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My ref 30421

Your ref

The Rt Hon John Major MP  
HM Treasury  
Parliament Street  
LONDON  
SW1 3AG

8 August 1990

Dear Chancellor,

LOCAL AUTHORITY FINANCIAL ASSETS *map*

Thank you for your letter of 16 July asking me to agree in principle to take the next available opportunity to legislate to require local authorities to redeem debt but I wonder whether this is the best way to proceed.

First of all the level of financial assets held by local authorities in England has actually fallen substantially from £9.5 billion when we considered this topic in the autumn of last year to £7 billion now.

Secondly there is no evidence that local authorities generally have been indulging in "intermediation" in the way that you fear. It seemed that in many cases local authorities have instead followed a policy of "internal" lending, under which they temporarily use the cash from their reserves as a substitute for external borrowing. This naturally reduces external borrowing and investments. I believe much of the £7 billion which you refer to as being set aside in the first year of the new system is likely to be used to write off such internal lending.

Thirdly, as you say in your letter, you have taken steps to limit local authority borrowing from the PwLB, particularly where the authorities concerned have approved investments which they could use instead. This presumably has helped to bring about the fall in investments which we have seen.

Finally, as you also say, the effect of local authority deposits on the Bank of England's ability to operate monetary policy is less of a concern to you than it was last year.



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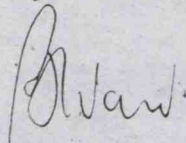
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Against that background, I am not convinced that there we need to change our policy of controlling the net indebtedness of local authorities. We have frequently reiterated that policy, which was developed and agreed by E(LF) for a very good reason, namely that it would be difficult to operate an effective system of compulsory debt redemption which did not force local authorities into inefficient management of their finances.

However, I do agree that it would be undesirable for local authorities to take the opportunity to hold monies set aside for debt redemption, even in approved investments, indefinitely. That is why I thought it would be sensible to develop a code of practice to cover this, as Norman Lamont suggested in his letter to me last September. I know that we were in the event unable to have such a code written into the legislation, but I still think it offers the best way forward. We should not underestimate the prospect of a voluntary code being successful. We have the precedent of the code on debt maturity periods, which was developed in the 1970s and which has subsequently led to the steady increase in the average maturity of local authority borrowing which it was intended to achieve.

I believe a code of practice is a better solution than a change in the capital finance system. And given the lack of a legislative vehicle at present, may be the only way forward. My officials wrote to yours with a draft outline for a paper proposing a voluntary code last October. I hope that on reflection you agree that the best course would be to ask our officials to take that work forward.

Yours sincerely



CHRIS PATTEN

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

