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TREASURY

PART

4

PART BEGINS

8 November 03.

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5 MAY 2005

CAB ONE

Labour Administration

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# PART

# CLOSED

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Series : **TREASURY**

File Title : **TAX**

Part : **4**

Date	From	To	Subject	Class	Secret
14/11/2003	PD(AMc)	PM	Local Income Tax	R	
14/11/2003	PD(MH)	PM	Council Tax: Waste/Recycling	R	
22/12/2003	EU/PS	HMT	Tax decision by the ECJ	C	
10/02/2004	PD(GM)	PM	Fat Taxes - Mea Culpa	U	
15/02/2004			Sunday Telegraph - Council Tax to be replaced by new levy on income	U	
17/02/2004	PMG		To Gerald Kaufman MP: Concerns about the anti-avoidance measure		
29/02/2004			mail on Sunday - MPs in a rage as whitehall drags its feet	U	
02/03/2004	CBI	PPS	Investing to meet the UK Productivity challenge	U	
11/03/2004	Ch.Staff	PRESS	PA news "Blair and Brown must tell truth on tax rises" Tories	C	
23/03/2004	pd(amac	PM	Council tax Options for reform	C	
26/03/2004	pd(amac	PM	Council Tax capping	C	
07/10/2004	SO	CH EX	Scottish Executiver's Tax Proposals for Budget 2005	U	
07/10/2004	DfT	CH EX	Tax Proposals for next budget	U	
09/11/2004	HMT	LPS	Commissioners for Revenue and Customs Bill	U	
09/11/2004	PMG	HOC - Leader	Tax Law Rewrite Project: Income Tax (Trading and other income) Bill	U	
25/11/2004	HOC - Leader	PMG	Tax law rewrite project: Income Tax (trading and other income) Bill	U	
04/03/2005	SU	PPS	Tax reform	C	
11/03/2005			Tax Credits reforming financial support for families	U	
21/03/2005	ss/defra	DPM	Council Tax Capping	U	





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**defra**

Department for Environment  
Food and Rural Affairs

21

March 2005

*DMC*  
*cc MH*  
*VB*

From the Secretary of State  
The Rt Hon Margaret Beckett MP

*Dear John,*

#### COUNCIL TAX CAPPING

I am replying to Nick Raynsford's letter of 11 March seeking agreement to the arrangements proposed for handling Council Tax capping in 2005/06.

I confirm my agreement to the arrangements set out in Nick Raynsford's letter and enclosure, and note you propose to make an announcement on 23 March.

I am copying this letter to the Prime Minister, Nick Raynsford, members of GL, Sir Andrew Turnbull and Paul Britton in Cabinet Office.

*Regards*

*Margaret*

MARGARET BECKETT



Fide

# **Tax credits: reforming financial support for families**

**The modernisation of Britain's  
Tax and Benefit System**

**Number Eleven**

---

March 2005



HM TREASURY





HM TREASURY

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Tax credits: reforming  
financial support for families

March 2005



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# INTRODUCTION

1.1 Over the past seven years the Government has reformed Britain's tax and benefit system to achieve three over-arching objectives:

- ensure adequate financial incentives to work;
- reduce child poverty and increase financial support for all families; and
- tackle poverty among the current generation of pensioners and support people in providing for their retirement.

1.2 In the past, the tax and benefit system failed to address the challenges of rising worklessness, and poverty among families and pensioner households that emerged from the early 1980s. In the UK even during periods with relatively high employment, rates of household worklessness and child poverty were higher than in most other industrialised countries, and reached historically high levels in the mid-1990s. Further, while pensioners' incomes were improving on average, there was a large group of pensioners whose standard of living was falling behind the rest of society.

1.3 To deliver the Government's aims of employment opportunity for all; giving every child the best start in life; and dignity in retirement for all pensioners, the need for fundamental reform of Britain's tax and benefit system was clear. This paper describes the reforms put in place since 1997 and the principles which underpin them, and sets out the evidence on their impact so far.

1.4 Chapter two describes the trends of rising worklessness and child and pensioner poverty, and outlines the structure of the tax and benefit system prior to the reforms the Government has introduced and the inadequate work incentives that it contributed to, especially for families.

1.5 Chapter three highlights the role of tax-benefit integration in providing effective incentives and targeted financial support for families and other groups. It outlines the key principles which underpin the Government's reforms of the tax and benefit system and the concept of net tax as the appropriate measure of a household's tax burden. Chapters four to six describe how the principles governing policy design have guided the Government's reforms and also assess the evidence on their impact.

1.6 The Government's policies to modernise the tax and benefit system constitute the most fundamental programme of welfare reform since the 1940s. Nevertheless there remain important areas where further reform could contribute to the Government's aims. Chapter seven explains how future policies to reform Britain's welfare state will be guided by the principles for modernising the tax and benefit system.



## THE LABOUR MARKET AND POVERTY

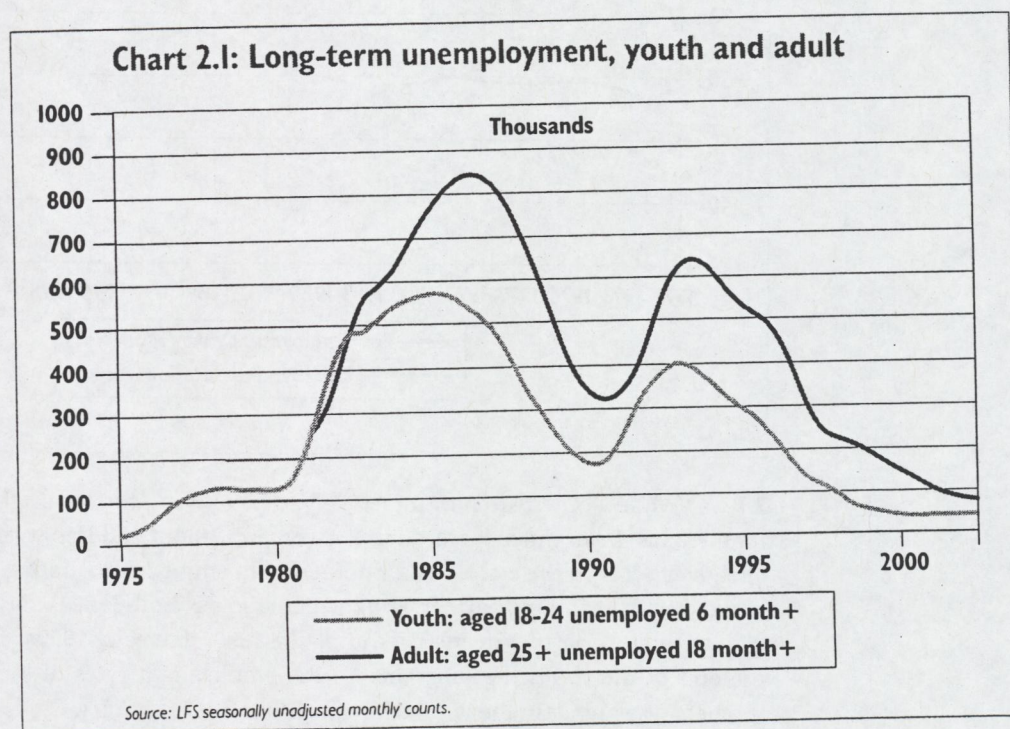
2.1 The first part of this chapter sets out the background to the Government's welfare reform programme by describing key labour market trends in the 1980s and 1990s and their impact on the distribution of incomes for households with children. The increasingly unequal distribution of income among pensioners is also briefly outlined. The second section of the chapter discusses some of the weaknesses of the tax and benefit system which the Government inherited.

### Unemployment and worklessness

2.2 After a period of comparative stability from the 1950s to the mid 1970s, the following twenty years saw unprecedented fluctuations in the UK's labour market. Dramatic swings in the macroeconomy pushed the unemployment rate up to post war highs of 11.9 per cent in the early 1980s and 10.5 per cent in the early 1990s, before the labour market started to recover. By the mid 1990s the unemployment rate had fallen back to around 8 per cent on the International Labour Organisation (ILO) measure with the employment rate rising to around 72 per cent. On the claimant count measure unemployment had fallen back from its peak in the early 1990s to around two million.

2.3 However these headline figures masked a set of structural changes in the labour market which were producing far more unequal outcomes for working-age households. Although by the mid 1990s unemployment had started to fall in aggregate, it had become much more concentrated, with some people experiencing much longer periods unemployed.

2.4 By 1997 the average worker's probability of becoming unemployed was almost as low as it had been thirty years earlier but the average spell of unemployment had increased approximately three-fold over the same period<sup>1</sup>. Chart 2.1 shows the number of adults and young workers in long-term unemployment.



<sup>1</sup> The State of Working Britain, Dickens, Gregg and Wadsworth, 1999.

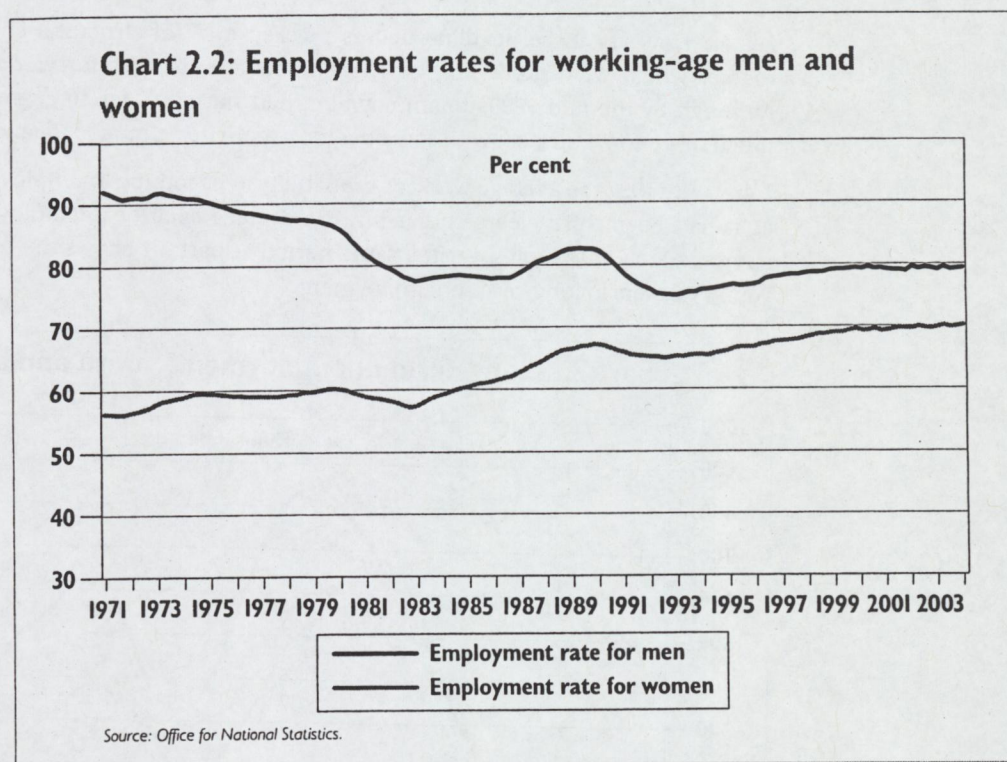


2.5 But the more profound change was a sharp rise in economic inactivity. Increasing numbers of men were leaving the labour market altogether and there were more lone parent families, who often faced some of the highest barriers to work. As discussed in the next section, the existing tax and benefit system had not been designed to provide the right support and incentives for these groups, and as a result they were left to depend on benefits related to economic inactivity, such as incapacity benefits<sup>2</sup> and Income Support. The other key labour market trends were:

- a significant gender shift in the labour market with rising employment among mothers with a working partner;
- falling employment rates for lone parents and couple mothers without a working partner;
- low employment rates among disabled people and some ethnic minority groups; and
- wages for the lowest paid workers falling further behind average wages.

**Changing  
employment  
patterns**

2.6 Over the past thirty years there has been a substantial gender shift in the labour market. The employment rate for working-age men has fallen from 92 per cent in 1971 to 80 per cent today while the employment rate for women has increased from 56 per cent to 70 per cent over the same period.

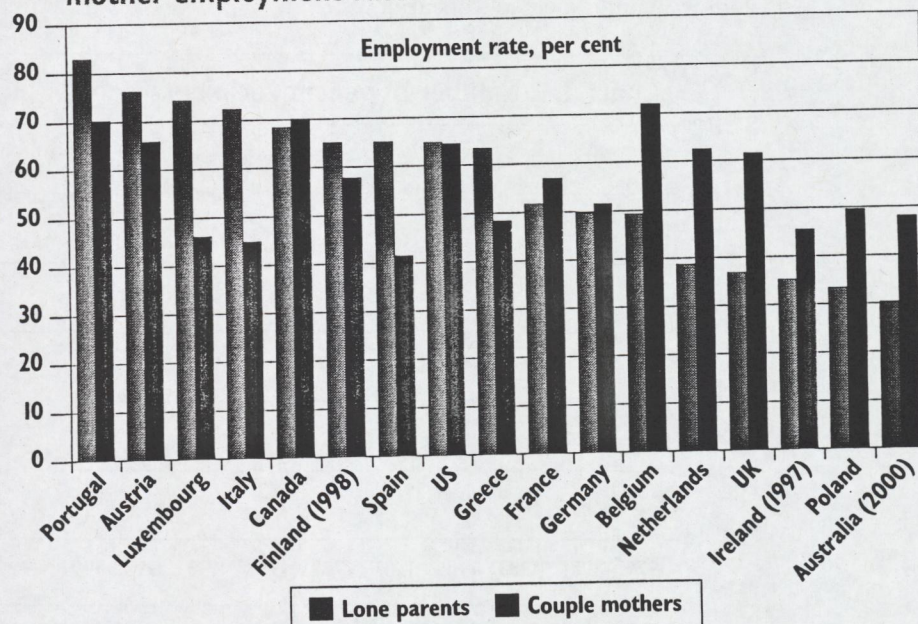


2.7 While women are now more likely to be in work, the rise in the employment rate of mothers has been much larger than for women without children, two-thirds of whom were already in work in the early 1970s. But the rise in employment among mothers was confined to those with a working partner. Employment rates of both lone parents and couple mothers with a workless partner decreased during the 1980s and early 1990s. Chart 2.3 shows that by the end of the 1990s the difference in the employment rates of lone parents and couple mothers was higher in the UK than in any other OECD country.

<sup>2</sup>Incapacity benefits include Incapacity Benefit, Income Support on the grounds of incapacity and Severe Disablement Allowance.



Chart 2.3: International comparison of lone parent and couple mother employment rates



Note: all data for 1999 unless otherwise stated.  
Source: OECD Employment outlook 2001.

**Worklessness among lone parents** 2.8 By the mid 1990s around 20 per cent of the 7.2 million families with children in the UK were headed by a lone parent. Compared with other industrialised countries, lone parent employment in the UK was exceptionally low. Around 44 per cent of lone parents were working in the mid 1990s while in many other OECD countries the lone parent employment rate exceeded 60 per cent.

2.9 The increase in the number of lone parents, together with their falling employment rate, led to a three-fold rise in the total number of lone parents receiving Income Support to over 1 million by 1995, as shown in Chart 2.4.

2.10 As a result children in lone parent families were disproportionately likely to be in workless families and in poverty. Around 60 per cent of children in lone parent families were living in a workless household in the mid 1990s and a similar proportion were living in absolute low-income households<sup>3</sup>. By comparison, in the same period about 10 per cent of children in couple families were in workless households and just over one quarter were living in poverty.

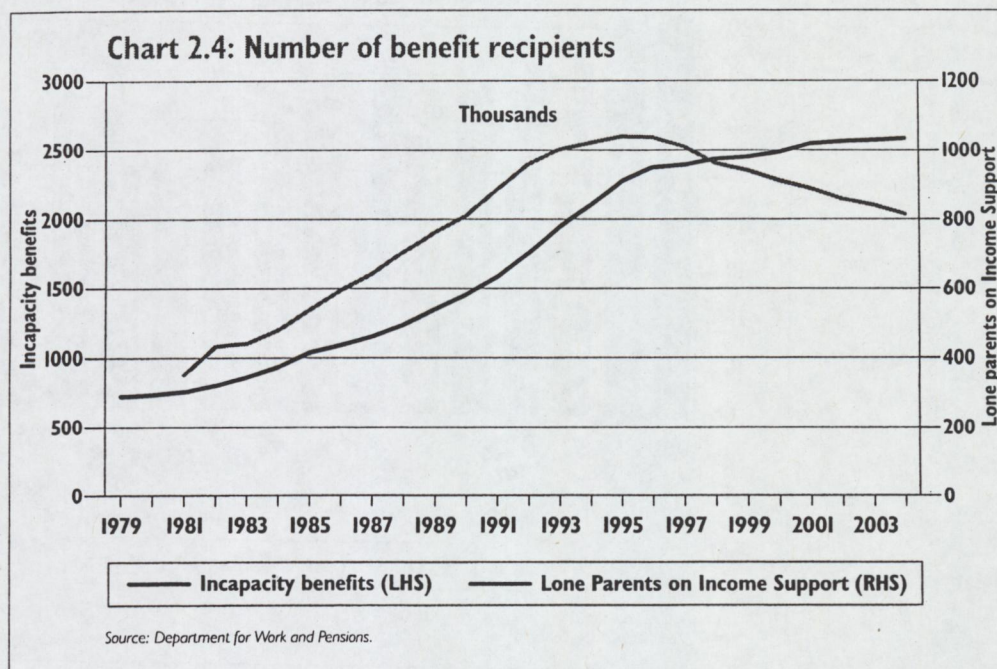
**Inactivity and disability-related benefits** 2.11 In addition to the rise in workless lone parents, since the late 1970s there has been a significant increase in the number of people in the UK who are economically inactive because of a health condition or disability. In 1979, around 700,000 people were claiming incapacity benefits. By the mid 1990s, inflows had increased to over 1 million a year and by 1997 the number of claimants had trebled to 2.6 million, as shown in Chart 2.4.

2.12 Many claimants were effectively consigned to long-term benefit receipt – evidence shows that once a person has been on incapacity benefits for 12 months, the average duration of a claim is 8 years. Claimants became increasingly isolated and distanced from the labour market and the welfare system at that time largely treated them as passive benefit recipients and afforded them neither the advice nor access to employment programmes that were available to the unemployed.

<sup>3</sup> Defined as a household with income below 60 per cent of 1996-97 median household income.



2.13 With the right employment and health-related support, long-term benefit receipt should not have been the inevitable outcome of the main conditions reported by incapacity benefits claimants: most new claimants, for example, have positive work aspirations – 90 per cent want and expect to work again.



2.14 Rising worklessness among people with a health condition<sup>4</sup> explains much of the long-term decline in the employment rates of older workers. In 1973 nearly 90 per cent of men aged between 50 and the state pension age were in work but by 1995 this had fallen to below two-thirds. This in turn contributed to the fall in the mean age of effective retirement from 67 in 1950 to 63 in 1995, which had a substantial impact on the UK's capacity to respond to the challenges of longer life expectancy.

**Ethnic minorities** 2.15 The labour market performance of ethnic minority groups also remained relatively weak. In 1992 the unemployment rate of Bangladeshi, Pakistani and Black Caribbean men was 15-20 percentage points higher than that of their White counterparts. Over the 1990s the scale of this disparity decreased but overall the employment position of ethnic minorities remained considerably worse than that of the White population<sup>5</sup>.

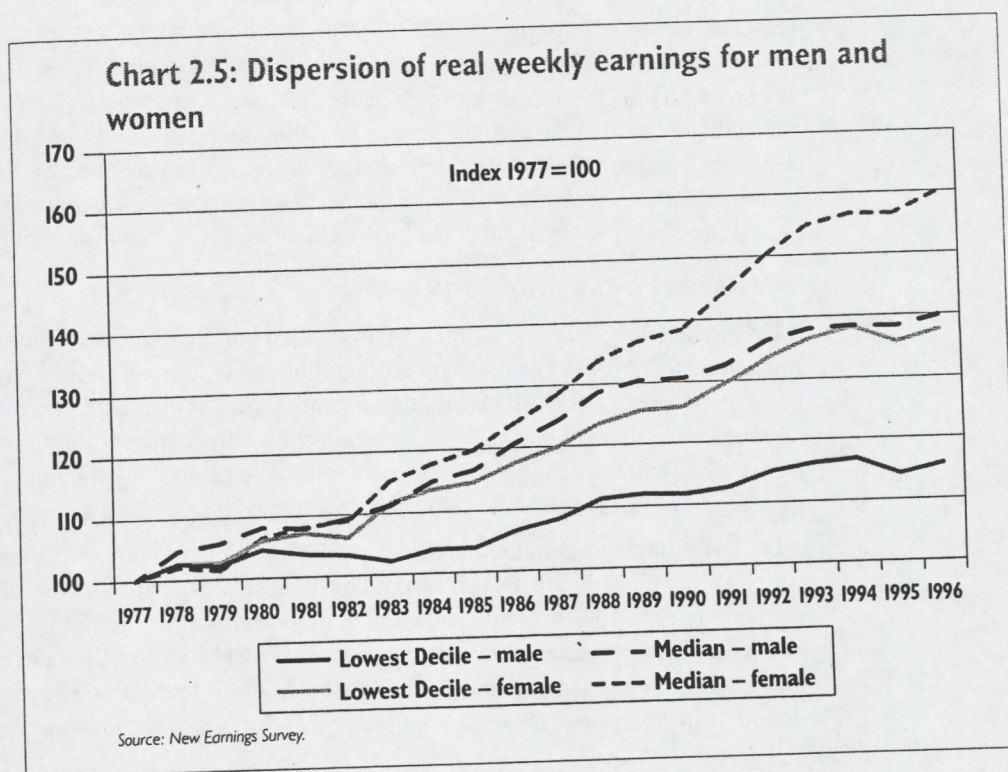
**Wage inequality and the skill premium** 2.16 A further dimension to the increasingly unequal outcomes in the labour market was rising wage inequality. From the mid 1970s growth in real wages for men at the bottom of the wage distribution<sup>6</sup> was well below earnings growth at the median. Low paid women saw significantly faster growth in their real wages but from a much lower base. These trends are illustrated in Chart 2.5.

<sup>4</sup>Inactivity among prime age men in the UK, Faggio and Nickell, 2005.

<sup>5</sup>Ethnic minorities and the labour market, Prime Minister's Strategy Unit, 2003, [www.number-10.gov.uk/su](http://www.number-10.gov.uk/su).

<sup>6</sup>Between 1977 and 1996 annual average growth in real wages at the 10th percentile of the wage distribution was 0.8 per cent for men compared with real earnings growth at the median of 1.8 per cent.





**2.17** The level of wages paid to people moving into work also grew more slowly than wages in aggregate, increasing the costs of unemployment in terms of lower expected future wages. Among men, a spell of unemployment was found to reduce wages by about 6 per cent on re-entry to the labour market compared with people moving directly between jobs<sup>7</sup>. More generally, there is evidence that between the early 1980s and mid 1990s spells of unemployment among men were leading to larger reductions in subsequent hourly earnings<sup>8</sup>.

**2.18** There is also evidence that unemployment has scarring effects through increasing worklessness in later life<sup>9</sup>. With the costs of a period of unemployment rising, macroeconomic stability attains even greater importance. Its role in providing a foundation for welfare reform is set out in Box 2.1 at the end of this chapter.

**2.19** The causes of the fall in economic activity among men and rising wage inequality are complex but part of the explanation is the decline in the demand for low-skilled workers. In the early 1980s 4.3 per cent of low-skilled prime age men were economically inactive compared with 1.9 per cent of those who were not low-skilled<sup>10</sup>. Twenty years later the inactivity rates in these groups had risen to 18.1 per cent and 3.9 per cent respectively.

**2.20** Over the same period the wage premium attracted by individuals with higher qualifications rose despite a dramatic increase in the proportion of the working-age population with these qualifications. The relative decline in demand for unskilled labour is attributable to two important trends which continue to shape the global economy. First, advances in technology which favour high-skill workers – either because they replace routine manual operations or because they increase the productivity of individuals with high skills. Second, increased trade with countries which have abundant labour supply, creating a comparative advantage in producing low-skill intensive goods.

<sup>7</sup> Is unemployment really scarring? Effects of unemployment experiences on wages, Arulampalam, *Economic Journal*, 2001.

<sup>8</sup> A Picture of Job Insecurity Facing British Men, Nickell, Jones and Quintini, *Economic Journal*, 2002.

<sup>9</sup> Persistent poverty and Lifetime Inequality: The Evidence, CASE report no. 5/HM Treasury Occasional Paper no. 10

<sup>10</sup> The Labour Market under new Labour, *The State of working Britain*, Dickens, Gregg and Wadsworth, 2003.

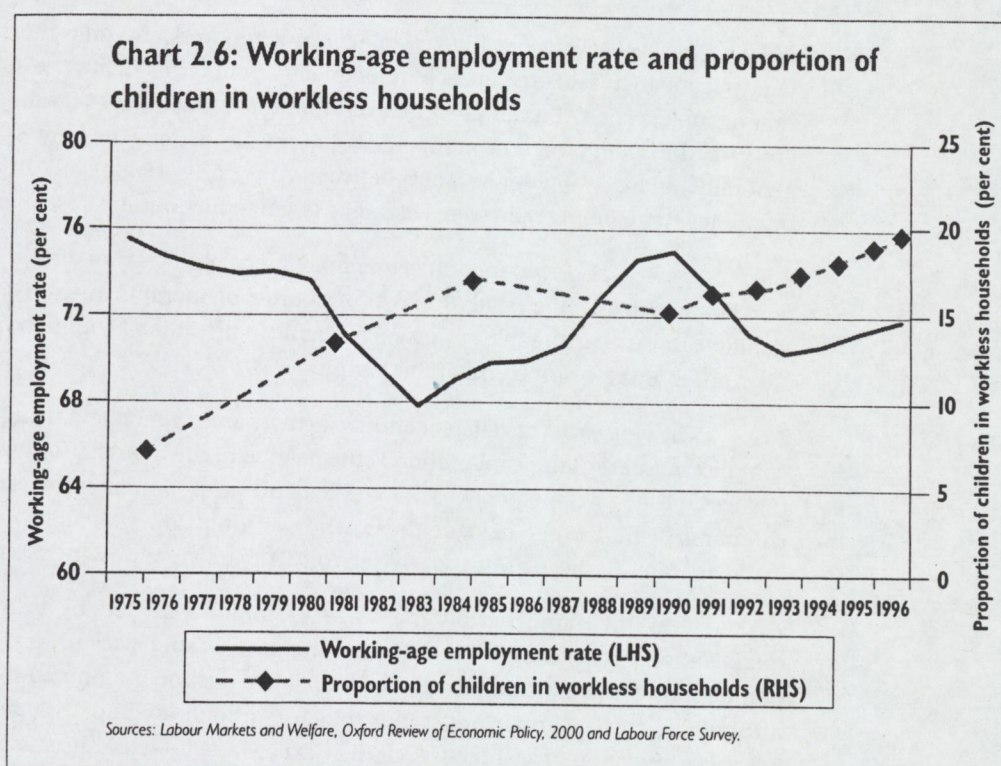


2.21 The changing world economy presents the Government with the challenge of ensuring that the economic benefits of trade are shared widely across society. This requires that everyone has the opportunity to acquire and update their skills, improving their employability. In the longer term, investment in skills, particularly at the lower end of the skills distribution, can help to reduce income inequality and poverty, in particular by reducing vulnerability to structural change in the economy. Further, the tax and benefit system should ensure that work is financially rewarding, especially for those who in the past would have been adversely affected by the changing structure of the economy.

### Worklessness and poverty

2.22 The falling employment rate of low-skilled men, the increased number of lone parent households and lower employment among mothers with unemployed partners contributed to an increasingly polarised distribution of work across households. The proportion of couple households with a single earner reduced sharply, with corresponding increases in workless households and households in which all adults were in work. By the mid 1990s just under 19 per cent of working-age households had no adult in work.

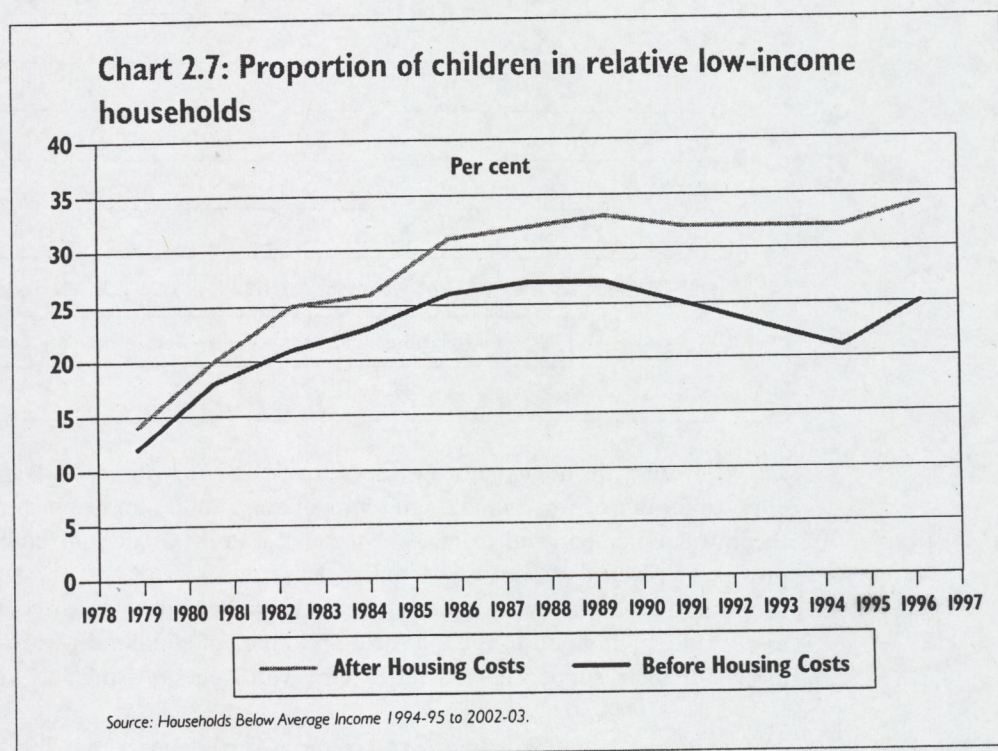
2.23 Although other industrialised countries had similarly high proportions of households with no adult in work, the UK was exceptional in the concentration of worklessness on families with children. In 1996 over 30 per cent of workless households in the UK contained children, compared with 14 per cent in France, 11 per cent in Germany and 18 per cent in Spain<sup>11</sup>. Even though the employment rate in 1996 was not far below its level of twenty years earlier, over that period the proportion of children living in workless households had increased nearly three-fold.



<sup>11</sup> The State of Working Britain, Dickens, Gregg and Wadsworth, 1999.



**Child poverty 2.24** Rising worklessness and wage inequality both contributed to the sharp increase in the proportion of children living in households with relative low income<sup>12</sup>. From the early 1980s to 1996-97, the proportion of children in relative low-income households (those with equivalised<sup>13</sup> incomes below 60 per cent of the contemporary median) rose from 12 per cent to 25 per cent measured on a before housing costs basis and from 14 per cent to 34 per cent on an after housing costs basis<sup>14</sup>. The UK had the highest proportion of children in low-income households in the EU in 1998<sup>15</sup>. Chart 2.7 shows the proportion of children in relative low-income households, both before and after housing costs.



**2.25** If child poverty is measured against a constant level of real income, the proportion of children in low-income households fell only slowly during the 1980s and the early 1990s, showing that poor families with children did not share significantly in the economic growth which took place during the period. Chart 2.8 shows the proportion of children living in absolute low-income households (those with incomes below 60 per cent of 1996-97 median household income).

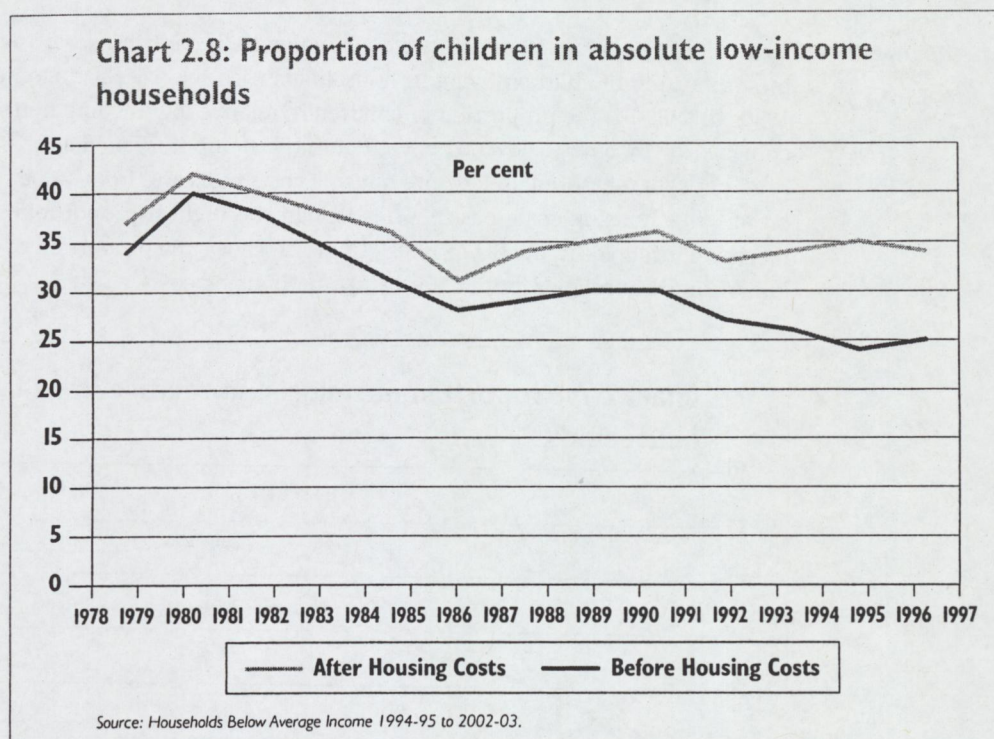
<sup>12</sup> *Poverty and worklessness in Britain*, Nickell, Royal Economic Society Presidential Address, Economic Journal, 2004.

<sup>13</sup> Equivalised incomes reflect the number of adults and the number and ages of children in the household, allowing the incomes of differently sized households to be compared.

<sup>14</sup> Households Below Average Income 1994-95 to 2002-03, DWP, 2004.

<sup>15</sup> European Community Household Panel Survey.





**2.26** During the 1980s and the 1990s financial support was available through Income Support for out-of-work families and for working families on low incomes (through Family Income Supplement and from 1988 through Family Credit). In addition, Child Benefit provided universal support for families. Nevertheless as Chart 2.7 shows, an increasing proportion of children were being left behind relative to the standard of living across society as a whole. In addition to the increasing numbers of children in workless households, the level of financial support fell in relative terms with benefits rising only in line with prices<sup>16</sup>.

#### The impacts of child poverty

**2.27** By the late 1990s there was a wealth of evidence about the negative impacts of growing up in poverty on children's short and longer-term outcomes. Research showed that poverty and its negative impacts were transferred from one generation to the next, leading to cycles of deprivation within families and areas. Intergenerational effects appear to have strengthened over time, with the correlation between a son's earnings and parental income rising between those born in 1958 and those born in 1970<sup>17</sup>. This is at least partly due to a stronger association between qualifications and earnings and between parental income and the qualifications of their children<sup>18</sup>.

**2.28** The determinants of the intergenerational transmission of poverty are not well understood but include linked factors such as: low income in childhood; growing up in a workless household; poor educational attainment; and family attitudes, expectations and aspirations<sup>19</sup>.

<sup>16</sup> *One hundred years of poverty and policy*, Glennerster, Hills, Piachaud and Webb, Joseph Rowntree Foundation, 2004

<sup>17</sup> *Comparing the 1958 cohort in the National Child Development Study and the 1970 cohort in the British Cohort Study*. Blanden, Goodman, Gregg and Machin; *Changes in inter-generational mobility in Britain*. Centre for Market and Public Organisation, University of Bristol, Working Paper Series No 01/43 2001.

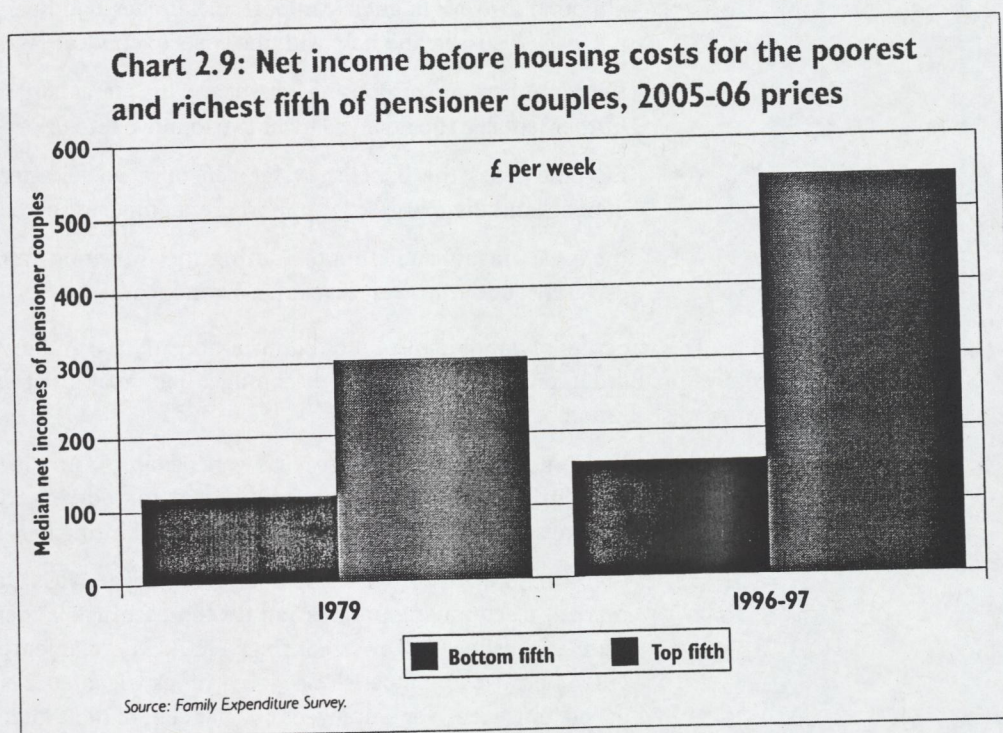
<sup>18</sup> *Inequality and the state*, Hills 2004 Oxford University Press.

<sup>19</sup> *Life chances and social mobility: an overview of the evidence*, Aldridge; Discussion Paper, Prime Minister's Strategy Unit. 2004 [www.strategy.gov.uk](http://www.strategy.gov.uk).



**Rising poverty among pensioner households** 2.29 Other vulnerable groups in society also saw their risk of poverty rise. Increasingly the poorest pensioners found themselves falling behind both pensioner households on average and society as a whole. In part this was due to the adverse employment trends for older workers noted above.

2.30 While pensioner income had risen over previous decades owing to the growth of occupational pensions and the maturing of the State Earnings Related Pension Scheme (SERPS), that growth had been unevenly distributed. Between 1979 and 1996-97 the net income of the richest fifth of pensioners rose by 80 per cent before housing costs compared to a rise of just 34 per cent for the poorest fifth. Many of the poorest pensioners had to rely on Income Support, the value of which had not been increased regularly in real terms.



### Incentives to work

2.31 While the tax and benefit system had failed properly to support those in greatest need, contributing to increased poverty among families with children and pensioners, it also undermined incentives to work. This had both immediate effects – through higher worklessness and lower saving – and longer term ones, as worklessness increased the risk of poverty now and in old age.

2.32 Before setting out how the tax and benefit system affected work incentives, it is important to distinguish the two ways in which work incentives can be inadequate. First, the incentive to move off benefits into work can be weak, because the difference between in-work and out-of-work income is too small – the unemployment trap. Second, when those in work have limited incentives to increase their hours or to move up the earnings ladder because it may leave them little better off, there is a poverty trap.



**2.33** For people with low potential earnings the falling financial reward from work is one key element in the rise in worklessness between the late 1970s and the late 1990s. In 1998, in its first report, the Low Pay Commission presented evidence on the extent of very low pay, showing that two-thirds of a million employees were being paid £2.50 per hour or less in 1997<sup>20</sup>. The Commission found that particular groups of workers were at much greater risk of low pay, including disabled workers and lone parents<sup>21</sup>.

**The burden of tax on the low paid** **2.34** In addition, the structure of the tax and benefits system created financial barriers to work for people with low potential earnings, and families in particular:

- the burden of income tax and national insurance contributions on low-paid workers was disproportionate;
- although in-work financial support for families had been introduced, it was narrowly focussed and help with the costs of childcare was limited;
- the administration of Housing Benefit and its interaction with in-work support further reduced the financial incentive to move into or progress in work;
- in some cases the benefits system encouraged long-term dependence on benefits and there was little support or incentive to search for work; and
- there was insufficient support during the transition into work and lack of certainty about the likely level of in-work income.

**2.35** The structure of national insurance contributions (NICs) and income tax created an excessive tax burden on the low paid and discouraged job creation at the lower end of the earnings distribution:

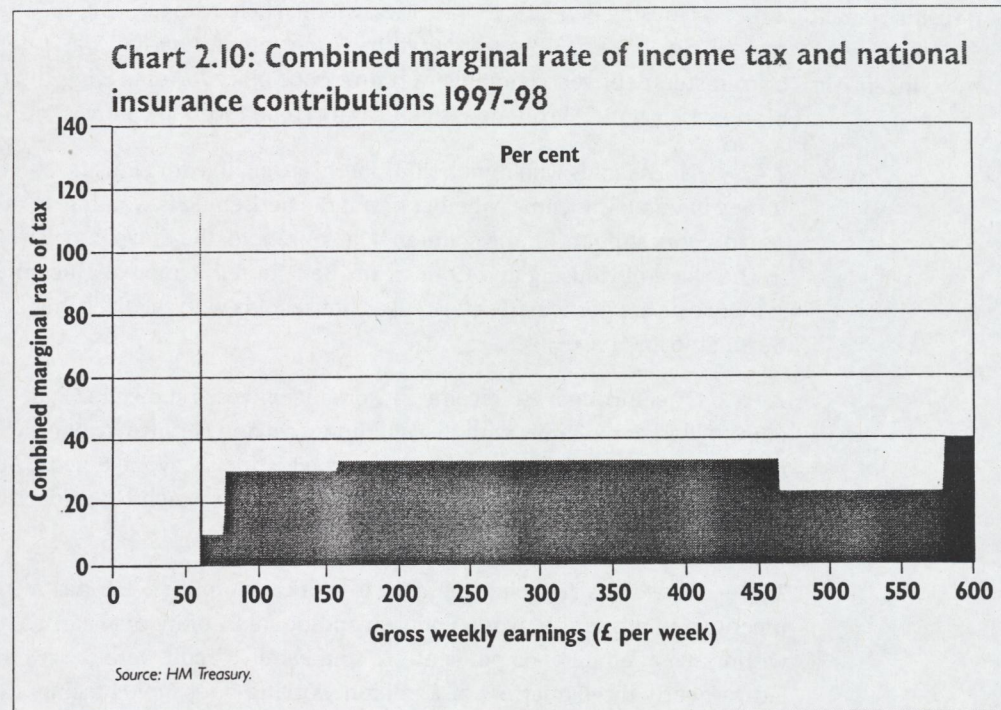
- both employer and employee NICs were payable from a lower level of earnings than income tax, reducing take home pay for workers with the lowest gross earnings and raising the costs to employers of hiring these workers;
- the structure of both employee and employer NICs distorted the labour market, discouraging progression up the earnings ladder. These distortions were greatest at the Lower Earnings Limit, where an employee began to pay NICs, because a one pence rise in earnings triggered a NICs charge (the so-called "entry fee") for employees of 2 per cent of their total salary and just over this amount for employers; and
- the income tax system made little contribution to improving work incentives for the low paid. In 1997 the marginal income tax rate for a low-paid worker was only slightly below the marginal rate for a person earning average male wages.

**2.36** Taking into account an employee's NICs and income tax the combined marginal rate of tax was lower for some employees whose earnings were well above average than for many low paid employees. This is shown in Chart 2.10 which also illustrates the impact on work incentives of the "entry fee" in NICs.

<sup>20</sup> *The National Minimum Wage, First Report of the Low Pay Commission, 1998.*

<sup>21</sup> *ibid.*





**Work incentives for families and disabled people**

**2.37** The unfair burden of income tax and NICs affected low-paid workers in general, but parents and other groups, such as people with disabilities, faced much greater financial barriers to work. Benefits for out-of-work families recognise the extra costs of bringing up children through additional allowances, paid on top of support for the adults in the family. Similarly, out-of-work support levels are higher for incapacity benefits claimants. While providing essential support, higher out-of-work income levels can reduce work incentives, where in-work support is inadequate.

**2.38** In-work support was available for families and for disabled workers in 1997-98 in the form of Family Credit and Disability Working Allowance but its scope was relatively limited. The maximum support available, the level of income at which support began to be withdrawn and the high withdrawal rate combined to ensure that only those with very low in-work incomes could benefit. Families and disabled people with earnings which were far below average could find they received no in-work support.

**2.39** Earlier in this chapter it was noted that one of the factors generating an increase in the proportion of children in relative low-income households was the tendency to uprate benefits for workless families in line with prices. With comparatively limited in-work financial support, increasing support for families out-of-work would risk damaging work incentives. Further, where families faced additional in-work costs, such as childcare, Family Credit offered limited support, and its interaction with Housing Benefit could create deep unemployment and poverty traps.

**In-work childcare costs**

**2.40** The in-work cost of childcare is an additional barrier to work for lone parents and second earners in couples. Although Family Credit provided help with childcare costs, because of the way this support was offered, parents with the lowest incomes were not able to benefit or could only receive partial help. This affected lone parents in particular who are more likely to have very low incomes and are least able to afford the cost of childcare. For example, a lone parent working part-time and with a low hourly wage could face a very low gain to work even with relatively modest childcare costs<sup>22</sup>.

<sup>22</sup> Under Family Credit in 1997-98 a lone parent working 16 hours per week and paid £3.60 per hour with two children and weekly childcare costs of £40 had a gain to work of £16.80 per week (in 2005-06 prices).

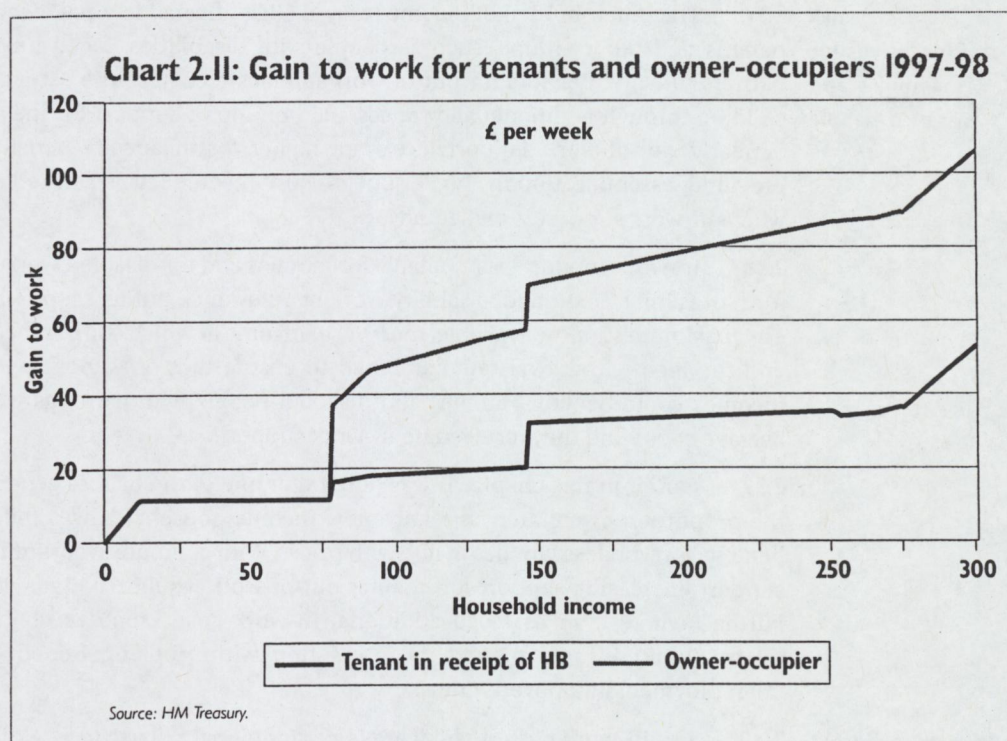


**Housing Benefit and work incentives** 2.41 Housing Benefit (HB) provides essential help with housing costs for 3.8 million tenant households but the HB system that the Government inherited was complex and difficult to administer, deprived claimants of the responsibility for managing their housing costs and along with Council Tax Benefit significantly eroded work incentives.

2.42 Households who rent their property are eligible for Housing and Council Tax Benefits if they have a low income, whether or not the household is working. In addition to the loss of out-of-work support for the children in a household, the move into work triggers a reduction in the value of Housing and Council Tax Benefit, reducing work incentives. Areas with high rental costs are particularly affected, as households with relatively high earnings continue to be eligible for HB.

2.43 The impact of HB receipt on work incentives is shown in Chart 2.11. It compares the gain to work for a family with two children receiving Family Credit only with a tenant family also receiving HB. The level of rent assumed is for an average Local Authority property in England; in high rent areas the range of income over which HB impacts on the gain to work would be much greater.

2.44 As well as reducing the gain to work for families, HB has a major impact on the incentive to progress in work. For each additional £1 of income earned, entitlement to HB is withdrawn at a rate of 65 per cent. HB and Family Credit were the two main benefits which led to nearly three quarters of a million working households facing a Marginal Deduction Rate<sup>23</sup> above 70 per cent in 1997-98.



**Failing to support the move into work** 2.45 Other aspects of the tax and benefit system were not well designed to help people move into work. The employment service and benefits agency were separate so for those on benefits such as Income Support and Incapacity Benefit there was no requirement to consider work as an option.

<sup>23</sup> The Marginal Deduction Rate is the combined rate at which tax is paid and benefits withdrawn.



## The structure of financial support in the 1997 tax-benefit system

**2.46** The first part of this chapter showed that trends in the labour market during the 1980s and 1990s had led to unprecedented levels of worklessness and child poverty. However, the tax and benefit system had not been reformed to respond to these new challenges. First, the level and scope of support was inadequate:

- the level of benefits for out-of-work families with children and for pensioners had not increased in line with rising national prosperity, resulting in increased poverty rates among these groups;
- working families with low incomes received only limited financial support and there was little additional help for childcare costs, making many families little better off in work than on benefits;
- in-work financial support for disabled people was insufficient and there was no support for older people returning to work after a period out of the labour market; and
- there was very little support for people during key transitions in their lives such as moving into work and becoming a parent.

**2.47** Second, the mechanisms for providing support were out of date and in some cases stigmatising:

- working age adults were often not aware of whether they would be better off in work and, without a National Minimum Wage, there was no guaranteed minimum income for working households;
- financial support for families was provided to those with the lowest incomes only, which risked stigmatising those who were eligible; and
- the poorest pensioners were means-tested through Income Support on a weekly basis, with even the smallest change in their income affecting their entitlement.

**2.48** The Government's reforms to modernise the tax and benefit system have been designed to tackle the problems of poor incentives to work, and to increase financial support to vulnerable groups. Chapters four to six set out these reforms in more detail, and the next chapter describes the principles behind these reforms. In particular it discusses the structure of financial support in tax and benefits systems.

**2.49** All of the reforms to the tax and benefit system that are set out in Chapters four to six require macroeconomic stability as their foundation. The labour market consequences of instability contributed to the problems of worklessness and poverty set out earlier in this chapter. But the importance of macroeconomic stability for welfare reform goes wider than the labour market. The links between stability in macroeconomic variables such as inflation and the long-term growth rate and their impact at the household level are discussed in Box 2.1.



**Box 2.1: Macroeconomic stability and welfare reform**

The Government's reforms of the tax and benefit system have been built on a foundation of macroeconomic stability. The frameworks for monetary and fiscal policy provide a coherent policy for maintaining high and stable levels of growth and employment, and in recent years the UK has experienced an unprecedented period of stability:

- the UK economy has now grown for 50 consecutive quarters;
- since 1997 inflation has been low and stable; and
- employment has risen by 2 million since 1997 and unemployment is at its lowest level for 30 years.

The volatility of real GDP growth and inflation are now at their lowest sustained levels in 50 years, and since the introduction of the new macroeconomic framework in 1997, the UK has been the most stable of all G7 economies.

In the past, the UK saw considerable periods of economic instability. This had a negative effect on the economy as a whole, increasing long-term interest rates and reducing the willingness of companies to undertake long-term investment. In addition, high and persistent unemployment affected millions of people as it:

- deprived many older workers of the chance to build a decent retirement income;
- eroded skills and discouraged those unable to find new employment; and
- reduced the resources available to provide financial support for the poorest children and pensioners.

While there has been much discussion of the extent to which high and volatile inflation can damage a country's economic growth potential, inflation is also associated with increased poverty and income inequality. Cross-country studies<sup>\*</sup> have shown that countries with lower inflation tend to have lower levels of poverty and less income inequality. This underlines the importance of macroeconomic stability not only in promoting long-term economic growth, but also in helping to protect the incomes of the poorest in society.

Macroeconomic stability has helped to tackle poverty in other ways:

- there are now around 481,000 fewer children in households where no one works. With work providing the surest route out of poverty, reducing worklessness contributes to the Government's aim of tackling child poverty; and
- the cost of support for unemployed people has fallen by £5 billion, freeing up valuable resources to provide support to those who need it most.

<sup>\*</sup>A summary of the evidence is provided in Chapter 4 of *Reforming Britain's Economic and Financial Policy*, Balls and O'Donnell (eds.), 2002.



# MODERNISING THE TAX AND BENEFIT SYSTEM

3.1 The Government's aim is to promote a fair and inclusive society where everyone shares in rising national prosperity and no one is held back from achieving their potential through disadvantage or lack of opportunity.

## Modernising the tax and benefit system

3.2 The Government believes that for those who can, work provides the best form of security and independence. This belief lies at the heart of the Government's reforms of the tax and benefit system. People of working age have the responsibility to work if they are able to and the right to expect a tax and benefit system that supports them in moving into work. Employment opportunity for all, the modern definition of full employment, is essential to reducing the risk that children grow up in poverty and to ensuring that those of working age today can provide for their own security in retirement.

3.3 However, employment opportunity for all is not sufficient in itself. It is vital that the most vulnerable and disadvantaged also share in rising national prosperity. The tax and benefit system should provide guaranteed support for adults of working age who cannot work due to a health condition or disability, and for pensioners to underpin their security and independence in retirement. And it should help ensure that every child, irrespective of their parents' circumstances, has the best possible start in life.

## The need for modernisation

3.4 The system of financial support in 1997 often failed to meet these requirements. The key to understanding its weaknesses lies in the complete separation of payments made to government through income tax and national insurance contributions and support from government through the benefits system.

3.5 Most working-age households pay income tax and national insurance contributions (NICs) for most of their working lives. At various times, they also receive financial support from government, for example through Child Benefit. And of course almost all households receive state financial support in retirement. So as their children grow up this means that at different points in their life-cycle households may be:

- net contributors to the Exchequer, when their tax liability exceeds the financial support they receive from the state; or
- net beneficiaries from the Exchequer, when the financial support received exceeds their tax liability; or
- neither net contributors to the Exchequer nor net beneficiaries from it, when the two cancel out.

3.6 Before the Government's reforms, the system for assessing and collecting income tax liabilities was quite separate from the system for providing financial support for families and disadvantaged or vulnerable groups. This separation between the tax and social security systems tended to obscure the fundamental financial relationships between government and individuals or families over their life-cycles and to label people as either "taxpayers" or "claimants". The stigma potentially attached to claiming benefits – even in-work benefits – was one of the factors thought to explain low take up.

3.7 Support through the social security system often involved complex and burdensome means-testing. The tax system, which has been based on the principle of independent taxation since 1990, was less intrusive. But it could not easily take account of different



household circumstances, and joint incomes, or make payments to households. This made it a very ineffective means of targeting support on families, particularly for increasing numbers of people who were choosing to combine work with care for their children<sup>1</sup>.

**3.8** It is possible to use the income tax system to improve work incentives for the low paid, but the range of options is limited. Special tax allowances can provide a degree of targeting but they cannot reach those on the lowest incomes because they cannot reduce an individual's tax liability below zero.

**3.9** It is often suggested that increasing the personal allowance is a good way of providing support for low-income working people. However, tax credits provide a number of advantages over increasing the personal allowance, discussed in more detail below.

**3.10** Whereas tax credits can make payments to households, increasing the personal allowance can only reduce a household's tax bill to zero. Tax credits mean that a family with two children and a full-time earner on £15,500 a year, around half male mean earnings, is receiving a net tax payment of £2,200 a year. If tax credits were abolished, and the money used to increase the personal allowance, this family would instead find itself making a net tax payment to the Exchequer of around £900 a year. In addition:

- tax credits can tailor support according to family circumstances – providing more support to families with more children or those who care for disabled children, while increases in the personal allowance benefit all taxpayers irrespective of their circumstances; and
- tax credits can provide the same financial support irrespective of the household's marginal rate of tax, while increasing the personal allowance provides greater benefit to those with higher marginal tax rates – so a higher rate tax payer would gain four times as much from an increase in the personal allowance as a starting rate taxpayer whose marginal tax rate is 10 pence in the pound.

**3.11** With tax credits, the support people receive from the tax system is not limited by the amount of tax they are liable for. Instead, they can receive tax credit payments from the Inland Revenue even where they would get no benefit from an increase in the personal allowance. All single earner households pay no tax on their first £4,895 of income. For a two child family, Child Benefit cancels out their income tax until they earn around £12,700 and tax credits mean they pay no net income tax until they earn £21,200. Increasing the personal allowance by £500 would raise the point at which this family's income tax liability was cancelled out by Child Benefit to £13,200, an increase of £500, but putting the same money into the Child Tax Credit would raise the point at which they start to pay net income tax to £22,500, an increase of around £1,300. So tax credits help more people to pay no net tax. The result is while the net tax rate for a single earner family with two children on half male earnings rose by 4 percentage points between the introduction of Child Benefit in 1977-78 and 1997, as shown in Chart 5.2, between 1997 and 2004-05 their net tax rate has fallen by around 23 percentage points and living standards have risen by 34 per cent.

**Negative Income Tax 3.12** Probably the most comprehensive approach to addressing these issues would be to design an entirely new tax and benefit system which delivered government financial support as payable tax credits, and paid credits to non-taxpayers in the same way as it pays tax refunds to taxpayers. In broad terms, a fully integrated tax and benefit system of this kind would

<sup>1</sup> Some 36 per cent of people in work have a dependent child. The way government supports parents in balancing work and caring for their children is set out in more detail in *Balancing Work and Family Life: enhancing choice and support for parents*, HM Treasury 2003



assess the family's overall tax position by taking account of its joint income, and its entitlements to state support (e.g. for children, or a disabled worker). Financial support would therefore be delivered through the tax system – either by reductions in the family's tax bill or through payments of “negative tax”. Such “negative income tax” systems have been the subject of extended debate in the economics literature<sup>2</sup>.

**3.13** In a system of this kind the tax burden effectively borne by a family is measured by:

- its **net tax liability** after taking account of its tax credit entitlements; and
- its **net (average) tax rate** which expresses that burden as a rate<sup>3</sup>.

**3.14** Both the values of the family's net tax liability and effective tax rate in a particular tax year could be positive, zero or negative, depending on the balance between tax liabilities and tax credits for the family in that year.

**3.15** The main advantages of the pure negative income tax approach to tax-benefit integration are that it would:

- enable the government to target support through the tax system to give help to those who need it, cutting out the requirement to contact different agencies, and fill in different forms, to claim support and pay tax;
- produce a single annual assessment of liabilities and entitlements, and a single overall net tax bill, with a single flow of payments to or from the government;
- make more transparent the financial relationship between the government and the individual or the family; and
- by fully integrating state support into the income tax system, eliminate any stigma attached to claiming benefits. This would help maximise take up of support by those entitled to it.

**3.16** But this purist approach to tax-benefit integration would also have important disadvantages, because it would entail:

- abandoning the Government's commitment to the important principle of independent taxation<sup>4</sup>;
- substantial and potentially very disruptive changes to the income tax and social security systems and payment and collection mechanisms;
- the risk of undermining the Government's approach of matching rights and responsibilities which requires the unemployed to seek work; and
- (assuming an acceptable level of guaranteed income out of work) the potential for very high marginal tax rates or large costs to the Exchequer.

**3.17** Whatever the balance of theoretical advantage in moving to a fully integrated system of negative taxation, it would undermine some of the key principles in the current system and

<sup>2</sup> *The Negative Income Tax and the Evolution of U.S. Welfare Policy*, Moffitt, *Journal of Economic Perspectives* 2003 provides a useful summary. Precursors to the concept of a negative income tax can be traced back as far as the Speenhamland system which operated in parts of England in the early part of the 19<sup>th</sup> century.

<sup>3</sup> The definition of tax liability and the tax rate would depend on whether NICs were included. For some purposes it would be appropriate to include NICs but in other cases it may not be because they finance pension entitlements and health services via the National Insurance Fund, and are therefore distinct from general taxation.

<sup>4</sup> Chancellor of the Exchequer's speech at the Institute of Fiscal Studies, May 1999. Available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)



the risks involved in the implementation of such systems are clearly very large<sup>5</sup>. Instead the Government has embarked on a fundamental programme to modernise the tax-benefit system – the most significant since the Beveridge reforms of the 1940s – but it has also introduced reforms in carefully planned stages, to minimise risks.

**3.18** The reforms have brought many of the key attributes of a system of negative taxation. These include reduced stigma; increased financial support for the vulnerable; a fairer distribution of that support across households and improved work incentives. They have also brought into sharper focus the fundamental financial relationship, described at paragraph 3.5 above, between the government and individuals or families.

**Integrating the tax and benefit systems** **3.19** The various policy changes which have so far made up this programme of tax-benefit integration have been guided by five key principles, that were set out in November 2000<sup>6</sup>:

1. to promote incentives to work, by reducing the tax burden on the low paid and the number of low-income households on high marginal withdrawal rates;
2. to ensure it is targeted on those who need it most, financial support should be assessed on a household basis where possible, while respecting the principle of independent taxation;
3. to tackle poverty, minimum levels of income should be guaranteed for the most vulnerable in society – the elderly, families and those who cannot work because of illness or disability;
4. to reduce stigma and maximise take up the income test should not be intrusive and the hassle of claiming should be minimised; and
5. to improve customer service and increase efficiency, the administration of tax and benefits should be modernised and brought closer together.

**3.20** This document focuses on the first three of these principles, covering work incentives and financial support in Chapters four to six. Issues related to the last two principles are also discussed.

**3.21** The reform programme has been accompanied by substantial increases in financial support. Based on the principle of progressive universalism, these changes ensure that while the vast majority of families and pensioner households have benefited, the largest increases in support have been directed to those with the greatest needs.

**3.22** The most radical of the reforms outlined in the remaining chapters is the introduction of payable tax credits. This has brought about a step change in the way in which individuals and families draw support from the Exchequer. Tax credit awards reflect, and respond to, the needs and circumstances of different households. For couples, they are based on joint tax-year income. Tax credits follow broadly the same rules and definitions as income tax, are closely aligned with the tax system and are administered and paid by the Inland Revenue.

**3.23** Under the new system, families receive state support for their children from the Inland Revenue through the Child Tax Credit and Child Benefit. Workers on low incomes, and

<sup>5</sup> It is interesting to note that although a Negative Income Tax system was the subject of extensive consideration in the United States in the late 1960s and early 1970s it was not implemented. Instead the Earned Income Tax Credit (EITC) was introduced in 1975; the EITC subsequently provided a model for the Working Families' Tax Credit. Similarly, "Proposals for a tax credit system" in the UK (October 1972, Cmnd 5116) gave rise only to Child Benefit.

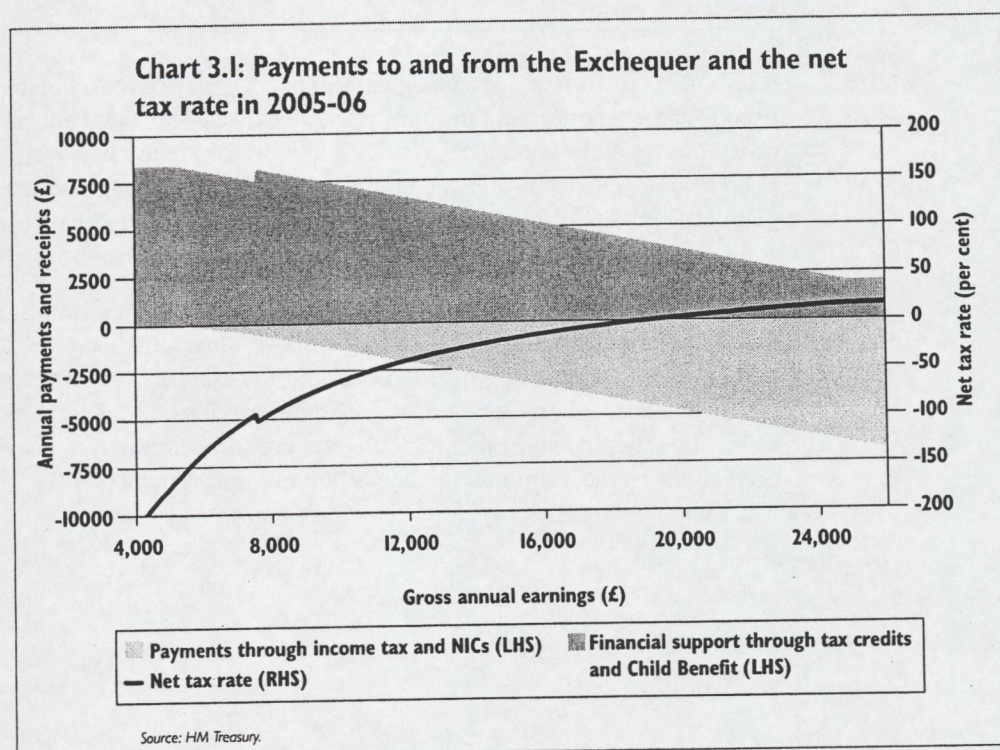
<sup>6</sup> *The Pension Credit: a consultation paper*, Department for Social Security, November 2000.



those with a disability, receive additional support through the Working Tax Credit. Parents can get help with their in-work childcare costs through the childcare element of the Working Tax Credit.

**Calculating net tax** 3.24 To work out a family's net tax liability and effective tax rate, the tax credits and Child Benefit payments the family receives are set against any income tax (and in some illustrations NICs) paid. These measures have the same effect on a family's financial position as those associated with a negative income tax system (see paragraph 3.11). But there are practical differences. For example, for a couple household income tax is not assessed on joint income and their tax payments to the Inland Revenue are distinct and they receive tax credit and Child Benefit payments separately.

3.25 As with a pure negative income tax system, both the family's net tax liability and its effective tax rate in the new, more integrated, tax system will depend on its precise circumstances, including the number of children in the household. This is illustrated in Table 4.2 in the next chapter which shows the lowest net tax rates for different household types.



3.26 Chart 3.1 shows how the net tax payments and the effective tax rate of a single-earner family with two children vary with family income. It shows that with an income of less than £18,700 the family receives net tax payments from the government. It pays no net tax until income rises above that level.

3.27 Table 3.1 shows how the breakeven point at which a single-earner family with two children pays no net tax has increased since 1997-98 as a result of the government's tax-benefit reforms and other measures. It shows the breakeven point calculated when NICs are included and when NICs are excluded from the calculation. The proportion of families with children paying no net tax has risen from 34 per cent in 1997-98 to 42 per cent in 2005-06 when NICs are excluded; the proportion of families paying no net tax including NICs has risen from 31 per cent to 39 per cent. The number of families paying net tax has fallen by around 500,000 on either basis."



Table 3.1: Earnings level where the net tax rate is zero per cent

Year	Earnings level <sup>1</sup> (£ per year)	
	Including NICs	Excluding NICs
1997-98	13,600	15,100
1998-99	13,600	15,100
1999-00 <sup>2</sup>	15,900	17,900
2000-01	16,600	18,700
2001-02	17,400	19,500
2002-03	17,600	19,800
2003-04	18,000	20,500
2004-05	18,500	21,000
2005-06	18,700	21,200

<sup>1</sup> For a single earner family with two children aged 11-15.

<sup>2</sup> The figures include Family Credit in 1997-98 and 1998-99. Although Working Families' Tax Credit was introduced in October 1999 the figures assume it was in place throughout 1999-00.

**3.28** Tax credits have therefore greatly enhanced the extent to which the tax system can be used to target support and improve work incentives. Together with the Pension Credit and other reforms of the tax-benefit system, tax credits promote a new way of thinking about how people contribute to or draw on support from the Exchequer over the life-cycle, providing additional net financial support when expenditure increases because of the costs of raising children and again in retirement when income is likely to be lower.

**3.29** The next three chapters set out what the reforms since 1997 have achieved and how they are informed by the principles set out above. Most have been developed and introduced in stages, and continue to evolve. For example, the Child and Working Tax Credits build on the experience and achievements of the Working Families' and Disabled Person's Tax Credits which took the first steps in integrating the tax and benefits systems. Similarly the Pension Credit built on the Minimum Income Guarantee for pensioners.



## INCENTIVES TO WORK

4.1 The first principle of tax and benefit reform stated above is that a modernised welfare system should *promote incentives to work, by reducing the tax burden on the low paid and the number of low-income households on high marginal withdrawal rates*. This section shows how the Government's reforms put this principle into practice across the tax and benefit system by:

- introducing a National Minimum Wage;
- reducing income tax and reforming national insurance contributions; and
- improving work incentives for families and people with a health condition or disability.

### Tackling low pay and improving work incentives

4.2 The National Minimum Wage (NMW) was introduced in April 1999 to ensure a decent minimum rate of pay for all employees. In addition it provides a foundation for in-work tax credits. The NMW and tax credits work together to provide a Minimum Income Guarantee for all working households. Table 4.1 shows the increase in the Minimum Income Guarantees since 1999.

**Table 4.1: Weekly Minimum Income Guarantees**

	April 1999	October 1999	October 2005
Family <sup>1</sup> 1 child, full-time work (35 hours)	£182	£200	£260
Family <sup>1</sup> 1 child, part-time work (16 hours)	£136	£144	£202
Single person, no children, 25 or over, full-time work (35 hours)	£113	£113	£169
Couple, no children, 25 or over, full-time work (35 hours)	£117	£117	£200
Disabled person (single), working full-time (35 hours)	£139	£155	£211
Disabled person (single), working part-time (16 hours)	£109	£112	£153

Notes: assumes a single earner household, the prevailing rate of the National Minimum Wage and that the family is eligible for the Working Families' Tax Credit or Disabled Person's Tax Credit and the Working Tax Credit/Child Tax Credit.

<sup>1</sup> applies to one parent families and couples with children alike.

4.3 The NMW and tax credits complement each other in achieving fairness combined with flexibility in the labour market. The NMW underpins in-work tax credits by ensuring a minimum rate of pay but it does not respond to household needs or the income of other workers in the household. By contrast, tax credits provide flexible support that can be tailored to an individual household's needs, for example, reflecting the number of children in a family. They can also help parents balance work and family life by providing more support to those working fewer hours.

4.4 The NMW brought to an end the long-term trend of wages at the bottom of the wage distribution growing more slowly than average earnings. Box 4.1 describes this in more detail. In addition, there is no evidence that the introduction of the NMW has reduced aggregate employment<sup>1</sup>, or total employment in the low-paying sectors as a whole<sup>2</sup>.

<sup>1</sup> The impact of the introduction of the UK National Minimum Wage on the employment probabilities of low-wage workers, Stewart, University of Warwick mimeo, 2003; *Estimating the Impact of the Minimum Wage Using Geographical Wage Variation*, Stewart, Oxford Bulletin of Economics and Statistics, 2002.

<sup>2</sup> Since 1999 aggregate employment has increased by nearly 1.5 million. Over the four years to September 2004 the number of employee jobs increased by over 300,000 in retail and hospitality, the two largest low paying sectors (Low Pay Commission Report, 2005).



**Box 4.1 Assessing the impact of the National Minimum Wage**

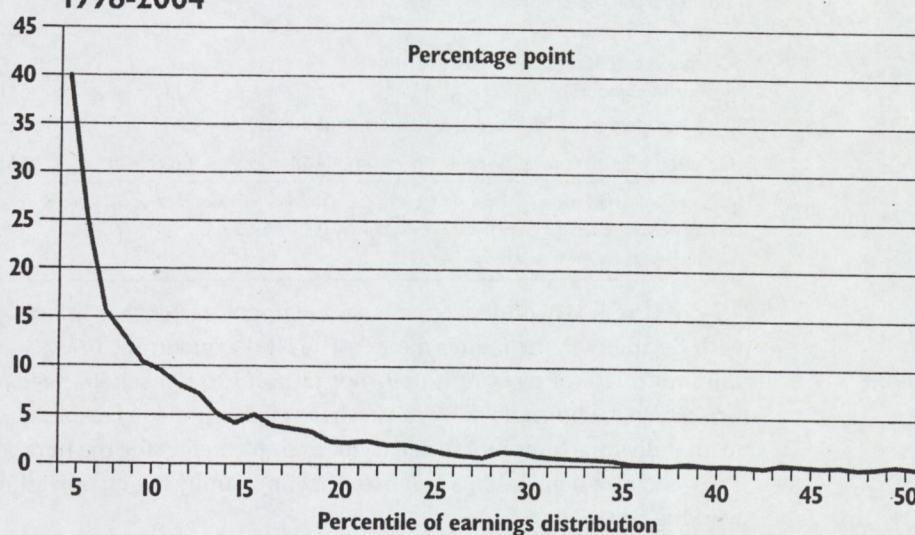
The National Minimum Wage (NMW) was introduced in April 1999 at a rate of £3.60 per hour for adults aged 22 and over. Since its introduction, the adult rate has been increased by 35 per cent in nominal terms to £4.85. By October 2006 the rate will be £5.35 and the cumulative increase just under 50 per cent.

The standard measure of the impact of the NMW has been the 'expected number of beneficiaries', the number of workers whose pay would otherwise be expected to be below the new NMW rate. However this measure does not include the impact of the NMW on the wage distribution more generally. For example, many firms increase their lowest pay levels to ensure that they remain slightly above the NMW rate. These low paid workers, who are benefiting indirectly from the increases in the NMW, are not captured by the 'expected number of beneficiaries' measure.

The NMW has helped to increase significantly the earnings of the lowest paid workers. The chart below shows the total increase in hourly pay across the bottom half of the earnings distribution between 1998 and 2004. The increase in median pay over that period of 25 per cent has been netted off, so that the chart highlights movements above the median. The lowest paid workers have benefited from above-average increases in pay in recent years – pay at the 10th percentile of the distribution has risen nearly 10 percentage points faster than median pay growth.

As a result, the introduction and uprating of the NMW has brought to an end the long-term trend of average wages rising faster than those of the lowest paid workers.

**Increase in earnings net of median earnings growth,  
1998-2004**



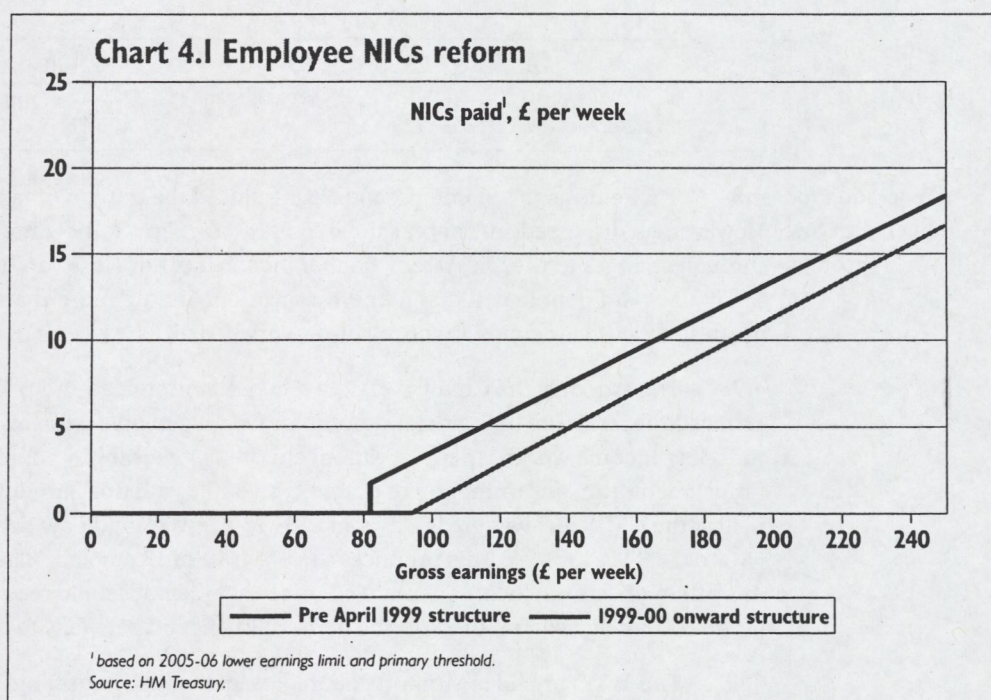
Source: Annual Survey of Hours and Earnings.



**Reducing the tax burden on low paid workers** 4.5 Following the recommendations of a review of work incentives by Martin Taylor<sup>3</sup> the Government reformed both income tax and national insurance contributions (NICs) to reduce the burden on low-paid workers. These reforms included:

- abolishing the “entry fee” in employee contributions;
- raising the threshold for contributions, aligning it with the personal allowance in income tax;
- simplifying the structure of employer's NICs, replacing the series of stepped contribution rates with a single rate; and
- introducing the 10 pence rate of income tax, the lowest starting rate of income tax since the 1960s.

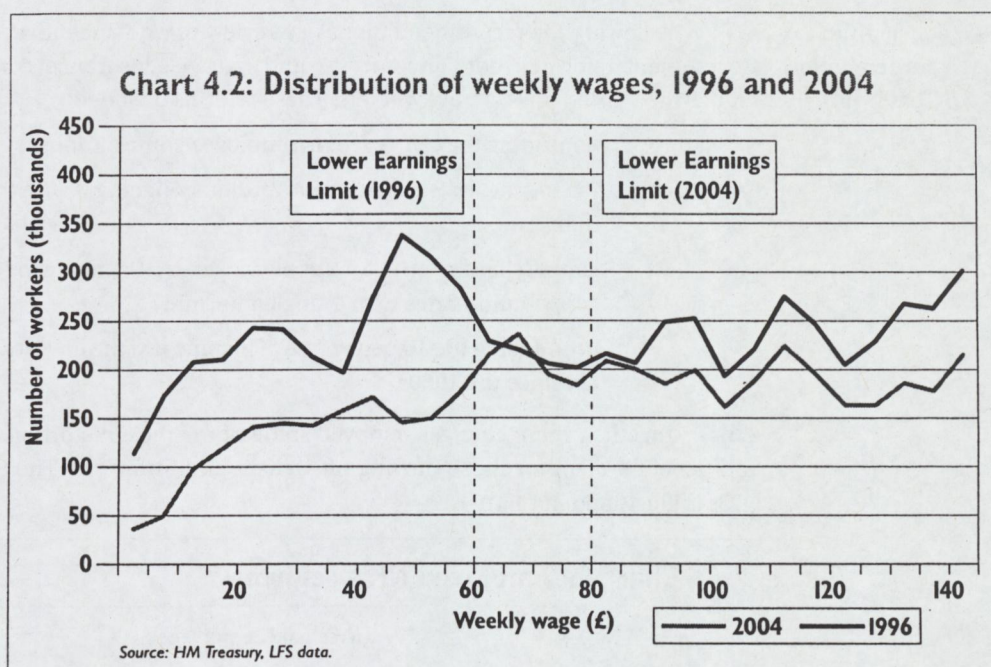
4.6 Together, these changes removed some of the most distortionary features of the tax and benefit system for those moving off welfare and into work. The impact on employee's NICs is illustrated in Chart 4.1.



4.7 The effect of abolishing the “entry fee” in employee contributions can be seen by looking at changes in the distribution of earnings between 1996 and 2004 as illustrated in Chart 4.2. It shows the significant bunching of employees with earnings just below the lower earnings limit (LEL) has diminished over time.

<sup>3</sup> *Work Incentives, A report by Martin Taylor*, HM Treasury, 1998.





**Tax credits for adults with low incomes**

**4.8** The reforms to income tax and NICs reduced the burden of tax on low-paid workers. However, as discussed in Chapter three, there was a limit to how much could be achieved through changes to the tax system: neither income tax nor NICs can be reduced below zero. Many low-paid people could still find that work paid little more than benefits. This was of greatest concern for couples whose out-of-work benefits are higher than for single people.

**4.9** The Working Tax Credit (WTC), which was introduced in April 2003, fundamentally changed the structure of financial support for working people with low incomes. For the first time, low-income working people without children or a disability could actually receive a net tax payment from government. For example, a couple with one earner working full-time<sup>4</sup> and paid at the NMW receives gross wages of £169.75 per week and pays income tax of £11.81 and NICs of £8.33 each week. This produces a net tax rate of 13 per cent. The WTC award of £48.74 more than offsets the income tax and NICs, so that the household receives a net tax payment of £28.60. Taking account of WTC, the household's net tax rate falls to minus 17 per cent.

**4.10** The WTC provides support tailored to individual household's circumstances. This means the net tax payment and the net tax rate faced by different households will vary. Table 4.2 shows the lowest net tax rates faced by different households<sup>5</sup>.

**Table 4.2: Lowest net tax rates<sup>1,2</sup>**

		Lowest net tax rate (%)
Single person	30 hours	-10
Couple	30 hours	-31
Disabled worker	16 hours	-94
Disabled worker, in a couple	16 hours	-133

<sup>1</sup>The net tax rate is equal to the difference between the amount of income tax and national insurance contributions paid and the amount of tax credits received, as a proportion of gross earnings.

<sup>2</sup>Figures in 2005-06 prices.

Source: HM Treasury.

<sup>4</sup>Full-time work is assumed to be 35 hours per week.

<sup>5</sup>These lowest net tax rates are based on the minimum hours of work which trigger eligibility for WTC with earnings per hour assumed to be the adult rate of the NMW, currently £4.85. Single people and couples without children are eligible for WTC if they work 30 hours per week while disabled workers are entitled if they work 16 hours per week or more.



## Improving work incentives for people with a health condition or a disability

**4.11** Tax credits are part of a coherent strategy to support people with a health condition or disability to find, remain and progress in employment. Jobcentre Plus is now providing a work-focused service to all people making a new claim for incapacity benefits. In addition the New Deal for Disabled People is providing employment support and advice for workless people with disabilities.

**4.12** The Pathways to Work pilots<sup>6</sup> are testing a new system of support and advice – from Jobcentre Plus, the health service and the voluntary and private sector – that has not previously been available to incapacity benefits claimants, including:

- a new framework of Work Focused Interviews within Jobcentre Plus;
- better links with New Deal for Disabled People job brokers; and
- improving employer and GP awareness of the implications of sickness absence.

**4.13** Many incapacity benefits claimants are concerned about the security of their income when they move into employment, so the Pathways pilots are also testing the effectiveness of a new Return to Work Credit, paid on top of any WTC entitlement. This is a payment of £40 per week, payable for 52 weeks<sup>7</sup>.

## Improving work incentives for families

**4.14** Families with children had often faced poor work incentives as they received more generous out-of-work support through the benefits system compared to those without children. As a first step towards delivering a better system of support for families with children, the Working Families' Tax Credit (WFTC) was introduced in October 1999:

- to provide more generous financial support to tackle poverty among working families on low earnings;
- to improve the incentives to move into and progress in work; and
- to tackle childcare costs as a barrier to work through the childcare tax credit.

**4.15** Box 4.2 sets out the key evidence on the impact of the WFTC, which extended financial support to many more families than had benefited from Family Credit. By November 2002 WFTC was providing financial support to over 600,000 extra families, and had increased the average award by over 30 per cent in real terms compared with the Family Credit system five years earlier<sup>8</sup>. WFTC also improved work incentives: the gain to work for a couple family with a single earner on half male mean earnings increased by one third<sup>9</sup>.

<sup>6</sup>The pilots started in October 2003 and are currently operating in around 10 per cent of the country.

<sup>7</sup>The credit is available to people who move from incapacity benefits to work of 16 hours a week or more and is payable to anyone whose annual earnings are less than £15,000. To ensure that it is a straightforward and visible incentive, the credit is disregarded for income tax, national insurance, tax credits, Housing and Council Tax Benefit and income-related benefits of any partner.

<sup>8</sup>Comparison of WFTC and Family Credit awards in November 2002 and November 1997 respectively. Compared with the peak Family Credit caseload in May 1999, the increase under WFTC was 556,000 families. Data available from [www.inlandrevenue.gov.uk](http://www.inlandrevenue.gov.uk)

<sup>9</sup>The real terms change in the gain to work between 1997-98 and 2002-03, estimated using half male mean earnings in 1997-98 (£208.40 per week). The calculation reflects the impact of increased tax credits on Housing and Council Tax Benefit.



**Box 4.2 Assessing the impact of the Working Families' Tax Credit**

The reforms introduced through the WFTC were aimed at improving take up of in-work financial support, increasing work incentives and tackling poverty for families with low potential earnings. Research using the Families and Children Study<sup>a</sup> showed that WFTC had a substantial impact on working families' incomes. For example, WFTC:

- boosted average income by 14.1 per cent among families receiving WFTC in 2000 who had also received Family Credit in the previous year;
- increased the income of lone parents who moved into work by 44 per cent on average, among those who had been receiving Income Support in 1999, and moved into work and were receiving WFTC in 2000; and
- reduced sharply the risk of severe hardship compared with Family Credit, both for lone parent and couple families.

The Inland Revenue commissioned independent research into the impacts of WFTC, in particular on the labour market effects<sup>b</sup>. Key findings were:

- by 2002-03 take up of WFTC exceeded take up of Family Credit and was higher among those in most need;
- WFTC led to an estimated net increase in labour supply of 81,000 extra individuals and added over five percentage points to the lone parent employment rate;
- there was no evidence to support the view that WFTC had an adverse effect on wage progression, and may even have encouraged it;
- stigma associated with claiming support fell under WFTC compared to its predecessor, Family Credit; and
- the childcare tax credit element of WFTC has helped families get back into work and has enabled more choice in securing childcare provision.

The findings on the positive impact of WFTC on lone parents' labour supply and on the effectiveness of the childcare element of WFTC in helping families move into work have been confirmed by other academic studies<sup>c</sup>.

<sup>a</sup> *Low/Moderate-income families in Britain: Changes in Living Standards*, Vegeris and McKay, 2002.

<sup>b</sup> The research can be found at [www.inlandrevenue.gov.uk/research](http://www.inlandrevenue.gov.uk/research).

<sup>c</sup> *The consequences of 'in work' benefit reform in Britain: new evidence from panel data*, Francesconi and Van der Klaauw, University of Essex, 2004.

**4.16** The next steps in the process of reform came with the introduction of the Child and Working Tax Credits in 2003. This represented a fundamental change in the way support for families and low-income workers is provided. Building on the achievements of WFTC, the Child and Working Tax Credits:

- provide, through the Child Tax Credit, a single system of support for families with children, which is independent of the parents' employment status. This provides a stable source of income as parents move into work, easing the transition to paid employment;
- enhance work incentives for second earners through a new and fairer assessment of family income, and a reduction in the rate at which awards are withdrawn;
- increase the gain to work for tenants working part-time through improving the interaction between Working Tax Credit and Housing Benefit; and
- reduce the number of working families in the poverty trap.

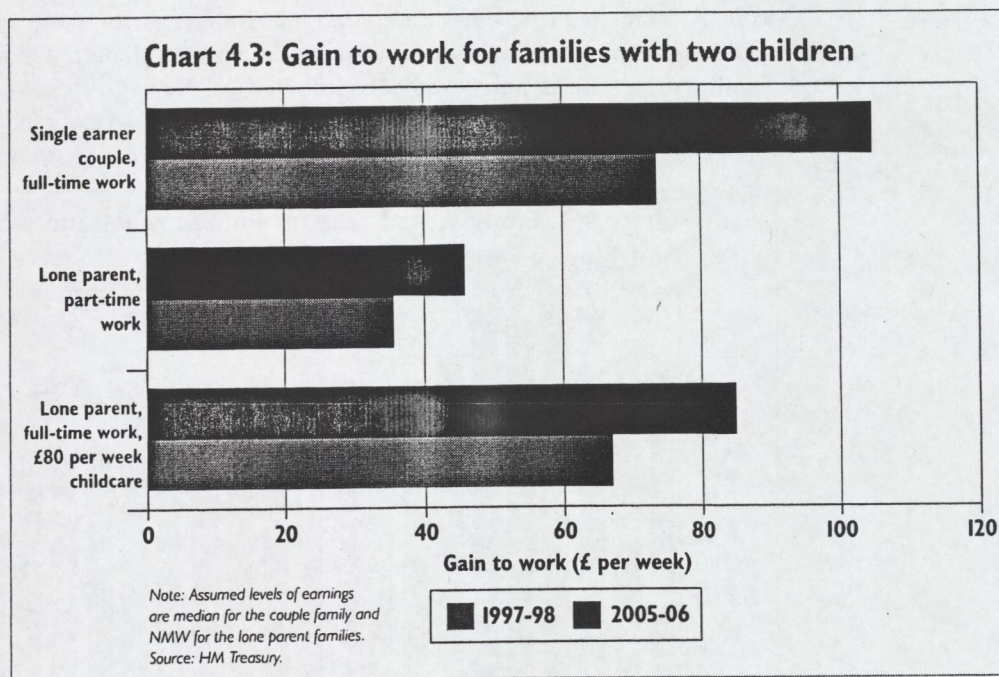


### Tackling the unemployment trap

**4.17** Tax credits improve gains to work for families on low incomes by integrating the system of support for families both in and out of work, increasing financial security during the move into work. In addition the WTC provides substantial help with childcare costs, which can be a major barrier to work. Families with childcare needs have up to 70 per cent of their costs met, helping to ensure that even parents on the lowest incomes can afford to pay for the childcare which enables them to work.

**4.18** Families who live in a rented property face the additional barrier to work of high withdrawal rates in Housing Benefit (HB). The tax credits system has increased help for those moving into work part-time (who tend to face poorer work incentives than full-time workers) by ensuring that less of the additional tax credits support is off-set by a reduction in HB. Further, childcare costs are now also fully disregarded in HB, so that tenant families with low earnings will still be better off in work even with very high childcare costs.

**4.19** Compared to previous systems of support, the Child and Working Tax Credits also provide support further up the income scale. This helps to ensure that more families on moderate incomes can now receive help with their childcare costs. For example, a family with two children and income of up to £24,000 per year can benefit from maximum support through the childcare element. In addition, incentives for second earners moving into part-time work have also been improved. The impacts of the reforms on gains to work for specimen families are shown in Chart 4.3 below.



### Tackling the poverty trap

**4.20** As a result of the introduction of tax credits, in combination with the reforms to NICs and the new 10 pence starting rate of income tax, the number of working families facing Marginal Deduction Rates in excess of 70 per cent has fallen by just over half a million since 1997-98. The reforms have also sharply reduced the number of working families with the highest MDRs – of over 90 per cent – from 130,000 to 30,000.



**Table 4.3: The effect of the Government's reforms on high Marginal Deduction Rates**

Marginal Deduction Rate <sup>1</sup>	Before Budget 1998	2005-06 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	30,000
Over 80 per cent	300,000	165,000
Over 70 per cent	740,000	235,000
Over 60 per cent	760,000	1,730,000

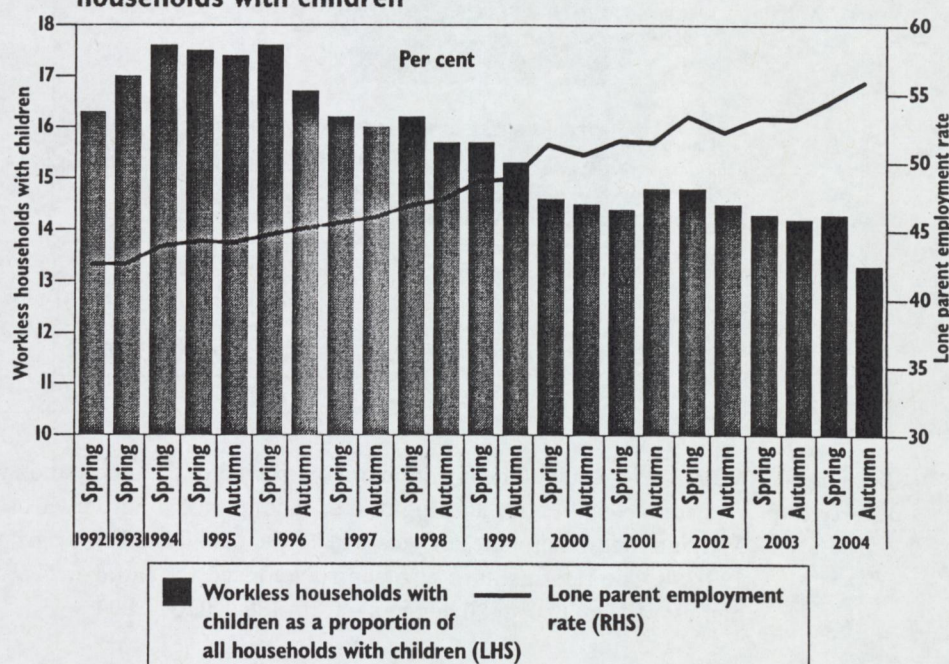
<sup>1</sup>Marginal Deduction Rates are for working households in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week, and the head of the household is not disabled.

Note: Figures are cumulative. Before Budget 1998 based on 1997-98 estimated caseload and take-up rates; the 2005-06 system of tax and benefits is based on 2003-04 caseload and take-up rates.

#### Children in workless households

**4.21** The reforms to financial support for families have contributed to a significant reduction in the number of children living in workless households. As well as providing the most sustainable route out of poverty, there is evidence that by having employment, parents positively influence educational attainment among older children, and their prospects of employment in later life. The number of children in workless households has fallen by 481,000 since 1997.

**4.22** A significant share of the reduction in the number of children in workless households is due to increased employment among lone parents. The introduction of tax credits means work is more financially rewarding and the New Deal for Lone Parents has provided additional support and advice on moving into work. Underpinned by macroeconomic stability, these policies have together contributed to a rise in the lone parent employment rate of 9 percentage points to over 54 per cent – the highest rate on record<sup>10</sup>. There are now almost one million lone parents in employment, an increase of 40 per cent since 1997.

**Chart 4.4: Employment rate for lone parents and workless households with children**

Source: Labour Force Survey.

<sup>10</sup>Between spring 1997 and spring 2004.



## Reforms to support improved work incentives

**4.23** The Government has introduced a set of reforms which complement the improvements to work incentives described in this chapter. The complexity of Housing Benefit is being tackled through the introduction of Local Housing Allowances. Further, there is extensive empirical evidence showing that help with the transition to work and improved work incentives are more effective when combined. The Government has introduced Jobcentre Plus to integrate the employment service and the benefits agency.

### Simplifying Housing Benefit

**4.24** The Housing Benefit (HB) system is complex and often poorly administered. As well as increasing the hassle of claiming support, delays in HB administration lead to rent arrears and deter tenants from moving into work. This is confirmed by research carried out for the Department for Work and Pensions which shows widespread concern about the transition to work amongst those who were close to entering employment<sup>11</sup>.

**4.25** As a result the Government has introduced a radical reform programme for HB which moves away from a system of payments to the landlord on behalf of a tenant and at the same time simplifies the assessment of the amount of support to which a tenant is entitled. These improvements in HB administration should lead to increased labour market flexibility and improved employment choices available to those in receipt of HB<sup>12</sup>.

### Local Housing Allowances

**4.26** Most rent payments made by the HB system go direct to the landlord, so that claimants have little interest in rent levels and no responsibility for ensuring that rent is paid on time. The rent assessment is excessively complex, creating uncertainty about the amount of benefit available. Flat-rate Local Housing Allowances (LHAs) are changing this: they are paid to the tenant and greatly simplify the assessment of rent. They have been implemented successfully in nine pathfinder areas for private sector tenants, and over 35,000 tenants are now receiving the LHA.

**4.27** Tenants taking part in these pilots know their benefit entitlement before signing a tenancy agreement, giving them the opportunity to choose where they live, keeping the difference if the rent is below the LHA or finding the extra money if it is above. The new system means that tenants are empowered to make choices about accommodation and employment. It also gives them the responsibility for paying the rent to the landlord, making the transition into work easier. The simplicity of the new flat-rate allowance should also allow much quicker claims processing.

**4.28** Qualitative evidence from this first round of Pathfinders is encouraging. The Government will introduce a second round in the private sector from April 2005<sup>13</sup> which will help develop best practice before the LHA is introduced nationally. However, the Government is also committed to developing a flat-rate LHA system for the social sector.

### Integrating financial support with worksearch

**4.29** There is widespread international evidence that active labour market policies and reforms such as tax credits which improve the financial incentives to work are more effective working together than in isolation<sup>14</sup>. A practical example in the UK context is the "better off

<sup>11</sup> *Easing the transition into work part 2 – client survey*, Woodland, Mandy and Miller, Research Report 186, DWP, 2003.

<sup>12</sup> The Government set out its strategy to reform the Housing Benefit system in the *Green Paper Building choice and responsibility: a radical agenda for Housing Benefit*, DWP, 2002.

<sup>13</sup> The second round of nine LHA pilots will be in Argyll-Bute, East Riding of Yorkshire, Guilford, Norwich, Pembrokeshire, Salford, South Norfolk, St Helens, Wandsworth.

<sup>14</sup> *What works among active labour market policies: Evidence from OECD countries' experience*, Martin, Mimeo, OECD, 1998; *Financial Incentives for Increasing Work and Income among Low-income Families*, NBER Working Paper No 6998, Blank, Card and Robins, 1999.



calculation" showing the gain to work for a particular individual, which is provided as part of a Work Focused Interview, and is one of the most effective tools in persuading benefits claimants to return to work<sup>15</sup>.

**4.30** Jobcentre Plus brings together benefits and labour market advice for all people of working age – providing an active work focus for those on incapacity benefits and Income Support as well as for those on Jobseeker's Allowance who are required to seek work, and reinforcing the link between rights and responsibilities. The creation of Jobcentre Plus is at the heart of the increasing focus on helping economically inactive people back into work.

**4.31** Instead of treating people on incapacity benefits and Income Support as incapable of or uninterested in work, Jobcentre Plus ensures that all working-age benefit claimants have the opportunity to return to work by providing tailored worksearch support through a personal adviser and access to a range of labour market programmes including the New Deals. For example, the New Deal for Lone Parents provides voluntary access to a comprehensive package of support including a personal adviser; training, education and childcare; and advice on benefits, in-work financial support and self-employment.

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<sup>15</sup> *Integrated Findings from The Evaluation of the First 18 Months of Lone Parent Work Focused Interviews.*, Thomas, and Griffiths, DWP Research report W184, 2004.



## FAIRNESS IN FINANCIAL SUPPORT

5.1 The second of the Government's five principles for modernising the tax and benefit system is that financial support should be provided fairly: *to ensure it is targeted on those who need it most, financial support should be assessed on a household basis where possible, while respecting the principle of independent taxation.*

5.2 This chapter sets out how existing structures of financial support in the tax and benefit system were not well designed to provide financial support for families which take into account household resources. It goes on to describe how the Child Tax Credit and Child Benefit together provide financial support on the model of progressive universalism, showing how tax credits have reduced the net tax rate for families on low and moderate incomes. The last part of this chapter shows how Pension Credit has ensured that the increased support for pensioners has been provided fairly, and sets out improvements to the delivery mechanisms of financial support.

### The structure of financial support for families

5.3 Since 1999, the Government has put in place a number of reforms to improve financial support for families with children. Introduced from October 1999, the Working Families' Tax Credit (WFTC) increased support and extended help to more working families than its predecessor, Family Credit. In addition, for the first time in a generation the additional costs of raising a family were explicitly recognised by the tax system through the Children's Tax Credit, a tax allowance which provided support for families paying income tax, introduced in April 2001.

5.4 These were important reforms to help make work pay, tackle child poverty and support family life. However, because they were developments of existing forms of support, some disadvantages remained. In particular:

- as an additional allowance in the income tax system, the Children's Tax Credit could not provide support to families on the lowest incomes, who had no tax liability;
- financial support for families should take account of the income of both parents in a couple, since they share the responsibility of providing for their children. But a tax allowance can only take account of the income of one individual;
- because Children's Tax Credit was an income tax allowance, in practice support was unfairly distributed between single and dual earner couples;
- WFTC retained some of the features of Family Credit. For example, awards were assessed over the six weeks prior to the claim and were unresponsive to changes in a family's income and circumstances. As a result awards could become insufficient to meet a family's needs or, if income increased substantially, unfair to other claimants; and
- the interaction of Children's Tax Credit and WFTC was complex and families receiving WFTC could not benefit in full from the additional tax allowance through Children's Tax Credit.



5.5 The WFTC and the Children's Tax Credit were introduced in response to the urgent need to improve work incentives and increase financial support for families, but there was a clear case for more fundamental reform.

**The Child and  
Working Tax  
Credits**

5.6 In April 2003, the Government introduced the new tax credits, the Child and Working Tax Credits. Their key advantages over all previous systems of income-related support are:

- the new tax credits are aligned with the tax year: awards generally last for the duration of the tax year and are assessed against income across a whole tax year, ensuring a fair assessment of family resources;
- unlike Children's Tax Credit, awards are based on family income, ensuring that support is fair between dual and single earner couples;
- they are also far more inclusive, with around nine out of ten families eligible for the Child Tax Credit; and
- tax credit awards take account of families' changing circumstances – for example, a reduction in income or a significant change in childcare costs.

5.7 Around 6 million families are benefiting from the Child Tax Credit (CTC), and 3.5 million families have benefited from the increases in the per child element of the CTC. Box 5.1 sets out how tax credits have extended financial support to more working families than ever before.



**Box 5.1 Families benefiting from the Child and Working Tax Credits**

The introduction of the Child and Working Tax Credits has sharply increased the number of working families benefiting from financial support for their children. The table below shows how the numbers of households benefiting from financial support through tax credits has increased since 1997.

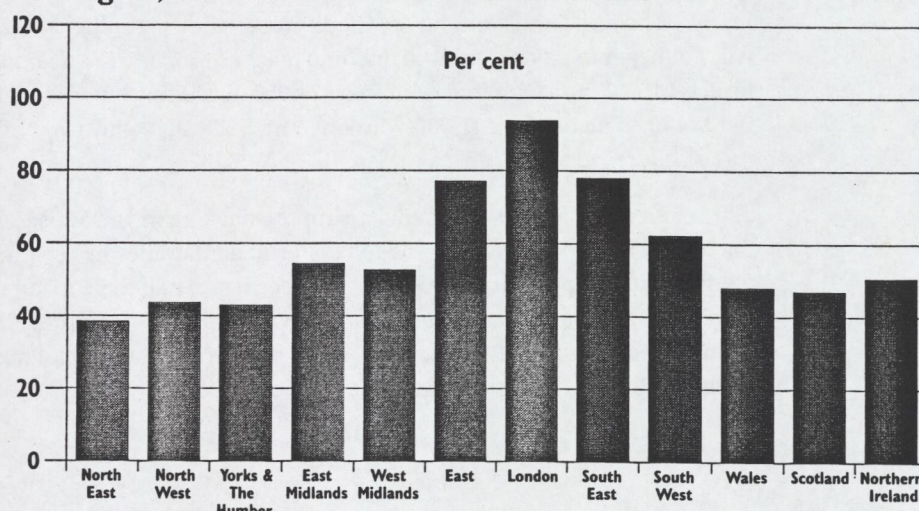
Thousands of working families	Family Credit/Disability Working Allowance <sup>1</sup>	WFTC and DPTC	Child and Working Tax Credits
	November 1997	November 2002	December 2004
Families with higher incomes	–	– <sup>2</sup>	2,075
Families with low and moderate incomes	766	1,394	2,186
Families with childcare costs	33	180	331
Families with a disabled child	0	32	116
Households with a disabled worker	14	38	87

<sup>1</sup> Great Britain only

<sup>2</sup> Children's Tax Credit was available to most families paying income tax in 2002-03. The number of families with higher incomes who benefited is not readily identified.

More families in every region and country of the UK are benefiting from the additional support provided through the Child and Working Tax Credits. The chart shows that London has seen the largest increase with 94 per cent more working families receiving an award of Child Tax Credit above the family element\* compared with the number receiving WFTC two years previously. Research had shown that take up of WFTC in London (and to a certain extent the South East) was lower than elsewhere in the UK, so the greater increase in caseload is encouraging.

**Increase in working families benefiting from tax credits by region, November 2002 to December 2004**

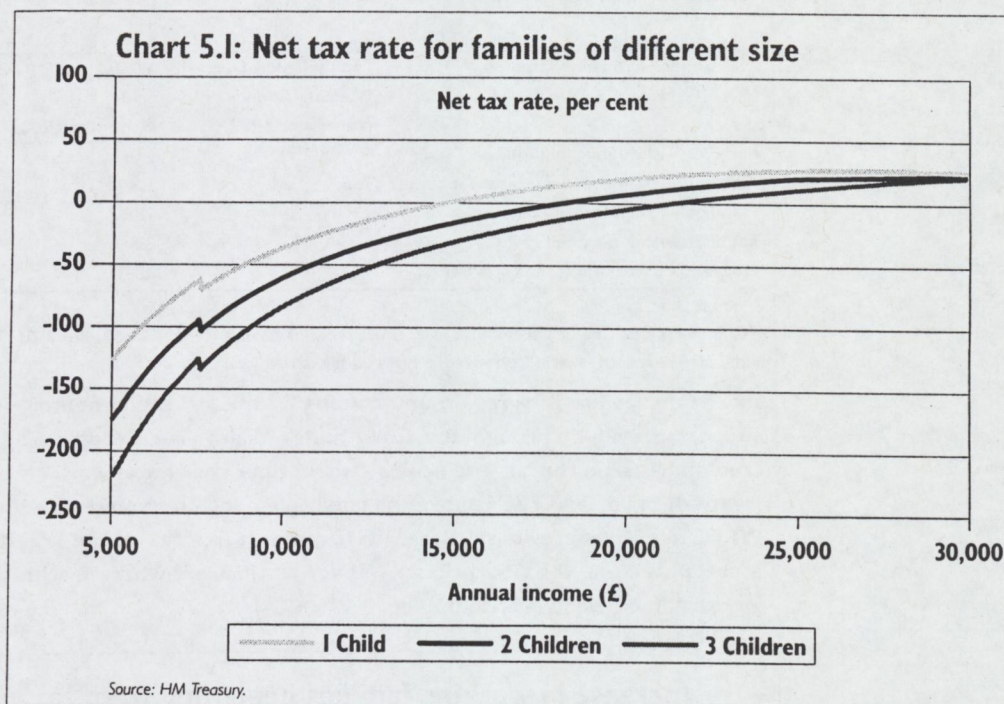


Source: Inland Revenue.

\* Families receiving more than the family element of Child Tax Credit have low or moderate incomes and are therefore the closest comparators to families eligible for the WFTC.



**Reducing the tax burden on families** 5.8 Chapter 3 introduced the concept of net tax rates and explained how – through the Child and Working Tax Credits – the net tax rate faced by a family will depend on its precise circumstances, including the number of children in the household. Chart 5.1 shows how the net tax rate including national insurance contributions (NICs) varies with income and family size.

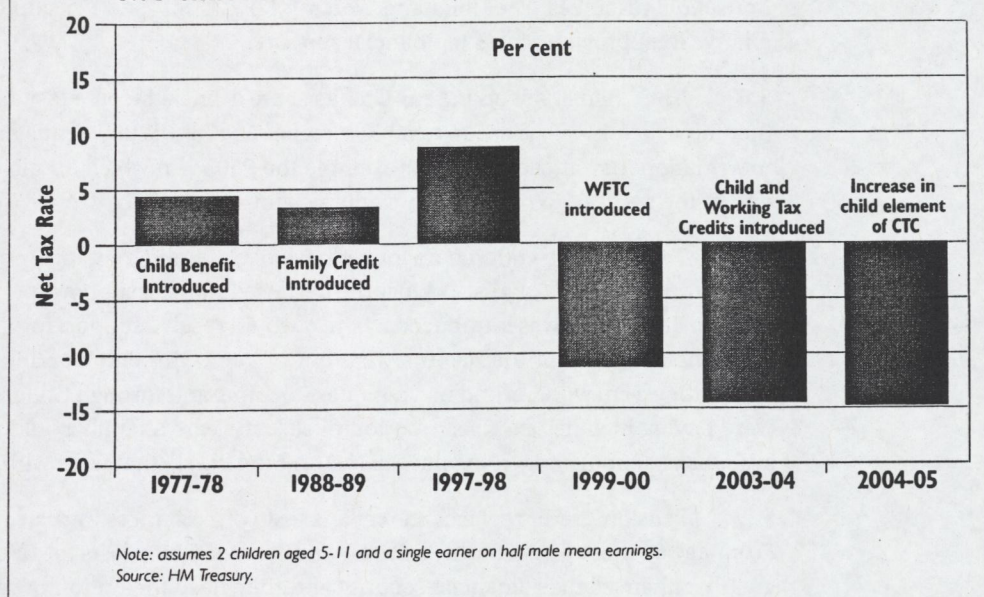


5.9 The Child and Working Tax Credits mean that, including NICs, a family with one child will not begin to pay net tax until income reaches £15,400. For a family with two children the level is £18,700 and with three children £21,900. Excluding NICs a family does not begin to pay net tax until income is £17,300 with one child, £21,200 with two children and £25,100 with three children.

5.10 As new systems of financial support have been introduced over the past 25 years, the overall financial support provided to particular families has changed. Chart 5.2 shows the net financial support for a family with one earner on half male mean wages. Although Family Income Supplement was introduced in the early 1970s, Child Benefit in the late 1970s and Family Credit in the late 1980s, it was only with the introduction of tax credits that this family benefited from a negative net tax rate.



**Chart 5.2: Net tax rate for a single earner family with two children**



**5.11** As set out in Chapter 3, tax credits are an effective means of ensuring that families with low incomes face a negative net tax rate, taking into account both tax paid and support received. Compared with the income tax system or Child Benefit, they provide a much more flexible way of providing support to families who need it most, because they can respond both to family income and circumstances. Further, because pension contributions are disregarded in the income test for tax credits, they can enhance the return to saving, as the Pensions Commission noted in its First Report<sup>1</sup>.

**Achieving fairness for pensioners**

**5.12** Just as tax credits were necessary to provide increased support for families on a progressive basis, the Government has introduced Pension Credit to improve support for pensioner households. At the same time, the Government has reduced the income tax burden on pensioners through higher personal tax allowances available to those aged 65 or over.

**5.13** Pension Credit replaces the weekly means test with a less intrusive form of assessment and fixes support over a much longer time period, up to five years, from age 65. Further, Pension Credit is assessed on a household basis, ensuring that financial support is fair, especially to those who may not have been able to build up pension rights because of a disability, or due to caring responsibilities.

**5.14** The introduction of Pension Credit, which includes the Savings Credit, also ends the unfair penalty on those who have saved for their retirement. Previously, support was withdrawn pound-for-pound meaning that many households with modest savings were no better off than if they had not saved at all. Around 1.9 million pensioner households benefited from the introduction of the Savings Credit. Pension Credit has also abolished the upper capital limit, increased the amount of liquid savings disregarded to £6,000, and halved the assumed rate of return on capital.

**5.15** The Government is committed to further improvements in financial support for pensioner households, on the model of progressive universalism. The guarantee element of Pension Credit will rise in line with average earnings up to 2007-08, ensuring that the poorest pensioners continue to share in rising prosperity.

<sup>1</sup> *Pensions: Challenges and Choices, The First Report of the Pensions Commission*, Pensions Commission, 2004.



**Abolishing the weekly means test** 5.16 Extending financial support to a larger number of families with children, and to many more pensioner households, brings with it the challenges of providing support more efficiently, with less hassle for claimants, and without imposing an intrusive assessment of household resources. The Child and Working Tax Credits, and Pension Credit provide a step change in improving access to financial support.

5.17 The Child and Working Tax Credits share a single income test and use a definition of income which is very close to taxable income. As a result tax credits enable families to use information they already have, for example the P60 form which employers provide after the end of the tax year, to make or renew their claim.

5.18 Families with children no longer have to claim different forms of support depending on their employment status and income because financial support for children is integrated in CTC. Before CTC was introduced a family would receive support for their children through the benefits system if the parents were out of work, through Working Families' Tax Credit where they were working and had a modest income, and through Children's Tax Credit if they were paying income tax. Over a period of several years a family could move between these systems of support, triggering new claims and the hassle that went with them.

5.19 Pension Credit replaces the means test with a far less intrusive form of assessment. From age 65 most pensioners receive an entitlement which lasts for five years at a time. This greatly enhances their financial security and they have the option of receiving more help if their income falls. A recent independent survey found that around 70 per cent of people claiming Pension Credit thought the application process was easy, with 85 per cent saying they would recommend Pension Credit to others<sup>2</sup>.

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<sup>2</sup> Age Concern Pension Credit Report, 2004.



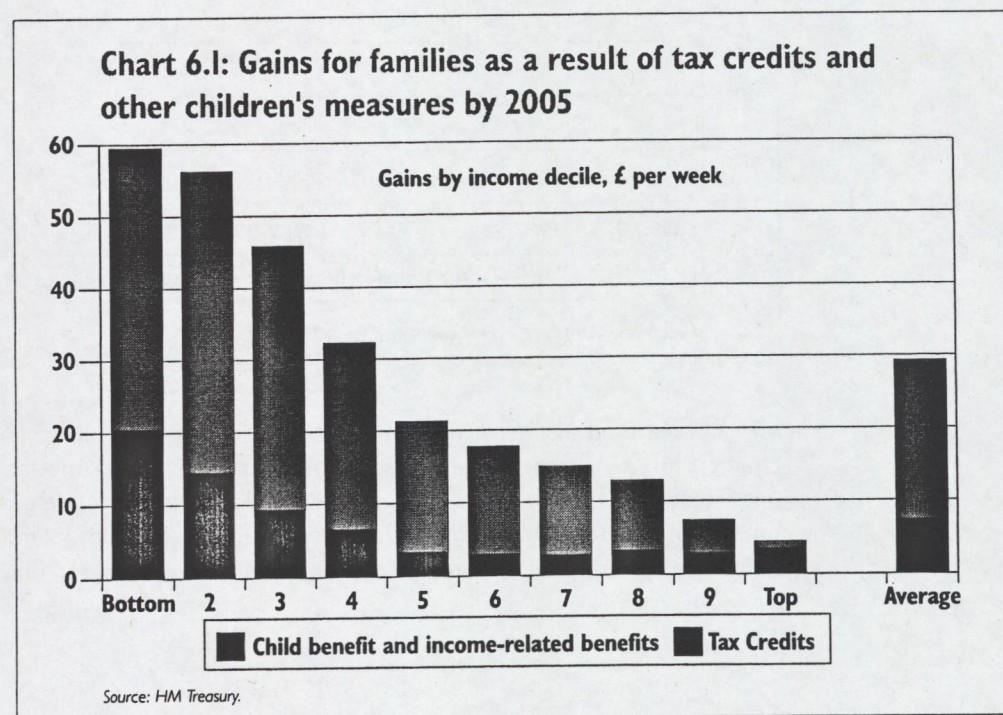
## TACKLING POVERTY AMONG VULNERABLE GROUPS

**6.1** The third principle guiding the Government's reforms of the tax and benefit system is that: *to tackle poverty, minimum levels of income should be guaranteed for the most vulnerable in society – the elderly, families and those who cannot work because of illness or disability.* The first section in this chapter sets out how the Government's reforms have increased financial support for families and the following one describes how the Government's reforms have increased pensioners' incomes.

### Financial support for families

**6.2** Child Benefit was first introduced in 1977, and is payable to every family in the UK in respect of each child. The Government believes it is right that society should recognise the importance of family life by providing financial support for every family with a dependent child. Since 1997 the value of Child Benefit for the first child has been increased by 25 per cent in real terms.

**6.3** The increased support for families with children through tax credits builds on Child Benefit. Overall support has been increased in line with the principle of progressive universalism, providing most support for those with the greatest needs. Chart 6.1 below shows the gains for families by income decile as a result of policy changes since 1997-98.

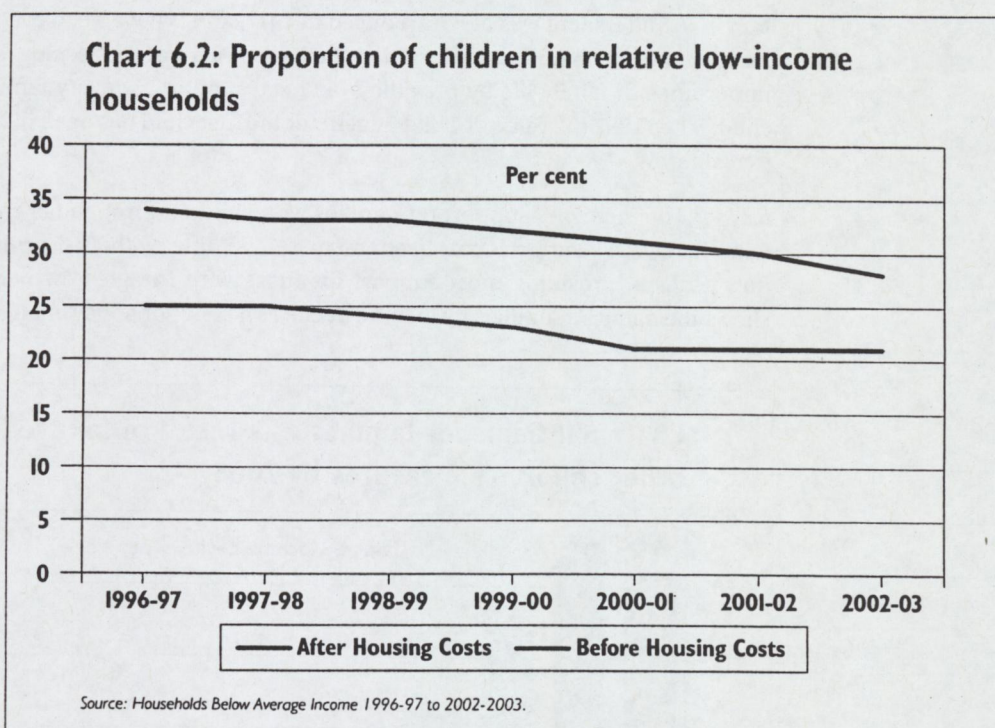


**6.4** While the extra expenditure on children has benefited all families, those with the lowest incomes, families with young children and those with disabled children have seen the largest increases in support. Box 6.1 sets out the impact of the additional support on families with the lowest incomes, showing how the extent of material deprivation has reduced in recent years. The next section, which looks at the Government's progress against its target to reduce the proportion of children in low-income households, is followed by a section discussing the increase in support for families with young children.



**Progress in reducing child poverty** 6.5 Since 1997 the proportion of children in low-income households has fallen and the Government is on track to reach the first milestone on the way to its long-term goal of eradicating child poverty by 2020. This requires a reduction in the number of children in relative low-income households of one quarter between 1998-99 and 2004-05. By 2002-03, the proportion of children in households with equivalised incomes below 60 per cent of the contemporary median fell from 24 per cent to 21 per cent measured on a before housing costs basis and from 33 per cent to 28 per cent on an after housing costs basis, a reduction of 5-600,000 children, shown in Chart 6.2 below.

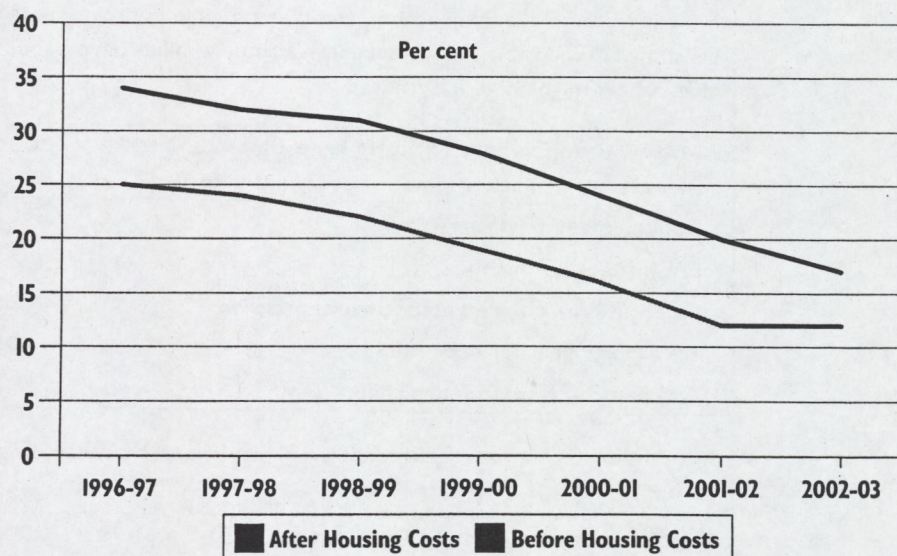
6.6 This reflects a number of factors such as the reduction in unemployment and worklessness including among lone parents, increased levels of benefits and tax credits related to children, and more evenly distributed growth in real income across the population.



6.7 Measured against a constant level of real income, the decline in the number of children in low-income households has been dramatic, reflecting the same factors as the relative income data, together with sustained and stable economic growth. By 2002-03, the number of children in absolute low-income households fell from 3.2 million in 1996-97 to 1.5 million before housing costs and from 4.3 million to 2.2 million after housing costs.



**Chart 6.3: Proportion of children in absolute low-income households**



Source: Households Below Average Income 1996-97 to 2002-03.

**A new measure of child poverty**

**6.8** The next milestone towards meeting the long-term goal of eradicating child poverty by 2020 is to halve the number of children in relative low-income households by 2010. In addition, the Government will reflect international best practice<sup>1</sup> in measuring poverty and monitoring progress, providing a balance between clarity and comprehensiveness. It will use three tiers:

- the number of children in households with less than 60 per cent of contemporary median income – to see whether the poorest families are keeping pace with the growth of incomes in the economy as a whole;
- the number of children in households with less than 60 per cent of median income held constant in real terms from a 1998-99 base – to see whether the poorest families are seeing their incomes rise in real terms; and
- the number of children experiencing material deprivation and living in households with less than 70 per cent of contemporary median income – to provide a wider measure of families' living standards.

**6.9** The choice of these tiers reflects the results of substantial public consultation, capturing different aspects of poverty whilst respecting the finding that income is at the core of people's conception of poverty<sup>2</sup>. The Government's approach to tackling child poverty reflects this complexity. The strategy hinges on ensuring decent family incomes through full employment and a modernised tax and benefit system, but it goes beyond this to include delivering excellent public services to improve children's life chances and break cycles of deprivation. The Child Poverty Review, published in the 2004 Spending Review, provides further details of this approach.<sup>3</sup>

<sup>1</sup> *Child poverty in rich countries 2005.*, UNICEF 2005, Report Card No. 6, Innocenti Research Centre. Best practice in measuring child poverty includes: avoiding unnecessary complexity; measuring material deprivation; basing poverty lines on social norms; establishing a regular monitoring system; establishing a "backstop" poverty line; and setting targets.

<sup>2</sup> *Measuring child poverty*, DWP 2003, <http://www.dwp.gov.uk/consultations/consult/2003/childpov/final.asp>

<sup>3</sup> *Child Poverty Review*, HM Treasury, 2004, [www.hm-treasury.gov.uk/spending\\_review](http://www.hm-treasury.gov.uk/spending_review)



**Box 6.1 Impacts of increased financial support on material deprivation**

Since 1997 increases in weekly incomes through employment and a more generous tax and benefit system have been accompanied by tangible improvements in poor children's lives. As shown in the table below more low-income families have been able to afford key items that others might take for granted.

<b>Material deprivation among lone parents</b> (per cent of families who want but cannot afford)	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Cooked main meal every day	8	6	5	3
Fresh fruit on most days	17	14	11	8
Celebration with presents at special occasions	27	23	17	14
Toys/sports gear for each child	24	21	15	12
Two pairs of shoes for each child	25	19	15	13

In addition to increased affordability of key items there are signs of reduced financial strain:

<b>Financial stress among lone parents</b> (per cent of families who experience)	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Problems with debts almost all the time	15	13	10	12
Always runs out of money before end of week	28	24	21	19
Worries about money almost always	45	38	33	30
Never has money left over	48	40	34	17

Source: Families and Children Survey

Case studies of the impact of Government policy since 1997 on families at risk of social exclusion<sup>a</sup> identified a range of positive impacts when an adult moved into employment, started training and experienced rises in incomes through benefits and tax credits. For example:

- moving into work often meant "extras" for children such as cinema trips, schools trips, trainers and clothes;
- people who had entered employment since 1997, particularly lone parents, talked of the benefits of meeting new people outside their homes;
- changes in employment were a primary source of improvements to well-being. People spoke of increased self-esteem, self confidence or generally feeling happier and children noticed the improvements in their parents' well-being; and
- tax credits were seen as pivotal in enabling people to return to work, especially part-time.

<sup>a</sup> *Making a difference to disadvantaged families? Qualitative case studies*, Social Exclusion Unit, 2004.



**Support in the early years** 6.10 With more parents combining the responsibilities of work with caring for their children, reform of the tax and benefit system needed to encompass appropriate financial support for parents to help them balance the demands of work and family during the early years of a child's life. It has achieved this by:

- increasing maternity pay and extending maternity leave;
- increasing support for young children in families with low and moderate incomes;
- introducing more generous help with the extra costs of a new baby for most families; and
- increasing dramatically the generosity of support for families with in-work childcare costs.

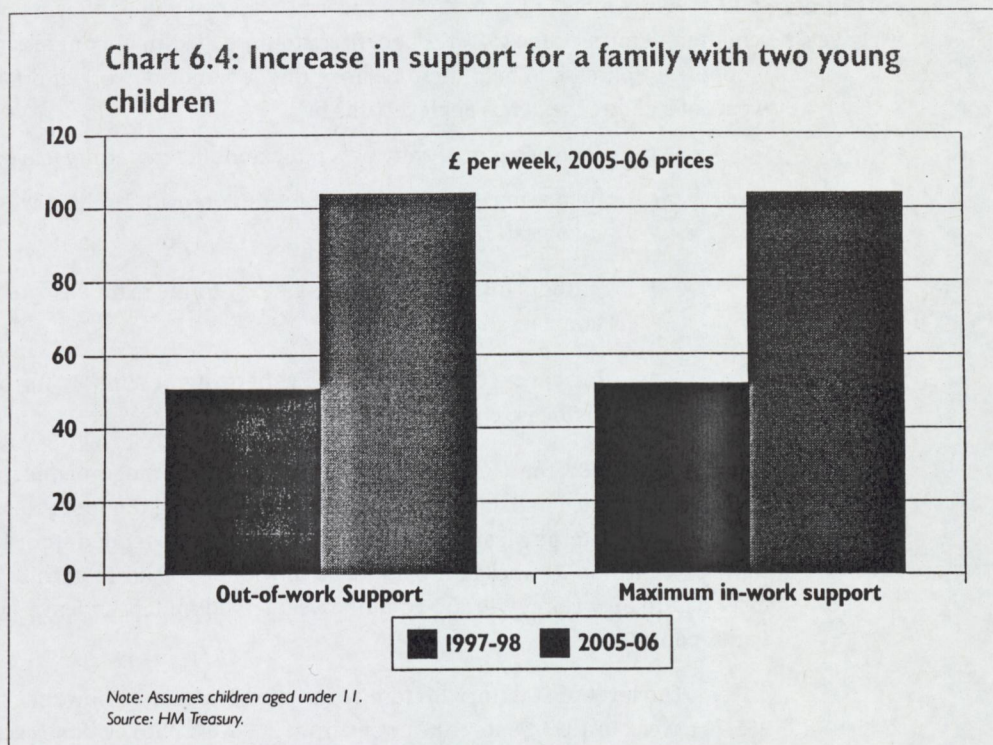
6.11 Since 1997 the Government has introduced a range of measures to improve the choice parents face in balancing work and family during the first year of a child's life. From 2003-04 paid maternity leave for working mothers was extended from 18 to 26 weeks, with a right to a further 26 weeks' unpaid leave introduced. Paid maternity leave will be further extended to 39 weeks, with the goal of a year's paid maternity leave by the end of the next Parliament<sup>4</sup>.

6.12 The level of Statutory Maternity Pay and Maternity Allowance has been raised from £55.70 a week in 1997-98 to £106 a week from 2006-07. With evidence suggesting that there is growing demand from fathers for increased involvement in caring for their children, paid paternity leave was introduced in 2003 for the first time. The Government is consulting on the introduction of a right for a mother to transfer a proportion of her maternity pay and leave to the father.

6.13 The Government has also increased the amount of financial support available to families with young children (under 11), both in and out of work, as shown in Chart 6.4. A family with two young children and a full-time earner on £15,500 a year, half male average earnings, will receive over £103 a week in Child Tax Credit and Child Benefit next year, a real terms increase of 85 per cent since 1997-98.

<sup>4</sup> *Choice for parents, the best start for children: a ten year strategy for childcare*, HM Treasury, 2004, [www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr04](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04).





**6.14** The Child Tax Credit provides extra support to families with a new baby through an addition to the family element, which provides help to all families with incomes up to £66,000 per year. For families on low or moderate incomes more support is available with the costs of a new baby through the Sure Start Maternity Grant, a one-off payment of £500.

**6.15** Childcare costs are typically much higher for pre-school age children than for older children and good quality childcare is critical for later life development. Evidence from the Effective Provision of Pre-school Education (EPPE) project<sup>5</sup> shows that early education can have a positive effect on child outcomes, boosting cognitive development and improving social skills and confidence. Further, although it cannot wholly eliminate the impact of disadvantage, quality pre-school education can provide children from lower-income households with a better start at school.

**6.16** The Government has increased financial support to families with childcare costs through the tax credits system, through the Employer Supported Childcare scheme, and through the provision of early years education for three and four year olds. Since 1997 expenditure on childcare through tax credits has increased fifteen-fold in real terms. In addition, Sure Start programmes provide help with childcare for families in the most disadvantaged areas and the Government has significantly increased funding to support new childcare places.

### Financial support for other vulnerable groups

**6.17** To put the third principle of welfare reform into effect for the elderly the Government has promoted policies aimed at guaranteeing security in old age and ensuring that all pensioners can share in rising national prosperity. The immediate challenge faced by the Government in 1997 was pensioner poverty, which the Government has tackled by targeting resources on the poorest and most vulnerable pensioners.

<sup>5</sup> *The Effective Provision of Pre-School Education (EPPE) Project: Findings from the Pre-School Period, Summary of Findings*, Sylva, et al, Institute for Education, 2003.



**6.18** Pension Credit, introduced in October 2003, builds on the previous Minimum Income Guarantee and is at the heart of these reforms. From April 2005 Pension Credit will guarantee pensioners a minimum weekly income of £109.45 if they are single and £167.05 for a couple. These income levels are 31 per cent and 29 per cent higher in real terms than in 1997-98 when the minimum income for a pensioner household was provided through Income Support.

**6.19** In addition to increased support for those who need it most, the Government has provided an improved foundation of support for all pensioners. The Basic State Pension is central to this foundation and since 2002-03 the Government has guaranteed an annual increase in line with prices or 2.5 per cent (whichever is higher). Overall since 1997 there has been a 7 per cent real terms increase in the Basic State Pension and a cash increase of nearly £20 per week for single pensioners.

**6.20** The introduction of the 10 pence rate of income tax and the increase in the age-related income tax allowances in line with earnings during this Parliament have worked with the Pension Credit to enable pensioners to share in rising national prosperity.

**6.21** The Government has also introduced a series of measures to meet specific needs, particularly of older pensioners, and to give those on fixed incomes greater scope to manage irregular expenses:

- the £200 Winter Fuel Payment for households with someone aged 60 or over, rising to £300 for those over 80;
- additional support to help households with someone aged over 70 with Council Tax bills and other living expenses;
- free eyesight tests and local travel concessions for the over 60s; and
- free television licences for households with someone over age 75.

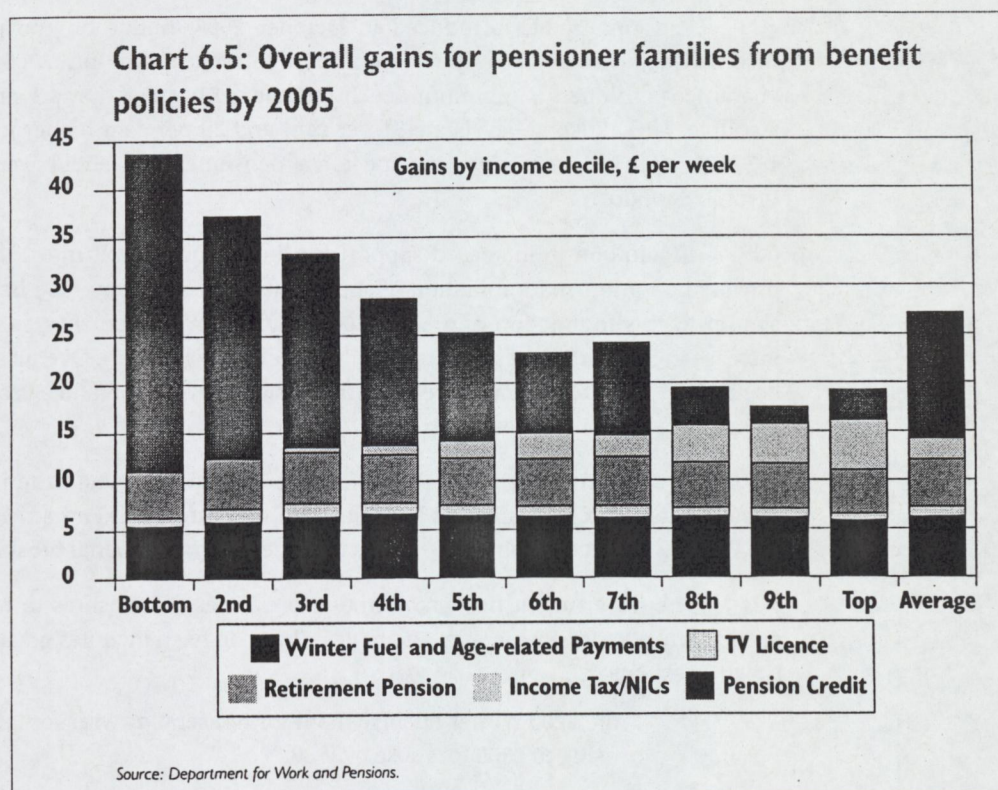
**6.22** Chart 6.5 shows the total impact of the Government's measures to improve support for pensioners since 1997-98, by income decile. The poorest 10 per cent of pensioners will be £44 a week better off in 2005-06 than they would have been under an indexed 1997 system<sup>6</sup>.

**6.23** By focussing on the most vulnerable, and on those who have had less opportunity to provide for themselves, while increasing support for the great majority of pensioner households, the Government's measures to improve incomes for pensioners have followed the principle of progressive universalism. Compared with a policy of uprating the Basic State Pension in line with average earnings, government support for pensioner households is both more generous and better focused on those who need it most:

- the Government has committed £7 billion more on support for pensioners in 2004-05 than if the Basic State Pension had been linked to earnings since 1998;
- on average the poorest 10 per cent of pensioners are £23 a week better off through the Pension Credit and other Government measures than if an earnings link had been applied to the Basic State Pension since 1997; and
- by 2005-06 pensioner households on average will be £1,350 a year better off in real terms as a result of personal tax and benefit measures introduced since 1997.

<sup>6</sup> Measures up to and including those announced in the 2004 Pre-Budget Report, in 2005-06 prices.





**6.24** Women pensioners, who in the past have often not been able to build up an entitlement to a full Basic State Pension, have been among those to benefit the most from Pension Credit. Only 48 per cent of women currently receive a full Basic State Pension in their own right but twice as many women benefit from Pension Credit as men.

#### Support for disabled people

**6.25** The introduction of tax credits has led to increases in support for other vulnerable groups: disabled workers and families with disabled children. Since 1997 there has been a six-fold increase in the number of households with a disabled worker receiving in-work financial support. With increases in the National Minimum Wage and more generous support through tax credits the Minimum Income Guarantee for a single disabled worker working part-time will increase to £153 per week by October 2005.

**6.26** Through tax credits the level of financial support for disabled children has increased dramatically since 1997-98, and far more families are benefiting. Prior to the introduction of the Working Families' Tax Credit there was no income-related support for working families with a disabled child.

**6.27** The Child Tax Credit integrates income-related financial support for disabled children by replacing the disabled child premium in Income Support with a much more generous tax credit. Support for families with low incomes through Child Benefit, Child Tax Credit and Disability Living Allowance is now at least £100 per week, 250 per cent more than was available to a working family with a disabled child in 1997-98<sup>7</sup>.

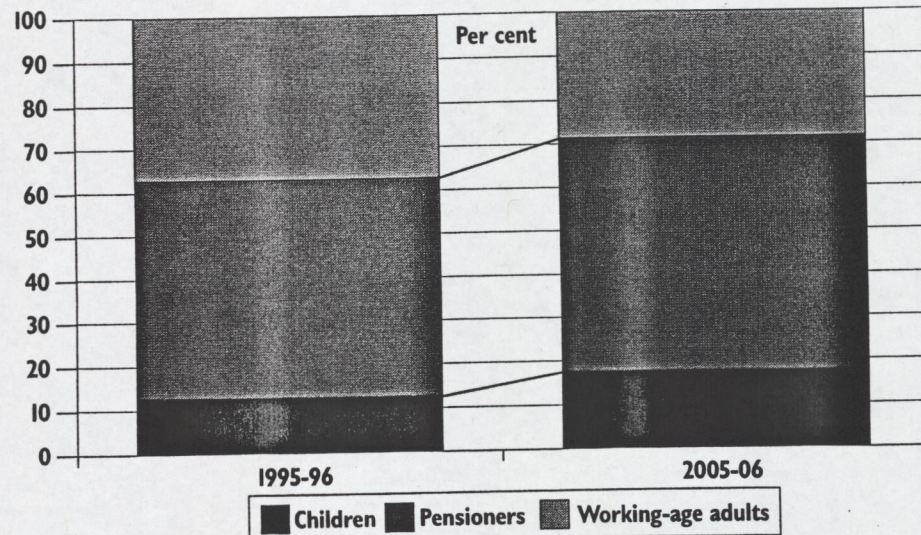
#### Directing resources to the most vulnerable

**6.28** The increases in support for families with children and pensioners have led to a marked shift in the balance of total expenditure through the tax and benefits system since the early 1990s. With lower unemployment the share of spending on people of working age has fallen, enabling more resources to be directed to the most vulnerable groups.

<sup>7</sup> The comparison assumes the child is under 11 and eligible for the lower rate of Disability Living Allowance.



Chart 6.6: Share of benefits and tax credit spending by age group



Source: Department for Work and Pensions and HM Treasury.







## LOOKING AHEAD

7.1 The Government has put in place a series of reforms to the tax and benefit system. These reforms have been guided by the principles set out in Chapter three and have made progress towards achieving the Government's three over-arching objectives:

- to ensure adequate financial incentives to work;
- to reduce child poverty and increase financial support for all families; and
- to tackle poverty among the current generation of pensioners and support people in providing for their retirement

7.2 The Government's policies to modernise the tax and benefit system constitute the most fundamental programme of welfare reform since the 1940s. Nevertheless there remain important areas where further reform could contribute to the Government's aims. This chapter looks at how progress to date can be built on and explains how future policies to reform Britain's welfare state will be guided by the principles for modernising the tax and benefit system and empirical evidence on the most effective interventions.

### Promoting incentives to work

7.3 A modernised welfare state should *promote incentives to work, by reducing the tax burden on the low paid and the number of low-income households on high marginal withdrawal rates.*

7.4 Financial incentives to work are essential in helping people make the transition from benefits to work and to remain in employment. There is, however, a growing body of evidence that to be most effective, financial incentives should be accompanied by a package of tailored support and information to help individuals make informed labour market decisions.

7.5 Building on this evidence, the Government will continue to test and monitor different ways to engage with those not in work and to help them make the transition to work. For example, the Lone Parent In Work Credit and Work Search Premium pilots are providing valuable evidence on the effectiveness of these measures. In addition, the Employment, Retention and Advancement Pilot is testing how best to provide support to help low-income families progress in work.

#### Improving incentives to work for disabled people

7.6 Achieving the Government's vision for incapacity benefits reform requires a balanced and principled approach across a number of fronts. The Pathways to Work pilots are a key component of a much wider programme of change – involving employers, GPs and ensuring civil rights for disabled people. The next stage is to reform the system of incapacity benefits, alongside the employment and health support offered through Pathways to Work.

7.7 The current system of incapacity benefits is complicated, creates uncertainty and in many cases acts as a disincentive to work. The Department for Work and Pensions (DWP) Five Year Strategy<sup>1</sup>, set out the Government's plans to reform incapacity benefits to reward work and give more help than now to people with the most severe limitations.

<sup>1</sup> Opportunity and Security Throughout Life, Department for Work and Pensions Five year Strategy, February 2005.



**7.8** The revised model for incapacity benefits would include a new payment for people with potentially more manageable conditions that might be called a Rehabilitation and Support Allowance. These claimants would receive a conditional extra payment for engagement in Work Focused Interviews and a further payment for fulfilment of an action plan agreed at the interview. People with the most severe health conditions or disabilities would receive a payment that might be called a Disability and Sickness Allowance and will get more money than now to reflect the increased risk of poverty that they face. The Government recognises the important contribution that external stakeholders have made to the development and delivery of the Pathways to Work pilots and intends to continue to work closely with interested parties to develop these proposals.

**7.9** The comprehensive support offered by Pathways to Work, combined with a reformed disability benefits system, will tackle the entrenched problems that have been created over the course of a generation. In parallel, the Government will consider carefully what changes can be made to tax credits to complement the reforms to incapacity benefits. While there are important differences between financial support for families with children and people with a health condition or disability, there may be valuable lessons from the development of tax credits, for example improving the fit between in-work and out-of-work support offered to disabled people.

**Improving  
incentives to  
work for families  
with children**

**7.10** The Child and Working Tax Credits have significantly reduced the average effective tax rates faced by low-income families with and without children. The 2004 Pre-Budget Report announced the new tax credit rates that will be payable from April 2005 and also announced increases in both the limits and percentage of childcare costs reimbursed by the childcare element of the Working Tax Credit. These changes will provide additional financial support to families with children.

**7.11** While the Government's reforms have done much to increase financial incentives to move into work, the improvements have been modest for those households in receipt of Housing Benefit (HB). Improved administration and the Local Housing Allowances currently being piloted offer significant advantages in terms of reduced uncertainty and greater choice for HB recipients. This will help those making the transition to work.

**7.12** However, the HB system is also problematic as it can reduce work incentives. Making further progress in the long term would therefore require a change in the overall structure of HB. The Government will examine the options for reform, including how HB could be more closely aligned with support provided through tax credits and the benefits system.

**Income Tax  
and National  
Insurance  
Contributions**

**7.13** Since Martin Taylor's report on work incentives in 1998<sup>2</sup>, the Government has been pursuing a policy of alignment of the tax and national insurance contribution (NICs) systems. This has resulted in the measures set out in Chapter four, which together amount to the most significant package of reforms of NICs since the 1970s. In taking this work forward the Government will be guided by the following principles:

- fairness for individuals, employers and tax payers;
- coherence of the tax and benefit systems, in the context of a modern labour market; and
- reducing administrative burdens.

<sup>2</sup> *Work Incentives, A report by Martin Taylor, HM Treasury, 1998.*



## Financial support should be assessed on a household basis where possible

7.14 The second of the Government's five principles for modernising the tax and benefit system is that financial support should be fairly targeted: *to ensure it is targeted on those who need it most, financial support should be assessed on a household basis where possible, while respecting the principles of independent taxation.*

7.15 Successive reforms have helped to deliver extra financial support to those who need it most including families with children, low-income workers, workers with disabilities and pensioners. In particular, tax credits, which use a household income test, have provided a foundation on which other forms of financial support can build. The Government has extended this principle through recent changes in the way young people are supported.

### Extending financial support for 16-19s

7.16 Education Maintenance Allowances (EMAs) have shown the important role of financial support and incentives in delivering higher post-16 participation rates. In *Supporting young people to achieve*, published alongside Budget 2004, the Government set out how it proposes to achieve its ambition to ensure every individual is supported and encouraged to make the most of their potential through post-16 learning. The Government's long-term vision is to deliver a single, coherent system of financial support for 16-19 year olds, radically simplifying the complexity of the current benefits system and building on the principle of a household based income test where that is appropriate.

7.17 As a significant step towards this long-term vision, from April 2006 the Government will extend Child Benefit, Child Tax Credit and Income Support to unwaged trainees on specific work-based learning schemes arranged by the Government<sup>3</sup>. In England, EMAs will also be extended to these trainees. The aim of these reforms is to deliver parity in financial support for education and unwaged training, enabling individuals to choose the learning route most appropriate for their talents and aspirations, rather than basing their decision on the amount of money available.

7.18 Furthermore, from April 2006 the Government will extend Child Benefit, Child Tax Credit and Income Support to 19 year olds completing a course of non-advanced education or training which they started before their 19th birthday, up to a limit of age 20. This will ensure that most of these young people are supported until the end of their course. The Child Benefit Bill currently being considered by Parliament is the first step in implementing these two important reforms.

## Tackling Poverty

7.19 The third principle guiding the Government's reforms of the tax and benefit system is: *to tackle poverty, minimum levels of income should be guaranteed for the most vulnerable in society – the elderly, families and those who cannot work because of illness or disability.* The Government has set itself ambitious targets to halve child poverty by 2010 on its way to eradicating child poverty by 2020.

<sup>3</sup> These programmes are set out in the draft Child Benefit regulations published by HM Treasury on 10 January, available from [www.hm-treasury.gov.uk/media/5C6/D9/draft\\_child\\_benefit\\_regulations\\_10\\_january.pdf](http://www.hm-treasury.gov.uk/media/5C6/D9/draft_child_benefit_regulations_10_january.pdf)



**7.20** The first milestone on the way to its long-term goal of eradicating child poverty is a reduction in the number of children in relative low-income households of one quarter by 2004-05. As set out in Chapter six, the Government is on track to meet this target. From 1998-99 to 2002-03, the proportion of children in households with equivalised incomes below 60 per cent of the contemporary median fell from 24 per cent to 21 per cent measured on a before housing costs basis and from 33 per cent to 28 per cent on an after housing costs basis.

**7.21** The next milestone on the way to the eradication of child poverty is halving the number of children in relative low-income households between 1998-99 and 2010-11<sup>4</sup>. To capture those aspects of poverty not covered by income alone, the Government will set an additional target in the next Spending Review to halve by 2010-11 the number of children suffering from both material deprivation and relative low-income. Child Benefit and Child Tax Credit have a key role to play in achieving these ambitious goals.

**Tax Credits 7.22** Almost 6 million families benefit from tax credits. Their introduction has changed the way that many families interact with government. Families can now contact the tax credits office, and be contacted, by telephone and through the internet. The Government recognises that customer service could be further improved which is why it is reviewing the content and clarity of the award notices received by tax credit claimants, and also improving the information on finalisation notices.

**7.23** The Government also continues to focus resources on the poorest pensioners. Key to this has been the Pension Credit, which further extends support to the poorest pensioners and rewards those who have built up small savings for retirement. To ensure that Pension Credit continues to take and keep pensioners out of poverty, at the time of the 2004 Pre-Budget Report the Government committed to increasing the guarantee element of Pension Credit by earnings in 2005-06 and in the period up to 2007-08.

<sup>4</sup> In line with international practice, low income will be measured on a before housing costs basis. The Government continues to monitor progress against a range of other indicators, including income measured on an after housing costs basis and data on regional variations in child poverty.



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**CONFIDENTIAL & PERSONAL**

**From :** Stephen Aldridge  
Strategy Unit

**Tel :** 0207 276 1470

**Date :** 4<sup>th</sup> February 2005

**Ivan Rogers**

**cc** Neil Kenward

**TAX REFORM**

1. I promised to let you have the results of some initial thinking and research we've done on tax reform. I now attach :

- a short presentation by Neil Kenward which provides a possible structure for a fuller paper or a note to the PM, and which highlights what seem to be the key issues; and
- copies of a selection of relevant background papers which you said it would be useful to have to read into.

2. Apart from Neil and me, no one else in the SU has been involved in this – though I've spoken to Simon Morys and Daniel Thornton in the No 10 PD (and you may want to get their views on the note we've done). The main sources have been the web and relevant publications or research we've been able to track down by other means. As a result the note is inevitably an initial analysis but hopefully the material will prove to be a useful first cut of the issues.

3. Happy to meet to discuss if that would be helpful.

*Stephen Aldridge*

**Stephen Aldridge**  
Strategy Unit

**CONFIDENTIAL & PERSONAL**





**CAUTION:**  
Needs checking  
by a tax expert

# **Tax reform – an initial analysis**

**04 February 2005**





# Introduction

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- The Strategy Unit was asked to produce a quick overview of the efficiency of the UK's tax system, identifying potential areas for reform
- This paper sets out our initial high level analysis, but note that it has been put together in a tight timeframe and without consulting tax experts
- Key messages:
  - the UK's tax system compares favourably with those of most other OECD countries
  - but the increases in the tax burden and the complexity of the tax system since 1997 have led to growing protests from business
  - the Government has already responded to these calls, with the merger of the Inland Revenue and HMCE, and recent initiatives in pensions, corporation tax, and small business taxation
  - but these changes have focused mainly on small scale technical details and there is scope for more radical welfare enhancing changes, in areas such as VAT, CGT, PAYE/NICs, local government finance, and environmental taxes
- We welcome your thoughts on this paper and would be happy to discuss further work on this topic



# Contents

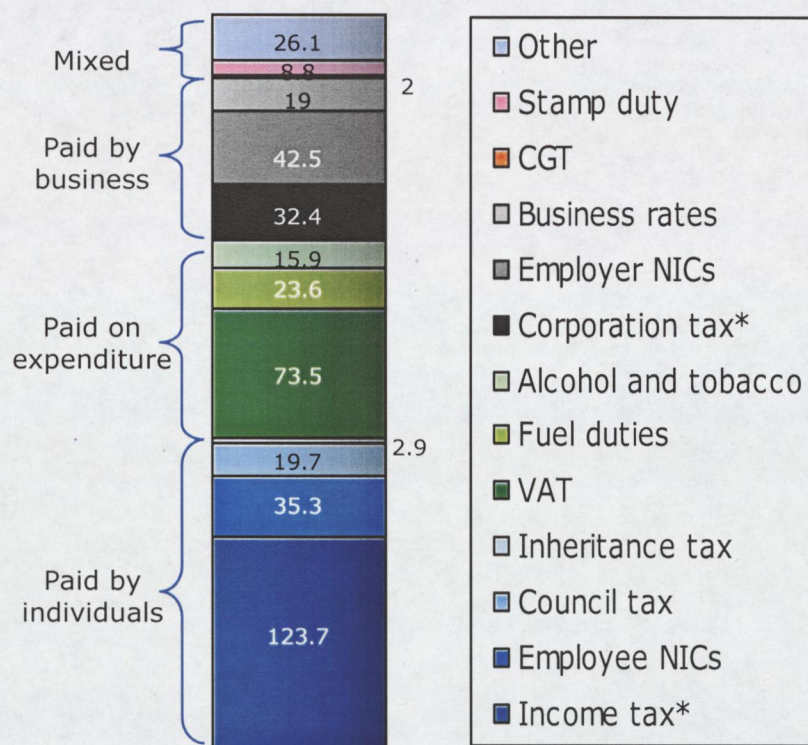
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- The UK tax system at a glance
- Desirable principles of a tax system and evaluation of the UK system
- Review of potential areas for tax reform:
  - Business taxation
  - VAT
  - Income tax and national insurance
  - Council tax
  - Capital Gains Tax
  - Environmental taxation
- Key sources and useful links



# The UK tax system at a glance

**Forecast tax revenues, 2004/5, £bn**



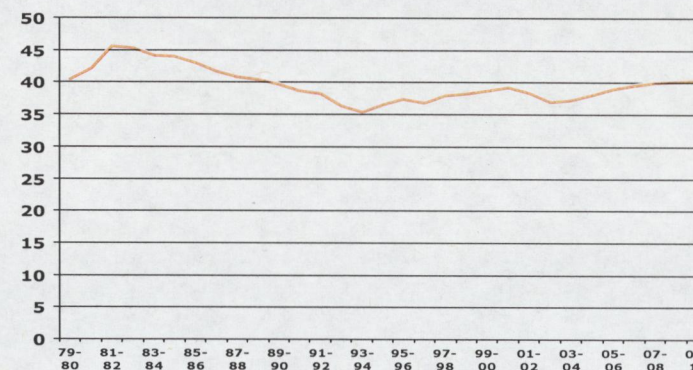
Source: HMT PBR 2004

\* net of tax credits

Note: the division between employer and employee NICs is an estimate based on historical data

- The UK does not have an explicit national tax strategy, although it does have strategies for elements of the tax system such as corporation tax and environmental taxation
- The UK fiscal policy framework limits borrowing over the economic cycle and sets a cap on overall government debt, but does not define an appropriate overall tax burden

**Public sector revenues as % of GDP**



Source: HMT Public Finances Databank, Jan 2005 (online)  
Figures for 2004/5 onward are forecasts



- 
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## Desirable principles of a tax system

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- **Fairness:** taxation should be related to ability to pay, and ideally be progressive (ie, higher earners pay a higher share of their incomes in tax)
- **Economic efficiency:** taxation can be designed to limit economic distortions in a number of ways:
  - tax bases should be broad and marginal rates should be low without exemptions, eg, Nigel Lawson's tax reforms
  - heavier taxation should be imposed on price inelastic goods and services, eg, cigarettes, and immobile factors of production, eg, property
  - taxes on goods and services with negative externalities should be high, eg, pollutants, with tax breaks or subsidies for those with positive externalities, eg, R&D, training
- **Administrative efficiency:** the costs of compliance and administration should be minimised, and the costs of avoidance / evasion should be high
- **Predictability:** tax regimes should be stable, changes should be announced with plenty of notice, and should not be applied retrospectively

Note that there are often tensions between these principles



## The UK tax system is amongst the best in the world, but there are weaknesses under all four principles

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Principle	Quick evaluation of the UK tax system
Fairness	The burden of taxation is roughly equal across the income distribution – gently progressive direct taxes are offset by regressive indirect taxes such as excise duties, VAT, Council tax, and the TV licence.
Economic efficiency	The UK tax system is relatively efficient: corporation tax has few exemptions and rates are relatively low; property is taxed relatively heavily and capital relatively lightly; there are high taxes on inelastic goods (cigarettes, alcohol, petrol) and negative externalities (landfill tax, climate change levy); and there are tax breaks for positive externalities (R&D, training). But the VAT base is relatively narrow, distorting spending decisions.
Administrative efficiency	<p>Proliferating exemptions and tax credits have increased complexity and compliance costs – 78% of businesses say compliance costs have risen in recent years (IoD survey, 2003). HMT is taking steps (set out in the following slides) to address these concerns.</p> <p>Inland Revenue costs (1.04% of revenues in 2003/04) are below the OECD average, but are roughly double the lowest (US and Scandinavia). Merger of IR and HMCE to create HMRC should reduce costs.</p> <p>Evasion of excise duties through illicit importing is a serious problem.</p>
Predictability	In contrast to previous budgets, the 2004 budget saw greater stability and consolidation in business taxation. But there is growing concern about retrospective rules against tax avoidance schemes, eg, on inheritance tax.



- 
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# The evidence suggests that business taxes and the costs of compliance have been rising

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## **The problem:**

- The burden of business taxation, at 9.9% of GDP, is higher than the US and Ireland, and on a par with Germany and the Netherlands and, unlike in most of our competitors, it has been on an upward trend (CBI report), a view shared by 80% of UK businessmen (IoD survey, 2003)
- And a large (60%) and growing share of these taxes are unrelated to ability to pay (eg, business rates, employers' NICs, and environmental taxes)
- The UK's corporation tax rate has continued to decline, but others have declined faster. Since last year's EU expansion, the UK tax rate has been above the EU average. And the tax rate for small businesses was cut from 10% to 0% in 2003, then put up to 19% in 2004 after a surge in new business registrations, attracted by the 0% rate to avoid income tax
- The CBI claim that business taxation is no longer a source of competitive advantage for the UK, a view reinforced by survey evidence ranking UK businessmen below average when asked whether corporate taxes in their country encourage or discourage entrepreneurial activity (World Competitiveness Yearbook 2004)
- Business lobbies also claim the costs of tax compliance (difficult to measure accurately) have been rising – a view expressed by 78% of businessmen (IoD survey, 2003). This administrative burden is a particular concern for small businesses - administering payroll taxes is up to 57 times higher per employee for small businesses (British Chambers of Commerce)
- Finally, businesses are concerned about the scope, lack of clarity, and administrative burden surrounding the new rules requiring businesses to disclose all measures whose "main purpose is tax avoidance"



# HMT is responding to the concerns of business, but more could be done

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## **Steps taken:**

- HMT has taken steps to simplify the taxation of pensions (merging eight tax relief regimes into a single lifetime limit), and is taking steps to modernise and simplify corporation tax
- HMT is consulting on the taxation of small businesses, the Inland Revenue has a PSA target to reduce compliance costs for small businesses, and HMRC has set up a dedicated Small Business Unit charged with improving customer experience and reducing compliance costs
- The Tax Law Rewrite project has been launched in an effort to make tax legislation clearer and easier to use
- The 2004 budget contained no increases in business taxation with some measures aimed at simplification
- Businesses will no longer be required to administer the Working Tax Credit

## **Policy options:**

- Review the overall tax burden on businesses, and consider rebalancing between business taxes on employment, property and profits
- Establish a regular survey of compliance costs (HMT Select Committee proposal)
- 100%+ tax deductions to encourage training would be simpler than the proposed tax credits (PwC)
- Transfer the administration of student loans and court ordered fines from businesses back to the government (BCC)
- Further simplify small business taxation (IFS, Conservatives)



# The coverage of VAT could be broadened, although this would have distributional implications

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## **The problem:**

- The UK VAT regime exempts and zero-rates a large number of goods and services, partly in an effort to keep down the cost of living for low income households
- As a result, VAT revenues are only 50% of what they would be if the standard rate of VAT were applied to all consumption. This 'tax effectiveness ratios' is higher in most other developed countries, eg, 60% in Germany and the Netherlands, and 100% in New Zealand
- This narrow tax base distorts consumption patterns

## **Steps taken:**

- The Government has made little effort to broaden the VAT base, for example, reducing the VAT rate on domestic energy that had been imposed by the previous government

## **Policy options:**

- The tax base could be expanded. This could be offset by either:
  - a reduction in the standard VAT rate (optimal for economic efficiency), or
  - a combination of lower taxes on low earners and higher welfare payments (compensating low income households, although less economically efficient)
- Steps could also be taken to remove the need for businesses to pay VAT in every EU country where they have sales (BCC)



# Income tax and National Insurance regimes have been gradually aligned, but full integration faces significant technical and political barriers

---

## **The problem:**

- Separate income tax (PAYE) and national insurance (NIC) regimes adds to complexity and administrative costs, both for the government and business - NI administration costs for business estimated at £760m (British Chambers of Commerce, 2004)

## **Steps taken:**

- Some steps to further align and simplify PAYE and NICs have been taken, eg, the starting threshold for paying income tax and NICs were equalised in 2001

## **Policy options:**

- A full integration of income tax and NICs would improve the efficiency of the tax system, but faces three obstacles:
  - *Technical*: the base on which income tax and NICs are charged are different, primarily because NICs are payable only on earned income
  - *Ideological*: the links between contributions and benefits have almost entirely gone (the main one remaining being the state pension which may also be eroded by pension reform), but the contributory principle retains significant support
  - *Presentational*: merging the tax regimes would increase the headline basic rate of income tax from 22% to 33% (the rate for high earners would increase by only 1%). So it might look like a tax rise on working families, even though it would make no difference to actual take-home pay
- Even without full integration, there are further steps that could be taken such as shifting NIC calculation to an annual basis and aligning the earnings definitions



# Council tax is regressive, but reforming it is probably preferable to replacing it with a local income tax

---

## **The problem:**

- Council tax is not clearly related to ability to pay and revaluations can lead to sharp increases for some

## **Steps taken:**

- In 2004, ODPM commissioned a Balance of Funding Review of local government finance which considered sources of funding. A second report, the Lyons Review, will make policy recommendations in autumn 2005

## **Policy options:**

- The Review's main *proposals on council tax* were:
  - more council tax bands with higher taxes on more expensive properties
  - regional banding so as not to penalise regions with strong property price rises
  - reform council tax benefit and implement measures to increase take-up
- A *local income tax* (advocated by the Lib Dems) could be considered as a supplement to council tax, and is arguably fairer and more transparent than council tax, but suffers from some significant drawbacks:
  - the need for additional bureaucracy
  - low revenues to districts populated by low earners
  - the risk that high earners would migrate to local tax havens



# Reforms to Capital Gains Tax have made it more complex and increased the scope for tax avoidance

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## **The problem:**

- 1998 reforms to Capital Gains Tax (CGT) introduced preferential treatment for business over non-business assets, and for assets held for longer periods of time
- These changes, whilst well intentioned, added to complexity (IR's CGT-related administration costs have risen 50%) and introduced distortions and scope for avoidance (triggering five subsequent changes to the definition of business assets and the length of taper)

## **Steps taken:**

- In 2001, HMT conducted a major consultation on CGT and has been implementing a number of the (minor) resulting proposals

## **Policy options:**

- Abolish CGT or replace it with a flat rate of 10% (Conservative proposals), but opening up a large gap between the tax on income and on capital gains will encourage tax avoidance
- Return to the pre-1998 system of indexation and retirement relief (Lib Dem proposals), reducing the scope for tax avoidance and lowering the CGT burden on the sale of small businesses



## New or enhanced environmental taxes/charges could be welfare enhancing and allow reductions in other taxes

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- The UK has various taxes that can claim environmental justifications including:
  - excise duties on petrol, and Vehicle Excise Duty on cars
  - the climate change levy
  - the landfill tax
  - London's congestion charge
- Although the UK's burden of environmental taxes is above than the OECD average, there may be scope for increasing them further, although some, such as petrol duties, are already higher than can be justified on the grounds of environmental costs alone
- There is also scope for introducing new welfare-enhancing environmental taxes, some of which would help meet other government objectives:
  - National road pricing / congestion charging (a distance based road haulage charge for lorries is already planned) – such measures could help transport policy objectives
  - Carbon tax – could help UK achieve emissions targets
  - Bin bag tax
- Welfare could be further enhanced if the additional revenues were used to reduce other non-environmental taxes



- 
- The UK tax system at a glance
  - Desirable principles of a tax system and evaluation of the UK system
  - Review of potential areas for tax reform:
    - Business taxation
    - VAT
    - Income tax and national insurance
    - Council tax
    - Capital Gains Tax
    - Environmental taxation
  - Key sources and useful links



# Key sources and useful links

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## Useful documents

- IFS Survey of **the UK Tax System** <http://www.ifs.org.uk/bns/bn09.pdf>
- **Creating HMRC:** Financing Britain's Future [http://www.hm-treasury.gov.uk/media/149/63/odonnell\\_fore\\_ch1\\_245\[1\].pdf](http://www.hm-treasury.gov.uk/media/149/63/odonnell_fore_ch1_245[1].pdf)
- IFS Green Budget 2005 (inc comments on **business taxation**) <http://www.ifs.org.uk/budgets/gb2005/gb2005.pdf>
- HMT discussion paper on **small business taxes** [www.hm-treasury.gov.uk/media/8EB/69/pbr04small\\_companies\\_228.pdf](http://www.hm-treasury.gov.uk/media/8EB/69/pbr04small_companies_228.pdf)
- HMT consultations on **Capital Gains Tax** [http://www.inlandrevenue.gov.uk/consult\\_new/cgt\\_simplification.pdf](http://www.inlandrevenue.gov.uk/consult_new/cgt_simplification.pdf)
- Treasury Select Committee Report on 'The Administrative Costs of Tax Compliance'  
<http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtreasy/269/269.pdf>
- IoD members **survey on taxation** [www.iod.com/intershoproot/eCS/Store/en/images/IOD/Images/pdf/Budget2003Survey.pdf](http://www.iod.com/intershoproot/eCS/Store/en/images/IOD/Images/pdf/Budget2003Survey.pdf)
- British Chambers of Commerce on PAYE and NI <http://www.chamberonline.co.uk/policy/issues/budget-tax/newtaxhorizon.pdf>
- CBI press release on **business taxation**  
[www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/1ce74d9c8852f2f280256dba004168eb?OpenDocument](http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/1ce74d9c8852f2f280256dba004168eb?OpenDocument)
- HMG Balance of Funding Review of **local taxation:** <http://www.local.odpm.gov.uk/finance/balance/report.pdf>
- HMT on **environmental taxation** <http://www.hm-treasury.gov.uk/media/D54/07/adtaxenviron02-332kb.pdf>
- OECD **comparative tax policy** studies:
  - Tax and the Economy - A Comparative Assessment <http://www1.oecd.org/publications/e-book/2301121E.PDF>
  - Tax Administration - Comparative Information Series <http://www.oecd.org/dataoecd/28/2/33866659.pdf>
  - Environmentally Related Taxes in OECD Countries <http://www1.oecd.org/publications/e-book/9701101E.PDF>

## Key organisations

- HM Treasury on tax [www.hm-treasury.gov.uk/documents/taxation\\_work\\_and\\_welfare/tax\\_index.cfm?ptr=40](http://www.hm-treasury.gov.uk/documents/taxation_work_and_welfare/tax_index.cfm?ptr=40)
- Inland Revenue [www.inlandrevenue.gov.uk](http://www.inlandrevenue.gov.uk)
- HM Customs & Excise [www.hmce.gov.uk](http://www.hmce.gov.uk)
- Institute for Fiscal Studies [www.ifs.org.uk](http://www.ifs.org.uk)
- Centre for Council Tax Reform [www.counciltaxreform.org](http://www.counciltaxreform.org)
- Low Income Tax Reform Group [www.litrq.org.uk](http://www.litrq.org.uk)
- OECD on tax policy [http://www.oecd.org/topic/0,2686,en\\_2649\\_37427\\_1\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/topic/0,2686,en_2649_37427_1_1_1_1_37427,00.html)
- Confederation of British Industry on tax  
<http://www.cbi.org.uk/ndbs/content.nsf/802737aed3e3420580256706005390ae/e9269212c096605d80256d67005291fd>
- Institute of Directors on tax [http://www.iod.com/is-bin/INTERSHOP.enfinity/eCS/Store/en/-/GBP/IODLeftNavigation-StartAdvice;sid=hc5NDNaXxgLnKjpCKzopuaFWDKkmAc\\_L0=?Target=Advice&TemplateName=Advice%2fContent%2fpolicy\\_index%2eism1](http://www.iod.com/is-bin/INTERSHOP.enfinity/eCS/Store/en/-/GBP/IODLeftNavigation-StartAdvice;sid=hc5NDNaXxgLnKjpCKzopuaFWDKkmAc_L0=?Target=Advice&TemplateName=Advice%2fContent%2fpolicy_index%2eism1)





LEADER OF THE HOUSE OF COMMONS

THE RT HON PETER HAIN MP

Our Ref: LP3412

25 November 2004

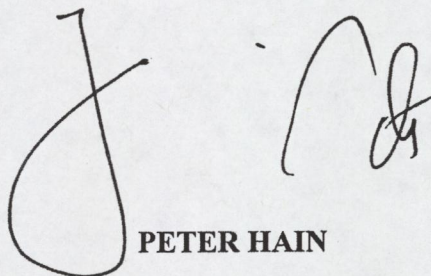
Dear Dawn,

**TAX LAW REWRITE PROJECT: INCOME TAX (TRADING AND OTHER INCOME) BILL**

Thank you for your letter of 9 November seeking LP agreement to introduce the Income Tax (Trading and Other Income) Bill in the week commencing 29 November.

No member of LP replied. You may take it that, subject to any minor drafting changes, you have LP clearance to introduce the Bill. Your officials should liaise with Business Managers' offices about the date of introduction and arrangements for establishing the Joint Committee. As you will be aware, there is even greater pressure on Parliamentary time in what could be a short session, and so if the Bill does require more time on the floor of the House than expected, LP will need to revisit its future handling in the context of the wider fourth session programme. To this end, you will want to avoid making any substantive amendments.

I am copying this letter to the Prime Minister, members of LP Committee, and to Sir Andrew Turnbull and First Parliamentary Counsel.



PETER HAIN

The Rt Hon Dawn Primarolo MP  
Paymaster General  
HM Treasury





HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

IR  
cc JTR  
KEG  
JPM

**The Rt. Hon. Peter Hain MP**  
**The Leader of the House**  
**Privy Council Office**  
**2 Carlton Gardens**  
**London**  
**SW1Y 5AA**

9 November 2004

*Dear Peter,*

**TAX LAW REWRITE PROJECT: INCOME TAX (TRADING AND  
OTHER INCOME) BILL**

As you know, the Tax Law Rewrite project aims to rewrite direct tax legislation to make it clearer and easier to use but without changing its general effect. The project's first Bill on Capital Allowances was enacted in 2001 and the second Bill, the Income Tax (Earnings and Pensions) Bill, was enacted in 2003. Both have been widely welcomed as a considerable improvement on the previous legislation. I am pleased to be able to tell you that the preparations for the project's third Bill (which covers trading, property, savings and investment and other income) are well advanced. I am assured by Parliamentary Counsel that the Bill will be ready for introduction in the week beginning 29 November. It has





been the subject of extensive and thorough consultation, and the project has political support across the House.

### **Procedure**

Tax Law Rewrite Bills are handled by a now established procedure. They are introduced in the Commons. Second Reading, in the case of the last Bill, was taken without debate after the Bill was considered in a Second Reading Committee (and I would expect the same procedure to be followed for this Bill). The Bill is then referred to a Joint Committee of both Houses with a Commons majority. Third Reading in the Commons is preceded by a short debate in the Whole House. The Bill then goes to the Lords where, being in all probability a Money Bill, it can be expected to proceed formally through its Lords stages. I am conscious that time may be short in the coming session, but this special procedure should minimise the time required for the Bill on the Floor of the House. Both our previous Bills were successfully handled.

### **Human Rights and EU issues**

On human rights issues, we have made one minor amendment to the Bill on the advice of the Law Officers, relating to the remittance basis of taxation. Having done that, we are confident that the Bill is compatible with the European Convention and a certificate to this effect will accompany it.

The Bill contains no provisions which give rise to substantive EU concerns. A recent ECJ case involving taxation has been decided against Finland (the Manninen case). It relates to the availability of tax





credits to be set off against the tax charge on non-Finnish dividends. We do not accept that this case reads across to the UK, and we are therefore leaving the relevant parts of this Tax Law Rewrite Bill unchanged.

### **Devolution**

Tax is a reserved matter and so the Bill raises very few devolution points. Where it does, the general approach is to reproduce the existing law although the Bill also makes one or two very minor technical changes to bring the law more fully into line with the devolution settlement.

### **Regulatory Impact**

The Bill will be accompanied by a Regulatory Impact Assessment, which has been subject to consultation.

### **Documents**

The Bill is some 580 pages long and is accompanied by comprehensive Explanatory Notes. Copies of:

- the Bill itself;
- the Explanatory Notes;
- the ECHR memorandum; and
- the Regulatory Impact Assessment

are available either electronically or in hard copies from Basil Rajamanie, Tax Law Rewrite Project, Inland Revenue, Room 826, Bush House, South West Wing, Strand, London WC2B 4RD. Tel: 020 7438 7606 (e-mail [Basil.Rajamanie@ir.gsi.gov.uk](mailto:Basil.Rajamanie@ir.gsi.gov.uk)).





Given that the provisions of the Bill have been subject to extensive consultation and revision over a period of some years, we are planning to publish a near final version of the Bill on the project's internet website shortly before it is introduced. We have done this with both of our previous rewrite Bills. It allows us to keep in the picture the two external Committees who steer and advise the project.

### **Conclusion**

We are aiming to introduce the Bill in Parliament during the first week in December. I would be grateful if you would seek the approval of LP Committee to this by 24 November. The Bill will need to receive Royal Assent in March in order to apply from 6 April 2005 (i.e. the 2005/2006 tax year).

I am copying this letter to the Prime Minister, to members of LP Committee, First Parliamentary Counsel and Sir Andrew Turnbull.

*Yours,*

*Dawn*

**DAWN PRIMAROLO MP**





HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

The Rt Hon Peter Hain MP

Leader of the House of Commons and Lord Privy Seal

2 Carlton Gardens

London

SW1Y 5AA

MG  
cc: IR  
KEA.  
Am

RH

9 November 2004

*Dear Peter,*

### COMMISSIONERS FOR REVENUE AND CUSTOMS (CRC) BILL

I said I would write to you about two matters raised at the meeting of LP Committee on 2 November 2004 about the CRC Bill.

#### Scotland Act

First, you asked for clarification on the provisions concerning the Scotland Act. As the issue raised came as a surprise to Counsel and me, I asked the Bill team to make urgent enquiries with colleagues in Scotland Office to get to the bottom of any concerns.

The outcome is that both parties agree that a misunderstanding appears to have arisen of a very minor nature. It does not involve any policy issues. Rather, it is a technical drafting point over one subsection in the draft Bill, whereby the draft provided to the





Committee included a textual amendment to the Scotland Act 1998 (which the Bill team understood was the correct constitutional route to adopt) whereas Scotland Office preferred the same outcome to be achieved without amending the Scotland Act.

By the time this small matter was picked up, it appears that it was too late to take corrective action before our meeting. Subsequently, Parliamentary Counsel has expressed no objection to approaching this in whatever manner appears best to those responsible for operating the Scotland Act. My officials and Scotland Office will work together with the Scottish Executive to clear any further Scotland issues that may arise from the Bill.

I have agreed this with Anne McGuire.

### **Timing**

You asked about the timing considerations for the Bill. Our decision to integrate the Revenue and Customs departments was announced in March this year. The prospective management of the new department, and its business customers are understandably keen to start taking advantage of the opportunities integration offers. But there are strict limitations on spending money and even planning in detail for the necessary re-shaping of services until we have the cover of 2nd Reading. Although good progress on preparation for HMRC has been made (the prospective Chairman and his deputy took up post on 1 September) they are reaching the limit of what can be achieved without progress on the legislation e.g. they need to





make senior appointments and empower those individuals across the full range of HMRC activities.

The practical impact on any delay is to put at risk the new department's ability to make efficiency savings (they have a target of 16,000 posts across the whole department – including 3,000 posts from the creation of HMRC alone by April 2008); and to improve the flow of revenue into the Exchequer through more effective compliance activity.

Your assurances of a Second Reading slot, at the latest, soon after Christmas are helpful, but I would hope that you will bear in mind the advantages an earlier Second reading would provide. My officials, in liaison with Counsel have advised me that the Bill could be ready for introduction for a pre-Christmas slot if necessary.

I am copying this letter to the Prime Minister, members of the LP Committee, Sir Andrew Turnbull and First Parliamentary Counsel.

*Yours,*

*Dawn*

**DAWN PRIMAROLO MP**





## Department for Transport

From the Secretary of State

Great Minster House  
76 Marsham Street  
London SW1P 4DR

Tel: 020 7944 3011  
Fax: 020 7944 4399  
E-Mail: [alistair.darling@dft.gsi.gov.uk](mailto:alistair.darling@dft.gsi.gov.uk)

The Rt Hon Gordon Brown MP  
Chancellor of the Exchequer  
HM Treasury  
1 Horse Guards Road  
LONDON  
SW1A 2HQ

Web site: [www.dft.gov.uk](http://www.dft.gov.uk)

Our Ref: AD/012285/04

- 7 OCT 2004

MG  
cc: IR  
MEL  
SF

*De Carlo*

Your Private Secretary's letter of 2 August invited Departments to put forward tax proposals for the next Budget. I would be grateful if you could consider the issues raised below, and if your officials could continue to work with mine in developing some of the ideas in more detail.

Transport taxation has a fundamental role to play in delivering a number of the Government's transport and environmental objectives. And the role of fiscal policy levers (particularly fuel duties and vehicle taxation) in delivering these objectives is likely to receive particular attention over the months ahead as the Climate Change Programme review gets underway. And there is increased political salience to this issue.

Against this background, I believe that we should restate the environmental principles which underpin our current vehicle taxation policies. This statement might take the form of a "vehicle taxation framework", analogous to the alternative fuels framework which you announced in PBR 2003. It would reaffirm the Government's commitment to using vehicle taxation policies as a way of rewarding the purchase of clean, fuel-efficient vehicles. And it might suggest that, over the medium to long term, the Government is prepared to keep under review the possibility of using vehicle taxation policies as a way of helping to meet our climate change goals, and the targets in our Powering Future Vehicles strategy. My officials would be happy to work with yours on the drafting of such a statement.



Secondly, you will be aware that the deferral of the planned introduction of a half pence per litre fuel duty incentive for zero sulphur forms of petrol and diesel has caused real difficulties for several major oil companies in the UK. I fully understand the reasons for the deferral, but I would be concerned if the introduction of the duty incentive were delayed for very much longer.

There are two main reasons why it is important for us to go ahead with the introduction of the incentive. First, we have a legal obligation under EU Directive 2003/17 to ensure at least some availability of zero sulphur fuels by 1 January 2005. We took a decision some months ago not to achieve this by means of Regulations, because we were confident that the duty incentive would ensure good availability. If we have no duty incentive in place by 1 January, however, there will be no availability of sulphur-free fuels in the UK, and we will run the risk of infraction proceedings. Second, I think there is a wider point about the Government's credibility with the oil industry. We have a very good record of using fuel duty incentives as a way of supporting the early introduction of clean fuels, and this policy is widely supported by the industry. If we do not now go ahead with a duty differential, we risk undermining the trust that the industry has in Government, and making it far less likely that companies will in future be prepared to respond to these signals and invest in clean technologies ahead of their legal obligations.

As you may be aware, we have recently consulted on whether and if so how the Government should support the further development and use of biofuels in the UK road transport sector. I hope that you will be in a position to make supportive announcements this year on enhanced capital allowances for advanced biofuels refining processes, and on the possibility of reforms to the fuel duty arrangements to allow companies to gain credit for processing biofuels in their refineries. You may also wish to refer to the outcome of our consultation, and to note that the Government is considering the possibility of increasing overall levels of support for biofuels.

Might I also suggest that you consider the possibility of some further tax concessions on Travel Plan measures? This could be a popular, low-cost way of encouraging the more widespread adoption of sustainable transport initiatives by employers. Examples might include some or all of:

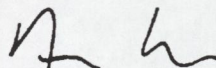
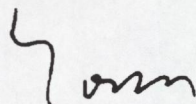
- enhanced capital allowances for the purchase of works buses or for the building of bicycle parking facilities or other travel-plan related infrastructure;
- allowing employees to have tax concessions on, eg, employer-subsidised bicycle maintenance schemes;



- allowing employers to claim tax credits for specified travel plan measures - such as the employment of staff to develop and implement travel plans, or for parking cashout payments.

These types of tax concessions could have a high symbolic value and could help reaffirm the importance that the Government attaches to "soft" transport measures. They could also provide support, in their encouragement for cycling and walking, for the cross-Whitehall initiative to raise levels of physical activity and combat obesity. My officials will be happy to discuss the details of these proposals with yours, and to share information on the likely costs and benefits.

On the company car tax side, my officials are already in touch with yours over a number of detailed issues, including in particular the question of whether or not there is still a case for a surcharge for diesel cars once all diesel cars are legally obliged to meet Euro IV emissions standards. We believe that there is a case for retaining a surcharge, but we suggest that you might want to consider building on the precedent already established and signalling that diesel cars meeting the even tighter Euro V emissions standards due to be agreed shortly will be exempt from the surcharge for a limited period to encourage early uptake.



**ALISTAIR DARLING**

I am copying this letter to the Prime Minister, Cabinet members and Sir Andrew Turnbull.





## SCOTTISH EXECUTIVE

Minister for Finance & Public Service Reform  
**Tom McCabe MSP**

St Andrew's House  
Regent Road  
Edinburgh EH1 3DG

Rt Hon Gordon Brown MP  
Chancellor of the Exchequer  
HM Treasury  
Parliament Street  
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SW1P 3AG

Telephone: 0845 774 1741  
scottish.ministers@scotland.gsi.gov.uk  
<http://www.scotland.gov.uk>

07/ October 2004

Dear Gordon

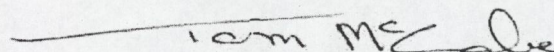
### SCOTTISH EXECUTIVE's TAX PROPOSALS FOR BUDGET 2005

As you make your preparations for your 2005 Budget, I would ask that you consider the proposals of the Scottish Executive. Thirteen proposals are attached as annexes to this letter. These are consistent with the policy aims of the Scottish Executive and enjoy a wide degree of support within government.

I would highlight in particular the proposal regarding the tax treatment of University spin-out companies (Annex N). I know that Jim Wallace, Deputy First Minister, is particularly interested in this issue and has previously had direct correspondence with HM Treasury.

I have copied this letter to Alastair Darling, Secretary of State for Scotland, Jack McConnell, First Minister of Scotland, Ivan Rogers in No.10 and to the Private Secretaries of members of the Cabinet.

Best wishes

  
TOM MCCABE

1-PR  
2-FINE  
Tax  
A4

IR  
cc: MG  
1MCG



**BUDGET 2005: TAX PROPOSALS**

**OVERVIEW OF PROPOSALS**

**ANNEX B**

Enhance Childcare element of Working Tax Credit

**ANNEX C**

Reduce VAT on Repairs to Listed Buildings

**ANNEX D**

Reduce VAT Rate for Building Repair and Maintenance

**ANNEX E**

Reduction of UK Duty on Scotch Whisky

**ANNEX F**

Increase Tobacco Duty

**ANNEX G**

Freeze Fuel Duty for Heavy Goods Vehicles

**ANNEX H**

Partially Exempt Regional Airports from Air Passenger Duty

**ANNEX I**

Extend the Continued Availability of Shipbuilders Relief

**ANNEX J**

Zero VAT rating on Ski Uplift Mechanisms

**ANNEX K**

Reduce VAT on Expenditure under Schemes Encouraging Greater Collaboration Between Central and Shared Services in Higher Education Institutions

**ANNEX L**

Tax Relief of PFI Bid Costs

**ANNEX M**

Tax Incentive to Encourage Equity Investment in Urban Regeneration Companies

**ANNEX N**

Exemption of University Spin-Out Companies from Schedule 22 of the 2003 Finance Act



## BUDGET 2005: TAX PROPOSALS

## ENHANCE CHILDCARE ELEMENT OF WORKING TAX CREDIT

The childcare element of Working tax credit currently pays for up to 70% of registered childcare costs for a maximum of two children. We recommend increasing this to 100% for families on very low incomes, and lone parents moving from benefits into work.

## Rationale

Cost of childcare can still be a significant barrier to people moving from welfare benefits into employment. Research into parents' demand for and access to childcare in Scotland found that a significant proportion of lone parent families were unhappy with their decision not to work – this decision is complex and relates to financial circumstances, availability and cost of childcare, and parental preferences in child upbringing.

Working tax credit (including the childcare element) is intended to make work pay for low and middle income parents, but for those on the lowest incomes, perhaps just returning to the labour market and having little experience/qualifications, 30% or more of the cost of childcare will still have to be funded, in addition often to losing benefits such as housing benefit, free school meals etc. This can mean that moving into work is unattractive, making it difficult to break the cycle of poverty and benefits dependency.

Benefit for UK: will help promote work and opportunity, achieve 70% target of lone parents into employment and tackle child poverty.

Benefit for Scotland: contribute towards growing the economy, and giving every child the best start in life.

## Revenue Implications

Based on April 2004 statistics from the Inland Revenue, 21,100 single parent households receive the childcare element, which averages £46.28 per week. On a simplistic basis, if this represents 70% (which it doesn't necessarily), then the full 100% cost for *existing lone parent recipients* would be £72.5m per annum, an additional annual cost of £21.8m (Our initial calculations suggest that this cost could be, depending upon the success of the policy, offset by savings on benefit payments and additional Tax and National Insurance revenues). For lone parents currently on benefits, the cost would be offset by savings in benefit payments and taxation and national insurance contributions from both employee and employer.

## General considerations:

- Effectiveness/value for money – cost effective. The more people who are encouraged back into work the more cost effective this policy will become.
- Macroeconomic implications (e.g. for prices) – Scotland faces an aging population and declining workforce. Increasing labour market participation offers the possibility to offset some of the potentially negative macroeconomic impacts flowing from these adverse demographics.
- Sectoral, environmental, distributional/equality, health impact – promote equality of opportunity, since most lone parent families are headed by women



- Administrative and compliance costs - unknown

### **Recommendation**

**We ask that the childcare element of working tax credit be enhanced in order to promote the support of lone parents and low income families into employment, which will help achieve Scottish Ministers' objectives of growing the economy and giving every child the best start in life.**



**BUDGET 2005: TAX PROPOSALS****REDUCE VAT ON REPAIRS TO LISTED BUILDINGS**

Repairs to listed buildings are taxed at the full rate of 17.5% while new-build and alterations are zero-rated. The proposal is that the reduced rate on VAT should apply to repairs to all listed buildings. It is supported by both Historic Scotland and the Scottish Executive.

**Rationale**

The present tax regime encourages alterations rather than repair. A tax neutral scheme would encourage repair, thus helping to preserve the architectural character and historic value of listed buildings, and promoting sustainability. Listed buildings make a significant contribution to the historic environment, which is a major contributor to the UK tourism industry.

**Revenue Implications - not known.**

**Other Considerations**

The proposal would be likely to gain support from DCMS. There continues to be a vocal campaign by the whole heritage sector across the UK in support of this proposal. A reduction would be very warmly welcomed and would benefit the owners of 47,000 listed buildings in Scotland as well as leading to enhanced protection of the built heritage for the benefit it offers to all.

The proposal has been put forward by Scottish Ministers previously.

We are aware that the discussions on the EU Sixth VAT Directive have stalled completely and that the whole future of the review is currently unclear.

We believe that it is very important to encourage owners to carry out repairs on historic buildings for their intrinsic value to the community. It is clear that the heritage sector will continue to lobby government heavily on what it regards as an anomaly in the VAT regime and a disincentive to the repair and maintenance of our historic building stock.

A neutral VAT scheme between repairs and alterations to listed buildings would support the Scottish Executive's policies for the built heritage, keeping it in good order as a contributor to the tourist industry, because of its contribution to sustainability, and its contribution to the quality of life.

**Recommendation**

**We recommend that repairs to listed buildings should be subject to the same reduced rate of VAT as alterations. This would help preserve UK's and Scotland's built heritage.**



**BUDGET 2005: TAX PROPOSALS****REDUCE VAT RATE FOR BUILDING REPAIR AND MAINTENANCE****Rationale**

Currently new-build housing benefits from a zero VAT rating unlike the repair and maintenance of an *existing* development. Introducing a new lower rate for repair and maintenance paid for, at least in part, by moving away from zero rating for new build would assist with maintenance of existing housing stock.

**Budget Implications**

Harmonised VAT rate could be set so as to ensure budget neutrality.

**Other Considerations**

At the margin the change would improve the feasibility of renovating existing sites vis-à-vis new build developments on green field sites.

**Recommendation**

**We ask that HM Treasury harmonise this VAT rate.**



**BUDGET 2005: TAX PROPOSALS****REDUCTION OF UK DUTY ON SCOTCH WHISKY**

We would like to see a fairer system of UK duty, through seeking a 4% duty cut relative to other drinks such as beer and wine as well as a review of the wider tax burden.

**Rationale**

A cut in duty would secure better trading conditions around the world and boost the competitive position of the UK spirits industry, with potential in Scotland for increased productivity and employment. A duty cut would recognise the historically higher taxes on the alcohol content of spirits compared with other drinks and ensure a level of fairness that the spirits industry has been lobbying for years. There are no obvious environmental advantages or disadvantages.

**Revenue Implications**

Difficult to quantify although the industry thinks that by lowering duty this will increase revenue.

**Other Considerations**

A cut in duty has been requested by the industry and supported by the Scottish Executive for a number of years on the basis of support for business i.e. importance of whisky industry to the economy - Growing Scotland's economy - encouraging and supporting key manufacturing industries.

A duty cut could see lower prices, and a corresponding reduction in fraud and smuggling.

The imposition of tax stamps announced earlier this year by the Chancellor is a further burden on the spirits industry.

**Recommendation**

We ask that HM Treasury reduce duty on whisky by 4% relative to other drinks such as beer and wine.



**BUDGET 2005: TAX PROPOSALS****INCREASE TOBACCO DUTY**

There should be a significant increase in real terms (at least 5%) in the duty on tobacco.

**Rationale**

Improving the health of the population and reducing inequalities in health are the key aims of health policy in Scotland. A reduction in smoking has a major part to play in achieving these aims. Mortality rates from coronary heart disease and cancer in Scotland are among the highest in the world and a high proportion of these deaths are linked directly to cigarette consumption. Smoking is also an important factor in the wide inequalities in health between the affluent and deprived. The burden of ill health associated with smoking also imposes considerable costs on the NHS.

**Budget Implications – no estimates available****Other Considerations**

There have been concerns that continuing increases in the real price of cigarettes will encourage further increases in smuggling of tobacco products. In 2000 smuggling was estimated to account for 22% of the UK cigarette market, and there were concerns that this figure was on a strong upward trend. In the same year, however, the Government introduced a strategy for Tackling Tobacco Smuggling which was initially designed to slow the growth in tobacco smuggling, and then to put it into decline within 3 years. In the 2004 Customs and Excise annual report it was noted that the market in illicit share of smuggled cigarettes had dropped from 21% in 2000-01 to 18% in 2002-03 and was on course to meet its target of 17% by March 2006.

We would expect the Department of Health to give support to a proposal to increase the duty on tobacco products in real terms. The Home Office may have concerns about the possible effects on smuggling and the criminal activity that is associated with it. The Treasury's view is more difficult to assess. The fact that for the last 4 years they have increased tobacco duties only in line with inflation suggests that they have been concerned that any further real terms increase would simply give rise to a further rise in smuggling. However, the success of their anti-smuggling strategy may make Treasury more responsive to a proposal for a real terms increase in tobacco duties.

**Recommendation**

The Chancellor has acknowledged the important part that increases in the real price of cigarettes can play in reducing demand. However, there has been no real increase in the duties on tobacco since 2000, and this means that cigarettes have become more affordable because of rising incomes. The success of the strategy for tackling tobacco smuggling suggests that further increases in the real cost of cigarettes need not lead to a rise in smuggling. Given the contribution that reductions in smoking can make to improving the health of the Scottish population and reducing inequalities, we ask HM Treasury to consider the very strong case for implementing a significant real increase in tobacco duties in the 2005 Budget.



**BUDGET 2005: TAX PROPOSALS**

**FREEZE FUEL DUTY FOR HEAVY GOODS VEHICLES**

**Rationale**

Restraint on fuel duty rates will act as a benefit by not discouraging industry from using domestic freight operators.

**Budget Implications – no estimate available**

**Other Considerations**

DfT (Logistics) may be in favour of a fuel duty freeze. However, it is possible that DEFRA and environmental groups would oppose a freeze on fuel duty as they want to see the haulage industry (and private motorists) pay the full costs of travelling on the road network (i.e. including pollution and congestion).

The Treasury has announced that lorry road user charging should be offset by a reduction in fuel tax. In the long run, this may be the best way of both ensuring fair competition in the industry and addressing the environmental damage associated with lorry use. The industry are also awaiting Treasury announcements in November following the earlier postponement of the planned fuel duty rise.

**Recommendation**

**We ask that HM Treasury consider a freeze on HGV fuel duty rates**



**BUDGET 2005: TAX PROPOSALS****PARTIALLY EXEMPT REGIONAL AIRPORTS FROM AIR PASSENGER DUTY (APD)**

An exemption from APD for the first three years for new direct international scheduled air services from UK regional airports. It would be restricted to those airports which had modified charging regimes to take account of local air quality impacts.

**Rationale**

This is in keeping with UK Government's wishes, contained in its White Paper – The Future of Airport Transport – to encourage the growth of regional airports in order to support regional economic development and to help reduce pressures on more over-crowded airports in the South East. In addition the UK Government considers that Route Development Fund (of the type operating in Scotland) could be helpful in establishing new services.

- 1 Encourage more direct routes from Scotland
- 2 Decrease journey time for business users
- 3 Make Scotland a more attractive destination – i.e. lower cost and reduced journey times – which will lead to an increase in inbound tourism
- 4 Relieve pressure on South East airports
- 5 Contribute to the sustainability of new air services

**Budget Implications – no estimate available****Other Considerations**

DfT are pursuing the development of Route Development Funds in the English regions and Wales. DEFRA would take an interest because of air pollution implications.

Other considerations include how such a reduction in an aviation tax dovetails with the policy of making the aviation industry meet its external costs. However the reduction would only apply to regional airports where the operator has introduced a charging regime which proactively encourages airlines to reduce the environmental impact of its operations.

We are advocating an exemption from APD for new services out of Scottish airports but this could apply to all regional airports in the UK.

**Recommendation**

We ask that HM Treasury consider abolishing APD for the first three years of any new direct scheduled international air service from a regional airport.



**BUDGET 2005: TAX PROPOSALS****EXTEND THE CONTINUED AVAILABILITY OF SHIPBUILDERS RELIEF**

Shipbuilders Relief (SR) is a 2% tax relief for shipbuilders which could be assumed in bidding for contracts and realised on delivery of completed vessels. John Healey, Economic Secretary to the Treasury (EST) announced on 12 January 2004 the abolition of Shipbuilders' Relief, in full and with immediate effect. SR will continue to be available for contracts placed on or before 12 January. The extension of continued availability from contracts in place to include bids underway would allow naval shipyards to proceed with bids for naval exports as planned. This would directly benefit the existing UK naval exporters such as BAE SYSTEMS Naval Ships on the Clyde and VT Shipbuilding at Portsmouth to try to supplement UK naval orders with overseas work.

**Rationale**

The impact on UK naval bids was revenue neutral but the industry viewed SR as a valuable aid in naval export markets and had been legitimately assumed to be available on bids underway. This could entail UK naval bidders either revising or withdrawing existing bids with overseas customers or assuming lower profitability. Around 2,400 employees at Scotstoun and Govan are reliant on naval orders in both the UK and overseas markets to secure or grow employment.

**Revenue Implications**

SR is contract related and therefore revenue implications are dependent on contract success. The latest contract being completed in BAE SYSTEMS' yards on the Clyde is for 3 Offshore Patrol Vessels for Brunei and still qualifying for SR will draw around £15m in total. Understood that 2 current contracts under bid by Scottish yards (BAE SYSTEMS Naval Ships) have assumed a total SR value of between £18 million and £22 million.

Failure by industry to secure contracts from bids underway would have little or no impact on government revenues/expenditure as the provision for claim of SR would not be realised.

**Other Considerations**

Jackie Smith wrote to John Healey earlier this year raising concerns about the way SR was withdrawn and the impact on existing bids for export work tabled in good faith.

The Chancellor announced in February last year that "...we are removing the last of the permanent, on-going subsidies for operating costs in coal, shipbuilding and steel...". In the 12 January 2004 statement EST gave the spirit of EC 1540/98 as the rationale for extending the abolition to all shipbuilding.

This is not a new tax measure but rather a request to phase the withdrawal of an existing provision to take account the impact on naval shipbuilders – to extend the continued availability for contracts in place on or before 12 January to include bids made on or before that date.

**Recommendation**

We ask HM Treasury that the continued availability of Shipbuilders Relief – a 2% contract related relief - be extended to not only apply to contracts in place on or before 12 January but also naval export bids already made. This would help sustain a strategically important



industry, assist the industry gaining export orders to help secure around 2,500 jobs on the Clyde and to mitigate the industry's reliance on domestic warship orders.





**BUDGET 2005: TAX PROPOSALS****ZERO VAT RATING ON SKI UPLIFT MECHANISMS**

The proposal is to have a zero VAT rating on uplift mechanisms at outdoor Ski Centres. Given the reduction in snowfall, due to climate change, the ski industry is in a fragile position. If they were able to retain current price levels without charging VAT this would help their financial position.

**Rationale**

The Cairngorm Funicular is exempt from VAT on the grounds of it being a railway under the jurisdiction of Her Majesty's Railway Inspectorate, therefore considered to be transport. However, Cairngorm Mountain Ltd do have to charge VAT on tickets for people using the railway as a ski lift/tow. Those who travel on the railway who are not going to ski do not pay VAT.

The VAT status of the lifts is a significant financial issue for the 5 Scottish Ski Centres. For example, Glenshee is currently paying 17.5% on all uplifts, totalling some £40-50k per season. The zero rating would give a financial boost to an industry that is enduring a difficult period due to a reduction in annual snowfalls.

**Revenue Implications**

It will lower tax revenue. In relation to the Scottish Ski Centres, we would expect this to be less than £1 million, although further work would need to be carried out to determine the exact figure.

**Other Considerations**

Relevant legislation is Annex H of Council Directive 77/388 EC (the sixth Directive) which provides that the transport of passengers and their luggage may be subject to reduced rates of VAT. In the UK the VAT Act 1994 Section 30 Schedule 8 specifies that the transport of passengers in any vehicle, ship or aircraft designed or adapted to carry not less than 10 passengers shall be zero rated for VAT. The Act further states that zero rating will not apply to the transport of passengers in any vehicle to or from or within a place of recreation or amusement, or a place of cultural, scientific, historical or similar interest, by a person who supplies a right of admission to or a right to use facilities at such a place.

An appeal to the VAT Tribunal by Lecht Ski Co. Ltd was reported on 27 May 2003. In this case the appellants argued that if the chairlift system were viewed as transporting skiers then there was scope for the system to be deemed exempt or zero rated.

The appellants argued that although the chairs on the transport system carry a maximum of three passengers the vehicle transporting the passengers to the top of a ski slope was the motorised wire with the seats and hangers attached thereto.

In his deciding that the appeal should fail the Tribunal chairman ruled that the chair lift system could not be classed as a vehicle. It was conceded that transport in chairs could be classed as vehicular but since they were restricted to carrying less than 10 passengers they could not fall within the conditions for attracting zero rating. The appeal was dismissed.



In many EU countries chairlifts are deemed VAT exempt under EU legislation (the Sixth Directive). However, there has been no harmonisation of laws in this area and as such individual Member States are left with a degree of discretion in the implementation of the Sixth Directive.

#### **Recommendation**

**WE ask HM Treasury to consider applying a zero rating to the uplift mechanisms, in line with other EU Ski Centres.**



**BUDGET 2005: TAX PROPOSALS****REDUCE VAT ON EXPENDITURE UNDER SCHEMES ENCOURAGING GREATER COLLABORATION BETWEEN CENTRAL AND SHARED SERVICES IN HIGHER EDUCATION INSTITUTIONS (HEIS)**

Work with the UK Government to create tax incentives to encourage higher education institutions to develop initiatives to share costs of central services.

Beneficiaries: Higher Education Institutions (HEIs)

**Rationale**

This will encourage HEIs to collaborate, develop shared services (in back office, administration and IT, payroll, estate maintenance, purchasing, etc.) , and encourage greater efficiency within the higher education sector. This would result in efficiency savings in a sector which is currently largely funded by public investment. This measure would encourage efficiency in the HE sector, and may result in shared benefit through shared procurement policies.

**Revenue Implications**

This measure will encourage greater efficiency in the higher education sector.

**Other Considerations**

This recommendation does not reflect current DfES policy, although encouragement towards greater internal efficiency in higher education institutions would support the Chancellor's position on the modernisation of public services.

This issue has been previously been considered by the Scottish higher education sector. The Scottish Higher Education Funding Council (SHEFC) provided a grant of 30k from its Strategic Change Grant in September 2002 to engage consultants to conduct a feasibility study into sharing services amongst six institutions (Glasgow, Glasgow Caledonian, Strathclyde, Edinburgh, Heriot Watt and Napier Universities).

The consultants (Price Waterhouse Coopers) concluded that there were efficiency savings to be made in sharing services in areas like payroll, estate maintenance, purchasing, but they also concluded that if HEIs developed shared services they would then need to charge institutions VAT on top of the cost of the service provided.

The main obstacle to the development of shared services, then, is a financial one. It results from the fact that if two or more parties come together to share service provision which was previously delivered internally, there is a VAT cost to that service provision to those parties to which it is delivered. Given the partially exempt nature of HEI's, a significant proportion of that VAT cost will be irrecoverable, making the potential cost savings of a shared service arrangement much less attractive and achievable.

PWC identified that this was a major barrier to progress and at their last contact with SHEFC, advised the problem over VAT was proving insurmountable. SHEFC were advised in March 2004 that it was unlikely that the consortium would proceed any further with this project.



This tax measure has not been proposed before although there has been pressure from higher education sector on this issue, and the British Universities Finance Directors Group (BUFDG) and the Higher Education Funding Council for England (HEFCE) are now preparing a paper on this issue for Treasury.

BUFDG's favoured solution to this problem is for Treasury to give consideration to the implementation of Article 13 A (i) (f) of the EU Sixth VAT Directive. Article 13 A deals with exemptions for certain activities in the public interest and is a mandatory exemption which the UK has not implemented in UK VAT legislation. Paragraph (f) cites the activities which would be exempt as "services supplied by independent groups of persons whose activities are exempt from or not subject to VAT, for the purpose of rendering their members the services directly necessary for the exercise of their activity, where these groups merely claim from their members exact reimbursement of their share of the joint expenses ...".

### **Recommendation**

**That Value Added Tax on services provided by shared and central service agencies developed by higher education institutions be waived, in order to encourage those institutions to work collaboratively, and to greater efficiency.**



## BUDGET 2005: TAX PROPOSALS

## TAX RELIEF OF PFI BID COSTS

We would recommend offering tax relief on PFI bidding costs. This would enhance the level of competition for PFI contracts and hence improve value for money.

## Rationale

If value for money is to be secured through the PFI, it is vital to ensure that there is a healthy level of competition for contracts. However, as noted in "PFI: Meeting the investment challenge", high bid costs for PFI projects are now becoming a significant deterrent to potential bidders:

"Undoubtedly, high bid costs and long procurement times can represent a concern for both the public and private sector, can impair delivery and value for money for the public sector and limit companies' capacity to bid for projects. Several companies have found that new technical guidance published by the Accounting Standards Board on how to account for pre-contract costs increased the impact of up-front costs. The guidance required some bidders to recognise as costs in the year incurred the expense associated with PFI bids, which previously they had been able to capitalise, and has increased the sensitivity of some companies to bid costs."

"The cost of bidding for PFI projects will always place some constraints on the private sector in its ability to bid for large number of PFI projects. HM Treasury's research into PFI companies suggests that the cost of bidding for PFI projects can be a consideration as important as the funding of an investor's equity and subordinated debt investments. In funding such costs, a key consideration for the private sector is its success rate in winning bids. Irrespective of success, however, the aggregate level of bid costs expended in a year does limit the number of bids a company can undertake in that year, usually determined by the overall financial capability of the contractor."

In response to these problems, the Treasury has proposed a number of measures such as increased contract standardisation and improvements to public sector procurement expertise. Whilst we recognise the value of such measures – some of which have already been implemented in Scotland – our experience suggests that they will be insufficient to counter the impact of the change in accounting treatment.

For example, we understand that some major bidders have taken strategic decisions to limit the number of bids to as little as two per year. Some have threatened withdrawal from bidding positions as they reach financial year end without a clear decision about preferred bidder status. Some companies are simply moving their sights away from PFI in favour of less costly bidding processes, e.g. conventional public sector work or commercial areas such as housing.

"PFI: Meeting the investment challenge" argued that the public sector should aim to "create an environment that encourages the private sector to bid for PFI projects, improving competition and delivering a stronger PFI market". It also notes that we should "continue to encourage new entrants into the PFI market, including firms currently active outside the UK".

We would endorse these aims, and believe that one of the most effective ways to achieve them would be to address one of the key deterrents to bidding – high bid costs. Whilst we have contemplated the idea of directly reimbursing bid costs, this strategy has a potential downside as it would significantly reduce the private sector's incentive to control these costs. We understand and share the Treasury's reluctance to subsidise bid costs, and the difficulty of introducing such a subsidy only for PPP contracts. So that is not our preferred solution. We instead believe that the simplest and most direct way of improving competition for PFI projects would be to offer tax relief on bid costs.

## Revenue Implications



The gross cost to of this proposal would be difficult to calculate. However, the net cost of the proposal is likely to be negative. Firstly, provided that there is sufficient competition, reduced bid costs should lead directly to lower-priced tenders. Secondly, enhanced competition for PFI contracts should lead to more competitive bids, both in terms of cost and in terms of quality. It could encourage greater focus on design proposals, which currently suffers as an area of savings in bid costs.

### **Other Considerations**

Other UK Departments are likely to be supportive, particularly those Departments with a significant PFI programme. As noted earlier, the Treasury PFU has also raised concerns about the impact of high bid costs. A wider benefit would be the easing of financial pressures on companies engaged in PFI, several of whom have encountered financial difficulties after entering the PFI market. In Scotland a number of regional construction companies have engaged in PFI consortia on a pooled basis, but are finding bid costs difficult to absorb and may withdraw on the basis of early experience. Tax relief would make a difference to their willingness to stay in this market. In general the well-being of the infrastructure support sector is vital to common policies in Scotland and elsewhere in the UK to modernise and improve the physical infrastructure on which public services depend.

A potential alternative budget measure would be to grant tax relief on specific aspects of bid costs. For example, the eligibility definition might be framed so as to ensure compliance with standardisation policies (i.e. standard contracts), which is presently proving difficult and costly in implementation.

The proposal would enhance the VfM of PFI projects through the generation of additional competition for contracts.

### **Recommendation**

**In the light of increasing concerns about the impact of high PFI bid costs and the accounting treatment of these costs, we would recommend that serious consideration should be given to offering tax relief on these costs. This would enhance the level of competition for PFI contracts and hence improve value for money.**



**BUDGET 2005: TAX PROPOSALS****TAX INCENTIVE TO ENCOURAGE EQUITY INVESTMENT IN URBAN REGENERATION COMPANIES (URCS)**

To reduce the tax payable by private sector firms committing to capital projects of URCS. The private sector would benefit from the lower tax rate but society would gain through a more successful urban regeneration project.

**Rationale**

Lenders will provide loan finance on the back of URC business plans. However while private sector loans provide funding for a URC they do not spread the risk inherent in the venture beyond the public sector. Were the private sector to instead take an equity stake in the project they would take part of the risk in return for a stake in the returns from the project. Second, equity partners can provide the project with additional input and expertise.

As far as the private sector is concerned there is currently a potential mismatch between the perceived and actual risks attached to regeneration projects. A reduced rate of tax on returns from an equity investment would lower the risk to the private sector and encourage a deeper participation in the project.

**Revenue Implications**

At this point it is not possible to estimate the actual impact on revenue. Should the measure increase company profits then the Exchequer would lose out from a lower marginal rate of tax on company profits generated from the project. However this loss could be more than compensated for by the increase in economic output (and profits) generated by the greater success of the venture.

**Other Considerations**

ODPM findings show that creating a favourable climate for the private sector is critical to the success of URCS. As part of the ODPM stock take of URCS in May 2004 consultees suggested improved tax concessions as part of Recommendation 5 – Certainty of Revenue Funding.

Currently business are allowed to deduct, for the purpose of calculating business profit, expenditure incurred on the making of contributions (in cash and kind) towards the running costs of a URC. However this concession has seen little or no take up suggesting alternative concessions should be considered. Tax relief is available for investment in new, independent higher risk companies through three venture capital schemes.

**Recommendation**

We ask HM Treasury to introduce tax benefits for private companies taking an equity share in URCS to increase their financial stake in URCS and, by association bring their expertise to bear on chosen regeneration ventures. This will help achieve the Scottish Executive's objective of regenerating run down urban areas



## BUDGET 2005: TAX PROPOSALS

## EXEMPTION OF UNIVERSITY SPIN-OUT COMPANIES FROM SCHEDULE 22 OF THE 2003 FINANCE ACT

Schedule 22, introduced in April 2003, has discouraged universities and academics from forming new spin-out companies, thus hampering the commercialisation of research. Despite lengthy discussions with the Inland Revenue, and some alternative suggestions, universities throughout the UK have concluded that the best way to restore confidence in formation of their spin-out companies would be to exempt university spin-out companies from Schedule 22 and revert to the *status quo ante*.

The direct beneficiaries would be the universities themselves, and more particularly, their spin-out companies and their most entrepreneurial academics. More spin-out companies established by entrepreneurial academics, less burdened by taxes, would, of course, benefit the economy as a whole.

**Rationale**

Schedule 22 is designed to ensure that shares which are "*acquired by a person where the right or opportunity to acquire the securities (i.e. shares) is available by reason of an employment of that person or any other person*" are subject to income tax and national insurance if the shares are acquired at less than market value. Originally introduced as anti-tax-avoidance legislation the impact of Schedule 22 is much wider. Although university spin-out company activity was not the specific target, it is affected as the academic founders normally incorporate the company and would hold the majority of shares with some being held by both the University (as part of the deal for licensing in Intellectual Property) and the investors. The founders are likely to have paid either nothing or a nominal amount for their shareholding and thus, according to the Inland Revenue, have acquired their shares *by reason of an employment* and at less than market value. This undervalue therefore gives rise to a potential Schedule 22 income tax charge. Under PAYE rules, this income tax would have to be paid by the University, which then has to recover this from the relevant founder. The University would also be liable to pay Class 1 employers national insurance contributions (NIC) based on the undervalue. This NIC cannot be recovered from the founders at present and therefore is a cost to the University. Additionally, if the founder is no longer an employee of the University at the time of conversion, the University still remains liable to pay any income tax via the PAYE scheme, but may be unable to recover such tax from the founder.

University spin-out companies (USOs) are a key and growing element in the commercialisation of research and the creation of the knowledge economy, as shown in the table below (Source: Higher Education Business Interaction Surveys, HEFCE, 2002, 2003, 2004). The authors of the survey point out that turnover and income figures should be treated with caution, but the slight drop in the number of new USOs formed in the last year (2001-02) for which figures are available, and the declining income, suggest that the growth of USOs cannot be assured. Although Schedule 22 only came into force in April 2003, many universities and academics have already been discouraged from forming new USOs. This effect will not become fully apparent until data for the current and next financial years are collected, and the economic consequences will not be seen for several years.



### UK University spin-out company numbers, staffing and turnover

	1999- 2000	2000-01	2001-02
Number established	203	248	213
Number still active which have survived at least 3 years	358	451	491
Estimated employment of all active firms (FTE)	5,801	10,710	12,165
Estimated turnover of active firms (£000s)	133,866	195,677	289,764
Estimated income to HEIs from selling shares (£000s)	38,000	30,000	14,000

Discussions between the Inland Revenue and the University Companies Association (UNICO) have produced a Memorandum of Understanding on a "safe harbour model" for the treatment of USOs which can defer tax payments until value of USO shares is realised. The most critical point about the safe harbour is that it does not remove the income tax or NIC problems created by Schedule 22, but delays both the calculation of the amount due and the payment thereof until some unspecified time in the future (of the academic founders choosing). The HEIs and their representative bodies Universities Scotland and Universities UK, have concluded that this is not sufficient to restore confidence in the formation of USOs. Since this is an issue which affects all UK universities equally, UUK, UNICO and the British Universities Finance Directors Group (BUFDG) are continuing discussions with the Inland Revenue on their behalf; however, they are now of the opinion that a solution within the Schedule 22 rules may well be unworkable, and that the best way to restore confidence in USOs would be simply to exempt them from Schedule 22. Failing this, the negative incentives of Schedule 22 could be off-set by tax relief such as that available under Enterprise Management Initiative (EMI) share option schemes.

### Revenue Implications

It is very difficult to estimate the revenue implications of either continuing to apply Schedule 22 to USOs, or of exempting them from Schedule 22. If the formation of new USOs were unaffected by the application of Schedule 22, they would provide a substantial increase in revenue in the form of income tax. However, since Schedule 22 is deterring academics and HEIs from forming USOs, this gain will be greatly off-set by the declining number of new USOs. On the other hand, if the sale of shares in USOs were to revert to being treated as capital gains, although the amount paid by each USO in Capital Gains Tax would be less than the amount paid in income tax under Schedule 22, the number of new USOs would continue to rise, as would the Corporation Tax paid by the companies and the Income Tax paid by their employees. Therefore, the net gain in revenue from applying Schedule 22 to USOs may be substantially less than at first predicted, and may even be less than the revenue gained by returning to the *status quo ante*.

### Other Considerations

Deputy First Minister has already written to the Chancellor expressing his concerns about the negative impact of this legislation and urging that a speedy resolution is found.

If, as suggested above, the likely effect of applying Schedule 22 to USOs would be a net reduction of revenue, and a stifling of the growth of this important part of research commercialisation, then other



UK Departments, especially the Department of Trade and Industry, and the Chancellor, might look favourably on exempting USOs from Schedule 22.

Restoring confidence in the formation of USOs, and encouraging their growth, would help deliver the following DTI PSA targets:

**PSA 1:** Demonstrate further progress by 2008 on the Government's long-term objective of raising the rate of UK productivity growth over the economic cycle, improving competitiveness and narrowing the gap with our major industrial competitors.

**PSA 2:** Improve the relative international performance of the UK research base and increase the overall innovation performance of the UK economy, making continued progress to 2008, including through effective knowledge transfer amongst universities, research institutions and business.

**PSA 6:** Build an enterprise society in which small firms of all kinds thrive and achieve their potential, with (i) an increase in the number of people considering going into business, (ii) an improvement in the overall productivity of small firms

### **Recommendation**

Schedule 22 of the Finance Act 2003 is discouraging the formation of University Spin-out companies. We recommend that such companies are exempted from Schedule 22, or that tax incentives are provided to off-set its negative effects. This would restore confidence in their formation, and help the Scottish Executive achieve its objectives of greater commercialisation of research and of stimulating the Knowledge Economy. The net gain or loss of revenue is hard to determine and may be less than predicted.



**From:** Alasdair McGowan  
**Date:** 26 March 2004

**PRIME MINISTER**

**Cc:** Jonathan Powell  
Ivan Rogers  
Geoff Mulgan  
David Hill  
Sally Morgan  
Pat McFadden  
Justin Russell  
Andrew Adonis  
Simon Morys  
Martin Hurst  
Paul Britton  
Simon Watts

## **COUNCIL TAX CAPPING**

Please find attached advice on capping from ODPM. GL is discussing this on Wednesday. You should therefore discuss this with JP at your bilateral on Monday.

The proposed capping criteria affect 3 police authorities and 5 fire authorities. For councils, there are two options for capping principles. Neither option will make any noticeable difference to the 5.9% average. The key question is how clear a signal you want to send to councils for next year.

Option 1 catches 16 councils. Option 2 catches 6 councils. If you want to send a tough signal on capping, Option 1 is the obvious choice. Nick Raynsford favours Option 2.

The next question is how you cap authorities. There are three options (again, starting with the toughest):

- Cap their budgets for 2004/5 (this leads to rebilling in the area concerned and so reduced actual bills in the year in question);
- Cap their budgets for 2005/6 at the time of the next local government settlement (this has no effect on 2004/05 bills, but gives affected authorities a maximum budget for 2005/6 and allows them to plan budget reductions);



- Set a notional budget for 2004/5 against which increases in the following year will be measured in deciding whether or not they are excessive (this has no effect on 2004/5 bills, but provides a clear warning for 2005/6, although it would involve in-year capping then if authorities failed to heed the warning).

With the exception of one fire authority, Nick does not propose capping any police or fire authority in year. This is because (a) the difference we could make to actual council tax bills would be very small (in each case, less than £5 a year) and (b) there would be high costs to the precepting authorities and huge inconvenience associated with rebilling across a number of districts who are themselves not subject to capping. These two problems do not apply in the case of Hereford and Worcester where the precept increase is almost 30%, and where Herefordshire itself is in line for capping.

For councils, similar considerations need to be taken into account. In the case of Windsor and Maidenhead, the annual reduction in Band D council tax bills would be just 39p (and even less if you live in a Band A property). Clearly, capping in such circumstances would seem pointless given the costs of rebilling. It is essentially a matter of judgement as to what reduction in council tax bills would justify the costs of rebilling. However, a useful rule of thumb might be to say that the practical difference to council tax bills per annum should at the very least be in double figures.

If you went for Option 1, this rule of thumb would allow you to cap 24 authorities, of which 10 authorities would be capped in year (the other 14 could be set maximum budgets for 2005/6). This compares to just 14 authorities, of which 4 would be capped in year under Option 2 (again, the remaining 10 could be set maximum budgets for 2005/6).

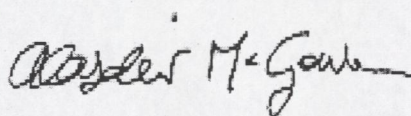
Option 1 also makes most difference to people's bills (although the most it will reduce council tax bills in any authority is £26.75 per annum). It is also quite possible that the process of capping reveals good reasons why councils have set budgets at these levels, in which case even these numbers might reduce – for example, some authorities (e.g. Windsor and Maidenhead) will say that this makes passporting impossible and we would not be able to enforce a minimum schools budget at this stage. So we should at least begin by staking out as tough a position as possible.

I am assuming that you will want to send the toughest possible signal (within reason) in relation to capping. If so, you will need to tell JP at your bilateral



that, while you recognise that we will have to be flexible in responding to councils with real difficulties, you want: (a) to go for Option 1 (b) to cap in-year the one fire authority proposed by Nick, plus any council where the savings to Band D bills is in double figures and (c) all other authorities to be capped for 2005/6. Left to their own devices, ODPM (with support from Home Office and DfES) will go for weaker options.

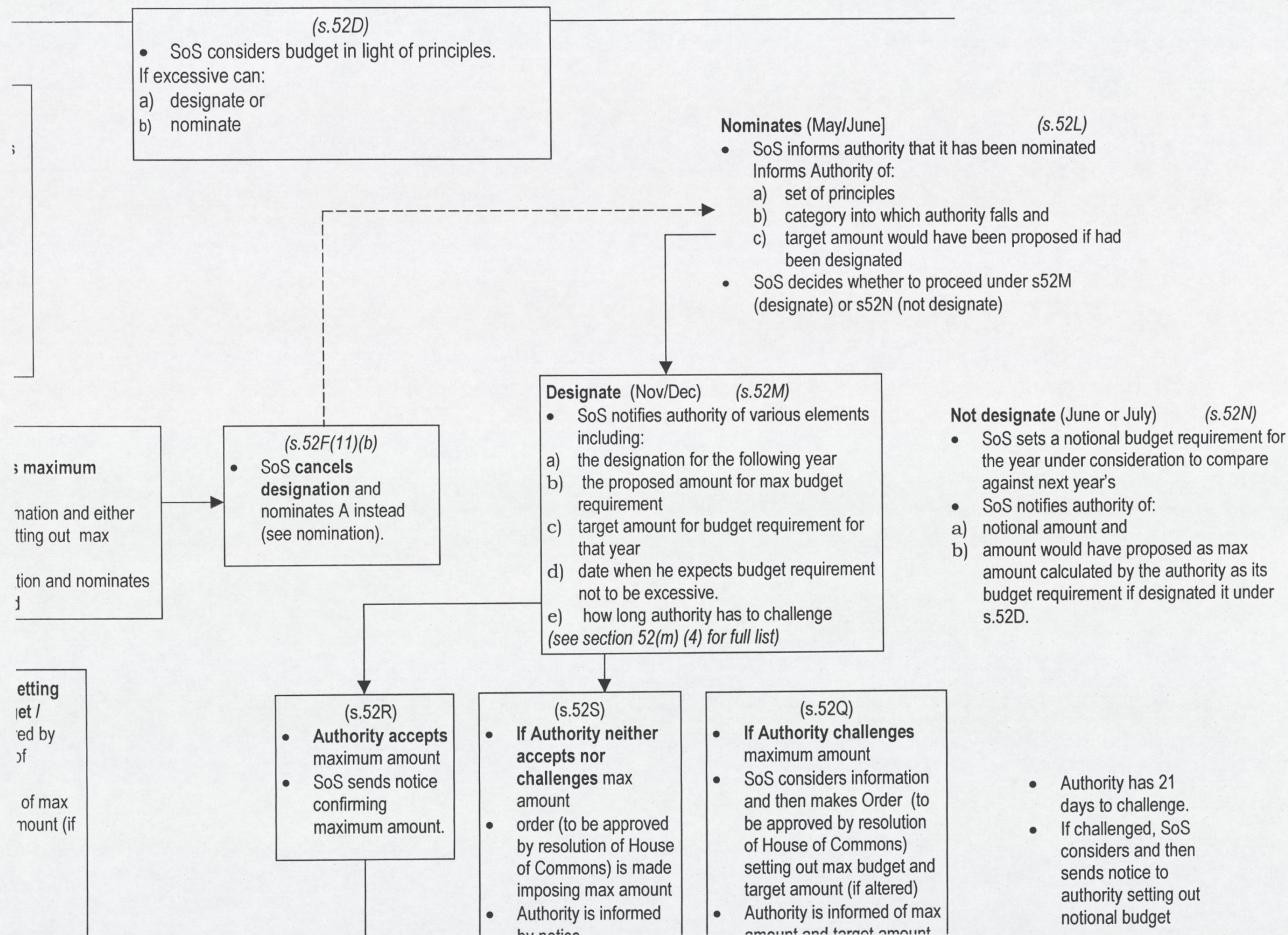
Do you agree?

A handwritten signature in dark ink, appearing to read 'Alasdair McGowan', with a stylized, cursive script.

ALASDAIR MCGOWAN



is amended by the Local Government Act 1999)





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**RESTRAINING COUNCIL TAX INCREASES**

**Note by the Minister of State for Local and Regional Government**

**Introduction**

The attached paper sets out options for using the powers in the Local Government Finance Act 1992 (as amended by the Local Government Act 1999) to limit council tax and precepts. Ministers have warned local government that they would use these powers if 2004/05 budget and council tax rises were excessive. The powers can be used either to reduce tax bills for 2004/5 or to signal that authorities must keep council tax down next year (2005/06) to a reasonable level. The paper invites GL to:

- consider the principles to be used in determining whether or not to limit taxes and precepts - the legislation requires that one principle must be a comparison between the budget requirement for the financial year beginning 1 April 2004 and the budget requirement of an earlier financial year, but it also allows other principles, such as council tax increases, to be determined by the Secretary of State;
- consider the options for dealing with authorities whose budget requirements are considered to be excessive in accordance with the principles. These include:
  - a) capping authorities in year (this leads to rebilling in the area concerned and so reduces actual bills in the year in question);
  - b) capping authorities at the time of the next local government settlement in respect of their budgets for 2005/06 (this has no effect on 2004/05 bills, but gives affected authorities a maximum budget for 2005/06 and allows them to plan budget reductions);
  - c) setting notional budgets for 2004/05 against which increases in the following year will be measured in deciding whether or not they are excessive (this has no effect on 2004/05 bills, but provides a



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clear warning for 2005/06, although it would involve in-year capping then if authorities failed to heed the warning).

We need to write to the authorities concerned by the end of April, if we are to make the necessary report to Parliament before the Summer Recess. This is particularly important, if we are to cap in year.

### Summary of key points

The key points in the paper are:

- a) The average increase in council tax in England in 2004/05 is 5.9% compared to an increase of 12.9% in 2003/04. This figure is lower than originally foreseen and has come down following strong messages from Ministers, including warning letters to 65 local authorities and meetings which Phil Hope and I held with authorities reported to be planning large increases. 25 authorities were called in for meetings, including two fire authorities and three police authorities. Hazel Blears participated in discussions with police authorities.
- b) Nevertheless some councils' rises in budget and council tax are still too high and it is important that the Government follows through previous warnings to councils by taking appropriate action against those which are considered to have made excessive increases in budget requirements. This is not something we should do lightly, since it sits uncomfortably with our policy on freedoms and flexibilities. However, capping will send out a strong signal to high-taxing authorities and demonstrate to all that the Government is committed to efficiency and responsible tax setting, as well as service delivery.
- c) Most authorities (with the exception of police and fire authorities) are clustered around the national average. Capping would not therefore affect the national average increase, unless we were prepared to cap a very large number of authorities. Moreover, decisions will be open to legal challenge and we need to be sure that the principles on which decisions are taken are consistent and defensible.
- d) The first step is to decide the principles by which to determine whether budget increases have been excessive. The key principles which I propose are applied to each category of authority are:

#### **Unitary authorities, London boroughs, metropolitan districts, counties, GLA and the Isles of Scilly**

Option 1: 6% budget increase and 7% council tax increase

Option 2: 6½% budget increase and 8½% council tax increase

#### **Shire districts**

Option 1: 2% budget increase and 7% council tax increase



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Option 2: 2% budget increase and 8½% council tax increase  
(each with a Band D council tax for 2004/05 greater than the shire district average in order to provide a *de minimis* cut off)

### Police authorities

7% budget and 13% precept increase  
(and a Band D precept for 2004/05 greater than the average for the relevant group of authorities – i.e. either metropolitan or shire police)

### Fire authorities

7% budget increase and 13% precept increase  
(and a Band D precept for 2004/05 greater than the average for the relevant group of authorities – i.e. either metropolitan or combined fire authorities)

- e) **Annex A** lists the authorities which would fall within the scope of capping principles under each of the options. For consistency, where there are options we should use either Option 1 or Option 2 in both cases, so that the council tax limits are the same. Option 1 would cover 16 unitary, etc authorities and 2 shire districts. Option 2 would cover 4 unitary authorities and 2 shire districts. The proposed principles for single-function authorities would cover 3 police authorities and 5 fire authorities. The advantages and disadvantages of each option are discussed in the main paper. There is, of course, the option of defining excessiveness at another level within the range represented by these two options.
- f) Many police and fire authorities have set budgets with exceptionally high increases in 2004/05. The proposals at Annex A recognise the pressures on these services. For the fire and rescue service, it was always accepted that we needed to take a two-year perspective on the pay for modernisation deal. On the other hand, we need to send a clear signal that these services share a duty to ensure efficiency and responsible tax increases.
- g) The second step is to decide what action to take against authorities which have set excessive budget requirements. They will have an opportunity to defend their case in response to the statutory consultation which we are required to undertake with them. This will allow for full consideration by the Government of all reasons put forward by authorities in defence of budget or council tax increases.
- h) In the case of **unitary, etc authorities and shire district councils**, I propose that we should initiate the capping process by writing to them to say that we propose to cap them in year in 2004/05 (it is at this stage that they are “designated”), but re-examine this in the light of the evidence they submit in response to the statutory consultation. We then have the options of:
  - a. capping them in year in 2004/05 (“designating”);



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- b. capping them in advance in 2005/06 (“nominating and designating”);
  - c. setting a notional budget against which to measure future increases for capping purposes (“nominating”).
- i) Capping in year would send the strongest signal. However, the low reductions in council tax which would result from the in-year capping of some authorities (see paragraph 23 of the main paper and **Annex B**) need to be borne in mind, especially given the cost of rebilling. In some cases, it might be advisable to start with nomination (and the option of ‘capping in advance’) rather than risk the presentational problems that would arise from proposing in-year capping for the sake of only small savings in council tax bills.
- j) In all cases, the ‘capping in advance’ option has the advantage of certainty and - for those authorities designated - it stops them sending out excessive bills in Spring 2005. Although we would nominate them in Summer 2004, we would not set the budget cap until the time of the draft local government settlement in November or December and would consult the authority on the proposed cap in parallel with consultation on the settlement itself. We would not therefore be acting blindly. However, the cap for those individual authorities would be taken as setting a precedent for next year’s capping levels for authorities more generally. This would be unfortunate if there were particular circumstances which required us to set a cap which was higher than the increases we wanted to see for authorities generally.
- k) In cases where we choose nomination, we will need to send a strong message to authorities who are nominated in 2004/05 that we would be prepared to use our in-year capping powers in 2005/06.
- l) In the case of **police and fire authorities**, I propose that, with the exception of Hereford and Worcester Fire and Rescue Authority, we should initiate the process by writing to them, nominating them. In the light of the evidence they submit in their formal response, we will then have the option of:
  - a. capping them in 2005/06 (“nominating and designating”);
  - b. setting a notional budget against which to measure future increases for capping purposes (“nominating”).

However, since **Hereford and Worcester** has exceptionally high budget and council tax increases, I propose that we proceed with the aim of capping them in 2004/05, as for non-police and fire authorities.

- m) A reason for not capping the majority of police and fire authorities in year is the high costs to the precepting authorities of rebilling across a number of districts who are themselves not subject to capping and the general inconvenience this would cause. But if the route of setting lower notional budgets this year is to be followed then this would entail being prepared to



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cap these authorities in year next year so the rebilling issue should not be considered to be a "show stopper". The problem is less in the case of Hereford and Worcester, since Herefordshire itself is in line for capping under both Options 1 and 2.

- n) We will now face questions about which authorities we are capping, and when – and what we consider to be an "excessive" increase. Until we have established capping principles, we cannot give any indication of which authorities might be capped, or what percentage increase we might consider "excessive". **It is important that Ministers take care to maintain this line on capping until the due process is complete.** Otherwise we risk authorities seeking judicial review. ODPM officials will prepare briefing for all Ministers, covering both generic issues and individual authorities.
- o) When we announce our initial decision, we will need to make it clear that subsequent decisions not to cap authorities in year are not a climb-down by Government, but a proper use of the more flexible capping powers that we are now able to use.



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### RESTRAINING COUNCIL TAX INCREASES

#### Tax Increases in 2004/05

1. The average council tax increase for all authorities in England in 2004/05 is calculated as 5.9% compared to an average increase of 12.9% in 2003/04. Council taxes have on average risen by 70% in England since 1997, a real terms increase of 43% (though local government expenditure has increased no faster than that of central government in this period). The average Band D tax has risen from £688 in 1997/8 to £1167 in 2004/05. Annual increases since 1997/98 are shown in the table below.

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Average Band D (£)	688	747	798	847	901	976	1102	1167
Increase from previous year (%)	6.5	8.6	6.8	6.1	6.4	8.2	12.9	5.9
Increase in real terms (%)	4.0	4.4	5.1	3.1	4.5	6.7	9.5	3.3

2. Authorities received a generous grant increase in 2004/05: formula grant increased by 5.5% and total grant, including specific grants, increased by 7.3%. For the second year running every local authority received at least an above-inflation increase with many receiving substantially more.
3. £340 million was announced in the Pre-Budget Report and the Government has also unringfenced £750 million of specific grants providing local authorities with greater local flexibility.
4. Given this significant extra investment and the scope for efficiency improvements, the Government made it clear that it expected local authorities to deliver council taxes in low single figures.
5. 5.9% is less than half of last year's rise of 12.9%. There were a number of pressures faced by local authorities in 2003/04 which in part accounted for the steep increases including: pay awards for teachers, increased employers' national insurance contributions and passporting to schools the increase in schools formula spending shares. Also, capping was no longer seen as a serious threat by authorities since no authority had been capped since 1998/99.
6. Clear warnings have been given that the Government is prepared to use its capping powers on any authority that sets an excessive budget for 2004/05. Many



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authorities have listened, and have agreed to reduce proposed council tax rises. I wrote to 65 authorities and in recent weeks Phil Hope and I have met representatives from 25 authorities (including 3 police authorities and 2 fire authorities) which were reported as planning high council tax increases. Hazel Blears also participated in the discussions with police authorities. Many of these subsequently reduced the council tax rises they were originally proposing. Other authorities, which we did not contact, also reduced their increases, having become aware that we had been in touch with some authorities.

7. However, there can be no room for complacency as there are still a number of authorities whose increases are significantly above the 5.9% average. It is important that we follow through our previous warnings to councils about setting excessive council taxes. Capping in 2004/05 will send out a strong signal to high-taxing authorities both now and in the future and demonstrate to all that the Government is committed to efficiency and responsible tax setting as well as service delivery. It will also help to reinforce the message about the need to drive down the level of increase in 2005/06 and subsequent years.

### Principles

8. The Government has powers to cap local authority budgets under the Local Government Finance Act 1992 (as amended by the Local Government Act 1999). These are new powers, which replaced the old system of "crude and universal", pre-announced capping, and they have not been used so far. They allow us to take decisions in the light of budgets which local authorities have actually set and provide a choice of actions: capping in year and/or the following year, or setting a notional budget against which future increases will be measured for capping purposes.
9. As a first step, we need to decide whether the amount calculated by an authority as its budget requirement for 2004/05 is excessive. We must do so in accordance with a set of principles. Different principles may be used for different categories (not necessarily the same as "classes") of authority.
10. The principles must include a comparison between the budget requirement for 2004/05 and an earlier year. In theory, we could go back beyond 2003/04, but it would be difficult to justify doing so, when we took no action over last year's increases, despite the fact that the average increase was more than twice as high as this year. Difficulties last year included the commitment not to cap "excellent" or "good" authorities, which was removed last Autumn.
11. Principles may include factors other than the budget requirement and we have chosen to include council tax increases as well. In considering excessiveness, we need to bear in mind:
  - ☐ the burden of increases upon taxpayers;
  - ☐ the scope authorities have for making efficiency savings;



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- ☐ general inflation levels of 2.6% (the RPI-X figure for last October, which was used in the local government settlement);
  - ☐ the increase in grant to local authorities in 2004/05 of 5.5%;
  - ☐ the statements we have made about our expectation being that council tax increases in 2004/05 would be in low, single percentage figures;
  - ☐ and for smaller authorities the advantage of setting a *de minimis* level in terms of the average level of Band D council tax.
12. GL should bear in mind that we cannot take formal decisions about the excessiveness of some authorities' budgets, until Parliament has approved the report which we laid before the House on 25 March on "alternative notional amounts" (ANAs). This enables us to make like-for-like comparisons between 2003/04 and 2004/05 budgets of authorities affected by the change in status of combined fire authorities from levying to precepting authorities. (We decided not to issue ANAs to make adjustments for other functional changes, including benefit payment changes, which have a particular affect on shire districts.)
13. Whether or not an increase has been excessive is a matter for the Secretary of State's judgement. However, I believe that it would be reasonable to consider increases as follows for the different categories of authority. The effects are shown in the tables at **Annex A**. There is, of course, the possibility of choosing further options lying within the range represented by the two options.

### Unitary authorities, London boroughs, metropolitan districts, counties, GLA, the Isles of Scilly

- Option 1: 6% budget increase and 7% council tax increase  
Option 2: 6½% budget increase and 8½% council tax increase

(For authorities affected by the change of combined fire authorities from levying to precepting bodies, we are using notional council tax increases based on the ANAs.)

14. Some of these authorities are likely to claim that their increase in budgets was due to the need to "passport through" education expenditure, which meant that increases in other services had to be met predominantly from council tax. In particular, Windsor and Maidenhead (Option 1) is one of the authorities whose increase in cash grant is no larger than the increase in the schools formula spending share which it is required to passport through. I propose that we deal with this issue at the next stage, once authorities have presented evidence as to why they should not be capped (see paragraph 25 below).
15. Milton Keynes is included in the list of authorities in Option 1 because of a technicality caused by changes to local precepting arrangements. The 7.5% council tax increase in Milton Keynes includes an extra amount needed to pay for services previously paid for through its parishes. The increase in Milton Keynes' council tax as a result of this change is matched exactly by a reduction in the amount payable in council tax to the parishes, so that there is no net cost at



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taxpayer level. We understand that, on a like-for-like basis, the increase would be about 6%, but it is not possible to use this figure in the capping calculations.

16. I propose that we also deal with this issue (if relevant to the option chosen) at the next stage, once authorities have presented evidence as to why they should not be capped.

### Shire districts

Option 1: 2% budget increase and 7% council tax increase

Option 2: 2% budget increase and 8½% council tax increase

(both with Band D council tax for 2004/05 greater than the shire district average)

17. These principles recognise the need to maintain parity of treatment between categories of authority in terms of their council tax increases. The budget figure for districts is lower, reflecting the fact that from 2004/05, authorities no longer contribute 5% of the cost of council tax and housing benefit payments.
18. One of the two districts, Shepway, is an authority whose population figures are being reconsidered by ONS. Whatever the adjustment, the ONS revision will not be available until August, which would be too late if we are to cap before the Summer Recess, and the authority might seek to use the uncertainty as grounds for legal challenge. Any capped authority might do the same, since any errors in population figures will have affected how grant as a whole has been redistributed, but in most cases the link is more tenuous.

### Police authorities

7% budget and 13% precept increase

(and a Band D precept for 2004/05 greater than the average for the relevant group of authorities – i.e. either metropolitan or shire police)

### Fire authorities<sup>1</sup>

7% budget increase and 13% precept increase

(and a Band D precept for 2004/05 greater than the average for the relevant group of authorities – i.e. either metropolitan or combined fire authorities)

19. Percentage changes in fire and police budgets and precepts are much higher than for other authorities. If the same capping principles were used as proposed for other categories of authority, a very large number of police and fire authorities would be identified for capping. It is recognised that there are special circumstances in their case – e.g. the fire and rescue service pay for modernisation deal – and that it would not therefore be desirable to apply the same principles to these services. The principles proposed at Annex A aim to balance a recognition of the pressures on these police and fire authorities with the need to send a clear signal that they also share a duty to ensure efficiency and responsible tax cutting.

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<sup>1</sup> Combined fire authorities will have to be treated as a separate category from other fire authorities, because we are using notional council tax increases for them, based on ANAs.



**The effects of capping**

20. Capping is not a tool that can be used to reduce the average increase in council tax by an appreciable amount. This is particularly so when, as is the case this year, most authorities (with the exception of police and fire authorities) are clustered around the national average, so capping will not affect the national average increase, unless we were prepared to cap a very large number of authorities. Moreover, decisions will be open to legal challenge and we need to be sure that the principles on which decisions are taken are consistent and defensible.
21. The threat of capping can, however, affect overall levels of council tax increases, but for this to happen the threat must be credible. The Audit Commission cited a perceived reduction in the threat of capping as one of the reasons for the high increase in council tax in 2003/04. Our warnings this year have had a real effect, but some councils' rises in budget and council tax are still too high and it is important that we follow through previous warnings to councils by taking appropriate action against those which we consider have made excessive increases in budget requirements. Capping will send out a strong signal to high-taxing authorities and demonstrate to all that the Government is committed to efficiency and responsible tax setting, as well as service delivery. The message will be particularly important in setting a more realistic climate for authorities' budget decisions for 2005/06.
22. However, we need to act proportionately: the more authorities we cap, the more likely they are to seek judicial review of the grounds that we have used our new powers indiscriminately. We should also avoid generating sympathy for capped authorities: for instance Milton Keynes, who are under growth pressures, but who would be unavoidably caught by the 6% and 7% principle for purely technical reasons (see paragraph 15 above).
23. The effects of capping in terms of the amounts saved on individual council tax bills are also very variable (see **Annex B**). They range from 39p for Windsor and Maidenhead to £26.75 for Torbay under Option 1 and from 68p for Telford and Wrekin to £13.12 for Torbay under Option 2. We will need to bear this in mind when we decide what specific action to take against individual authorities.

**Designation or nomination**

24. The procedures described below are set out in diagrammatic form at **Annex C**.
25. If the Secretary of State is of the opinion that an authority's budget requirement is excessive, he may either:
- ☐ designate (i.e. cap) the authority in relation to 2004/05; or
  - ☐ nominate the authority and either:
    - ☐ designate the authority in advance in respect of 2005/06; or



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- ☐ set a notional budget for 2004/05 against which increases in the following year will be measured in deciding whether or not they are excessive.

There are also powers to designate an authority over more than one year.

26. He must write to the authority informing it of the maximum amount which he proposes the budget should be for capping or nomination purposes, giving the authority 21 days in which to respond. If the authority accepts the limit, the Secretary of State sends a notice confirming it. If a designated authority challenges the amount, the Secretary of State must consider the information it sends and then either:
- ☐ make an order (debated by the House) confirming the amount or a revised amount; or
  - ☐ nominate the authority rather than designate it.
27. If a nominated authority is designated for the following year and challenges the amount set for the budget requirement for the following year, the Secretary of State must consider the information it sends and then make an order (debated in the House) confirming the amount or a revised amount. There is no provision for the Secretary of State to drop action against an authority, once the process has begun. He may, however, make an order setting the budget requirement of the authority at an amount equal to its actual budget for 2004/05 (though not more than that amount).
28. If we nominate an authority and decide to cap it for 2005/06, we would not set the budget cap until the time of the draft local government settlement in November or December and would consult the authority on the proposed cap in parallel with consultation on the settlement itself. We would not therefore be acting blindly, although the cap for those individual authorities would be taken as setting a precedent for next year's capping levels for authorities more generally.
29. In the case of **unitary, etc authorities and shire district councils**, I propose that those considered to have excessive budget requirements for 2004/05 should be designated at the level of the threshold used to determine excessiveness. Once we have had an opportunity to consider any representations made by the authorities, we will be able to decide whether to designate them at a different level, or nominate them instead. Different decisions may be taken in respect of different authorities according to their individual circumstances.
30. However, in cases where there would be only a small saving in council tax bills from in-year capping (see Annex B), it might be advisable to start with nomination (with the option of 'capping in advance' for 2005/06) rather than risk the presentational problems that would arise from proposing in-year capping for the sake of only small reductions in actual bills.



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31. In the case of **police and fire authorities**, I propose that, with one exception, we nominate the authorities with excessive increases and decide, in the light of representations they make, whether to cap them for 2005/06 or set notional budgets against which increases in 2005/06 will be measured. The case for not capping the majority of these authorities 'in year' rests on the high costs to precepting authorities of rebilling across a number of districts which are not themselves subject to capping and the general inconvenience this would cause. If the route of setting lower notional budgets this year is to be followed, then this would entail being prepared to cap these authorities in year next year so the rebilling issue should not be considered to be a "show stopper". The 'capping in advance' option has the merit of certainty and – for those authorities designated – it stops them sending out excessive bills in Spring 2005. But this decision would create a precedent for capping levels next year.
32. The exception is the Hereford and Worcester Fire and Rescue Authority. This has exceptionally high budget and council tax increases, which I do not feel we can ignore. I therefore propose that we should begin by designating it in respect of 2004/05. The problem of rebilling is less in the case of Hereford and Worcester, since Herefordshire itself is in line for capping under both Options 1 and 2.

### Communications with press and authorities

33. We will now face questions about which authorities we are capping, and when – and what we consider to be an "excessive" increase. Until we have established capping principles, we cannot give any indication of which authorities might be capped, or which percentage increase we might consider "excessive". **It is important that Ministers take care to maintain this line on capping until the due process is complete.** Otherwise we risk authorities seeking judicial review. ODPM officials will prepare briefing for all Ministers, covering both generic issues and individual authorities.
34. We also need to emphasise that we must give careful consideration to the actual figures from all authorities, which we have had only since 18 March, before taking capping decisions.
35. When we announce our initial decision, we will need to make it clear that subsequent decisions not to cap authorities in year are not a climb-down by Government, but a proper use of the more flexible capping powers that we are now able to use.



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Annex A

## Local authorities that would be identified for capping using different capping principles

London boroughs, metropolitan districts, unitary authorities, counties, Isles of Scilly, Greater London Authority

Option 1 capping principles:

1. 6% increase in budget between 2003/04 and 2004/05 and
2. 7% increase in council tax between 2003/04 and 2004/05.

Authority	Proposed Band D Council tax 2004/05 (£)	Budget increase	Council tax increase
<u>London boroughs</u>			
Haringey	1,018	6.3%	7.2%
Sutton	939	7.8%	7.4%
<u>Metropolitan districts</u>			
none			
<u>Unitary authorities</u>			
Bracknell Forest*	835	7.1%	8.4%
Herefordshire*	972	8.3%	8.9%
Leicester*	983	6.4%	8.7%
Milton Keynes*	895	8.0%	7.5%
Nottingham*	1082	6.6%	9.6%
Rutland*	1153	8.0%	7.6%
Southampton*	1017	6.7%	7.6%
Telford & Wrekin*	895	7.0%	8.6%
Torbay*	1000	7.1%	9.9%
West Berkshire*	1023	7.1%	8.0%
Windsor & Maidenhead*	884	6.0%	8.9%
York*	849	6.5%	8.5%
Isles of Scilly	779	7.3%	7.5%
<u>Counties</u>			
Cornwall	838	8.6%	7.2%

Note All figures exclude parish precepts.



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\* For unitary authorities, and some counties, the council tax increase will be calculated with reference to a notional council tax for 2003/04, to take account of the new precepting status of combined fire authorities.

Option 2      capping principles:

1.      6½% increase in budget between 2003/04 and 2004/05 and
2.      8½% increase in council tax between 2003/04 and 2004/05.

Authority	Proposed Band D Council tax 2004/05 (£)	Budget increase	Council tax increase
<u>London boroughs</u> none			
<u>Metropolitan districts</u> none			
<u>Unitary authorities</u>			
Herefordshire*	972	8.3%	8.9%
Nottingham*	1082	6.6%	9.6%
Telford & Wrekin*	895	7.0%	8.6%
Torbay*	1000	7.1%	9.9%
<u>Counties</u> none			

Note All figures exclude parish precepts.

\* For unitary authorities, and some counties, the council tax increase will be calculated with reference to a notional council tax for 2003/04, to take account of the new precepting status of combined fire authorities.



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### Shire districts

#### Option 1      capping principles:

1. 2% increase in budget between 2003/04 and 2004/05 and
2. 7% increase in council tax between 2003/04 and 2004/05 and
3. Band D council tax greater than the shire district mean

Authority	Proposed Band D Council tax 2004/05 (£)	Budget increase	Council tax increase
Fenland	206	6.2%	14.5%
Shepway	207	6.1%	28.9%

#### Option 2      capping principles:

1. 2% increase in budget between 2003/04 and 2004/05 and
2. 8½% increase in council tax between 2003/04 and 2004/05 and
3. Band D council tax greater than the shire district mean

Authority	Proposed Band D Council tax 2004/05 (£)	Budget increase	Council tax increase
Fenland	206	6.2%	14.5%
Shepway	207	6.1%	28.9%



# RESTRICTED - POLICY



## Police authorities

Proposed capping principles:

1. 7% increase in budget between 2003/04 and 2004/05.
2. 13% increase in council tax between 2003/04 and 2004/05.
3. Band D precept for 2004/05 greater than the metropolitan or shire police mean.

Police authority	Proposed Band D council tax (precept) 2004/05 (£)	Budget increase	Council tax (precept) increase
Cumbria Police	150	7.3%	15.0%
Northamptonshire Police	149	7.1%	14.9%
West Mercia Police	138	7.3%	14.9%

## Fire authorities

Proposed capping principles:

1. 7% increase in budget between 2003/04 and 2004/05.
2. 13% increase in precept between 2003/04 and 2004/05.
3. Band D precept for 2004/05 greater than the metropolitan or combined fire authority mean.

Fire Authority	Proposed Band D council tax (precept) 2004/05 (£)	Budget increase	Council tax (precept) increase
Bedfordshire Fire*	74	13.7%	20.1%
Durham Fire*	74	11.3%	19.8%
Essex Fire*	56	11.1%	16.0%
Hereford and Worcester Fire*	60	19.4%	29.4%
Nottinghamshire Fire*	57	9.5%	14.3%

\* For combined fire authorities the council tax (precept) increase will be calculated with reference to a notional precept for 2003/04, as combined fire authorities did not precept in 2003/04.



# RESTRICTED POLICY



## Annex B

### Effect of capping on council tax increases and council tax bills (Band D)

	% Council tax increase after capping		Reduction in Band D council tax due to capping (£ per year)	
	Option 1	Option 2	Option 1	Option 2

	6% budget increase, 7% council tax increase	6.5% budget increase, 8.5% council tax increase	6% budget increase, 7% council tax increase	6.5% budget increase, 8.5% council tax increase
Haringey	7.0%		1.90	
Sutton	7.0%		3.51	
Bracknell Forest	7.0%		10.79	
Herefordshire	7.0%	8.5%	17.03	3.82
Leicester	7.0%		15.64	
Milton Keynes	7.0%		3.87	
Nottingham	7.2%	9.3%	23.84	2.49
Rutland	7.0%		6.73	
Southampton	7.0%		5.41	
Telford & Wrekin	7.0%	8.5%	13.04	0.68
Torbay	7.1%	8.7%	26.75	13.12
West Berkshire	7.0%		9.03	
Windsor & Maidenhead	8.8%		0.39	
York	7.4%		11.31	
Isles of Scilly	7.0%		3.42	
Cornwall	7.0%		1.48	

	2% budget increase, 7% council tax increase	2% budget increase, 8.5% council tax increase	2% budget increase, 7% council tax increase	2% budget increase, 8.5% council tax increase
Fenland	7.0%	8.5%	13.48	10.78
Shepway	19.9%	19.9%	15.51	15.51

	7% budget increase, 13% precept increase		7% budget increase, 13% precept increase	
Cumbria Police	13.7%	~	1.60	~
Northamptonshire Police	14.5%	~	0.53	~
West Mercia Police	13.9%	~	1.23	~
Bedfordshire Fire	13.8%	~	4.12	~
Durham Fire	18.0%	~	4.22	~
Essex Fire	16.4%	~	1.44	~



## RESTRICTED - POLICY

Hereford and Worcester Fire	13.1%	~	7.62	~
Nottinghamshire Fire	16.5%	~	0.65	~



**MATRIX**

Pr  
File  
Tr  
Pr

From: Alasdair McGowan  
Date: 23 March 2004

**PRIME MINISTER**

Cc: Ivan Rogers  
Geoff Mulgan  
Matthew Taylor  
David Hill  
Sally Morgan  
Pat McFadden  
Andrew Adonis  
Paul Britton

## **COUNCIL TAX - OPTIONS FOR REFORM**

This paper sets out a range of potential options for reforming local government finance in the short, medium and long term.

### **What is the problem?**

In essence, we have three problems:

- Firstly, a short term problem: how do we limit increases to low single figures between now and the next election?
- Secondly, a medium term problem: how do we get through revaluation (which starts in 2005 and ends in 2007) without large numbers of winners and losers – particularly in London and the South East?
- Thirdly, the long term problem: how do we create a sustainable local government finance system which is capable of underpinning strong and effective local government and financing improvements in public services?

To answer all of these questions, we need to understand how we got to where we are today.

### **Why is council tax so unpopular?**

There are lots of criticisms that have been levelled at council tax:

- Firstly, council tax is regressive. The lowest income deciles pay a much higher proportion of their incomes on council tax than the highest deciles.



- Second, council tax lacks 'buoyancy'. Unlike income tax, council tax yield doesn't rise automatically as people's earnings increase. Instead the taxbase is linked to property values. So unless there is a revaluation or there is an increase in the number of properties in a neighbourhood, the council tax base is unlikely to change much from year to year. This means that council tax yield is fairly predictable – but it also means that the only way councils can increase their tax yield is by increasing tax rates.
- Third, the balance of funding is heavily skewed towards central government grant. On average, three quarters of local spending is funded through central sources with the rest coming from council tax. This is what creates the gearing effect. And poorer councils who have lower tax bases and are therefore even more dependent on central government grant for their spending have even higher gearing ratios.

These are all perfectly valid criticisms and are undoubtedly part of the current problem. But these criticisms tend to be confined to local government and academic circles rather than taxpayers. And they are hardly 'new' problems – so they cannot explain why council tax has suddenly become so unpopular.

Why, then, do people now think council tax is so unfair? Has council tax, as Nick Raynsford put it, simply reached 'the limits of acceptability'?

It is worth remembering that, until last year, council tax was not seen as a problem. This suggests that people do not think that council tax is manifestly unfair in the sense that the Poll Tax or the rates were. Although council tax is regressive (in the sense that the lowest income deciles pay a higher proportion of their income on council tax than the highest income deciles), it is not as regressive as Poll Tax. If you are in a higher banded property, you pay more. And single person discounts mean that we no longer have the situation we had under the rates where a pensioner living on their own would look at their next door neighbour with two or sometimes three earners paying the same rates bill as them.

When council taxpayers say that council tax is unfair they are usually talking about two things:

- Firstly, the relatively weak link between property values and people's income means that groups such as pensioners who are income poor and/or asset rich can be hit disproportionately hard by high council tax rises. In theory, this



should not be a problem given that Council Tax Benefit is designed to help people on low incomes. But in practice, levels of take-up are particularly low compared to other benefits. One third of pensioners (up to 1.7 million in 2001/2) and half of all owner occupiers fail to claim. Up to £1 billion was unclaimed in 2001/2 (of which £770 million was for pensioners). This is because (a) people are put off by the stigma of means-testing (b) the forms are still very long and complex (although they have been reduced by a third recently for pensioners, they are still 24 pages long) and (c) the sums involved are relatively small (average CTB in May 2001 was £10).

- However, it is not just pensioners who are complaining. The second and perhaps more important problem is that council tax has started to grow at a faster rate than people's average earnings and inflation. While last year's average council tax rose by 12.9%, RPI rose by 3.1%, and average UK earnings only rose by 2.6%. Before 2002/3, council tax had never once risen by twice the rate of growth in average UK earnings. Yet in 2003/4, council tax rose at almost five times the rate of earnings growth and more than four times the rate of inflation. And because council tax is much more visible than other taxes, people inevitably scream louder about it.

Therefore, we need to be clear what we mean when we say that council tax has reached the limits of acceptability. It is not that it could not rise further. It is perfectly possible, for example, to imagine people accepting year on year increases based on RPI.

The problem is not so much the absolute level of council tax. The problem is the gap between council tax rises and average earnings and RPI plus the weak link between people's property values and their income. The two problems are linked. The more we deal with the first problem, the less important the second becomes.

Conversely, if we wanted to raise more money through council tax to improve local services, the more acute the second problem becomes. So how much you can raise depends in part on how you raise it.

**Why has council tax grown so far in advance of average earnings and RPI?**

There were a number of specific factors behind the rises in 2003/4:



- The main answer is that we failed to match funding to local authorities pressures: e.g. NICs, local government pay, pensions, increases in social services and waste disposal/recycling costs etc. On top of that, David Blunkett under-funded the settlement for police authorities, forcing them to drive up the police precept to pay for extra police officers. In London, Ken's precept added to London bills.
- Despite our attempts to water down ODPM's changes to the grant formulae, there were still large numbers of winners and losers. When these formulae were combined with large changes to population data in the Census, some authorities – particularly those in London and the South - lost out significantly. Although every authority received an above inflation grant increase, authorities who had traditionally received lots of grant suddenly found themselves having to make do with a lot less.
- Systemic problems like the gearing effect made matters worse. So did the requirement on councils to passport most if not all of their extra grant to schools because it made it harder for them to protect non-school services without putting up council tax.
- But central government was only partly to blame. ODPM calculate that even taking into account known pressures, council tax should have risen by 9.6% on average. Instead, it rose by 12.9% on average.
- Councils have to shoulder some of the blame too. Some of the councils who lost out from the changes to grant formulae used this as an excuse to put up council tax by even more than they strictly needed to and blame the government (particularly if they didn't face elections). And those who actually got more grant (and had no excuse at all to put up council tax) then used the losers as cover to put up council tax themselves. As the Audit Commission study diplomatically put it, the usual peer pressure between authorities to keep council tax low was virtually absent.
- Local government did not take our threat to cap excessive rises seriously, because (a) we hadn't used our reserve capping powers in years and (b) we had ditched even these reserve powers in respect of 'good' and 'excellent' councils.

*We therefore have to close the gap between the growth in people's local tax bills and the growth in their average earnings. We have started to close the gap already. Council tax rises for 2004/5 are less than half those for 2003/4 and are the lowest for almost a decade.*

How have we done this?



- Firstly, we added more money to the settlement – £760 million over and above SR2002. But it is worth noting that the increase in general grant for 2003/4 was 5.9%. For 2004/5, it is 5.5%. Councils have therefore managed lower council tax rises with less grant.
- Secondly, we have consistently stuck to our message about capping. Councils now take our threat to cap seriously (although we will have to follow through on this if we want to maintain our credibility). The process of arm twisting has also helped to re-establish the peer pressure among authorities that was absent last year. And councils themselves are more sensitised to taxpayers' concerns. Authorities have in effect capped themselves.
- Thirdly, pressures overall seem to have slightly reduced. Last September, ODPM estimated that council tax ought to have increased by 6 to 8% on the basis of known pressures. The comparable figure for 2003/4 was 9.6%. However, it is worth noting that we were much tougher on passporting this year.
- Fourthly, we managed to give councils more financial flexibility by reducing ring-fencing. Councils were also able to tax second homes more.
- And last but not least, there have been some real and painful cuts to some local services.

So we have made progress but only by throwing money at the problem, twisting councils' arms and forcing them to make real cuts. And even then, council tax is still two to three times RPIX with capping unlikely to make much difference to the overall average. This begs two questions:

- Are current policies sustainable both in terms of delivering low council tax rises and meeting our objectives in terms of local services?
- And perhaps more importantly, is this low enough?

### **Prospects for 2005/6**

For 2005/6, we can probably just about maintain council tax rises at their current level. On the negative side, there will be slightly less grant in 2005/6 (5.2% compared to 5.5% in 2004/5) and councils might have to meet part of the costs of getting the Supporting People budget under control. But on the plus side, we can expect councils to take the capping threat even more seriously and there will be natural pressure to keep council tax down in an election year. We are unlikely, however, to get council tax much lower than 6% on the basis of current policies.



### More radical short term options

It is essentially a matter of political judgement as to whether this is low enough. The key question is could we get it lower and if so what are the tradeoffs?

There are limits as to how much we can use our reserve capping powers to limit council tax. Because we are forced to cap councils after they set their budgets (1) this leads to rebilling costs which can often outweigh the benefit to local taxpayers and (2) by the time we get round to capping, it is too late to enforce minimum schools budgets if a council tries to use capping as an excuse to renege on their passporting requirements because (as Wandsworth did this year).

If we want to get it lower, more radical options include:

- A return to crude universal capping. This would get round some of the practical problems associated with rebilling and passporting by announcing capping criteria before councils set their budgets. It would certainly be more effective in restraining increases than the current reserve powers. But it would be very controversial and a complete reverse in policy since 1997. It would even further undermine our wider policy of greater freedoms and flexibilities for local government. And ultimately, it means across the board cuts at a time when we want the dividing line between us and the Tories to be investment versus cuts. If we wanted to protect schools from these cuts by continuing to insist on passporting, it will simply mean even more swingeing cuts elsewhere. The DPM, Chancellor and local government would probably oppose it vehemently.
- Require councils to hold referenda if they want to increase council tax by twice the rate of inflation or more. Councils would have to make the case for higher increases and force taxpayers to face up the tradeoffs. But in almost every case, council taxpayers would go for the lowest option. So this is in effect crude universal capping by the back door.
- Shift more of the burden of local taxation on to business. While council tax has increased by substantially more than RPI since 1993/94 (94% compared to 28.9%), increases in the business rate have been capped at the rate of inflation. This has meant that in recent years the proportion of local government revenue expenditure funded by business rates has declined - from 27% in 2001/02 to 22% in 2003/04. Linking business rate rises to increases in council tax rises would mean increases in the business rate of around 6% unless you limited council tax rises further. A less radical option which is



worth looking at is increasing the cap for business from RPI to RPI+X although even this would meet with strong CBI opposition.

- Increase the 2005/6 settlement yet further. HMT would undoubtedly resist as they have been firm on sticking to 2005/6 totals. The 2005/6 grant rise is at any rate pretty generous by historical standards – 5.2%, even taking into account the now higher 2004/5 baseline. We can't keep throwing money at the problem indefinitely. At some stage, we need to stop 'feeding the spending habit'. If central government has to tighten its belt in SR2004, so should local government.
- Increase help for pensioners. An alternative might be to target any extra cash to pensioners. We will at any rate face demands to extend this year's one off payment of £100 for the over 70s for another year, as well as demands to extend it to those under 70. However, we would need to get HMT to cost any options.
- Demand greater efficiency from local councils. We should certainly use the Efficiency Review to demand greater efficiency and set councils ambitious targets for SR2004. But in practice it will be difficult to realise major efficiencies in the short term for 2005/6. Most of the real efficiency gains are only likely to be achievable in 2006/7 and beyond.
- Reduce the strain that is put on council tax. HMT's Local Services Review is already examining council tax pressures for 2005/6 and beyond as part of SR2004 and will make recommendations to reduce them. We should certainly be looking to reduce the pressure on the police precept and we need to tell David Blunkett that he cannot fund ever higher police numbers through the police precept. But the experience of 2004/5 is that we will have to be much tougher with departments if we are serious about limiting their demands on local councils.

### **Council Tax Benefit Reform**

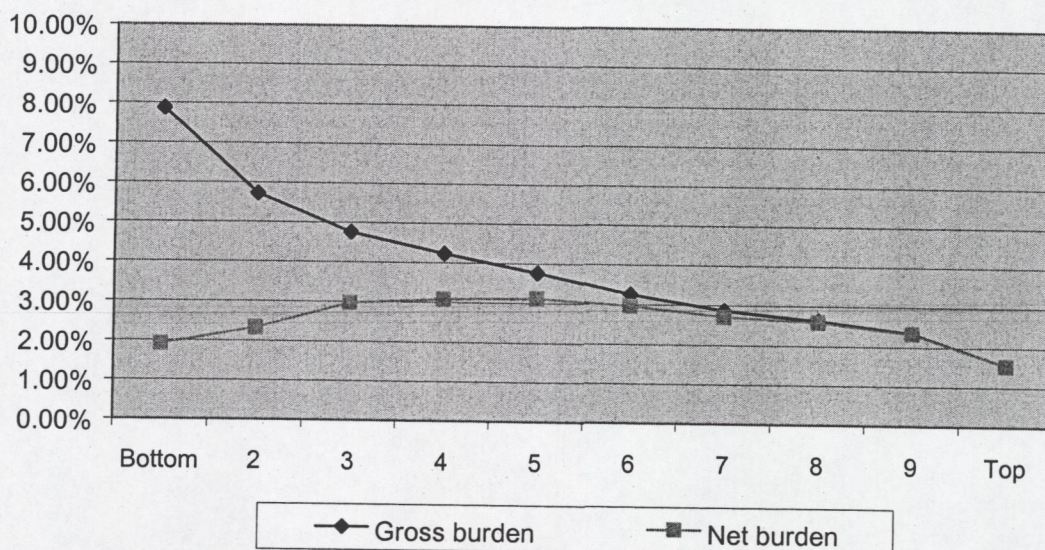
Whatever we do on local government finance in the long term, one thing is certain. We will still want council tax to be part of councils' tax base. It would be madness to throw away a tax which is stable, predictable and easy to collect. It also makes sense on economic and fairness grounds to tax property wealth.

So whatever we do, we need to make sure that Council Tax Benefit is working properly. If we could increase take up of CTB, it would also make council tax feel a lot fairer. DWP have recently launched a national campaign to boost take-up and support local councils in encouraging pensioners to apply. They are also using the Pension Credit roll-out to promote CTB take-up.



The attached table shows the difference which improved levels of CTB take-up could make:

Council tax as a proportion of gross income for each income decile  
(N.B. The net burden assumes full take up of Council Tax Benefit)



This table shows that council tax would still not be progressive (in the sense that the highest income deciles would not pay a higher percentage of their income) but it would improve the lot of those groups who are income poor but face high council tax bills e.g. pensioners.

Clearly 100% take-up is not realistic and CTB reform is unlikely to be a panacea for our CT problems. But we might be able to boost take-up by changing the appearance and administration of CTB, transforming it from a means tested benefit into what is in effect a maximum tax liability. The actual calculation of CTB would remain the same. But it would be administered as a tax with taxpayers given an assessment of the maximum amount they have to pay, thus removing the stigma associated with claiming a benefit.

Moving to a maximum liability scheme administered by DWP or Inland Revenue as part of a benefit or tax assessment would involve considerable change and we would need to do further work on this option. In the meantime there is a package of smaller options which we should explore:

- We could change the name of Council Tax Benefit to Council Tax Rebate removing the reference to benefit and emphasizing instead the amount of



council tax a household has to pay. Although this is essentially a cosmetic change, it would help to remove the stigma associated with claiming a means tested benefit.

- We could require councils to be more proactive in publicising the availability of Council Tax Benefit.

Clearly, there are costs associated with increasing take-up of CTB although these would depend on success in boosting take-up.

We should therefore ask Andrew Smith to conduct an urgent internal DWP review of Council Tax Benefit to look at both eligibility and systemic changes to improve take-up.

Do you agree?

### **The Medium to Long Term Problem**

The most obvious looming problem is revaluation. This begins in 2005 with bills based on the new 2005 values landing on doorsteps in April 2007. If we stick with the current system of council tax bands, and uprate them to take account of the average increase in UK property values since 1991 (when council tax was last revalued), this will mean that areas where property prices increased by more than the UK average (e.g. London and the South East) will lose out substantially.

Meanwhile, those who are in the bottom band A already cannot possibly gain whilst those in the top band H cannot possibly lose out if we simply uprated the bands according to the increase in UK property values without changing the structure of the bands or the multipliers between them. It would be those in bands B to G who would lose out.

It may seem tempting to postpone revaluation. But aside from the fact that we would have to legislate to move it from 2007 (having just legislated to have it in 2007), the last thing we would want to do is postpone it to 2008 or 2009 i.e. right before the General Election after next. Realistically, you would need to postpone to 2011 or 2012 which means you would have to deal with almost 20 years of property price growth to deal with. There is a real danger under this scenario that council tax would seriously fall into disrepute and would never be revalued, strengthening the case for its abolition.



Moreover, revaluation is not necessarily as scary as it sounds. There are a number of options we could deploy to manage the process:

- Firstly, we could move to a system of regional banding whereby the bands in each region increased by the average increase in property values in that region. This would limit the total gains and losses for regions like London and the South East.
- Secondly, with the next revaluation not due until 2017, we could phase in any changes over ten years.
- Thirdly, we could simply limit the overall gains and losses in any one year.

You could also if you wanted use revaluation to change the council tax bands to make council tax less regressive. But we would need to be very careful indeed that this did not hit those groups – particularly in London – who are income poor living in high value rented properties.

There is, however, a more fundamental problem about the sustainability of councils' tax base. While we can probably limit rises to around 6% for 2005/6, the financial settlement for councils will be much harder for 2006/7 and beyond. There is already an obvious tension between our policy on schools funding and our policy on capping. On the one hand, we are asking councils to spend more money on schools. On the other hand, we are telling them to spend less. This year, this tension has been partially masked by the extra money we have given councils. But it will become much more apparent in a tighter settlement.

### **More radical long term options**

A more fundamental problem with virtually all of the options above is that they ultimately imply a revenue constrained and therefore relatively weak system of local government. Politically, we risk becoming cast as obsessive centralisers, leaving big political space for the Tories and Lib Dems to fill.

And more importantly, as long as we provide the lion's share of funding, we will get the lion's share of the blame for council tax rises and cuts to services. If we want in the long term to get away from capping and try to break out of the blame culture which pervades central/local relations and tackle the gearing effect, we need to shift the balance of funding more towards local sources of revenue.



### Options for Shifting the Balance of Funding

There are two basic methods of increasing the proportion of local authorities spending that is financed locally:

1. Whilst maintaining the current range of functions (and therefore spending), increase local taxation whilst reducing central government grant (and by implication national taxation) by a commensurate amount. The total local tax bill would increase but the national tax bill would be lower<sup>1</sup>.
2. Reduce councils' responsibilities (and therefore spending), so that the same level of local taxation would make up a larger share of a smaller budget.

These two methods are of course not mutually exclusive. You could in theory do both.

### Route 1 – Increase local revenue raising through a local income tax

Under the first method, we would still need to keep some central government grant for 'equalisation' to ensure that deprived areas with low tax bases were able to meet their assessed needs. But it would be possible to shift the balance of funding to around 50:50 through this route whilst still maintaining current levels of equalisation.

However, if council tax is the only local tax, you would in effect be shifting the burden for financing local services from national taxes - which tend to be less visible - to a local tax base which is very visible indeed. So this is very tricky politically. You would also be placing more weight on a regressive tax (although you might offset this by making a commensurate reduction in a regressive national tax like VAT).

Alternatively, if councils had access to a capped supplementary local income tax, it would be easier to shift the balance of funding in this way, as the increases in local taxation would be both fairer and (once established) less visible i.e. instead of people receiving a council tax bill, LIT would be deducted through PAYE. HMT calculate that a capped local income tax of 3p would shift the percentage of council spending funded locally from 26% to at least 42%. However, there are other pros and cons with local income tax too.

Pros:

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<sup>1</sup> Precisely how this affected individuals would depend on which national tax you cut.



- It is progressive, not regressive – so it is fairer.
- It is buoyant – i.e. it rises in line with people's incomes. So councils would not always have to change the rate to raise more tax.
- It is unlikely that we will be able to increase Council Tax Benefit take-up enough to solve the problem of large increases in local taxation hitting people on low and fixed incomes – e.g. pensioners. A local income tax would, however, allow you to increase local revenue substantially without hurting pensioners.

Cons:

- It is impossible to square with a third term Manifesto pledge not to increase the basic or top rate of income tax.
- In the short term, it would inevitably be portrayed as yet another Labour tax.
- Families with more than one earner would lose out.
- It is a less stable and predictable form of revenue than a property tax. As incomes move up and down, so would councils tax base.
- Administratively, it would be difficult but not impossible. We would need to resolve difficult issues like how to treat individuals who incorporate as small businesses and take their income in the form of dividends. HMT estimate £100 million set up costs and £25 million per annum ongoing costs. It would, however, cost business (mainly small businesses) at least £100 million per annum to computerise their PAYE system, with annual updates and running costs.

The policy case for a capped supplementary LIT is therefore reasonably strong. It is the politics which are difficult. There may, however, be ways of dealing with some of the downsides. Clearly, if you don't want to carry the current pledge on income tax into a third term, the first problem vanishes. If, however, you want to keep it, one option would be to set up an independent review now to look into the future of local government finance. If that review concluded that council tax should be supplemented by a capped local income tax, you could then legislate in a third term with a view to implementing LIT in a fourth term. HMT advise that it would take 4 years from announcement to implementation of LIT.

In order to address the accusation that it was just another Labour tax, one option might be to require local referenda to activate the power (in the same way as we required a referendum to activate the Scottish Parliament's tax varying power). Local people would therefore decide whether they wanted it or not. And of



course any supplementary local income tax would have to be capped. We would also need to consider the knock on effects for Scotland and Wales (the Scottish Parliament, for example, only has the power to vary the basic rate of income tax and the Welsh Assembly has no tax raising powers at the moment).

*Nonetheless, even a capped supplementary local income tax is very tricky indeed. The key issue to decide for now is whether we try and keep it on the table or whether we think it is a non-runner politically.*

#### Route 2 - reducing the burden on council tax

Another way to shift the balance of funding would be to reduce the range of services for which councils are responsible. Clearly, council tax cannot continue to bear the load it has been asked to bear. But we should seriously ask ourselves whether the answer is to give councils new additional taxes which can take the strain or whether we should remove some of the pressure in the first place. Because it is not taxes that cannot take the strain - it is taxpayers. Indeed, one might ask whether we have reached the 'limits of acceptability' not just on council tax but on local tax and spend.

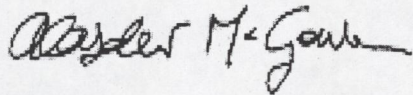
If we funded schools centrally either through a national funding agency or by ring-fencing schools spending completely (effectively buying out the council tax contribution to schools funding), this would shift the balance of funding for non-schools services and reduce the gearing effect.

The proportion of revenue raised for non-school services locally would increase to around 40% if the whole schools budget was paid for by the centre. It would only increase to around 30 to 32% if all spending for secondary schools was paid for by the centre.

Clearly, there are pros and cons with both these options from an educational standpoint which are beyond the scope of this paper. In the long run, it is likely to be the most effective way of ensuring that the money for schools goes to schools. But meeting this objective comes at a cost. Because education will make up a large share of a smaller local government pot in SR2004, ring-fencing schools funding would leave very little for other services. Unless we can extract major long-term efficiency gains from local government, this will mean either cuts in these services or higher council tax. So any decision on schools funding needs to be informed by an analysis of the likely pressures on other services over the SR2004 period. The choice is therefore between more money for schools or



higher council tax. We need to do further work, though, before we can tell just how big the pressure would be on council tax.

A handwritten signature in dark ink, appearing to read 'Alasdair McGowan'. The signature is written in a cursive, slightly slanted style.

ALASDAIR MCGOWAN





Office of the  
Deputy Prime Minister

Creating sustainable communities

# TOWARDS A STRATEGY FOR LOCAL GOVERNMENT

For discussion between Prime Minister, Deputy Prime  
Minister and Chancellor on 30 March 2004

local and regional government • housing • planning • fire • regeneration • social exclusion • neighbourhood renewal

Amey  
CCMRL





Office of the  
Deputy Prime Minister

Creating sustainable communities

# Introduction

ODPM is  
building on the  
No 10 Strategy  
Unit work to  
develop a bold  
new strategy  
for local  
government

- No 10 SU work completed late 2003
- ODPM to take this forward, together with Whitehall and local government
- Developing a 10 year vision based on:
  - Outcomes for people and places in a changing society
  - Effective partnership between central, regional and local government
- With specific measures to enhance delivery in the short to medium term

local and regional government • housing • planning • fire • regeneration • social exclusion • neighbourhood renewal





Office of the  
Deputy Prime Minister

Creating sustainable communities

## **Role of local government:**

Providing effective  
leadership to the  
local community

Democratic  
accountability to  
local people

Joining up services  
to meet local needs

## **Key Message**

- Local government needs to improve further, in order to perform its role effectively
- But effective local government also depends on a workable relationship with central government
- Over time, local government needs more freedom, within a managed framework
- Central government needs to be better too
  - More joined up
  - More focussed on supporting delivery

Local and regional government • housing • planning • fire • regeneration • social exclusion • neighbourhood renewal



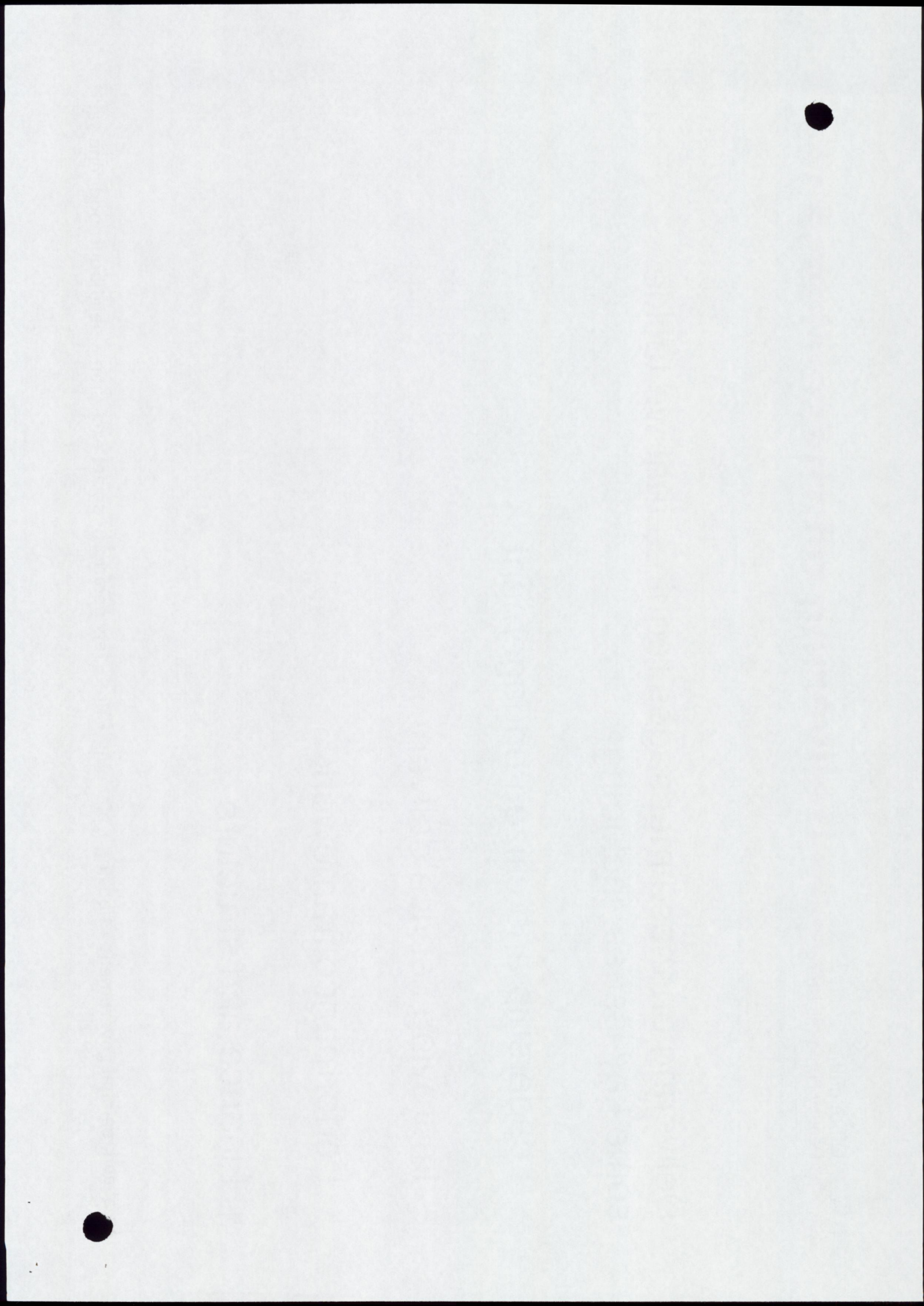


# Delivering on these Messages

Delivering on these messages requires that we tackle some key issues, including:

- Leadership and citizen engagement
- Improving service delivery
- Performance framework
- Finance and structure









# Leadership and Citizen Engagement

- **Enhancing the strategic leadership role of councils**
  - Effective partnership working at the local level (Local Strategic Partnerships 'with teeth')
  - Tensions with drive towards single service boards
- **Improving political and managerial leadership**
  - Smaller number of councillors with clearer roles
  - Encouraging visible leaders
  - Capacity building - a new Leadership Centre
- **Encouraging participation**
  - Increasing turnout: postal and e-voting; all out elections
  - Neighbourhood engagement - new localism





# Improving Service Delivery

- **Better council services - whoever delivers them**
  - Internal and external challenges to performance
  - Greater accountability to users and taxpayers
  - More focus on users and customer satisfaction
- **Influencing all public services at local level**
- **Exploiting scope for efficiencies and cost-effectiveness**
  - Standardisation, aggregation, joint delivery, etc.
  - Gershon
- **Clarifying national, regional and local responsibilities for services**





# Performance Framework

- **A joined-up approach to centre-local government relationships**
  - A small and coherent set of national standards
  - Greater devolution to the frontline - with an acceptance of diversity in inputs / outputs / outcomes, where appropriate
  - Dialogue about delivery - local PSAs and Local Area Agreements
  - Much less inspection and regulation; moving towards more self-assessment and review
  - But recognising the role of national government in setting national priorities - and, at times, intervening
- **This requires change on the part of central government...**
- **...and a robust transition process, in which local government performance is demonstrated, not presumed**





# Finance and Structure

- The local government finance system needs to support the vision - a sustainable solution, setting an appropriate framework of accountability to local people
- A long-term vision for local government must include a vision of its future organisation: regions/unitaries/neighbourhoods
- Both issues will be shaped by external considerations
  - Balance of Funding Review
  - Referenda on Elected Regional Assemblies





# Taking this Forward

- Working up specific proposals with Ministers and officials, across Whitehall
- Engagement on selected proposals with local government
- Publication, in July, of the key elements of the strategy
- Programmes of activity and pilot proposals
- A new strategy for local government - next year



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### LOCAL GOVERNMENT FINANCE LONG TERM OPTIONS

#### OVERVIEW PAPER

##### Summary

This paper invites Ministers to consider the options for achieving a sustainable local government finance system for the long term. It is divided into sections as follows:

- A The challenge (p. 3)
- B Strategic choices (p. 5 -16)
- C Illustrative scenarios for reform packages (p.17- end)

The paper has five annexes:

**Annex A** - analysis of six illustrative options for revaluation / reform of council tax highlighting winners and losers.

**Annex B** - a summary of work by officials on options for introducing a local income tax to complement council tax. This includes some analysis of winners and losers.

**Annex C** - a brief discussion of the arguments for and against re-localising business rates.

**Annex D** - a brief discussion of other, smaller local taxes / charges that could be considered.

**Annex E** - an illustration of the possible effect of one combination of a number of different options.

The key points are as follows:

- The Government's policy of strengthening local government, together with the "gearing" problem, suggests that we should consider the case for a significant shift in the balance of funding away from central grant and towards local funding to improve accountability and reduce gearing.
- At the same time we need to consider reforms to council tax and other tax changes to deliver a more buoyant, more diverse and fairer system.
- Council tax is already reaching the limits of acceptability. It is regressive and bears particularly heavily on those on low incomes who live in higher value properties. There are no practicable means of reforming council tax alone to address these issues. A number of worthwhile reforms could be made, not least improving take-up of Council Tax Benefit to help those on low incomes and in making the



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structure more progressive so that those in more expensive houses pay more. However, that would make matters worse for those on low incomes who live in expensive houses and do not qualify for Council Tax Benefit. Reform cannot make council tax significantly more progressive, nor can it be the means to achieve greater flexibility (it will remain non-buoyant) or a significant shift in the balance of funding. Although revaluation in 2007 provides an opportunity for limited change, there will be significant numbers of losers under any option.

- The only means to increase flexibility, reduce pressure on council tax and achieve a significant shift in the balance of funding would be to give local government a new, buoyant stream of tax revenue alongside a reformed council tax. In practice, the main option for this would be a capped local income tax. Such a tax could take a variety of forms. And it could be complemented by other changes.
- Reducing the services for which local authorities are responsible (e.g. through introducing direct funding of schools) would have a significant impact on this debate. But it would conflict with our commitment to strong and effective local authorities that play a key role in joining up and co-ordinating local services. It would shift the balance of funding, but would not provide local authorities with significantly more financial flexibility. With secondary schools alone removed, problems with council tax will remain without a further stream of tax revenue. Councils would lack a buoyant revenue stream and be forced to raise extra local revenue through a regressive tax.
- There is a range of options - but none is easy.



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### A. THE CHALLENGE

1. The finance system is not an end in itself - but the means to deliver strong, vibrant, innovative and responsive local government. We need a fit-for-purpose system which will help deliver the vision of local government in the long term Strategy for local government which ODPM is preparing - a system which will support continuous improvement in local service quality and efficiency; will balance delivery of national priorities and targets with local financial freedom and responsibility; will be fair to those who use and pay for local authority services; will clarify who is accountable for financial decisions; and will be transparent to all stakeholders.
2. Obviously there is strong interaction between the local delivery of objectives and the finance system that underpins it. If the Government wishes to devolve greater operational decision making, then it must design a finance system that supports, rather than hampers, local ability to make decisions and be held accountable for them by the local electorate.
3. The immediate issue that the Government needs to address is that public concern about council tax has risen sharply. Council tax is increasingly seen as unfair, especially to those on low or fixed incomes. The level of council tax rises seen in 2003/04 is not sustainable. The Government has had to threaten capping in 2004/05.
4. However, while there have been many criticisms of council tax, some have more resonance than others with council taxpayers. Concerns about buoyancy, regressivity and the balance of funding, whilst valid, are mainly concerns expressed by local government and academic opinion. There is not the same degree of perceived (and visible) unfairness in the council tax system as there was under the rates or the poll tax.
5. The two main public concerns are (1) the impact of council tax on those groups which are income poor/property rich, or non-owner occupiers (hence the pensioner revolts we have seen) combined with (2) the increasing gap between growth in council tax bills and the growth in people's earnings/incomes. In so far as we have reached the limit of acceptability in relation to council tax, it is more likely that this limit relates to the growth in council tax rather than its absolute level. Continued council tax increases which matched (rather than outstripped) earnings growth might prove acceptable.
6. The Local Government Act 2003 requires revaluation of council tax. This will be reflected in council tax bills in 2007/08 but the process begins in 2005 and we may need to consult on banding options as early as Spring 2005 or at the latest Autumn 2005 depending on whether automatic valuation is feasible. Even with reform of the council tax system, revaluation will create large numbers of winners and losers. Some of the biggest losers will be among those on relatively low incomes in London



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and the South East because house prices in these areas have increased faster than other parts of the country since 1991.



**B. STRATEGIC CHOICES**

7. The Strategy Unit report on the future of local government set out the arguments for a new relationship between central and local government which would underpin the revitalisation of local democracy and the delivery of improved local services.
8. ODPM is taking forward these wider issues, building on the Strategy Unit report, in the context of its own work to develop a strategy for local government. An initial document on the strategy is being circulated to colleagues during February. The ODPM paper for GL is likely to ask how far Ministers wish to give local authorities more scope to raise funds locally and, if so, how. It will also ask how important is equalisation - i.e how far are we prepared to see greater local discretion over resources and service levels / standards at the cost of greater disparities between areas.
9. These issues are covered in the discussion below which addresses the three key strategic choices which were highlighted in the Strategy Unit report as being of particular relevance to developing an appropriate finance system:
  - the scope of local government services
  - the extent of equalisation
  - the degree of discretion over finances
10. Each of these issues is discussed in turn.

**The scope of local government services**

11. The Strategy Unit report raises the issue of the scope of local government. One of its "design principles" is that the extent of local authorities' responsibilities and their powers and resources should be more closely aligned. In particular, it highlights the future of schools funding as a strategic issue with major implications for the whole local government finance system. DfES are doing separate work on this issue, but broad options from the local government finance viewpoint seem to be as follows:

***(i) Local Funding Role***

- Schools would be funded through the local government finance system as now, and local authorities would have some discretion over the amount of schools spending in their areas and how this was distributed among schools. There would be no change to the balance of funding.



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- This option seems to be the one most compatible with a positive local government strategy. It is certainly the one local authorities themselves would favour. Nor does it necessarily represent the status quo. There are many possible variations on the basic model and the government could have some control either via outputs (national floor standards and/or agreed local aspirational targets) or to some extent via inputs, but in principle this approach would involve accepting some degree of local decision-making both about the overall level of schools funding in a particular area and how this overall quantum was distributed, subject to delivery of national standards.

### ***(ii) Ring-fenced funding for schools***

- All current schools spending would be converted into a DfES grant paid to local authorities and ring-fenced for schools. In practice, £22.2 billion (the 2003/04 spending figure) of RSG would be transferred to DfES. There would be no change to the balance of funding. Council tax bills would remain unchanged.
- This would mean that local authorities would have no discretion over how much to spend on schools. However, they could be left with some discretion over how to divide the funding up between schools; or this could be taken away by a national schools funding formula.
- The new ring-fenced grant would increase the ring fencing percentage (as in 2003/04) from 13% to 54%. Most of local government would be opposed to such a change. By reducing councils' flexibility the ring-fencing could increase the pressure on council tax.
- In order to continue to use the current local government finance system to equalise resources between authorities we would need to merge the distribution of RSG and business rates (something we said at the time of the Local Government Bill we would not do).

### ***(iii) Ring fenced funding for secondary schools only***

- Similar to (ii) but the effects would be smaller; about £10 billion would transfer from RSG to a ring fenced grant. Ring fencing would be about 30%. It is just possible that, as with option (2), we would need to merge the distribution of RSG and business rates (something we said at the time of the Local Government Bill we would not do).

### ***(iv) Direct grant funding of all or some schools***

- Schools funding would be taken away from local authorities altogether; schools would be funded direct by DfES or an agency. £22.2 billion of RSG would transfer to DfES to fund this. The balance of funding for remaining local authority services would change to about 40% raised locally. Council tax bills would remain unchanged, paying for 40% of the present level of services.
- As with other options, we would need to merge the distribution of RSG and business rates.



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- Similarly, a variant involving *direct grant funding of secondary schools only* would be possible. That would change the balance of funding to about 30% raised locally.
- Local government would be completely hostile to either option.

### The extent of equalisation

12. Local authorities in England have very different tax bases and also very different needs and costs. The present local government finance system aims to iron out these differences through the payment of central government grant in the process called "equalisation". In fact, the system in England goes to greater lengths to provide a fair allocation of funding to each local authority than any other in the world.
13. As the Strategy Unit report explains, there is headroom within the system for redistributing resource from central to local government that results in a "vertical" transfer of resources from the centre that exceeds what is needed to achieve equalisation. The amount represented by this vertical transfer from the centre could instead be raised locally without reducing equalisation.
14. Moving to a more progressive tax system would mean a greater disparity between rich and poor areas. So central government would need to pay more grant to maintain current levels of equity. An alternative would be to require the rich authorities to subsidise the poor ones. Both options would have an impact on the flexibility provided by the new system, for both poor authorities (who would have a weaker tax base) and for rich authorities (for whom equalisation would reduce the effective increase in resources received from any given level of local taxation). However, without significant loss of equity, there could be scope to allow councils to retain some of the benefit of growth in local tax bases building on the existing, proposed Local Authority Business Growth Incentives scheme (involving limited retention of business rates).

### Increasing local authorities' funding discretion

15. Currently local government raises only about 25% of its expenditure through local taxation with the rest made up through grants from central government (including redistributed business rates). Local government is pressing for greater autonomy - not least to reduce the "gearing" problem whereby at present a 1% increase in a local authority's budget above the level assumed in the local government settlement requires on average a 4% increase in council tax. (The Balance of Funding Review, chaired by the Minister for Local and Regional Government, is looking at this.)
16. The Strategy Unit report on local government outlined clear benefits from increasing the level of local revenue raising. These include: increased autonomy and accountability for local tax and spending decisions, and greater local government scope to define and deliver against its objectives.



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Arguably, it will be hard to deliver a strong and vibrant local government without a significant increase in local revenue raising.

17. It is important to bear in mind that consideration of options for local government finance has a real bearing on any medium term tax raising strategy for higher spending on key local services such as schools and police. Should central government take (almost) total responsibility for this, or would it be better to create a local tax base that would allow more of this revenue to be raised locally?
18. The case for enabling a greater degree of local funding does not depend on a prior decision that the balance of funding must be changed. It would be quite possible to give local authorities some powers to supplement council tax simply to create a buoyant tax base that would make it easier to pay for higher spending on services even if that meant little or no change in the balance of funding. If the main objective is simply greater buoyancy, that could be provided, for example, by giving authorities an assigned share of national income tax as a supplement to council tax but without any power to vary the income tax rate. That could be presented as a shift in the balance of funding. If the main objective is to increase flexibility, that could be achieved by giving local authorities a limited power to vary the national income tax in their areas and to benefit from the revenues thus raised. But in that case there would be little change in the balance of funding.

### Reform of council tax

19. Council tax is under significant pressure because of recent increases. Some have suggested that it be abolished. However, compared with the poll tax, council tax has been widely understood generally accepted (at least until this year when the effect of very large increases has been felt, and has in turn led at least some to question some of the underlying principles of the tax, as well as the increases themselves). Obvious benefits are that:
  - it is an existing tax under the control of local government;
  - the basic principles are easy to understand;
  - it is easy to collect;
  - the yield is easy to predict.
20. As recent research for the Balance of Funding Review has shown, in other European countries property tax has historically been the primary form of local tax - found in 23 of the 25 Council of Europe countries (all but Sweden and Malta). The basis of the tax varies; it can be on buildings and / or land. However, within Europe, only the UK and Ireland rely on property tax as the **only** local tax.



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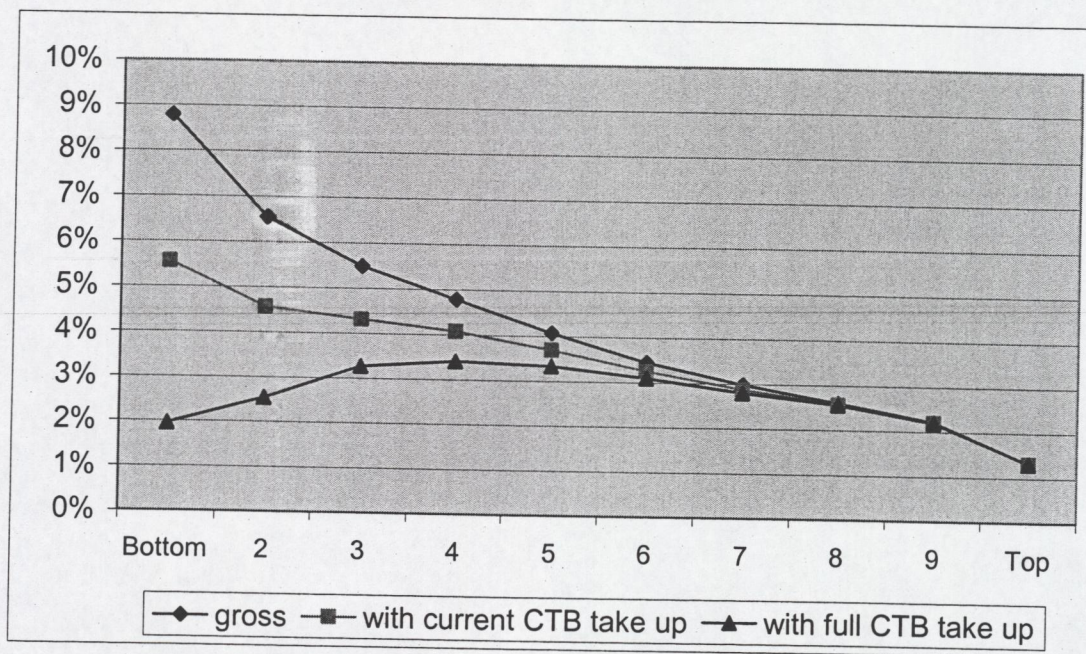
21. Given these advantages, and the fact that complete replacement will be extremely disruptive with large numbers of winners and losers, we assume that Ministers do not wish to abolish council tax altogether. However, it is clear that council tax is having to raise a significant amount of extra revenue compared to when it was introduced - since 1993/94 tax bills have increased by 94% in cash terms and 50.5% in real terms (which is more than three times the rate of inflation, nearly double the increase in average earnings and 30% more than the increase in grant). Part of the reason why these increases are so visible and painful is that council tax is not a buoyant tax (the tax yield does not increase with property values, as council tax remains calculated on 1991 values).
22. As noted above, the pace of increase has become faster in recent years – in 2003/04 council rises averaged 12.9%, leading to the Government's threats of capping in 2004/05 – which has brought the issue firmly into the public eye.
23. These rises cause even greater problems that they might otherwise do because council tax is regressive to income, and therefore in terms of the proportion of income taken hits harder those on low incomes (particularly those on low incomes living in higher valued homes) than those on higher incomes. Those people in the lowest income decile pay on average (excluding the effect of council tax benefit) 9% of gross income (i.e. before tax) in council tax before council tax benefit is taken into account, whereas those in the top decile pay only a little more than 1% - *see chart below*.
24. This comes about because of two related reasons:
  - Firstly, council tax is only indirectly, and weakly, related to income. It is based on the value of the property in which one lives and property values do not correlate exactly with incomes.
  - Secondly, the structure of council tax means that it is regressive to property value – while the ratio between property values in the top and bottom bands is at least 8 to 1, the ratio between the amounts of tax payable is only 3 to 1.
25. This does ignore the fact that Council Tax Benefit exists to tackle precisely this problem. However, low levels of take-up reduce its impact, and mean that, at current levels, the overall effect of council tax is still regressive to income, as shown by the chart below. Full take up would reduce regressivity significantly, but not remove it. Take-up is particularly low amongst owner-occupiers and pensioners. DWP have in hand a number of measures to improve take up. In particular, from 1 April 2004 they are abolishing the restriction which limits the maximum Council Tax Benefit for people in council tax bands F, G and H. They are also considering an interesting proposal from Help the Aged and the New Policy Institute that CTB should be replaced by a system for assessing a household's maximum liability to council tax as part of the tax system. This could have major attractions in terms of improved transparency and ease and efficiency of administration as well as removing the perceived means test stigma. If we were able to transform CTB into what would in effect be a



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council tax credit which was easier to collect, this would go a long way to addressing the concerns of pensioners on low or fixed incomes living in high value properties or facing high increases in their CT bill – a major source of the perceived unfairness of council tax.

### Council tax burden as a percentage of gross income at 2003-04 rates for each income decile



26. In addition, the forthcoming revaluation could intensify current problems with the tax structure. The Local Government Act 2003 requires revaluation of properties based on 1 April 2005 values to take effect on 1 April 2007. This will mean that the tax is more closely related to actual property values. This is likely to cause problems because house prices in the South have risen faster than house prices in the North in the period since properties were valued for council tax in 1991 – so revaluation will change the relative tax bases, and therefore the levels of grant provided to, of the different parts of the country. (We cannot say exactly what the position will be at April 2005 as the market will continue to change between now and then.) One key feature here is that there is a big difference in the proportion of properties in the different council tax bands in each region. In the North East, 86% of all properties are in Bands A to C (with almost 60% in Band A - 82% in the case of Easington) whereas in London the figure is only 44%. So revaluation will have very different effects in different regions. It will tend to increase the gearing problem in poorer areas. It will also mean increases in individual bills for large numbers of council taxpayers in London and the South East, hitting many of those on low or fixed incomes in high value properties (although improve take-up of CTB would help here), as well as many Band C taxpayers – in many cases, key workers.



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27. This suggests that:

- some reform will be required to manage the effects of revaluation;
- although revaluation will automatically alter the balance of funding for some authorities because of increases / decreases in the tax bases of some authorities, it would be difficult to use council tax to effect a significant shift in the balance of funding at national level. Doing so would create unacceptable losses for poor households including many pensioners, even though there would be a commensurate cut in national taxation.

28. **Annex A** sets out six illustrative options for revaluation of council tax and reform with an indication of the winners and losers in each case. All options produce many winners and losers although these vary between options. (However, the analysis provides indicative trends only as it is based on 2001/02 property values. There have been changes in the housing market that may alter the impact of revaluation / reform. We will be re-running the analysis with more up-to-date information in the spring. )

29. These options are:

1. baseline - a straight revaluation position where the existing structure is maintained;
2. moderate restructuring of bands;
3. as for 2, but with a change in band ratios to give a more progressive structure;
4. one possible regional option, based on Government Office boundaries, with a straight revaluation. The tax take is kept constant in each region but there are no other changes;
5. a regional option where the tax take is kept constant in each region and there is a minimum restructuring of bands as for option 2;
6. a regional option where the tax take is kept constant in each region and there is a more progressive restructuring as for option 3.

30. The analysis considers for each option:

- estimated proportions of properties moving up and down bands, by current band, by region, and by class of authority;
- estimated changes in council tax bill, by region;
- the estimated proportion of gross income spent on council tax for each income decile;
- the impact of Band C properties in London and the South East to attempt to give a feel for the impact on key workers.

31. With Option 1, 56% of properties would stay in the same band, 28% would move down and 16% would move up. Revaluation could adversely affect households on low or fixed incomes living in high value properties as their



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council tax liability could rise significantly. And there would be significant regional shifts in council tax liability between regions if the current regional disparity in house price rises since 1991 were to continue. For example, in London 36% of properties would have council tax bills rising by over 5% and about 7% of properties would have bills rising by more than 30%. In the North East only 2% would have an increase of over 15%.

32. Options 2-6 show how council tax could be restructured to make it more progressive by adding bands, changing the ratios between bands and / or adopting a regional approach to restructuring. Option 2 would remove the most glaring inequities by adding more bands at the top and bottom of the structure. However, it would create more winners and losers in those bands. Option 3 would create even more turbulence, but have surprisingly little effect on progressivity in terms of council tax liability as a proportion of gross income. Options 4 - 6 would reduce the distributional impacts of revaluation between regions. The advantages would be that they would soften the effects of revaluation in London and the South East where on average house prices have been higher. However, there would also be disadvantages.. There would also be "cliff edge" problems at regional boundaries - properties of the same value would appear in different bands. (It should however be noted that cliff edges are a feature of the current system - with Band D council taxpayers paying different levels of council tax depending on where they live.)
33. The advantage of options 4 and 5 is that they soften the impact of revaluation on London and the South. However, the disadvantage of both these options (but particularly option 6) is that they create additional losers in the North.
34. All the options beyond straightforward revaluation are worth considering. They would not make much impact on regressivity of council tax liability in relation to gross income and would increase the numbers of properties moving up one or more bands. Nor, even with a commensurate significant reduction in national tax, are they likely to make council tax an acceptable means of raising more local funding.
35. A transitional process would be essential. It is too early to suggest how this would work, but in principle it would be possible to phase in increases due to revaluation and reform over, say, 5 or even 10 years. For example, for a property which had a total increase in its bill of £800 because of revaluation, the annual increase would be about £160 if phased in over 5 years and about £80 if phased in over 10 years. In a similar way, any reductions in bills due to revaluation could also be phased in over a period of years, to 'pay for' the phasing in of any rises.
36. It would also be possible to make council tax more buoyant. This would require the tax base to be tied more closely to house price movements - assuming that they would increase year on year. That would require regular e.g. annual updating of the tax base which is technically not possible at the moment but might be possible in the short to medium term. The Local Government Act 2003 currently includes provision for 10 yearly



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revaluations of properties. Other radical modifications to the tax would also be needed to make it buoyant, e.g. taxing a percentage of house value rather than using bands – again, this might be possible in the medium term, depending in the first instance on the success of the automated valuation method currently being tested by the VOA.

### Supplementing council tax

37. Given the difficulty of raising more money locally through council tax (either to enable local taxation to meet an increased requirement for revenue or as a way of changing the balance of funding and boosting local flexibility and accountability), we need to consider other possible sources of local funding. The main alternatives are capped local income tax or re-localisation of the business rates.

### ***Capped local income tax***

38. A capped local income tax seems feasible, though with substantial political, presentational and technical challenges. More detail on capped local income tax is given in **Annex B**. (This paper has been prepared by officials and does not necessarily reflect Treasury Ministers' views.)
39. This paper assumes that a capped local income tax would **complement** (rather than replace) council tax. There are two options for such a tax:
- An assigned tax, which would involve hypothecating a proportion of national income tax receipts to local authorities, presumably on the basis of the amount collected in their areas, without the ability to vary the rate.
  - A capped variable tax, which would involve giving local authorities the power to vary the rate of tax, subject to a cap, and to keep the extra revenues.
40. The two could also be combined, with authorities given a certain amount of assigned revenue and a degree of variable power.
41. There are a number of technical and practical issues which affect the parameters of such a tax. The paper looks at a number of these, and suggests that:
- A capped local income tax, if pursued, should only apply to the basic, or the basic and higher rates of income tax. Fairness would suggest that it should cover both the basic and higher rates, but applying it to the higher rate would make a local income tax inconsistent with the Scottish Variable Rate (which only applies to the basic rate) and therefore would lead to pressure to make changes to the devolution settlement.
  - There are two options for collecting the tax – either requiring all taxpayers to submit a tax return, or making modifications to the existing Pay As You Earn system (which is how the Scottish Variable Rate would operate if it was used). A modified PAYE would be simpler to



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implement, substantially cheaper (£100m set-up and £25m per annum ongoing costs, compared with £1bn in ongoing costs alone for a tax return model), and impose fewer burdens on taxpayers. It would, however, impose additional burdens on employers. There is an issue about how one would tax income from savings and dividends, which might pose accountability and fairness issues, particularly with regard to self employed individuals who incorporate as businesses.

- There would need to be a limit on the size of either the assigned amount or the variable power. The limit would need to be about 3p if all tiers of local government are included or just under 5.5p if only the upper tier is given revenues from and power over a local income tax. However, given that the Scottish Variable Rate only gives power over 3p, we would probably want to restrict it to that even if only upper tier authorities were given power over a capped local income tax.
  - It would probably be most sensible to restrict to upper tier authorities in any case, given that this would make the tax simpler to operate and restrict power to the authorities with the largest budgets and biggest public service priorities.
  - Income tax is a progressive tax, which means that raising extra revenue through a capped local income tax will be "fairer" than council tax – a significant benefit. However, this also means that the tax base of a capped local income tax would vary more between authorities than the council tax base currently does. With a variable tax, it will be easier for authorities in richer areas to raise additional revenues than for those in poorer areas to a greater extent that is currently the case. Decisions on how a capped local income tax interacts with the equalisation system will be of critical importance, as they will alter the degree of flexibility it provides.
42. Both forms of capped local income tax would give local authorities a buoyant income stream, though one which is less predictable than council tax (as variations in the national economy affect the yield of the tax).
43. Either option could deliver a significant increase in the average amount of locally raised funding with an assigned tax, or a variable tax used to its full, depending on which local authorities were given powers to receive revenues. The maximum possible change is from 25% to 36% (if 3p of basic rate income tax belonged to local authorities) or to 45% (if 5.5p of basic rate income tax belonged to upper tier authorities only).
44. Overall, an assigned tax seems to have relatively little to recommend it. Although it would be much simpler to implement, would alter the overall balance of funding, and could give local authorities some additional buoyancy, it seems unlikely that it would have much impact on local accountability or flexibility.
45. A variable tax, on the other hand, would also boost local accountability and flexibility – it would be a perceptible local tax, and its greater revenue raising potential would reduce gearing and thus provide better signals about increases in spending.



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46. However, if local authorities can point to inadequate central funding and pressure for delivery as the reason for increases in local income tax, then there is a risk that this option would not deliver an increase in local accountability. In such a situation central government would still be seen as the primary driver behind increases in local taxation, rather than local decisions.
47. The introduction of a capped local income tax as a tool for additional revenue raising would take some pressure off council tax. However, there are too many variables to indicate how much pressure or for how long (including the size of future pressures from central government). Initial work suggests that even if local authority revenue needs rose considerably (8.5% per year) and yield from council tax (including tax base growth) rose by only 3.2% per year, a capped local income tax would, in aggregate, be able to supply the additional revenue needs for at least 8 years before reaching its cap (3p in the £ basic rate, a total of £9.6 bn - though this should rise over time, given the buoyancy of income tax). Of course, tax increases such as this would still be highly visible to taxpayers and extremely contentious.
48. A capped local income tax would be more progressive than council tax. It would make local tax raising distributionally fairer, benefiting pensioners and non-working households at the expense of working households. Indeed many people (e.g. two thirds of pensioners) would not pay at all - which in itself raises accountability concerns.
49. There may be a case for having local referendums to allow the authority powers to vary the tax rate. This might limit local turbulence over the introduction of what may be seen as a new additional Government tax.
50. If a capped local income tax were pursued, we would need to consider the implications for Scotland and Wales. It is likely that local authorities in those countries would seek similar local tax powers.
51. There are also serious implications for national manifesto commitments on income tax. If local authorities could increase rates of income tax locally, central government would find it almost impossible to make promises or win arguments about not increasing income tax levels, as it would not have sole control over the rate of income tax. And clearly a local income tax would appear to many as a new tax, adding to their tax burden.

### *Re-localising business rates*

52. **Annex C** discusses the pros and cons of re-localising the business rates. This would certainly be feasible as the rates were localised until 1990. The main advantage would be:
- a major shift in the balance of funding to about 45% local.
53. Its main disadvantages would be:
- extremely unequal distribution effects which would raise equalisation issues;



## RESTRICTED - POLICY

- lack of accountability as businesses cannot vote;
- different rates in different areas;
- hard for business to predict future rates levels;
- strong opposition from the business community.

54. There may be scope for limited local retention of rates building on the Government's Local Authority Business Growth Incentives scheme. That would provide more non-ring-fenced local funding and help to foster local partnerships, but would have little effect on the balance of funding.
55. In recent years the proportion of local government revenue expenditure funded by business rates has varied, but is lower now (22% in 2003/04 than ten years ago (28% in 1993/94), whereas the proportion funded by council tax has increased from 21% to 26% over the same period. One possible way to redress this growing imbalance might be to change the law so that increases in business rates were no longer restricted to RPI increases but were linked either to an increased formula (e.g. RPI + 1%), to increases in rateable values, or to some other less restrictive cap. This will need further thought and analysis. Depending on the formula used, it might be less strongly resisted by business than re-localisation.

### ***Smaller charges / taxes***

56. A range of possible smaller local charges and taxes are discussed in **Annex D**. These would not deliver a major shift in the balance of funding, but they may be worth pursuing in their own right or as part of a wider reform package. However, many are regressive and might be seen as "stealth taxes".

### ***A possible combination option***

57. The Local Government Association has recently published a paper suggesting the way forward may be a combination of a reformed council tax with a variety of other revenue sources. For illustrative purposes, **Annex E** explores the overall effect of one such option combining a reformed council tax with assigned national taxes, business rates with something other than the current RPI cap, and a new tax on takeaway food.



### **C. ILLUSTRATIVE SCENARIOS FOR REFORM**

58. This is difficult territory. There is no single package that would deliver all the objectives that Ministers might wish to pursue for local government and the local government funding system. However, decisions are needed on council tax given the current problems and the imminence of revaluation. Ministers may also wish to change schools funding. Some illustrative scenarios are set out below.

#### **Scenario I: Reformed council tax supplemented by capped local income tax**

##### ***What it would look like***

- The scope of the Local Government Finance Settlement remains as now (i.e. schools remain locally funded).
- Capped local income tax is introduced and could be used to introduce more buoyancy and / or to shift the balance of funding.
- Council tax is revalued and is regionally banded.

##### ***Rationale for choosing this option***

- We wish to implement a finance system that underpins a strong and autonomous local government.
- Schools remain a service shared between local and national government.
- We accept that we cannot manage distributional effects of revaluation **and** build a sustainable structure of council tax that will be robust to expected future rises.
- Capped local income tax can take the strain of future increases in local revenue raising.
- Therefore we can reform council tax through regional banding to minimise the distributional impact of revaluation without worrying too much about regressivity because income tax will become the source of future local tax rises.

##### ***Benefits***

- Supports the delivery of the wider local government agenda.
- Local Government can increase its contribution to local services (particularly schools).
- Reduced risk of future unsustainable council tax rises.



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### ***Risks***

- Winners and losers from introduction of capped local income tax.
- Even if capped local income tax were to change the balance of funding from 75:25 to nearer 50:50, there would still be arguments about who is to blame for local tax increases. Capped local income tax could make those arguments even more potent.
- Winners/ losers from council tax reform/ revaluation (often the same as those affected by capped local income tax).
- Possible administrative and political risks in running two local taxes. (However, this seems to work in other countries.)

### **Scenario II: Status quo with continued reliance on a reformed council tax**

#### ***What it would look like***

- The scope of the Local Government Finance Settlement remains as now (i.e. schools remain locally funded).
- A reformed council tax is the sole local tax. The balance of funding is unchanged (on average only 25% or so raised locally). Council tax continues to bear the whole weight of budget increases above the level assumed in the Settlement.

#### ***Rationale for choosing this option***

- Ministers decide not to introduce a capped local income tax.
- Schools remain a service that is shared between central and local government.
- We can adequately reform council tax to manage revaluation **and** we expect future council tax increases to be tolerable.

#### ***Benefits***

- Low structural change – no introduction of a large and controversial local tax.
- Local government remains with a familiar and well understood tax.

#### ***Risks***

- This will compromise the wider local government agenda: it is unlikely that we will be able to support a strong and vibrant local government with this finance system.
- Without continuing capping or increased grant or decreased pressure on delivery future increases in council tax could be high because



## **RESTRICTED - POLICY**

council tax remains the only local tax and the "gearing" effect magnifies increases.

- We probably cannot increase the progressivity of council tax significantly. Even if we can, this will have a high distributional impact post-revaluation on those on low incomes in expensive houses. If we wish to manage revaluation through regional banding, then council tax may not be robust to expected future increases.
- Local government is unlikely to be able to contribute more to key local services with council tax as its only lever.

### **Scenario III: Reduced local scope – direct funding of secondary schools**

#### ***What it would look like***

- Secondary schools are directly funded from the centre.
- Primary schools remain locally funded.
- Reliance on a reformed council tax as the sole local tax for the remaining local government services
- A variant is that we introduce a supplementary capped local income tax.

#### ***Rationale for choosing this option***

- Secondary schools are appropriately funded by the centre, but the transitional arrangements for direct funding of primary schools are too complex.
- Removing secondary school funding from local government will not change the balance of funding significantly and so will do nothing significant to increase local financial autonomy.
- If we still want to support autonomous/ strong local government, we need to introduce a capped local income tax to supplement a reformed council tax.

#### ***Benefits***

- Greater clarity for secondary schools.
- It is possible to define a strong financially autonomous local government in this framework with the introduction of a LIT. [However, we are unlikely to want to do so given the long term strategy will be to remove primary funding.]

#### ***Risks***

- Local government in an ambiguous position regarding primary schools and children's services.



## **RESTRICTED - POLICY**

- Direct funding would be likely to produce winners and losers at school level, which would be politically difficult.
- Reducing local government's scope would compromise the Government's commitment to enhancing the role of local government.
- Council tax would remain the only local tax – therefore we have the same issues regarding reform as outlined in the previous option.
- Given central government funding of secondary schools, local government is unlikely to contribute to future increases in spending on secondary schools.
- It could be politically hard to introduce a capped local income tax at the same time as secondary schools funding is removed from local government.
- If schools are taken out, there is a risk that there will be even more hostility from local taxpayers towards large council tax bills.

### **Scenario IV: Reduced local scope – direct funding of all schools**

#### ***What it would look like***

- Direct funding of primary and secondary schools.
- Reliance on a reformed council tax as the sole local tax.

#### ***Rationale for choosing this option***

- We want to define a local government with greater autonomy over non-school services.
- Schools are a fully national service – responsibilities and risks are most appropriately with the centre.
- Minimum structural change in local government finance - no risk of introducing a new local tax.

#### ***Benefits***

- Clarity on school funding.
- Clear separation between central and local government responsibility.
- Some limited, but increased, local discretion over remaining services

#### ***Risks***

- Reducing local government's scope would be incompatible with the Government's commitment to enhancing the role of local government.
- The resulting increase in the proportion of revenue raised locally will not be enough to deliver a high degree of local financial autonomy.



## **RESTRICTED - POLICY**

- Without access to a buoyant and progressive tax base local government will have difficulty defining and delivering its own objectives (above floor standards).
- Council tax could still be under some pressure

**ODPM**

**February 2004**





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Headline : (with pics)<

# 'BLAIR AND BROWN MUST TELL TRUTH ON TAX RISES' - TORIES<

By John Deane, Chief Political Correspondent, PA News<

The Tories challenged Tony Blair and Gordon Brown today to "come clean" over the tax increases which they predict would follow a third New Labour general election victory.<

Shadow chancellor Oliver Letwin argued that, in total, the tax burden has risen by £5,000 per year per household since Labour came to power in 1997.< He equated that to the cost of a new kitchen or a two-week holiday for a family of four in Florida.<

Mr Letwin arrived at the figure by dividing the increase in net taxes and social security contributions between 1996/97 and 2003/04 - which he put at £127.9 billion - and dividing it by the approximately 25.2 million households in Great Britain and Northern Ireland.<

Launching his challenge at Conservative Central Office in Westminster, Mr Letwin used the backdrop of a house front made up of £10 and £5 notes to illustrate his point.<

Mr Letwin said that despite 60 tax increases since New Labour came to power, the Government had yet to achieve "real reform and improvements in our public services".<

In addition, he argued, Chancellor Gordon Brown was still on course to preside over a major deficit in the public finances.<

Mr Letwin said that respected, independent audit organisations were suggesting that the "black hole" in the nation's finances could require Mr Brown to raise taxes by £10 billion to £17 billion.<

The objective of the Tories' spending plans, unveiled by Mr Letwin last month was, he said, to avoid the need for such increases.<

He added that if black hole was not "too big", then an incoming Tory government might have scope for tax cuts.<

Mr Letwin said: "Before New Labour came to power, Tony Blair promised he had 'no plans to increase tax at all'."<

"Since 1997, Labour have increased taxes 60 times. Two terms of Labour government have seen annual taxes rise by £5,000 per household. That is more than enough to pay for a new kitchen or a two-week holiday for a family of four in Florida each year.<

"I challenge Tony Blair and Gordon Brown to come clean and say whether they will fill the black hole with yet more tax increases if they win a third term."<

Aides to Mr Letwin acknowledged that his calculations were based on total taxation, including business taxes.<

But they argued that corporation tax and business rates account for only 12% of the total tax take, and even if they were excluded the £5,000 figure would be little affected.<

In any case, they argued, one way or another even business taxes impact on individuals' incomes eventually.<

Today's challenge is intended to be the first in a series of Tory events designed to put the issue of tax squarely at the centre of political debate in the months leading up to the next general election.<

mfl

*David H. 11/4*

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# INVESTING TO MEET THE UK PRODUCTIVITY CHALLENGE

CBI INPUT INTO THE SPRING 2004 BUDGET

of next wce 2/3  
BF: 9/3/04

## EXECUTIVE SUMMARY

The CBI supports the government's aim to improve the UK's underlying productivity performance, and believes that tax policies can have an important bearing on that objective. Targeted tax incentives, such recent changes for R&D, SMEs and entrepreneurs, can play a valuable role and we urge the government to carry forward that agenda. But if the UK's productive potential is to be fully realised, tax policy *as a whole* must be shaped with that goal in mind.

This report sets out a framework for tax policy which we believe will allow UK productivity to thrive. Targeted tax incentives have their place, but so too do other policy strands: straightforward, across-the-board reductions in rates of general business tax; changes to counter more generous tax treatment overseas; changes to remove anomalies within the UK tax system; and a presumption against tax change in the first place unless there is a strong case.

Given the importance to productivity performance of investment and enterprise, we suggest that business taxation should respect the need for: (i) a high level of profitability, after all taxes and costs; (ii) a business climate that is competitive internationally; (iii) neutrality and simplicity; and (iv) stability and certainty.

This means that business costs should not be pushed up any further by policy action, including in the areas of local authority, environmental and transport taxation amongst other things. And, for the medium term, government should commit to rolling back the general business tax burden.

Specific changes to business tax should take place when, but only when, they are needed to:

- Offset identified barriers to efficient growth ('market failures'). Further improvements to the R&D tax credit, and a package of measures specifically benefiting SMEs, are warranted.
- Take account of tax treatment overseas, at sectoral as well as national level. Fundamental reviews should be set up covering 'green' taxes, transport taxes and excise duties.
- Remove anomalies within the UK tax system. The whole rationale for taxing business property purchases, share transactions, and business insurance needs to be re-examined. North Sea taxation, aviation taxes and certain aspects of VAT also warrant attention.

In addition, general taxation should respect the need for: (i) a climate fostering saving; and (ii) a total, economy-wide burden which is not excessive, thereby blunting incentives.

We set out the clear case for improved fiscal incentives for savings and investment vehicles, in addition to the pensions tax simplification project. And we argue that the total, economy-wide tax burden must not be increased any further. Given the state of the public finances, this in turn makes it all the more important to improve the efficiency and effectiveness of public spending.

*The CBI is the national body which represents the views of the UK-based business community to the UK government and to other authorities in the UK, Europe and elsewhere. It is an independent, non-party political organisation funded entirely by its members in industry and commerce. With a direct corporate membership employing over four million and a trade association membership representing over six million of the workforce the CBI is the premier organisation speaking for business in the UK.*



## CBI BUDGET PROPOSALS 2004

Ultimate objective - maximise UK productivity (but not at expense of employment)

<u>Interim objective</u>	<u>Measures to avoid</u>	<u>Affordable changes for this Budget</u>	<u>Desirable goals for the medium-term</u>
<b>Business taxes</b>			
A general business tax burden low enough to ensure adequate profitability, taking into account the situation in competitor economies. (Future profits provide the incentive for investment and enterprise; past profits often provide the funds to reinvest.)	Any further rise in business taxation or tax compliance costs. (We have specific concerns in the local authority finance, 'green' and transport tax areas, and with aspects of corporation tax reform.)	Pursue 'deregulation' initiative.	Commitment to roll back the business tax burden, including through across-the-board reductions in rates of general business taxation. Reductions in taxes adding to the cost base would be especially productive.
A tax system shaped to counter 'market failures' resulting in barriers to productivity growth. (This can be taken to include the cash flow constraints facing small businesses.)		Further extension of the R&D tax credit. Reliefs for investors in SQCs and further improvements in special SME allowances.	
A tax system shaped to take into account the situation in competitor economies, at the sectoral as well as overall level.		Widen access to climate levy discount agreements.	<i>Need reviews of:</i> - Transport taxation - 'Green' taxation - Excise duties - Aspects of VAT (eg tourism).
A tax system which is otherwise 'neutral', taxing all activities and expenditures equally and not penalising specific activities without justification. (This will foster the most efficient allocation and use of resources.)		Remove anomalies within the corporation tax system which hinder SME activities: - treatment of associated companies; - treatment of equity fund-raising costs. Modify stamp duty land tax on commercial property: do not charge on VAT element.	<i>Need reviews of:</i> - Stamp duty land tax on business property - Stamp duty on shares - Tax on business insurance - Aviation taxation (replace APD) - Aspects of VAT (eg property). <i>Also case for:</i> - Return of extra North Sea revenues to the sector.
A tax system which is relatively stable, fostering business certainty and minimising the costs associated with having to adapt to tax change.	Any change in business tax unless prior consultation has shown clear benefit.		
<b>General taxes</b>			
A tax system which avoids penalising savings and investments.		Push ahead with pensions tax simplification.	Need to address bias against saving built in to the tax and benefit system, with increased incentives for employer and employee pension provision. Push ahead with real estate investment trusts.
An overall, economy-wide tax burden which is not so high as to stifle incentives for work, enterprise and the building up of wealth in productive assets.	Any further rise in the overall, economy-wide burden. (This year: need to avoid personal as well as business tax rises, to avoid pushing recovery off course.)		



Source: Mail on Sunday (Financial Mail)

Date: 29 February 2004

Page: 11

*cc JPM*

TREASURY CHIEF TO FACE QUIZ OVER INLAND REVENUE REFORM

# MPs in a rage as Whitehall drags its feet

By Dan Atkinson

GUS O'Donnell, the Treasury's top mandarin, will be summoned before MPs to explain a delay of nearly three months in unveiling his overhaul of the tax services, Financial Mail has learned.

He will face suggestions, flatly denied by the Treasury, that a Whitehall turf war involving the 'British FBI' has held up publication of the reform proposals, originally planned for December and now expected in late March.

O'Donnell's 'favoured option' is a merger of the Inland Revenue and Customs & Excise, cutting about 12 per cent of the joint 100,000-strong workforce and simplifying the collection of business taxes.

The crime-fighting wing of Customs is to join Home Secretary David Blunkett's planned Serious Organised Crime Agency. This transfer and the question of how the new tax service will work with Soca are said to have triggered infighting between the Treasury and the Home Office, notably

over who will have primary responsibility for investigating tobacco and alcohol smuggling.

The Treasury admitted O'Donnell's report had been delayed. A spokesman said: 'We have had to take account of the impact of Soca and other changes, but there is no question of a turf war. The creation of Soca is largely a parallel process.'

Not all members of the Treasury Select Committee are satisfied. Conservative MP David Ruffley said: 'I fear this inexcusable delay might have something to do with a row between Gordon Brown and David Blunkett. If true, the creation of this merged tax service has all the makings of a disaster.'

Once O'Donnell's report is published, the backbench Treasury Select Committee will summon him for detailed questioning on these and other issues.

Another bone of contention is likely to be the proposal to bring management of the merged service under direct Treasury control. O'Donnell's review was

launched last July after both services were involved in a string of fiascos. Revenue chairman Sir Nicholas Montagu and Customs chairman Sir Richard Broadbent, who are both leaving, have been under fire over a sale-and-lease-back deal on hundreds of properties with Mapeley Steps, a company based in a tax haven.

The Revenue was also criticised over the bungled launch last April of tax credits to millions of families and its failure for six years to send reminders to 200,000 people to top up their state pensions.

» John McFall, committee chairman, is preparing to recall High Street bank bosses after saying he was concerned they had not made enough progress towards clear information and fairness for credit card customers.

He has written to the Association for Payment Clearing Services, which represents leading card issuers, complaining that committee recommendations had yet to be implemented.



# Ordinary houses, big IHT bills: Revenue gets tough

Inheritance tax reforms will make it harder to shield assets, says **Simon Hildrey**

**T**housands of people will be denied the chance to minimise the inheritance tax (IHT) bill on their homes by the Inland Revenue's closure of a number of loopholes. To make matters worse, existing schemes could be affected as the Revenue wants to impose income tax retrospectively.

IHT is a growing problem for homeowners in the UK because it is charged at 40 per cent on estates in excess of £255,000. Given that the average house price in London is now £244,600, many beneficiaries have to pay the tax since a person owning a home of this value needs to have just £10,400 in savings for their estate to be caught in the IHT net.

IHT is lucrative for the Government: it is estimated that the amount collected by the Revenue has doubled over the past 10 years to £2.4bn. The number of people paying IHT has gone up by 55 per cent since 1998.

The Revenue's attempts to stop parents minimising the IHT their children will pay after their deaths are being introduced in several stages, starting in June 2003 with the closing of the loophole known as the Eversden scheme. This had allowed people to protect their homes and other assets from death duties while still enjoying the benefits of them.

And, since last December, capital gains tax (CGT) holdover relief has no longer been available for gifts to so-called "settlor interested trusts". A settlor is the person

who sets up a trust, and the trust is regarded as settlor interested if the settlor or his or her spouse benefits from assets held in it.

This change will hit a range of tax planning schemes relying on gifts to trusts under which settlors or their spouses can continue to enjoy the use of an asset such as a house. From now on, they will not be able to use holdover relief to avoid paying CGT when the home is taken out of their estate and put into a trust.

Settlors can avoid CGT if the property is their main home, since they are allowed to claim principal private residence relief (PPR). But the Revenue made another change from 10 December so that CGT cannot be avoided both when the house is placed in a trust and when it is subsequently sold. A settlor can either claim PPR to avoid CGT when the house is put into the trust, or pay the tax up front so that beneficiaries don't have to pay it later on.

The second stage of the Revenue's attack comes in its proposed income tax charge. The consultation period ended earlier this month.

Under current IHT anti-avoidance rules, which date from 1986 and concern what are known as "gifts with reservation", you cannot make a gift for IHT purposes unless you no longer benefit from what has been given away. If it is your home, you should either move out or pay a market rent to continue to occupy the property. In the case of rented property, you can no longer re-

ceive the income.

The Revenue proposes to block IHT schemes that get round the "gifts with reservation" rules by imposing an annual income tax on assets such as a house that you have put in trust, unless you are paying a market rent.

Robert Ham of the Society of Trust and Estate Practitioners says that the Revenue plans to levy income tax on the deemed benefit in kind of the home from April 2005. For example, if your house is worth £500,000 and has an annual rental value of £25,000, you will either have to pay the trust the full market rent or pay tax on the benefit – equal to £10,000 a year for a higher-rate taxpayer. In effect, although you are not renting out the property, you are being taxed on the income you would have received had you done so.

This proposal has been criticised by tax advisers because it is retrospective and will apply to existing IHT schemes.

"Thousands of homeowners have placed their properties in trust to pass their estate intact to their families," says Mr Ham.

The Revenue has suggested that settlors will be able to dismantle schemes to avoid paying retrospective income tax, but this presents problems. The home has been given to a trust and no longer belongs to the settlor. The trustees have a duty to act in the interests of beneficiaries, which is unlikely to involve handing the house back to the settlor.

Tax advisers argue these

rule changes mean there is little if anything you can now do to reduce the IHT bill on your home. If you have IHT planning in place, Chris Shepard, senior trust manager at Smith & Williamson, the professional and financial services group, recommends you sit tight and wait for the outcome of the current consultation process on pre-owned assets.

Paul Knox, director of Ernst & Young Private Client Services, says the rule changes underline the need to be cautious about the use of your home in tax planning. "We generally take the view that the family home is the last thing you involve in tax planning. For most people, it's their most important asset, and there must be a doubt whether they should give it away to a trust."

Margaret Jago, specialist tax manager at Scottish Equitable, warns that the consultation paper on taxing pre-owned assets could have far-reaching effects. "This could catch schemes beyond home loans," she says. "The consultation paper talks about capital assets, but this could mean anything."

Indeed, trusts have already been attacked with an increase in the income and capital gains tax they will pay from 6 April 2004. This will be raised from 34 to 40 per cent and the corresponding dividend trust rate from 25 to 32.5 per cent, reducing the amount of income that can be distributed to beneficiaries.



To; Prime Minister

From: Geoff Mulgan

cc JPo, Sally Morgan, Ivan Rogers, David Hill

20 February 2004



**Fat taxes – mea culpa**

You will have seen some media coverage over the last few days of a 'fat tax' proposal. This resulted from an SU paper on personal responsibility which you saw before Christmas, and which was discussed at a seminar with people from inside and outside government. The paper has been fairly widely circulated.

The paper included a short paragraph which very unwisely suggested that 'there might even be a case for' some taxation of fatty foods, referring to ideas floated by the BMA last year. This was picked up by the Times and, predictably, amplified into a firm proposal.

We immediately ruled it out, and made clear that it wasn't a proposal, wasn't government policy, and wasn't seen as either desirable or feasible. But once the cat is out of the bag there is no way to put it back in.

This is entirely my responsibility. I had read over the report but failed to spot this particular sentence buried on page 55. If I had spotted it I would of course have taken it out.





HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

The Rt Hon Gerald Kaufman MP  
House of Commons  
London  
SW1A 0AA

17 February 2004

Dear Gerald,

I understand that you have expressed concerns about the anti-avoidance measures announced on 10 February as they affect the film industry.

I am very willing to meet with you to discuss this as the Minister responsible for tax and the Finance Bill. It may help if I provide some background to the changes.

Firstly, I would stress that the specific tax reliefs available for British qualifying films are still in place and available to film-makers. The measures we introduced last week are necessary to counter a general abuse of the loss reliefs available to individuals who carry on a trade in partnership. Unfortunately, some film-makers were attracted aggressive tax planning schemes because they offered them more money than the film reliefs.





In many cases film-makers they used both the aggressive schemes and film reliefs. Typically, such a scheme would be used to fund about 30% of the film's budget. These schemes provide investors with tax relief in excess of their capital invested by manipulating both stock valuation and the allocation of profits and losses. Film tax relief would then be accessed via a sale and leaseback to gain a further 15% of budget.

Many in the film industry believe that the additional funding available through the schemes has led to inflated budgets and a number of commercially unviable films being made, primarily as vehicles to allow individuals to access tax relief.

This state of affairs is extremely disappointing, to say the least, given previous abuses of the film reliefs that required correction in FA2002. I gave a very clear warning in debate that any further abuses would not be tolerated.

The Film Council and the industry representative bodies have supported the action the Government has taken to shut off the abuse. The concerns expressed to me are solely about the date from which the measures take effect.

It is quite normal for anti-avoidance measures to be announced with immediate effect. In this case the measures apply to those individuals who are in one of the "film partnerships" that fund the film and will apply only to expenditure incurred on or after 10 February 2004. A partner will have incurred expenditure before that date to the extent that he or she





has contributed money to the partnership and that money has been contractually committed by the partnership.

In practice this means that a film will not be affected if the funding by the partnership was fully contracted by 10 February. This should be the case with all films in production on that date. However, it may not be the case with films in pre-production on that date because the production company may not have had its funding contractually in place, despite having committed expenditure. This is the area where the Film Council and others are looking for clarification and we are evaluating their proposals.

The necessary action we have taken should in no way be taken as a sign that the Government has weakened its support for the British film industry. This Government has been extremely supportive of the industry, primarily but by no means exclusively, through the very generous tax reliefs available and that support will continue.

As you know, the Chancellor announced in the Pre-Budget Report that outcome of discussions with the industry about a successor to the main relief for low budget films, which is due to expire in 2005, will be announced in the Budget. That announcement will be unaffected by recent events and will further demonstrate our commitment to the future of the British film industry.

*Yours ever,*  
*Dawn*

**Dawn Primarolo**



# Carillion rides out trains loss in style

BUYING into construction and engineering company Carillion may not sound like a smart move to anyone who has kept track of the railway industry in recent months. But behind some apparently disastrous headlines for Carillion, the company has established a sound footing for growth.

The bad news came last autumn when Network Rail declared it was cancelling all maintenance contracts with outside firms. Carillion lost a raft of business at a stroke and its shares slumped. The contract loss is expected to see profits in its rail business fall by £7 million in 2004 and a further £15 million in 2005.

But this is only a fraction of the Carillion story and in almost every other field of its operations, the group is in a

strong position – strong enough to more than offset losing the rail work.

Its full-year results, due on March 10, will show profits in 2003 just above 2002's £50 million. Chief executive John McDonough expects profits to rise by at least five per cent this year, and the City believes him. Analysts forecast earnings of up to £55 million in 2004 and £60 million in 2005. This means the shares, which are now 172½p, are trading at about ten times forecast earnings – far from excessive.

Carillion is able confidently to forecast this profit growth because its other maintenance and construction businesses are doing well. Only last week, the group announced it had won an £84 million contract to maintain roads in Warwickshire.

Adding extra strength are Carillion's raft of investments in Public Private Partnerships. Its stakes in existing projects are now valued at about £115 million – more than twice the sum Carillion invested in them.

This will mean a stream of one-off profits at the group in the future. One example is an £11 million profit Carillion made by selling its stake in Darent Valley Hospital in Dartford, Kent. Some of it is being returned to investors in a special dividend, a policy likely to continue with future sales.

» *Midas verdict: The rail loss dealt Carillion a blow, but the real damage was much less than it first appeared. The rest of the business is on the up and at 172½p the shares are a buy.*



Confident: John McDonough expects profits to rise by at least five per cent this year



Source: Sunday Telegraph

Date: 15 February 2004

Page: 1

# Council tax to be replaced by new levy on incomes

BY COLIN BROWN  
Political Editor

## Government to launch charge based on earnings as well as property values

COUNCIL TAX is to be replaced by a combination of property tax and income tax in an attempt by the Government to defuse growing anger among householders before the next general election.

The plan will be unveiled by Nick Raynsford, the local government minister, within the next few weeks when the interim results of a government review of council tax are published.

One senior minister admitted last night that it would be "madness" for the Government to go into the election without addressing public concerns about council-tax bills, which will rise sharply again in April.

As the new charges loom, John Prescott, the Deputy Prime Minister, is threatening to cap 65 councils for raising taxes above his target of low single figures.

In addition, Hazel Blears, the Home Office minister,

telephoned some police authorities last week to warn them they would have to restrain their spending to avoid pushing up council tax to unacceptable levels. Big increases in the precept levied by Devon and Cornwall police authority led to protests by pensioners last year.

To prevent similar outcries in the run-up to the election – expected next year – Tony Blair will promise in Labour's manifesto to introduce a fairer system of local taxation.

The Prime Minister is anxious to ease some of the mounting anger among homeowners in the South which, he fears, could give the resurgent Conservatives under Michael Howard a pre-election fillip. Mr Blair is also keen to avoid a widespread revolt when properties are revalued in 2007.

"Tony fears that council tax could become another fuel-tax protest unless something radical is done," said one

minister and close ally to the Prime Minister.

The fuel protests brought Britain close to a standstill in autumn 2000, and threatened to bring down the Government.

"It would be madness to go into the election with council tax as it is. It is already unsustainable," the minister added.

Senior ministers have ruled out replacing council tax purely with a local income tax, as advocated by the Liberal Democrats, because many of the wealthiest people could use tax-avoidance measures to escape any charge.

Instead, they intend to devise a mixed system in which householders are charged according to both income and the value of their properties.

"It cannot be solely a property tax, but property valuation will be part of it," said one senior minister. "We recognised that 18 months ago, and we set up a review to look at what share local government should carry and central

government should carry. Even so, we don't think property tax is enough. You have to look at other measures."

Council tax was introduced in 1993 by John Major's Tory government to replace the poll tax, which had provoked riots in London. The council tax is based on property values in 1991 and is levied in eight bands in England – ranging from £40,000 in Band A to £320,000 in Band H.

Stephen Byers, the former cabinet minister who remains close to Mr Blair, will this week float an idea – raised within No 10 – to give Britain's three million pensioners the choice of deferring payment of their council-tax bills until they die.

Under the proposal, they would be allowed to pay with the equity from their homes after their death. This would increase their spending power, but cut the amount they could pass on to their children. A similar scheme

Not true



Source: Independent on Sunday  
Date: 15 February 2004  
Page: 1

# Children to inherit parents' tax bill

By Andy McSmith Political Editor

Children who inherit large sums from the sale of the family home when their parents die could also receive a rather less attractive legacy: their parents' backdated council tax bill.

Stephen Byers, the former cabinet minister who is helping develop policy ideas for Labour's next election manifesto, will float his suggestion in a speech later this week.

Ministers are worried by the increasing number of pensioners who struggle to pay their council tax bills. More than a million have failed to claim the council tax benefit to which they are entitled.

There have already been widespread protests over this year's proposed council tax rises, but the problem could become far worse in 2007, when the next nationwide property valuation is due.

The local government minister, Nick Raynsford, has threatened to force councils to cut spending rather than allow excessive tax increases.

Mr Byers's suggestion is modelled on the deferred payments scheme operated by local councils for elderly people who go into residential care homes.

The patient is given free residential care for life in

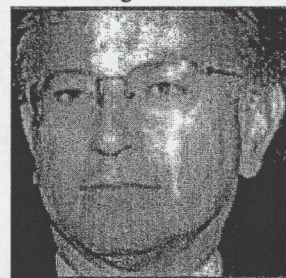
return for signing an agreement for the bill to be paid retrospectively from the sale of the family home.

Mr Byers wants the Treasury to lend the money to pay the council tax bills of "asset-rich, income-poor" pensioners. The loan would be repaid when the properties are sold.

The idea has yet to be agreed by the Chancellor, Gordon Brown. The Deputy Prime Minister, John Prescott, who is in charge of local government, may also think that there are better ways he could use any extra money from the Treasury.

Some heirs may also object

to having to settle council tax bills out of what they regard as their rightful inheritance, but the proposal is in tune with Tony Blair's interest in exploring new ways of financing public services, other than through direct taxes.



Byers: deferred payments

Source: Sunday Telegraph  
Date: 15 February 2004  
Page: 1



applies to deterring the cost social care for the elderly.

Mr Byers will say in a speech: "This will provide all pensioner owner-occupiers with a choice – either to pay the tax as it falls due or to defer payment until the family home is sold or otherwise transferred. Such a scheme is simple, not means-tested and

uses the value of the home as security for the tax liability."

He will say that the Government should subsidise councils for their lost income, until the clawback from the value of the homes can take place. However, a senior Treasury official said: "We know nothing about this scheme."

Mr Prescott is expected to

give short shrift to such initiatives from No 10. One ally of the Deputy Prime Minister said: "This is blue-sky thinking, but it is strictly for the birds. It is going to cost billions. The idea that [Chancellor] Gordon Brown is going to allow more borrowing for that is cloud-cuckoo land. It is just headline-grabbing policies

from a few advisers – not the Prime Minister."

Mr Byers may also anger the Chancellor with other parts of his speech to the New Local Government Network in which he will say the general burden of taxation is too high.



**Local government** » Pensioners should be allowed to 'bequeath' council tax liability to their children, says leading Blair ally

# OAPs 'should pass tax bills on to heirs'

By Andy McSmith  
Political Editor

Pensioners faced with large council tax bills should be allowed to pass the problem on to their heirs by borrowing the money as a charge against their homes, a leading ally of Tony Blair will propose this week.

Stephen Byers, the former secretary of state for transport and local government, believes that pensioners living in valuable homes should be allowed to pay no council tax at all, making the bills a charge on their property.

Speaking to the New Local Government Network conference on Thursday, Mr Byers is due to say: "A deferred-payment scheme would provide all pensioner owner-occupiers with a choice – either to pay the tax as it falls due or to defer payment until the family home is sold or otherwise transferred.

"Such a scheme is simple, not means-tested and uses the value of the home as security for the tax liability."

The scheme would bring immediate relief to hundreds of thousands of "asset-rich,

cash-poor" pensioners, who are being sent bills for four-figure sums to be paid out of small, fixed incomes.

But it is likely to receive a cool reception from the Chancellor, Gordon Brown, because the Treasury would have to lend local councils the money they are not collecting from pensioners and recover it years later.

It would also deliver an unwelcome shock to sons and daughters waiting to inherit the proceeds from the sale of their parents' house and who find a huge council tax bill attached. The Government has acknowledged that there are serious problems in the council tax system – invented in a hurry by the Conservatives after the fall of Margaret Thatcher as a means of replacing the hated poll tax.

One of the biggest is the 1.25 million pensioners who are entitled to council tax benefit but are not claiming. This may be because many are put off by the stigma of receiving state benefit, or they may be deterred by the complex 24-page form that they have to

fill in.

The Office of the Deputy Prime Minister is now looking at ways of simplifying the system, so that it is easier to claim and is seen as a rebate rather than a state handout.

The tax was devised in a way which has ensured that the amount which businesses contribute to the costs of local government has fallen relative to the bills sent to householders, although businesses have continued to use council services.

Facing the threat of a widespread pensioners' revolt when this year's council tax bills arrive, the local government minister, Nick Raynsford, has sent warning letters to more than 60 councils, threatening to force any councils that are planning unreasonable council tax increases to cut spending instead.

The public has begun to see council tax bills as a form of "stealth tax" for which the Labour Party is held responsible. But Mr Raynsford has persistently claimed that Conservative-

and Liberal Democrat-run councils are the worst offenders. He said last week that the increases proposed by Labour councils average less than 5.5 per cent.

An even bigger problem looming on the horizon, however, is the nationwide property revaluation due in 2007, the first for 15 years, which could lead to huge increases for householders in parts of the country where house prices have risen disproportionately.

The Government is so worried by the prospect of what could ensue from the revaluation that ministers are thinking of ending the present system under which there is one "banding" system for the whole of England, replacing it with regional bands.

Under the present system, houses valued at less than £40,000 when the council tax was first introduced are in the lowest band, band A, and those that were then worth more than £320,000 are in the top band, band H. The figures apply throughout England.





10 DOWNING STREET  
LONDON SW1A 2AA  
020 7930 4433

File  
Copy in DCO inbox

22 December 2003

Dear Jon,

### TAX DECISIONS BY THE ECJ

/ As you know, the impact of recent ECJ decisions affecting tax was raised by the CBI in Digby Jones' letter to the Prime Minister of 14 November. I enclose a copy of his letter and of the Prime Minister's reply.

John Cridland raised the issue with me again when he called last week. It is clear that this issue is rising up the CBI's agenda.

I know you have discussed the issue with partners with, as I understand it, only limited buy-in from them so far. I would welcome a chance to talk to you in the new year about how we handle this. I imagine we will hear more about it in public than we have hitherto.

I am copying this letter to John Grant (UKRep Brussels) and Ivan Rogers here.

Yours ever,

J S WALL

Jon Cunliffe CB  
HM Treasury

SM





10 DOWNING STREET

LONDON SW1A 2AA

020 7930 4433

24 November 2003

THE PRIME MINISTER

Dear Sir,

Thank you once again for your welcome and hospitality at the CBI conference last week.

Thank you also for your letter of 14 November on the CBI's views on the draft EU constitutional Treaty. It was helpful to get your input on the negotiations before our meeting and we covered some of the issues at lunch.

As I said in my speech on Monday, I do believe that we must update the way Europe's institutions work, and that is why I support a new constitution for the EU. But there is no question of us ceding our red lines or agreeing to anything that would be damaging for this country. I would like to address your points one by one.

On the subsidiarity protocol, you say that business wants to see the "yellow card" strengthened to a "red card", requiring a unanimous vote in Council to proceed with a dossier which is opposed by a third of national Parliaments. I agree that, in an ideal world, that would be desirable. Nevertheless, the draft Treaty already says that where one third of national Parliaments object to a Commission proposal on grounds of subsidiarity, the Commission shall "maintain, amend or withdraw" it. One third of national

net



Parliaments in practice means one third of Governments, which translates into a blocking minority in the Council. In other words, the essential political safeguard is already there.

Second, you mention business' concern about the impact of incorporating the Charter into the Treaty. In the Convention we negotiated changes to the Charter to make it clear that its provisions only affect Member States when they are implementing EU law. Additional changes make clearer that the Charter "does not extend the field of application of Union law beyond the powers of the Union or establish any new power or task for the Union" (Article II-51). And the official Charter Explanations establish that the rights contained in the Charter are drawn from existing laws. I would simply not sign up to incorporating the Charter if that meant, for example, overturning our industrial relations settlement.

You say that unanimity on social policy is "vital to British business given the distinctiveness of our labour market". I agree. That is why we successfully negotiated unanimity for social policy in the Convention.

You argue for decisions on tax and social security to remain at unanimity. As you know, this Government is publicly committed to this position via our manifesto commitment on tax. I have made clear to our partners this is a deal-breaker for us. Nevertheless I am confident that we are winning round a significant number of allies, particularly in accession countries. Retaining unanimity will allow us to block proposals to harmonise taxes that we think will damage competitiveness. Our approach to (for example) the savings tax dossier shows that we are serious about this.



On the so-called Passarelle Clause, I will not agree to anything that undermines Parliament's role in approving changes to the Treaties.

I accept your real concern over ECJ activism "eroding national sovereignty on tax matters" and "dismantling of tax regimes". But we need to be realistic about what we can achieve in the IGC. Many Member States continue to favour more harmonisation of taxes. We are fighting hard to retain our veto on legislative proposals in this area. Frankly speaking, proposing that the Treaty should carve out tax systems from basic freedoms would not be negotiable in this IGC. It would also open a path to protectionism by other Member States: I do not believe that UK interests' are best served, in general, by weakening the four freedoms of the Single Market. I do believe, however, that Member States need to consider more how to address the issue within the Treaty framework. For example, the Council may need to "bless" standard practises, such as those approved by the OECD, so encouraging the ECJ to take decisions balancing Treaty objectives with the need for coherent tax systems.

You say that the Treaty must make clear that only the Council is empowered to agree rules constraining national budget deficits. I agree. Ecofin Ministers reached consensus on this point which we and others are now pressing the Presidency strongly to take on board. I also agree that decisions on the EU's (Own Resources) budget should require unanimous approval by the Member States. Again, Ecofin Ministers have collectively agreed this line and UK and other Member States are lobbying the Presidency hard to ensure this consensus amongst Governments is reflected in the final text.



You say that the energy provisions give the Commission new powers in areas that could "disproportionately damage British interests" and "our ability to control our own energy resources". We are looking carefully at the Convention text. Article 157(2)) already says that EU action "shall not affect a Member State's choice between different energy sources and the general structure of its energy supply". Energy liberalisation has been good for UK business and consumers. We need to ensure that other Member States are not able to row back on hard-won commitments to liberalisation. But we will ensure that we preserve our essential interests.

I am aware of the strong feelings in the business community about the risk of a financial sector regulator being created by QMV. I agree that this is an issue of major national importance and we strongly oppose it. Ecofin Ministers agreed by consensus that the offending article - allowing ECB to take on regulatory responsibilities - must remain at unanimity. Again, we are pursuing this forcefully with the Presidency, as are other Member States, to ensure that this consensus is reflected in the final Treaty.

On external matters, legal personality for the EU and the creation of a Foreign Representative do not undermine Member States' freedom to act on the international stage. The key is to ensure that unanimity remains the general rule in foreign policy and that the Foreign Representative is answerable to the Council. In this way, no changes can be made to our position in international fora without our consent. We will not agree to anything on foreign direct investment that would weaken the unanimity lock on taxation.



I look forward to staying in touch as we approach the difficult endgame in these negotiations.

Yours truly,  
\_\_\_\_\_  
Tony

Mr Digby Jones



020 7395 8009

**NATIONAL2003  
CONFERENCE**16-18 November 2003  
The ICC, Birmingham

www.cbi.org.uk/conference2003

**CBI**  
THE VOICE OF BUSINESS

91712

14 November 2003

The Rt Hon Tony Blair MP  
Prime Minister  
10 Downing Street  
London  
SW1A 2AA

Dear Prime Minister,

I am writing to set out the CBI's views on the draft Constitutional Treaty for the European Union. We do, of course, recognise how hard the Government has worked, and is working, on the Treaty, but this is a matter of major concern to British business and there are a number of changes which we believe must be achieved before the Treaty is acceptable to business.

We need to strengthen Europe's competitiveness in global markets, for the benefit both of the UK and the Union as a whole. We had to fight too hard even to get competitiveness included in the Union's objectives. There is little new in the Treaty to boost wealth creation in Europe, some proposals that will actively hamper it and nothing to add to competitive advantage in a globalised economy.

We are encouraged by the protocol to give national parliaments a role in commenting on legislative proposals. This should help to improve the relevance and effectiveness of new EU legislation. Business wants to see this 'yellow card' strengthened to a 'red card', requiring a unanimous vote in Council to proceed with a dossier which is opposed by a third of National Parliaments.

The CBI continues to have strong reservations about the inclusion of the Charter of Fundamental Rights in the Constitutional Treaty because of the risk of the European Court of Justice (ECJ) reinterpreting British employee relations law, a key plank of the UK's competitive European and global position. We recognise the efforts of your Government to try and limit the effect of the Charter. However, in the absence of seeing the detailed legal opinion from Government Law Officers on this matter, the CBI continues to advocate that the Charter should not become legally binding.

Business accepts the need for qualified majority voting in many areas in order to make decision making in the enlarged Union effective, but there are two particular areas where unanimous voting must be maintained. These are tax and social policy.



INVESTOR IN PEOPLE

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The CBI believes in tax competition between Member States. This is central to Britain's competitive position and our attractiveness for business investment. We also believe it is central to improving Europe's competitiveness within the global economy. Moreover, tax decisions are a basic democratic choice, only to be exercised at the national level. Unanimity on remaining areas of social policy is also vital to British business given the distinctiveness of our labour market. Any move from this would be unacceptable to the CBI.

The two 'passarelle' clauses will fundamentally change the nature of the Treaty from that of a fixed document outlining the areas where European action is permitted, to a flexible one where change to the parameters of the EU can be made without the necessary and proper parliamentary oversight. These clauses must be removed if the Inter-Governmental Conference (IGC) is to meet its commitment to make the work of the EU's institutions clear and open.

Our national sovereignty on taxation is already being eroded by the decisions of the ECJ in its interpretation of the basic freedoms in the Treaty. The inclusion of transfer pricing in the current corporation tax reform consultation is just one result. The IGC provides the last opportunity for the foreseeable future for Member States to review the position. We firmly believe that the UK and fellow Member States must decide whether they are content to allow the ECJ to continue this dismantling of their tax regimes or whether they want to circumscribe its activities, for instance by including binding guidance to the Court in the new Treaty.

On the co-ordination of Member State economic policies, the Treaty must make it clear that only the Council of Ministers is empowered to agree to any rules that constrain national budget deficits. It must also make clear that any decisions on the EU's own budget may only be taken with the unanimous agreement of the Member States.

There are then three particular areas of the draft Treaty where the CBI believes that the competitive position of business could be at risk.

The first is energy. The new competence on energy gives the Commission new powers in areas that could disproportionately damage British interests and our ability to control our own energy resources. This risk must be removed.

Secondly, our financial sector members are concerned that the Treaty as it stands could leave open the possibility for the creation of a single financial services regulator by majority vote. Steps must be taken to protect the UK's position as Europe's leading financial centre.

Thirdly, we are concerned that Britain's international position should not be put under risk by the EU's proposed new role in the global arena. The establishment of a legal personality and the creation of a Foreign Representative must not be allowed to impinge on the UK Government's ability to represent business interests in international fora. Our ability to negotiate and sign bilateral investment treaties must be protected.

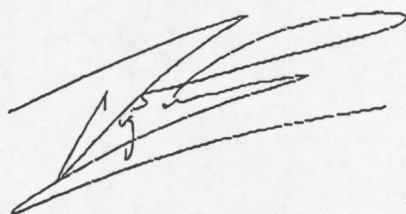


These are the measures by which the CBI and UK business will judge the success of the IGC.

I look forward to applauding a positive outcome for British business, and for the country and for Europe as a whole, from the Government's efforts in these negotiations.

However, of possibly greatest importance, is that Europe's economic success for future generations in a globally competitive environment depends on a positive outcome.

I wish you well

A handwritten signature in dark ink, appearing to be 'Digby Jones', written in a cursive style with several long, sweeping horizontal strokes.

Digby Jones  
Director-General

cc. Rt Hon Gordon Brown  
Rt Hon Jack Straw



**RESTRICTED**

**From:** Alasdair McGowan  
**Date:** 14 November 2003

**PRIME MINISTER**

**Cc:** Jeremy Heywood

**LOCAL INCOME TAX**

**URGENT:** Please find attached a draft of remarks on local income tax which Nick Raynsford wants to make tomorrow (Saturday) at a Devon County Council Conference on council tax. The rest of the speech is basically fine. I have suggested an alternative wording (also attached) but Nick is adamant that he wants to stick to his original wording.

Jeremy and I are both agreed that if Nick uses his wording, it will set all manner of hares running. You have already made it clear that you do not favour replacing council tax with local income tax but have asked for further work to be done privately on the option of LIT as a supplement to council tax (as suggested in the Strategy Unit report on local government).

Nick understandably wants to make clear that the Balance of Funding Review will consider all options. However, I think my form of wording does this. If anything, Nick's form of words will make it obvious that you haven't strictly ruled out the supplement option. The press will then ask you whether you support it, and it will be hard not to then rule it out.

I will speak to Nick Raynsford tomorrow morning (his speech is at 12.30pm) to try and persuade him to adopt our alternative wording or something like it. But if he still refuses, can I tell him that you have seen his proposed wording and are not content? I would be grateful for an urgent steer.

PM's comments relayed  
to Alasdair  
14/11.

Alasdair McGowan → He has to re-phrase it  
so that he says: we  
as a Govt are against it; but,

**ALASDAIR MCGOWAN**

obviously, the Review shd  
look at every trip. As it  
stands, it will be double

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PM:

NICK'S WORKING

Nick Raynsford – speech to Devon CC conference on Council Tax – 15/11/03

the consultation was that people thought that council tax should be made more progressive – in other words, it should reflect more closely peoples' ability to pay and should more accurately reflect variations in property values. There are ways of doing this - for example, through a new banding system – and we will be asking for evidence on this. We may also consider whether any changes need to be made through alterations to the Council Tax Benefit system.

44. The second main issue put to us by consultees was local income tax. There is support in some quarters for raising some local funding from an income tax – which is, of course, related closely to the ability to pay. But much of our tax revenue in the UK already comes from national income tax – so we would need first of all to be very sure of the case for having a local income tax too.

45. The Prime Minister has made clear that he does not favour replacing council tax with local income tax. Such a major change would in any event cause considerable turbulence. There may however be a case for taking more account of people's income than under the current council tax scheme and



**Nick Raynsford – speech to Devon CC conference on Council Tax – 15/11/03**

it might be possible to combine a reformed council tax with an element of local income tax.

46. And if we were to consider the case for an element of local income tax what kind should it be? Would a system where councils set the rate be better, or one where a fixed amount of national income tax was assigned to each council? And one vital question is how much would a local income tax cost local authorities, businesses and the Inland Revenue to administer? The suggestion that has been made by some advocates of local income tax that its administrative costs are minimal are frankly not credible. It is clear that the Review will need to hear a great deal of evidence about this issue.

47. The third issue that was highlighted by the consultation was the re-localisation of the non-domestic – or business – rates. For the last ten years, although local authorities have collected business rates, they have not set the level of rates or kept the proceeds. Central government now sets a national business rate and redistributes the money to areas on a per capita basis. Re-localisation – a return to the pre-1990 system – is not



PM: MY ALTERNATIVE

Nick Raynsford – speech to Devon CC conference on Council Tax – 15/11/03

the consultation was that people thought that council tax should be made more progressive – in other words, it should reflect more closely peoples' ability to pay and should more accurately reflect variations in property values. There are ways of doing this - for example, through a new banding system – and we will be asking for evidence on this. We may also consider whether any changes need to be made through alterations to the Council Tax Benefit system.

44. The second main issue put to us by consultees was local income tax. There is support in some quarters for raising some local funding from an income tax – which is, of course, related closely to the ability to pay. But much of our tax revenue in the UK already comes from national income tax – so we would need first of all to be very sure of the case for having a local income tax too.

45. Some have suggested that there is a case for taking more account of people's income than under the current council tax scheme and that it might be possible, for example, to combine a reformed council tax with an element of local income tax.



**Nick Raynsford – speech to Devon CC conference on Council Tax – 15/11/03**

46. I should point out that the Prime Minister has made it clear <sup>the Government</sup> that ~~he~~ does not favour replacing council tax with local income tax. However, we are certainly prepared to listen to reasoned arguments and the Review will be taking evidence from experts on the pros and cons of these and other options.
47. One vital question, though, is how much would a local income tax cost local authorities, businesses and the Inland Revenue to administer? The suggestion that has been made by some advocates of local income tax that its administrative costs are minimal are frankly not credible. It is clear that the Review will need to hear a great deal of evidence about this issue.
48. The third issue that was highlighted by the consultation was the re-localisation of the non-domestic – or business – rates. For the last ten years, although local authorities have collected business rates, they have not set the level of rates or kept the proceeds. Central government now sets a national business rate and redistributes the money to areas on a per capita basis. Re-localisation – a return to the pre-1990 system – is not something the Government has favoured in the past, but there is strong demand for it from many in local government.



From: Martin Hurst  
Date: 14 November 2003

PRIME MINISTER

cc: Jeremy Heywood  
Alasdair McGowan  
Vicki Bakhshi  
Sally Morgan  
Paul Britton

### COUNCIL TAX: WASTE/RECYCLING

JP's GL letter, based on Paul Britton's detailed suggestions, identified two ways in which Defra should ease burdens on councils:

- a) deferring the introduction of 'trading in landfill allowances' by a year. Since the trading system is aiming to deliver EU targets in 2010, there is no real case for requiring its introduction in 2004. This would save Local Authorities up to £10m in 2004-05 and a little more in subsequent years.
- b) putting back or revising downwards the 25% target for recycling of domestic waste in 2005. This might save LAs up to £40m in 2004-05, and more in 2005-06. But it would require secondary legislation. Michael Meacher would inevitably make mischief, despite the fact that he deferred the target – from 2000 to 2005 – when environment minister! (The Tories had also delayed the target, from 1995 to 2000, under John Gummer.)

Margaret is very unhappy about this – and b) in particular (she has reluctantly bought a)). She feels (with some justification) that **we and Treasury have pushed her very hard on delivery of the target**, and now she is making real progress for the first time we are asking her to take the political flak associated with deferral. She wrote to you on Wednesday in this vein (attached at A).

Jeremy's letter to OGDs on Wednesday therefore gave Margaret a few days grace, by asking for costed options to be worked up with ODPM. The resulting paper is attached at C. Following a conversation with Jeremy, Margaret has written again (attached at B) – her opposition to b) has not diminished and she is now also stressing the political risks with regard to the secondary legislation.

We have also raised the possibility of un-ringfencing a £90m recycling challenge fund. In principle Margaret would find this less painful than changing the targets.



But it would probably have less impact on Council Tax. Bids have already been invited for the fund in 2004-05, the last full year of the scheme – which has proved fairly successful in raising recycling – but money has not been allocated: councils could therefore be given freedom in deciding how to spend it.

The recycling target is actually shorthand for a range of targets across local authorities, which average 25%. An authority starting from a low base might only have to achieve 18%, while one which is already well up with the game might have to achieve over 30%. This has some sense to it, but it means we may be clobbering an authority that has a good record, but can't readily up its game further, while being lenient on a fairly lacklustre performer. Perhaps 20% of authorities will miss their 2005-06 targets.

There are two options for changes to the recycling targets – both of which require the secondary legislation that Margaret wants to avoid:

- 1) delay the targets by a year, but perhaps setting a 'floor target' so that the poor authorities still have to reach 18% in 2005-06 (only saves LAs up to £16m).
- 2) reduce the percentage recycling required for 2005-06. An average target of 19% instead of 25% would save up to £40m in 2004-05, and perhaps more in 2005-06. A figure of 21% would save up to £25m. It should be noted in this context that the ultimate objective remains to get recycling to 30% or (as the SU recommended) above in 2010 – we would not undermine this in any way. If we cut the 2005-06 targets, I would suggest again setting an 18% floor target for the worse authorities (we could even increase the figure a little, giving Margaret something positive to say).

You know much we have pushed other departments to offer savings: just accepting a) would clearly let Margaret off more lightly than her colleagues. **And the LGA place waste pressures high on their hit list.** But she is right about the likely political pressures with the secondary legislation.

**Should we:**

- i) accept Margaret's offer of a) plus removing the ring-fencing from the £90m grant if possible – accepting her argument about the political downside to changing the targets;
- ii) as i) but make it clear that if the ring fencing can't be removed we need changes to the targets?

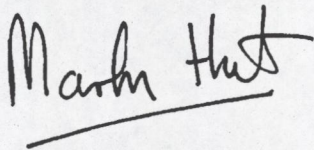


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- 3 -

- iii) continue to push for some changes to the targets: at least option 1) above;
- iv) hold firm for the maximum saving - option 2).

Alasdair would recommend iii) or iv). I would advise at least ii).

A handwritten signature in dark ink, reading "Martin Hurst". The signature is written in a cursive style with a horizontal line underneath the name.

MARTIN HURST

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## PRIME MINISTER

From the Secretary of State  
The Rt Hon Margaret Beckett MP

Dear Tony,

Recently Jeremy Heywood wrote asking departments to identify their priorities and what they would want to be judged by over the next five years.

As you know, waste has long been one of our top five priorities.

I understand that in his capacity as Chair of GL, John has written to you to recommend acceptance in full of the paper proposed to ease pressures on levels of council tax.

The paper has only managed to identify five areas in the whole of Government where it is said we can "ease pressures" on local government, (as opposed to releasing ring-fenced money). Two of those five are waste related measures. (Incidentally, we are the only department, as well as this being the only subject area, where two steps are proposed).

I completely understand both the pressure about council tax and also John's irritation at objections to every proposal that was made. However, I am deeply sceptical about just how much difference to council tax levels the waste proposals would make.

Consequently I asked, (and I thought John had agreed), that our officials should endeavour to quantify the impacts of these two proposals before a decision to proceed was taken. I am not aware that any such work has been done, or even attempted.

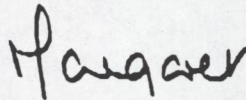


I would be very reluctant to delay the onset of the Landfill Allowance Trading Scheme – not least because we are out to public consultation on it at this very moment.

However, what really alarms me, and what I do press most urgently to have reconsidered, is the prospect of changing the statutory targets for recycling of household waste. We would have to introduce regulations into the House (which would of course be debatable) to abandon them.

Needless to say, the changes would make a mockery of our response to the Strategy Unit report – in the foreword to which you sought a step change in local authority recycling performance – and everything we as ministers have said about the importance of raising our game on sustainable waste management. We would also give a contrary signal to the waste management industry, who tell us that repeatedly that they need clear and consistent signals to promote investment.

I am sorry to have to write to you about this, but I understand that the decision is about to be taken.



MARGARET BECKETT

12 November 2003



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PRIME MINISTER

From the Secretary of State  
The Rt Hon Margaret Beckett MP

### **Council Tax and Waste Targets**

I had intended to pursue this with John (copied to you) but he had already written, recommending two changes on waste, including abandoning statutory targets, which were placed on local authorities by the Waste Strategy 2000.

Since my note to you of Wednesday, the further work on impact I had requested has been done.

Because local authorities will in many cases be tied into contracts, the potential savings on Council Tax is now said to be at an absolute maximum about £3 on a £1,000 Council tax bill.

You will recall that the Waste Strategy 2000 was ruled to be inadequate to meet our EU commitments, and that I was urged to revisit it – a process which culminated in the Strategy Unit report of 2002. So for two years, we have been saying that local authorities must do more on waste.

**Every one of the options now identified and costed requires us to lay debatable regulations.** These are statutory targets.

I repeat that I understand and sympathise with the concern to alleviate Council Tax, but it is still an uphill struggle to convince the waste industry to invest and innovate because they somewhat doubt our commitment. To resile from even our original target for recycling will, politically and practically, be about as negative a signal as we could give.



A debate in the House on this would be extremely difficult.

Robin Healey

(Approved by the Secretary of State &  
Signed in her absence)

pp. MARGARET BECKETT  
14 November 2003



## RESTRICTED: POLICY

### WASTE MANAGEMENT: DEFRA PROPOSALS FOR REDUCING FINANCIAL BURDEN ON LOCAL AUTHORITIES IN 2004/05

1. This paper responds to the request, in Jeremy Heywood's letter of 12 November to David Prout, for ODPM and Defra to "examine as a matter of urgency specific and costed options [in relation to waste recycling targets] ... for reducing the financial burden on local authorities".

2. Current targets are listed in **Annex 1**.

### OPTIONS

3. Cost-saving options cover two areas :

- Landfill Allowance Trading Scheme, and
- Statutory Performance Standards for recycling and composting.

4. The options and resulting maximum and likely potential savings in 2004/5 are summarised in **Table 1** below. The resulting recycling trajectories to 2010 are illustrated in **Table 2** and **Figure 1**.

**Table 1 – Options and potential savings in 2004/05**

Option	Description	Maximum Potential Saving 2004/05 (£m)	Likely Outcome in Range 40-60% £m <sup>1</sup>
1	Delay start of Landfill Allowance Scheme from 2004 to 2005	10	N/A
2	a) Delay application of 2005/06 recycling and composting targets to 2006/07	16	6-10
	b) Delay application of 2005/06 recycling and composting targets to 2006/07 with a minimum of 18% in 2005/06	12	5-7
3	Aim for 2010 Landfill Directive target and national recycling and composting target of 30%, by		
	a) set a new national recycling and composting target for 2005/06 of 21% (assumes straight-line trajectory between 17% national target for 2003/04, and 30% target for 2010; individual targets scaled down accordingly), or	26	10-16
	b) set a new national recycling and composting target for 2005/06 of 19% (assumes back-end loaded trajectory between 2003/04 and 2010; individual targets scaled down accordingly), or	36	14-22
	c) require local authorities at least to maintain recycling and composting at the level of their 2003/04 Statutory Performance Standard (average 17%)	Uncertain, but not less than Option 3b)	Not less than Option 3b)
	d) require local authorities at least to maintain recycling and composting at the level of their 2003/04 Statutory Performance Standard (average 17%) in 2004/05, and meet a minimum of 18% in 2005/06 <sup>2</sup>	Same as 3c) in 2004/05, but will depend on how those affected by 18% minimum for following year react	Same as 3c)

<sup>1</sup> The probability of delivering the full savings is assessed in paragraphs x-y.

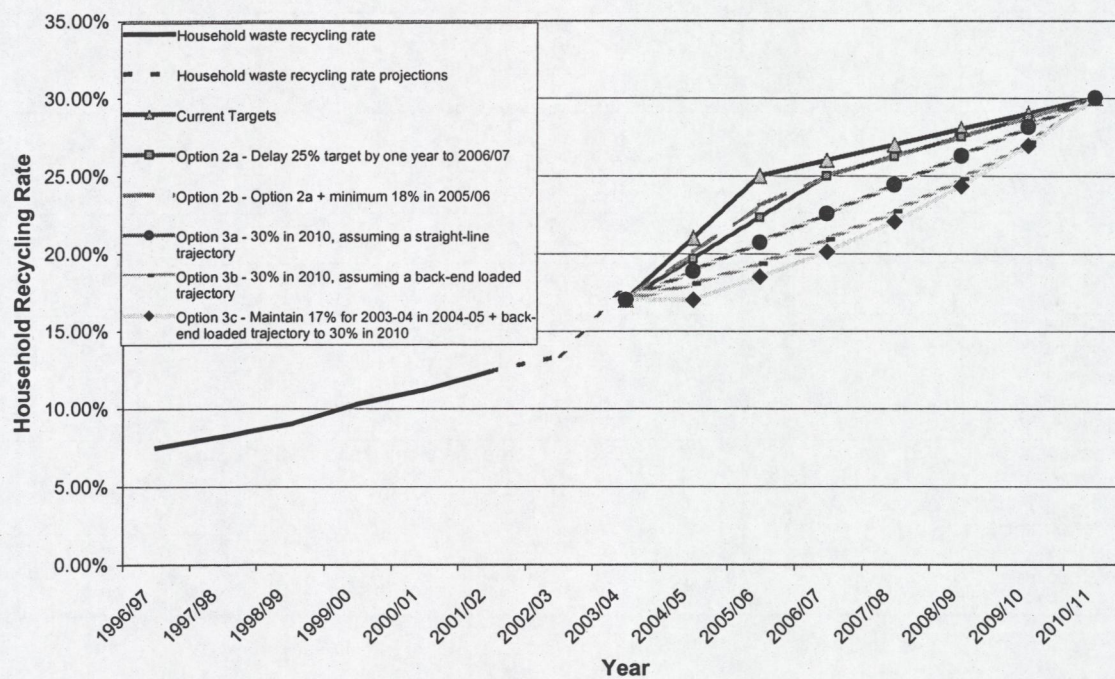
<sup>2</sup> It has not proved possible to model the cost and impact of option 3d) in the time available, because of the level of local authority data required. It therefore does not appear in Tables 2 or 3, or Figure 2.



**Table 2 – recycling rate trajectories under Options 2 and 3**

Option	Description	2003/04 (%)	2004/05 (%)	2005/06 (%)	2006/07 (%)	2007/08 (%)	2008/09 (%)	2009/10 (%)	2010/11 (%)
	Current targets (%)	17	21	25	26	27	28	29	30
2	a) Delay application of 2005/06 recycling and composting targets to 2006/07	17	20	22	25	26	28	29	30
	b) Delay application of 2005/06 recycling and composting targets to 2006/07 with a minimum of 18% in 2005/06	17	20	23	25	26	28	29	30
3	Aim for 2010 Landfill Directive target and national recycling and composting target of 30%, by								
	a) set a new national recycling target of 21% (straight-line)	17	19	21	23	24	26	28	30
	b) set a new national recycling target of 19% (back-end loaded)	17	18	19	21	23	25	27	30
	c) require local authorities at least to maintain 2003/04 Statutory Performance Standard levels for recycling and composting (average 17%)	17	17	17	17	17	17	17	30

**Figure 1 – recycling rate trajectories under Options 2 and 3**





5. Options 2 and 3 must be viewed in the light of the Government's commitment to carry out a full review of its targets for recycling and composting next year, in light of local authorities' performance against their 2003/04 Statutory Performance Standards and where we will need to be in 2010 in order to meet our Landfill Directive target for diversion of biodegradable municipal waste from landfill.

6. The costings have not been discussed with local authorities, but are however based on the Strategy Unit's work to inform its *Waste not, want not* report. The underpinning assumptions and an explanation of each option are given at **Annex 2**.

7. **Table 3** provides a breakdown of the maximum potential savings offered by each option in the years from 2004/05 to 2009/2010.

**Table 3**

Option	Description	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	Total
		(£m max. saving)	(£m max. saving)	(£m max. saving)	(£m max. saving)	(£m max. saving)	(£m max. saving)	(£m max. saving)	
1	Delay start of Landfill Allowance Trading Scheme from 2004 to 2005	0	10	50	36	24	14	0	134 <sup>3</sup>
2	a) Delay application of 2005/06 recycling and composting targets to 2006/07	0	16	30	10	7	4	2	69
	b) Delay application of 2005/06 recycling and composting targets to 2006/07 with a minimum of 18% in 2005/06	0	12	22	10	7	4	2	57
3	Aim for 2010 Landfill Directive target and national recycling and composting target of 30%, by								
	a) set a new national recycling target of 21%	0	26	49	36	25	15	7	158
	b) set a new national recycling target of 19%	0	36	64	53	41	28	15	237
	c) require local authorities at least to maintain 2003/04 Statutory Performance Standard levels for recycling and composting (average 17%) <sup>4</sup>	0	36	64	53	41	28	15	237
	d) require local authorities at least to maintain recycling and composting at the level of their 2003/04 Statutory Performance Standard (average 17%) in 2004/05, and meet a minimum of 18% in 2005/06	0	As Option 3)	Savings somewhere between Options 3a) and 3b)					

<sup>3</sup> Figures differ from those set out in the published draft partial Regulatory Impact Assessment for the Scheme due to refined assumptions and new data.

<sup>4</sup> Option 3c) cannot be costed, because the timing of investment decisions to meet the minimum 30% target in 2010 would be made by local authorities and cannot therefore be predicted/modelled.



## **COUNCIL TAX IMPLICATIONS**

8. A £100m increase in spending by local authorities would increase council tax by ½%. Assuming that there is a delay in the start of the Landfill Allowance Trading Scheme, the reduction in council tax as a result of the above options ranges from 0.05% to 0.25%. A reduction at the top of this range would be significant.

## **CONSEQUENCES**

9. Any action now to rein back the drivers of improved local authority waste management performance, either by delaying the Landfill Allowance Trading Scheme or by changing the recycling and composting targets for 2005/06, increases the risk of failing to meet the 2010 and 2013 Landfill Directive targets and national recycling targets for 2010 and 2015. Fines of up to £0.5m per day could eventually be incurred for breaching Landfill Directive Targets, although it is not yet clear on what basis the European Commission intends fines should apply. National targets are aimed primarily at reducing the environmental and health effects of landfill, including reducing greenhouse gas emissions from landfill to help meet our Kyoto targets, by encouraging waste management activities higher up the waste hierarchy.

10. Moreover, if landfill is reduced on target to 38% and recycling is on target at 30% in 2010, at current rates of incineration (9%) some 23% of waste would either need to be recycled and/or incinerated or treated using new technologies (e.g. anaerobic digestion). This suggests that recycling rates will need to be higher than 30% by 2010 which is why the Strategy Unit recommended 35% in 2010 and 45% in 2015. Action now to hold back recycling activity simply stacks up disposal problems for future years.

11. In practical terms, the impact of relieving the pressure to recycle more will be felt most by unitary authorities and, in two-tier areas, by county councils (because they are required to compensate their collection authorities for any recycling or composting undertaken), rather than by district councils. We understand, however, that the major council tax problem in 2004/05 relates to district councils.

12. Reductions in the rate of recycling growth will lead to increased pressure for incineration or energy from waste. So far, this option has been extremely difficult to deliver on the ground because of local unpopularity. Moreover, lead times for investment to be realised can take six years or more.

## **PROBABILITY OF DELIVERING FULL SAVINGS**

13. The maximum figures in Tables 1 and 3 assume that all of the savings can be delivered. However, local authority spend on waste management in 2004/05 will be driven or constrained by a number of factors, including :

- growth in waste arisings as compared with 2003/04;
- long-term waste management contracts;



- existing long-term plans to meet Landfill Directive targets, including preparations for the start of the Landfill Allowance Trading Scheme;
- Waste Implementation Programme funding and support;
- local PSAs;
- local political considerations.

14. These can be expected to reduce the actual savings delivered by the options outlined above although the precise impact is very difficult to quantify.

#### Waste arisings

15. All local authorities will have to collect and dispose of the projected 2.9% increase in waste arisings over 2003/04 levels<sup>5</sup>.

#### Contracts

16. The vast majority of authorities are already legally bound to contracts for the delivery of their waste services in which the recycling and composting element will have been linked to the existing statutory performance standards. It is likely that authorities will find it very difficult to alter those contracts and claw back investment with just over three months to go before the start of 2004/05. Where the community sector delivers the service, any such withdrawal could cause the organisation to go bankrupt. (The community sector delivers 10 – 15% of recycling services at present).

17. By April 2004, approaching 10% of England's municipal waste will be covered by PFI contracts, from which it would not be possible to make any savings in 2004/05.

18. It is possible that authorities whose waste services are provided through a Direct Service Organisation may find it easier to vary their contracts and make savings in 2004/05.

19. Poorly performing authorities are less likely to have long-term plans for investment in recycling and composting to meet future targets. They are therefore less likely to be tied into contracts, and can be much more flexible about investment in 2004/05. However as they will be recycling and composting less in the first place, they will have less to save and in the longer term will have more catching up to do if they relax now.

20. Authorities may be able to make savings by deciding not to proceed with further investment in new infrastructure on which decisions have not yet been made. In particular, this is likely to cover those authorities which do not already collect dry and biodegradable materials, or who do so on a small scale.

#### Landfill Allowance Trading Scheme

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<sup>5</sup> Strategy Unit projection



21. Waste disposal authorities know that they will be required to comply with the Landfill Allowance Trading Scheme in the years up to and beyond 2010. Regardless of the year in which that Scheme starts, the so-called target years are fixed in EU law. High-performing authorities are already gearing up to ensure they meet their 2010 target and to ensure that they can make the most of the Scheme by trading surplus Allowances, particularly in the early years<sup>6</sup>. Such authorities will already have a long-term investment plan in place, and may well decide not to change it in 2004/05 given that the longer-term goals will not have changed, and investing now is for them the most cost-effective option.

#### Waste Implementation Programme

22. The savings do not take account of the grant funding and support available through the Waste Implementation Programme, which will reduce spending pressures on recycling.

#### Existing Local PSA targets

23. A third of upper-tier authorities (51) have agreed LPSAs based on achieving a significant stretch against their 2005/06 Statutory Performance Standard. Unless each of these targets was re-negotiated (something which Defra and ODPM would be keen to avoid) spend in those local authorities would still be driven by the higher target. Options 2a) and b), which involve delaying rather than re-setting targets for 2005/06, are likely to give rise to least pressure to re-negotiate targets. But the implications for existing and future Local PSA targets can be discussed by GL (P) as necessary.

#### Local political considerations

24. Recycling services are very popular among householders and the higher performing authorities set considerable store on their performance on waste. Members may therefore be reluctant to cut back on services or reverse decisions already taken on further investment.

#### Summary

25. In the short time available, it has not been possible to quantify with any accuracy the extent to which local authorities will react to a relaxation in their Statutory Performance Standards by cutting back on existing services and refraining from investing in new services. But, particularly given the contractual constraints outlined above, we estimate that only around 40-60% of the potential savings could actually be delivered.

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<sup>6</sup> As initial Allowances under the Scheme will be based on the most recent year's data for amount landfilled by each local authority (2003/04 for a start year of 2005). Therefore any diversion in 2004/05 will lead directly to surplus allowances in the first year of the Scheme's operation.



## PRESENTATIONAL AND PRACTICAL IMPLICATIONS

26. All of the options set out above will have presentational and practical implications, and will need careful handling to ensure that the damage to the Government's credibility is minimised and that the significance of the long-term Landfill Directive targets is not undermined.

27. During the passage of the Waste and Emissions Trading Bill, the Government was repeatedly called upon to give assurances that it sees sustainable waste management as a priority, and has done so. Making changes now would call into question the Government's credibility on waste. We will certainly be challenged if we introduce regulations into the House in order to make changes to the Statutory Performance Standards.

28. Aside from any investment decisions, local authorities will cease believing that the Government is seriously committed to sustainable waste management and their level of commitment to achieving the Landfill Directive targets will reduce accordingly. The profile of waste in budget setting will be reduced and, undoubtedly, they will take their feet off the accelerator in the short term. This will make improvements in the longer term, particularly in meeting the very challenging 2013 Landfill Directive targets much more difficult to secure.

29. The waste management industry has long complained that they are unable to make long-term investment in a climate of fluctuating targets. The banks are not prepared to support them in such circumstances, given the generally low levels of profitability and relatively high risks. This risks upsetting investment in infrastructure and new technologies needed for the longer term.

30. The increase in recycling and composting necessary if we are to achieve our Landfill Directive targets can only be sustained with the development of the markets for recyclates. Development of the market is driven in large part by a commitment to targets, which guarantees a certain level of supply. Lower targets or no targets for the short term will reduce certainty and therefore inhibit market development.

31. In public perception terms, the focus on recycling is a winner – it is popular, everyone can contribute, it is easy to measure and understand, and the outcome is meaningful. It is a tangible demonstration of the Government's commitment to environmental issues. A relaxation of the targets will undermine our credibility at a time when many householders and NGOs are pressing for more, not less, recycling. If authorities choose to make savings by withdrawing existing recycling services, this not only risks criticism of government but would make it more difficult to re-introduce them at a later date, as public confidence in the authority's policies would be much reduced.

32. We are on the point of submitting the UK's response to the European Commission's communication "Towards a thematic strategy on the prevention and recycling of waste". The European Commission, European Parliament and member



states can be expected to interpret any relaxation of targets now as an example of the UK reining back on its commitments. This will not only undermine the impact of the UK response but will weaken our influence on the development of future European policy on waste at a critical time.

## CONCLUSION

33. Defra hopes that it will not prove necessary to offer up savings beyond the £10m associated with delaying the Landfill Allowance Trading Scheme by one year. However, should it be necessary to do so, given the risks of completely destabilising significant progress in local authorities' understanding of the significance of the waste management challenge, Defra would favour options which do not undermine the Government's central message. Of those options set out in Table 1, Option 2b) meets this objective best by maintaining the pressure on low performers while recognising that, given all the other pressures on local authorities, those which are already performing well on recycling may wish to defer reaching their 2005/06 target by a year. One additional possibility to offer maximum encouragement to low performers to raise their game would be to lay a particular emphasis on adoption of a waste recycling target as part of their second generation Local PSA.

34. ODPM's priority, on the other hand, is to send a clear signal to local authorities that the Government is doing its best to minimise spending pressures in 2004/05, and expects to see that reflected in council tax rates. As a result, ODPM's preference is for an option which maximises that signal and the likely savings.

35. The Government will need to think carefully about the presentation of any changes in this area, but it should be possible to reassure the public and the waste industry that this is a response to a recognition of the pressures faced by local authorities, council taxpayers and the public purse. It retains the long-term aspirations of central Government on waste management and keeps the statutory EU targets but provides greater freedom to local authorities in how they work towards those targets.

## THE LONGER TERM

36. A more rational approach to minimising the pressure that the unavoidable improvements in waste management will place on local authority budgets and council tax, will be to encourage local authorities to act to reduce the unit costs of waste management. Options for bringing this about e.g. through more action to minimise waste arisings at all levels, should be pursued actively in parallel with any short term action to reduce pressures in 2004/5.

37. A further option, although one which would not deliver savings in 2004/05, would be to make changes to the new Landfill Tax escalator which is due to apply from 2005/06. This might involve freezing the Tax at 2005/06 levels, delaying the introduction of the new escalator, or introducing it at a lower rate. Such changes could



deliver large savings, e.g. around £50m in 2005/06. This would be a matter for HM Treasury to consider.



## CURRENT TARGET FRAMEWORK

**National targets for recycling and composting** for the period up to 2015 : to recycle or compost :

- 17% of household waste by 2003/04 (Defra PSA target)
- 25% of household waste by 2005/06 (Defra PSA target)
- 30% of household waste by 2010
- 33% of household waste by 2015

Last year's Strategy Unit report *Waste not, want not* suggested that those targets should be raised – to 35% in 2010, and 45% in 2015 – in order to send clear signals about the desired direction of change and secure the associated change in behaviour necessary to help us to meet our targets under the Landfill Directive.

**Statutory Performance Standards** (for recycling and composting) for **individual local authorities** were introduced in March 2001 to allow them a long lead time to make the necessary plans to achieve them.

The minimum Standard is 10% for **2003/04** and 18% for **2005/06**. However, each authority must roughly double its performance in comparison with 1998/99 by 2003/04 and treble it by 2005/6.

These targets complement the Landfill Allowance Trading Scheme, which requires waste disposal authorities increasingly to divert biodegradable municipal waste from landfill, by providing an incentive for them to do so through increased recycling and composting. Without this incentive, local authorities may choose to comply with the Scheme by increasing incineration.



**EXPLANATION OF OPTIONS AND ASSUMPTIONS****Option 1: delay start of Landfill Allowance Trading Scheme from 2004 to 2005**

Landfill Allowances for the first year of the Scheme's operation will be based on the amount of biodegradable waste land-filled during the previous year. The additional burden local authorities will face is in diverting from landfill the biodegradable content of any increase in waste arisings during that year not already catered for by planned investment in recycling and composting.

**Option 2A: delay application of the 25% national target, and associated Statutory Performance Standards, by one year to 2006/07**

Authorities have a further year to meet their 2005/06 Statutory Performance Standard.

**Option 2B: delay application of the 25% national target, and associated Statutory Performance Standards, by one year to 2006/07, but require authorities to reach a minimum of 18% recycling and composting in 2005/06**

Ensures that the pressure on the poorest performers is maintained, but retain flexibility for better performers.

**Option 3A: focus on achievement of 30% recycling and composting target in 2010, assuming a straight-line trajectory between the existing national targets for 2003/04 (17%) and 2010 (30%)**

This would give a new, lower, national target of 21% for 2005/06, individual targets would be scaled down accordingly.

**Option 3B: focus on achievement of 30% recycling and composting target in 2010, assuming a back-end loaded trajectory between the existing national targets for 2003/04 (17%) and 2010 (30%)**

This would give a new, lower, national target of 19% for 2005/06, individual targets would be scaled down accordingly.

**Option 3C: focus on achievement of 30% recycling and composting target in 2010 and the imperative to meet 2010 Landfill Directive target, requiring all local authorities at least to maintain recycling and composting at the level of their 2003/04 Statutory Performance Standard (average 17%)**

This option cannot be costed, because the timing of investment decisions to meet the minimum 30% target in 2010 would be made by local authorities and cannot therefore be predicted or modelled.

**Option 3D: require local authorities at least to maintain recycling and composting at the level of their 2003/04 Statutory Performance Standard (average 17%) in 2004/05, and meet a minimum of 18% in 2005/06**

This option cannot be costed, because the timing of investment decisions to meet the 18% minimum cannot be predicted or modelled.



## ASSUMPTIONS

The following assumptions have been made in estimating potential savings :

- i) We will reach 17% recycling and composting in 2003/04 (NB we have evidence that the actual rate will be 17.85%. If the latter happens, the effect would be to reduce any potential savings in 2004/05 and beyond).
- ii) Biodegradable municipal waste accounts for 68% of municipal solid waste going to landfill (NB the Environment Agency is doing new compositional analysis which may change this figure, as could the mass balance approach).
- iii) 1% growth in landfill per annum until Landfill Allowance Trading Scheme starts (i.e. until 2005).
- iv) Household waste arisings increase at 2.9% per annum (this is at the very top end, if it were less, savings would be lower).
- v) Landfill costs £40/tonne, recycling costs £100/tonne.
- vi) Any waste not recycled is being sent to landfill (the cheapest option).
- vii) Minimum Landfill Tax escalator of £3/tonne (if the rate increases faster, this will reduce the level of savings generated by changing recycling targets).
- viii) Unless a back-end loaded trajectory is specified, it is assumed that local authorities will increase recycling and composting on a straight-line trajectory between targets. If they are unable to do so, the level of savings will be reduced.
- ix) No interaction with packaging targets set for business (which could reduce the overall cost of recycling and therefore the savings available).



