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Council Tax

Problems with the Current System

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COUNCIL TAX

The current system

In principle, council tax is relatively simple, but in practice it is very complex.

In principle, the **actual** amount of council tax that any authority has to collect is the difference between what it, **actually** spends and the total government grants that it **actually** receives. However the practice is somewhat more complicated:

- There are many local bodies, other than the billing local authority, who levy council tax precepts on residents of the billing authority's area. This all adds to the council tax bills actually received by residents.
- Some, (but not all), of these same local bodies also receive government grants in their own right.

This means that the actual amount of council tax that has to be collected is the difference between the **total** spend of all the relevant bodies receiving a portion of the council tax in any billing authority's area and the **total** central government grant made to each of those bodies. In practice there are yet further complications. since the total government grant actually awarded is the difference between what the government thinks that the authority, (together with its various precepting authorities), **ought** to spend and the amount that it **ought** to collect from council tax.

- The amount that the government thinks that a local authority ought to **spend** is covered by the Formula Spending Share, (FSS), which attempts to estimate what ought to be spent on each "Service Block", (essentially a measure of "needs" like social care, education and so on - largely determined by the demography and degree of deprivation of the authority concerned). The FSS is, in practice, so complex that it has been described by one County Council Leader as "incapable of understanding".
- The amount that the government thinks that a local authority ought to **collect** by way of council tax is based on its Share of Average National Council Tax, (SANCT). SANCT is based on the **mix** of properties in its area and the percentages of each band that are subject to **discounts**, (through being unoccupied, singly occupied, occupied by students and so on) and the number of properties concerned.
 - The mix of properties is basically what we might term the "average" band of the properties in its area. The average band is simply the ratio between the council tax revenue that an authority would actually receive and the revenue that it would receive if all properties were in Band D and not subject to any discounts. It is calculated by a weighted average of the CT multipliers - i.e. the sum of the products of percentage of properties in each band and the relevant CT multiplier for each band.

As noted by Leicester City Council in their submission to the "official" Lyons Inquiry, if all local authorities were to spend at their assumed FSS level, then Band D council tax would be the same for every local authority in the country. The same would also be true for any other band: Band A council tax would be uniform across the country, so would band B and so on.

Some problems with the current system

There can be few people who doubt that council tax is unpopular with most of those who have to pay it. However, we would suggest, as a working hypothesis, that very few people would be much concerned about the council tax if it were to be more directly related to income. People would probably even tolerate a mildly regressive tax of this sort - at least provided that other taxes and benefits made the **overall** tax and benefit system progressive. The problem is that different people find themselves paying widely differing percentages of their income in council tax - and in a significant number of cases, these percentages are high where income tends to be small.

There are two quite distinct and different aspects to this problem:

- In the first place, there are normally problems **within** any one council district. There are again two quite distinct and different effects occurring:
 - The mix of property bands is often very different from the mix of incomes. In the North East for example, around 58% of all properties are to be found in the lowest band, Band A. This means that more than half of all households all pay much the same in council tax, (shades of the old poll tax!). It also means that many people up to and beyond the **local** median income all pay much the same as well.
 - Even within any one locality, people do not always live in the “right” sorts of houses for their incomes. This is, in part, because many people bought their houses when property was cheaper and they themselves were relatively better off. Such people, typically – but not always - pensioners, could no longer afford to buy these houses today. Does it really make sense to tax people on the basis of something that they can no longer afford?
- In the second place, there are also problems **between** council districts. People on very similar incomes can face very different council tax bills - which are mainly dependent on **where** in the country they happen to live.

Problems between regions

In an idealised council tax world, the people who occupy the lowest taxed properties would be those on the lowest incomes whereas those who occupy the most highly taxed property would be those with the largest incomes. For example, if in any authority, there were 1000 Band A houses, 600 Band B houses, 400 band C houses and so on, then the best we could hope for is that the poorest 1000 people all occupy the band A houses, the next poorest 600 occupy all the Band B properties, the next poorest 400 occupy all the band C properties and so on. One of the problems with the council tax system is that such a distribution is **not even possible** nationally.

The Office for National Statistics publishes data on the income distribution of families in different regions of the UK, (Table 3.6 available on <http://www.statistics.gov.uk/StatBase/Expodata/Spreadsheets/D7579.xls>). The Office of the Deputy Prime Minister publishes data on the number of houses in each Band for each region of the UK, (<http://www.local.odpm.gov.uk/finance/stats/data/dwellnew2.xls>). These two pieces of data enable us to investigate what would happen if we were to fill up the housing stock in each region in such a way that

nobody in a property of any particular band within any region were to be poorer than anyone in a property in a lower band in the same region. Table 1 shows some of the results of such an exercise - which is the **best** that could be achieved given the current regional mix of property bands.

	Band A	Band B	Band C	Band D
North East	55.7%	44.3%	0.0%	0.0%
North West	0.0%	100.0%	0.0%	0.0%
Yorks & Humber	0.0%	100.0%	0.0%	0.0%
East Midlands	0.0%	100.0%	0.0%	0.0%
West Midlands	0.0%	100.0%	0.0%	0.0%
Eastern	0.0%	4.5%	95.5%	0.0%
London	0.0%	0.0%	40.2%	59.8%
South East	0.0%	0.0%	100.0%	0.0%
South West	0.0%	0.0%	100.0%	0.0%
Percentage of households with incomes between £300 and £400 / week who could live in various property bands				

Table 1

Although this data is now a little outdated, Table 1 does illustrate how people on the same incomes in the North East can live in lower banded property than people in other regions - especially London and the South East. (For a more detailed view of inter-regional problems see Appendix *****)

None of this would matter if the Government did not try to equalise council tax on all properties, (wherever they are in the country), in the same band, and ensure that any differences are down to local authorities spending more or spending less than the Government thinks that they “should” do. However this is what the Government actually does **do**. The result is that people on the same incomes, but in different parts of the country, pay widely differing amounts in council tax and these differences have relatively little to do with whether or not they live in an extravagant or frugal local authority area.

Resource Equalisation

There appears to be a great deal of confusion between the concepts of **tax-base** and **taxable capacity** underlying many of the published submissions to the “official” Lyons Inquiry, (including many of those from local authorities). The **taxable capacity** is simply the (monetisable) economic wealth, (income, savings or credit worthiness), possessed by the inhabitants of the population being taxed - and as such is very closely related to their ability to pay, (see section ****). On the other hand the **tax-base** is the quantifiable entity on which the amount of tax payable is actually calculated. In the case of the council tax, the tax base is the value of the properties concerned as expressed by their council tax bands / SANCT.

“Resource Equalisation” is the term used to describe the process whereby the government adjusts its grants so as to make local taxes “fairer” - in effect adjusting their grants so as to reflect how much tax the government believes any local authority can actually raise locally in a manner that is “fair” as between one

authority and another. As we noted above, in the case of council tax this means making all properties in any particular band, regardless of where they are in the country, pay roughly the same amount in council tax, (assuming that local authorities spend what the government thinks that they ought to spend!).

Unfortunately, the basis of the Government's calculation for resource equalisation is the **tax base** - whereas it would probably be "fairer" to use **taxable capacity**, i.e. **incomes**. This is probably the underlying reason behind the motivation of those who call for the council tax to be wholly or partially replaced by, (or supplemented by), a local income tax.

We can compare the consequences of basing resource equalisation on the average band tax-base with basing it on average incomes relatively easily. For example, if we assume that local authorities spend what they **actually do** spend and that the Government's assessment of what they **ought** to spend is correct, (i.e. any over or under spending with respect to what the government thinks ought to be spent is completely reflected in council tax), then the correlation coefficient between **actual** council tax, (i.e. with resource equalisation based on average band etc.), with average incomes for the 320 English local authorities outside London is 0.6752. This means that 54.4% of the variance in council tax between authorities is unrelated to the difference in the average incomes of their residents. However, if we were to base resource equalisation on the average incomes of the residents in each local authority's area, then the correlation coefficient would rise to 0.9136, which leaves only 16.5% of the variation in (the new) council tax unrelated to incomes. This residual variance (of 16.5%) is entirely accounted for by the amount that each local authority over or under spends with respect to what the Government thinks that it ought to spend

In basing resource equalisation, (and hence government grants), on average incomes rather than a property-banding tax-base, we have not made any assumptions about how the burden of local taxation is shared out **within** any authority - It could be by the existing council tax system that we use at present, or it could even be by some system not based on property at all. Nor have we made any decisions about how progressive or how regressive the local taxation system should be. In fact we could make the system more regressive or more progressive at will and still retain the better correlation noted above. We could achieve this by making the government grant consist of two parts: the first part being a fixed amount per capita and the remainder being proportional to income. In the extreme case, if a very high degree of progression were to be desired, we could even make the fixed amount per capita **negative**. We would then have a sort of poll tax levied on local authorities! What we have done in our analysis is to ensure that the **total** amount of government grant to be distributed among the 320 local authorities concerned remains unchanged.

Problems within regions

As we remarked above, some of the problems of hardship caused by the council tax are the result of people in living in more expensive houses than their (current) incomes really "warrant". Apart from making council tax **less** progressive / **more** regressive, (see section***), there is not much that can be done to the **structure** of council tax to alleviate this problem, (except in those cases where the properties concerned are "too highly" taxed because of their location / region). However, some of the less important causes of "unfairness" are associated with having a mix of property bands in an authority which is very different from the mix of incomes to be found in that authority.

Figure 1 shows the actual distribution of weekly household income in the UK for the financial year 2002/03, (source: *Households Below Average Income*, Department for Work and Pensions).

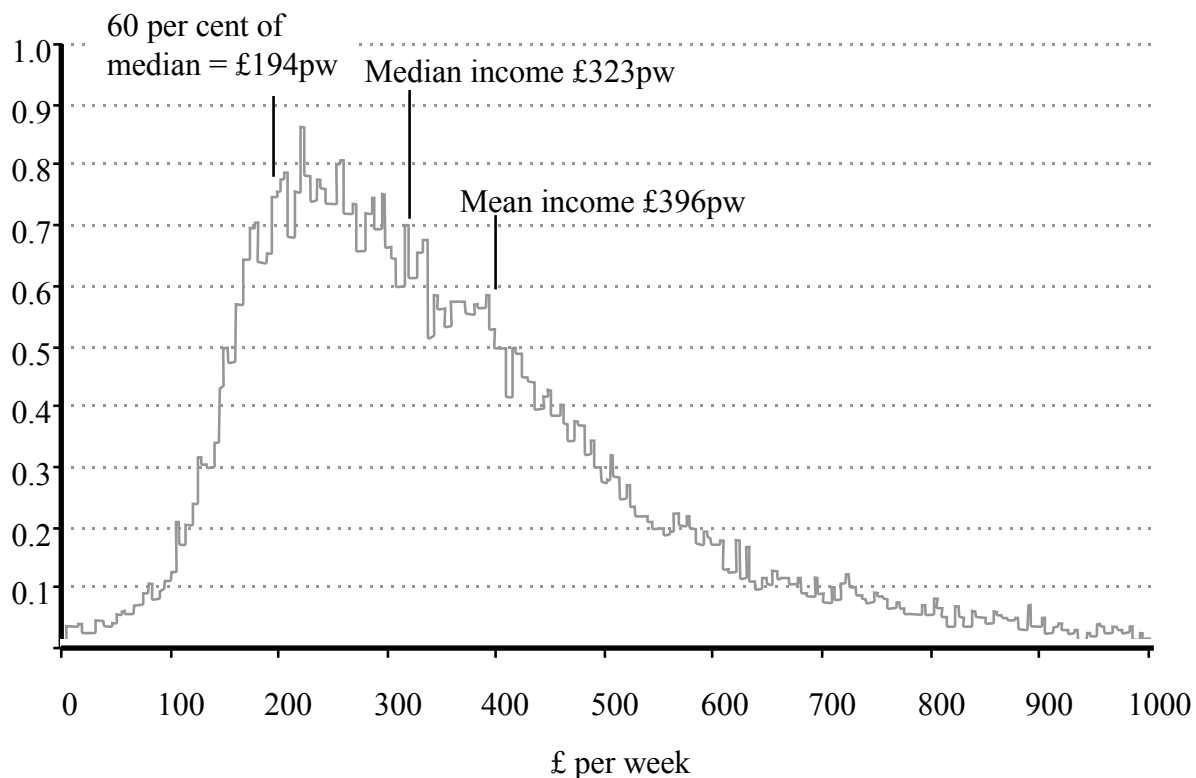


Fig 1

The **shape** of this income distribution is typical of the income distribution of almost **any** community almost anywhere in the world. There are always a few people on (relatively) low incomes and a few people on (relatively) large ones. The number of people, (the vertical axis in figure 1), on a given income usually rises quite steeply as income increases until it reaches a peak, after which it tends to decline much more slowly.

Although, there is very little published data on the distribution of household incomes at the sub national level, what little has been published is entirely consistent with local income distributions having exactly the same **shape** as the national pattern shown in figure 1. Indeed, it would be very odd if this were not the case! The main differences between different communities, (whether in the UK or elsewhere), concern the **placing** of the curve on the horizontal (i.e. the income) axis, and the degree to which it is **spread out** or squashed up along that axis.

If we want to have a property tax that **could** be properly related to incomes, then we would need to group properties in such a way that there were relatively few lowly taxed and relatively few highly taxed properties at each end of the income spectrum and a larger number of properties being taxed intermediate amounts in the middle. In other words, we would need to have a tax distribution, (or council tax banding distribution), which looked very like the income distribution shown in figure 1.

Actually, of course, we have nothing of the sort! Far from having a small number of dwellings in the lowest taxation band, in England there are more properties in Band A than there are in any other band! Only in London, and to a lesser extent in the South East is the mix of property bands similar to the, (national - and therefore presumably local), income distribution. The banding distribution in the North East, the North West, Yorkshire and the Humber, the East Midlands and the West Midlands is completely “wrong” from this perspective. That in the South West and the East of England is neither particularly good nor particularly bad.

Given the distribution of council tax bands that we actually have at the moment, it is inevitable that many people will be paying the “wrong” amount of council tax when compared with their incomes. Many people in the middle of the income distribution are paying “too little”, whereas those at the extremes are, in general, paying “too much”. Only the **very** well-to-do are really “winners” in this sense and virtually all the “poor”, are “losers”. The poor are especially hard hit in places like London, the South East, the South West and the East of England regions. This problem is particularly acute in the South West since they have a much higher percentage of the “asset rich but income poor” than other areas.

The solution to this particular problem, (as we discuss in section *** and Appendix ***), is to be found in some form of local revaluation in which we “force fit” the banding distribution to the local income distribution. The degree to which the actual tax charged on any band “should” be made more progressive or more regressive depends upon how many people are in the “wrong” bands. In general, with local revaluation, we would expect this number to be reduced.

Should council tax be made more progressive?

Knee jerk reactions

The typical “knee-jerk” reaction of many when confronted with a situation where some people are faced with tax bills which they experience difficulty in paying is: “Then make the tax more progressive”. Many of the published submissions to the “official” Lyons Inquiry follow just this approach. They argue that making council tax more progressive, (either by altering the band multipliers or adding more bands at the top and bottom - or both), is the answer to making the tax better related to ability to pay - and hence the way to relieve the hardship that it causes.

However, it is self evident that the number of people who find themselves in the “wrong” housing band with respect to their incomes will be completely unaffected either by adding bands at the top (and / or bottom), or by changing the multipliers of different bands with respect to Band D. Any council tax hardship which arises from people being in too high a band for their incomes will be completely unaffected by adding any further bands. Also, only if they are in bands whose multipliers are reduced will they receive any benefit; if they are in bands which would have their multipliers increased, (usually in bands above band D), they would actually be in a worse position.

Indeed, making taxes more progressive does not always make them either “fairer” or improve people’s ability to pay them - as is demonstrated by the following rather stupid situation.

The little finger tax

Let us imagine for a moment that we have an idiotic government that decides to tax people on the basis of the length of their little fingers - say at a rate of £100 per millimetre. Since, so far as we are aware, there is absolutely no correlation between ability to pay and digital length, it is obvious that with such a tax there are almost bound to be some people with very low incomes and / or wealth who just happen to have very long little fingers. Clearly such people would have a very low ability to pay our imaginary little finger tax.

Now let us imagine that we were to make the our little finger tax more progressive - charging say £200 per mm for all finger-millimetres above a certain length but only £50 per mm for any finger-millimetres below that length. Obviously the finger rich but income poor would be hit even harder by such a change. Far from relieving hardship, making our little finger tax more progressive would actually worsen it.

The type of car tax

Now let us imagine a slightly less idiotic government that introduces a tax which has some sort of relationship with ability to pay but where that relationship is a long way from being perfect. A tax based on the original list price, (up-rated in line with car-price inflation), of the car that you happen to drive would be an example of just such a tax. In general, the rich do drive rather more expensive cars than the poor - but the poor also tend to drive more second hand cars than the rich. Indeed, for a low mileage user, a middle aged Rolls-Royce is probably the cheapest sort of car to run! If we were to make our type-of-car tax more progressive, many of the poor would end up paying more tax and many of the rich would end up paying less. The supposed type-of-car tax is a sort of mixture between the little finger tax and an income, (or wealth), tax. When we have such a mixed tax, we can see that changing the degree of progressiveness of the tax could either make the injustice better or it could make it worse - depending upon the proportions of the little finger type tax and the income type tax in the actual tax concerned.

Council tax

Statistically, there is quite a good correlation between the value of the dwelling where people live and their incomes. In fact, this correlation is better than the correlation between smoking and lung cancer. However, just as many people who smoke do not get lung cancer, and some people who do not smoke do get lung cancer, there are also significant numbers of people who live in the “wrong” band of house when compared with their current incomes. In this respect, the council tax is not unlike our imaginary type-of-car tax. Our modelling of the actual situation has convinced us that making council tax more progressive in the manner proposed by many, would actually make the hardship of those who are currently suffering even worse. We note that in his December 2005 Interim Report, Sir Michael Lyons has reached broadly similar conclusions.

Should there be more council tax bands?

There is little case, in terms of revenue collection, for adding more bands at the top i.e. above Band H. Outside London, only 0.36% of houses are in band H. The highest percentage, at 6.77%, is to be found in South Bucks and only 35 councils (out of 320) have 1% or more dwellings in Band H. London, which probably is something of a special case, (at least inner London might be), has only 1.71% overall, and the highest borough, (Kensington and Chelsea), has “only” 16.53%, (equivalent to just 14,089 dwellings!). This particular suggestion would seem to smack more of class envy / class warfare - i.e. “soak the rich” - than it does of any more rational approach. The only real justification for “soaking the rich” is to enable the

poor to pay less tax. However, in the case of very costly houses, the likely yield on a national scale would be so minute as to make virtually no difference whatever to the tax bills faced by the poor.

There is a somewhat better case for adding more bands at the bottom - i.e. below Band A. For example, in the North East, around 58% of the total housing stock is to be found in Band A, (the figure in Easington is 80.62%). This means that more than half the population of the North East is paying broadly the same amounts in council tax, (like the old poll tax!). The problem is that there is too little **differentiation** between properties for council tax purposes, (but not **physically**, and not between incomes), in that region. This problem could be addressed by adding more bands below Band A. It could also be addressed just as effectively by making more use of existing bands, (there are plenty), through regional / district revaluation.

There is little doubt that it would be much easier politically to “sell” a new lower band or set of lower bands than it would be to re-value / re-band properties upwards. However, it is important that any additional lower bands should **not** be used as an excuse to shift yet more money from other regions, (through Resource Equalisation) - arguing that the tax base has now diminished, (which it would do) - since, (as we show in section ***), the North East **already** gets more from other regions than perhaps it “should”.

There is also a potentially serious and costly administrative problem with a situation where we have more council tax bands than we do at present. The more bands that there are, the more boundaries there will be between bands. It is only people who think that they are near the band boundaries who are likely to appeal against their valuations. The fewer band boundaries that there are, (i.e. the fewer bands that there are), the fewer costly appeals are likely to result. We also note that the more progressive the tax rates are made between the bands, the more does one’s banding affect one’s tax bill. Making the multipliers more progressive is also likely to lead to more appeals.

Should the council tax multipliers be changed?

Many of those arguing the case for making the council tax more progressive by altering the council tax multipliers point to the fact that the ratio of council tax charged between houses in the top band, Band H, and the bottom band, Band A, is only 3:1 whereas the ratio between house prices in these bands is more like 8:1. People who argue along these lines seem to miss two important points.

- First, they ignore the fact that the ratio between house prices and incomes is not constant. Although average house prices in an area do increase monotonically as the average income in that area rises, the average **gross** income in the highest decile of English local authority Districts (outside London) is only 1.93 times the average **gross** income in the lowest decile, whereas average house prices in the richest decile are 3.12 times higher than the average for the poorest decile.
- Second, they also ignore the fact that the rest of the tax and benefit system is highly progressive. Comparisons of council tax bills with **gross** incomes make council tax look a great deal more regressive than do similar comparisons based on net incomes, (i.e. incomes after all taxes and benefits have been taken into account). In fact it would appear that, on this basis, council tax is actually slightly progressive at the lower end of the income distribution. Taking net rather than gross incomes into account also increases the ratio of house price to incomes in the richer deciles when compared with the poorer ones.

Although there is no doubt that the council tax system is regressive in the **technical** sense - higher valued properties are charged a lower percentage of their value in council tax than lower valued properties are - our modelling shows that making council tax more progressive by increasing the band multipliers above Band D and / or reducing those below Band D does not always improve the correlation between the average council tax band in local authority districts and the average household incomes of residents of that district. In fact, we find that:

- If we were to make banding even more regressive at the higher end, by giving all council tax bands above band D the same multiplier as band D, (i.e.1), we find that the correlation between average band and average household income actually **improves!** The effect is particularly marked, (large as well as being statistically significant), in the Districts / Shire Counties. The effect is still important, (and still statistically very significant), in the unitary authorities. However, in the metropolitan authorities the effect is to **worsen** the correlation - but only by a very small, (but nonetheless statistically significant), amount
 - If we go the other way and make banding, (and hence council tax), more progressive at the upper end, then we find, as one would expect, that the correlation between average band and average income gets **worse**.
- On the other hand, if we were to make banding more progressive at the lower end, we find that the correlation between average band and average household income does indeed improve. As before, the metropolitan authorities go the opposite way
 - As we would expect, flattening at the bottom end. by giving all bands below band D the same multiplier as band D, causes the correlation between average band and average income to get worse - except in the metropolitan authorities of course!

The explanation for these, at first sight, rather strange results lies in the “unfairness” of central government grant distribution between the different local authorities and the inappropriateness of the banding distribution when compared with the income distribution..