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LORD PRESIDENT OF THE COUNCIL

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PRIME MINISTER

1. We had a word last week about the way in which you wish to consider possible changes in the impact of the Community Charge.

2. Since it is almost seven years since I was last able to give close consideration to local government finance, I thought it could be useful for me to bring a relatively uncluttered mind to bear upon the problem.

3. Hence the attached paper, Towards a Community Charge Package, which I am copying at this stage only to John Major, Chris Patten, Sir Robin Butler and Tim Renton, with whom I have recently discussed the problem.

G H

12 April 1990

TOWARDS A COMMUNITY CHARGE PACKAGE

1. To find the best way forward, we need to identify the causes of present disquiet. The charge is criticised for three reasons: it is seen as too high; as unfair, distributionally, between authorities; and as unjust, structurally, between families and individuals. I consider these three points in reverse order.

SHAPE OF THE PROBLEM

Structure of the Charge

2. The basic idea, of switching from a property-based tax to a flat-rate charge, was by definition regressive (with the top 10 per cent or so receiving significant relief). A shift of this kind could be acceptable only if the new tax base was not overloaded. This no doubt is why the 1981 Green Paper argued (para 7.14) that such a charge should carry only 20-25 per cent of the burden previously borne by domestic rates; and, presumably, one reason why the 1986 Green Paper foresaw a long transitional period.

3. Even so, the 1981 Green Paper identified (para 7.8) the need to consider separately - possibly by exemption - the position of individuals who had no incomes of their own eg housewives. So it is no surprise that the structural grievance that strikes me as most strongly felt arises from the single income, married couple

(often pensioner) household. (Particular dismay is expressed at the introduction of head-of-household liability in the same year as the change in the opposite direction for income tax).

4. There are (as with any new tax) other structural shortcomings: we have already focussed, for example, on the Standard Charge, its multiplier and the extent (or absence) of exemptions in "hardship" cases. Others will no doubt come to light from year to year - almost inevitably, for example, over the treatment of the disabled.

Fairness between authorities

5. We have all been overwhelmed by examples here. SSAs - which are essentially a distribution mechanism for Aggregate External Finance (AEF) - are often based on historic data and, perhaps inevitably, less refined than the GREs which they replaced. They have been introduced, in the context of the Community Charge, at the same time as other far-reaching changes in the rules of local government finance (the treatment of capital expenditure, for example), which has increased the risks of error. In the event, the effect has been so widely diverse as to make quite unattainable, in a fair number of cases, the national target figures for the Community Charge. And this diversity is seen to have produced results that depart so widely from common-sense and experience that the credibility of the whole system (including the target figure) has been impaired.

6. The idea of using the gainer's gains to safety-net the loser's losses was no doubt an admirable Treasury approach. But it seems to have been a recipe for misunderstanding for as long as it lasts - all the more so if the "gainers" (sometimes justly) do not see themselves as such. I fear that next year too we shall hear much more from those who are due to receive less from the safety net than from those who no longer have to pay; even in the latter case it is not easy to be confident that the charge-payer personally will benefit from the relief.

Overall burden of the Charge

7. The impact of the first two problems is hugely increased because of the extent to which any overspending, or shortfall in AEF (as designers of the new system, we tend to be blamed almost equally for both), has to be paid for by the charge-payer. Because of the simultaneous introduction of the UBR, under central government control, the only variable source of revenue left to local authorities is the Community Charge, which was intended to provide no more than 30% of their total revenue. This produces a fierce gearing effect, whereby a multiplier of 3.5 - in percentage terms - applies to any increase in a council's spending over and beyond its AEF.

8. This multiplier effect, operating in the context of a 1990/91 grant settlement that was clearly, in retrospect, too tight, has played a large part in producing the overshoot in this

year's Community Charge levels. So far as I can see, the 1990/91 Grant settlement assumed total standard spending (TSS) 11% higher than 1989/90 assumed spending. This was only 3.8% above 1989/90 actual spending. But in fact local authorities' 1990/91 budgets are 15% up on their 1989/90 budgets. And within AEF Government Grants went up only 8.5%, and this was 6.5% less than budgets. The cumulative effect of all these overshoots falls exclusively upon the charge payer.

9. All this helps to explain why last year's yield of domestic rates, £9.7bn, has risen by about one third to produce this year's Community Charge yield of £13.1bn. The contribution to this total from the 10% of householders who were paying the highest rates has apparently fallen from £2.4bn (that is to say 25% of £9.7bn) to £1.7bn (13% of £13.1bn). This means that the total paid in local taxation by the remaining 90% of householders is likely to have risen between 1989/90 and 1990/1991 by something like 50%. less rebates.

POSSIBLE SOLUTIONS

Lightening the load

10. Since the size of last year's grant settlement and the effect of the multiplier on any local overshoot are the joint cause of a large part of today's problems, it seems clear that the first (but not the only) answer must come from a substantial increase in AEF in the settlement for 1991/92. My guess is that it would cost, say, £2.5-3bn in respect of this year and as much

again for next year (£5-6bn in total for next year) if we were to try, for example, to ensure that next year's average outturn figure comes out close to where we thought we should be this year. The figures are so huge that the limit on the total size of any package must be set by what we can afford rather than by what we should like to achieve.

11. Even so (exceptionally - at least for a former Treasury Minister), it looks as though an expensive solution might be, if not the right then at least, the inescapable one. Throwing money at the problem (if we have any money to throw) seems like the only way of tackling the main points covered in paragraphs 7, 8 and 9 above. It should also do something to make the roughness of SSAs (paragraph 5) rather less of a problem. But we should still need to tackle the SSA inequities directly, as Chris Patten has said we will do - since they are real enough: and we do need to try in this way to maximise the political benefit of what we are able to spend.

12. I should say that I have considered and (very far from the first time) rejected any proposal for the "transfer" of any function (or its cost) from local to central government. Either it is a pure book-keeping transaction, more easily handled by a cash transfer. Or it involves administrative upheaval on a scale and of a kind that we could not contemplate.

Capping ?

13. This inevitably raises the question: how do we ensure that such money actually does go towards solving our problem- and not just to fuel the flames of council extravagance ? Experience so far makes very plain how directly over-spending feeds through into a high Community Charge. It is extremely perceptible and should dramatically promote our key objective of accountability. In the 1986 Green Paper (paragraph 5.28) we said that we should need to retain Selective Charge Capping only in the early (transitional) years before rates had been completely replaced. Having dispensed with most of the transition, we should logically be able now to do without the Capping. That would be a high risk conclusion. But logic and principle should persuade us to move capping increasingly into a reserve role rather than towards centre stage. I look forward to Chris Patten's advice on this thorny question.

Structural change ?

14. One comes back, finally, to the perceived structural unfairness of the charge (paragraphs 2, 3 and 4 above). It would be tempting to conclude that if everything else is improved by extra money, this will wear off in time. But the perception of unfairness having established itself, I believe it will need to be dealt with specifically: the Government are past the point where charge payers will give us the benefit of the doubt.

15. The easiest changes to envisage are those which work by extending or refining the system as it now is :

- the transitional relief scheme;
- the taper which determines when rebates are paid;
- the earnings disregard for benefit;
- the way assumed interest on capital savings is taken into account in calculating benefit or rebates (which is thought to be undermining the effect of the concession in the Budget).

16. I am myself doubtful whether any of these are aimed directly enough at identified grievances. They spread money so generally - and so relatively thinly - that they produce little sense of fresh relief. They all tend, moreover, to extend the coverage of an immensely complex scheme of dependancy - with all the problems of bureaucracy and low take-up, which so much (and so understandably) affront Ralph Howell and others like him.

17. I am no more attracted to ideas which involve revising the main income tax structure, as a means of off-setting perceived inequities in the Community Charge. We have not come all this way together in order to start unpicking one of our main achievements, the reform of the direct tax system.

18. So we should, I think, be ready to look for two possible changes in the structure of the Community Charge itself:

(a) The first, designed to ease the heaviest burden, should aim to help what I perceive as the worst case: the one-income married couple household - pensioners particularly. Would it be possible to provide a kind of marriage allowance, a system whereby the joint liability of the couple was based upon a multiplier significantly less than two ? (For pensions and for income tax allowance the multipliers are about 1.6).

(b) The second, designed with the opposite intention, should aim to restore part of the burden on those who have benefitted most from the charge. Such an upward multiplier could, I think, only be based upon income or upon size/value of dwelling. The first, could all too easily be seen as the start of a local income tax. Does enough of the rateable value system survive (for the sake of levying water charges ?) to enable this to be used as a crude multiplier for the "better off" charge payers ?

If I am right in believing that we do need to undertake some structural changes of this kind, then we should, of course, have to devote a significant part of any money that was available to this good cause instead of to the general abatement of the burden.

Alternative sources of revenue

19. In this context, I am sure we should not exclude the possibility of additional sources of flexible income for local government. Anything that had the effect of mobilizing fresh revenue as well as reducing the gearing multiplier to a significant extent, would be an advantage. Is there any scope for reviving the idea of a discretionary non-domestic rate ? The advantage of this was discussed in Annex D (paragraphs D.7 to D.9) of the 1986 Green Paper. Limited to a maximum of 5% of the national poundage (as then proposed) it would at least yield some £.5bn towards our need. This might not be enough to justify the political down side with the business community - at least not this side of an election. There may be better ideas.

PROBLEMS WITH THE SOLUTIONS

20. Whatever kind of package we do put together, there are two pitfalls to beware :

(i) a technical point. We need to avoid assessing our options simply by reference to reductions in the average charge/head. What matters more, in deciding if any package would work, is how it would affect the present pattern of gainers and losers - both at authority level and at the level of individuals and families. In other words, we need exemplifications of possible packages.

(ii) an economic point. £5bn for a rescue package could be paid for, for example, by a combination of reducing the PSDR (published in the FSBR at £3bn for 1991/92); tightening up on other public expenditure plans more than foreseen in the PEWP; making a pre-emptive bid against the Reserve; and delaying any projected reductions in income tax (if the FSBR arithmetic ever assumed any). But any such package would be seen, quite rightly, as a relaxation in our fiscal stance: we should have to consider most carefully how to handle the effect on markets and the exchange rate.

THE MECHANICS

21. The need to produce an effective package is politically urgent. And urgent for practical reasons as well. Legislation needs to be in place in time to affect next year (1991/92). (For this year the die is very largely cast). As much as can be done by secondary legislation (prescribing multipliers for the standard charge, for example) should be done that way. This year's legislative programme is already looking as large as we can cope with. We certainly could not find space for more than one substantive Community Charge (Amendment) Bill. Politically too we should benefit from a single package. For both reasons, it would need to be compact and well directed - and well on its way to the statute book before the summer recess. Even to achieve this we should probably need to look for ways of lightening the present programme. I am examining he possibilities of this. Finally, of course, we shall need advice

from the Chief Whip about the parliamentary marketability of any package.

CONCLUSIONS

22. (A) A package will need to address all three factors

(i) Total size of possible relief;

(ii) Fairness as between councils (SSAs);

(iii) Structure of the charge.

The first of these is the most important because of the scale of the overshoot (magnified as it is by the multiplier). The limit, within which to cope with all these factors, will be set by what we can afford.

(B) Perceptions of the unfairness of the charge are so well established that some changes in the structure are essential, if a package is to carry political weight. More of the same as the transitional (and similar) reliefs already in place are unlikely in themselves to be enough. But we should try to avoid sowing the seeds of a local income tax and, if humanly possible, any reversal of our own reforms of the income tax structure.

(C) Structure changes worth considering include:

(a) A reduction in the liability of single-income married couple households (particularly pensioners);

(b) An increase in the liability of high income/high value households.

The question is whether we can find suitable multipliers, one in each direction.

(D) There is no joy to be found in any so-called "transfer of functions". There is a case for identifying additional sources of flexible resources for local government, possibly a discretionary non-domestic rate: but probably not in the year ahead. Charge capping may have a part to play, but probably in reserve, rather than centre stage.

(E) To assess our options properly we need to look beyond averages and at a proper range of exemplifications.

(F) Any package is likely to involve some relaxation of our fiscal stance; its effect on markets will need most careful handling.

(G) Politically and practically we need to concentrate our proposals into a single package, with only one piece of primary legislation, to be in place before the end of the present session. The Chief Whip's judgement on all this will be important.