PRIME MINISTER 2 October 1985

REFORM OF LOCAL GOVERNMENT FINANCE

The main purpose of the meeting is to decide two issues that need to be settled before any further progress can be made:

i. Should each spending department control grant for each service, with a large proportion of specific grants, as Keith Joseph suggests?

ii. What method should be adopted for reducing the severity of the regional gains and losses?

Separate Service Grants and Specific Grants

We still believe that it would be wrong to give individual spending departments control over grants:

- It would intensify pressure for higher central government spending, since the Treasury would have to conduct bilaterals with each department, rather than concentrating on a single discussion with DoE.

- It would antagonise local authorities, since they would regard it as 'centralist'.

- It would probably be ineffective in practice, since local authorities could still use grant given by one Minister to fund some other service.

- Insofar as it was effective, it would give more power to DES - who have probably done even more damage to education, over the years, than most local authorities.

DES do not in fact expect E(LF) to approve separate service grants. **They are raising this extreme proposal only as a means of obtaining approval for their second, more moderate, suggestion that specific grants should be increased.**

We are sceptical about this, too:

- It is not clear what DES would spend the money on. Do they really have urgent projects that merit special funding? If so, why have they devoted £1m of the £30m specific grants which they already administer to 'ethnic minority projects'?

- Although specific grants can sometimes be useful as a means of introducing welcome structural changes, they can also be used by subsequent governments to produce not-so-welcome changes: once the power is there, it can easily be abused.

- There was a tremendous fuss when the DES reserved a small amount of money for its Education Support Grants. There would be a much larger fuss if a substantial amount were reserved.

This issue is, in fact, a red-herring. It has no real connection with the reform of local finance, and is a symptom of Keith's understandable frustration at the slow speed of change, combined with the general DES tendency to use any occasion as a means of increasing Elizabeth House's power.

Regional Gains and Losses

At the last meeting of E(LF), Ministers were unhappy about the number and severity of the regional gains and losses. These accounted for over half the losses caused by the entire package.

Ken Baker proposes to remedy this by constructing an explicit 'safety net subsidy' - in effect reinventing domestic rate relief - for those Local Authorities whose domestic taxes would rise sharply as a result of centralising the non-domestic rate.

DoE are asking for an additional £600m p.a. from the Treasury to fund the grant. But this is a try-on, which should be speedily rejected.

The grant could eliminate all the domestic losses due to regional shifts, without any additional funds, merely by transferring money from the South-East to the North-West. (Remaining losses would be due to the change from rates to a new domestic tax - which will be discussed at the next meeting of E(LF).)

If you want to reach a quick agreement, this option - once the extra £600m is removed - looks sensible, and is certainly better than the other two possibilities raised and rejected by DoE.

But we still prefer our original proposal to cap non-domestic rates instead of centralising them, using resource-equalisation and special London arrangements to offset regional disparities.

This possibility is slightly more difficult to set up than the DoE safety net subsidy. But it offers three major advantages:

1. Instead of a centralised non-domestic rate, with heavy losses for small job-creating businesses in the South-East, (and complex transitional arrangements), there would be a simple guarantee that business rates never rose by more than, say, RPI. There would be absolutely no business losers. And local authorities with high business rates could be brought gradually downwards by restricting them to rises of only RPI - 1% or even RPI - 2%. (This is a slightly amended form of Ken Baker's Option 1.)

2. Ken Baker's review after three years would give councils a splendid opportunity to ask for more grant; whereas our proposal would need no such review.

3. Instead of a new grant from DoE, the capping proposal would involve resource-equalisation between authorities. As you have seen, local councillors in Westminster understand that resource-equalisation actually costs them money; whereas a grant is regarded by all councillors as 'somebody else's money', and this generates constant pressure for more 'generous' settlements.

Timetable

We agree with Ken Baker that the Green Paper should not be produced until the turn of the year (to avoid hasty drafting errors), with a preliminary statement before the 2nd Reading of Norman Fowler's Social Security Bill.

But there are two caveats:

1. The terms of the Statement will have to be carefully prepared. Sloppiness might cause almost as much trouble as a hasty Green Paper.

2. The Statement will need to explain, at least in outline, how the E(LF) reforms and the social security proposals reinforce one another.

Conclusion

We recommend that you should:

- reject the DES proposals for individual service grants and increased specific grants;

- press for the capping of the non-domestic rate with resource-equalisation, special London arrangements, and a tougher regime for authorities with high business rates;

- agree to Ken Baker's 'safety net grant' as a second-best if necessary;

- agree to a Green Paper at the turn of the year with a preliminary Statement before the social security Second Reading;

- insist that the Statement should be carefully prepared, and should include an outline of the relation between the two sets of reforms.

DLW

for OLIVER LETWIN