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PRIME MINISTER

8 November 1985

RATE REFORM

E(LF) has already achieved a great deal. It looks as if the Committee will find a feasible way of protecting non-domestic ratepayers; a much simpler grant system that will bring each extra £1 of council spending to bear on the local inhabitant; and a proper system for controlling capital spending. Once combined with Norman Fowler's Housing Benefit changes and the retention of domestic tax-capping, these changes should yield both a more accountable system and one which satisfies the Chancellor's requirements.

The only remaining major issue is the replacement of domestic rates by another form of taxation.

Almost all your colleagues seem to agree that the pure residence charge would, in principle, be superior to domestic rates. But it is clear that moving directly to a residence charge in England and Wales would produce too many big losers. Kenneth Baker therefore proposes a mixed tax; and Nick Edwardes proposes an even more gradual introduction of the residence element.

Kenneth Baker's figures show that the mixed tax does, indeed, dramatically reduce the number of losers and the amounts that they lose. Nick Edwardes' scheme has not yet

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been fully exemplified; but it would clearly produce even fewer and less severe losses.

But any form of mixed tax has distinct disadvantages:

1. The losses are still electorally dangerous. Even under Kenneth Baker's half-and-half option, 11% of Londoners lose more than £100 a year, and 7.9 million people in England as a whole lose amounts up to £100 a year.
2. However hard the Government tries to describe the tax as a single entity with two elements, the newspapers will still go on describing it as two taxes in place of one.
3. Your opponents will spend a lot of time explaining to everybody how complicated and incomprehensible the new tax is; and many people will be silly enough to believe them.
4. As long as the mixed tax is in place, the great benefit of the residence charge - its simplicity and universality - will be obscured by the continuing presence of the property element.

In other words, you have an apparent dilemma: a sudden move to residence charges in England and Wales is too dangerous; but a gradual transition via the mixed tax is unattractive.

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We believe that George Younger may be offering a way out of this dilemma. He is clearly extremely keen to use Scotland as a trail-blazer for the pure residence charge. Until he presents exemplifications of the effects, and a full description of the first-year safety nets which he would operate, you cannot be sure whether a radical move of this sort would be politically sensible. It has to be remembered that he and the rest of the Scots plunged willingly into the disastrous revaluation; that experience must not be repeated. But if the exemplifications show that the effects of a sudden change would not be as dramatic in Scotland as they would be in England and Wales, then it might be possible to use Scotland as a trail-blazer.

You could make all the changes to grants, non-domestic rates, capital controls and Housing Benefit in England and Wales, but try out the residence charge in a pure form only in Scotland, and leave domestic rates intact for the time being in the rest of the country. This has obvious attractions:

1. No-one can say that you are being insufficiently radical, since you will be curing the disease of the non-domestic rates (which was the worst element of the old system) and trying out an extremely radical system in a significant part of the country.

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2. By the same token, no-one can accuse you of being rash, since you will be reserving your options on domestic rates in England and Wales.
3. If the Scottish experiment worked, it could make a pure residence charge look sensible rather than extreme, and thereby pave the way for its introduction in England and Wales.
4. Although you will have drastically overhauled the finance system, there will be no significant domestic losers.
5. You would probably have a united Cabinet, since the radicals would be able to trumpet the Scottish experiment, and the sceptics would be comforted by the absence of any turbulence on the English domestic front.

We therefore recommend that, if you are not willing to move to a pure residence charge in England and Wales immediately, you should not introduce a mixture of taxes, but should rather use the Scots as a trail-blazer for the real thing - subject to the Scottish exemplifications proving acceptable.

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Domestic Revaluation

The question of domestic revaluation arises if you accept either our suggestion for England and Wales, or the DoE's proposed mixture of taxes.

Kenneth Baker proposes that - to avoid general domestic revaluations - all domestic properties should be revalued on change of occupancy. This would apply either to the property element of the mixed tax, or to the domestic rates if they were retained.

In theory, the proposal is attractive. It would gradually eliminate anomalies, without causing a political storm. But, in practice, it would have a disastrous effect on the housing market. The need for a revaluation between occupancies would put an enormous brake on the speed with which house purchasing was conducted. The process of negotiation would be made more complicated, and there would be a burgeoning of contingent offers and subsequent withdrawals. Mobility, which is already very poor in this country, would be further impeded.

The best thing might be to leave domestic revaluation completely alone. True, there are anomalies. But if you eventually move over to a residence charge - either in a sudden swoop following the success of the Scottish experiment, or by the gradual introduction of a mixed tax -

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the anomalies will be ironed out without the need for any changes in the revaluation system.

We therefore recommend that you should reject Kenneth Baker's theoretically ingenious proposal.

Conclusion

E(LF) is still on the rails. The Fowler changes, the new grant system, the protection of non-domestic ratepayers, and the proper capital control system constitute a radical overhaul of local authority finance which will produce far better results than the present system. Rather than risk ruining this excellent package by moving to what could be a very unpopular mixture of taxes, we suggest that you should:

- leave domestic rates intact in England and Wales for the time being;
- use Scotland as a trail-blazer for the pure residence charge, if the exemplifications prove that this is feasible; and
- avoid all forms of domestic revaluation.

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