10 (a-e)

PRIME MINISTER

COMMUNITY CHARGE

You are meeting Chris Patten tomorrow afternoon for a further discussion. I thought it might be helpful to provide an aide memoire on the ideas being explored and some other possibilities.

There are three basic problems:

- stopping the excessive growth of local authority current expenditure;
- keeping down the level of the Community Charge; and
- ameliorating the perceived unfairness of the Community Charge.

Controlling Local Authority expenditure

The main idea which emerged from last week's discussion was to cash limit each and every Local Authority. Each local authority would face a cash budget limit set by central government. The limits would be defined by formula in relation to SSAs and/or local authorities' preceding year budgets as appropriate.

The key issue is the penalties for exceeding those cash limits. One option would be to make any excess above the limit ultra vires. That would be controversial and needs careful consideration (see below). A second approach would be grant withdrawal. This was the approach of "target and hold-back" tried in the mid-1980s, and eventually discredited because low spenders felt they were nonetheless penalised.

A third approach would be "stick and carrot". This would involve a cash target (set by formula as above for each LA) rather than a cash limit. Those LAs spending above the cash target would risk being capped: and to be effective, such capping would have to be much more extensive and cover many more authorities (50? 100?) than at present. Those LAs which kept to target or below would be rewarded with additional grant. This would be so designed (i.e. paid after budgets declared) so that it could only feed through into lower Community Charges, not higher spending. It would represent an enhancement of local accountability. The focus would be on the extremes - the virtuous and the sinners.

In the long term the cash limit approach may be the most effective way of controlling local authority expenditure. But it would involve a redefinition of the statutory relationship between local authorities' functions, spending powers and their relationship with central government - and some greater control over budget and LAs use of funds (including their large reserves). It seems unlikely that this could be devised in time for implementation in 1991-92.

In the short term, i.e. for next year, the introduction of the cash target, plus stick (capping) and carrot (grant bonuses) may be best. New powers would still have to be taken to enable grant bonuses to be paid to the virtuous, and to impose tough caps on the sinners. But that should be practical within the timescale.

Keeping down the level of the Community Charge

If community charges are to be reduced or even held constant in cash terms, then a greater burden will have to fall upon the general taxpayer next year. That in itself could do something to address the perceived unfairness of the tax.

But such a switch is not enough. Indeed on its own it is dangerous. Unless powerful instruments to curb spending are also employed, local councils can still use the Community Charge as a buoyant source of revenue. Indeed lowering that absolute charge without such safeguards, increases the risk of excessive spending.

Perceived unfairness of the Community Charge

However misjudged or unreasonable the perception of unfairness is, it may now be more important to change that perception than to produce a substantial reduction in the cash level of the

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Charge. Four approaches might be considered:

A. The graduated charge - the so-called Mates proposal. Previous examinations have emphasised the practical difficulties of operating on banded incomes and the undesirability of giving local Councils access to information about people's incomes.

B. Further measures to improve rebates/transitional relief Further work is under way on helping the low to middle income groups by re-examining the scope of the transitional relief scheme and whether its duration might be extended. Improvements to the rebate scheme for those on low incomes are also being examined.

C. A new Community Charge surcharge (your own proposal). This would not be a local tax but a national tax with the yield paid to local government. One option might be to set it at one Community Charge for those on incomes of £50,000 p.a. and two Community Charges for those on incomes of £100,000 and above. The amount would be set according to the national average Community Charge (that would have to take account of the existence of separate and varying national charges in Scotland, England and Wales).

D. Hypothecation of income tax revenue. This would go further than the idea of the surcharge (but could be pursued alongside it). It would be an element of income tax raised to be spent by local government. The product of a particular penny rate would be overtly hypothecated to local government. The yield would be added to the NNDR pool and redistributed on a per capita basis to all authorities. For example, it could be presented as a short-term measure, pending long-term statutory controls over spending which should allow community charges to be limited.

E. 1p per gallon on Petrol

Approach A. has been already considered and rejected. Work on B. is under way. The key question is whether further changes to rebates and reliefs will really change the perception of unfairness or whether something more radical is required.

Your own proposal (C.) would directly attack the perceived unfairness of the new Community Charge regime. The amount raised is uncertain but it may be around £100 million, equivalent to some £3 or so off Community Charges. It would help remove some of the perceived unfairness, though it would not of course help those in the low to middle income group. And it would not address the problem of buoyancy - that, for the short term, authorities may need a source of income, other than the Community Charge.

You may like to consider whether approach D. has some merit. It can be seen as merely repackaging the inevitable cost to taxpayers of putting in more grant (i.e. extra AEF next year). But it would bring home the key point: excluding business rates, LA expenditure has essentially to be financed <u>either</u> by community charge or by higher grant - and that means higher income tax.

Providing a new hypothecated source of income for local authorities, raised on a basis that is seen as fair, would avoid aggravating the concern about the community charge. The charge could be held say level in cash terms next year. Yet it would make it clear to the local electorate that local government, not central government, have imposed higher taxes. If more grant is inevitable to keep charges down next year (and it is), why not make it clear that the cost is recouped in a special higher income tax, rather than higher AEF - where the link to income tax would be obscure.?

And it need not mean higher income tax above what it would otherwise have been. The sources of funds for local government (at least for the short term) would thus be:

i) AEF (including business rates)
ii) hypothecated income tax
iii) community charge.
(iv) 1p per gallon of petrol - excise duty

Further work might now be commissioned on the idea of statutory cash limits on local authority spending and its repercussions for the relationship between central and local government. For the short-term i.e. 1991-92, a possible approach might be:

- cash targets for each LA set by formula; those above targets would face community charge capping ("stick"); those at or below would receive a grant bonus ("carrot") to reduce community charges;

- a community charge surcharge for those on high incomes;

- a new hypothecated income tax, designed to keep down community charges in general next year in a way more generally perceived as "fair".

- local excise duty on petrol.

BHP

BARRY H. POTTER
<u>10 April 1990</u>

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