c/c

CONFIDENTIAL

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

E(LR)(85) 2nd Meeting COPY NO 42

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON LOCAL GOVERNMENT FINANCE

MINUTES of a Meeting held at
10 Downing Street on
MONDAY 23 SEPTEMBER 1985 at 2.30 pm

PRESENT

The Rt Hon Margaret Thatcher MP
Prime Minister

The Rt Hon Viscount Whitelaw
Lord President of the Council

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer

The Rt Hon Sir Keith Joseph MP
Secretary of State for Education and Science

The Rt Hon Norman Fowler MP
Secretary of State for Social Services

The Rt Hon Lord Young of Graffham
Secretary of State for Employment

The Rt Hon John MacGregor MP
Chief Secretary, Treasury

The Rt Hon Leon Brittan QC MP
Secretary of State for Trade and Industry

The Rt Hon Douglas Hurd MP
Secretary of State for the Home Department

The Rt Hon George Younger MP
Secretary of State for Scotland

The Rt Hon Norman Tebbit MP
Chancellor of the Duchy of Lancaster

The Rt Hon Kenneth Baker MP
Secretary of State for the Environment

The Hon William Waldegrave MP
Minister of State, Department of the Environment (Minister for the Environment, Countryside and Local Government)

CONFIDENTIAL

5

THE FOLLOWING WERE ALSO PRESENT

The Rt Hon Kenneth Clarke QC MP
Paymaster General

Mrs Lynda Chalker MP
Minister of State, Department of Transport

Mr Michael Ancram MP
Parliamentary Under-Secretary of State, Scottish Office

Mr Wyn Roberts MP
Parliamentary Under-Secretary of State, Welsh Office

SECRETARIAT

Mr J B Unwin
Mr A J Langdon
Mr J E Roberts

SUBJECT

LOCAL GOVERNMENT FINANCE STUDIES

CONFIDENTIAL

LOCAL GOVERNMENT FINANCE STUDIES

The Sub-Committee considered a Memorandum by the Secretary of State for the Environment covering the Second Specification Report produced by the Local Government Finance Studies (E(LF)(85) 4). They also considered a Memorandum by the Chancellor of the Exchequer, attached to which was a report by officials on a possible Modified Property Tax (E(LF)(85) 5), and a Memorandum by the Secretary of State for Education and Science (E(LF)(85) 6). Their discussion and the conclusions reached are recorded separately.

Cabinet Office

24 September 1985

C/L

COPY NO 23

CABINET

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON LOCAL GOVERNMENT FINANCE

LIMITED CIRCULATION ANNEX
E(LF)(85) 2nd MEETING MINUTES
MONDAY 23 SEPTEMBER 1985 at 2.30 pm

LOCAL GOVERNMENT FINANCE STUDIES

The Sub-Committee considered a Memorandum by the Secretary of State for the Environment, covering the Second Specification report setting out the results of the Local Government Finance Studies (E(LF)(85) 4). They also considered a Memorandum by the Chancellor of the Exchequer, (ELF(85) 5),attached to which was a report by officials on a possible Modified Property Tax, and they had before them a Memorandum by the Secretary of State for Education and Science (ELF(85) 6).

THE SECRETARY OF STATE FOR THE ENVIRONMENT said that the existing system of Local Government Finance could not continue indefinitely. The attempt to control local authority spending through central pressures had had only limited sucess, but had alienated the Government's supporters, had fostered extremism in inner cities, had embroiled the Government in local affairs, and was complex to operate. Local accountability had proved ineffective given the present grant and tax regime. A new system was therefore necessary. The choice lay between greater centralised control or greater reliance on local accountability. He did not support the former option, since pluralism would be ended, central Government would become answerable for local services, there would be no incentives to local efficiency, and a large Government bureaucracy would be needed. He therefore preferred a system which relied on improved local accountability: central Government could then stand back, there would be effective pressure on local authorities to improve services, and all local tax payers would have a financial stake in local decisions.

It had been suggested that many of the problems could be solved by transferring to the Exchequer responsibility for funding the education service. This would halve the amount of money to be raised through local taxation, would promote uniform education standards, and would provide effective control on education spending. But there could be no real financial control unless there were also managerial control. Local electors would have no stake in the education service, the Shire Counties would become largely redundant, and central Government would have to take on a role for which it was not best suited. Moreover, national taxation would have to be increased to find the necessary resources. He therefore opposed this option.

Instead he advocated an approach which would lead to a closer identification between tax payers, voters and users of local services. There were four key elements: a limit to the extent to which Local Government could raise revenue from business; a broadening of the local tax base; a requirement that all electors should contribute at least something towards the cost of local services; and the principle that the full cost of any additional spending should fall on local people.

Some local authorities raised as much as three quarters of their revenue from non-domestic ratepayers, and had therefore been able to increase their expenditure substantially without domestic rate payers having to bear much of the cost. Moreover, only a proportion of the electorate paid rates. Of the 35 million adults in England, only 12 million householders paid full rates, with a further 6 million paying part rates. In some areas, such as Hackney, only half the domestic rate payers paid full rates, with 30 per cent receiving full rebates. The proposal that the local electorate should bear the full cost of any additional expenditure was the key to increasing the effectiveness of local accountability as a discipline over spending, but was equally the most politically difficult part of the package.

THE MINISTER FOR THE ENVIRONMENT, COUNTRYSIDE AND LOCAL GOVERNMENT said that at their earlier meetings the Sub-Committee had considered a reforms based on three key elements:

i. the non-domestic rate would be levied at a poundage determined nationally, with the yield being pooled and distributed as a per capita grant;

ii. a new, simpler grant system, comprising a standard grant and a lump sum needs grant calculated on the basis of a new needs assessment; and

iii. a residents' charge to replace domestic rates.

On the non-domestic rate, two modifications to the original proposal were now being put forward. First, it was proposed that the national rate should be set 5 per cent below the present average, and that local authorities should have a discretion to levy an additional 5 per cent and retain the yield locally. This would maintain a genuine link between the business community and local government. Secondly, the Confederation of British Industry (CBI) had been concerned that future Governments might increase the national non-domestic poundage disproportionately. He therefore proposed that the poundage should be indexed to the Chancellor of the Exchequer's autumn forecast of GDP growth. It was also proposed that there should be regular or rolling non-domestic revaluations in order to keep the taxation base up to date. Assuming that all local authorities used their discretion to the full and the effective rate poundage was therefore at the national average, 1.3 million non-domestic rate payers would face an increased bill, although the majority by less than 10 per cent and only very few by more than 20 per cent. 462,000 non-domestic rate payers would see a reduction in their bills, with a significant number receiving a 20 per cent cut. Provided that the new system, together with revised rateable values, were phased in over a five year transition period commerce and industry could cope with changes of this size. In general, the losers were shops and small businesses in prime sites in the south of England, and for them rates were only a small proportion of their costs. The number of losers could be reduced if the amount raised from non-domestic rates were reduced; a cut of £300 million per year would result in equal numbers of gainers and losers, while a cut of £700 million would result in three times as many gainers as losers.

The proposals for the new grant system were intended to produce equal tax bills across the country if authorities spent at the same level in relation to their assessed needs: resource equalisation would be removed. A new, improved needs assessment would be required, and in general this would favour inner cities and northern towns. The amount of Exchequer grant would be fixed, so that any expenditure above assessed need would have to be financed entirely by local domestic tax payers. This would provide greater pressure against high spending than under the existing grant arrangements, except for a very few authorities.

Some might criticise the package as being too centralist, since the only tax over which local authorities would have control would bear heavily on the local electorate. It was therefore proposed that to counteract this the amount of standard grants available should be determined by hypothecating a share of a national tax. This would improve accountability by giving a greater certainty about the level of resources available, would bring home the extent to which central Government supported local government, and would introduce a progressive element of taxation into local government finance to counter criticism that a residents' charge would be too regressive. It was therefore proposed that 25 per cent of the national yield of Value Added Tax (VAT) should be used to finance the standard grant.

There had been concern at the previous meeting of the Sub-Committee that in some areas the residents' charge would be too high, and also that the proposals would unduly favour the better off. Environment Ministers had therefore concluded that an element of property taxation might usefully be retained to mitigate these affects. It was now proposed that the local charge should have two components: 70 per cent being raised through a residents' charge and 30 per cent through a property charge. A property element would provide a very rough proxy for ability to pay, as well as widening the tax base and giving greater continuity with the existing systems, although the combined tax would be more complex. It would be possible to base a new property tax on rental values, capital values or floor space, and of these he favoured the last because it was objective, cheap to administer, and it would require no further revaluations.

A package on these lines would provide a tough regime for controlling current expenditure. It would provide clear signals to the electorate, would widen the local tax base, and would require local electors to pay the whole of any additional spending.

THE SECRETARY OF STATE FOR THE ENVIRONMENT described the effects of the package on average tax bills. He said that the aim had been to moderate some of the most extreme effects of the original proposals considered in May. A number of assumptions had been made, including taking account of the results of precept control on joint boards and of increasing needs assessments for urban areas. He emphasised that the package needed to be viewed as a whole, and it was not possible to remove particular unattractive elements without changing the whole balance of the package that was being presented.

Under the new regime, the average cost per adult through the local domestic tax would be £151, with the lowest authority charging £62 and the highest £624. A majority would charge between £125 and £175. 70 per cent of authorities would have lower tax bills and 30 per cent higher, although the charge for particular households within these authoritiees would depend on their family circumstances. In general the regime would increase tax bills where spending was high. A majority of shire districts would have lower tax bills, while a majority of metropolitan districts and London boroughs would face increases. For households, there would be more gainers than losers, although there was a strong regional pattern. In the South East, West Midlands, and East Anglia there were substantially more gainers than losers, while in the North and in Yorkshire and Humberside the reverse was true. In 70 per cent of cases the loss or gain was less than £2 per week, although 3.6 million households would gain more than £2 per week and 2 million would lose more than this amount. The cost for particular households would depend on their circumstances, but in general those with a single adult would be substantially better off, while those with three or more adults would face higher bills.

He recognised that it might be difficult to secure public acceptance of some of the elements in the package. But equally it would become increasingly difficult and unpopular to continue with the present local government finance system. It was important that the sub-committee should reach firm decisions soon, either to endorse the approach described based on improved local accountability or to indicate that some other solution should be sought.

In discussion the following points were made -

a. Parliament had a basic right to set the limits of taxation, and the Government had a duty to protect tax payers against excessively high spending local authorities pursuing policies diametrically opposed to those of central Government.

b. There was a particular risk that during the transition to any new system local authorities would take the opportunity to increase spending while putting the blame on Government.

c. Increased accountability to the local electorate would not necessarily be a sufficient restraint on high spending, and it would therefore be unwise to abandon all the existing controls. The progressive withdrawal of grant as spending increased had not proved effective in deterring the most notorious high spenders, and had enabled local authorirites to attempt to shift some of the blame of the high rates or service cuts to central Government. It might therefore be more appropriate to retain a reserve power to set expenditure limits.

d. The proposal in the Social Security Review that those receiving housing benefit should pay 20 per cent of their rates would ensure that all electors had a financial interest in the policies pursued by local authorities, and was essential if reliance was to be placed local accountability. On average a single person receiving benefit would face a bill of £40 per year, and a couple would face £58. Even if the basic benefit rates were increased to reflect this national average, individuals would still stand to gain or lose according to the level of charge established locally.

e. Linking the quantum of the Exchequer Standard Grant to a proportion of the yield of VAT would undesirably pre-empt decisions about the allocation of public expenditure. Moreover, since the yield of VAT was buoyant, it would not be consistent with the objective of reducing public expenditure as a proportion of the Gross Domestic Product unless central Government expenditure were reduced more than proportionately.

f. The proposal to pool the yield of the national non-domestic rate was a major factor in establishing the pattern of both commercial domestic gainers and losers across the country. Broadly, industry and commerce gained in the North of England while business in the South would face higher bills: domestic rate payers faced the converse effect.

g. The extent to which the present arrangements subsidised the North at the expense of the South was not widely appreciated. Removal of this cross-subsidy would give rise to considerable public controversy that would not be confined to the potential losers in the North. The average domestic tax bill in areas of low rateable values would rise by a significant proportion, even if the absolute amount was small and the resulting bill would not be out of line with the national average bill.

h. An alternative means of limiting the extent to which local authorities could raise revenue from industry and commerce would be to cap non-domestic rate poundage, and allow the yield to remain where it accrued. This would reduce the extent of redistribution from the North to the South, and would also make the package less centralist as a whole. But equally, it would reduce the number of gainers in the South of England and would also perpetuate the existing inequalities in non-domestic rate bills across the country.

i. The non-domestic revaluation would favour older industrial premises largely in the North of England at the expense of newer developments in the South. But so long as the effects of the revaluation and of changes in the rating system were introduced over a five year transistion period, business seemed likely to be able to cope.

j. Many voters who favoured a policy of low spending lived in areas where the majority of the electorate was prepared to return a high spending council. These people already faced high rate bills, and were looking to the Government to bring them relief. But the effect of the package, designed to bring home the cost of high spending, would be to increase their rate bills. There would be substantial opposition on this score.

k. There could be substantial difficulties in enforcing a residents' charge. The greatest difficulties would be likely to be in those areas where relations between the community and authorities were already most strained.

l. While it was recognised that the inclusion of a property element in the local domestic charge would modify the extreme effects of the package, in Scotland at least there would be considerable resistance to any property element. It was not necessarily the case, however, that the local tax in Scotland need be on the same basis as that in England and Wales.

m. There were fundamental objections to basing the property charge on capital values: it would be close to being a wealth tax, some form of revaluation would be necessary, and shifts in the property market would result in changes which were perceived as unfair. Despite the drawbacks of a tax based on rental values, the continuation of the existing rates system for the property part of a local charge might be the best option, at least for the time being, and would reduce the number of changes being introduced simultanously.

THE PRIME MINISTER, summing up the discussion, said that the Sub-Committee was grateful to the Secretary of State and Minister of State for their further work. The proposals would need to be considered along side those for the reform of Social Security so that the combined effects on household incomes, and the timing of the implementation of the two sets of proposals, could be assessed. The proposals on personal taxation would also be relevant. Subject to that, the Committee accepted that the main thrust of the reform of local government finance should be towards increased accountability. The Government could not, however, abdicate its ultimate responsibility to set the limits of taxation, and it would be prudent to retain a power to limit the spending of the most extravagant authorities. The proposal to hypothecate a proportion of the yield of VAT to provide the Standard Exchequer Grant had been rejected. The proposal to limit the extent to which local authorities could raise revenue from industry and commerce was welcome, but alternatives such as capping non-domestic rates should not be ruled out: if the yield were retained locally the extent to which householders in the North of England would face substantially increased domestic bills would be reduced. The extent of the redistribution from the North to the South of England gave rise to concern, and further means of moderating the problem should be examined. The Sub-Committee accepted that the local domestic tax might be a combination of a residents' and property charge, although further work was required on the appropriate proportion and the basis of the property element. There were, however, strong objections against any system based on capital values. The Sub-Committee would consider at a further meeting the proposals in the paper by the Secretary of State for Education and Science about the hypothecation of the block grant, and would also wish to return to other issues including capital controls, fees and charges, annual elections, and the budgetary framework. The aim should be to produce a consultative Green Paper before the second reading of the Social Security Bill.

The Sub-Committee -

1. Took note, with approval, of the Prime Minister's summing up of their discussion.

2. Invited the Secretary of State for the Environment, in conjunction with the Chancellor of the Exchequer, to set in hand further analysis on the lines indicated in the summing up.

Cabinet Office

24 September 1985