

Prime Minister
I found the
decision chart on the



Handwritten mark

PRIME MINISTER
very last page helpful. *DLW 11/11*

E(LF)(85)5th Meeting: The Local Domestic Tax
(E(LF)(85)15, 16, 17 and 18: Letter of 30 September from the
Home Secretary to the Secretary of State for the Environment and
Reply of 2 October)

BACKGROUND

*Orders -
Sketched?*

1. The Committee have reached a number of provisional conclusions about the proposal for local government finance reform. The rationale is to increase local accountability, particularly by ensuring that the cost of marginal spending by local authorities falls on the electorate. To this end, the Committee have agreed that local authorities should lose the power to tax business and commerce directly: a non-domestic rate will be set nationally, with a pooled yield distributed to authorities on a per-capita basis. There will be a new fixed, lump sum grant to each authority, comprising a 'needs' element and a 'standard' element. There will also be a 'safety net' grant to ensure that these changes do not at the outset result in any re-distribution of resources between local authorities. Last week, under the Chairmanship of the Lord President, the Committee also reached a number of decisions on less central issues, including the system for controlling capital expenditure.

2. The main element of the package requiring further consideration is the tax which is to replace domestic rates. The original proposal was for a residents' charge payable by all adults. This would avoid the perceived unfairness of the rating system and widen the tax base from occupiers to all electors. In the second specification report Environment Ministers modified the proposal slightly in order to eliminate the extreme distributional effects, and proposed a combined charge with two elements: 70 per cent to be raised from a residents' charge and 30 per cent from a property tax.



CONFIDENTIAL

3. The Committee had a preliminary discussion of this proposal in September (E(LF)(85)2nd Meeting). Subject to further work, they accepted that the local tax might be a combination charge as suggested. The basis of the property element was not decided, although a system based on capital values was ruled out.

4. The following papers are now before the Committee:

(i) E(LF)(85)15 by the Environment Secretary sets out the distributional effects of a combined residents' and property charge;

(ii) E(LF)(85)18 by the Scottish Secretary raises a number of Scottish issues, and in particular argues against retaining any property element in the local domestic charge, and for changes in the way the commercial rateable values are set;

(iii) E(LF)(85)17 by the Welsh Secretary proposes transitional arrangements for introducing the domestic local charge;

(iv) E(LF)(85)18 by the Environment Secretary sets out proposals for the valuation basis of the property element, and on the non-domestic revaluation;

(v) An exchange of letters between the Home Secretary and Environment Secretary about the practical difficulties of enforcing a residents' charge.

5. The intention is to publish a Green Paper at the turn of the year, and before the second reading of the Social Security Bill towards the end of January. Since the timetable is tight, it is important for the Committee to reach decisions on these outstanding issues as quickly as possible so that DoE may begin drafting.

MAIN ISSUES

6. The main issues are:

- (i) should the main burden of the new domestic charge be placed on a residents' charge?
- (ii) should a property element be retained, either indefinitely on ground of principle or as a transitional arrangement?
- (iii) if a combined charge is adopted what proportion should be raised from the property element, initially and finally?
- (iv) what should be the basis for a property element.
- (v) when should non-domestic revaluation be announced?

The DoE Proposal

7. DoE proposed in the Second Specification Report (E(LF)(85)4) that the flat-rate residents' charge should raise 70 per cent and the property charge 30 per cent of domestic tax revenue in each authority. This reflects the notional split between local authority services which benefit people only and those which benefit both property and people. All adults would be required to register with and pay a residents' charge to the authority where they have their main or only residence. Ideally a separate bill would go to each adult, with the householder's bill including the property charge element. Husbands and wives would be jointly and severally liable for payment of the charge.

2nd home?

8. In order to avoid the particular problem of registering and collecting a charge from mobile groups and those resident in institutions, DoE propose a 'collective charge' based on bed space in hostels, hotels or institutions. The precise details remain to be settled.

The Principle of the Local Charge

9 There is a fundamental problem that if local accountability is to be effective the consequences of excessive spending must be painful for the electorate. Moreover, if the tax base is to be expanded, some people will have to pay who have not done so before. The local charge will therefore almost by definition have to be unpopular, at least in high spending areas. The Committee will have to assess the proposals with this in mind.

10. The DoE proposal raises issues of both practicality and principle. A requirement for all adults to register with the local authority on arrival in an area may be criticised as an encroachment on civil liberties, and considerable extra administration (costing perhaps £30 million a year) will be needed. The Home Secretary's letter of 30 September raises problems about the enforcement of a residents' charge, particularly in the inner cities. He points out the difficulty of checking whether householders declare all the individuals in their households. There will be a considerable incentive to avoid registration - particularly if the tax is painful - and experience with for example TV licences is not encouraging. In addition, there will be difficulties in enforcing payment, where the courts may be reluctant to impose penalties commensurate with the benefits of evasion. The need for effective enforcement measures carries out the risk of further alienating parts of the Community.

11. The Environment Secretary, however, believes that these problems are overstated, and in particular that the proposed 'Community Charge' will avoid the problem of registration and collection for the most difficult categories. But the Committee will wish to satisfy themselves that his confidence is well founded. It might be possible to devise practicable alternatives such as having no register but placing a duty on each householder to declare how many adults are resident with him.



CONFIDENTIAL

12. If it is accepted that a residents' charge is a practicable tax, the Committee will need to consider whether a combined property and residents charge is acceptable in political terms. Their preliminary conclusion was that it would be, particularly if presented as a single tax. But the Scottish Secretary again argues that any element of property taxation in the combined charge would be unacceptable in Scotland.

13. The property element was re-introduced to remove the more extreme distributional effects, and to counteract to some extent the perceived regressiveness of a pure residents' charge. Since then, the Committee has decided to introduce a safety net grant which removes the redistributional effects between areas, and so reduces to some extent the extreme effects of the package as a whole. The Committee may therefore wish to re-assess whether a residents' charge alone might be acceptable.

14. If the Committee confirm their earlier view and decide to retain a property element, it must be clear whether this is to be presented purely as a transitional arrangement designed to reduce turbulence, or because the Government believe that as a matter of principle part of the local tax should be based on property. The thrust of the Green Paper will be different in each case. It will also be necessary to consider whether it would be practical to have different systems operating in England and Wales and in Scotland.

The Mix of the Local Charge: distributional implications

15. If it is decided that there should be a combined charge, the Committee will need to decide the appropriate proportions. The DoE proposal is that the charge should be split 50:50 in the first year, moving to 70 residents' charge: 30 property tax after a three year transitional period. The exemplifications contained in E(LF)(85)15 demonstrate the effect of both regimes. In summary the effects of the package now are:



CONFIDENTIAL

- there is no particularly strong regional pattern, although Greater London is, as always, exceptional, with a larger number of losers of between £2 and £5 per week;

- with a 50:50 split there are almost exactly equal numbers of gainers and losers - the vast majority of people gain or lose by no more than £2 per week, and apart from 1 per cent of Londoners, nobody loses by more than £5 per week;

- with a 70:30 split, while the majority of people still see a change of less than £2 per week, slightly more people see more extreme gains or losses. 200,000 households would lose between £100 and £250 per year.

16. The majority (88 per cent) of the big losers are single adults aged 18-24: they have not so far paid rates, but would pay the residents' charge. The big gainers would be single pensioners and single adults in their own households. Two-thirds of them are either pensioners or unemployed.

17. You will remember that at the Sub-Committee meeting on 23 September you drew attention to the need to consider these local government proposals alongside the reform of social security so that the combined effects could be assessed. As the Environment Secretary points out, the general thrust of the two exercises is in opposite directions. In particular the low income gainers under the present proposals tend to be single person households, while the social security review directs help away from them. In general, therefore, the two exercises balance each other out, and the severest effect of the local government proposals is now confined to a very small number of people. But I suggest that it would be prudent to check with the Social Services Secretary that there is only a negligible possibility of vulnerable groups attracting both the most severe effects of the social security review and of the present proposals.

18. The Environment Secretary's paper also brings out the problem with housing benefit of which you are already aware. In essence, the social security reforms (through the 20 per cent provision) will streamline housing benefit and sweep large numbers of cases off the housing benefit caseload, while the local government reforms will inevitably have the reverse effect. The effect of the social security legislation on housing benefit will be felt in April 1988, and, depending on your precise decisions on timing, the present proposals will follow within the next couple of years. All this will require very careful presentation, bearing in mind that the local government finance Green Paper will need to appear in time for Second Reading of the Social Security Bill at the end of January.

19. The DoE assessment is that the proposals will have negligible effects on marginal tax rates and replacement ratios, although there will be a slight reduction in the incentives for young adults to take work.

20. The Committee will need to consider whether they can accept the pattern of gainers and losers implied by the 70:30 split which is DoEs proposal. To the extent that this position is reached only after a transitional period, the gains or losses will appear only gradually. If not, would 50:50 be acceptable as the permanent split? If not even this is acceptable, the Committee are effectively driven back to retaining rates in their existing form, although perhaps with a system of rebates and surcharges related to occupancy in order to mitigate the worst perceived unfairness.

21. The Welsh Secretary has set out (in E(LF)(85)17) proposals which would enable a residents' charge element to be phased in gradually. In summary, the residents' charge would start at, say, £50 in the first year (assuming the authority budgeted in line with the Government's expenditure plans), with an equivalent reduction in rates. The rates element would then be frozen, so that all



CONFIDENTIAL

subsequent increases in the local domestic charge (through inflation or excessive spending) will fall on the residents' charge element. The initial turbulence of such a scheme would be less, but it would be compatible with any final scheme. If the Committee is attracted by this transitional arrangement, the Environment Secretary might be asked to consider it further.

The Valuation Base for the Property Tax

22. The Committee have already decided that a system based on capital values is not acceptable. DoE had originally proposed floor space as the basis for the tax, on the grounds that it is objective and once measured does not require periodic revaluation.

23. But they have now moved away from that proposal, because it is clear that a switch from the existing system to one based on floor space would involve significant re-distribution. Moreover it is not clear that floor space is necessarily a better indicator of the amenity of a property than its rateable value. (DoE believe that similar arguments apply to cubic capacity; moreover there is no easy way of measuring the volume of irregular properties).

24. The Environment Secretary therefore proposes that annual rental values should remain the basis for valuation. The Valuation Register is now 12 years out of date, but any general re-valuation would cause considerable upheaval. He therefore proposes that there should be no revaluation, and that 1973 should continue to be the basis in perpetuity. He does propose, however, that whenever ownership of a property changes any anomalies in rateable values through physical changes should be removed. So while changes in the housing market would have no effect, the installation of central heating or the building of an extension would result in an increase in rental value for the next owner.

*A minor point!
DoE have
confirmed
that central
heating does
not count.*

25. To the extent that the combined charge would place less weight on the rates element, it becomes less important to remove all the unfairness in the present rates system. The Committee will need to balance the continuation of some unfairness against the consequences of a general revaluation. The proposal that physical changes should only be taken into account on change of occupation, will ensure that no existing occupier has a disincentive to improve his house, while ensuring that eventually rental values reflect the actual state of the property.

Non-Domestic Revaluation

26. The Government have already announced their intention to set in train the work required for a non-domestic revaluation. Since there is no proposal to replace non-domestic rates, a revaluation cannot be postponed indefinitely. There are strong arguments that the new valuations should come into effect at the same time as the reform package. The advice from the Valuation Office is that in order to have new valuation lists available by April 1989 (which DoE regard as the earliest realistic date for implementing the rates reform) it is necessary to announce the intention to compile a new list before Christmas. If the option of implementation in 1989 is to be kept open, the Committee will therefore need to agree to the announcement being made.

27. The Scottish Secretary proposes in his paper that in order to ease the burden of rates on smaller businesses rating valuation should take some account of turnover. He has in mind particularly the problem faced by smaller businesses. This would introduce an entirely new element into rating policy, and the effect would be to penalise those businesses which can achieve a high turnover out of a given retail site. In addition there are accountancy problems that will need to be addressed: why turnover rather than profit, and how is turnover to be assessed where a business operates on more than one site? The Scottish Secretary recognises that more work would be needed to elaborate a system, but at this stage the Committee might decide whether this proposal is worth considering further.



The Green Paper

28. The Welsh Secretary has stated his preference for a separate consultation document for Wales, while the Scottish Secretary favour a single Green Paper for Great Britain. To a large extent this issue turns on the questions of substance referred to earlier. If Scotland and England are to have fundamentally different systems, with a property element retained in one but not in the other, it will be difficult, though not impossible, to present intellectually compelling arguments for different solutions in a single document. Ultimately the argument turns on presentation rather than policy, and the Committee will wish to approach it in this light. On the whole, if Scotland is to pursue a separate course, a separate Green Paper would seem preferable, particularly given the Welsh Secretary's preference for a separate one for Wales.

Next Steps

29. The intention is to publish the Green Paper before the second reading of the Social Security Bill, ie in mid-January. Since the draft will need to be considered both in E(LF) and Cabinet, drafting will have to be set in hand shortly. DoE will therefore need guidance on as many issues of principle as possible at this stage, although if further work is necessary it should be possible to convene another meeting of the Committee towards the end of November to resolve final points.

HANDLING

30. You may wish to divide the meeting into the following three main sections:

(i) issues related to the local community charge, including the principles, practicalities, distributional effects, transitional arrangements etc;

(ii) issues related to the basis for valuation of property taxes, and also the timing of the non-domestic revaluation;

(iii) timetable, presentaion and next steps.

In steering the Committee through (i) and (ii) I thought that you might find the chart annexed helpful. This shows (in summary form) the key issues for decision and the logical relationship between them. The Committee will need to work through the issues in the order shown.

31. You will wish to ask the Secretary of State for the Environment to introduce his latest proposals for the community charge and the Scottish Secretary to explain his arguments for a tax based entirely on the residents' charge. The Secretary of State for Wales will wish to explain his proposals for a transitional arrangement, which would be compatible both with the Environment Secretary and the Scottish Secretary's proposals. The Home Secretary will wish to discuss enforcement issues. All other Ministers will have views, particularly the Chief Secretary on the distributional effects, the Social Services Secretary on the relationship with his review, and the Employment Secretary on the effect on incentives to work.

32. On the basis for the property element, and the timing of the non-domestic revaluation, you will wish to ask the Environment Secretary to introduce his proposals. The Chief Secretary will wish to comment.

33. The Environment Secretary will wish to speak to the issues of timetable, presentation, and next steps.

CONCLUSIONS

34 You will wish to reach the following decisions:

The local domestic charge

(i) to confirm that a residents' charge is acceptable in principle and in practice;



CONFIDENTIAL

(ii) on whether the community charge should comprise both a property and person based element;

(iii) on whether in Scotland the local tax can be the residents' charge alone;

(iv) on whether the inclusion of a property element is to be presented as a transitional arrangement or as justified in principle and therefore as a permanent element;

(v) the appropriate proportions between the property and person based element, both initially and finally;

The property element

(vi) on whether the property element should be based on annual rental values as now;

(vii) on whether 1973 valuations should continue as the basis for the tax;

(viii) on whether revaluations to take account of physical changes should be carried out on change of ownership;

Non-domestic revaluation

(ix) on whether the intention to start the non-domestic revaluation should be announced before Christmas;

(x) on whether further consideration should be given to including turnover in the basis for commercial valuations;



CONFIDENTIAL

Presentation

(xi) on whether there should be separate Green Papers for Scotland and Wales.

J B UNWIN

Cabinet Office

8 November 1985

DECISION CHART

