



Prime Minister

E(LF): "STOP" POWER FOR THE DISTRICT AUDITOR

~~E(LF)~~ ^{ATTACHED} on 3 November raised a number of points about my proposal for a reserve power to impose prudential ratios. My more limited proposal to enable the District Auditor to act pre-emptively against unlawful or improper conduct, instead of having to wait until after the event, was agreed in correspondence in the summer.

We agreed last week that the development of prudential ratios should be as swift as possible. The two constraints are that rules to self-regulation have to be developed through full public discussions; and that workable ratios will have to be based on the approved accounting practice introduced into the local authorities this year. The first full set of improved accounts become available in Autumn 1988. April 1989 is therefore the earliest practicable date to have prudential ratios in effect.

I suggest therefore that we postpone legislation on that until the 1989/90 session. The reserve power that I proposed could still be effective during the 1989/90 financial year if we legislated for it then rather than in the current Local Government Bill. That timetable would allow us to see more clearly the emerging detail of the prudential ratios next Spring. I suggest we take the paper that I promised for E(LF) at that time.

If we legislate in the next session, the relation between prudential ratios and our capital controls will also be evident. The new capital controls will be designed as far as possible to remove the advantages of creative accounting. However these are annual controls and will not in themselves be a complete guarantee of prudent financial behaviour by authorities.

Prime Minister 2 ^{CCBG}
 Agree, but not to be
 for information. (DDE
 have a slot for a Bill in
 the 1989/90 session.)

DDE

10/11.

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The prudential ratios will therefore reinforce them by acting to prevent individual authorities accumulating spend-now, pay-later commitments.

In the meantime I believe it is important not to miss the opportunity of legislating in the Local Government Bill on the more limited proposal to enable the District Auditor to act pre-emptively against unlawful or improper conduct. I am therefore initiating a short period of public consultation on this aspect alone with a view to introducing provisions into the Local Government Bill at Commons Report.

Copies of this minute go to the other members of E(LF) and to Sir Robert Armstrong.

R. J. P.

N R

9 November 1987

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

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cc BQ



Treasury Chambers, Parliament Street, SW1P 3AG

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

NRAN

20 November 1987

Dear Secretary of State,

"STOP" POWER FOR THE DISTRICT AUDITOR

I have seen a copy of your minute of 19 November to the Prime Minister setting out revised proposals for stopping local authorities entering into creative financing deals.

I very much support the principle of preventing local councils accumulating further spend-now, pay-later commitments through creative financing. I recognise however that further work in this area is needed to try and develop self-regulation and statutory schemes - not least on the definition, interpretation and statistical robustness of the prudential ratios. As this work develops, we will be better able both to determine whether the self-regulation and statutory schemes are likely to be practicable, and if so to judge whether the statutory scheme might be introduced at the outset. We should look again at the respective merits of these options in E(LF) once the position on prudential ratios and other aspects is clarified.

In the meantime, however, we face a hiatus - possibly until the new capital control regime can come into effect - with inadequate powers to prevent creative financing deals in general. I appreciate that the flow of such deals appears to have slowed down in recent months. But small changes in the political balance on certain councils could quickly renew their interest in creative financing.

I believe that we must take action on specific types of creative financing where we can. I understand we can make it more difficult for local authorities to arrange

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some types of sale and leaseback deals if we bring property leases of less than twenty years within the scope of the existing capital control system. I hope you will therefore agree to do so. We should look again at interest rate swaps once the Haringey Court case has clarified the legal position. But whatever steps prove practicable to limit particular types of deal, we also need to take a high profile in public pronouncements in opposing further creative financing. Moreover we should encourage the Audit Commission to continue publicising the need for prudent financial conduct by local councils, and to reinforce their condemnation of spend-now pay-later deals, as financially irresponsible.

In the meantime, the work on developing practical schemes to promote prudent financial conduct needs to go forward quickly; I would wish my officials to be involved in this exercise.

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

Yours sincerely,

Jim Ruth

pp JOHN MAJOR

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



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P 02900

PRIME MINISTER

A "STOP" POWER FOR THE DISTRICT AUDITOR

[Letters of 6 and 29 October from Mr Ridley and of 12 October from the Chief Secretary]

DECISIONS

The Environment Secretary wants the Government to table a Government amendment to the Local Government Bill which would give him a new power to impose prudential requirements on local authorities. The Audit Commission is currently trying to develop such a system in the form of prudential ratios which would limit an authority's borrowing in the light, presumably, of its revenues and assets (although the details of what they envisage seem unclear). Mr Ridley hopes that local authorities will accept such a regime voluntarily, but he wants a power in reserve to impose it if necessary.

BACKGROUND

2. Ministers agreed in correspondence in July that the Local Government Bill should include new provisions to give the auditor pre-emptive powers to stop unlawful spending by local authorities, in addition to the auditor's existing power to act after the event. But Mr Ridley's colleagues reserved judgement on a second proposal to impose a new prudential regime on local authorities: the underlying concept at that time was to require local authorities to balance the interests of present and future rate or community charge payers when they undertook borrowing or other financial liabilities. Doubts were expressed about whether such a system would be workable in practical or legal terms.

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MAIN ISSUES

3. Mr Ridley's new proposal has much the same aim, but is entirely different in form. It appears to avoid the difficulties of interpretation and enforcement associated with his earlier proposal, but it is far from precise. All that the note attached to his letter of 6 October says on the actual technical substance is that the limits of financial prudence defined under the regulations would be likely to be in terms of ratios between financial commitments and the means to meet them; but that the proposed power would not prevent other possibilities. This seems sensible so far as it goes, but it appears that prudential ratios for local authorities are still only a broad concept, and much work is required to make them a reality.

4. The main issue therefore is whether it is wise to take the power which Mr Ridley proposes in the Local Government Bill in view of the work which remains to be done. You may wish to explore where the Audit Commission have got to. Mr Ridley's latest letter of 29 October mentions that the Commission is setting up a new joint working party with the local authorities. You might find it helpful to know how long the work of this working party is likely to take, and what are its chances of success.

5. Mr Ridley is likely to argue that it is worth taking a power now to show that the Government means business. He points out that legislation might in itself persuade authorities to agree to a voluntary regime. On the other hand the power would presumably be broad and unspecific which might raise suspicions in Parliament and elsewhere about the Government's intentions; and the power might turn out not to do what was wanted. The choice appears to be between taking the power as Mr Ridley proposes, or deferring any legislation in the hope that local authorities will accept prudential ratios voluntarily or that, if they do not, a suitable slot could be found in a future legislative programme to deal

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with the problem in an authoritative manner. You will want to decide whether Mr Ridley's arguments are strong enough to justify legislation in the present Session.

VIEWS OF OTHER MINISTERS

6. The Chief Secretary, Treasury is likely to suggest that the benefits of Mr Ridley's proposal depend entirely on the success of the Audit Commission in developing workable prudential ratios. He will probably press the Environment Secretary to do everything he can to push this work forward quickly. He may nevertheless agree that it would be helpful to take a reserve power at the earliest opportunity. The Secretary of State for Wales will be concerned that any powers can be operated separately for Wales if necessary.

HANDLING

7. You will want to ask the Environment Secretary to speak to his proposal. The Chief Secretary, Treasury and the Secretary of State for Wales will want to comment. You may also want to ask the Business Managers whether the amendments which Mr Ridley would have to introduce would measurably affect the Parliamentary handling of the Local Government Bill.

RJW.

R T J WILSON
Cabinet Office
30 October 1987

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C. J. P. C. B. S.



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My ref:

Your ref:

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

29 October 1987

Dear Chief Secretary,

NBRM

A "STOP" POWER FOR THE DISTRICT AUDITOR

My letter of 12 October proposed a reserve power to reinforce the Audit Commission initiative for self-regulation on local authority financial prudence. This is linked to the main (Part I) "Stop" power proposals, which it is already agreed should be included in the Local Government Bill. ^{with request if required}

Your reply of 12 October acknowledged the time pressures, noted the discussions between officials that have now taken place, and asked for a discussion with colleagues. We are meeting in E(LF) next Tuesday, and taking this item on the basis of our exchange of letters. Our officials have exchanged further details.

The Audit Commission have now approached the local authority associations for a joint working party on their self-regulatory proposals. It is important that I back this initiative with consultation on my "Stop" power and reserve power proposals. I hope that you and other colleagues will agree next Tuesday that I may press ahead with public consultation, and with drafting clauses for the reserve power. At best, there will only be five weeks available if we are to be ready for report stage of the Local Government Bill in mid-December.

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

Yours sincerely,

Nicholas Ridley

NICHOLAS RIDLEY

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

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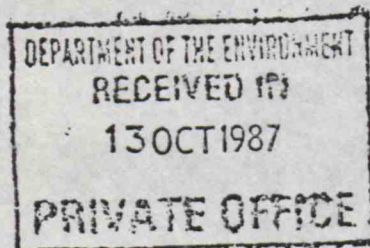


cc *BB* Dept Mr Ennals
 cc *B* Mr Howard
 P. Mr. Clough
 B. Pen. Sec.
 Mr. Gresham
 Mr. Stamp
 W. Roscoe
 Mr Ramsay
 Mrs Ramsay
 S 15 - to see

Treasury Chambers, Parliament Street, SW1P 3AG

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

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12 October 1987

Dear Nick,

A "STOP" POWER FOR THE DISTRICT AUDITOR

Your letter of 6 October to Willie Whitelaw set out revised proposals for a power that will enable Auditors to stop imprudent financial transactions by local councils. I note that you now envisage the proposed stop power being in reserve on the basis that the Audit Commission are able to secure local authorities support for a self-regulatory approach.

This represents an important and interesting new development in the original concept of graduated response within a prudential regime. I would welcome the opportunity to discuss with you and colleagues this approach to the stop power in detail. More generally, I think we should consider how far you envisage other elements of the prudential regime, such as the overseer, operating within a voluntary or self-regulatory rather than statutory framework.

However, even under the proposed self-regulatory approach, the effectiveness of the scheme would in large part depend upon the development of suitable prudential ratios; and we have yet to see on an empirical basis how the Audit Commission propose to make these work. I understand my officials are meeting yours on 20 October, under the aegis of the Working Group on Local Authority Financial Prudence, to discuss inter alia prudential ratios. I am aware of the time pressures if you are to consult the local authorities and introduce the necessary legislation before Christmas. I therefore hope we will be able to meet and discuss these proposals once our officials have had these further discussions.

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

Yours Ever,
John

JOHN MAJOR

D. J. Evans

PS/W/2nd G. Py. 15-1087

PS/CC

PS/TH

B. Evans (+ PP)

B. Bradley
Sharp
RoscoeCitelaw CH MC
Council

Your ref:

6 October 1987

Dear Lord President,

A "STOP" POWER FOR THE DISTRICT AUDITOR

Thank you for your letter of 23 July agreeing to the inclusion in the Local Government Bill of my proposal to give the auditor pre-emptive powers to stop unlawful acts by local authorities. This was supported by John Major and Wyn Roberts and I shall be sending instructions to Parliamentary Counsel shortly.

John and Wyn shared your view that a collective discussion would be helpful on the second part of the proposal, enabling the auditor to deal with acts that are highly imprudent but not at present illegal. As it happens the Audit Commission has recently expressed some further thoughts on the way forward with the prudential regime which have given me cause to reconsider the form of the legislation on the second part my proposal. The Commission's intention is to launch consultation with local government and the accounting profession on a system of prudential ratios during the autumn. This will be presented as a voluntary initiative in self-regulation by local government; as David Cooksey, the Chairman, has been saying publicly, it will represent an opportunity for local government to put its own house in order so as to avoid the need for further controls by central government.

Whilst I still seek your agreement to proceed with the inclusion of stop power, part 2, in the Local Government Bill I now think it would be better to provide for it to come into effect only if and when an appropriate order was made.

I believe that prudential ratios represent a promising development and I would like to give local government every encouragement to make them a success as the basis of a system of self-regulation. I therefore propose to make known when I introduce the provisions on part 2 in the Bill that I will refrain from making the order to bring them into effect provided that local government moves speedily towards self-regulation. I am sure that this reserve power will act as a spur to progress. But if that progress is lacking, the order can be made putting in place the powers to allow the auditor to take action against authorities who continue irresponsibly piling up forward commitments.

The new duty on local authorities to balance the interests of various groups which I had proposed and which was set out in my letter of 17 July was framed in very wide terms. I think it would be difficult presentationally and politically to enact a general duty of this kind with the express intention of holding it in reserve. It could also create problems in the courts to have in reserve a duty which local authorities are in part required to abide by anyway as part of their common law fiduciary duty. The reserve power I am now proposing will be defined in much narrower terms. This is described at greater length in the annex to this letter. It would simply require local authorities to abide within such levels of future commitments as I may specify in regulations. If local government signs up to a voluntary system of ratios which works well in practice, then no action need be taken. If, on the other hand, the Audit Commission initiative on prudential ratios fails to gain local government backing, I could then make regulations on the matter setting out my own criteria for prudence or I might require the Commission to produce a set of prudential ratios, which I could then adopt in regulations.

I believe that provisions defined in these narrower terms would not raise any fundamental questions of legal principle nor present the same enforcement difficulties in the courts to which the wider duty might have given rise.

We have discussed our thinking with the Chairman of the Audit Commission who believes that a reserve power along these lines would fit well with what the Commission has been saying about the need for local government to put its own house in order.

I hope that if necessary we can meet with colleagues as soon as possible after the Conference to discuss these proposals so that we can work up instructions to Parliamentary Counsel and consult local government in time for introduction at Report stage.

X I am copying this letter to members of E(LA) and to Sir Robert Armstrong.

Yours sincerely,

Nicholas Ridley

NICHOLAS RIDLEY

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

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RESERVE POWER AGAINST LOCAL AUTHORITY FINANCIAL IMPRUDENCE

It is proposed that a power be introduced into the present Local Government Bill to ensure that there is an effectual means of preventing local authorities over-committing themselves: it is intended that this should be a reserved power to be exercised only if local government's own attempt to set effective standards of financial prudence should fail.

2. The power would enable the Secretary of State to make regulations which local authorities would have to comply with. These regulations would define the limits of financial prudence. Failure to comply with the prescribed limits would be the basis upon which the Treasurer would act (under the duties we are laying upon him in the Rates Reform Bill) or the auditor could act to restrain the authority from over-committing itself (under the powers we are giving him stop an authority incurring unlawful expenditure).

3. The Secretary of State might prepare his own regulations or the Audit Commission might be required to submit proposals to him for financial prudence which the Secretary of State might provide for by order.

4. The limits of financial prudence defined under the regulations would be likely to be in terms of prudential ratios: ratios between financial commitments and means to meet them. But the proposed power would not prevent other possibilities.

At the moment work is going forward, under the leadership of the Audit Commission, on the development of prudential ratios for local authorities as a means of self regulation. If this voluntary initiative is successful, potential lenders and the authorities' electors would be put on public notice when an authority exceeded or is in danger of exceeding these limits of prudence.

6. Our new power would be used if the local government world fails to produce an effective system of prudential ratios, or if authorities were to ignore or evade such ratios. There is a precedent for the use of a reserve power in this way in the Financial Services Act which empowers the Secretary of State to make rules where it appears to him that a professional body has failed itself to make rules or issue guidance. The existence of this reserve power in the Bill would be calculated to concentrate local governments' attention on ensuring that a voluntary system is devised and made to work.

7. The necessary technical basis of calculation for the accounting concepts needed to express financial prudence is being taken forward from the basis provided by the voluntary accounting code introduced by the local authority world this year (under threat of regulations being introduced if their progress is not satisfactory). In particular, the concept of the financial commitments of a local authority is being clarified in the further work on capital accounting and in our own work on capital controls.

ce BG

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From The Minister of State

CT/6110/87

7 August 1987

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wbpm

Dear Nicholas,

A 'STOP' POWER FOR THE DISTRICT AUDITOR

AT FLAP PT32

WILL REQUEST IF REQUIRED

In the absence of Peter Walker I am responding to your correspondence with Willie Whitelaw. Your letter of 17 July proposed two measures to extend auditors' powers. Willie Whitelaw's letter of 23 July, commenting on your suggestions, said he was content with the first proposal but felt that the second needed more detailed consideration.

I am sure Willie is right. We shall shortly have the full report of the Working Group, promised in your letter of 26 June. This should allow us to consider a comprehensive package of measures, including possible clarification of local authorities fiduciary duty to balance the interests of current and future ratepayers among other considerations. Only then can we decide the best way to progress. In doing so we shall also have to pay regard to the interest of the great majority of local authorities who behave responsibly.

/ I am copying this letter to the Prime Minister, members of MISC 109 and E(LA), the Attorney General, First Parliamentary Counsel and Sir Robert Armstrong.

James
Wyn

WYN ROBERTS

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

LOCAL GOVT : Kelantan PT33

