PRIME MINISTER 20 September 1985

REFORM OF LOCAL AUTHORITY FINANCE

The present system of local authority finance needs reforming because:

- it has made the Government unpopular;
- it has given the far-Left a field day;
- it gets more unfair each year; and
- it is virtually incomprehensible.

The reform package advocated by Ken Baker and William Waldegrave could help to overcome these problems and is certainly the one serious runner, since the changes proposed by the Chancellor and Keith Joseph would be politically suicidal. But we still have doubts about some of the components.

Control of Local Spending

The Chancellor wants to retain both rate-capping and a power to reduce grant for the high-spenders.

If you agree with him that these controls will still be needed, then there is absolutely no point in proceeding with any package of radical reforms. You would merely succeed in upsetting a lot of people, without removing either the complexity or the unpopularity of the present system; and the far-Left would have an even better time of it.

Much the same applies to Keith Joseph's idea that each spending department should control grant for each service, with a large proportion of specific grants. This would transfer power from the local authorities to Elizabeth House: out of the frying pan, into the fire. And a great deal of hostility would be generated in the process.

Reforms make sense only if they create a simple system that checks spending without the need for central intervention. At present, even with the tough block-grant regime, no class of authority has to add as much as £1 to domestic rate bills when an extra £1 is spent; whereas under the new system, the whole of each extra £1 will fall on the domestic tax. And, since domestic taxes will raise only 15% of the total revenue, the outcome will be a 5% or 6% addition to household bills for each additional 1% of spending.

But this intrinsic check would be seriously compromised by the DoE's new proposal to hypothecate a fixed proportion of VAT, instead of leaving central government to fix the overall amount of grant. Since VAT is buoyant, the effect would be to provide local authorities with an ever greater proportion of grant, and ever more incentive to spend.

Gainers and Losers

Many of the DoE's tables deal in averages. These are of little importance. Politically, it is the individual losers that matter.

There are still:

- 100,000 households that lose more than £500 pa; and
- 100,000 households that lose 5-10% of their net income.

The numbers may seem small by comparison with the 17.8 million households in England. But pressure groups and your political opponents can make a lot of fuss on the basis of 100,000 casualties. Take the following example, based on the DoE figures:

> Four young people have set up a new computer-game business, with the help of the Enterprise Allowance Scheme. They share a house in South London, which one of them owns, and have a small workshop in Croydon.

At present, they have a net income of only £8,000 between them, and are struggling to meet a domestic rate bill of £300 and a non-domestic rate bill of £500. They are told that, under the new system, they will be expected to pay £800 in domestic charges and £650 in non-domestic rates - in all, a jump from £800 to £1,450, knocking away almost 8% more of their net income.

Dr Owen and his economists will know what to say about cases like this.

The Chancellor claims that his system of domestic rates, based on capital valuation, would improve matters. But the figures in his Inland Revenue report do not bear this out. As Table 2 of the report shows, a change to capital valuation would tend to produce big gains and losses. And it has other disadvantages:

- there will be large numbers of appeals;

- there will be a great temptation to bribe valuers into classing a house as worth £59,999 rather than £60,001;

- your supporters will regard the scheme as a wealth tax;

- the distributional effects (according to the Chancellor's figures) will hurt large numbers of voters in the middle of the price range, who already resent what they see as the Government's failure to deliver tax cuts;

- the effects on some single occupiers will be horrific.

Even with "occupancy relief" for single pensioners, capital valuation is not a runner.

A Workable Solution

The only way of keeping losers at an acceptable (ie a minimal) level is to adopt the DoE package, but with two important amendments, as well as the abandonment of the VAT hypothecation:

1. **Proper transitional arrangements**. Chapter 6 of the DoE report, which deals with the transition, needs strengthening. Shouldn't you look at ways to ensure that nobody's local tax bills (domestic or non-domestic) rise by more than, say, 10% per year?

2. **Capping of the non-domestic rate, instead of nationalisation**. Besides causing at least half of the redistributional swings on the domestic front, nationalisation will be unpopular with many Government supporters on local councils; will damage job-creating small businessmen in hi-tech and service industries in the South East; and will cause heavy losses for rate-payers in London. If the non-domestic rate were capped instead of nationalised - say, a maximum rise of RPI+1% in any given year - and if there were a resource-equalising grant with special arrangements for London, most of the large domestic gains and losses could be avoided and small businesses would be protected, without antagonising your supporters in local government.

Retaining a Property Element in the Residence Charge

We agree that DoE have found the best way of augmenting the residence charge, if it is still felt that the £150 a head personal charge is too high and too regressive. Basing the property element on floor area is a satisfactory compromise, providing the proportion financed by the property tax is kept low so that people can see a large and dramatic decline in their rates bill as opposed to their total local tax bill.

No Special City Grant

DoE make out a sensible case here. But the Green Paper should not rule out the possibility of giving more money to the inner cities through direct Government programmes, so that you can reduce the amount of Grant wasted.

Relation to Other Reforms

Cabinet Office have rightly asked about the combined impact of the Welfare, Local Government, and Income Tax reforms. We will need more figures on this; but, so far as we can see, the proposals should mesh fairly well.

In general, poor working families come out well - helping to encourage job-seeking; and single pensioners, who are hit hardest by Fowler, recoup from Baker. The main losers are probably working households with large numbers of earners (who have been especially well treated in the past) and married pensioners with incomes near the top of the benefit range (who have previously been exempt from contributing to the cost of local government).

True, there will be an addition of £35 million to Housing Benefit, and another 700,000 people on means-tests. This is obviously unattractive, but it is a necessary consequence of exposing all adults to some local tax.

Subsidiary Issues

The DoE report does not deal with a number of important issues:

1. The precise construction of the needs grant. Will it be comprehensible? And will it produce sensible results?

2. Increasing fees and charges. This admirable proposal was strongly touted in earlier DoE drafts. Why has it now dropped largely from view?

3. Capital controls. These need to be worked out fast, so that they can come into operation next year, regardless of the progress of the rest of the reforms.

4. Annual elections. We still believe that fiddling with elections is politically unappetising - however pure the motive; but DoE are threatening to come back on this.

All these points will need to be settled before a Green Paper can be issued.

Timing

There is no technical obstacle to early legislation. You could have:

Green Paper	December 1985
White Paper	Spring 1986
Bill Introduced	Autumn 1986
Act Passed	Summer 1987
Implementation	April 1988

This would involve controversial legislation in the 1986/87 Session; but there is no other way to have the proposals in force by 1988. If you delay beyond then, the reforms will not have worked through in time to be accepted by the Election after next!

Conclusion

We recommend that you should:

- accept the DoE's package, as the basis of a Green Paper at the end of the year;

but press for:

- no hypothecation of VAT, leaving the Government free to settle the total amount of grant;

- fully worked-out transitional arrangements to prevent all sudden swings for individual households;

- capping of the non-domestic rate, instead of nationalisation, with appropriate resource equalisation and London arrangements, to eliminate the swings for businesses and to minimise losses for domestic taxpayers;

- full details of the new needs grant, with analyses of gainers and losers;

- firm proposals for increasing fees and charges, and for reforming capital spending controls;

- analysis of the relationship between these reforms and the Welfare and Income Tax proposals, without delaying the Fowler White Paper.

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