions to funds

	f bn
1981-82	+0.2
1982-83	+0.6
1983-84	+0.5
1984-85	+0.2
1985-86	-0.6
1986-87	-0.2
1987-88	-0.4
1988-89	-0.4
1989-90	-0.4
1990-91	-

28.7.87

USE OF SPECIAL FUNDS TO AVOID BLOCK GRANT PENALTIES

The example of Nottinghamshire

	fm				
	1982-83	1983-84	1984-85	1985-86	1986-87
Underlying Expenditure	338	366	376	397	415
Special Funds	28	0	-22	-34	-18
"Total" Expenditure	366	366	354	363	397
Rate Income	-172	-188	-213	-231	-270
Block Grant	-146	-154	-172	-164	-145
Change in Balances	-48	-24	+31	+32	+18
Block Grant Gain from Using Special Funds	-2	0	+49	+85	+9

Total gain
of which

£141m

£9m from other local authorities through
close-ending effects

£132m from HM Treasury through holdback

8.6.87

TABLE 3

EXAMPLES OF CHANGES TO CAPITALISED HOUSING
REPAIRS BETWEEN 1985-86 AND 1986-87 (£m)

	1985-86	1986-87
Camden	23	32
Greenwich	6	23
Hackney	7	12
Hammersmith and Fulham	7	9
Islington	8	11
Lambeth	0	17
Lewisham	10	16
Southwark	13	21
Tower Hamlets	5	12
Wandsworth	15	19
Brent	10	10
Ealing	4	10
Hillingdon	9	14
Newham	9	11
Liverpool	21	15
Newcastle-upon-Tyne	6	10

8.6.87

DEFERRED PURCHASE, LEASE/LEASEBACK, ETC:
PLANNED OR REPORTED FACILITIES

TABLE 4

	Parallel Loan	Deferred Purchase	Sale/Lease Leaseback	Premia on Interest Rate swaps	Total
Doncaster		£22m			£22m
Dudley		£20m			£20m
Leeds		£70m			£70m
Liverpool		£60m			£60m
Manchester		£130m	£200m		£330m
Rochdale		£10m			£10m
Sheffield		£110m			£110m
Tameside		£10m			£10m
Wakefield		£11m			£11m
Camden	£98m	£11m	£11m	£10m	£130m
Greenwich		£22m			£22m
Hackney		£48		£1m	£49m
Hammersmith and Fulham		£100m			£100m
Islington		£197m	£150m	£20m	£366m
Lambeth		£11m	£7m		£18m
Lewisham		£95m			£95m
Southwark		£42m			£42m
ILEA			£20m		£20m
Brent		£80m	at least £10m		£90m
Ealing		£100m			£100m
Haringey		£135m	£100m	£29m	£264m
Hounslow		£35m			£35m
Newham		£23m			£23m
Waltham Forest		£41m			£41m
Basildon		£44m			£44m
Brighton		£6m	£46m		£52m
Harlow		£50m			£50m
Leicester		£36m			£36m
Luton		£31m			£31m
Oxford		£20m			£20m
South Buckinghamshire		£2m			£2m
Kingston upon Hull		£5m			£5m
Edinburgh		£104m			£104m
Glasgow		£75m			£75m
Lothian		£49m			£49m
Monklands		£6m			£6m
Total	£98m	£1811m	£534m	£70m	£2513m

TABLE 5

EFFECTS ON LOCAL AUTHORITY CONTROLS OF
MAIN CREATIVE ACCOUNTING DEALS

	assets acquired	spending for control purposes	fm net gain to LA
1987/88			
Current+			
Capitalised repairs	500	275	225
Sale and leaseback	0	-75	75
Special funds	400	0	400
RCCO for fin. leasing*	0	200	-200
Total RSG effects	900	400	500
Capital			
Deferred purchase	600	0	600
Finance leasing	400	0	400
Total gain to local authorities			1500
1988/89			
Current +			
Capitalised repairs	500	325	175
Sale and leaseback	0	-75	75
Special funds	400	0	400
RCCO for fin. leasing*	0	260	-260
Total RSG effects	900	510	390
Capital			
Deferred purchase	200	0	200
Finance leasing	100	0	100
Total gain to local authorities			690
1989/90			
Current+			
Capitalised repairs	500	375	125
Sale and leaseback	0	-25	25
Special funds	400	0	400
RCCO for fin. leasing*	0	240	-240
Total RSG effects	900	590	310
Capital			
Deferred purchase	0	300	-300
Finance leasing	100	0	100
Total gain to local authorities			110
1990/91			
Current+			
Capitalised repairs	500	425	75
Sale and leaseback	0	25	-25
Special funds	0	0	0
RCCO for fin. leasing*	0	200	-200
Total RSG effects	500	650	-150
Capital			
Deferred purchase	0	300	-300
Finance leasing	50	0	50
Total gain to local authorities			-400
+Total expenditure for block grant purposes			
* Revenue contributions to capital outlay (RCCO) score as spending for RSG purposes.			

TABLE 6

MAJOR AUTHORITIES WITH SIGNIFICANT REVENUE FUNDING GAPS

Col (i) Authority	Col (ii) Rate-Capped	Col (iii) GRE	1987/88			1988/89			Col (xi) Col x as % of col viii	
			Col (iv) Underlying expenditure	Col (v) Underlying Income	Col (vi) Funding gap	Col (vii) Col vi as % of col iv	Col (viii) Underlying Expenditure	Col (ix) Underlying Income		Col (x) Funding Gap
Basildon	* +	7.967	17	14	3	17.6	22	14	8	36.4
Brent	*	164.354	207	183	24	11.6	228	183	45	19.7
Brighton	*	13.638	20	15	5	25.0	21	15	6	28.6
Camden	* +	100.773	179	136	43	24.0	200	137	63	31.5
Ealing	+	154.588	184	176	8	4.3	200	157	43	21.5
Greenwich	* +	68.411	128	95	33	25.8	135	95	40	29.6
Hackney	* +	110.221	163	128	35	21.5	175	129	46	26.3
Hammersmith and Fulham		74.498	101	86	15	14.9	108	86	22	20
Haringey	* +	132.377	204	156	48	23.5	219	156	63	28.8
ILEA	* +	579.751	1026	950	76	7.4	1080	955	125	11.6
Islington	*	100.125	154	106	48	31.2	166	106	60	36.1
Lambeth	* +	131.489	198	152	46	23.2	212	152	60	28.3
Lewisham	* +	89.955	146	116	30	20.5	166	116	50	30.1
Liverpool	+	266.760	332	306	26	7.8	353	308	45	12.7
Manchester	+	276.684	401	316	85	21.2	422	317	105	24.9
Newham	*	154.229	184	168	16	8.7	195	168	27	13.9
Sheffield	*	241.036	316	269	47	14.9	344	269	75	21.8
Southwark	* +	112.227	159	134	25	15.7	179	134	45	25.1
Tower Hamlets	* +	101.651	141	124	17	12.1	150	124	26	17.3
Waltham Forest	+	122.480	155	152	3	1.9	170	142	28	16.5
TOTAL		3003.204	4415	3782	633	14.3	4745	3763	982	20.7

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NOTES TO TABLE 6

Col ii: * rate-capped in 1987/88
+ rate-capped in 1988/89

Col iv: underlying expenditure represents net committed spending adjusted for anticipated extra income (eg from fees and charges) and unallocated savings but without taking account of financial devices.

Col v: underlying income is broadly equivalent to the expenditure which can be funded from rates and block grant. For rate-limited authorities it is the Expenditure Level set under the 1984 Rates Act or by formula in the 1987 Local Government Finance Act.

Col vi: Col iv - Col v

Col viii: Col iv rolled forward in line with recent trends

Col ix: 1987/88 underlying income (col v), or provisional expenditure levels for rate-capped authorities.

Col x : Col viii - Col ix

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TABLE 7

PRUDENTIAL RATIOS

Interim Examples of ratio figuring - 1985/6

	<u>Oldham MB</u>	<u>Cheshire CC</u>	<u>Winchester DC</u>
			£m
INCOME = Rates, Collected	101.9	365.0	9.7
<u>less</u> Parish, etc precepts			
<u>plus</u> Block grant,			
(Rents less standard rebates)			
Trading surplus*			
Interest on balances			
DEBT = Temporary & long term external borrowing (creative accounting liabilities to be added)	224.1	66.4	29.1
RATIO = $\frac{\text{DEBT}}{\text{INCOME}}$ 1985/6	220	18	301

Earlier Years Ratios

1984/5	231	22	383
1983/4	210	18	313
1982/3	188	20	384

* Gross Trading Income to be substituted

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