



Treasury Chambers, Parliament Street, SW1P 3AG  
071-270 3000

16 July 1990

Rt Hon Christopher Patten MP  
Secretary of State for the  
Environment  
Department of the Environment  
2 Marsham Street  
LONDON  
SW1P 3EB

*Dear Secretary of State*

**LOCAL AUTHORITY FINANCIAL ASSETS AND CAPITAL SPENDING**

During the passage of the Local Government and Housing Bill last year, our predecessors corresponded about the provisions which govern local authorities' receipts from the sale of capital assets. Specifically, Nigel Lawson was concerned that the "reserved" part of capital receipts should be employed to repay debt within a reasonable period, rather than be held indefinitely and so swell local authorities' balance sheets.

In the event, it did not prove possible to reach agreement in time for the Bill, as it then was, to be amended, and the discussion lapsed with an exchange of letters between you and Norman Lamont (in Nigel Lawson's absence) in September. In consequence, local authorities are free to hold the "reserved" proceeds of asset sales indefinitely, even if they have large quantities of debt outstanding and are undertaking new borrowing. I understand that around £7 billion of receipts will have been set aside as provision for credit liabilities by the end of this year, while English local authorities' external debt was £40 billion at the end of 1989, the vast bulk of it from central government via the Public Works Loan Board (the PWLB).

As you know, I have already acted to limit local authority borrowing from the PWLB, particularly where authorities have financial assets which they can draw down as an alternative to borrowing; and it has been agreed that PWLB rates should be guided towards market rates as circumstances permit. These measures have gone some way to put downward pressure on local



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authority deposits. However, I believe that the present arrangements are inherently unsatisfactory.

The basic point is that it is wrong in principle that local authorities should maintain deposits larger than those reasonably needed for their immediate purposes. It is not always easy to draw the line between legitimate debt management and excessive market activity. Nevertheless it is clear that the present system can allow local authorities to become financial intermediaries on a large scale; in effect, to play the markets. Unlike financial institutions, authorities are not subject to financial supervision, and - as the swaps debacle has shown - their chargepayers can be put at risk for very large sums. Even where an authority is consistently successful in its sophisticated market dealings, there is a good argument that its management resources would be better employed on improving efficiency and cutting costs in its everyday operations.

Furthermore, the size of local authority deposits has threatened the Bank of England's ability to operate monetary policy. This is less an immediate matter of concern at present than it was, say, six months ago. But the problem could come back quickly if we do not act and it is only sensible to do what we can to prevent this situation from recurring.

I realise that there is no legislative vehicle immediately in prospect which could be used to tighten the Local Government and Housing Act 1989 in this particular respect. I have of course looked at the idea of a voluntary Code, which was floated at the end of last year's correspondence. I do not find it a convincing substitute for a tighter legislative regime, and I suspect that the experience of the last few months suggests that in practice it would not be worth the trouble of negotiating the Code.

So I hope that we can agree in principle that it would make sense to take the next opportunity to legislate to require local authorities to employ their future "reserved" receipts within a short period, either to repay existing debt or to substitute for new capital finance; and to run down their stock of "reserved" receipts over a reasonable timescale. If you are content with this approach, our officials could work up the details so that we could be ready to legislate quickly when the occasion arises.

I am sending copies of this letter to the Prime Minister and to the Governor of the Bank of England.

*Yours sincerely*

*Kate Gaselthie*

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*Approved by the Chancellor*

16.07.



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