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Report On The Funding And Structure Of Local Government

Part IV - Some Non-Solutions

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1. INTRODUCTION

The original, July 2004, terms of reference for the "official" Lyons Inquiry concentrated purely on the funding of Local Government and the taxes that might be adopted in order to provide it. These terms of reference were extended in September 2005 to encompass issues relating to the structure of Local Government and its relationships with Central Government. Although, as I remarked in Part I of this report, it does not really make much sense to discuss how Local Government should be funded without considering what Local Government is **for**, most of the published submissions address the issues of taxation and funding more or less in isolation from any considerations of the purpose of Local Government. It is also obvious that the vast majority of the submissions that the Inquiry has chosen to publish are those from organisations. Individual submissions only appear to be published when they come from Professor this, Councillor that or individual MPs. Only the **names** of other individual contributors are published - not what they say. This is unfortunate, as many of the public sector submissions are very "samey". Indeed, many of them use much the same form of words - suggesting that these submissions are not truly independent but have been co-ordinated - possibly in order to provide an appearance of consensus, (or maybe Local Government people only talk to each other and ignore the general public?!?). The inevitable result is that there is an over concentration on the views of those who have to collect and spend any tax and an almost total absence of views from those who would have to pay it. Whatever the reason, this bias can only tend to give the impression that the "consultation" is little more than a sham and that the whole Inquiry is something of a "stitch up".

The purpose of this part of my report is to examine some of the alternatives, or supplements, to Council Tax that have been proposed to, and published by, the Inquiry. In particular, this part of the report concentrates on which of these proposed solutions probably **won't** work - and the reasons why not. My emphasis is not so much on the problems of collection that might be associated with any changes to the local taxation regime, (although I do not of course ignore or underestimate the importance of these), but on the impact of any such changes on groups of individuals - in particular on those who would be likely to end up being most "unfairly" treated.

In general, the alternatives to, or modifications of, the Council Tax which have been proposed consist of one or more of:

- Retaining a property based tax like the Council Tax but changing its structure so as to change its incidence on different groups within society. Proposals include adding more Bands, changing the Multipliers, (usually so as to make the tax "more progressive"), and adopting an *ad valorem* system such as that about to be implemented in Northern Ireland. I address the various issues under this heading, (apart from the *ad valorem* approach) in section 2 of this Part of my Report. The possible effects of adopting the Northern Irish approach are considered in section 3.

- Allowing some of the existing tax take to be localised, (such as the business rates / NNDR , excise duty on road vehicles or VAT), in order to "improve the balance of funding". I discuss the issue of "repatriation" of the business rates and the balance of funding in section 4 of this part of my report.

— It is obvious that any localisation of existing taxes cannot possibly **replace** the Council Tax unless other **national** taxes were to be increased in order to compensate for the loss to the exchequer of the yield from the existing taxes so localised.

- Introducing supplementary taxes like a Local Income Tax, a Local Sales Tax, tourist taxes and so on. I discuss the issue of local sales taxes in Section 5, and local income taxes in Section 6 of this part of my report.

- Introducing additional or increased charges for services or "bads", (car parking, rubbish collection/ non-recycling and congestion charging for instance). Since it seems likely to me that none of these, including tourist taxes, will actually yield very much in the way of revenue, I only discuss these ideas very briefly where appropriate in other sections of this part of my report.

2. PROPOSED MODIFICATIONS TO THE COUNCIL TAX SYSTEM

Many of the submissions to the "official" Lyons enquiry, especially those from Local Authorities and their various umbrella organisations have started from the assumption that there is nothing inherently wrong with the Council Tax system and so there are no problems which cannot be "fixed" by relatively minor modifications to it. This part and section of my report deal with those proposed modifications which I believe **won't** work.

Broadly speaking, the proposed modifications fall under one of the following two headings:

- Many of the submissions argue that making the Council Tax "more progressive" is the "answer" to the current problems being experienced by Council Tax payers. Strangely, none of the Local Authorities making this statement provide any **evidence** whatsoever to back up this claim. Nevertheless, they propose to make the tax more progressive by one or both of:

  — Adding new Council Tax Bands - either at the top, or at the bottom or both.

  — Changing the Council Tax Band Multipliers. Usually this means increasing those above Band D and reducing those below it

.

- Many of the submissions also argue that making Council Tax Benefit easier to claim so as to "improve" take-up will remove most of the (remaining) problems associated with the tax.

  — It is widely believed that only about 70% or so of those entitled to claim CTB do in fact claim it. The origins of this figure, and the method by which it was estimated, seem to have been lost in the mists of time - although it is widely quoted. All that we actually **know** is how many people do actually take up CTB and what, on average, the amount is that they receive by doing so.

2.2 Should Council Tax be made more progressive?

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. The implicit assumptions underlying this view is that it is the "poor" who are most "unfairly" treated, (or who experience the most difficulty in paying their Council Tax), and that one's income and the Council Tax Band of the property that one lives in are very closely correlated. Unfortunately neither of these assumptions turns out to be true in a very significant number of cases.

It is relatively easy to determine to what extent, on a **national** scale, people live in houses that are "appropriate" to their incomes. What was the Office of the Deputy Prime Minister publishes details of the number of dwellings to be found within each Council Tax Band, the average Council Tax per Dwelling and the "standard" Council Tax for a Band D house for every bill collecting Local Authority. From this it is a simple matter to work out what the average bill is for each decile of Council Tax bills - and so, if everybody actually lived in the most "appropriate" housing, what the average bill would be for each income decile. We can then compare this with data from the Office for National Statistics showing the actual Council Tax bills faced by people in each income decile. The degree to which the two sets of figures don't match up is a measure of the extent to which people don't live in the housing most appropriate to their incomes. Figure 1 compares the actual Council Tax bill with what it would be if everybody did indeed live in the most "appropriate" housing.

Council Tax bills for each income decile - actual v perfect income match										
Decile	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Actual	737	786	822	854	900	958	988	1037	1141	1310
Perfect	652	736	778	849	899	975	1034	1127	1319	1712

Fig.1

It is obvious from these figures that there must be a considerable degree of "mixing" whereby people live in the "wrong" housing Band with respect to their incomes.

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 fairly steadily 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, and after any Council Tax Benefit, Council Tax is actually slightly progressive at the lower end of the income distribution, (see below). Taking net rather than gross incomes into account also increases the ratio of house prices 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 - making it more progressive will not necessarily improve the correlation between incomes and Council Tax bills. In fact my modelling shows that making Council Tax more progressive by altering the Council Tax Band Multipliers often achieves the opposite effect!

Is Council Tax regressive?

Much of the criticism levelled at the Council Tax is concerned with the observation that it is regressive. In the technical sense it is indeed regressive in terms of its **tax base** - as I mentioned above. However, most people are probably more interested in whether Council Tax is regressive against **income**. There is little doubt that Council Tax is regressive when measured against **gross** incomes. However, it would seem to be more appropriate to investigate whether it is regressive against **net** incomes, (i.e. after all other taxes and benefits have been taken into account). Because income tax and means tested benefits together produce a highly progressive tax and benefit system, it would seem to be better to investigate what proportion each tax forms of **net** income - out of which each of these taxes actually have to be paid. (If we use **gross** incomes, virtually every tax, other than income tax, would appear to be regressive).

We can estimate the degree to which Council Tax is either progressive or regressive against expenditure, (which ought to correlate fairly well with **net** income), from the Family Expenditure Survey for 2005, produced by the Office for National Statistics, (http://www.statistics.gov.uk/downloads/theme_social/FamilySpending_2004-05/FS04-05.pdf). The results are shown in figure 2, below. The weekly cost of Council Tax for each expenditure decile is taken from Appendix A Table 2.3 of that report whereas the total expenditure / household income is taken from Table A8.

Household expenditure by income decile 2004-05										
Council Tax £/wk	5.5	8.4	11.0	15.1	16.7	17.8	18.5	20.0	21.5	25.3
CT as % Tot	3.7%	4.7%	4.4%	4.8%	4.5%	4.1%	3.8%	3.5%	3.2%	2.8%

Fig. 2

Should the council tax multipliers be changed?

There are, of course a whole range of possibilities once one starts to consider altering the Band Multipliers. However, figure 3, shows one particular more progressive version of the Multipliers that I have actually investigated.

A	B	C	D	E	F	G	H
0.4000	0.6667	0.7778	1.0000	1.4444	1.6667	2.0000	3.0000

Fig. 3

It will be seen that what I have done to arrive at this particular set of multipliers is to take the current Multipliers below Band D and move them one place to the right, (so that Band B has the old Band A Multiplier and so on), take the current Multipliers above Band D and move them one place to the left, (so that Band G gets the old Band H Multiplier and so on), give a new lower Multiplier to Band A and a new higher Multiplier to Band H, leave Band D as it is currently and "lose" the old Multipliers for Bands C and E.

The effect that these Multipliers have on the resulting Council Tax bills experienced by different segments of the population depends upon whether one allows these new Band Multipliers to drive any further Resource Equalisation, (thereby shifting Central Government grants **between** different Local Authorities), or whether one limits the changes to the bills faced **within** each Local Authority, (in other words each individual Local Authority has to raise the same total amount in Council Tax as it did before the change).

As I showed in Part III of this report, the current Council Tax system together with the current Resource Equalisation "unfairly" penalises certain types of Local Authority and certain Regions whilst rewarding others. Using a more progressive Banding structure to drive Resource Equalisation will make the "unfairness" **between** one Local Authority and another even worse - whatever it might do to the "fairness" **within** Local Authorities.

If we do not allow the new Band Multipliers to drive any Resource Equalisation, then it is obvious that the bills faced by people who live in Band A houses will be reduced. However, despite the Multiplier for Bands B and C being lower than they were before, it does not follow that people living in houses in those Bands will actually be faced with lower Council Tax bills. The loss of Council Tax yield from the Band A houses has to be made up somehow!

In fact, it is easy to show that out of the 320 non-London Local Authorities, the bills faced by Band B Council Tax payers will increase in 94 of them whereas the bills faced by Band C taxpayers will increase in no less than 103. Of course, if these increased bills fell on the richer half of the community one might not be too concerned. However, on the assumption that people live in the most "appropriate" houses for their incomes, (any other assumption would make the situation **worse**), one finds that there are 57 Local Authorities where Council Tax bills would increase for some people with incomes below the median income for the residents of that Authority.

Of course, if people don't live in the housing that is most "appropriate" to their incomes in any area, (and for historical reasons many don't), then if you happen to be someone having a lowish income living in a relatively highly Banded house, (usually, but not always, above Band D), then making the Council Tax more progressive by altering the Band Multipliers will actually make your situation **worse**.

Should we add new Council Tax Bands at the top and bottom?

It is self evident that the number of people who find themselves in Bands other than A or H will be completely unaffected by adding Bands either at the top or at the bottom. Any Council Tax hardship which arises from their being in too high a Band for their incomes will not be ameliorated by adding any further bands at the bottom.

However, 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 the effect of using additional Bands to drive Resource Equalisation makes the situation **worse.**

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 should 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

Modelling the effects of a more progressive Council Tax

Because there is very little real and reliable data about how Council Tax bills actually relate to individual household incomes, (all that we have is some very crude averages), I have had to use a model based approach in order to make any further progress in relating personal incomes to Council Tax bills. I have successfully used this particular income distribution model on many occasions in other contexts. Since it accurately reproduces all the known data on income distributions as published by HM Government / the Inland Revenue, (where the Government's results are self consistent!), it does not seem unreasonable to use it to investigate the likely effects of changing the Council Tax Multipliers or adding new Bands at the top and / or bottom.

Although I give considerably more detail on the usage of this model and the results derived therefrom in the Appendix to this report, it seems appropriate to include a brief description here as a "taster".

In order to relate Council Tax bills to incomes, the basic model starts with the assumption that the poorest people in any area all live in the most lowly banded houses and the richest in the most highly banded. In other words, everybody lives in the most "appropriate" **available** accommodation for their incomes. I then test the sensitivity of the results to this assumption by allowing differing percentages of people to live in housing that is "appropriate" to those whose incomes are one or two deciles away.

- This is probably a better sensitivity test than allowing the same fixed percentages to live in the "wrong" band of housing - or allowing the same fixed percentage of the housing stock in each band to be occupied by the "wrong" sort of people. Either of these latter two approaches would overestimate the number of people living in the wrong bands where bands were unevenly distributed and underestimate the numbers where it was more evenly distributed. For example in Easington 80.62% of all housing falls into band A. This means that less than 20% of the population there could ever live in the "wrong" housing band - even if all the richest people lived in the cheapest houses and all the poorest lived in the most expensive ones! In a more evenly banded Local Authority, (such as Teignbridge), 20% of the population living in the wrong band is not only possible but even moderately likely.

Using the actual property band distribution, the actual band D Council Tax and the actual average Council Tax per dwelling in each Local Authority area, I then use this model to determine what percentage of people in each Local Authority are paying a given percentage more (or less) in Council Tax when compared with the average for people in their income bracket (over England as a whole). I consider people at all income levels, with incomes from £0 - £50k being treated in bands only £1k apart. Between £50k and £80K, the income brackets are £5k wide and above that level £10k wide. I then examine how the percentage of people paying too much or too little changes as we change the Band Multipliers and / or add more Bands.

Figure 4 shows the percentage of the population of England paying more than 10% "too much" in Council Tax when compared with the average for their particular income bracket. As can be seen, when we introduce two new bands - by dividing Bands A and H into two equal portions and having multipliers of 0.3 and 4 for the new top and bottom bands respectively - the percentages of people paying too much increases. This increase is even more marked when we include resource equalisation as well

% of English population paying Council Tax bills >10% higher than average for their income band			
	Standard	New No RE	New RE
0% Mixing	22.6%	23.0%	28.9%
30% Mixing	24.4%	27.2%	30.6%

Fig. 4

As would be expected, allowing people to live in housing appropriate to other income deciles increases all the percentages.

Figure 5 presents similar results for those paying more than 10% “too little” Council tax according to the same criteria. Once again, we see how the additional bands makes things worse and how Resource Equalisation makes things worse still

% of English population paying Council Tax bills >10% lower than average for their income band			
	Standard	New No RE	New RE
0% Mixing	24.5%	28.2%	34.9%
30% Mixing	27.9%	34.2%	37.7%

Fig. 5

The model gives very similar results when one investigates the effect of making the Council Tax more progressive by changing the Multipliers, (rather than adding more Bands). For example, figure 6 shows the percentage of people in England, outside London, who would be paying more than 10% too much Council Tax, (compared with the average for their income bracket), if we were to use the particular Band Multipliers already illustrated in figure 3, above.

	No Resource Equalisation		Full Resource Equalisation	
Multipliers	Standard	More Progressive	Standard	More Progressive
No mixing	22.6%	27.0%	22.6%	32.0%
30% mixing	24.4%	29.4%	24.4%	32.8%
% of population paying >10% too much Council Tax				

Fig. 6

From the above, and from the much more extensive modelling that I have undertaken, (some of which is described in the Appendix to this report), I am forced to conclude that simply making the Council Tax more progressive will, **on its own**, not help at all - in fact it will make things worse!

As part of a package of other measures, then it is indeed possible that a more progressive structure might help - but **NOT** with the current banding structure / distribution.

2.3 Modifying Council Tax Benefit

What would be the effect of improving CTB take-up?

Many of the submissions published on the Lyons Inquiry website claim that Council Tax could be made much more tolerable if it were to be made more progressive and if the take-up of Council Tax Benefit could be improved. As we have just seen, simply making Council Tax more progressive probably won't work and indeed it is probably **already** progressive at the bottom end of the income distribution once all other taxes and benefits, (including CTB) are taken into account.

It is perhaps worth remarking that the numbers shown in figure 2, above are remarkably similar to those shown in the bottom line of Chart 2.3 of the December 2005 Interim Report of the Lyons Inquiry. This purports to show how regressive or progressive Council Tax would actually be if Council Tax Benefit were to be taken up in full by all those entitled to claim it. The family expenditure figures shown above are based on survey data - i.e. the **actual** expenditure after all taxes and benefits **actually** paid and claimed have been taken into account. This leads me to suspect that "improving" the take up of Council Tax Benefit will have little effect on how progressive or regressive against income the actual amount of Council Tax paid would turn out to be.

I think that there is a real danger that Chart 2.3. in the 2005 Interim Report of the Lyons Inquiry could unintentionally mislead people about the effect of improving the take up of CTB. The upper line is based on the purely theoretical situation that would occur if **nobody** were to claim CTB. In fact many of those entitled to CTB **do** take it up. No alterations to the CTB system can possibly "improve", the difference between zero take-up and the actual take-up that we have at the moment. The correct comparison to make would be between actual take-up as it is now and the supposed results of 100% take-up.

However, as shown above, once the **actual** take up of **all** benefits, (and not just CTB), as well the effects of income tax and NICs are taken into account, the profile of Council Tax as a percentage of actual spending in each spending decile looks very similar to the lower line of Chart 2.3 (which is supposed to represent what would happen with 100% CTB take up). In other words, there is a danger that the beneficial effect of improving the take-up of CTB could be over-estimated.

Nobody knows for certain how many people who are entitled to CTB fail to claim it nor does anyone know what the total of claimable, but unclaimed, CTB might be. However, having said this, I would **suspect** that most of the non take-up of CTB is amongst those whose total benefit would be too small to be worth the hassle and "degradation", (as they might see it). There is a little bit of support for this view within the 2005 Lyons Interim Report: the amount of CTB unclaimed appears to form a lower proportion of the amount claimable than the non-claimers do of the total of those supposedly entitled to claim it.

Technical Note: *It is far from clear how one gets decent data for entitlements to benefits that are* ***not*** *taken up - especially when the benefit concerned involves a means test based on* ***both*** *income* ***and*** *savings. To be sure, we do have a known correlation between the average savings of people in different income ranges. However, this correlation is not really good enough to draw any useful conclusions about the take-up, or not, of CTB. The 95% confidence limits on all the data and modelling that I have been able to find / do are so wide that the results on the effect of altering CTB take-up are virtually meaningless.*

The origin of the estimates of how much CTB is or is not left unclaimed is also unclear. Many people quote similar figures but give no reference to their sources. As Michael Orton notes in another context: people are very reluctant to disclose their savings to those conducting surveys - so survey data tends to be skewed towards the assumption of lower savings than is perhaps the case. All of which could lead to a potential over-estimate of how much CTB is left unclaimed

3. AD VALOREM PROPERTY TAXES

The key difference between the local *ad valorem* tax on property now being introduced in Northern Ireland and the Council Tax is that, whereas the Council Tax is regressive against property values, the Northern Ireland tax charges the same proportion of the value of a property for all properties, (below a cap which will actually affect very few Northern Irish properties).

Given that I have already shown that making the Council Tax more progressive, (whether by adding extra Bands at the top and bottom or by changing the Band Multipliers), will actually tend to make things worse, we would expect that the adoption of an *ad valorem* approach, (which is more progressive / less regressive than the Council Tax), would also fail to improve matters as well.

In contrast to the situation in England, there is much less disparity between both house prices and incomes as one moves from one part of Ulster to another. In Northern Ireland the average income of the residents of the richest Local Authority, (North Down) is only 36% higher than the average income of those in the poorest, (Strabane). In England it is much greater. The average income of the residents of the richest Local Authority area outside London, (Elmbridge), is 182% higher than that of the poorest, (Blackpool). A similar story applies to property values. The average price, (based on the detailed data for 2002), in the most expensive area outside London is 838% higher than that in the cheapest. Meanwhile the average price of property in the most expensive town in Northern Ireland is only 45% higher than the average price in the cheapest. At the county level the difference is much less - only 17%.

Whilst there is nothing inherently wrong with progressive, (or even regressive), taxes, it makes less sense to have more progressive taxes as the link between the tax base, (in this case property prices), and ability to pay, (usually treated as a synonym for income), becomes more haphazard. Where, as in Ulster, the differences in both the tax base and the ability to pay are relatively low, it hardly matters whether the tax is flat, progressive or regressive. Even if the relation between tax base and ability to pay were to be non-existent, there would be relatively little "unfairness" since most people would be paying much the same in tax anyway. However, as we have just seen, in England the differences in tax base and ability to pay are much larger. This means that for the Northern Irish model to work in England, there needs to be a very close correlation between income and house prices - at least if a single **national** flat rate of tax were to be imposed.

As will be seen, I conclude that this correlation is not sufficiently good for a flat tax to be levied at a uniform rate across the whole country. Even with the Council Tax, the "middling poor" in the "richer" areas end up subsidising the "middling rich" in the "poorer" areas even though the actual incomes, (let alone the purchasing power), of the former are lower than those of the latter. This is a direct consequence of Resource Equalisation being based upon the tax base of the populations concerned rather than their incomes / ability to pay. The adoption of the Northern Irish approach would exacerbate this problem

3.1 The relationship between incomes and house prices

It is clear that, **in general**, people on higher incomes tend to live in the more expensive houses while people on lower incomes tend to live in the cheaper ones. However, in examining the case for any taxation based upon house prices, one needs to establish how many exceptions there are to this general rule and how far away these exceptions lie from the trend line.

There is a wide variety of quantitative and qualitative evidence to suggest that incomes and house prices are not particularly well correlated.

Anecdotal / qualitative evidence

Amongst the more important bits of qualitative evidence are:

- 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 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

Quantitative evidence

My investigations have convinced me that there are many more and much larger exceptions when one compares incomes and house prices across England as a whole than there are when one does the same exercise within any one region or Local Authority. One particularly stringent test for exceptions that we could apply would be to ask how many people living in the cheapest type of housing, (which is usually, but not always, a flat), in one area have to pay more for their housing than do those living in the most expensive type of housing, (which is always a detached house in every Local Authority), in another while, **at the same time**, having lower incomes than those dwelling in the more expensive housing.

Unfortunately, there is no good published data on the relationship between house prices and incomes. However, we do have sufficient data to make a reasonable stab at answering this question. We know, (from the Inland Revenue), the mean and median incomes in every Local Authority Billing Area. We also know the average prices for each type of house, (detached, semi-detached, terraced and flat), in the same areas. If we make the assumption that the poorest people always live in the cheapest type of housing, the wealthiest live in the most expensive types and so on through the income and property ranges, (a sweeping assumption - but this is the **best** possible outcome for those advocating a tax based on property values - remember, we are looking at **exceptions**!), then we can indeed see that there are some Local Authority areas where the cheapest type of housing is more expensive than the most expensive type of housing in others and where those dwelling in the more expensive type of housing have incomes above the incomes of those dwelling in the cheaper houses in the more expensive housing area.

A particularly extreme example of such a Local Authority "pairing" is provided by the contrast between Elmbridge and Hull. In Elmbridge, the cheapest type of property is a flat and the average price for a flat there in 2002 was £191,019. In contrast, the most expensive type of property in Hull is the detached house, which at that time commanded an average price of £95,688 - which as almost exactly half that of the cheapest type of property in Elmbridge. Is it really likely that the average income of detached house dwellers in Hull is lower than the average income of flat dwellers in Elmbridge?. This seems to be extraordinarily unlikely given that detached housing in Hull accounts for only 5.9% of the housing stock there and that flats in Elmbridge account for just over 21% of the housing stock there. Is it really plausible that the richest 5.9% of people in Hull are poorer than the poorest 21% in Elmbridge? My best estimate is that the detached house dwellers in Hull enjoy an average income at least three times as high as the average for the poorest 21% in Elmbridge - and probably a great deal more than that!

Admittedly, the above is an extreme example, but there are many such pairings which cause serious doubts about the viability of adopting the Ulster approach in England.

If the most expensive type of housing accounts for less than 50% of the housing stock, then our assumption about people living in the most "appropriate" housing for their incomes means that those living in this expensive housing must **all** enjoy more than the median income for their Local Authority area. Indeed, they must, on **average**, enjoy more than the mean income - usually substantially more. Similarly, if the cheapest type of housing accounts for less than 50% of the local housing stock, then those dwelling in the cheapest housing must receive, on **average**, less than the median income for their area - normally a great deal less.

This suggests that if we could identify Local Authority Districts where the cheapest type of housing is both more expensive than the most expensive type in one or more other Districts and where the median income in the former is lower than the mean incomes in the latter, then we would indeed have a very clear demonstration of the dangers of adopting a uniform rate on English properties. This is, after all, a very difficult test for any "exception" to pass.

Actually, there are sixty different Local Authority Districts, (out of the 320 available / examined), which "pass" this exceptionally difficult exception test. Using a similar reverse test, (i.e. where we look for Local Authority Districts where the most expensive type of housing is cheaper than the least expensive type in other areas with the former also having a higher mean income than the median incomes in the latter), we find that there are 124 Local Authority Districts passing this test

Obviously, in those cases where either the cheapest or the most expensive type of housing accounts for more than 50% of the housing stock, it could just about be argued that this test is invalid. However, there are, in fact, only three Local Authorities, (Burnley, Kirklees and Stockport), in which the cheapest type of housing takes up more than 50% of the housing stock and only seven, (East Dorset, East Lindsey, North Lincolnshire, South Kesteven, South Northamptonshire, South Somerset and West Oxfordshire), where the most expensive type accounts for more than 50%. None of the former are to be found in the list of those paying "too much" for their housing and only East Lindsey, North Lincolnshire, and South Kesteven are to be found in the list of those paying "too little". Indeed, West Oxfordshire and East Dorset are to be found in the list of those paying "too much"! Given that the worst "offenders" in terms of paying "too much" pay more for their housing than as many as 98 other Districts passing our exception test whereas the worst "offenders" paying "too little" pay less than as many as 33 other Districts "passing" our exception test, the three "questionable" Districts, (East Lindsey, North Lincolnshire, and South Kesteven), can hardly be biasing the results significantly!

A list of some of the worst "offenders" is given in Figure 7. The column labelled as "No" in the left hand half of this figure refers to the number of Local Authorities whose most expensive type of housing is, on average, cheaper than the cheapest type of housing in the Authority mentioned and whose residents have higher average incomes than the median income of the residents of the Authority concerned. Likewise in the right hand half, "No" refers to the number of Local Authorities where the cheapest type of housing is, on average, more expensive than the most expensive type in the area concerned and who, at the same time, have residents with average incomes higher than the median incomes of the Local Authority named.

House prices too high	No	House prices too low	No
Oxford	98	Copeland	33
Bath & North East Somerset	69	North East Lincolnshire	33
Tunbridge Wells	54	Sedgefield	27
Reading	46	Boston	25
Winchester	46	East Lindsey	25
Brighton & Hove	30	North Kesteven	25
South Buckinghamshire	30	North Lincolnshire	25
South Hams	25	Bolsover	24
Christchurch	24	Wear Valley	22

Fig. 7

We cannot, of course, assume that **all** flats in those areas where they are the cheapest type of property are cheaper than **all** the detached houses. After all, flats can vary between inadequately converted basements to luxury penthouse suites! Similarly, not all terraced property will necessarily be cheaper than every semi-detached property even in those places where the average price for terraced housing is lower. For example, some terraced property might consist of very grand Georgian housing. Inevitably there will be some overlap in prices between different types of property. This means that the average price for the cheapest **type** of property will be somewhat higher than the average price of the cheapest property making up the same percentage of the housing stock. Similarly the average price of the most expensive **type** of property will be somewhat lower than the average price of the most expensive properties making up the same percentage of the housing stock. If this “mixing” were to occur on a large scale then the meaning of my above “test” could, in some instances, be called into question. One cannot determine how important this effect might be without a proper investigation of the actual mix of properties in the various Local Authority areas.

One can make a reasonable estimate of median property values by extrapolation from the average values of the second cheapest and second dearest property types, (where the median falls into one of those two classes that is). One can estimate the top and bottom limits for price in these two types by taking it as the mid point between the average for the prices of the type below, (for the lower limit), and the average for the type in question and the average for the type in question and the type above, (for the upper limit). The median property value can then be estimated by how far the median is from the top and bottom, (in terms of the percentage of the housing stock), of that particular property type in which it falls.

Since we know, (from Inland Revenue data), the median incomes in every Local Authority, we can compare median incomes with median property prices for each area. Of course, this only allows us to compare **local** median values directly when we would really prefer to compare property prices with **national** incomes. However, since the median values for both incomes and property prices differ quite substantially across the 320 English Local Authorities being investigated, we can sort these Local Authorities into deciles based on either incomes or property prices. This enables us to compare property prices for Local Authorities where the median incomes or median property prices are broadly similar. Unfortunately because of the paucity of South Eastern (and other rich area) representatives in the lower income (and property) deciles and the similar scarcity of North Eastern (and other poorer area) representatives in the upper deciles, we are really only able to make realistic comparisons in the middle deciles. If we sort on the basis of incomes, then we get the results illustrated in figure 8, which shows the relative ratios of house price to income ratios. (I have done this rather than showing the ratio of house prices because the median incomes are not **exactly** the same.)

Decile	**NE**	**NW**	**Y&H**	**EM**	**WM**	**EE**	**SE**	**SW**
1	1.1785	1.0543	1.5638	1.0000	1.3320	1.5565	1.6700	1.6662
2	1.1216	1.0708	1.0000	1.1535	1.3725	1.3886	1.8984	1.6145
3	1.0000	1.2227	1.0494	1.0666	1.1372	1.2013	1.9349	1.8064
4	**1.0000**	**1.4277**	**1.3056**	**1.4151**	**1.3562**	**1.3366**	**1.5507**	**1.7741**
5	**1.3611**	**1.2804**	**1.1693**	**1.0000**	**1.2908**	**1.4253**	**1.7552**	**1.8709**
6	**1.0036**	**1.1113**	**1.0020**	**1.0000**	**1.0735**	**1.1387**	**1.5392**	**1.3215**
7		1.0000	1.0498	1.0334	1.0588	1.0511	1.2421	1.1459
8	1.1181	1.3676		1.0000	1.2067	1.3226	1.5213	1.4749
9		1.5009		1.0000	1.0899	1.4214	1.4751	1.3966
10						1.0181	1.0000	

Fig.8

The disparities between one Region and another, in terms of the relative ratios of house prices to incomes are very obvious. This is, to some extent, rather surprising. The people whose incomes are most likely to be out of line with the values of their houses are the poorer people in the richer areas, (because of the anecdotal evidence already mentioned), and the richer people in the poorer ones. By basing our analyses on medians, we exclude all these people from consideration!

These results, together with some modelling results, (which I describe later), show, pretty conclusively, that a flat rate *ad valorem* property tax with one **uniform national** rate would be grossly "unfair" to people living in expensive housing areas. They already have problems in the "affordability" of housing in such areas. It would seem perverse and sadistic to make their problems worse. Only a very regressive national tax on property values would avoid having a highly regressive and discriminatory effect on poorer people in the richer areas. This is exactly how the Council Tax operates, so that, from this point of view, (but **only** this point of view), it is not such a bad tax!

However, whilst making a property tax regressive improves the situation that would apply **between** different Local Authorities, it does nothing to help the situation **within** each Local Authority. The problem is that for every single one of the 320 Local Authority Districts examined, the ratio of house prices to (gross personal) incomes is higher in the lowest **local** house price decile than it is in the highest local house price decile. A regressive tax would simply ensure that those on the lowest incomes would pay the highest proportions of their incomes in tax. This is exactly the problem with the Council Tax. It is certainly regressive against gross personal incomes. However, there is some evidence that it may be a more or less flat tax, (slightly progressive at the bottom; slightly regressive at the top), once all other taxes and benefits have been taken into account when measuring household incomes.

Examining the ratios between house prices and incomes also shows why different regions are hit differently when one considers an *ad valorem* property tax. My modelling, (described later), shows that there is a strong tendency towards the ratios between the top and bottom deciles being greater as the average price of a house increases. This is because the house price distribution is much narrower than the income distribution. This will always mean that the poorer people in the richer areas will have trouble in affording their housing - let alone any tax levied on it!

3. 2 The effects of using the Ulster system in England

Many people believe that local, (and possibly all), taxation should be related as closely as possible to income - possibly directly through a Local Income Tax. Without the use of a good income distribution model, it is virtually impossible to assess how individuals would be affected in anything other than a flat rate income tax regime. However, since we know, (from the Inland Revenue), the **average** incomes in each Local Authority area, it is a comparatively simple matter to work out what the tax rates would need to be in order to yield the same amount as Council Tax does today. Likewise, since we know the average prices of houses in every Local Authority District, (albeit in 2002), it is also a simple matter to work out at what rate an *ad valorem* tax would need to be levied in order to achieve the same yield. (The result in England and ignoring London is 0.79% of 2002 values in order to produce the same yield as Council Tax did in 2005/06).

Given this, it is also possible to work out which Local Authorities would gain and which would lose if a local tax, yielding the same as Council Tax, were to be replaced by either **flat** *ad valorem* or **flat** income taxes levied at uniform **national** rates. It is also possible to see which Councils would gain and which would lose if a flat rate income tax regime were to be replaced by a flat rate *ad valorem* property tax regime. The results, in millions of pounds, of such an exercise are shown in figure 9.

	Shires	Units	Mets	Region
North East	95	97	98	290
North West	181	58	370	608
Yorks & Humber	-5	111	381	487
East Midlands	226	46		272
West Midlands	28	33	134	194
Eastern	-287	7		-280
South East	-876	-163		-1040
South West	-375	-156		-531
England	-1015	32	983	0

Fig. 9

I should emphasise that these results do not, in any way, depend upon the use of any income or property price distribution models.

Another way of looking at the same results is to express the winning or losings in terms of pounds per household. The results of this exercise are shown in figure 10.

	Shires	Units	Mets	Region
North East	260	337	198	253
North West	174	221	212	200
Yorks & Humber	-21	231	257	219
East Midlands	150	128		146
West Midlands	29	130	123	85
Eastern	-136	24		-117
South East	-337	-183		-297
South West	-264	-188		-236
England	-99	9	204	

Fig. 10

From this it is easy to see which parts of the country would be likely to support such a proposal and which ones would be likely to oppose it vigorously!

Another way of looking at the impact of replacing Council Tax with an *ad valorem* property tax is to investigate what percentage of Local Authorities in each region would "win" and what percentage would "lose out" when compared with the current Council Tax situation. In order to exclude those who only "win" or "lose" by relatively small amounts, I show, in figure 11, the percentage of Local Authorities of each region and type that would find themselves in the top 25% of winners and the top 25% of losers.

	S	U	M	R	S	U	M	R
North East	0.0%	0.0%	0.0%	0.0%	84.6%	100%	80.0%	87.0%
North West	4.2%	0.0%	6.7%	4.7%	58.3%	75.0%	66.7%	62.8%
Yorks & Humber	0.0%	0.0%	0.0%	0.0%	28.6%	80.0%	88.9%	66.7%
East Midlands	2.8%	0.0%		2.5%	33.3%	0.0%		30.0%
West Midlands	12.5%	0.0%	14.3%	11.8%	16.7%	33.3%	28.6%	20.6%
Eastern	34.1%	25.0%		33.3%	0.0%	0.0%		0.0%
South East	65.5%	66.7%		65.7%	0.0%	0.0%		0.0%
South West	25.7%	44.4%		29.5%	0.0%	0.0%		0.0%
England	27.3%	28.3%	5.6%		18.1%	28.3%	66.7%	
% of LAs in the top 25% of losers					**% in top 25% winners**			

Fig. 11

Given that it is relatively easy to demonstrate that Regions like the South East and the South West **already** "lose out" under the **current** Council Tax system, the idea that it should be replaced by a system that would cause these Regions to "lose out" **even more**, could only be rationally supported by those Regions which are "winners" acting out of purely selfish considerations.

3.3 Modelling incomes and house prices

Unless we have good figures for both the distribution of property prices and the distribution of incomes in any area we cannot really investigate how people at different levels of income might be affected by an *ad valorem* property tax. Unfortunately, there is no good published information on either incomes or property price distributions - at least not in a collated from. However, the web-site http://www.houseprices.co.uk/ gives very detailed information on recent house sales and the prices realised at the level of **individual** properties

I have used the information from this (and other), web-sites to undertake a fairly detailed analysis of property prices in a small number of places and a much more superficial and cursory analysis in many more. Surprisingly I have found that I can use my (well proven) income distribution model to describe the property price distribution as well. When checked against data from the above website the model achieves a good level of accuracy. However, the values of the parameters used for property are different from those used for income - which indicates that income and property prices are not particularly well correlated across the country! If this property price distribution model is reasonably valid, then it would be possible to use it, in conjunction with my income model, to investigate just how well property prices and incomes **are** related. (I provide data in the Appendix to this report that shows just how well this model **does** fit all the data that we have.)

While one always has to be careful when using models that have not yet been well tested in a variety of situations, I do think that it is likely that, whereas results on **individual** Local Authorities might be somewhat tenuous, results on **aggregates** of Local Authorities are likely to be reasonably accurate and meaningful.

In this context, figure 12 shows how, (on the basis of the model), the **national** income deciles and **national** property price deciles fail to match up properly on a Regional basis. In the North East Region, some 82.8% of the population can live in property that is in a lower property price decile than their income decile. In contrast, only 1.4% of the population of the South East Region can do so. In this Region, around 72.7% of the population have to live in more expensive property than their incomes would warrant, (when considered on a national basis).

	NE	**NW**	**Y&H**	**EM**	**WM**	**EE**	**SE**	**SW**
Below	82.8%	70.5%	69.1%	54.9%	46.7%	8.4%	1.4%	4.2%
Same	14.7%	20.2%	21.5%	27.4%	26.7%	30.9%	25.9%	24.6%
Above	2.4%	9.2%	9.3%	17.7%	26.6%	60.7%	72.7%	71.2%

Fig. 12

It is well known that property prices in the South East Region are higher than those in other parts of the country. But, are they out of line with incomes in the South East? If we use the models to examine the likely property prices paid by those in each **national** income decile on a Regional basis we get the results shown in figure 13.

	Average property prices for each income decile as a multiple of the minimum									
	1	2	3	4	5	6	7	8	9	10
NE	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
NW	1.16	1.23	1.30	1.32	1.31	1.21	1.14	1.13	1.14	1.16
Y&H	1.31	1.42	1.46	1.43	1.42	1.35	1.26	1.20	1.21	1.17
EM	1.40	1.45	1.51	1.51	1.51	1.44	1.31	1.28	1.42	1.33
WM	1.46	1.59	1.70	1.74	1.62	1.50	1.41	1.42	1.46	1.42
EE	2.03	2.28	2.50	2.45	2.34	2.06	1.84	1.68	1.71	1.58
SE	2.56	2.83	3.07	2.89	2.71	2.45	2.19	1.94	2.00	1.84
SW	2.23	2.51	2.68	2.56	2.41	2.16	1.99	1.88	1.93	1.74

Fig. 13

This shows that, if a flat uniform rate of tax were to be applied to property values, then people in the South East Region could end up paying as much as two to two and a half times as much tax as those living on similar incomes elsewhere. Obviously, since this conclusion is based on model data, we need to be careful not to set too much store by this particular result. However, most models with any sort of claim to validity, usually work best at values close to the medians, (incomes and property prices in this instance). It is noteworthy that the results around the median income deciles are not dissimilar to the results in other parts of the income distribution. It is also noteworthy that the results shown in figure 13 are broadly in line with the completely independent set of results shown in figure 8. For the reasons I have already mentioned, we would expect the results based on medians, (i.e. those shown in figure 8), to be somewhat less extreme than the true situation since there is a bias against including any of the more extreme cases.

From the above discussion we would expect that the average incomes enjoyed by people in any given **national** property price decile would vary widely from one part of the country to another - with people in the South East Region enjoying (?!) substantially lower incomes for a given property price than those in (say) the North East. This is indeed what the model shows - the results of which are displayed in figure 14.

	Average incomes for each property decile expressed as a fraction of the maximum									
	1	2	3	4	5	6	7	8	9	10
NE	100%	100%	100%	100%	100%	100%	100%	100%	100%	97%
NW	86%	89%	78%	79%	81%	80%	80%	82%	85%	100%
Y&H	93%	82%	82%	75%	69%	73%	72%	77%	81%	64%
EM	72%	71%	74%	62%	64%	67%	67%	69%	71%	98%
WM	80%	68%	58%	61%	59%	56%	58%	59%	64%	87%
EE	48%	44%	33%	32%	36%	40%	38%	47%	57%	93%
SE		36%	21%	20%	24%	29%	30%	37%	44%	87%
SW		39%	27%	26%	30%	34%	36%	40%	50%	78%

Fig. 14

The models confirm the point I made earlier, namely that the property price distribution in any area is much narrower than the income distribution. The consequence is that poor people in rich areas are actually worse off, even before any taxation, than some apparently richer people in the poorer areas.

4. BUSINESS RATES / NNDR

4.1 Why the burden of Council Tax has grown

One of the reasons for the large rises in the Council Tax over recent years is that Central Government funding has grown more slowly than Local Government expenditure. Central Government funding mainly consists of money from two completely different “pots”. The first of these, the Revenue Support Grant, is money derived from general taxation. Broadly speaking, the Revenue Support Grant has more or less kept pace with the growth in Local Authority costs. It is the remaining element of Central Government funding, the redistributed Uniform Business Rate, which has fallen behind. This is because, by law, business rates can only be increased in line with the Retail Prices Index, whereas we would expect that Local Government expenditure on services, which tend to be labour intensive, would rise broadly in line with wages, (actually it has risen considerably faster). As a result, whereas in 1990/91 business rates covered around 29% of Local Authority expenditures, by 2004/5 this proportion had shrunk to only 20.4%. Council Tax has had to make up for the difference.

Obviously, had business rates been linked to average earnings, or better still, to business rents, (as they were under the old local rating system), instead of to inflation, Council Tax rises could have been somewhat smaller. Figure 15 shows how Council Tax would have risen had business rates been adjusted in line with average earnings and compares this with actual Council Tax rises.

Year	93/4	95/6	97/8	99/0	0/1	1/2
Earnings index	100.0	106.8	117.1	128.2	133.8	138.6
Actual CT index	100.0	113.5	133.3	154.6	164.7	180.7
New CT index	100.0	112.1	127.1	139.6	144.5	156.2

Fig. 15

While I can see no logical argument for any particular share being the "right" one, I do consider that, so far as possible, business property should be taxed in exactly the same way as residential property. Obviously this does not mean that we should treat the headquarters of Intergalactic Plc as a band H property. We could however make the reasonable claim that it should pay the same amount of tax that a block of flats with the same square footage in the same location and with the same standard of fittings and fitments would be charged. Since we already possess a system that is arguably more or less "fair" in its treatment of different businesses with respect to other businesses, we could use the linkage between offices and flats to arrive at a system that broadly meets the aim of treating residential and business property on an equitable basis. With such a system in place, it would be an easy matter to index business rates to the Council Tax or to whatever form of any property based tax were to replace it, (assuming that something of the sort remains).

4.2 Accountability and the Balance of Funding

Many of those making submissions to the Lyons Inquiry seem to take it as almost axiomatic that reducing the Central Government contribution to Local Authority spending will improve democratic accountability. The favoured method for achieving this supposedly desirable end is to "repatriate" the business rates, (NNDR), as called for *inter alia* by the Local Government Association. Given that businesses have no votes, it is a little difficult to follow this particular bit of logic! It was largely because some Local Authorities over-taxed local businesses whereas others had too few or too small businesses available to tax, that the business rates were nationalised in the first place. Overtaxing, (or even under-taxing), local business does not, so far as I can see, improve democratic accountability. This is especially the case where those who work in, or own these businesses live elsewhere, (as is the case, for example, with many businesses in London).

It could, of course be argued that since businesses have no national votes either, then repatriating the business rates should not **reduce** accountability. However, I believe that it is more important for any government, whether local or national, to be accountable to the **stakeholders** in a business than it is to be accountable to its management These stakeholders include employees, customers, suppliers and shareholders. In the case of large businesses, these stakeholders will, in all likelihood, come from far and wide. In the case of smaller businesses, the majority of these stakeholders might well be local.

In fact, in the early days of business rates most businesses were indeed local and only householders who paid Rates had the right to vote. Since, in those days, many business owners lived "over the shop", or at least locally, (including as it happens some very substantial plutocrats), they did indeed have votes - albeit not as business owners but as householders. It is only as businesses have grown, (often by amalgamation), and thereby become less local, that the real problem of accountability for the taxation of local business has emerged.

If a Local Authority were to over-tax a large business, many of the jobs that might be lost as a consequence will be those of employees who live and vote in areas governed by other Local Authorities. In this event, the Local Authority causing the problem would not be accountable to those who are affected. However, a national government that caused increased unemployment by over-taxing business would certainly be held accountable by those who lost their jobs, their investments, their customers or their suppliers. Most stakeholders **do** have the opportunity to vote **somewhere** - usually in the relevant **national** elections - but not always in the **relevant** local ones!

On the other hand, it could equally well be argued that Local Authorities are more likely to be accountable to small **local** businesses than national governments are. Where stakeholders are all local, a Local Authority has a greater interest in being "business- friendly", (particularly in areas where the local economy is less buoyant than the national economy), than a national one for whom "small local difficulties" might appear to be nothing more than a distraction. This argument tends to be stronger in the sparsely populated rural areas where Local Authorities cover a large geographic area than in the smaller urban ones, and especially in London, where many of the stakeholders of even quite small businesses may well have their residences and votes in a completely different Local Authority.

It also seems to be taken as axiomatic by many of those making representations to the Lyons Inquiry, (or at least those whose submissions have been published), that altering the balance of funding will not only increase democratic accountability but that it will also raise turnouts at local elections. Sadly, on this point, nobody seems to have examined the evidence.

If we examine the actual **current** balance of funding after allowing for each authority's per capita share of the relevant police, fire and county (or GLA) funding and Council Tax, we find that there are substantial differences. At one end of the scale we find Richmond on Thames, (raising 49.65% locally), and Elmbridge, (raising 48.70% locally), whereas at the other end we find Newham, (raising 16.42% locally), and Sefton (raising 18.21% locally) - all figures are for 2005/06. All of these, and indeed every other council, seems to be just about as centrally micro-managed as each other. Not only does the actual balance of funding at the moment vary quite considerably between Local Authorities, so too does turnout at local elections. A linear regression analysis between the two should show up very clearly whether there is any validity in this argument or not

I have actually performed such a linear regression between the percentage of local spending raised by Council Tax on the one hand and the percentage turnout at local elections on the other. Admittedly the two sets of variables are for different years, and I have only been able to find the turnout figures for the all postal voting experiment. However, the correlation coefficient is only 0.12 , (i.e. only 1.44% of the variation in turnout is accounted for by the differences in the balance of funding). This would suggest that the argument about the balance of funding and democratic accountability is erroneous. The (non) relationship between local election turnout and the percentage of Local Authority expenditure raised through the Council Tax is shown graphically in figure 16, which, I believe makes the point rather forcefully!

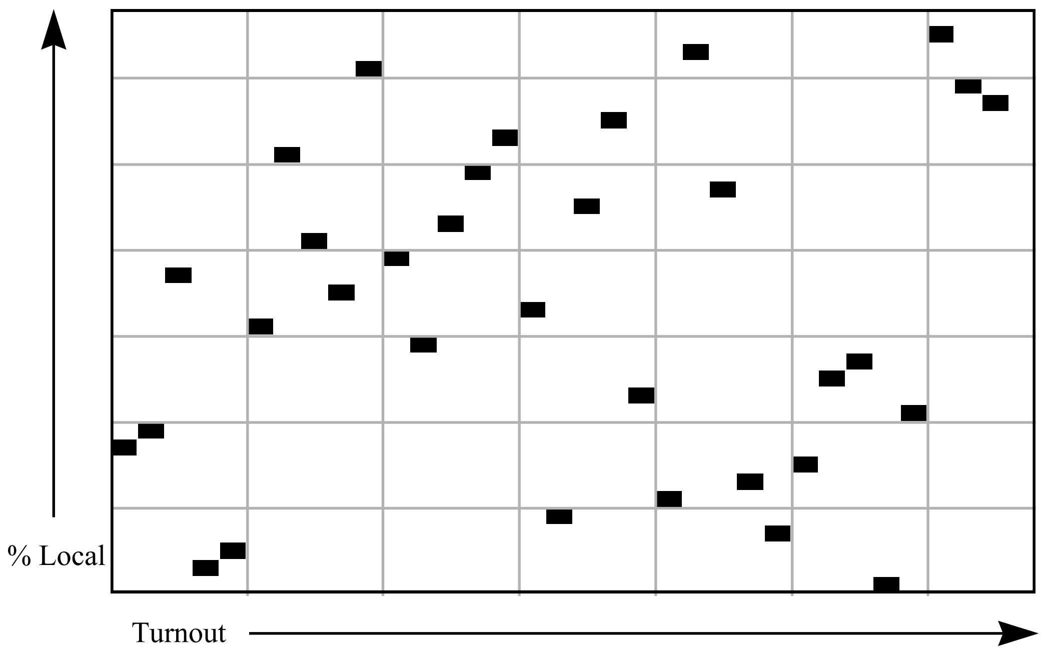

Fig. 16

Many of the Local Authorities responding to the "official" Lyons Inquiry have complained about the effect of "gearing" and have therefore asked for the proportion of local spending raised locally to be increased. At the same time, many of these same Local Authorities make the case elsewhere in their submissions for increased Central Government funding in their own particular cases! Their logic baffles me.

As I understand it, gearing was introduced (according to some sources) quite deliberately in order to magnify the effect of Local Authority increases in expenditure so as to bring home to people the implications of demanding ever better services. Of course if Central Government then rewards the spendthrift Local Authorities at the expense of the frugal ones, the whole exercise becomes absurd.

A linear regression between the proportion of local spending covered by Council Tax on the one hand and the total spending by each Local Authority on the other gives a correlation coefficient of **minus** 0.62. This means that there is a marked tendency for the more highly geared Local Authorities to spend more than the lowly geared ones. In other words gearing is **not** achieving the purpose stated above, (it's always easier to spend other people's money!) In fact even the correlation between Council Tax per head and Local Authority spending per head is also negative as well. (No wonder people are cynical!)

If every council had the **same** gearing, (with say 75% of all local spending being financed by Central Government - what is assumed, wrongly, to be the current average), then gearing might actually achieve its stated purpose - especially if those who did not contribute to local taxation, (including those on full Council Tax Benefit), were to be denied the vote. However it is difficult to see any sane politician proposing this.

As I remarked earlier, many of those Local Authority respondents who complain about gearing are also those who ask for more government grant and / or the retention or extension of Resource Equalisation, (so as to reduce the burden of Council Tax on their residents). Clearly, this is illogical nonsense!

I suspect that these Authorities are thinking of the situation that would apply were Central Government grants to increase in line with, or faster than, Local Authority spending. Clearly, in such circumstances, Council Tax payers would be protected. Gearing would still exist but its effects would be hidden. However, the tone and context of many of these submissions are to the effect that: "We deserve to get a bigger grant than we do and other Local Authorities should pay for this by getting less". A particularly egregious example of this is the submission by Derby City Council.

An alternative interpretation is that these Authorities think that once they can get their hands on the National Non-Domestic Rates, then they can make these more "buoyant", (i.e. they could increase them!), thereby producing much the same effect as an increase in Central Government grant would achieve. This is presumably why most businesses and business organisations that have made submissions to the "official" Lyons Inquiry have opposed the repatriation of business rates. They fear a return to "the bad old days".

4.3 Repatriating the business rates

When they have addressed the question at all, the overwhelming majority of businesses and business organisations making formal submissions to the "official" Lyons Inquiry have vehemently opposed any re-localisation of the business rates (NNDR). On the other hand, virtually all the submissions from Local Authorities that have addressed this issue have been in favour of such re-localisation. With such a pronounced measure of disagreement between those who pay and those who receive business rates it seems pertinent to try to understand the motivations and arguments used by each side.

The business view

There seems to be little doubt that the main reason for the almost universal opposition to the repatriation of the business rates is one of fear and distrust. The fear is that businesses would be used as a “soft touch” by hard pressed Local Authorities seeking to raise revenue without upsetting those who have votes by raising Council Tax. This is mainly down to the experience of what happened, (or maybe what business thought happened), prior to the nationalisation of business rates in 1990.

The fear and distrust of Local Authorities on the part of business is not helped by some of the language and arguments used by some Local Authorities in their own submissions to the Lyons Inquiry. For example it does nothing to reassure business to ask for the inflation cap on National Non-Domestic Rates (NNDR) to be removed - even if it is proposed to replace the inflation cap by rises linked to Council Tax. Council Tax has risen a lot faster than the RPI! Nor does it help to ask for more “buoyant” revenue streams - code for taxes that can be raised easily and / or automatically. Again, pointing out that the share of revenue raised by NNDR has dropped from around 29% to around 20% and suggesting that the revenue raised from Council Tax and NNDR should be equal is not particularly reassuring either!

The Local Authority view

The main motivation for the Local Authorities in calling for a repatriation of the business rates would appear to be a desire to escape form the apron strings of Central Government. There seems to be a belief that, if more of Local Authority expenditure were to be raised locally, then there would be less justification for micro-management of their affairs on the part of Whitehall. Morally, this case is probably unanswerable, but I am not convinced that any change in the balance of funding would make a significant difference in this respect.

It seems to me that if **any** funding at all is to come from Central Government, then Central Government will feel itself obliged to exercise **some** oversight over Local Authority spending in the name of Central Government remaining accountable to **national** taxpayers. As long as central funds and local funds are mixed up and managed by the same set of people, I really do not see how this particular circle can ever be squared.

Fairness

Although there is no completely objective test of “fairness”; (it is a somewhat nebulous concept lying mainly in the mind of the thinker); it nevertheless does not seem unreasonable that those who contribute to the success or profitability of a business should be the ones who should be entitled to the lion’s share of the benefits arising from that prosperity. These people are the major stakeholders, (essentially those who work in the business, form its customer or supplier base, the shareholders and, to a limited extent, the Local Authorities where they are situated and the community that those Authorities represent). There seems to be little case for allowing others, who have not contributed to that prosperity, to share in the benefits thereof.

On these grounds, for small local businesses, where most of the stakeholders are likely to be local, a repatriation of some or all of the business rates does not seem unreasonable. However, for larger, more diffuse businesses, where the major stakeholders are likely to be more widely spread, such repatriation would seem to be less appropriate.

I note that these conclusions regarding "fairness" are very similar to those I arrived at when considering accountability.

Economics

The original nationalisation of the business rates created a number of economic problems - all of them related to the fact that the business rate was made **uniform**. London and the South East were hit particularly hard. This is because since business rents were **higher** than in other parts of the country, rateable values also tended to be **higher**.

Unfortunately, businesses have to pay both rent **and** rates - and the amount that any business can afford from these two costs **taken together** is more or less fixed. If Rates bills are low, then landlords can get away with charging more in rent. If Rates bills are high, then the amount of rent than can be levied becomes relatively low. In the South East, where rents were relatively high at the time of the "nationalisation" of the business rate, the rateable values of business premises were (inevitably) correspondingly high. This meant that Local Authorities could raise sufficient money by charging a relatively low **rate in the pound**. (The amount of money that a Local Authority needs is driven by the cost of the services that is has to provide and not by the rental value of properties in its area). "Nationalising" the rate to a uniform value based on historic rents, (whose high level was partly the consequence of low Rates), therefore resulted in an **increase** in Rates in London and the South East and a decrease in Rates in some other regions. The result was that the overall bills for property usage that businesses in the South East had to pay rose substantially.

Of course in the long run, (when, as Keynes said, we are all dead), this situation will become self correcting. If Business Rates **rise**, (as they did in London and the South East since the rate in the pound was (eventually) equalised across the country as a whole), then rents have to **fall** if businesses are not to face severe difficulties. However, most commercial leases have upwards-only rent revision clauses. As a result, the expected fall in rents, (which has been largely concealed by inflation), consequent upon an increase in Rates took a long time to take place. This was one of the reasons why, for virtually the first time, the South East was hit particularly hard during the early 1990s recession. This effect was predictable, (and incidentally the author of this document **did** predict it). Had the changes not been phased in, the effects would have been even worse. Even so, the full effect was felt by those potential new businesses that would have replaced those that ceased trading - as normally happens in both booms and recessions. Such businesses either did not start trading or else started trading elsewhere.

Just about anybody running a complex organisation feels the need to be able to predict as many as possible of the financial variables that affect it. It is interesting to note in this context that many of the submissions to the Lyons Inquiry from Local Authorities make just this point as regards their own income, the government grants that they receive and the obligations that Central Government places on them. (How they can simultaneously ask for more "buoyancy", i.e. taxes that grow in line with economic prosperity, baffles me. What is supposed to happen to their tax take when economic prosperity takes a dip?). Businesses are no different. For many businesses the Uniform Business Rate is one of their top three costs of doing business. Although most businesses would prefer this to be a variable cost - i.e. one which rises and falls with the level of their business activity and / or their profitability - if it is to remain a fixed cost they would prefer it to be predictable. For this reason, businesses particularly welcome the inflation cap on non-domestic rates and the fact that rates are fixed centrally, thereby providing, as they see it, a "level playing field".

However, I am not convinced by the "level playing field" argument. Prior to 1990, although the rates in the pound charged to businesses varied widely from one part of the country to another, apart from a few notorious situations, the actual rates payable were much more even - since Local Authority costs were not all that different and rateable values were generally higher in areas where the poundage was lower. Even if business rates were to be re-localised, it would seem likely that any variations would, in the fullness of time, be compensated for by changes in the rents charged to business. The problems, as in 1990, would arise during the transitional period between one regime and another. We should also note that **any** argument about "level playing fields" is much more relevant to those businesses whose customers are national, (or international), than it is for those whose customers are purely local. One corner shop is not much affected by the rates charged to other corner shops hundreds of miles away!

I am much more convinced by the argument that, with the current system, Local Authorities have little incentive to be "business friendly". In particular, Local Authorities can increase their revenues through Council Tax by granting planning permission for new housing, (especially "executive" housing in the higher Council Tax Bands - assuming that this gain is not taxed away by reduced Revenue Support Grant!), whereas they do not gain much from the extra business rates resulting from granting planning permission for new business premises. It is true that schemes such as BIDs and LABGI do, to some extent, deal with this issue. However, it would seem that a more direct, and less bureaucratic, incentive would be more likely to be effective.

Potted history

In any discussion about re-localisation of the NNDR it is important to recognise that non-domestic rates were nationalised for good reasons. It is important that any "repatriation" of business rates does not reproduce the problems that caused them to be nationalised in the first place. The principal problems of the pre-1990 regime were:

- Some councils, especially the so-called "loony left" ones, who had a high proportion of businesses within their boundaries, severely overtaxed businesses mainly in order to keep down domestic rates and thereby maintain their grip on power. This tended to drive out the "victim" businesses or send them into bankruptcy. This strategy "worked" since there were rate rebates and benefits for the poor who tended to vote for the left anyway - while the remaining few "rich" tended to move elsewhere.

    — This was a particular problem in some of the London Boroughs and the metropolitan areas in general. Many of the people who lost their jobs as a result of business failures caused by excessive taxation did not have the vote in those Local Authorities raising the tax. Indeed, because of the relatively high unemployment at the time, many of those who did have the vote were themselves already unemployed and on benefits. Keeping down any local taxes that they themselves paid was much more important to them than any considerations about “incomer” business profitability.

- Some councils were especially lucky in that they had large enterprises such as a steel works or an oil refinery within their boundaries and were able to offer their residents an exceptionally attractive range of cheap services based on rates collected from those businesses, whilst neighbouring councils, where many of those who actually worked in those large enterprises and actually lived, received nothing.

Resource equalisation

Since the money raised by way of business rates is already redistributed back to local authorities, “repatriation”, in itself, would not result in raising any more money overall. Nor would it do much to alleviate the problems associated with the Council Tax. All that it **might** do would be to give local authorities more **control** over their own destinies. Inevitably, if the Central Government Revenue Support Grants, (RSG), were to remain at their current level, there would be both winners and losers from such a change. Some Local Authorities in those areas where there is a net export of the proceeds of the NNDR, seem, from their submissions, to believe that repatriation would allow them to keep more of the proceeds for their own residents. However it seems to me to be much more likely that the RSG to the winners would be reduced and that to the losers would be increased. The net effect in terms of the actual money available to local authorities to spend would be much the same. Indeed, the separation of Central Government grants into the two components of RSG and NNDR is more a matter of presentation than any underlying reality.

4.4 The basis for taxing business property

As with the old domestic Rates, business rates are based upon a property's supposed rental value. However, unlike residential property, there is still a lively rental market for some types of business premises such as shops, offices and so on. This makes valuations of these types of property relatively straightforward. On the other hand, other types of business property, such as chemical factories and oil refineries, are hardly ever rented, if at all. The valuation of such properties for the rates is therefore somewhat theoretical, arbitrary and hence potentially "unfair".

A number of those making submissions to the "official" Lyons Inquiry, especially when they come from a more academic background, have proposed that local businesses should be taxed on the basis of the value of the **land** which their premises occupy - a so-called Land Value Tax. On the other hand, many of those from a business background, including some Chambers or Commerce, have proposed that any tax on business property should be based on the value of the **buildings** that they use - or possibly their replacement cost. Clearly these views are diametrically opposed. The total value of business premises must be some sort of sum of the value of the land and the value of the buildings thereon. A sort of mid point between the two positions is therefore something very like the situation that we have at the moment!

The real advocates of a Land Value Tax would argue that it is economically efficient. By taxing land, you end up with an incentive to use it in the most economically effective way possible. I must admit that I fail to see why the normal economic signals of the market place don't do this already. It seems to me to be completely unnecessary, and possibly harmful, to either amplify or attenuate these signals. In fact, what this argument tends to ignore is that any change of land use is not cost free. It costs money to demolish buildings, (any residual value that the buildings might have in their current use is automatically lost), and it also costs money to build afresh. These are real economic costs that consume real resources. Artificially making these costs less significant, (as a Land Value Tax would), merely makes it more likely that economic resources will be wasted.

A second argument put forward by those in favour of a Land Value Tax is that the value of land is largely determined by community action - such as the granting of planning permission. In this context it is interesting to observe that the original advocates of Land Value Taxes were writing their tracts long before there was any such thing as planning permission! The use of planning permission as an argument is therefore an "add-on". The real objection to this argument is a practical one. What is to stop a cash strapped Local Authority from designating unsuitable land, through the planning process, as suitable for development in a manner that would appear to maximise its value? In this way, they could tax business in a way that businesses themselves had no control or influence over. Given the past "business-hostile" attitudes of certain Local Authorities, it would seem to me that, to say the least, this would be a very unwise innovation to adopt.

There are also very practical difficulties associated with valuing land for taxation purposes. As I have indicated above, there is a lively rental market for most types of business premises and so a tax based on rental values is at least a reasonably accurate reflection of the different values that different business **in the same locality** "extract" from occupying their premises. A Land Value Tax would have to be based on much more "academic" and "theoretical" considerations. Of course this does not worry the surveyors. Just imagine what such a system would do to their employment prospects!

Although it is fairly easy to value buildings on the basis of their replacement cost, (buildings are being built all the time and any builder should be able to give a reasonable estimate), and indeed such valuations are regularly made for insurance purposes, except in the case of very modern buildings, these values do not necessarily represent the value extracted from the premises by the businesses that occupy them.

4.5 Summary and conclusion

From the above arguments I conclude that the case for repatriation of the business rates is not proven. Arguments based on the balance of funding strike me as bogus. I do not believe however that it would **necessarily** be a bad thing to repatriate business taxation provided that certain safeguards for business were built in as part of the re-localisation. In particular, I think that the most important of these would be the indexation of business rates to Council Tax or whatever may replace it. In fact I think that this would be a good idea even if business rates were to remain “nationalised”. It would probably also be necessary to ensure that any attempt to bring business rates into line with domestic taxes which involved increasing business taxation should be phased in over a number of years so as to give businesses the reasonably predictable financial environment that Local Authorities are so keen to ensure for themselves.

Given the economic disruption caused by the “nationalisation” of the business rates, I believe that the case for “denationalisation” needs to be made much more strongly before any action is taken. Do we really wish to repeat the experiences of the early 1990s?

I am not persuaded by the arguments of those who wish to move from the current Rating system to something else. The system does seem to work reasonably well. “If it ain’t broke, why fix it?”

5. LOCAL SALES TAXES

One of the recurring themes amongst the various letters written to the national and local press as well as in the published submissions to the “official” Lyons Inquiry and in Isitfair’s own private correspondence is the feeling that **everybody** should pay **something**, however small, to the cost of providing local services.

Since everyone spends money, virtually everybody would also pay some sales tax where such taxes exist. (Very few people indeed will only purchase exempt or zero rated VAT goods and services for example). This is one of the virtues claimed for a local sales tax.

Another advantage claimed for local sales taxes is that, unlike the existing Council Tax, they are almost bound to be **affordable**. People don’t usually buy things that they can’t afford! Affordability would be virtually guaranteed if “essentials” were exempt from such taxes - as they are with VAT at the moment. Purchase of “non-essentials” is essentially voluntary. However, opponents to such taxes could legitimately claim that adult clothing and heating are really “essentials” - making this argument rather less cogent than it might at first appear to be.

One of the more persuasive arguments against **local** sales taxes is that they suffer from the potential problem of **displacement** of the activity on which the taxes are charged. What is there to stop people from doing their shopping in whatever convenient nearby Local Authority area levies the lowest sales taxes? (Anyone who is familiar with the area around the border between Belgium and Luxembourg will have noticed that buying petrol on the Belgian side is almost impossible whereas there is something of an excess of filling stations on the Luxembourg side - all caused by the large difference in road fuel tax in the countries concerned). Indeed, what is to stop many transactions **appearing** to take place (on paper) somewhere other than where they really took place?

In any case, would it not be better to ensure that any revenue went to the areas where the purchaser and / or the vendor actually **lived**. After all, it is **people** who consume local services! Achieving such a distribution of funds would be fiendishly complicated. However, if Local Authorities were to be much bigger than they are today, (say the size of the Regions as defined by the EU), then many of the problems of sales displacement and distribution according to where people lived would disappear. (The percentage of people near the borders relative to the population of the region as a whole would be much smaller). However, such an approach is hardly compatible with **very** local democracy!

From the above it would appear that the main advantages claimed relate to **sales** taxes per se and the main potential disadvantages relate to the fact that they are **local**. Given that all businesses try to make a profit, it is obvious that, if they succeed, then **all** their costs must somehow be reflected in the prices that they charge their customers. One of these costs is that associated with business rates. An alternative to a local sales tax is simply a local business rate levied on premises associated with retailing - but once again, this could suffer from the problem of displacement.

6. LOCAL INCOME TAXES

It would appear from my perusal of the various published submissions made to the "official" Lyons Inquiry, (as well as from submissions that Isitfair has received), that there is widespread support for some form of local income tax. However, support is far from universal. Some people are very strongly against the introduction of such a tax. In this section I examine some of the arguments, both for and against, a local income tax as a means of financing local expenditure.

It is obvious that the only way to be absolutely certain that any tax is closely related to income is to tax income itself. Indeed, the strongest argument in favour of a local income tax is that such a tax would, like national Income Tax, obviously be directly linked to ability to pay. Whether used as a supplement to, or as a partial or total replacement for, the Council Tax, there is little doubt that a local income tax would enable the overall burden of "local" taxes to be more closely related to people's incomes. However, it is worth remarking that using local income tax purely as a **supplement**, (in order to increase the proportion of local expenditure that is funded locally), would do absolutely nothing towards removing what some people see as the "unfairnesses" associated with the Council Tax. Only if local income taxes were to be used as a partial or total **replacement** for some or all of the revenue currently collected through Council Tax would any of the problems of "unfairness" be alleviated. Unfortunately, for most of its adherents, (apart from the Liberal Democrats), local income tax is seen as one of the more promising ways of raising **additional** funding. It is not (generally), seen as a **substitute** for Council Tax.

Local income taxes also tend to be favoured by those who believe that, overall, the tax system should be somewhat more progressive than it is currently. There is of course no doubt that a local income tax could be made considerably more progressive than the current Council Tax system without reproducing any of the extra "unfairness" that I describe in Section 2.2 of this part of my report. However, whether or not we **"should"** have a more progressive or more regressive tax system than we currently have is a matter for political debate - and therefore beyond the scope of this report.

For most people, a local income tax would be a tax levied on the total income of each person resident in a given Local Authority area with the **rate** at which this tax is levied being decided locally by the Local Authority concerned. This provides one of the strongest arguments against a local income tax. As with local sales taxes, the issue is one of **displacement**. This is a question of economics and tax avoidance / tax evasion. Whether this displacement is **real**, or whether it merely happens "on paper" is immaterial. For example, in the case of local income taxes payable to the Local Authority in which the tax payer resides, what is to stop a person with a large income from registering his residence in whatever Local Authority charges the lowest tax rates, (while presumably no longer "officially" cohabiting with an (officially) penniless partner who continues to reside where both **really** live)? Indeed, what is to stop a Local Authority from adopting the Channel Islands or Isle of Man strategy and deliberately encouraging the wealthy to live there, (on paper)? Low taxes charged to wealthy outsiders would raise very substantial revenues to the benefit of truly local residents! Local income taxes would appear to encourage beggar my neighbour policies. This might well lead to lower taxation overall, but it would also tend to lead to a decline in public services.

A related problem is that it is not clear **which** Local Authority should receive the money from any local income tax. Is it the one in which the money was earned or is it the one in which the earner resides? One can adduce plausible arguments for both. If the tax is payable where the income was created, then another form of displacement becomes a problem. Although it is relatively easy to determine where the typical worker on a factory assembly line earns his money, it is much harder to determine where knowledge workers do. In the extreme case a management consultant might earn all his money (in different countries) abroad, yet still live in the UK.

A second strand of opposition to a local income tax comes from those who fear that additional taxes will be used mainly as a way of increasing the overall tax burden on taxpayers.

The third main argument against a **local** income tax is one of the cost of collection and administration. **National** income taxes are levied at **uniform** rates and allowances for each band of income and most of the cost of administration is borne by employers through the PAYE system. These employers will usually have computerised payroll systems which may well not be flexible enough to deal with a whole range of **different** rates, (in theory up to 354 different rates for each band of income, and possibly 354 different break points for the different bands of income within England alone!). Moreover this same multiplicity of rates might also apply to investment and other sources of income besides pay and pensions, (and many pensioners have more than one source of pension!). At present only a minority of people have to complete self assessment forms - all of which have to be checked by Inland Revenue staff - because their investment income, (and their pensions), is already taxed at source at a **uniform** rate. This means that the Inland Revenue only really needs to know about the investment income and pensions of higher rate taxpayers. With a local income tax, virtually everybody would be required to complete such self assessment forms and many more tax office staff would be required to deal with them.

I regard this as a particularly severe drawback to any **genuinely** local income tax. I am particularly concerned that the Balance of Funding Review calculations concerning the probable cost of implementing a local income tax seem to ignore most of the points raised above. I also note that the cost of national income tax collection only **looks** small because the total amounts collected are so large. If the national rate were only one penny in the pound then the **absolute** costs of collection would remain much the same as now but the **proportion** of tax collected that would disappear in administration costs would then look horrendous. Even if only existing basic and higher rate tax payers were to pay a "local" income tax, the average rate required to achieve the same yield as the Council Tax would only be around 4.7p in the pound. I believe that the administration costs as a proportion of the tax collected would simply be too large to be sensible.

Of course, if the rates of tax and the breakpoints were to be uniform, many of these extra costs would not be incurred - but then we would not have a local income tax. We would merely have a national income tax masquerading as a local one! In fact I suspect that rates would become **almost** but **not quite** uniform - which is probably the worst of all possible worlds. It is almost inevitable that Central Government will feel constrained to provide extra national funding for those local authorities that have lower taxable capacities than others. It is obvious that, under such circumstances, any "local" income tax which merely supplemented **national** funding of Local Government would very rapidly become merely another, more bureaucratic, **national** income tax, (unless the equivalent of "Resource Equalisation" were to be abandoned - which seems to be unlikely / "unfair").

Probably the only way that a true local income tax could be collected at an acceptable cost would be to allow local authorities to set the level of the personal allowance, (lower than the national standard), for their taxpayers. This would enable existing payroll and taxation systems to be used, (via the usual coding of allowances), and it would be comparatively simple for the Inland Revenue to pay Local Authorities their "cut". I develop this idea in Part V of my report.