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[1. MR EDWARDS] agreed in draft.
2. CHANCELLOR

FROM: R FELLGETT
Date: 1 November 1988

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mr Monck
Mr Turnbull
Mr Culpin
Mr Potter
Mrs Holmans
Mr H Burns
Mrs Chaplin
Mr Tyrie
Mr Call

Ch
Seems OK to me.

Many thanks.
See my response in margin of para 32.

NON-DOMESTIC RATING: REVALUATION EFFECTS AND TRANSITIONAL ARRANGEMENTS

I attach a near-final draft of the Inland Revenue's report into the likely effects of the current business rating revaluation and move to National Non-Domestic Rate (NNDR) in England and Wales.

2. The key parts of the report are section 4, about the estimated pattern of gainers and losers, and section 5 about possible transitional arrangements. Section 1 is a summary; I also summarise the main points below. (I have not appended the detailed annexes to the report, but have them if you or others wish to see them.)

3. E(LF) will need to meet to consider the transitional arrangements later this month, probably on the basis of a paper to be circulated by Mr Ridley. The Government is committed to announcing the transition this Autumn. Apart from informing you of the results of the Revenue study, this submission seeks your initial views on the way in which you wish to approach that collective discussion.

Summary of Gainers and Losers

4. After transition to the new bills, on average, shops and offices are expected to be losers from the combined effect of the revaluation and move to NNDR (by 12% in both cases). Most properties in the "other" category which includes a number of Government and NHS buildings are also losers on average, compared to a broadly constant real rates burden. Small offices and large shops may be hardest hit.

5. Gainers on average are expected to be warehouses (-14%) and factories (-26%).

6. Regions where the average property will lose by more than 10% are inner London (+28%), the South West (+21%), East Anglia (+15%), and the South East outside London (+13%).

7. Regions gaining on average are in the North and Midlands and Welsh valleys.

8. There is a tendency for small properties to lose and large ones to gain.

9. There is a very wide distribution of gainers and losers. About 900,000 properties lose, with an average increase in their rates of £2,200 a year. The average loser therefore faces an increase of about 45% in their rates bill. About half the losers, ie very roughly a quarter of properties, face larger increases.

10. There are about 750,000 gainers, who on average will see a reduction of £2,600 a year in their rates bills. The average reduction among gainers is about 30%.

11. I attach a histogram of the distribution of gains and losses, derived from Table 4.4 of the IR report.

12. In all, gains and losses are each about £1.9 billion in estimated 1990-91 prices. This is a redistribution of nearly 20%

of the aggregate business rate revenue. But in addition the NNDR poundage after 1990-91 will be indexed to the RPI, representing a growing general gain to business compared to real rates rises in most recent years.

Transitional Options

13. The Government has announced that there will be self-financing transitional arrangements. Decisions will need to be taken on the rate at which losses are phased-in; how these are paid for; and whether there is to be some special scheme for small businesses.

14. E(LF) agreed last spring, with your strong support, that phasing-in the increases in rates bills for losers should be accompanied by phasing for gainers. It was agreed that the process would be self-financing. This was preferred to Mr Ridley's earlier proposal to pay for phasing for losers by increasing the NNDR for everyone else by very roughly 10%.

15. The main options canvassed in the paper are to phase-in increases at 25% or 20% or 15% a year from 1990-91. (For example, a property facing an increase of 30% would pay 25/20/15% more in 1990-91 and about 5/10/15% more in 1991-92.) These increases are before the annual increase in the NNDR, which will be no more than the RPI the previous September; ie they are broadly in real terms.

16. Because the distribution of percentage gainers and losers is not symmetric, the corresponding percentage reduction for gainers will need to be about 15% or 12% or 9% respectively. Indeed, to be exactly financially neutral the percentage reduction will have to fall a little each year. For example, with a 25% limit on increases, there would be a 15% limit on reductions in 1990-91 falling to 8% by 1994-95. Otherwise, there would be an increasing shortfall in NNDR revenue amounting to around £100 million (or about 1%) by the end of the 5 years.

17. In response to political pressure during the passage of the Local Government Finance Act, Mr Ridley took powers to set the annual limit on losses lower for small businesses. For practical reasons, a small business will need to mean any business property whose rateable value is less than some figure, which might be around £7,000 on the new 1988 rateable values. A lower limit on losses for small businesses, thus defined, which was 5 percentage points below the limit for larger businesses would assist over half of losing properties. It would cost only about £20-40 million a year, because the bulk of NNDR revenue is raised from a relatively few large properties. The paper envisages that this cost would be met by a very slightly lower percentage limit for all gainers, implying a small subsidy from large to small businesses.

18. Because the distribution is so spread, all the options mean that the bulk of businesses would have their rates determined by the transitional arrangements in the early years from 1990. Even in 1994-95, the number of properties still affected by the transition would be between 350,000 (with a 25% limit on losses and 15% limit on gains) and 650,00 (with limits of 15% and 9%). The remainder would have reached their final new bill, based on the NNDR and new rateable value, in time for the next revaluation.

19. A number of these large percentage changes are in fact for relatively small sums. Around 700,000 properties (over 40% of the total) are estimated to face changes of less than £250 a year. Such small changes (gains and losses) could be brought in immediately, without much affecting the arithmetic.

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20. The IR have calculated transitional arrangements separately for England and Wales. For the same limit on losses in both countries, gains could be phased in slightly faster through a slightly higher limit on reductions in rates bills in Wales.

Assessment

21. The IR have produced a very useful report directed specifically at the decisions you and colleagues will need to take about the transition. It puts you in a much better position than in the Spring to settle on a transition that will be right, both for business and for the Exchequer. DOE were then inclined to announce a scheme that would meet immediate political pressures, but without knowing whether it would be self-financing and in the (false) expectation that limiting changes to 15% a year would phase-in all but the largest changes within a year or two.

22. Inevitably, from such a sample survey, there remain uncertainties about the figures. We need to explore these further with the VO and IR statisticians.

23. I assume that you wish to stick firmly to the agreement that the transition is self-financing, and that the cost of phasing for losers will be met by phasing for gainers. We do not want to repeat throughout GB the revaluation rate relief grant conceded for Scotland after the 1985 revaluation.

24. Within this framework, our preliminary advice is that you argue in E(LF) for the new system to be phased in as quickly as practicable, given the likely reactions of business. Losers, after all, are largely those who have for some time paid too little in rates. Gainers are conversely those who are paying too much at present. The new bills should, in the interests of equity and to avoid market distortions, be brought in as quickly as possible.

25. It is ultimately a political judgement how fast the new system can be brought in. In reaching your view, you will wish to bear in mind that changes (up and down) in rates bills will often be partially offset in Corporation or Income Tax payments. Over time, they will also tend to be offset in rents. These points

argue for a fast transition. On the other hand, the CBI and others were earlier pressing for just 10% phasing for losers (with the cost borne by the Exchequer not gainers) and E(LF) felt that 15% might be around the right figure.

26. You may wish to argue hard for increases of 25% a year. That would allow gainers to see reductions of 15% a year, and enable over three-quarters of properties to have completed the transition by 1994-95. In practice E(LF) may favour a lower figure, so 20% would be a realistic fallback.

27. A special scheme for small businesses will inevitably be very complex and produce anomalies around the demarcation line, for example between a chain with small shops and a single larger shop. We do not favour it in principle. But the small business lobby may press hard for just such a scheme, which many now expect, given the powers to introduce one. The sums of money at stake for gainers are fairly small. I suggest that you accept Mr Ridley's judgement, if he decides that a special scheme for small businesses is politically unavoidable.

Will be. Shouldn't you get some credit by proposing/supporting it from outset?

28. There may be a case for bringing in small cash changes in 1990-91, however large they are as percentages of previous (small) rate bills. For example, many of the small changes cover "properties" like advertising hoardings rather than small shops and offices. One way to do this would be to phase-in losses at, say, either £250 a year or 25% (or 20% for small businesses), whichever is larger. The phasing for gainers would then be either £250 or 15%, whichever is larger. This would enable more properties to complete the transition early, and emphasise the symmetric nature of the change by having the same cash figure (£250 in this example) for gainers and losers. But an option of this type would depend on satisfying ourselves that such an arrangement could cover only advertising hoardings etc and not also small businesses. If you agree, we will consider this option further. ?

29. To be exactly financially neutral, a phasing scheme will have to involve either successively higher percentage losses each year, or successively lower gains. You may come under intense pressure in Committee to accept that the scheme may not be completely self-financing in the later, or indeed any, years. There is a strong expectation among, in particular, businesses in the North and manufacturing that they will see quick large gains. They may not be happy to see those gains deferred; and may particularly object to long-overdue reductions in bills being brought in at an increasingly mean rate. But fixed percentages of, say, 25% for losers and 15% for gainers would lead to an increasing shortfall of up to about £100 million a year. Unless local authorities react by reducing their spending, that would add £3 to the Community Charge or (more likely) have to be met by additional Exchequer grant.

30. Progress towards a uniform business rating system will be reinforced by the estimate that the NNDR will be almost exactly the same in both countries - 34.5p for England and 34.2p for Wales. There are strong arguments for fixing the same poundage in both countries, leaving only Scotland (which will not have a country-wide rate poundage, but where business rates are likely on average to be higher) outside the NNDR system. But it would then be anomalous to have different transitional arrangements in England from those in Wales. It would therefore seem preferable to have identical transitional systems, even if that meant small transfers of grant between the two countries to offset the fact that identical transitional arrangements might not be quite finally neutral either side of the border. The principle could instead be that the transitional arrangements for England and Wales together should be self-financing.

Which way? V sensitive if Wales → England

31. You will finally wish to note that the IR paper assumes that the transitional arrangements are based on 1989-90 rates bills. We are separately considering with DOE the option of re-basing the transition on 1988-89 bills, to avoid an incentive on businesses

to appeal against their existing rateable values, which exacerbates the VO's shortfall of professional valuers. The option looks unattractive, but we hope to report finally to you on it very shortly.

Conclusion

32. We need to examine the figures in more depth, but subject to that should be grateful for your reactions to the following broad approach to the forthcoming E(LF) discussion:

(i) the scheme must be self-financing, and meet the cost of phasing for losers by phasing gainers;

prefer 20/12

(ii) that you argue that generally increases in rate bills should be phased at up to about 25% a year, financed by phasing reductions for gainers at up to about 15% in 1990-91 falling to 8% by 1994-95;

OK, but less grudging

(iii) if necessary, that a special scheme for small businesses would just be acceptable;

OK provided transfer of grant to/from E to EW & vice versa

(iv) the transition should be self-financing for England and Wales as a whole, with a presumption in favour of common transitional arrangements and a common NNDR poundage in the two countries;

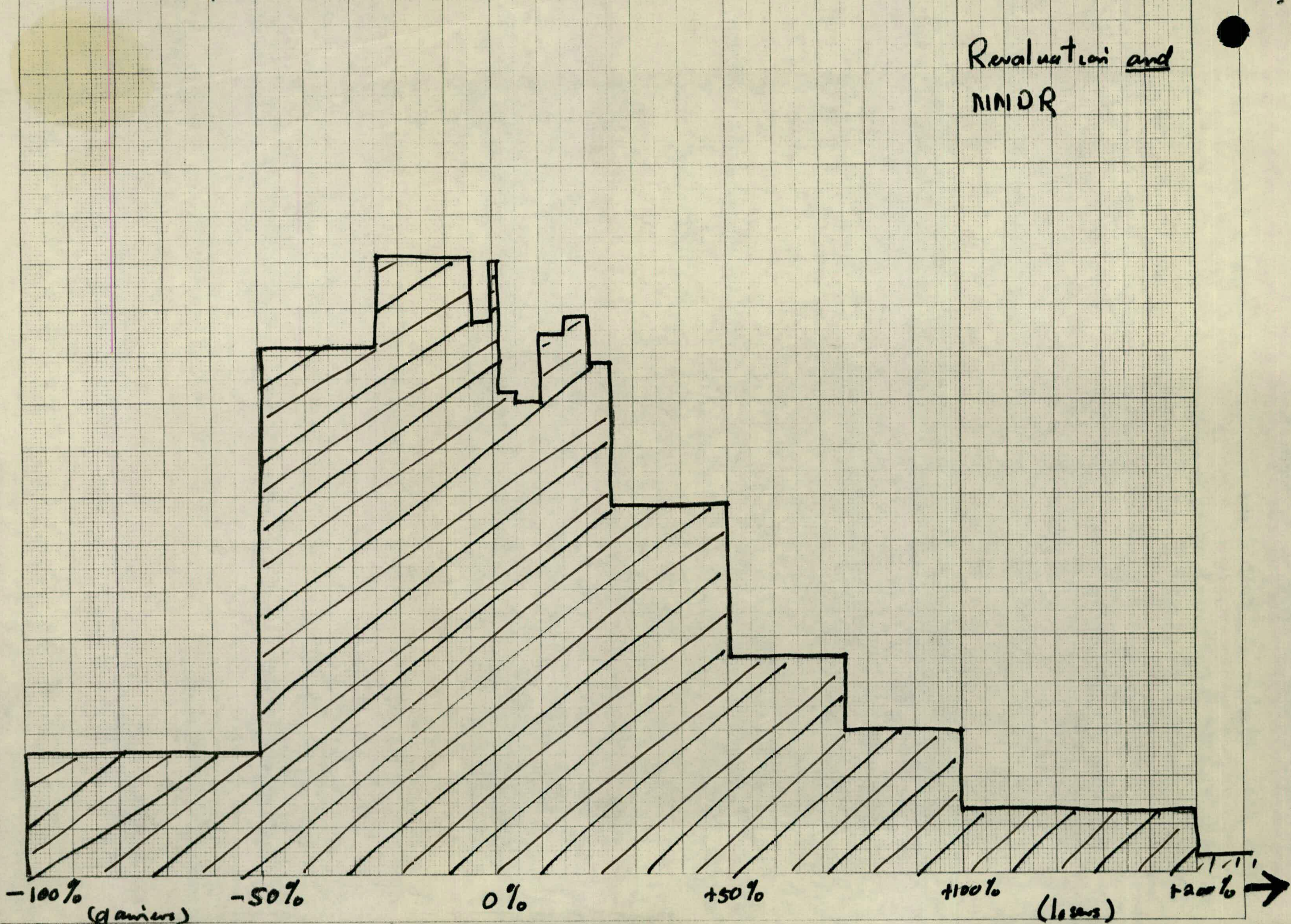
(v) we should consider further options for phasing-in small cash changes early after 1990, even if they represent large percentage changes.

33. If you agree, we will plan accordingly and provide more detailed (and where necessary updated) briefing for the E(LF) meeting.

Robin Fellgett

R FELLGETT

Proportion of properties showing various % gains and losses



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FROM: A C S ALLAN
DATE: 3 November 1988

MR FELLGETT

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr Scholar
Mr Culpin
Mr A J C Edwards
Mr Turnbull
Mr Potter
Mrs Holmans
Mr H Burns
Mrs Chaplin
Mr Tyrie
Mr Call

NON-DOMESTIC RATING: REVALUATION EFFECTS AND TRANSITIONAL ARRANGEMENTS

The Chancellor was most grateful for your minute of 1 November. He had the following comments on the points in your paragraph 32:

(i) He agrees that the scheme must be self financing, and that the cost of phasing for losers must be met by phasing gainers.

(ii) He would prefer to argue for phasing increases in rate bills at 20 per cent a year, financed by phasing reductions for gainers at 12 per cent a year (as compared with 25 per cent/15 per cent).

(iii) He would be ready to accept a special scheme for small businesses, and would not want to appear too grudging.

(iv) He is content to accept that the transition should be self financing for England and Wales as a whole, with a presumption in favour of common transitional arrangements and a common NNDR poundage, provided the "small transfers of grant" you refer to are from England to Wales and not vice versa.

(v) He agrees we should consider further the options for phasing in small cash changes early, even if they represent large percentage changes.

ACSA

A C S ALLAN