

cc J. Mills
25.(a-q.)^B

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

... As agreed at our meeting on 17 April, I am circulating (herewith) a note by officials:

- (a) on local indirect taxes which might provide additional income for local authorities; and
- (b) on direct tax measures to address the "fairness issue".

2. I should say at the outset that both these options are peripheral to the main issue which is whether we can prevent local authority expenditure rising and thus afford a more generous exchequer settlement in 1991-92 without disrupting our economic strategy. We will of course be discussing these wider issues at our meeting on the basis of Chris Patten's minute.

3. The first part of the paper considers possible local taxes on motoring, in the form of surcharges on VAT or excise duty on fuel, and on Vehicle Excise Duty. My firm view is that the problems with these proposals identified in the paper would be on a scale and of a nature which must rule them out.

4. The second part of the paper looks at the "fairness" issue. It examines the scope for imposing a national community charge surcharge, collected by the Inland Revenue, on people on high



b.

incomes and distributing the proceeds between authorities according to adult population. The objective here would be to rebut the perception that the community charge is unfair, rather than to provide a safety valve.

5. The paper sets out a number of options:

- (i) a lump sum surcharge on high incomes;
- (ii) an income related surcharge, and
- (iii) a surcharge on occupiers of residential property of high rateable value.

(i) and (ii) could be temporary or permanent but (iii) would have to be temporary since the rateable valuations would become more and more outdated. Doubtless there are other variations but I think these three bring out the main issues. Certainly doing something to address the "fairness" issue is important in presentational terms, but all of the options have real disadvantages. None of them really meets the "Duke and dustman" point adequately.

6. Taking them in turn, the simple flat rate surcharge offers some defence but is insignificant in terms of the incomes of those affected and would only reduce the average community charge by some £3. There is surely a risk that we would be seen to be conceding that the community charge is "unjust" and at the same time failing to deal with that injustice convincingly.

7. An alternative would be to introduce a (possibly temporary) surcharge for high earners, graduated so that the highest earners pay most. This could generate a larger sum for distribution to



C

poorer chargepayers or those who are losing the most. For example, a 45 per cent tax rate for those on a taxable income of £40,000 a year upwards as a community levy supplementary to the community charge would yield around £750 million and could be applied directly to increasing transitional relief, or possibly community charge benefit. However, such a surcharge would be seen as a straightforward income tax increase [as indeed it would be]; money would be collected by the Inland Revenue and handed out by central Government. We would be attacked for covertly increasing taxes with the additional administrative difficulty of hypothecating part of them. It would be difficult to explain why, if it was right for the next few years, it should not be made permanent. And by accepting the principle of relating tax to income we would make it more difficult to defend the basic principle of the community charge.

8. A further alternative would be to allow authorities to surcharge in some way the occupiers of residential property with a rateable value significantly or very significantly above the average. I do not underestimate the political difficulties in returning, even to this limited degree, to an element of the rating system. Nevertheless, this may be worth consideration as a transitional measure, and as addressing the "fairness" problem wholly in the local authority arena.

9. Each of these options could provide some defence on the "fairness" issue. They have some attractions and they are operationally possible (though difficult in some cases). However, they all have a huge downside as well. They would all be seen as a major retreat from the principle of the community charge yet they might well be seen as tokens which would not meet the substance of criticisms over fairness. They are messy and the first two options would be criticised as reintroducing higher



d.

rates of income tax (a major retreat on one of our most dramatic and important reforms).

10. At this stage I am not convinced that the advantages outweigh the disadvantages. But in any event I think it would be unwise to take final decisions on this issue or the wider package before the results of the local authority elections have been fully analysed.

11. I am sending copies of this minute and the enclosed paper to Sir Geoffrey Howe, Peter Walker, Kenneth Baker, Malcolm Rifkind, Chris Patten, Norman Lamont, David Hunt and Tim Renton.

[J.M.]

24 April 1990

SECRET AND PERSONAL

e

COMMUNITY CHARGE: SUPPLEMENTS FROM TAXATION

Note by officials.

This paper considers the various possibilities for supplementing the community charge through modest additions to other taxes. The first section covers the possibility of giving local authorities discretion to add a certain amount to VAT on petrol, or other motoring-related taxes, paid in their own area. The intention of such arrangements would be to provide a "safety valve" whereby local authorities could raise revenue without increasing the community charge. The paper then looks at the possibility of a centrally-set and administered surcharge on higher rate income taxpayers to make the community charge more progressive, and to counter the criticism that it is unfair. It looks finally at a property-related supplement.

Local Taxes on Motoring

2. The paragraphs which follow discuss possible local additions to VAT or excise duty on motor fuel, and to Vehicle Excise Duty on cars. All options would involve local decisions on tax levels, with collection and enforcement through national tax machinery. Legislation outside a Finance Bill would be necessary.

SECRET AND PERSONAL

SECRET AND PERSONAL

f.

3. Along with a generalised Local Sales Tax, such taxes have been rejected publicly in the past as main sources of revenue for local authorities. The question is whether they could provide a helpful additional source of revenue to the community charge in current circumstances, either as a "safety valve" or as a permanent means of reducing the call on community chargepayers.

4. Assuming that such taxes provoked no increase in local authority spending and no change in consumer behaviour, a reduction of £1 billion in receipts from the community charge, ie £25 off the average community charge bill in Great Britain, could be achieved if on average local authorities imposed surcharges equivalent to either:

(i) 11 percentage points on VAT on petrol (17p/leaded gallon at a price of 200p); or

(ii) 14p a gallon on excise duty (16p after VAT);
or

(iii) £45 on VED (currently £100).

The difference between (i) and (ii) is that "input" VAT (that paid by business) would have to be refunded, while excise duty would not. The RPI effects would be between 0.25 per cent and 0.5 per cent.

SECRET AND PERSONAL

SECRET AND PERSONAL

g.

5. Taxes on fuel would lead to cross-border shopping, and would benefit some authorities disproportionately relative to others (eg a district council with a motorway service station relative to an inner city borough). Accountability would therefore be poor, and receipts by individual authorities hard to predict. Wide differences between authorities' tax levels would dislocate trade; convergence, on the other hand, would in time make the tax indistinguishable from a national tax hypothecated to local government.

6. Administration and compliance costs would be high, as Customs, retailers and businesses registered for VAT all rely on highly centralised systems. On VAT:

- retailers would need to split VAT between petrol and non-petrol at point of sale, and retail chains to split petrol sales between points of sale in different authorities;
- Customs would need to enhance enforcement, operate its system with many more rates, and pay receipts over to many authorities;
- all business users of petrol would have to reclaim their input VAT at a variety of different rates.

SECRET AND PERSONAL

SECRET AND PERSONAL

Of these, input compliance for business users of petrol in itself is probably enough to rule out the VAT option. Excise duty would avoid the input difficulty, but would require the introduction of effective compliance, enforcement and collection arrangements extending to individual points of sale for a tax which is at present collected at the refinery gate (30 points only). This would be a major task.

7. VED raises different issues. It would be more accountable, and raise fewer difficulties for business. But it would be regressive within the population of car owners, and so hit in particular the not-so-well-off who are just above community charge benefit levels. There would be substantial evasion, both through increased non-payment and the registration of vehicles at addresses outside high VED areas. The DVLA's task in tracking taxpayers and collecting the right amounts of tax would be greatly complicated. Deterioration in the quality of the vehicle register through increased evasion and errors would prejudice safety and the fight against crime.

8. It follows that the implementation of any of these local taxes would require substantial new machinery both in the public and the private sectors. It would not make sense and might not be practical to use that machinery simply as a "safety valve", and even if it were, local authorities could not rely on a predictable or timely source of revenue. Whether it would be worth introducing one of these options as a permanent addition to local government revenue would depend

SECRET AND PERSONAL

SECRET AND PERSONAL

on the balance Ministers see between providing additional revenue sources and the very considerable costs and disadvantages summarised above.

Flat-rate Surcharge for higher rate income tax payers- Coverage and liability

9. Within the income tax machinery, a surcharge could be levied on higher rate tax payers at a flat rate of, say, £350, equal to the average 1990-91 community charge in Great Britain or an assumed charge for later years (eg the Community Charge for Standard Spending), for all those with incomes of, say, £50,000 or above. A larger amount could be paid by people with very large incomes, eg above £100,000, though this would reduce the simplicity of the flat-rate approach, would sit uneasily with the single higher rate of income tax, and would invite amendments seeking to make the surcharge more progressive.

10. In order to fit the surcharge as closely as possible into the machinery for collecting income tax, it would be necessary to base it on a given level of taxable income, ie income after taking account of reliefs and allowances. Ministers would, however, still be able to target the surcharge reasonably closely on people with a given level of gross income, simply by adjusting for the average level of

SECRET AND PERSONAL

SECRET AND PERSONAL

reliefs and allowances, eg if the aim were to target people with gross incomes of £50,000, the charge would apply to those with taxable incomes of around £40,000.

11. A simple flat-rate surcharge would have the disadvantage of a cliff-edge: people increasing their income from £50,000 to £50,001 would become liable for the full £350 at a stroke. Ministers might judge this acceptable, since the sums involved would be only a small fraction of the taxpayer's income. Alternatively, a simple taper could operate, at the price of some extra complexity.

12. One consequence of these arrangements is that the surcharge would be paid by some taxpayers who were not necessarily community chargepayers, eg people who were not resident in the UK, but had UK income. Consistent with the principles of independent taxation, the incomes of a husband and wife would be looked at separately, in determining whether either or both was liable to the surcharge. In some cases, a person's liability would not be clear until after the end of the tax year, eg where their affairs were complicated, or the position turned on the size of their reliefs and allowances.

13. Basing the charge on income for 1990-91 would lead to various difficulties, eg with taxpayers whose incomes were above £50,000 in 1990-91, but not in 1991-92, eg because they had retired. If it were introduced part-way through 1990-91, it would also be criticised as retrospective. We suggest,

SECRET AND PERSONAL

SECRET AND PERSONAL

k

therefore, that any charge should be imposed for 1991-92, on the normal definition of income for that year (broadly the current year's income for most taxpayers, but the previous year's income for many of the self-employed).

- Timing and practicalities

14. It would be extremely complicated for the proceeds of the surcharge to be formally hypothecated to local authorities. A substantial proportion of income tax is not collected until after the end of the tax year. It would be impossible to collect any of the surcharge through PAYE in the first year, since the cover normally provided by the Provisional Collection of Taxes Act does not apply to the new charges not yet established in primary legislation. The yield of the surcharge could not be predicted precisely. The legislation (which could not be in a Finance Bill) and the administration would also be more complicated. It therefore seems best for the yield to be paid into the Consolidated Fund, and for the estimated yield to be taken fully into account in the local authority grant settlement. The link between the surcharge and the payments made by chargepayers would then be essentially presentational.

15. There is a timing difficulty about this course too. The average community charge is not known until long after the local authority grant settlement for the year in question: for 1991-92, the main lines of the settlement will be

SECRET AND PERSONAL

SECRET AND PERSONAL

announced in July; but the average charge will not be known until the end of March 1991. One solution may be to base the surcharge on the GB average of the Community Charges for Standard Spending settled in the July negotiations.

16. The detailed coverage and organisation of a surcharge would have to be considered further, if Ministers wished to look at this option further. Even with a surcharge linked as closely as possible to income tax, the operational and computer system changes would need to be fitted in to the work already going on, to tight schedules, on independent taxation and the abolition of the composite rate.

- Yield and distribution

17. The yield of a surcharge of £350 for people with taxable incomes above £50,000 would be around £100 million in 1991-92. This is equivalent to £2.50 on the average community charge bill in Great Britain. Charging a further £350 on incomes above £100,000 would raise an additional £20 million, (equivalent to 50 pence on the average charge). These are very small changes compared with the £350 average bill.

18. As has been argued above, the simplest way of using the surcharge would be notionally to identify within grants paid to local authorities or to chargepayers a sum equivalent to its expected yield. The simplest way to do this would be to identify a flat rate payment per adult within AEF. In

SECRET AND PERSONAL

SECRET AND PERSONAL

England and Wales, this could probably be done in conjunction with the distribution of the business rate pool; the procedure in Scotland would have to be considered separately.

An alternative would be to use the proceeds of the surcharge notionally to fund additions to particular grants, eg the community charge transitional relief, or community charge benefit.

19. The distribution of the yield between the three countries would have to be considered. There would be some slight awkwardnesses: taxpayers in Scotland and particularly Wales would argue that the surcharge was well above the average charge in their country; and taxpayers in Northern Ireland would probably have to be liable for the surcharge, but are unaffected by the community charge. The latter point could probably be dealt with, if necessary, by adjustments to grants in Northern Ireland.

- Legislation and classification

20. Assuming the surcharge were a Central government charge, paid into the Consolidated Fund, the legislation, which would clearly distinguish the surcharge from income tax (although many of the income tax management provisions would have to apply), could be contained in a Finance Bill. Given that the surcharge would be a tax on income collected by the Inland Revenue, some (including perhaps the CSO) would classify it as a form of income tax.

SECRET AND PERSONAL

SECRET AND PERSONAL

- RPI

21. The addition to taxation should have no impact on the Retail Prices Index, subject to the deliberations of the RPI Advisory Committee.

Alternative approaches to an extra charge for higher ratepayers

22. An additional charge on higher rate tax payers could be imposed in other ways, integrated more closely with the present tax system. As with the surcharge discussed above, the receipts would notionally be passed on to chargepayers, rather than formally hypothecated.

23. One possibility would be to introduce a percentage surcharge of, say, 5 per cent, for those with high incomes - similar to a new income tax band. This would have the disadvantage that, even if designated as a payment for local government, it could more easily be represented as an addition to income tax, rather than a separate community charge surcharge. But it would be simpler, and the yield would arise more quickly, since the new charge could be brought into PAYE.

24. An additional 5 per cent starting at taxable income of £40,000 would generate extra tax of around £500 a year for someone on £50,000, and £3000 for someone on taxable income of £100,000 a year. In a full year, the additional revenue generated might be around £750 million (which should reduce

SECRET AND PERSONAL

SECRET AND PERSONAL

D.

the average community charge by nearly £19, if there were no leakage into higher expenditure). The extra payment could be described as a "community charge surcharge rate", or "community levy".

25. For the sake of completeness, one further possibility should be mentioned, though it suffers from the disadvantage of appearing closer to an addition to income tax.

26. This would be to place a surcharge on the higher rate itself of, say, a penny or twopence in the pound. This could be presented as the higher rate of 40 per cent, with an additional percentage point (or two) to help finance local government. The yield would be around £300 million for each percentage point in a full year, which would reduce the average community charge by £7-8. The distribution of the money to local authorities could be as above. This option would be the most straightforward of all to run, since the surcharge would, in practical terms, be part of the higher rate itself.

27. An objection to this option, which runs to some extent against all these surcharge options, is that it invites the argument that, if we can bring in the Inland Revenue in this way to provide finance for local authority expenditure, we should do so in a thorough-going way, permitting local authorities to add up to x pence in the £ to both basic and higher rates of income tax, such tax to be collected by the

SECRET AND PERSONAL

SECRET AND PERSONAL

P.

Inland Revenue and handed over to each authority. Although there are powerful objections to this line of criticism it would be inconvenient to get it running again.

Surcharge based on rateable value

28. A different approach would be to link the surcharge to the value of property, as represented by the old rateable value.

29. Such a surcharge might, for example, apply to all domestic properties whose rateable value was more than a given multiple of the average for the area. The level of the surcharge could either be left to local authorities' discretion, or set by central government, or some combination of the two, eg set by local authorities at up to, say, 5 per cent of the revenue they expected to raise from the community charge.

30. Although the administrative procedures would be familiar for authorities, there would be formidable practical difficulties. Rating lists will still exist in the vast majority of authorities, but will be increasingly out of date, not least because they will take no account of new dwellings, so it is unlikely that this approach could be more than a transitional measure. Collecting the surcharge separately from the community charge would require a new machinery, and would give the impression of two local

SECRET AND PERSONAL

SECRET AND PERSONAL

authority taxes. Collecting the two together would add a layer of complexity to the procedures for the community charge.

31. If Ministers judged this idea worth pursuing, the practicalities would require a good deal of further work. It is, of course, open to the criticism that it would be reinventing the rates, or at least introducing the abandoned "dual running", proposal by another route.

Next steps

32. Once Ministers have decided which of these options should be pursued, or which further options should be identified, officials will need to do further work on the details of the scheme.

HM TREASURY
24 April 1990

SECRET AND PERSONAL