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RATES

A paper by Michael Heseltine

I. The pledge made at the October 1974 General Election contained two elements:

> "Within the normal lifetime of a Parliament we shall abolish the domestic rating system and replace it by taxes more broadly based and related to people's ability to pay",

and

> "Local authorities must continue to have some independent source of finance".

To implement the pledge in full at today's figures would cost £2,000 million. This could be phased over any chosen period. There are a very limited number of alternative local tax options available.

1. Poll Taxes. These taxes on the whole adult population are popular with ratepayers, but because they are flat rate taxes they would not reflect ability to pay and among lower income groups become extremely regressive. They would be difficult to administer and collect especially in localities where there is significant population mobility. To raise £2,000 million would require a poll tax on all adults of about £70 per head; a poll tax of about £4 per head would raise £100 million. It is also doubtful if this would be seen as a genuine abolition of the rates system.

2. Local Income Tax would be technically feasible. It was recommended by Layfield as a supplement to Rates. It would be fairly expensive to administer (Layfield in 1976 estimated that 12,000 extra staff would be needed at a cost of £50 million) but Inland Revenue computerisation would enable the taxpayer to pay LIT to his home authority without difficulty. The major obstacle is that the Party is committed to a reduction in direct taxation and that this would be difficult to achieve if LIT was introduced. To raise the equivalent of the revenue of domestic rates would require an increase of five pence in the standard rate of income tax.

3. Local Expenditure Taxes have been discussed by the Party. In a geographically small country like Britain there is little scope for regionally and locally varied VAT. It is widely believed that for the purchase of expensive items customers would resort to border-hopping. It is also possible that the EEC would block a locally varied VAT. Shopkeepers are hostile to the proposal because they believe that they would be used as tax gatherers and see no prospect of a complementary remission in the burden of commercial rates. Layfield criticised the proposal because they felt that few people would connect a variable element in prices caused by local VAT with the performance of the local authority. To raise the equivalent of the revenue of domestic rates would require an increase of five per cent on VAT. One

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form of expenditure tax which is less vulnerable to some of these criticisms is a local tax on motor fuels. This would have the merit of being based on local expenditure, operated through a limited number of sales outlets, already subject to local variations in price. It is however a useful regulator and there would be strenuous Treasury resistance to the annexation of all or part of this tax for local government. To raise the equivalent of the revenue of domestic rates would require a levy of forty pence per gallon on motor fuel duty.

4. Increased Charges. There is scope for increases in the charges levied for a number of local authority services, including rents, and for the introduction of new charges for services like dealing with planning applications. Current revenues from charges are shown in Appendix I.

II. In the Right Approach we said: "While we remain committed to the objective of abolishing the domestic rating system, the recent report of the Layfield Committee will have to be carefully studied before we bring forward detailed proposals."

If we do not opt to move to one of the choices set out above we can freeze the rates payments at their present level by adjusting the Rate Support Grant contribution from Central Government and we can as circumstances permit gradually increase the present 61 per cent RSG to anything up to 100 per cent over any period.

1. Full Exchequer Funding

This first option is centralist. It would remove from local government an element of autonomy and discretion in the raising of revenues which the majority of councils use responsibly. It would be fought bitterly by large sections of the Party in local government. This option would also remove the real but limited accountability of the local authority to the electorate. Although only some ratepayers have the vote and only some voters pay rates, accountability consciously exists. Furthermore the disappearance of the domestic ratepayer would leave the commercial and industrial ratepayer in a vulnerable position. In particular the small business ratepayer would feel very exposed and we would need to legislate to curtail local government's power to place unsustainable burdens on industrial ratepayers.

In the short term it would be possible to switch to full exchequer funding - and thus to honour the October 1974 pledge - by increasing the RSG by four annual tranches of about £500 million, raising the level of grant progressively from 60 per cent to 100 per cent. Something like this is being done in Ireland. Alternatively the transfer to exchequer grant might be made over a longer period, say 10 years at £200 million per annum.

The Irish Government were able to implement their proposals because

(a) their rating system was far more distorted than ours (the last general revaluation occurred in the 1860s);

(b) their local authorities provided fewer services, e.g. they were not responsible for Education and received Government Grants to cover capital expenditure on housing;

(c) they have a tradition of intervening to remove the rates burden (this is already done for farming);

(d) the revenue of commercial and industrial rates, except in Dublin, is comparatively small;

(e) the position of local authorities is weaker than in Britain and the Government expect to be able to set a statutory limit to rate increases.

2. Retain Modified Rates

As it is likely that we will not wish to proceed too fast with our commitment we could adopt a modified proposal which I would recommend as the basis of our policy for the manifesto.

The Manifesto

We should restate our view that the domestic rate system is unfair and should be phased out but we should put this commitment firmly in a lower priority than cuts in income tax.

We should promise by further increase in the exchequer contribution through the RSG to reduce the domestic rate by stages after the prime objective of reduced direct taxation had been met but not commit ourselves to the total abolition of domestic rates within the next Parliament.

We should pledge protection to the commercial and industrial ratepayer as domestic rates are replaced.

We should promise that increasing central funding as a percentage of local expenditure would be accompanied by a root and branch reappraisal of centralised decision taking and monitoring by Whitehall with a view to its reduction. In this way we would offer an increased discretion to local authorities, and would hope to achieve significant savings by reducing the cost of detailed scrutiny. Genuine success in this direction would be very popular with our local government colleagues and would go some way to overcome their anxiety about the phasing out of domestic rates.

I have considered a freeze of rates at their existing level but the costs in terms of central government expenditure could be daunting. If next year saw inflation at 15 per cent there would be an increase in local authority expenditure of about £1.8 billion. The domestic rate contribution to this would be £400 million. This would have to be found to honour such a pledge.

Should colleagues wish, Michael Alison has designed a scheme which would go much further and introduce a more direc[t] and perceptible change in the relationship between local and central taxes. The method would be that of tax allowance for the domestic ratepayer, effectively making the average household domestic rate tax deductible for the standard rate taxpayer. In principle, such an allowance would represent an extension of the rate rebate scheme (which is itself a form of tax relief): indeed at present levels of taxation and rebate, many of those now drawing rate rebate would be better off with a tax allowance in lieu. The allowance could be made subject to a specific limit to ensure progressiveness. The full details of the scheme are developed in appendix II.

There will still be attendant problems in the field of local authority finance:

(a) Colleagues will remember that Peter Shore told us privately that as another rental valuation was not possible he sought our support for a switch to capital values. We refused this request and the Government are now seeking to delay the revaluation for obvious political reasons. But the long term problem of updating valuations remains. The Inland Revenue Department argues that rental values will not be adequate for another revaluation, although Layfield disagreed with this view. A shift to capital values could provide an alternative, but problems of market volatility and local variation are not easily solved and would in some ways exacerbate the anomalies of the present system.

(b) Further changes will be necessary in the constitution of rate support grant, because the alterations in grant determined by the Secretary of State for the Environment can have more effect on the local rates payable than have the spending policies of the local authority. Colleagues will be very familiar with the anti-shire county bias of recent RSG settlements.

(c) Local authorities must look to charges including rents to provide a more significant share of revenue.

(d) Measures to mitigate the impact of rates are necessary. These should include

(i) measures to help small business ratepayers including a statutory right to payment by instalment and eligibility for domestic relief where appropriate;

(ii) much improved publicity for rate rebates, and for payments by monthly instalments.

(e) As long as the rating system remains we shall achieve no economies in its administration as the on-going valuation and collection is just as expensive if you are collecting 40 per cent of relevant expenditure from ratepayers or 10 per cent.

(f) A new basis will have to be found - once rates go - for collecting water charges. Although there is much dissatisfaction at the moment with water rates, as long as the domestic rating system exists, whether for four or ten more years, we can continue the present method of collection.

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APPENDIX I

Charges

At present local authorities raise approximately £1,400 million in fees and charges, half of which is derived from rents for council housing (the total cost of rate fund subsidies to housing revenue accounts in 1977-8 was £251 million plus £87 million towards rent rebates). Trading services including municipal transport account for about £140 milliin and charges levied on various services such as licence fees, charges for old peoples' homes, parking fees, trade refuse collection, library charges and the sale of school meals and milk raise a further £540 million. (The cost of school meals to local government was £377 million in 1977-8, and transport £98 million 1977-8). During recent years the contribution of fees and charges has fallen sharply, particularly in the housing field, where the proportion of expenditure covered by rents has fallen from 61 per cent in 1973-4 to 48 per cent in 1974-5.

In a recent IEA Paper "Pricing or Taxing" Harris and Seldon point out that many services meet only a very small proportion of expenditure from charges (England and Wales 1973-4), school meals and milk 34 per cent, libraries and galleries 6 per cent, refuse collection 4 per cent and parking 61 per cent.

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APPENDIX II

Income Tax-relief for Rates - by Michael Alison

In the short term it will be necessary to find ways of mitigating the unpopularity of the rates among ratepayers. Several methods are available including a drive to increase the take-up of rate rebates and the more vigorous promotion of repayment by monthly instalments.

Another means of mitigating the rates burden, which has been canvassed by the Rating and Valuation Association, and discussed but rejected by Layfield, is the introduction of income tax relief for ratepayers against all or part of their rates liability. Until 1975 it was in operation in Australia and a householder could claim the total amount of municipal rates as a deduction in assessing personal income tax. This concession disappeared when the Whitlam Government replaced eligibility for specific tax relief with a general tax allowance.

An allowance for rates against income tax would clearly benefit the ratepayer and remove some of the discrimination against him. By inference non-ratepayers would pay for the tax allowance, by higher levels of other taxes to meet the deficiency. The direct relationship between the rating authority and the ratepayer would however remain, although the element of accountability associated with payment of rates would be affected by this tax relief. The principle of tax relief is consistent with the present practice of allowing the offset of commercial rates, etc. as a loss against Corporation Tax. Rate rebates are also conceived as a form of tax relief. The threshold of tax allowances would be integrated with the rebate system to avoid the creation of a poverty trap.

Arguments for and against

1. Allegedly a tax-deductible domestic rate would weaken the responsibility and accountability of the elected members of local authorities for the financial consequences of their decisions because it reduces the impact of rates on the elector.

   This is partially true, but it would clearly be less damaging to accountability than total abolition, i.e. the switch to full and direct Exchequer funding of local authority expenditure. The accountability which derives from the rate is in any case weak because:

   (a) all ratepayers do not have the vote in local elections

   (b) all electors do not pay rates

   (c) the RSG in general, and the domestic element included to cushion domestic ratepayers in particular, already subsidise the ratepayer and reduce the impact of rates.

   It would in any case probably be necessary to combine the introduction of a tax allowance with the abolition of the domestic element of RSG, thus making the relief to the ratepayer more direct and tangible.

2. Allegedly, it is bad in principle because taxes are in general non-recoupable against other taxes so far as individual taxes are concerned.

   This may be true, but the offset of commercial rates against Corporation Tax is already used.

3. Allegedly it would add further illogicality to the domestic element of RSG.

   This is true, but the domestic element is expendable and tax allowance might be a preferable way of giving relief because ratepayers will see the full cost of the rates without a hidden subsidy.

4. Allegedly allowing rates against income tax would produce further inequities for those below the tax threshold in particular and for taxpayers whose rate contribution is indirect.

   The scheme would have to be integrated with rate rebates so that the poverty trap was eliminated. It would be administratively possible to give tax relief to tenants who paid the'r rates as part of the rent.

5. It might be seen as a move by the Government to subsidise luxury housing or to relieve gross 'over housing' of its natural economic consequences.

   This could be overcome simply by the use of a fixed allowance. The ratepayer in more expensive property would receive no more relief than the householder in more modest premises. This would recognise the requirements of basic housing up to certain standards, and an element of choice in housing beyond that point. A tax allowance with a set limit would be less regressive than the present domestic element of RSG which gives greater relief to ratepayers with larger rate bills.

How the Scheme Would Work

In 1977/8 local authority revenue from domestic rates amounted to £2,000 million, and the domestic element of the rate support grant contributed £660 million. The total domestic sector revenue is therefore £2,660 million.

If a Government was prepared

(a) to make available £750 million new money from general taxation,

(b) to abolish the domestic element on the grounds of its regressiveness, and

(c) to make the sums available for an income tax allowance against domestic rates,

it would be able to reduce the Domestic ratepayers contribution from £2,660 million by £1,410 million (£750 million new money and £660 million in lieu of domestic ele..nt) to £1,250 million. Domestic ratepayers would, therefore, pay £1,250 million net as against £2,000 million at present. The £1,410 new tax allowance is 53 per cent of the Gross Rate Bill. To calculate the entitlement of individual ratepayers we need to assume that the average domestic rate bill in 1977/8 (allowing for domestic element in RSG) was £110. Without the domestic element it would be £146. The average cash value of the allowance would need to be 53 per cent of £146. This is roughly £75. To achieve the cash value of allowance of £75 at the standard rate of tax (34 per cent) the tax allowance would need to be £220.

The effect of such an allowance on four types of ratepayer is set out below:

		£	£	£	£
(a)	4 houses - Rateable Values	75	150	200	400
(b)	Say present Domestic Rate (80p in £)	60	120	160	320
(c)	Say new Rate with no Domestic Element (98.5p in £)	74	148	197	394
(d) (i	Saving at present to each Householder by reason of Domestic Element (18.5 x Rateable Value)	13.87	27.75	37	74
(e)	Saving to each Householder by reason of an Income Tax Allowance of £220 (Assumes tax payments at Standard Rate)	75	75	75	75
(f)	Difference to each Householder from replacement of Domestic Element by an Income Tax Allowance of £220	61 Better off	47 Better off	38 Better off	1 Better off

This demonstrates how the proposal would help to reduce regressiveness and promote progressiveness in the net rate payment.

Proportion of Rates being met by Tax Allowance	100%	51%	38%	19%

The benefit at the lower end could be reduced by using a percentage allowance with a mxximum allowance at the level indicated. This would reduce the cost but would increase the administrative problems for the Inland Revenue.

If a Government was only prepared to put in £250 million or £500 million of new money, the allowances would need to be reduced to

£500 million new money - cash benefit £66, therefore, Tax Allowance £195.

£150 million new money - cash benefit £55, therefore, Tax Allowance £162

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