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# **Is The Council Tax System Broken And Can It Be Mended?**

**Michael Boon**

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## 1. INTRODUCTION

This paper represents an interim report into whether or not the existing Council Tax system is in some way “unfair” and, if so, whether or not the system can be made significantly less “unfair” by making changes to either the system used by Central Government for allocating grants to Local Authorities and / or changing the banding structure within individual Local Authorities. In undertaking this work, Grey Hairs Ltd. has made use of the same type of statistically based demographic and financial modelling that it has used extensively, (and successfully!), over many years and in many different countries to evaluate infrastructure investment proposals.

“Fairness” is a very subjective concept lying mainly in the mind of the contemplator. However, we believe that the vast majority of the voting public would subscribe to the following two statements of principle:

- People on higher incomes should not, on average, be required to pay less tax in total than the tax that those people on lower incomes are required to pay.
  - This not the same thing as saying that taxes should be progressive. Even under the Community Charge / Poll Tax, the “rich” did not pay any less than the poor. They paid essentially the same amount. It is perfectly possible to have a regressive tax by which the “rich” still pay more than the “poor”, even if they pay a lower **proportion** of their incomes than the “poor” do.
- Local taxes raised to finance local expenditure should, in general, be higher in those areas where local council expenditure is higher, (and therefore where, presumably, services are better), than in those areas where the local councils are more frugal.
  - If voters can vote for higher council expenditure, (often, though sometimes misleadingly, thought of as better services), then it seems reasonable that they, themselves should be asked to foot the bill. It certainly does not seem reasonable to ask voters from elsewhere to contribute to financing services which are better than they themselves are entitled to, (or do), receive.
    - There is a real danger that if this principle is not adhered to, local governments will have very little incentive to be frugal or to supply services cost effectively.

Given these two principles, it seems pertinent to enquire about how well the existing system of local taxation and funding performs against these criteria. It also seems to be legitimate to pose the question of whether some other system could create a better match to the two principles enunciated above.

Although this is only an interim report, and as such covers work that is still in progress, it would appear that the Council Tax system, even on these very generous criteria is indeed “unfair”. It would also appear that it can be made a great deal “fairer”, (as measured by the above criteria), than it currently is.

## 2. EVIDENCE FOR THE UNFAIRNESS OF THE EXISTING SYSTEM

### 2.1 Qualitative evidence

There is a wide variety and quantity of qualitative evidence to suggest that many people consider the existing Council Tax system to be “unfair”. Amongst the more important are:

- It is unlikely that the Lyons Inquiry would have been commissioned had it not been for the concern that many in politics, the media and the wider public feel with respect to the current system for financing Local Government
- It is widely believed that there is lack of “affordable” housing in rural areas for local people to live in
  - This must mean that local property prices, and hence presumably Council Tax bands and bills, are out of line with “ordinary” incomes in these areas
- “Key worker” loan schemes indicate that, in some areas of the country, house prices are out of line with key worker incomes
  - This must mean that key workers in these areas will generally be paying more Council Tax than similar workers in other areas on similar incomes.
- It appears to be necessary to offer Council Tax Benefit to enable some people to pay their Council Tax bills
  - There has to be something wrong with the **structure** of any tax which can only be paid for with benefits specifically designed to make it “affordable”. There are bound to be people who are just the wrong side of the benefit boundary

### 2.2 Statistical evidence

There are four main possible causes of “unfairness” within the Council Tax system. These are:

- People living within any one Local Authority area may not always live in the housing that is most “appropriate” to their current incomes. This may be because they simply choose to spend more of their income on housing than others, or it may be due to historical reasons. Many people, especially pensioners, (and those who have recently been made redundant), bought their homes when their incomes, (relative to those of other people), were somewhat higher than they are now, and their houses, (again relative to other houses), were less expensive than they now are.
  - This will inevitably cause some problems of “unfairness”, but there is virtually nothing that one can do about this - except abandon property based taxes altogether.

- Even if people lived in the most “appropriate” housing for their incomes, (e.g. if there are 10,000 Band A homes in any particular Local Authority area and these are occupied by the poorest 10,000 households, there were 1,000 Band H houses and these were occupied by the richest 1,000 households and so on), there might not always be enough of the “right” sort of housing to go round. People would simply be forced to live in the “wrong” sort of housing.
  - This certainly happens to some extent. In London, around 23% of families are said to be living in relative poverty, (based on **national** median incomes), yet only 3% of houses fall into Band A. There simply is not enough cheap housing in London to go round all the relative paupers. The same is true of the South East, The South West and the Eastern LGO Regions. In complete contrast, in the North East LGO Region around 58% of all properties fall into Band A. This means that there is sufficient Band A housing so that all people up to and beyond the local median income can all live in the most lowly banded houses, (and pay much the same as each other in Council Tax).
- There may well be an “inequitable” distribution of Central Government grants as between one Local Authority and another. This could be the result of either an inappropriate banding mix being used to determine what the “appropriate” level of the benchmark Band D Council Tax “ought” to be, or it could be the result of Central Government’s assessment of spending needs being inaccurate.
  - This certainly happens if income is taken as the main criterion of ability to pay. Only 46% of the total variance between one Local Authority and another in terms of Council Tax bills per head is accounted for by differences in the average incomes of their residents
    - How much of this is down to Local Authority extravagance or frugality and how much of it is down to Central Government grants depends upon whose “proper” spending assessments you trust: Central Government or Local Government
- People may well live in the area of a Local Authority that is either unduly extravagant or unduly frugal. It might be objected that the electorate determines who runs the Local Authority so it is only fair that they should be the ones to suffer or benefit from appropriate or inappropriate spending levels. Whilst this point is to some extent justified, many people who pay little or no Council Tax also have votes. Where a minority of people in an area pay the full amount of Council Tax, those unfortunate enough to be forced to pay the full amount could suffer “unfairly”
  - There are a few examples of Local Authorities where this does seem to be the case. However, as a rough estimate, and based upon what Central Government thinks that each Local Authority “ought” to spend, only around 6% of the total variance in Council Tax per head is down to the Local Authorities themselves. The rest is accounted for by the Revenue Support Grant.

### 2.2.1 Extravagance or frugality

We could always achieve a perfect correlation between personal incomes and Council Tax per head for each Local Authority simply by making the Council Tax per head proportional to the relevant personal incomes and adjusting the distribution of Central Government grants within the same overall total to make this so. We could still retain this perfect correlation by adding some uniform positive or negative poll tax element to the Council Tax per head. (A negative poll tax would make the Council Tax more progressive and a positive one would make it more regressive). However, such a system, if implemented, would take no account of any Local Authority's frugality or extravagance.

If we could work out how much each Local Authority over or under spends in terms of Council Tax per head, (according to Central Government), then we could adjust the Council Tax figure designed to achieve a perfect correlation with income by adding or subtracting the appropriate over or under spend per head to arrive at a "perfect" Council tax for each Local Authority. The amount of variance in Council Tax per head unaccounted for by income variance would then provide a direct measure of how much of the "unfairness" is down to Local Authorities, (according to Central Government). When we run such a regression analysis, we find that the percentage of variance unaccounted for by income drops to 5.86%. This is the origin of the 6% figure quoted above. Of course, if a Local Authority's assessment of the proper spend is right this figure would drop to zero. The figure of 6% is therefore the **maximum** that could reasonably be attributed to Local Authorities.

We can work out how much each Local Authority does under or over spend, (according to Central Government), as follows. In principle, if every council spends what Central Government thinks that it ought to spend, then all Band D houses would pay the same amount in Council Tax. This means that we can easily work out what Central Government thinks that each Local Authority should charge in terms of Council Tax per head. First we work out what the "correct" national Band D Council Tax "ought" to be. We do this by taking the, (non-London English), weighted average, (weighted by the number of dwellings), of Band D rates. We then convert this uniform Band D rate into what each Local Authority would charge per dwelling by multiplying it by the current ratio between actual Band D Council Tax and Council Tax per dwelling. Finally we convert this figure into Council Tax per head by multiplying by the number of dwellings and dividing this by the population. The difference between this "proper" Council Tax per head and the actual Council Tax per head is then a measure of how much each Local Authority over or under spends according to Central Government.

## 2.2.2 Central Government grants and banding

It is widely believed that Central Government grants, (made up of the Revenue Support Grant and the National Non Domestic Rates), discriminate “unfairly” between different parts of the country and between different types of Local Authority. Indeed, as the Audit Commission said in its report, (into why Council Tax rises for the year 2003/04 were so high): *“But grant distribution – which moved grant from London and the South to the Midlands and the North – led to some councils putting up Council Tax more than others. We found a clear association between the size of grant increase a council received and their increase in Council Tax”*.

Our own analysis suggests that such redistribution, (which actually marginally improved the correlation between Council Tax bills per head and average incomes of the residents of the Local Authorities concerned), has indeed been “unfair” in the sense which we defined in section 1. Table 1 shows the percentage of people within each Region and type of Local Authority whose incomes are below £50,000 p.a. who would be paying over 10% more in Council Tax than the **national** average for their income bracket, (with each income bracket being only £1,000 p.a. wide).

	Shire	Unit	Met	Total
North East	6%	0%	0%	2%
North West	9%	0%	0%	3%
Yorks &Humber	35%	0%	0%	4%
E Midlands	6%	4%		6%
W Midlands	11%	12%	0%	6%
Eastern	29%	0%		26%
South East	48%	14%		39%
South West	31%	3%		20%
England	26%	5%	0%	15%

**Table 1: Percentage of people paying >10% MORE in Council Tax than the average for their income bracket**

These rather striking results would appear to confirm the widely held suspicion that Shire Counties lose out with respect to Unitary Authorities who, in turn, lose out to Metropolitan Authorities. It also shows that the South is “unfairly” treated with respect to the North and the Midlands.

We would not wish to set too much store by this data alone, (after all, the figures would all be zero if everybody paid exactly the same in Council Tax, regardless of their income - a situation reminiscent of the Community Charge which was widely felt to be “unfair”). However, the “unfair” distribution is confirmed by the figures in Table 2, which shows the percentages of people who would be paying over 10% **less** than the average for their income bracket. Table 2 is almost a mirror image of Table 1!!

	Shire	Unit	Met	Total
North East	34%	58%	70%	56%
North West	12%	72%	65%	48%
Yorks &Humber	0%	50%	90%	72%
E Midlands	28%	80%		38%
W Midlands	7%	55%	75%	46%
Eastern	6%	76%		15%
South East	1%	34%		9%
South West	1%	15%		7%
England	9%	46%	76%	34%

**Table 2: Percentage of people paying >10% LESS in Council Tax than the average for their income bracket**

**Technical note:** *In Tables 1 and 2 we have looked at the **best** possible outcome - i.e. we have assumed that everybody lives in the most appropriate housing for their income which is actually available in their Local Authority area..*

*For ease of computation we have divided the population in each Billing Local Authority into 50 equal slices ranked according to their incomes and treated the average income of each “slice” as being the income of all people in that “slice”*

*The income distribution that we have used fits all the data on average and median incomes for each billing authority as published by the Inland Revenue as well as the regional and national income deciles as published by the Office for National Statistics - all with an error of less than 1%*

Moreover, as part of our investigation into whether a property based local taxation system can be made “fairer” than that currently in force, we have studied the effect of altering government grants, within the same overall total, so as to satisfy three main constraints **simultaneously**:

- Achieving a better correlation between Council Tax per head and average personal incomes across all the 320 non-London English Local Authorities, (except for the Scilly Isles - for which there is no good data), than that which currently applies
- Achieving a better correlation between Local Authority spending per head and Council Tax per head, (the existing correlation is actually a **negative** one!), than we have at present.
- Keeping the same broad relationship between Council Tax and income for each income decile that we have at present - i.e. making it no more progressive or regressive than it is now.

These constraints more or less dictate what Central Government grants “should” be if they are to be satisfied, (although they take no account of any differences in extravagance or frugality or real differences in needs as between one Local Authority and another). The overall surpluses in terms of millions of pounds on a regional and type of council basis are shown in Table 3. Once again we see the same pattern emerging whereby Shires are unduly discriminated against, as is the South, with Metropolitan and Northern areas gaining most.

	Shire	Unit	Met	Total
North East	-2.3	36.2	65.7	99.6
North West	-63.5	29.8	268.7	235.0
Yorks &Humber	-44.8	16.4	245.0	216.5
E Midlands	-39.7	56.4		16.7
W Midlands	-77.1	7.6	254.8	185.3
Eastern	-185.3	40.7		-144.6
South East	-349.8	23.9		-325.9
South West	-234.6	-48.1		-282.7
England	-997.1	162.8	834.3	0.0

**Table 3: Current under (-) or over (+) payment of Central Government grants in £m when compared with income, local authority expenditure at the same level of progressiveness**

We have chosen the upper limit of £50,000 for gross personal incomes for our analysis since those on higher incomes are unlikely to find any “unfairness” in Council Tax creating serious problems of affordability. Moreover, this figure of £50,000 p.a. lies in the top decile **nationally**, (our income figures are for 2003/04), and so should cover most of the population.

This degree of “unfairness” in the allocation of Central Government grants spreads over all deciles, (except for the top one), and shows much the same pattern. Table 4 gives the percentage of people paying over 10% more than the national average for their income bracket arranged by **local** income decile.

<b>Decile</b>	<b>NE</b>	<b>NW</b>	<b>Y&amp;H</b>	<b>EM</b>	<b>WM</b>	<b>E</b>	<b>SE</b>	<b>SW</b>
Bottom	0%	0%	1%	4%	2%	25%	36%	2%
Second	0%	2%	2%	4%	3%	39%	44%	16%
Third	0%	1%	1%	3%	4%	31%	50%	12%
Fourth	0%	2%	5%	5%	2%	27%	39%	20%
Fifth	3%	2%	4%	5%	5%	28%	43%	14%
Sixth	3%	4%	4%	7%	4%	16%	37%	20%
Seventh	2%	2%	3%	3%	4%	13%	24%	16%
Eighth	3%	4%	3%	5%	7%	7%	24%	28%
Ninth	4%	2%	5%	6%	7%	8%	18%	29%
Top	17%	15%	10%	16%	16%	21%	20%	23%

**Table 4: Percentage of people paying >10% MORE in Council Tax than the average for their income bracket by LOCAL income decile**

### **3. CAN THE SYSTEM BE MENDED?**

Any attempt to “mend” the Council tax system needs to start with the realisation that the root cause of the problem is that the distribution of property bands within most Local Authorities does not match the distribution of incomes within those authorities at all well. This problem is compounded by the fact that property banding is currently used for two quite distinct, and not always compatible purposes. In the first place it is used to determine the **share** of the total Council Tax burden borne by each householder **within** each individual Local Authority. In the second place it is also used to determine how much each Local Authority should raise for itself as part of Central Government’s assessment of local spending needs, and hence how much Central Government grant needs to be allocated to each Authority.

One problem resulting from this dual purpose use of property bands is to render many attempts to make the system less “unfair” virtually nugatory. For example, if we try to make the system more progressive, by for example, adding new bands at the top and bottom, or changing the Multipliers for each band, then the potential gain **within** any one Local Authority tends to be cancelled out by the increased “unfairness” between residents of different Local Authorities as a result of the operation of resource equalisation. In particular, the sorts of “unfairnesses” illustrated in Tables 1 and 2 are exacerbated since the richer regions would get even less grant than they currently enjoy - and it is the richer regions where we find most people suffering. The solution to this particular part of the problem is simply to assess Central Government grants on a different basis - probably one directly related to the average incomes enjoyed by each Local Authority’s residents.

As an illustration of the difficulties associated with reforming the system, let us consider one of the more popular supposed remedies for the Council Tax system which involves making it more “progressive” by adding new bands at the top and bottom. Far from alleviating the situation, we find that if we were to add a new band at the bottom by splitting Band A in each Local Authority into two equal halves, giving the Lower half a new Band Multiplier of 0.4, (instead of 0.6667), the portion of the variance in council tax bills which is not explained by individual income differences actually **increases** by 3.6% in the absence of resource equalisation but by a massive 14.1% if we include the effects of resource equalisation as well. Similarly we find that adding a new band at the top by splitting Band H into two equal portions and giving the higher portion a Band Multiplier of 3, (instead of 2), the unexplained portion of the Council Tax variance **increases** by 39.2% with resource equalisation. Clearly, **on its own**, this is not a sensible suggestion!

In fact we find that we can improve the overall “fairness” of the system somewhat by making Central Government grants somewhat more **regressive**. We do this by attenuating the difference between actual Council Tax per dwelling, (after allowing for any Local Authority over or under spending), and the average Council Tax per dwelling, (i.e. the number of dwellings weighted average over all Local Authorities), and then adding this to the same average Council Tax per dwelling. On the other hand we find that, provided that Central Government grants remain as they are today, (i.e. no **further** resource equalisation takes place), making the system more **progressive** by increasing the Council tax multipliers above Band D and reducing those below Band D again improves the system somewhat.

However, these improvements are relatively minor. If we want to make major improvements we probably have to change the banding distribution in **each** Local Authority so as to match the distributions of incomes within that authority, whilst at the same time changing the Band Multipliers on a national basis. We also need to redistribute Central Government Grants, (within the same overall total), so as to reflect incomes within each authority rather more closely. Obviously, if we were able to get a near perfect match to local income profiles merely by altering banding, then we could continue to use the current resource equalisation system using the new bands and multipliers.

We have investigated a number of options in this area and have devised a scheme whereby the “fairness” is much improved over that currently applying. We are **NOT** recommending that this particular scheme be adopted. (We have in fact based it on **gross personal** incomes and not on **disposable household** incomes after tax and benefits. Equally, we have not made any allowances for the substantially different costs of living to be found in different parts of England. Any truly “fair” scheme would need to take both of these factors into account.) The purpose of investigating these options is solely to determine whether the system really **can** be mended. We believe that we have shown that it can, indeed, be very substantially improved.

We have created a model using 10 bands with different multipliers to those in force today. With this particular model, (which has not yet been fully optimised), we find a reduction in the Council Tax bill variance which is not explained by differences in income of 76.2%, (or, if we assume it is the Local Authorities who spend the right amount, the reduction is 82.7%). The percentage of people paying 10% or more in Council Tax than other people in their income bracket is also much reduced. The regional and type of council analyses, comparable with Table 1, are shown in Tables 5 and 6.

	Shire	Unit	Met	Total
North East	25%	1%	2%	9%
North West	3%	2%	10%	7%
Yorks &Humber	2%	2%	0%	1%
E Midlands	15%	6%		13%
W Midlands	1%	0%	0%	1%
Eastern	7%	0%		6%
South East	5%	1%		4%
South West	3%	0%		2%
England	7%	1%	4%	5%

**Table 5: Percentage of people paying >10% too much in CT assuming that Central Government assessed spending is “right”**

	Shire	Unit	Met	Total
North East	1%	1%	1%	1%
North West	2%	2%	8%	5%
Yorks &Humber	1%	2%	1%	1%
E Midlands	1%	2%		1%
W Midlands	1%	0%	2%	2%
Eastern	2%	1%		2%
South East	2%	3%		2%
South West	1%	0%		1%
England	2%	1%	4%	2%

**Table 6: Percentage of people paying >10% too much in CT assuming that Local Government assessed spending is “right”**

#### 4. CONCLUDING REMARKS

Obviously the easiest way to link the funding of local expenditure more closely to incomes is to do so through either an income tax or an expenditure tax. Indeed, Isitfair’s central proposal is to abolish Council Tax altogether and replace it with increases to both income tax and VAT, (as based on our earlier report for yourselves).

However we believe that we have shown, on the basis of Tables 5 and 6, that it is possible to relieve much of the “unfairness” associated with Council Tax. In particular, most, but not all, of the biases towards different regions and different types of authority implicit in the current system can be removed. This is somewhat less marked in Table 5, (which assumes that Central Government assessed spending is “right”), than it is in Table 6. Indeed it would appear from a comparison of the two tables, that the East Midlands and the North East have something of a tendency to overspend, whereas other regions, (such as the South West), are somewhat more frugal.

This observation is very much in line with some of our other observations. For example, we have shown that there is no statistically significant correlation between the average Council Tax per head collected by each Local Authority and that Local Authority's spending per head. In fact, what little correlation that does exist is a **negative** one - councils which tend to spend **less** tend to have **higher** levels of Council Tax. On the other hand, there is a large and statistically very significant **positive** correlation between a Local Authority's spending per head and the amount of grant per head that it receives from Central Government, (or, to put it another way, there is a strong **negative** correlation between a Local Authority's spending and the percentage of that spending that is funded locally.)

The uncharitable might suggest that these two observations taken together merely show that it is much easier to spend the money of those taxpayers who do not form part of one's own electorate than it is to spend money collected from those who do. The more charitable might suggest that Local Authority spending was driven mainly by **need** and that the size of Central Government grants are also driven by the same need. Which "explanation" is right? If **need** were the main determinant of spend as well as of government grant, we would expect to find a strong **negative** correlation between average income per head in an area and the relevant Local Authority's spending per head. We do indeed find a negative correlation - but the effect is **small** and only just about statistically significant. Thus, although there is some support for both explanations, the overwhelming conclusion is that Local Government is less frugal with other people's money than it is with its "own".

This view is consistent with the Audit Commission's observation, (in its report into Council Tax rises for the year 2003/04) to the effect that: "*We found that increases tend to be higher in authorities that are not directly elected – 13 of the 20 highest increases were agreed by police authorities*".

Despite the potential improvements that we have been able to identify, there will always remain the problem of people who live in housing which is not "appropriate" for their incomes. It is obvious that this problem would disappear completely if the funding local expenditure were no longer to be based on property.

Since the political establishment appears to be wedded to property taxes we can only suggest that, in addition to following and implementing something like the type of re-banding described here, the total burden of local taxation should be reduced to that proportion of local expenditure that is truly controlled by Local Authorities and that it is not expected to fund the activities for which Local Authorities are simply **agents** of Central Government. We doubt whether there would be so much concern about the "fairness" or "unfairness" of the Council Tax if the bills were to substantially smaller than they currently are.

It will be observed that one of our findings is that the Council Tax system needs to be made more **regressive between** different Local Authorities and more **progressive within** each Local Authority. Great care needs to be exercised before any system based on the latter part of this finding is implemented. Any increase in the degree of progressiveness of any property tax is likely to make the suffering of those who live in “inappropriate” housing above the “pivot point” even **worse**. This is particularly the case if a banding scheme based upon relative **national** valuations were to be retained, (since there would then be more relatively poor people above the “pivot point” as a result). If, as we suggest, property taxes were to be based on relative **local** valuations, then only the comparatively well off would find themselves above the “pivot point”. Although their excess tax might still be reasonably considered to be “unfair”, one could hardly claim that they were suffering real hardship as a result.

Unfortunately we do not have any good data relating to how many people actually do live in “inappropriate” housing and how far that housing is indeed “inappropriate” in terms of the taxes that they are expected to pay. Whilst our own studies on this matter are in broad agreement with those of Michael Orton, we would consider that the data used, (by both of us), is simply not robust enough to draw any firm conclusions upon which policy could be soundly based. Indeed, this seems to be a widespread problem. We can only **guess** at how many people who are entitled to Council Tax Benefit do not claim it, we can only **estimate** the actual income distribution within different Local Authorities, we can only **guesstimate** the degree to which people live in “inappropriate” housing and we only have **regional** indications of the different cost of living in different parts of the country. (We believe that, since **average** personal incomes vary so much between different Local Authorities in the same Region, it is likely that the cost of living does as well. The Regions are simply not homogenous enough for regional data to be used as a sound basis for policy making.). We are concerned that so much policy discussion is occurring amidst such a degree of ignorance concerning the real situation on the ground. If only a small part of the effort currently being devoted to the very detailed revaluation of housing, (which, on the basis of our work, is likely to achieve very little in terms of improved “fairness”), were to be devoted to gathering decent statistical data on the above and similar subjects, then policy could be made on a sounder basis and better policies would almost certainly be the result.