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P.01546

PRIME MINISTER

Local Government Finance Studies

(E(LF)(85)1, 2 and 3)

BACKGROUND

The review of local government finance was announced at the Party Conference last October. The Sub-Committee discussed the general approach and work programme in November, and commissioned DoE Ministers to set in hand the first phase, exposing the issues and presenting options for consideration. The preliminary results were discussed with the Ministers most closely involved at a meeting at Chequers on 31 March. That Group invited DoE Ministers to prepare proposals for this meeting, including an assessment of the impact of the changes on typical authorities, individuals and businesses.

2. The memorandum by the Secretary of State for the Environment
- A** — (E(LF)(85)1) covers two reports. The first (the "Introductory Report") identifies the defects in the present system, sets out the objectives which should underlie reform, and suggests the elements of a new
- B** — system, while the second (the "Specification Report") specifies in more detail how these elements might work and exemplifies the effects on a range of typical ratepayers. The memorandum by the Secretary of State
- C** — for Education and Science (E(LF)(85)2), while agreeing with many of Mr Jenkin's objectives, sets out a rather different way of handling central Government support for the education service, and by implication other
- D** — services also. In E(LF)(85)3 the Chancellor of the Exchequer proposes a more radical approach to the financing of education, opposes the proposal for a poll tax or residents' charge and argues instead for reform of the rating system.

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MAIN OBJECTIVE

3. The meeting is the first opportunity for most Ministers to discuss the DoE proposals. You will not want to reach final decisions on a reform package: there is insufficient information to be sure of all the impacts, and further work will be needed, eg on ways to mitigate some of the effects. But you will wish to secure agreement to the underlying principles, and to give DoE clear guidance for further work.

4. DoE Ministers will open the meeting with a short slide presentation explaining the basic facts of local government finance, setting out objectives, and introducing the proposed reforms. Although the package must be seen as a whole, I suggest that you structure the subsequent discussion to cover:

- i. general reactions to the objectives; and in particular whether the "local accountability" thrust of the DoE proposals is likely to be an effective control over local government expenditure;
- ii. non-domestic rates, particularly:
 - whether a national non-domestic rate is acceptable;
 - whether the yield should be pooled nationally;
- iii. the Central Government grant, particularly:
 - whether it should be paid to authorities as a fixed (lump) sum;
 - whether the education element should be under more central Government control as Sir Keith Joseph proposes;
- iv. alternatives to domestic rates, particularly:
 - whether the residents' charge is an acceptable alternative, with or without permanent or transitional cushioning arrangements;

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v. subsidiary matters, including capital controls, fees and charges, annual elections and the budgeting framework;

vi. assessment of the package as a whole.

5. In addition it will be necessary to decide whether any form of public discussion should be entered upon now, and to give preliminary consideration to the timetable for a White Paper and for legislation.

i. General reactions to the objectives

6. The criticisms made of the current systems of controlling local government expenditure and of distributing Exchequer grant are both well known and well founded. These systems have produced only modest success in achieving the Government's expenditure objectives while embroiling the Government in widespread conflict with local authorities.

7. The DoE paper suggests that there are two options for reform: more direct Government control over local authority spending, or a "self-regulating" system based on improved accountability. The second is regarded as being more consistent with Conservative Party tradition. The DoE proposals are therefore based on the premise that there should be no fundamental change in the relationship between central and local government (and no changes in responsibilities for services), but they are designed to ensure that more electors bear directly and more fully the financial consequences of councils' spending decisions while limiting councils' power to draw on the resources of non-domestic ratepayers and of the Exchequer.

8. It follows from the DoE proposals that there will be no significant change in responsibilities for the financing and management of individual services, and that the Government will surrender most of the existing mechanisms for controlling local government current expenditure. It will retain control only over the quantum of the non-domestic rate and the central government grant. These are very crude weapons and a key issue is whether the Government is prepared to accept the uncertainties

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for total expenditure that this implies. Because the changes proposed are so comprehensive it is not possible to predict the likely outcome for total expenditure. The uncertainties will become greater the more steps are taken to mitigate the effect of the change in local taxation on particular types of area or individual.

9. In this context the Chancellor of the Exchequer has advocated (E(LF)(85)3, paragraph 5) that central Government might take over complete responsibility for financing and some aspects of the management of education. This would necessarily increase Government control over education policy and expenditure but it would not on its own account do anything to enhance the powers to control remaining local expenditure. DoE have argued against the approach suggested by the Chancellor because it would require a substantial increase in DES control over local authorities, with the need to set an education budget for each local education authority, and would be cumbersome, inefficient and expensive. The Secretary of State for Education and Science has made a more limited proposal for modifying the block grant regime to give him greater influence but without assuming full responsibility. This involves a modification to the proposed Exchequer grant arrangements, and might be considered in that context - paragraph 18 below.

ii. Non-domestic rates

10. DoE suggests that non-domestic rates should be retained but that they should be collected nationally, at a single nationwide rate set by the Government. The amount collected would be allocated to local authorities as a standard amount per head (ie in proportion to population and not in proportion to the non-domestic rateable values within each district).

11. This proposal will prevent profligate local authorities taxing business excessively. But it will also have major redistributive effects both for non-domestic and domestic ratepayers. If the national rate is set at the current average level, businesses in low spending areas will face 30 per cent rate increases. Businesses in high spending

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areas will benefit from a corresponding decrease. Generally the effect on domestic ratepayers will be the opposite. The effect of pooling will be to transfer resources from areas with a relatively high proportion of non-domestic ratepayers (eg Inner London or Croydon) to other parts of the country.

12. The Sub-Committee will wish to consider whether an increase of almost a third in the rates paid by business in some areas can be contemplated, although this effect could be softened by transitional arrangements. Discontent would be accentuated by the fact that the level of service provided by the local authority would continue to vary: those paying increased rates would continue to receive the services provided by a low spending authority. Alternatives are:

- i. to set a maximum rate, or increase in rate, nationally but, within that constraint, to leave the existing pattern of rates unaltered; and
- ii. not to redistribute the proceeds of the rate between areas.

This would still ensure that marginal spending would be financed by the electors rather than by business, while reducing the scale of the domestic taxation needed in high spending areas. It would, however, perpetuate to some degree the existing, unfair pattern of non-domestic poundages.

13. You will wish to explore in discussion whether a uniform national non-domestic rate is acceptable in principle, and if so whether the yield should be pooled nationally. If this is endorsed, DoE will need to undertake further work on how a national rate should be set, on transitional arrangements, on special arrangements for London, and on the problem of different levels of service being provided.

iii. The central Government grant

14. Central Government provides currently about 46 per cent of a local authority's income on average. Some of it is distributed as specific grants but most as Rate Support Grant (RSG). This is allocated by a

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formula which compensates for differences in authorities' rateable values and, through mechanisms such as target-holdback and grant slope, can be used as a lever to influence authorities' total current spending. Rate limitation had to be introduced to provide a more effective weapon. The system is unfair, inflexible, and often ineffective, and the political and practical pressures to abandon it are strong.

15. DoE propose that a simpler system should be introduced. They argue that the need to compensate for differences in the rateable values in different areas would disappear if non-domestic rates were replaced by an alternative tax not related to property. But the difference in "need" would still have to be taken into account. So they propose a "lump sum needs grant", consisting of an element to compensate for differences in assessed need and cost of provision and above that a standard sum per elector determined nationally. This would ensure that local taxpayers receiving a similar level of service would pay a similar amount for it.

16. Furthermore under this system the amount of grant received by an individual authority will not vary (as the present one does) according to the level of expenditure it decides upon. The whole of the cost of higher spending would fall on the local electors, and conversely they would receive all the benefit of any reduction. The system is also simple and easy to explain and justify. It does, however, remove almost all direct Government influence over levels of expenditure, relying primarily on increased accountability for pressure to contain spending. If local electors return a council bent on high spending the Government would have neither the responsibility nor the power to prevent that.

17. The effect of increased accountability might be dramatic: the new grant arrangement coupled with pooling of the non-domestic rate would result in much higher local taxes for households in high spending authorities. When combined with the results of the Social Security Review some low income households in a few of the highest spending authorities could find their rate bills doubled or tripled. This might

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create an effective pressure for reducing spending. Conversely there are modest gains for all ratepayers in low spending authorities.

18. The Secretary of State for Education and Science proposes in E(LF)(85)2 that he should become responsible for the total of central Government grants for education, ie that the lump sum grant should be divided into at least two, and possibly more, separate elements. This would give him scope for exerting greater influence over local education authorities by switching within the education block between specific and block grant. This raises issues of principle and practicality. The division of the block grants into service sectors would represent a significant change in the relationship between central and local government, with the latter much closer to being agents of the former rather than having power to determine their own priorities between services. Much work would need to be done on how a scheme would work.

19. The Sub-Committee will need to consider whether a lump sum needs grant is acceptable in principle, and if so to invite DoE to do further work on methodology.

iv. Alternatives to domestic rates

20. The ideal local tax should be perceptible and widely based. Property taxes are perceptible but not widely based, and DoE therefore propose a resident's charge to replace domestic rates. This would be paid by all adults, thus increasing the tax base from 18 million to 35 million people. It would also produce substantial shifts in incidence between households, with single person households and those living in high rateable value houses gaining, and those with three or more adults or living in low rateable value households losing.

21. The average resident's charge would be £160 per adult. About 90 per cent of authorities would levy charges in the range £60-200 per adult, although a small number (all in London) would charge over £300 up to a maximum of £780. This form of tax is completely regressive. Domestic

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rates are also regressive, but because there is at least some relationship between the rateable value of houses in which people live and their income they are not completely so. There would be some assistance for people on very low incomes, but otherwise the charge could represent, eg up to 20 per cent or more of the income of households on relatively low incomes in a high spending area in London, assuming their authority maintained spending at present levels. This would be the price of maintaining pressure for economies in local authorities' spending through accountability alone.

See
Table 3(c)

22. It would be possible to mitigate the more extreme effects through a graduated resident's charge so that those on high incomes paid more, although this type of scheme akin to a local income tax poses administrative problems. Alternatively a hybrid scheme using both a resident's charge but with domestic rates at a reduced level might be constructed, permanently or for a transitional period. Any such relaxation would, of course, blunt to some extent the effect of the reform on accountability. The Chancellor (in E(LF)(85)3) argues that a more equitable property tax would be preferable to a resident's charge with all the complexities that he believes would be needed to make it acceptable.

23. There would also be administrative difficulties with a resident's charge. Other annual fixed rate taxes - the television licence and vehicle excise duty for example - suffer high degrees of evasion, and the resident's charge, being higher, will offer a greater temptation. Because it would be collected locally, it would be necessary not only to detect that somebody was not paying the tax, but also that they were resident in the area concerned. The scope for evasion would appear considerable.

24. The Sub-Committee will need to consider whether the resident's charge meets the Government's requirements better than the other alternatives to rates which have been considered - principally local income tax and local sales taxes. If so, is it likely to be too regressive to be used alone, and should any permanent or temporary means of relief be built into it?

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v. Subsidiary matters

25. The DoE package contains a number of other elements: reform of the controls of capital expenditure to provide better delivery of the Government's spending plans, an increase in the use of fees and charges to finance local services, annual elections to reinforce accountability to the local taxpayer, and better rules to prevent "creative" budgeting to circumvent the consequences of high spending. While these are important - particularly capital controls and annual elections - none affect directly the structure of the main reform. It might therefore be appropriate to postpone detailed consideration and decision to a later meeting.

vi. Effect of the package as a whole

26. The package is designed to be self-regulating. The contribution to local government spending from non-domestic rate payers and the Exchequer will be determined by the Government, while councils will have the freedom to tax their adult electors as far as they will permit. The consequences for typical taxpayers will therefore depend on how councils and electors respond. DoE have exemplified in the Specification Report the changes in cost for a range of typical households, but necessarily based on existing patterns of spending. It follows that if these exemplifications were to materialise in full, the reforms would have failed in their objective of increasing the pressure on high spenders.

27. The exemplifications are on pages 25-29 of the Specification Report. They show for a range of typical households the effects which flow from (i) the changes already agreed in the social security system (ie to restrict rate rebates), (ii) the changes in non-domestic rates and block grant in addition, and (iii) the change in domestic rates on top of that, according to the spending pattern and rateable mix of a range of authorities. They show that:

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- i. for inner London the combined package results in local taxes taking a substantial proportion of income;
- ii. single member households are generally better off and multiple member households worse off under the new regime;
- iii. people in high spending authorities will pay more; those with low spending authorities will pay less.

Effects (ii) and (iii) are of course intended, though not necessarily on the scale shown. The figures on pages 20 and 21 of the Specification Report show the number of households gaining and losing by various amounts as a result of the changes to non-domestic rates and block grant (page 20), and by the change to domestic rates in addition (page 21). The Sub-Committee will need to consider the acceptability of changes of this order. If they are thought to be broadly acceptable though too extreme in some cases, the scope for a permanent or temporary degree of relief could be investigated. This is likely to be necessary for London in particular.

NEXT STEPS

28. There will be a strong public expectation that the Government should indicate how much progress has been made. For their part, DoE believe it would be helpful to be able to consult slightly more widely outside Government in the next phase - as had always been envisaged. The Sub-Committee might wish to consider releasing much of the preliminary analysis contained in the Introductory Report, but stopping short of detailing the detailed elements of the package.

29. Within Government, if the Sub-Committee is content with the basic principles behind the package, they might invite DoE to refine their exemplifications and to consider what transitional or permanent special arrangements might be needed to reduce the extreme effects. The Specification Report does not deal with the Public Expenditure, revenue and PSBR effects, and the Chancellor of the Exchequer has also called for a more wide-ranging consideration of macro and micro-economic

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impacts. These would need to be considered between DoE and Treasury officials. DoE could perhaps produce a progress report by July, though September might give them more time to carry the work forward significantly, for further discussion in E(LF) or in a smaller group if appropriate, with final proposals in the later autumn. This would enable the original timetable of a White Paper in the autumn and legislation in 1986/87 to be adhered to if the Government wished. During the next phase it would also be appropriate for the Scottish and Welsh Offices to consider the implications for their parts of Great Britain.

HANDLING

30. You will wish to invite the Secretary of State for the Environment, the Minister for Local Government and Mr Waldegrave to introduce the subject using slides. You might then suggest that it will help to structure the discussion by dealing with broad philosophy, non-domestic rates, lump sum grant, alternatives to domestic rates, subsidiary issues, overall effects and next steps in that order. For each of the detailed areas DoE Ministers will wish to introduce the proposals. Treasury Ministers and those responsible for particular local authority services will wish to contribute to most topics and the Secretary of State for Education and Science will wish to introduce his alternative proposal for education grants during discussion of the lump sum grant.

CONCLUSIONS

31. You will wish to reach conclusions on:

- i. whether the general principles set out in the Introductory Report are accepted, and if a self regulatory system offers the best prospect;

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- ii. whether non-domestic rates should be set nationally, whether the yield should be pooled and distributed on a per capita (rather than rateable value basis), and whether any special arrangements are needed to protect London local taxpayers;
- iii. whether the Exchequer contribution should be on the basis of a lump sum needs grant, comprising a needs element and per capita allowance;
- iv. whether a resident's charge is a suitable alternative to domestic rates, and whether it is too regressive to be used without modification;
- v. whether the package as a whole is adequate in principle and whether the practical results seem likely to be acceptable;
- vi. what further work DoE should put in hand, in particular on modifications or alternatives to the resident's charge to mitigate the effects either permanently or in a transition period;
- vii. the arrangements for reviewing progress in July or September; and
- viii. what information might be released at this stage.

PLG

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17 May 1985

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