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PRIME MINISTER

<u>Local Taxation:</u> E(LF)(83)7, 8, 9 and 10.

BACKGROUND

- 1. At its previous two meetings the Sub-Committee invited the Secretary of State for the Environment to arrange for officials to study a scheme of local finance under which increases in rates would be either prohibited or severely controlled but which would equip local authorities with a local tax on expenditure, perhaps in the form of a local sales tax, or some other 'safety valve'. To deal with the period before a new source of local revenue could be put in place, officials were also to study an interim scheme which would either freeze rates or strictly limit increases in them. The Sub-Committee accepted that this might entail an increase in the contribution of the Exchequer to local expenditure; and that the interim scheme (and indeed the long-term scheme) might have to include direct central control of current expenditure by individual local authorities (E(LF)(83)1st and 2nd Meetings).
- 2. The Interdepartmental Group on Local Taxation has carried out the studies required by the Sub-Committee. Its report is circulated with E(LF)(83)7, which sets out the views of the Secretary of State for the Environment.
- 3. The Secretary of State argues that any general scheme of control of the rates or expenditure of individual local authorities, such as those outlined by the interdepartmental group, would be impracticable. It would have to apply to all local authorities, except those to whom the Secretary of State gave a specific derogation. It would therefore carry a risk of legal challenge from a substantial proportion of the 500-odd local authorities in Great Britain. Instead, the Secretary of State recommends that the interimal scheme should be based on selective control over the expenditure of a small number of the highest-spending authorities: the disciplines of the block





grant system and 'holdback' would be relied on to contain rate increases by the generality of local authorities within a tolerable level. (By implication, the Secretary of State endorses the judgement of the interdepartmental group that a limit on rate increases is preferable to a rate freeze).

- 4. For the <u>final scheme</u>, the Secretary of State recommends a permanent ceiling on rates, applying to all local authorities. This requires that an additional source of local revenue should be found: the Secretary of State, in effect, offers a choice between local sales tax (LST) in the form of a single-stage tax with coverage and certain other features based on value added tax (VAT), and a combination of a vehicle excise duty (VED) and road fuel duty (RFD). He suggests that the Government should put forward both possibilities in a consultative document. The final scheme would also include the selective control over the expenditure of the highest-spending authorities recommended for the interim scheme. It would take effect from 1988.
- 5. E(LF)(83)7 also proposes that the package of relatively minor reforms in the rating system recommended by the Ministerial Group on Local Government Organisation and Finance (MISC 79) should be adopted; and that the burden of rates should be removed from empty industrial property. It discusses the problem of devising a new system of Exchequer grant for a situation in which local authorities have more than one source of tax revenue but does not advance definite proposals.

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6. The Secretaries of State for Scotland (E(LF)(83)10) and Wales (E(LF)(83)8) agree that there should be no general scheme to limit the rates. Both draw attention to the success of the Government's existing policies in limiting rate increases (and there is similar material in Annex C to the report of the interdepartmental group). Both support the introduction of a selective scheme of control, although the Secretary of State for Wales suggests that even this may be unnecessary in Wales; the Secretary of State for Scotland, who already has selective powers of control, proposes to take general holdback powers, so as to match the English position.



- 7. For the longer term, both Secretaries of State draw attention to the disadvantages of a scheme based on RFD and VED. They also express scepticism about the acceptability of LST; but the Secretary of State for Scotland explicitly agrees that it should be put forward for public consultation, and the Secretary of State for Wales does not object.
- 8. Finally, the Secretary of State for Scotland proposes some reforms of the Scottish rating system and indicates that he intends to pursue separately some possible changes in Unified Housing Benefit.
- 9. The Chief Secretary, Treasury (E(LF)(83)9) argues for a general, rather than a selective, scheme of limitation on rate increases. For the longer term he doubts the need for a supplementary local tax, though agreeing that the Government should put the possibility forward in public consultation. The amount of any supplementary tax should be limited by central government. On a point of relative detail, he suggests that instead of abolishing rates on empty industrial property, the Government should limit the maximum to 25 per cent of the full rate.

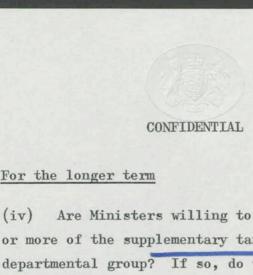
MAIN ISSUES

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10. It will not be possible to deal with all the issues raised by the report of the interdepartmental group; and you will wish to ensure that the Sub-Committee concentrates on the main questions of principle. These are as follows.

For the interim scheme

- (i) If there is to be an interim scheme should it
 - be selective or general?
 - be based on a rate freeze or a limitation of rate increases?
- (ii) Do the benefits of the interim scheme outweigh its advantages?
- (iii) If not, is there a preferable alternative?



(iv) Are Ministers willing to confer on local authorities one or more of the supplementary taxes discussed by the interdepartmental group? If so, do they regard one form of supplementary taxation as clearly preferable? Or would they prefer to leave the decision to follow a further round of public consultations?

(v) How should the Government's position be publicly presented?

(vi) Should the longer term scheme include a limit on the expenditure or taxation of individual local authorities?

Finally, the Sub-Committee will need to consider:

(vii) Should the reforms in the rating system recommended by MISC 79 be endorsed for legislation in the 1983-84 Session?

(viii) Should empty industrial property be exempted from rates?

Interim Scheme

11. In considering the options for a scheme of control of rates or expenditure, the most important criterion is the likely workload. It will simply not be possible to run a scheme in which dozens of disputes have to be fought out - ultimately in the courts - between individual local authorities and Ministers. There are over 500 local authorities in Great Britain. Of course, not all would object to Ministerial decisions under a control scheme; and not all objections would be fought to a finish. You will wish the Sub-Committee to explore this aspect carefully. But at the least it seems



clear that any general scheme of control will have to lie fairly lightly on the average local authority.

- 12. This has the important implication that either permissible rate increases under the scheme or Exchequer grant to local authorities would have to be set fairly high: otherwise too many authorities would ask for derogations. The consequence could well be higher local expenditure than under a severe block grant and holdback scheme (perhaps coupled with selective control of particularly high-spending authorities). In the long run, lower expenditure should lead to lower rates. But, under the holdback scheme, this may well be achieved by grant penalties and therefore, in the short run, higher rates. Ministers may therefore face a choice between -
 - (a) a general scheme to keep down rates if their prime aim is to minimise rate increases in the short run; and
 - (b) reliance on block grant and holdback (perhaps coupled with a selective scheme of control for a few authorities) if their prime aim is to keep down expenditure (which should also keep down rates, eventually, but not necessarily in the short term).

A selective or a general scheme?

13. These considerations are clearly relevant to the choice between a selective and a general scheme. A selective scheme would allow the Government largely to determine its workload; and it is a fact that the bulk of local authority over spending is attributable to a small number of authorities. Moreover, by focusing on a small number of authorities who can reasonably be represented as behaving outrageously, it minimises the political difficulties of central government taking general powers to control the expenditure or rates of individual local authorities. On the other hand it may be argued that the Government is making a major contribution to dealing with the exceptionally high spenders by abolishing the GLC and metropolitan counties. Is a selective scheme of control necessary as well? It may also be argued that a selective scheme is of little relevance to the general problem of rate increases. Many authorities may impose increases in rates that are high, but not so



unreasonably high as to justify intervention by the Government. In such cases, the Government will have to rely on arguments based on its success in controlling inflation and its construction of a grant and holdback system determing excess of expenditure in order to rebut criticisms that it is doing too little to keep the rates down.

A freeze on rates or limitations of increases?

14. A scheme based on a freeze of the rates would multiply applications for derogation and require substantial increases in national taxation. For both these reasons it is unlikely to find favour with the Sub-Committee. You will recall that opinion in the Sub-Committee was already tending strongly in that direction at the last meeting; and all four papers for the present meeting are based on limiting rate increases.

The merits of an interim scheme?

15. Whatever its form, any control system seems likely to have to feature default powers (so that the Government can, in the last resort, take over essential services in defaulting local authorities). There are also the arguments based on 'service policies' (paragraph 4(iii) of the note by the Chairman of the Interdepartmental Group) and the problems of reconciling the responsibilities of Ministers responsible for local government services in England with the fact that, for operational reasons, decisions under any control scheme would have to rest with the Secretary of State for the Environment. The Sub-Committee will wish to consider whether these difficulties outweigh the advantages of whatever control scheme it may favour.

Possible alternatives

16. If the Sub-Committee does not favour any scheme of direct control of the expenditure or rates of individual local authorities, you will wish it to consider possible alternatives. Paragraphs 13 to 15 of E(LF)(83)7 discuss the possibility of requiring authorities wishing to levy what the Government regards as excessive rates to hold a referendum or special election. The recent history of this idea is not encouraging; but it could be argued that it would have more attractions if it were carefully presented.

17. An important difficulty with such ideas is that if those who vote are not the same, or nearly the same, as those who pay local taxation,



referenda or special elections do not meet the point that it is unfair that people should be able to vote for policies towards whose cost they do not contribute. On the other hand, if they are the same, the normal process of accountability through elections should suffice at local, just as it does at national, level.

The longer-term scheme.

18. The essential feature of the longer-term scheme is that it would contain a general limitation on rate increases. This requires that local authorities should have some alternative source of revenue to rates. (The only other possibility is a permanent system of deficit grant from the Exchequer, which hardly seems acceptable). Ministers cannot therefore promise a general limitation on the rates unless they are confident that some form of supplementary local taxation will be acceptable.

Which supplementary tax?

19. The arguments in the papers for rejecting possibilities other than LST, RFD and VED seem persuasive; and the arguments relating to those three taxes are also clearly set out. There are, however, a few additional points which you may wish the Sub-Committee to consider.

(a) Road fuel duty

High local rates of RFD will easily be avoided in metropolitan areas, but not in rural areas. The Government would therefore be attacked on the one hand for pretending to be prepared to allow local authorities the power of decision (at least within limits) over their expenditure while conferring on them a tax which in practice will prevent their using that power; and, on the other, for exposing some sections of the community to heavy taxation on what is a virtual necessity of life. It will also be argued strongly that RFD is, in many areas, completely unrelated to residence; and in all areas is unrelated to either use of local services or income (two of the main criticisms of the rates).

(b) Local sales tax

Somewhat similar arguments could be advanced against LST, but



to a much lesser extent. On the other hand, it would be argued that those least able to avoid heavy local sales taxes are the old and the immobile.

(c) Vehicle excise duty

If Ministers favour using road taxation as a source of local revenue, there may be more to be said for using VED than RFD, since it would at least be levied on the basis of residence. The interdepartmental group did not regard VED as adequate by itself because they regarded themselves as bound to assume severe restrictions on both rate increases (in fact, a rate freeze for several years) and Exchequer grant. If Ministers were prepared to relax these assumptions, VED by itself might be an adequate source of local taxation to support the rates. There would remain the problem that, in so far as VED (yielding £ $1\frac{1}{2}$ billion a year) is used to relieve the rates, an alternative source of revenue has to be found for central government.

Implications for Exchequer Grant

- 20. Although the Sub-Committee does not need to take any decisions in this area, it should be aware that, as paragraphs 25 and 26 of E(LF)(83)7 point out, the introduction of an additional form of local taxation will lead to serious complications in the system of Exchequer grant. The technical problems should be soluble. But -
 - (a) the existing RSG system is already widely criticised as too complicated to be understood; a new system will be still more complicated;
 - (b) equalisation of resources under the present system already rests on the shaky foundation of an outdated valuation of domestic property. It may be impossible to defend basing a completely new system on this valuation. The upshot could be a full revaluation of domestic property, which Ministers have so far wished to avoid.
- 21. In short, the need to devise a new system of Exchequer grant would lead to a good deal of public criticism; and this would be bound to rub off on to the other features of whatever the Government may propose.

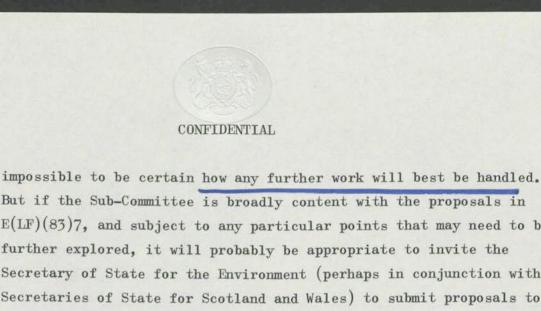
Public presentation of the options

- 22. If Ministers favour either or both of RFD and VED as the supplementary tax, it will be natural to put forward a proposal to that effect in either a White or a Green Paper. If they favour LST, it would probably be prudent to present both it and RFD/VED as options in case consultation with the European Commission should suggest that LST would be likely to be struck down by the European Court. If Ministers agree that the Government should advocate giving local authorities a new form of tax but have no clear preference for a particular tax, the options would be put forward for public discussion.
- 23. The papers before the Sub-Committee, however, suggest that Ministers might prefer to avoid proposing new forms of local taxation. The Sub-Committee will need to consider the alternative approach, indicated in the papers, under which the Government would canvass the possibility of a general limitation on rates, point out that such a limitation inevitably implies the creation of a supplementary form of local taxation, and set out the options. If the ensuing public debate suggested that most people would prefer to stick with the rates as the sole form of taxation, even though no general scheme of rate limitation would then be possible, the Government would be free to accept that judgement.
- 24. Such an approach would need careful presentation. The local taxes being considered by the Sub-Committee have secured little public support in earlier consultations. There is a danger that if the Government were to put forward one or more of them as its preferred option it would be accused of making proposals which it knew would be rejected in order to escape from its previous pledges on the rates. It would be necessary, in particular, to explain why local income tax was not acceptable. It might also be helpful to point out that the Government was considering supplementing, not replacing, domestic rates; and that for that reason some of the objections previously seen, for example, to local sales tax no longer applied.

A permanent control scheme?

25. If Ministers favour including in the interim scheme a general system of control of rates or expenditure, it would be logical to continue it

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But if the Sub-Committee is broadly content with the proposals in E(LF)(83)7, and subject to any particular points that may need to be further explored, it will probably be appropriate to invite the Secretary of State for the Environment (perhaps in conjunction with the Secretaries of State for Scotland and Wales) to submit proposals to the Cabinet for approval.

HANDLING

- 31. It will be convenient to divide the discussion into two main parts:
 - (i) The interim scheme; and
 - (ii) the long-term scheme.

On each, you might ask the Secretary of State for the Environment to open the discussion; the Secretaries of State for Scotland and Wales could then be asked to speak and, in particular, to make any Scottish or Welsh points. The Chief Secretary, Treasury will wish to comment, both from the standpoint of control of public expenditure and on the tax options. All other members of the Sub-Committee are likely to wish to contribute. The Attorney General will be able to advise on the risks of legal challenge under any control system.

CONCLUSIONS

- 32. You will wish the Sub-Committee to reach conclusions on the following.
 - Should there be an interim scheme to control rates or current expenditure of individual local authorities? If so. should it be -
 - (a) selective or general;
 - (b) based on a rate freeze or a limitation on rate increases?

- (ii) If not, should there be some alternative, such as a requirement for a local authority wishing to rate above a prescribed figure to hold a referendum or a special election?
- (iii) For the longer term, are Ministers willing to propose that local authorities should be empowered to raise revenue from one or more of the following sources:

local sales tax;
road fuel duty;
vehicle excise duty?

- (iv) If so, do they regard one or more of these possibilities as so clearly preferable that it (or they) should be put forward as the Government's preferred option? Or would it be better to consult on the basis of an open choice?
- (v) Alternatively, do Ministers regard the difficulties of the possible new sources of local taxation as sufficiently serious to make it inadvisable to put them forward in public as favoured by the Government? If so, would they wish -
 - (a) to rely on an extension of the interim scheme of control; or
 - (b) to canvass the possibility of new sources of local taxation coupled with a general limitation on rates, but without positively advocating it?
- (vi) Should the package of minor reforms of the rating system recommended in paragraph 30(ii) to (vi) of E(LF)(83)7, be endorsed with a view to legislation in the 1983-84 Session?

Depending on the course of the discussion you will also wish the Sub-Committee to give guidance for the handling of future work.

33. Finally, it may be appropriate to record conclusions relating to:

(vii) the minor proposals in paragraphs 13 and 14 of E(LF)(83)10; and

(viii) rates on empty industrial property.

But you will probably prefer to invite the Ministers concerned to resolve the issues outside the Sub-Committee.

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P L GREGSON Cabinet Office. 26 April 1983