



no.

Prime Minister

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DWS

14/5.

MISC 109: CREATIVE ACCOUNTING AND FINANCIAL PRUDENCE

You may find it helpful before the Election to have a summary of where, following discussions in MISC 109 earlier this year, we stand on tackling the problem of those local authorities who persist in handling their financial affairs irresponsibly.

It does not now appear that we need to make measures for dealing with the imminent breakdown of local government in any area our highest priority. Although our information is not comprehensive, it seems likely that all the most difficult authorities have secured sufficient finance, by one means or another, to support their activities for the current year. Obviously we cannot completely rule out trouble and my officials will continue to monitor the position closely.

A more immediate need, therefore, is to develop preventative measures which will ensure that no authority can, either through incompetence or through deliberate courting of disaster, drive itself to the brink of financial collapse. My letter of 1 May to the Lord President outlined the measures which I considered to be the most promising, and I have now received the Chief Secretary's support for this approach, in his letter of 8 May. Certain of these measures will, however, require legislation. My officials are developing further the proposals to strengthen the roles of the auditor through the provision of a "stop" power, and of the local authority Treasurer through the imposition of a statutory duty to report to the authority on unlawful or excessive expenditure, for possible legislation if we think it appropriate. Other aspects of these proposals, such as the definition of prudential ratios for local authorities, may not require legislation but are also being worked up as quickly as possible.



We cannot ignore the possibility that in the longer term an authority or authorities will get into serious financial difficulties. Officials are therefore continuing work on the proposal to appoint overseers to help authorities to put their financial house in order whilst leaving the councillors in position. I doubt whether this is a proposal for which the climate is right to legislate in advance of a crisis, but we need to have a scheme on the stocks.

The overseer scheme requires the co-operation of existing councillors. If that co-operation is not forthcoming we need to be prepared with a mechanism to take on the full range of an authority's services in the event of financial collapse. We do of course already have a Commissioners Bill ready drafted. Officials will be reviewing this to see how far it needs amendment in the light of more recent developments and reconsidering the necessary financial arrangements. Other ideas which have been mooted, such as the replacement of the authority by a body akin to an Urban Development Corporation (UDC), on examination seem less promising. The need for the new body to continue to provide a wide range of disparate services would stretch the UDC concept too far; the only practical difference between the present authority and the successor body would be likely to be the appointment of a Board (in effect, Commissioners by another name) in place of the elected Council. The alternative, of dispersing services to a number of different agencies, would make the return to normality at a future date too difficult and costly. My officials will, however, continue to look for alternative methods of dealing with authorities who have actually precipitated financial collapse.

I am copying this to members of MISC 109 and to Sir Robert Armstrong.

A handwritten signature in dark ink, appearing to be the initials "NR" with a stylized flourish.

N R

14 May 1987



JA

cc: BG

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

15 May 1987

Dear Robin,

MISC 109: Creative Accounting  
and Financial Prudence

The Prime Minister has seen your Secretary of State's minute of 14 May and has noted the present position on measures to tackle the problem of irresponsible local authorities.

I am copying this letter to Private Secretaries to members of MISC 109 and to Trevor Woolley (Cabinet Office).

Yours,  
David.

(DAVID NORGROVE)

R.U. Young, Esq.,  
Department of the Environment.

DS

CCB/UP

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PRIME MINISTER

LOCAL GOVERNMENT: CREATIVE ACCOUNTING AND FINANCIAL PRUDENCE

These papers come to you today to reduce overload tomorrow. *!!*

The Bank of England surely ought now be brought closely into these discussions:

- (i) they should already be leaning heavily on the City not to lend to imprudent authorities;
- (ii) they will have a key role if a local authority collapses, keeping the creditors in order, backing up "the IMF", commissioners (or whoever) and organising debt rescheduling.

The paper refers twice to discussions on housing "in another forum". This may disturb Scotland, Wales and others. I have told DOE to say if asked that these are references to the Strategy Group.

Annex D, Table 2, gives figures for expenditure and the projected funding gap in the eight London boroughs most at risk. Islington is top of the league and Southwark third, after Camden.

*DW*

DAVID NORGROVE

*£100m*  
*£150m*

3 March 1987

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PRIME MINISTER

Local Government: Creative Accounting and Financial Prudence  
[MISC 109(87) 2]

DECISIONS

1. There are no immediate operational decisions to be taken. The purpose of the meeting is to decide whether the two possible approaches identified in MISC 109(87)2 (or any alternatives) for dealing with a breakdown of local government are sufficiently promising to be worth working up in detail. The two approaches are:

- a. The appointment of an "IMF type" overseer;
- b. The transfer of key services from local authorities to other bodies.

You may also wish to ask for a brief oral report on the latest situation on Liverpool.

BACKGROUND

2. At their meeting on 10 February, the Group had a preliminary discussion of options for dealing with a breakdown of local government in certain urban areas. They agreed that the Secretary of State for the Environment should take an early opportunity to make it clear that the Government did not, and never had, stood behind local authority debt, and this has now been done (see  
----- Written Answer of 19 February attached). The Group also invited the Secretary of State to set in hand work on various longer term options. The possibility of appointing 'IMF type' overseers had been identified by the Secretary of State, and in discussion you

and other Ministers put forward the possibility of establishing executive boards or corporations to take over certain functions.

3. The Group also touched on the problem of citizens of the Irish Republic having the right to vote in British elections. The Home Secretary will be reporting further on this to H Committee on 19 March.

#### THE ISSUES

4. Nothing has happened to change the Secretary of State's assessment that collapse is more likely in 1988 than sooner. The Government therefore have a little time in which to prepare for their response. Mr Ridley's paper covers three options:

- the overseer approach;
- the Executive Board approach;
- appointing Commissioners.

A key issue in appraising these is whether there is any middle-ground that can be occupied between the Government and a local authority that seems set on a deliberate collision course. There is a Catch 22 situation here. Unless local councillors are prepared to cooperate in averting a collapse, the Government can do little without taking extensive powers itself: but this would only be publicly defensible when it had become generally apparent that collapse was imminent.

5. The various proposals put forward by Mr Ridley are not mutually exclusive. It would be possible, for example, to use the overseer approach in parallel with stripping out some local authority functions, with the use of Commissioners as a fall back in either case.

The Overseer Approach

6. Annex A to Mr Ridley's paper discusses this proposal in more detail. It does not, however, take it very much further. The basic idea is that an 'IMF representative' would be appointed to identify and help implement a path back to financial rectitude. He might be appointed by the Secretary of State or some other body (for example, the Public Works Loan Board (PWLB)), or at the instigation of the council itself. But in either case, the council would continue to exercise the full range of legal functions, and the overseer might well be an agent of the council.

7. It is clear that some cooperation would be required if the overseer model is to work. An overseer could not be expected to succeed if a council remained resolutely hostile. But at the same time he must have sufficient sticks and carrots to enable him to apply "a measure of persuasion" in difficult cases. To pursue the IMF analogy, the carrot (pace Brazil at the moment) is the passport that an agreed Fund programme offers to Paris Club rescheduling and resumption of commercial bank loans. But no such carrot seems currently to be available in the local authority scene and this paper does not yet properly tackle this problem.

8. The position of the PWLB could be crucial here. At present, it appears that the PWLB is obliged to lend to any authority up to the point at which it is acting illegally or appears unable to service or repay a loan. But the paper is not absolutely certain on this point - the last 3 sentences of paragraph 6 of Annex A are still somewhat approximate. If the overseer approach is to work, this must be clarified. The objective would presumably be to give the PWLB a degree of discretion, so that they could withhold finance unless the overseer were satisfied that the local authority was beginning to adopt a prudent programme. Further detailed work needs to be done on this and any other "carrot/stick" possibilities (eg access to certain Government grants, or arrangements for debt rescheduling) before it can be certain that the overseer model is practicable and would be effective.

Transferring Services from Local Authorities to Other Bodies

9. This approach is closely related to other possibilities you have been considering separately. It is directed not so much at dealing with financial collapse but at a breakdown in the delivery of services . Housing, personal social services (PSS) and education, for example, might be removed from the local authority and run by appointed boards answerable to the Secretary of State. The assumption would be that such boards would be managerially more efficient than local authorities, so that they would not only deliver services more effectively but also in time make substantial economies. In the case of housing, for example, an executive board would be expected to adopt a much more entrepreneurial approach.

10. But for this approach to be successful, some practical problems would have to be solved. Among them are:

(i) The executive boards would still need to raise finance from the rate payer. This is particularly so for PSS, where most of the expenditure is current and there are few assets which the managers could sell in order to balance the books. The executive boards would therefore have to levy a precept which would fall to be collected by the rump council.

(ii) The immediate problem of the financing gap would remain. The difficulties caused by creative accountancy would either remain with the councils, and would fall to be financed by rate payers, or alternatively would be transferred with the assets to the executive boards. Although the executive boards might well realise assets and make efficiency savings in the medium or longer terms, in the short term the financial problem would be unchanged and additional public expenditure might well be unavoidable.

(iii) Work is already in hand elsewhere on education and on



housing policy, and you will not wish to commission anything cutting across that. But there are formidable problems on PSS which are not addressed in this paper and have not so far been discussed in any detail with DHSS. Transfer of this (controversial) function to a board could well lead to pressures for higher expenditure, and Ministers (rather than the local authority) would be more directly responsible for the level of provision and delivery of services (there is a more general risk too that boards might become lobbyists for higher expenditure on their services).

11. Nothing in these papers rules out this approach and it has some obvious attractions. But before you can be confident that it does offer a realistic response to the situation hypothesised you will want to commission further detailed work on its practicalities (especially on PSS) and on its wider implications for the central Government relationship with local authorities generally.

#### Commissioners

12. You will not want to spend much time discussing this. A summary of the work previously done (including the drafting of legislation in 1984) is at Annex B. It is difficult to imagine resort to it except in a very serious emergency, but it seems sensible to keep the planning on the stocks.

#### Timing

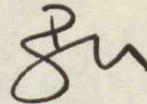
13. The Government will wish to be in a position to act by early 1988 if circumstances require. Legislation will be needed for all options except (subject to the PWLB point) that of an overseer working by cooperation and persuasion alone, and it will therefore be desirable to have draft bills ready by early autumn. The Group will then have to decide whether legislation should be introduced on a contingent basis in advance of any particular authority facing default, or whether it should be kept in the cupboard for introduction only at the last moment.

Liverpool

14. Mr Ridley minuted you on 19 February about the current situation in Liverpool. You endorsed his view that the Government should continue to let events take their own course. You may wish, however, to ask Mr Ridley whether there have been any recent developments, and in particular when the outcome of the Lords appeal against disqualification is likely to be known.

## HANDLING

15. You will wish to invite the Secretary of State for the Environment to introduce the discussion. The Chief Secretary, Treasury will wish to speak on the position of the PWLB, and the Secretaries of State for Social Services and for Education on their respective services. All other Ministers will wish to comment.



J B UNWIN

3 March 1987  
Cabinet Office

## Local Authority Debt

Mr. David Howell

asked the Secretary of State for the Environment what protection Her Majesty's Government provide for lenders and other creditors in the event of default by a local authority.

**Mr. Ridley:** A local authority's debt and its creditworthiness have always been its own responsibility. The Government do not stand behind local authority debt. The great majority of local authorities understand the importance of maintaining their creditworthiness and behave in accordance with the rules of financial good practice.

All loan debt is a statutory charge on all the revenues of an authority. If a local authority were to default, creditors — including those who have provided finance for authorities under arrangements such as deferred purchase schemes which do not legally constitute borrowing — might have to take action in the courts to recover their money. The Public Works Loan Board could not lend to an authority which chose to act illegally or which appeared unable to service and repay the debt, even under its lender of last resort facility.