CONFIDENTIAL

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PRIME MINISTER

Local Government Finance Studies
E(LF)(85)4, 5 and 6

BACKGROUND

At the last meeting of the Committee in May, Environment Ministers explained why the existing system of local government finance could not continue, and outlined a possible new one. This was designed to require less central Government involvement in local government affairs, and to be simpler and more transparent and automatic in its operation. In particular, DOE Ministers proposed a national non-domestic rate and pooled receipts, a simplified grant distribution mechanism, and the replacement of domestic rates with a resident's charge.

2. The Committee saw attractions in the DOE package, but asked to see further exemplifications of the effects of possible changes before reaching firm decisions. They also did not rule out other possibilities than those suggested by Environment Ministers. In particular, the Chancellor advocated the retention of a property tax, and was invited to circulate proposals.

FLAG A

3. The paper by the Secretary of State for the Environment (E(LF)(85)4), together with the attached 'Specification Report', sets out the results of further work. The basic proposals remains unchanged, but some important refinements have been made. In essence Mr Baker now proposes:-

- retention of the proposal for a uniform national non-domestic rate, but with increases index-linked and discretion to local authorities to set a local non-domestic rate of up to 5% of the national rate;

- instead of a new residents' charge alone in place of domestic rates, a combination of a flat-rate residents' charge (payable by all adults) to raise 70% of local revenue; and a property charge on householders, based on floorspace, to raise 30%;

- the new grant regime as proposed before, except that the standard grant element would be calculated as a guaranteed share of a national tax (probably VAT).

FLAG B 4. The paper by the Chancellor of the Exchequer (E(LF)(85)5) argues that local accountability alone will not restrain high spending authorities, and that under the DOE proposals the hard won gains of recent years achieved through rate capping will be lost. He also proposes that a modified property tax should be the domestic local tax.

5. The paper by the Secretary of State for Education and Science FLAG C (E(LF)(85)6) again argues for greater Government influence over local authorities in order to secure the achievement of national policies. He argues for a system based on the central Government grant being hypothecated to individual services, supplemented by specific grants.

MAIN ISSUES

6. There are major issues of procedure as well as substance. Although you will wish to reach agreement on as much of the reform package as possible now, so that the Department can proceed to the preparation of a Green Paper envisaged for the turn of the year, further work and discussion will be necessary on important aspects. You will also need to relate the effect and timing of these changes to the reforms planned for social security and personal taxation.

7. Messrs Baker and Waldegrave will open the meeting with a further slide presentation. It will be clear that virtually all their proposals are informed by the thrust towards disengaging central government and

establishing automatic systems instead, and towards putting the control of local expenditure on the local elector. In considering the balance of the package the Committee will need to come to a view on the relative importance of the proposals, and whether they are all cumulatively necessary to achieve the radical reform that is being sought. With that in mind, you may wish to structure the subsequent discussion to cover:

AGENDA.

(i) Whether the 'local accountability' thrust of the DOE proposals will provide effective control over Local Government expenditure;

(ii) On non-domestic rates: – Ind. / Commercial.

- whether a national non-domestic rate, with a pooled yield, is acceptable;

- whether it should be indexed linked or index capped;

- whether there should be local discretion to levy 5 per cent of the rate;

(iii) On the central government grant:

- whether it should be paid to authorities as a fixed (lump) sum;

- whether the standard grant should be calculated as a guaranteed share of a national tax (eg VAT);

- whether there should be hypothecation to particular services;

(iv) On alternatives to domestic rates:

- whether a residents' charge is an acceptable local tax;

- if so, whether a combination of this and a floor-space based property charge is acceptable;

- or whether a modified property tax based on capital value (as proposed by the Chancellor) would be preferable.

(v) the effect of the package as a whole on households, according to area, size and financial circumstances, taken in conjunction with the social security and taxation reforms that are also planned.

Subsidiary matters, including capital control, fees and charges, annual elections and the budgeting framework, can be held over for a future meeting.

Control over Local Government Expenditure

7. The Committee were concerned that any new system should not allow local government spending to increase. The present Rate Support Grant (RSG) distribution system imposes pressure to moderate spending by progressively withdrawing exchequer grant as expenditure rises. This has been largely ineffective in the case of the notorious high spenders, and rate capping was introduced to restrain them.

8. Under the DOE proposals the main pressure towards moderation would come from greater accountability to the local electorate. The Government grant would be fixed, irrespective of spending levels. Consequently the cost of spending above (or the benefits of spending below) a standard level would fall locally. Hitherto much of the burden has been born by non-domestic ratepayers, but a vital part of the DOE package is that local authorities would no longer be able to raise revenue from business without limit. Domestic taxpayers would therefore bear the bulk of any additional cost. Furthermore, if rates were replaced or supplemented by a residents' charge, all electors would have a direct financial interest. (Under the Social Security Reform proposals, even

those receiving Supplementary Benefit would still pay a proportion of the charge.) Since domestic taxpayers contribute 15 per cent of local revenue, a 5 per cent increase in spending would on average produce a 30-35 per cent increase in the residents' charge. This is, however, less than the highest rate of grant withdrawal under the target system used until recently.

9. Ministers will need to consider whether they can prudently rely on this mechanism. The Chancellor of the Exchequer is strongly opposed. He suggests that Government should retain the power to withhold grant from high-spending authorities, and to cap individual authorities expenditure. This would give greater control, but would continue two of the difficulties of the present system: Government would remain involved in conflict with local government, and local councillors would continue to try to attribute at least part of the blame for rate rises or service cuts to the Government.

10. The Committee will need to reach a view on the extent to which the advantages of disengagement and simplicity are sufficient to outweigh the risk that greater local accountability will not restrain high spending authorities.

Non-domestic rate

11. DOE propose that the Government should establish a single national non-domestic rate poundage, with the yield pooled and re-distributed on a per-capita basis. In previous discussion the Committee were concerned that a national rate poundage at the current average would involve many businesses paying more than at present, even though many others would pay less. DOE's figures suggest that, although many businesses would pay more, the amounts are much less than the significant reductions that the small proportion of businesses in very highly rated areas would secure. They therefore stick to their original concept. On the other hand, under the proposal the losers will outnumber gainers.

12. I understand the CBI are likely to accept the proposal in principle. They shared the concern expressed by some members of the Committee that a future Government might use the national rate to increase significantly taxation on business and suggested that this risk could be minimised by a statutory provision indexing the annual increase in the rate poundage to the forecast growth in GDP. To amend such a provision would require primary legislation. Treasury Ministers will wish to comment on the principle of statutory indexation of taxes.

13. DOE also now propose that the national rate should be set 5 per cent below the present average, and that local authorities should have power to raise a 5 per cent levy locally. The objective is to maintain a direct link between business and the local authority. It would also soften the effect of national policy on the authorities with high non-domestic rateable values - essentially the cities. The Committee will wish to consider whether this token link between business and the local authority, and mitigation of the cities problem, is worth the slight complexity it would add to the regime.

The Exchequer Grant

14. DOE retain their recommendation for a new lump sum block grant. This would compromise two parts: a needs related element, so that the same standard of service would result in the same local tax bill in all parts of the country; and a standard per capita grant. Under this scheme, the 'resource equalisation' element of the existing RSG would be removed. Resource equalisation keeps down rate bills in areas with low rateable values; effectively the north of England benefits at the expense of the South. The removal of this cross-subsidy, together with the pooling of the non-domestic rate, is responsible for the pattern of gains and loses between areas. Table 11 of the DOE specification report (following page 25) shows that the South East, South West, West Midlands and East Anglia gain at the expense of the North and Yorkshire and Humberside. The extent of the present cross-subsidy is not transparent and not therefore widely appreciated; but proposals for its removal, accentuating the perceived North-South divide, would obviously be

controversial once the point is exposed for fuller discussion.

15. The following technical point should also be borne in mind. If domestic rates are replaced by a residents' charge, resource equalisation would necessarily end because no one adult has any inherent greater taxable capacity than any other. If a property tax based on variable values were retained, resource equalisation could be kept, dropped or adjusted as the Government wished.

16. At the last meeting, DOE Ministers envisaged that in addition to the basic grant there might need to be an additional grant for city areas, on the grounds that they face exceptional needs, which are not adequately reflected in the basic methodology. They now believe, however, that the needs assessments could be made sufficiently robust to reflect the particular circumstances of inner city areas in the basic system. Moreover, if authorities are allowed to retain up to 5 per cent of the yield of non-domestic rates this will favour cities and so reduce the need for an exceptional grant.

17. There is an important new proposal in this area. DOE suggest that the per capita grant in support of local spending should be a prescribed proportion of a national tax (eg VAT). This would establish the grant each year by automatic formula rather than political decision, and explicitly link the resources available to local government with economic prosperity. There are, however, fundamental objections to the hypothecation of any tax to particular services. Treasury Ministers will no doubt emphasise the need for Government to be able to take decisions annually in the light of competing priorities for public expenditure: it is unlikely to be acceptable to them that a significant proportion of central Government expenditure should be pre-determined. Moreover, there are particular problems about the selection of VAT in the revenue source. VAT is buoyant and Treasury Ministers will argue that it should be no part of the Government message that local authorities will be allowed to increase expenditure in line with any growth in consumer spending.

Hypothication of Grant to Services

18. The Education Secretary argues for greater influence in securing national policy objectives by hypothicating the education element of the exchequer grant on the basis of a separate needs assessment for education. He would set the grant and be accountable to Parliament. This would be a significant step towards centralisation (on top of the "nationalisation" of non domestic rates), and would make local authorities closer to being agents of central Government. The Committee will wish to consider the principles involved which apply to services other than education.

The Local Domestic Tax

19. All the proposals for replacing domestic rates are compatible with the other elements in the DOE package and, to that extent, the issue is free standing. It is however crucial in determining the gainers and losers within local authority areas (the point now at issue with the abandoment of resource equalisation). At its last meeting the Committee saw attractions in the proposal to replace domestic rates by a residents' tax. This would widen the tax base to all adults, and go as far as possible in emphasising to the electorate the link between services and the cost of providing them. There were, however, concerns that such a tax would be too regressive. A graduated residents' tax, which would be less regressive, was rejected as coming too close to a local income tax and involving the same objections.

20. Some Ministers saw attraction in combining a residents' charge with some other source of local revenue so that the whole burden would not fall on the former. DOE now propose that there should be a combination of personal and property taxes, with 70 per cent of revenue being raised by a residents' charge and 30 per cent from a reformed property tax based on floor space. A dual arrangement of this kind would be less regressive than a residents' charge alone and would also enable a phased introduction over a period. However, these advantages

might be bought at the cost of incurring the long term administrative burden (and, perhaps, the unpopularity) of both taxing systems rather than one alone, as well as the administrative and political turbulence of the actual period of introduction. Although DOE soundings so far indicate that a residents' charge could be administered without too much difficulty, this is by no means certain and there could be serious problems of enforcement and evasion.

21. The Chancellor of the Exchequer opposes the DOE proposal. He fears that there would still be too many losers under the DOE scheme and that local authority spending would go up during the introductory period. He favours a property tax as the sole domestic tax, based on capital rather than rental valuations, and with other modifications to meet criticisms of the present system. One of these is a suggested occupancy relief for eg single occupiers aged over 60. A system of this kind (explored in detail in the Revenue study) seems administratively feasible. But you will wish to consider wiether it would appear sufficiently different from the present discredited rating system, and the fact that it would not significantly widen the tax base to involve more local electors.

22. Clearly any option chosen will require much more work on the details. But if the target of a Green Paper at the turn of the year is to be met, it is important for the Committee at this stage to focus on the basic underlying issues, and, if possible, reach strategic decisions on which the necessary further work can be based. I suggest, therefore, that you try to get the Committee to indicate a view whether the new tax should be:

(i) property based

(ii) people based, or

(iii) a combination of the two in some proportion.

The main considerations that bear on this are:

(a) Should there be a link with ability to pay?

(b) The width of the tax base

(c) The number of gainers and losers, and the sums involved

(d) The complexity and cost of long term administration and enforcement

(e) The administrative and political turbulence of introduction.

The last three points represent just those detailed questions on which further work would be needed before a Green Paper; but the broad picture should be clear enough for decisions in principle now.

The Effects of the Package as a Whole: Relationship with other Policy Developments

23. Table 10 of the DOE Report (following page 24) shows the number of gainers and losers of the DOE package according to Region. These show that there are more gainers than losers (although this reflects in part the achievements of rate capping which the proposed reforms will abolish). A majority of the changes are less than £2 per household per week (some £100 a year). Some regions suffer disportionately, for reasons explained above: over a quarter of the households in the Northern region will lose between £100 and £260 a year (although transitional arrangements will phase this over three years). Some households - 2 per cent of these with three or more adults - will lose over £520 a year. The Committee will wish to judge the political acceptability of such changes. The Treasury believe a package based on a modified property tax would reduce the number of extreme gains and loses.

24. However, before any final judgements are made on the local authority changes, their effects need to be considered together with those for major changes in social security and personal taxation. The figures in the DOE report assume that the social security changes have

already been implemented. But, so far as I understand, there has been no assessment of the combined effects of the three changes on particular households or on the economy generally. On the face of it, there are a number of proposals pulling in conflicting directions. For example:

- the low income gainers under the DOE proposals will tend to be single person households, whereas the Social Security Green Paper makes the case for directing more help to families with children;

- the DOE proposals will significantly increase the housing benefit caseload, whereas the Social Security proposals are designed to reduce the scope of the housing benefit scheme.

25. There is therefore a risk that when the details are exposed the Government will appear to be presenting conflicting proposals, particularly as (on present plans) the local authority Green Paper would emerge at the turn of the year when the Social Security legislation is being processed through the House. I understand that Mr Fowler is unlikely to be able to circulate a paper for discussion on the outcome of the Social Security Green Paper consultations until immediately after the Party Conference. This will make the timing very tight indeed if legislation is to be introduced in time to make an April 1987 start possible. But in view of the interlocking problems of substance and presentation referred to above, you may think it prudent to ensure that Ministers have an opportunity to consider the combined effects of these important reforms in local and national domestic taxation and income support before final decisions are taken. The Treasury might be asked to arrange for this to be done in consultation with DOE and DHSS.

Next Steps on Local Authority Finance

26. Environment Ministers envisage publication of a Green Paper at the turn of the year. This would allow time for the remaining elements (eg capital controls) to be examined at a future meeting of the Committee, and also for further work on the domestic local tax. Decisions

could then be made by the end of 1986. On this basis, legislation would not seem feasible before the next election, although it would be possible to give a full description of the Government's proposals, perhaps supported by a Bill in draft. You may wish to have a preliminary discussion of these issues now, bearing in mind the "read across" to the social security and personal taxation proposals discussed above. But it does not seem necessary to take firm decisions now, except on the approximate timing of the Green Paper.

HANDLING

MEETING

27. You will wish to invite the Environment Secretary and Mr Waldegrave to introduce their proposals with a slide presentation. (They have been asked not to exceed 45 minutes=. You may wish to structure the subsequent discussion:

(i) local accountability vs central control

(ii) elements of the DOE package

(a) non-domestic rates

(b) central Government grant

(c) domestic local tax

(iii) relationship to related proposals and next steps.

All Ministers will wish to contribute, especially the Chancellor of the Exchequer on the control of public expenditure and on the modified property tax and the Education Secretary on the central Government grant. The Chancellor of the Duchy of Lancaster will wish to comment on the presentational aspects, and particularly on the acceptability on the redistribution effects. The Scottish Secretary and Mr Wyn Roberts (deputising for the Welsh Secretary) will have views on the implications for their territories.

CONCLUSIONS

28. Subject to the need to be able to assess the combined effects on the economy and on households of the local authority, social security and personal taxation proposals, and to consider the timing and presentation of changes in the light of this, you will wish to reach decisions at this stage on the following local authority finance points:

(a) General

(i) whether the Government should retain direct controls over individual local authorities' spending through grant control and rate capping;

(ii) whether the DOE package taken as a whole strikes the right balance between local accountability and centralisation;

(b) Non-domestic Rates

(iii) whether non-domestic rates should be set nationally, with yield pooled and distributed per-capita;

(iv) whether the annual increase in non-domestic rate should be linked to (or alternatively constrained by) the GDP deflator;

(v) whether local authorities should be empowered to raise up to an additional 5% of the non-domestic rate and retain the yield;

(c) Government Grant

(vi) whether the proposed regime of needs and standard grant, with the abandonment of resource equalisation, is acceptable;

(vii) whether the quantum of the standard grant should be determined by hypothecating a proportion of the yield of a national tax eg VAT;

(viii) whether any further consideration should be given to the hypothecation of the grant to individual services;

(d) The domestic local tax

(ix) what options for the domestic local tax should be considered further ie whether there should be a single or dual tax and whether it should be property based.

(e) Next steps

(x) to invite DOE, the Treasury, and other Departments to review specific grants;

(xi) to invite DOE to present proposals on capital controls and other outstanding issues (eg annual elections) during the autumn, and

(xii) to confirm the intention to publish a Green Paper about the turn of the year.

J B UNWIN

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Cabinet Office