GREY HAIRS
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Local Authority Funding

A Fairer Tax Raising system

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Isitfair is an organisation campaigning for the reform of the Council Tax. This paper considers replacing the present funding of Council Tax with increases to national income tax and VAT. However, Isitfair recognises that this is just one of the possible alternative approaches to relieving the hardship being caused by the Council Tax in its current form.

1. Summary

The existing Council Tax system is now widely considered to be unfair because:

- The amount being demanded of householders bears only a passing relationship to either their net incomes or their net wealth. Its incidence is **haphazard**.

- The level of Council Tax, and the corresponding bills with which taxpayers are presented, bears only a very loose relationship to the amount a local authority actually spends. The local electorate is, in effect, **disenfranchised**.

- Many local residents, who benefit from council services and who could easily afford to pay more, contribute little or nothing to those services while others, whose ability to pay is much less, can end up having to pay as much as 25% of their income in Council Tax.

  — Many of those who vote for local services do not have to pay for them, whereas others, who make little or no use of those same local services have to foot the bill.

Because Council Tax has grown considerably faster than either inflation or median earnings, many people, especially those on low fixed incomes, or on low incomes linked only to retail prices, such as some pensioners, are now suffering real hardship.

The Isitfair Campaign proposes that the Council Tax in its present form should be scrapped and replaced by a more **broadly based** system of taxation which reflects an individual's **ability to pay** and which provides a real incentive for local authorities to give **good value for money**.

Isitfair propose that the **first step** to achieving these aims should be to fund the abolition of the Council Tax by increasing the basic rate of income tax from 22% to 25%, the higher rate of income tax from 40% to 41% and the standard rate of VAT from 17.5% to 20.05%. Most people would only notice very marginal differences in their overall standard of living from the implementation of these proposals. However, those most unfairly treated by the Council Tax and who are suffering real hardship, will find their situation much easier to bear. The main losers from these proposals would be those people on higher incomes who currently pay little or no Council Tax but who are entitled to use locally provided services.

The Isitfair campaigners are not inciting people to opt out of paying their way in the local community. They are quite happy to pay a reasonable cost based on their ability to pay and their consumption.

If you would like a better system of funding local services, then please read on.

To find out more about the Isitfair campaign visit our website at www.isitfair.co.uk. Alternatively, write to us at:

Willow Cottage, Church Lane, Headley, Hampshire, GU35 8PJ

enclosing an A4 size SAE.

2. Underlying causes of the problem

2.1 Increases in Council Tax exceed rises in income and inflation

Ever since the current system was introduced, the annual increase in Council Tax has been above both the annual inflation rate and the increase in average earnings. Only house prices have risen faster than the Council Tax. This latter is however a recent phenomenon. For example, in 2002 house prices had only grown by 73.5% since 1993 whereas the Council Tax had risen by 86.8% in the same period. Table 1 below shows the percentage change in these four key index values since 1993:

Index	1993	2004/5	% Change
Council Tax*	£8,912m	£20,302m	127.8%
House Price	£62,455	£156,831	151.1%
Earnings	£18,559	£29,181	56.9%
RPI	165.6%	223.6%	35.0%

Table 1

The Council Tax Index has been compiled from figures supplied from the Office of the Deputy Prime Minister, National Statistics, Local Government Finance Key Facts. (www.local.odpm.gov.uk/finance/stats/keystats/keyfacts.pdf). The remaining data has been obtained from HBOS, (www.hbosplc.com/economy/includes/historic_data.xls).

Since most local authority services are labour intensive then, (other things being equal - which they rarely are!), we would expect their costs to increase broadly in line with the appropriate earnings index. For various reasons, (including increased productivity and improved terms of trade with less developed industrial countries, like China), earnings in the UK tend to increase faster than prices. However, as Table 1 shows, Council Tax has risen considerably faster even than average earnings. Other additional reasons, besides simple cost pressures, must therefore have come into play.

2.2 The balance of funding has changed

There are, in principle, a number of different ways in which local authority accounts might be presented. For example, on one view, in 2001/02 Council Tax, on average, only covered 16% of gross local government expenditures. However, using the more familiar presentation, Council Tax covered approximately 25% of such expenditures. The difference arises because of the treatment of fees and costs for certain services , (and similar items). Since these are supposed to be revenue and cost neutral, these figures are normally netted off to give the more familiar picture. Whatever presentation is adopted however, it is clear that the current system for financing local authorities is heavily reliant on central government funding.

There is also extensive central government control of local expenditure. Central government can dictate how much local authorities are required to spend on services such as education and social services. This can often account for up to 80% of local authority spending.

Table 2, (based on data taken from www.local.odpm.gov.uk/finance/stats/keystats/keyfacts.pdf), shows how Council Tax has risen much faster than local authority spending.

Year	93/4	95/6	97/8	99/0	1/2	2/3
CT Index	100	113.5	133.3	154.6	180.7	205.8
LA Cost index	100	106.0	115.4	131.5	148.5	164.6

Table 2

It is clear from this table that central government funding must have 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. 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 local rating system), instead of to inflation, Council Tax rises could have been somewhat smaller. Table 3 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

Table 3

Table 3 shows quite clearly that, while Council Tax would have increased less had business rates been linked to average earnings, Council Tax rises would still have outstripped earnings growth. It is obvious that local authority expenditures must have risen faster than earnings.

2.3 Local authority expenditure has risen faster than earnings

Table 4 compares the average earnings index over recent years with the local authority cost, (= expenditure), index. This demonstrates that local authority costs have indeed risen faster than average earnings.

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
LA Cost index	100.0	106.0	115.4	131.5	148.5	164.6

Table 4

There are two prime drivers of any increase in local authority costs / expenditures. These are central government demands and local government priorities. Cost increases caused by central government actions include:

- Increases in national insurance contributions and increased pension costs
    - Increases in pension costs have been largely driven by the need to fill the pension fund deficits whose primary cause is the change in the way pension funds are taxed, (Gordon Brown's infamous £5Bn "raid"). Indeed it is clear from Table 4 that the approximate link between council expenditure and average earnings only broke down sometime in 2000 - when pension fund deficits first began to be widely appreciated!
- Pressure from central government to spend more to meet central government priorities - such as the requirement to increase funding for schools by an amount determined by government or pressures to meet waste recycling or other "targets" imposed by national government
- The role of inspectorates and other regulators in requiring councils to meet more demanding standards ("red tape").

The reasons for cost increases caused by local government actions include:

- Public expectations that services will improve
    - Many voters do not pay Council Tax. Extra services are therefore, in effect "free" in so far as they are concerned.
- Local policy priorities, such as additional spending on highways

- Lack of adequate incentives to keep costs down. For example, according to the recent Audit Commission's report into why increases were so high in 2003/04:

  — "Work by council auditors found the increases in spending in local government - which averaged 9 per cent - justifiable; but they were not in all cases unavoidable."

  — "Our report finds there is insufficient countervailing pressure to keep Council Tax increases down. This came in part from the perceived reduction in the threat of capping, but the main reason was that double-figure increases in Council Tax were no longer seen as exceptional."

Different councils respond to spending pressures in different ways, with some managing budget increases by reducing spending and increasing charges and others using Council Tax increases as the main way of funding spending pressures.

2.4 Local variations and the effects of "gearing"

There are considerable variations in average Council Tax levels in different regions of the country. In part this reflects different local authority spending patterns and in part it reflects the variability of central government grants to the different regions. Table 5 shows how central government grant per head of population, local authority spending per head of population and average Council Tax per dwelling varied from one region to another for the financial year 2001/02.

Region	Grant per Head	Local Funding	CT per Dwelling	LA Costs per Head
North East	1,041	22%	681	1,335
North West	1,014	24%	734	1,335
Yorks & Humber	973	22%	665	1,247
East Midlands	823	26%	717	1,112
West Midlands	923	24%	721	1,215
East of England	782	29%	763	1,102
London	1,367	19%	771	1,688
South East	753	30%	808	1,076
South West	757	29%	746	1,066

Table 5

It is immediately apparent that despite the South East region being the second most frugal region in terms of local authority expenditure per head it nevertheless has the highest level of Council Tax per dwelling. It is easy to see why this is so. Not only does the South East receive the lowest central government grant per head, but the central government grant also finances the lowest proportion of the total local authority expenditure.

Even within any region there are considerable variations in the proportion of total local expenditures that are locally financed. For example, in 2002/3, Newham, Wandsworth, Westminster and Tower Hamlets all raised less than 11% of their expenditures through Council Tax whereas, at the opposite end of the scale, Chiltern raised 60%.

Since 2001/02, (the year to which Table 5 refers), differences between individual local authorities have increased . This is because in 2003/04, the previous Standard Spending Assessment (SSA) was replaced by the Formula Spending Share (FSS). This was described by one county council leader as "incapable of understanding". It is the method used to determine the amount of grant payable by central government to the local authority. However, along with FSS, the government also introduced Resource Equalisation, which is a euphemism for redistribution. Grant redistribution - which moved grants from London and the South to the Midlands and the North - led to some councils putting up Council Tax more than others. 2003/04 saw a much wider variation in Council Tax and precept increases than in previous years. The highest increase for metropolitan councils was 19.9 per cent and the lowest was 2.3 per cent, a range of 17.6 per cent.

This illustrates the effect of "gearing" on Council Tax bills. It is obvious that if local authorities raise (say) only 25% of their revenues from local taxation, then a 1% increase in their costs, (whether caused by central or local government decisions), translates into a 4% increase in local taxes if central government funding remains the same. The smaller is the proportion of revenue raised locally, the greater is this "gearing" effect. A precisely similar effect would occur if central government reduced its funding by one point from75% to 74%: the local authority would have to increase its funding from 25% to 26% which once again represents a 4% increase on Council Tax..

It is difficult without very detailed analysis to draw any conclusions about the reasons for variations in Council Tax increases between individual local authorities. This is amongst other things because:

- Councils may deliberately decide to build up or draw down reserves in any particular year. In fact, in 2003/4 councils as a whole tended to reduce their use of reserves, partly in response to central government and other external expectations that councils would maintain reserves at a "prudent" level.

- Individual councils may over or under-estimate their requirements in one year meaning that in the following year there may be a surplus or deficit to be dealt with.

However, **aggregates** of local authorities, whether by region or otherwise, probably do tell a consistent story and this is usually one of the varying impact of government grants or political complexion of the areas concerned. (Although there are undoubtedly different levels of need in different local authority areas, this could hardly account for dramatic **changes** in Council Tax from one year to the next. It could however account for the **level** of Council Tax or council spending.) Table 6 shows the percentage changes in Council Tax for local authority areas.

Region	98-99	99-00	00-01	01-02	02-03	03-04
North East	7.66%	6.33%	5.06%	4.96%	8.25%	8.73%
North West	7.23%	5.27%	4.69%	5.14%	5.29%	8.71%
Yorks & Humber	8.28%	5.35%	5.19%	6.42%	7.13%	10.28%
East Midlands	10.11%	7.44%	6.37%	5.87%	9.70%	9.18%
West Midlands	7.99%	7.25%	6.05%	7.07%	7.81%	10.05%
East of England	10.93%	8.38%	7.01%	6.76%	10.39%	15.11%
London	5.42%	6.43%	6.50%	8.09%	6.44%	18.17%
South East	10.74%	7.67%	6.39%	6.46%	9.64%	15.72%
South West	9.61%	6.95%	6.92%	5.92%	10.44%	13.81%

Table 6

Table 6 shows how the London area, where Council Tax rises had previously been very small, suffered immensely from both the gearing effect and the change in methods for calculating central government subventions in 2003/04.

2.5 Council Tax is based on property values

The present system of Council Tax was introduced on April Fool's Day 1993, and replaced the previous system of the Community Charge - popularly known as the Poll Tax. The tax is based on property values which are themselves based on 1991 valuations, (later in the case of newly built properties).

Unfortunately, property prices can be very volatile - as we saw in the late '80s, early '90s and again very recently - with "hot spots" occurring in different regions at different times. This means that a snapshot of values taken at any one particular point in time may not be representative of the underlying situation as time goes on. Moreover prices for what are otherwise similar properties vary enormously between regions, (as the estate agents say: "location, location, location"). One can buy something almost palatial in some areas for a sum which in other areas would buy little more than a hovel. This would not matter if Council Tax were based on **relative** valuations. However, this is not the case. Council Tax is based on **absolute** valuations, with property values being distributed across eight bands on a **national** basis.

One of the perverse effects of setting bands on an absolute, national basis is that only 3.4% of properties in London, (which contains some of the most deprived areas in the country), fall into the lowest band, (band A), whereas on the other hand 58.6% of all the properties in the North East fall into this same band A! It is for this reason that we have chosen, in table 5, to present figures for Council Tax **per dwelling** rather than the more usual Council Tax for a band D property. (The prime minister's private home in County Durham would be around three bands higher if it were in the London commuter belt!)

If central government grants are set at a level which is partly designed to equalise Council Tax on band D properties, (as they are), then this can be very "unfair" on those who live, or are forced to live, in more expensive areas.

2.6 Council Tax is not directly linked to ability to pay

The underlying assumption of the Council Tax is that an individual's wealth is linked to the value of the property they occupy so that people who live in higher valued properties can afford to pay more than those who live in lower valued ones. This is no doubt true in many instances. However this is by no means always the case.

Many people bought their current houses when their real incomes, (or at least their real incomes relative to other people), were much higher, and the real price of their property relative to other properties and other prices were much lower, than they are today. Such people could not now afford to buy their own houses out of their current incomes or their other savings. This must, at the very least, call into question their ability to pay a tax designed to raise substantial amounts of revenue when the amount of their liability is based upon the value of something that they could no longer afford!

Regions in which property prices are high have much the same need for the services of lower paid “essential” workers as do regions where property prices are lower than average. These workers already have to pay more for their housing through higher mortgage payments or rent than do people in other areas. Does it really make sense to pile on the agony through additional Council Tax? Won’t the long term effect be to drive them elsewhere, causing a lack of amenity in the hitherto expensive areas, eventually causing house prices to fall there, while still perpetuating the historical anomaly of a high tax regime?

We appreciate that ability to pay is not just a matter of income. A person’s wealth is also important in this respect. The real problem with the Council Tax is that property is only one of the many types of wealth. More liquid forms of wealth, such as savings or financial securities, are much more easily mobilised than property wealth and for many older people are a better measure of what they can afford than their incomes are. Moreover Council Tax takes no account of a person’s **net** wealth or equity interest in property - only the **gross** wealth. A lot of property is mortgaged. People with mortgages could be said to be treated more “unfairly” than those without!

In principle, if one has substantial equity in one’s property one could always sell up and move to a smaller one - or else engage in some equity release scheme, (possibly devised and run by local or central government). We are **NOT** advocating this - nor, we suspect, would any politically sensitive party. The people who are really unable to pay are those with lower incomes and with small or negative equity in their properties - e.g. the young who have just been made redundant! Pensioners are actually in a rather better position.

3. Options for reform

Any reform of the Council Tax system designed to address issues like affordability is bound to involve an element of redistribution of the burden. In any such redistribution there are always losers as well as winners. It is especially important that the **losers** see any changes as being broadly “fair” - even though they will almost certainly not like them! It is also important that the **impact** of any changes is phased in gradually. It is not just the poor who find it difficult to cope with large, sudden, unexpected demands on their resources. Many people on substantial incomes have already committed large slices of it on mortgages, school fees and the like. Only those with considerable liquid savings do not need to budget and plan so carefully.

The activities currently undertaken by local government require funding. This will be true whoever undertakes them. Such funding must be achieved in such a way as to ensure that any new or increased taxes are **affordable** for those who have to pay them, **predictable** in terms of their impact both by those who pay them and by those who impose / collect them, as well as being "fair" and **non-discriminatory**. Ideally also they must do minimum damage to the economy, bear a direct relationship to the expenditure that they are supposed to fund and who benefits from, or votes for, that expenditure. They should also be easily, efficiently, and cheaply collected and difficult to avoid.

Any discussions on tax which fail to take into account any countervailing benefits are probably futile. What really matters is the **overall** effect of **all** taxes and benefits when **taken together** on particular types of individual or groups of citizens. It is perfectly possible to devise a "fair" scheme, (provided that the criteria for "fair" are rigorously defined), at the macro level from what are a set of wholly "unfair", (defined in the same way), taxes and benefits at the micro level. In any case, does it really matter if someone pays £1000 more tax than is really "fair" if, at the same time that person also receives £1000 more in cash benefits than he really "should do" from the point of view of "fairness"?

From this perspective, Council Tax Benefit is often touted as "the answer" to the problems of the Council Tax. In **theory** this may even be true - but in **practice** it is not. Many of those who are entitled to claim CTB fail to do so, (for whatever reasons). The hardship goes unrelieved. In any case there has to be something wrong with the **structure** of any tax when it can only be paid by resorting to benefits!

The present system of local authority financing may be best described as one of **muddle**. With huge variations in the amount of funding raised locally and the amount raised centrally, there is very little relationship between levels of, or increases in, Council Tax and local expenditures. There is a lack of **accountability**. When the electorate complains about Council Tax, central government blames local government and local government blames central government.

Currently, central government provides, on average, 75% of local authority funding, and dictates up to 80% of local authority expenditure. The local tax payer is simply presented with a bill and is required, by law to pay it. In reality local government is almost totally dictated to by central government . There is very little local accountability. Central government can, (and maybe does), use redistribution for gerrymandering and party political ends. If we can not get a better match between **power** and **responsibility**, we might just as well have all taxes imposed and collected centrally. At least this would remove the fiction that we currently have local taxation. What we have, in effect, is some locally **collected** taxation whose **rates** are really set centrally.

Note: *A somewhat more detailed version of the subject matter in this section is to be found in Appendix I to this document*

4. Examination of options

There are really only four basic options for reform which have any real potential to solve most of the problems highlighted in earlier sections of this document. These are:

- Reforming the **structure** of the Council Tax in order to make its impact less "unfair".

  — The proposed revaluation of properties in 2005 and the possible introduction of more bands to the existing system, to be implemented in 2007, **ought** to provide an excellent opportunity for reforming the Council Tax. Unfortunately, because of past experience and the lack of trust in politicians, the prospect of revaluation is already causing concern.

  If the Council Tax were to be scrapped there would be no need to reform it and there would be no need for any revaluation to take place and so no cause for any worries about it.

- Reforming the **benefits system** so as to make the **impact** of the Council Tax less "unfair".

  — Reform of Council Tax Benefit would become irrelevant if Council Tax were to be abolished. Reforming benefits other than CTB, (or pensions), while highly desirable, will in itself do little to alleviate the unfairness or hardships associated with the Council Tax.

- Changing the **relationship** between central and local government so that **local** people have more control over the **local** taxes that they are asked to pay to fund **local** activities.

- Changing the **balance of funding** so that the Council Tax takes a significantly **smaller share** of the overall tax burden than it does at present.

  — Obviously this means that more tax would have to be collected centrally. We examine the options for increasing the central government tax take in section 5 of this document.

None of these options are mutually exclusive. In principle we could simultaneously implement all four. However Isitfair believes that the current problems are so urgent and acute that a **quick** solution, at least initially, is essential. Far reaching reforms need to be carefully thought through. This means that any significant reforms to the structure of the Council Tax, the benefits system or the relationship between local and central government, however desirable they may be, are matters for future consideration.

As a result, Isitfair's proposed solution is to scrap the Council Tax altogether because we do not believe that anything but the most radical surgery will solve the problems that we have highlighted. Nevertheless we do recognise that if the Council Tax were asked to shoulder a substantially smaller proportion of the total burden of local authority finance, then much of the concern about its inherent unfairness and the impact of any rises in the tax on those less well off people whose incomes can not keep pace with those rises would disappear.

Note: *A somewhat more detailed version of the subject matter in this section is to be found in Appendix I to this document*

5. Increasing the tax take of central government

Any reduction in Council Tax, including its complete abolition, will have to be paid for by changes elsewhere in the tax regime. We do not believe that any relevant changes to the local taxation regime can be made **in time** to relieve the current hardship.. This section is therefore restricted to a consideration of some of the more plausible options at the central government level.

Note: *Some of the possible changes to local taxation are dealt with in Appendix I*

Table 7, which uses data from Table C8 of the budget report for 2005, shows the Treasury projections of the yields expected in the financial year 2005/6 from the major revenue generators.

Income Tax	£138.1Bn
National Insurance	£82.6Bn
VAT	£76.3Bn
Corporation Tax	£43.7Bn
Fuel Duties	£24.6Bn
Council Tax	£20.9Bn
Business Rates	£19.4Bn

Table 7

Unless there are good reasons for supposing that the revenues from any other existing tax could be substantially increased without causing undue disruption to the economy or rioting in the streets, these are the only **existing** taxes that it makes any sense to take into consideration when discussing how reductions in, (or abolition of), the Council Tax could be financed. The yields on all other existing taxes are simply too small to be able to make a significant contribution. Small increases in big, broadly based taxes are also much less likely to cause unexpected problems or unintended consequences, (such as hardship), than are large increases in narrowly based, small taxes. In a sense, this is exactly what has now gone wrong in the case of the Council Tax.

In the following subsections we briefly examine each of these major revenue generators in turn and assess their potential for increased yield. Where appropriate, we also make comments about the "fairness" of any possible changes. We have not examined the scope for substantial reform of the **structure** of any of these taxes. Such considerations are beyond the scope of this particular document, although some of our thinking on these matters is contained within Appendix I.

5.1 Income Tax

There are three main ways in which we could increase the take from income tax:

- We could increase tax **rates**
- We could reduce tax **thresholds / allowances**
- We could introduce **new bands and rates**

Table 8 shows the extra yield that would be generated from each extra penny on income tax at each rate as well as the effect of adding an extra 10p on that portion of **gross** incomes above £100, 000 p.a.

	Change	Yield
Starter IT rate:	10% ➡ 11%	£0.55Bn
Basic IT rate:	22% ➡ 23%	£3.69Bn
Higher IT rate:	40% ➡ 41%	£1.16Bn
Incomes over £100K:	40% ➡ 50%	£4.72Bn

Table 8

Although it is well known that any tax increase always has the effect of reducing the size of the tax base on which it falls, (the Laffer curve), we have ignored any such considerations in making the above calculations - mainly because we have little idea as to how big the effect would be, (nor for that matter does anyone else). We do however suspect that the effect may be quite large in the case of a 50% rate on incomes above £100k p.a.. On both occasions when the top rate of **tax** was **reduced** in the UK the **yields** from those taxes actually **rose**. Other countries have had similar experiences.

Table 9 shows the extra yield that would be generated for every £100 by which each allowance / threshold were to be reduced. Again we have made no allowances for the Laffer curve effect.

	Change	Yield
Personal Allowance	£4895 ➡ £4795	£0.61Bn
Basic rate threshold	£2090 ➡ £1990	£0.31Bn
Higher rate threshold	£32400 ➡ £32300	£0.04Bn
Super rate threshold	infinity ➡ £100,000	£4.72Bn

Table 9

It is immediately apparent from these two tables that the lion's share of any extra yield from income tax has to be taken from adjustments to the basic rate of tax. Adjustments to other rates and allowances really only make much sense when used to remove problems that might arise at the margin or to make the change politically more acceptable.

There will never be complete agreement on what the appropriate rates of income tax on different slices of income "should" be. Some people, (usually those on lower incomes), would like income tax to be more progressive than it currently is. Other people, (often those on higher incomes), would like it to be less progressive. We do not, at this juncture, propose to try to adjudicate on this issue.

We are aware that many of the ex communist countries in Eastern Europe have introduced flat rate income and other taxes with apparently considerable success. Our own thoughts on this matter are described in Appendix I to this document.

5.2 National Insurance

Although we doubt whether the National Insurance system is the best possible design of system for the function that it is supposed to perform, we do believe that the impact of the system on different sections of society is broadly "fair".

In any case, since the government has recently tapped National Insurance Contributions in order to provide extra funds, Isitfair does not regard it as being a prime candidate for further milking at this juncture.

5.3 Value Added Tax

Just about everybody spends money so that just about everybody also pays VAT. The virtues of increasing the take from VAT are very similar to those associated with the old community charge. Everybody who has the right to vote has to bear some of the consequences of their views on public expenditure. **Everybody** contributes **something**, (however little), to the common pot. There are two main ways of increasing the VAT take:

- We could increase the **rate** of VAT but still charge on the existing basis. Each "one per cent", (e.g. from 17.5% to 18.5%), increase in the rate would, on the latest figures available to us, lead to an increase in the revenue from VAT of between £3.68 Bn and £4.36 Bn. The lower figure assumes that consumers still spend the same amount in **pound** terms on items liable to VAT. The higher figure assumes that they still purchase the same amount in **volume** terms. Both calculations assume that intermediate rates of VAT rise in line with, (i.e. proportional to), the standard rate. The actual outcome is likely to come somewhere between these two values.

- We could **broaden the tax base** by increasing the range of goods and services on which VAT is payable and / or removing some of the lower rated, zero rated or exempt items and charging standard or the next higher rate for them. There are so many possible options here that any detailed calculations are probably meaningless. However it is comparatively easy to estimate the effect of charging VAT at the uniform rate of 17.5% on **all** consumer expenditure. Doing this would have raised between £35.5Bn and £41.8Bn extra in the financial year 2003/04. The lower figure is based on the assumption that the **gross value** of consumer spending stays unchanged, (i.e. that the volume of trade is reduced because of the effect of the VAT increase), whereas the latter figure assumes that the **volume** / pattern of consumer spending remains unchanged, (i.e. people save less). The actual turnout would be somewhere between these extremes.

> There are many objections to most ideas for broadening the VAT base - many of which on closer examination appear to Isitfair to be ill founded.

The main disadvantages of increasing VAT are that it would add to headline inflation, (although this **ought** to be a once-off effect), and could lead to some of the extra revenue being diverted to the EU as part of Britain's budget contribution.

5.4 Corporation Tax

Although it would be perfectly possible to increase the tax take from businesses with very little ensuing fuss, (businesses don't have votes), we believe that the probable resultant economic damage should preclude this option from any further consideration.

5.5 Fuel Duties

Road fuel in Britain is already more highly taxed than it is in most competitor countries. This already causes real commercial problems for hauliers near the channel tunnel and the ferry ports. Any increases in the price of diesel fuel would seem to us to be economically unwise. In fact, remembering the fairly recent fuel protests, **any** increase in the tax on **any** road fuel would appear to be asking for trouble.

5.6 Council Tax

Obviously we would not contemplate raising Council Tax in order to reduce it!

5.7 Business rates

Since business rates are already redistributed back to local authorities, "purloining" any portion of them will do nothing to solve the funding problem associated with the abolition of the Council Tax. We could however potentially increase the share of the total burden borne by business rates. Indeed, we have already seen in section 2.2 how the share of business rates in funding local authority expenditure has fallen over recent years. While we can see no logical argument for any particular share being the "right" one, we do consider that, so far as possible, business property should be taxed in exactly the same way as residential property. This would inevitably mean that any residual Council Tax and business rates would march in step so that no further decrease, other than perhaps a one-off adjustment, in the business rates share of the total burden would take place.

The Local Government Association has called for the "repatriation" of business rates. Isitfair is neutral on this particular issue. We are aware that the business rates were nationalised for good reasons

5.8 Inheritance Tax

At first sight Inheritance Tax does not appear to be a particularly attractive candidate to replace any revenue lost from reductions in, (or abolition of), the Council Tax. The budget projections anticipate total revenues of only £3.4Bn from this source for the fiscal year 2005/06. Nevertheless, as we discuss in Appendix I, we believe that Inheritance Tax could yield much more substantial funds. However, we regard this as an option for the future - not for the urgent task of financing substantial cuts in, or total abolition of, the Council Tax.

5.9 Summing up

As a result of the considerations dealt with in this section, as well as in Appendix I to this document, we have concluded that only income tax and VAT offer sufficient scope in the short term for funding a substantial reduction in, or preferably the total abolition of, the Council Tax. How this extra tax is raised is a matter of taste .

6. Some sample calculations

In section 4 and Appendix 1 we discussed a number of different ways in which the unfavourable impact of the Council Tax might be reduced. Most of these involve changing the balance of funding so that central government contributes more and local taxpayers contribute less to what is deemed, (by central government), to be local authority spending. However a few of the possibilities we considered do not necessarily involve any change in the balance of funding. They involve ways in which local government might potentially collect the same amount of local tax in a "fairer" manner.

6.1 Changes within local government finance

See Appendix II for illustrative calculations relating to possible reforms to locally collected taxes.

The discussion and calculations in Appendix II demonstrate that there is very little to be gained by reforms to any local taxation under the current balance of funding and redistributive arrangements. Local government would have to do less, and be responsible for less, before any really substantial gains from local taxation reform could be realised.

6.2 Changes at the national level

According to figures from the Office of the Deputy Prime Minister, Council Tax in **England** is expected to yield revenue of £20.3Bn in 2005/06. According to the most recent census, the population of **England** represents 83.9% of the total population of the **UK**. On this basis to abolish the Council Tax in the whole of the UK, (including the rates in Northern Ireland), we would need to raise around £24.2Bn from other sources. However, the figures from the ODPM website are <u>gross</u> revenues. In 2002/03 Council Tax Benefit in Great Britain, (i.e. excluding Northern Ireland), amounted to £2.84Bn. Whilst gross receipts from Council Tax amounted to £19.4Bn. Assuming that the same ratio for CTB to Council Tax applies in 2005/06 as applied in 2002/03, then the <u>net</u> amount of Council Tax collected should be of the order of £20.7Bn. The Treasury's estimate for the same figure, (obtained by a completely different method and using different data), is £20.9Bn. The difference between these two figures is within the normal margin of error that has applied in the past to the Treasury's estimates of this particular budget item.

If we abolish Council Tax altogether, then the need for Council Tax Benefit will disappear. Calculations on alternative funding to enable the **total abolition** of the Council Tax can obviously be made on the net figure for the Council Tax yield. However, if we are only to **reduce** Council Tax, we need to recognise that, although the amount of Council Tax benefit that needs to be paid will be reduced, some need for CTB will still remain. In our calculations, (most notably those involving table 20 in section 7), we have assumed that the amount needed for CTB is directly proportional to the rate of Council Tax.

On the basis of adding a bit to cover Northern Ireland rates, (we need to do this because those in Northern Ireland pay income tax and VAT just like the rest of the UK), and for the reasons given later, (in section 7), we believe that we should deliberately aim for some over-funding. On this basis we believe that aiming for a total yield from additional taxes of the order of £25Bn would be appropriate.

6.2.1 Income Tax

According to the Inland Revenue there are expected to be 22.6 million basic rate tax payers in the UK contributing £59.6Bn to the exchequer in 2005/06, while the 3.6 million higher rate taxpayers are expected to provide a further £73.3Bn. Only £20.9Bn of this comes from having a higher rate tax of 40%. The remaining £52.4Bn comes from what is, in effect, basic rate tax on these same higher rate taxpayers.

In section 5.1, table 8 we showed that the effect of putting a penny on the standard rate of income tax would be to increase revenues by £3.69Bn. In round terms, £1.2Bn of this would come from higher rate taxpayers whereas £2.5Bn would come from basic rate taxpayers. Basic rate taxpayers would **on average** therefore contribute an extra £111 per head per annum whereas higher rate taxpayers would **on average** contribute an extra £333 p.a. per head. These averages could easily be misleading. The effects on people just below or just above the higher rate tax threshold would be much the same. Those just below the threshold would pay a bit more than £111 extra each whereas those just above would pay substantially less than £333 extra. The very highly paid would contribute much more than the extra £333.

Table 10 shows how much extra revenue would be raised by the various possible combinations of putting 2 p, 3p or 4 p on basic and / or higher rates of income tax.

Basic Rate IT	Higher Rate IT	Extra Revenue	Funding Gap
24%	42%	£9.69Bn	£15.31Bn
25%	42%	£13.38Bn	£11.62Bn
26%	42%	£17.07Bn	£7.93Bn
24%	43%	£10.85Bn	£14.15Bn
25%	43%	£14.54Bn	£10.46Bn
26%	43%	£18.23Bn	£6.77Bn
24%	44%	£12.01Bn	£12.99Bn
25%	44%	$15.70Bn	£9.30Bn
26%	44%	£19.38Bn	£5.62Bn

Table 10

The funding GAP shown in table 10 is the amount of extra revenue that would still have to be raised from other tax increases in order to reach our target of £25Bn.

It is a simple matter to work out how much more, (or how much less), any individual on a given income would pay in income tax resulting from any changes to rates or allowances. However, for most people, total **household** disposable income is much more important than **individual** disposable income in determining their well-being. Unless we have a flat rate income tax regime, or unless we revert to taxing joint incomes of husband and wife, (or more accurately start taxing total household incomes), then the effect of any income tax changes on household incomes will be very dependent on how the total income is split between the various individuals comprising the household.

Under any progressive, separate taxation regime, one earner households will always be penalised when compared with similar households on similar gross incomes whose incomes arise from more than one earner. This point is illustrated by table 11 where we show how much more income tax would be paid by various households if we were to increase both basic rate and higher rate income tax rates by 10% in round terms, (basic rate from 22% to 24% and higher rate from 40% to 44%). For two earner families the amount of extra tax rises as the percentage of the total household income that the main bread-winner brings in rises. A single earner household is simply one where the main bread-winner brings in 100% of household income - as shown in table 11.

Gross Household Income	Earnings Ratio 100%	Earnings Ratio 90%	Earnings Ratio 80%	Earnings Ratio 70%	Earnings Ratio 60%	Earnings Ratio 50%
£5,000	0	0	0	0	0	0
£10,000	60	40	20	0	0	0
£15,000	160	130	100	70	40	21
£20,000	260	220	180	140	121	121
£30,000	460	400	340	321	321	321
£50,000	1114	914	775	721	721	721
£100,000	3114	2775	2575	2375	2229	2229

Table 11

Table 11 demonstrates very clearly how the effect of splitting earnings between two people is very pronounced at all household income ranges, including the lower incomes.

In table 12 we show the percentage of the extra tax that would otherwise be payable that is saved by splitting incomes.

Gross Household Income	Earnings Ratio 100%	Earnings Ratio 90%	Earnings Ratio 80%	Earnings Ratio 70%	Earnings Ratio 60%	Earnings Ratio 50%
£5,000	-	-	-	-	-	-
£10,000	0%	33%	66%	100%	100%	100%
£15,000	0%	19%	37%	56%	75%	87%
£20,000	0%	15%	31%	46%	54%	54%
£30,000	0%	13%	26%	30%	30%	30%
£50,000	0%	18%	30%	35%	35%	35%
£100,000	0%	11%	17%	28%	28%	28%

Table 12

As can be seen, the effect of splitting incomes is most marked among lower income households. This is unfortunate since most single earner households which are not just single adult occupancy ones, usually consist of families with young children. Children tend to be expensive. Since people also tend to earn less when they are younger and less experienced, and since people with young children tend to be young themselves, one wonders whether this apparently undesirable effect is simply the unintended result of governments pursuing otherwise desirable but mutually contradictory objectives.

The only way to mitigate this effect is to make income tax somewhat **less progressive** as one raises the total amount of income tax that one tries to collect. With a totally flat tax and no allowances, the effect would disappear altogether.

Bearing in mind that our sole purpose in considering rises in income tax is so as to be able to fund substantial reductions in the Council Tax, or preferably its complete abolition, it makes sense to examine how a household's disposable income would change in money terms from combining the reduction in Council Tax with the increases in income tax. There are obviously many possible combinations. Much will depend upon the band of the property one lives in and how the earnings within the household are split as well as on the level of gross household income itself. Table 13 illustrates just one such possible combination where we have assumed that Council Tax has been completely abolished, the main earner earns twice as much as the secondary earner and that the basic rate of income tax is set at 25% with the higher rate at 42%. For the purposes of calculating the savings we have set the average Council Tax for a band D property a£1167, which is the actual average value for 2005/06.

Gross Houshold Income	Council Tax Band							
	A	B	C	D	E	F	G	H
5000	778	908	1037	1167	1426	1686	1945	2334
10000	778	908	1037	1167	1426	1686	1945	2334
15000	688	817	947	1077	1336	1595	1855	2244
20000	588	717	847	977	1236	1495	1755	2144
25000	447	577	706	836	1095	1355	1614	2003
30000	297	427	556	686	945	1205	1464	1853
35000	147	277	406	536	795	1055	1314	1703
40000	-3	127	256	386	645	905	1164	1553
45000	-153	-23	106	236	495	755	1014	1403
50000	-303	-173	-44	86	345	605	864	1253
100000	-1509	-1380	-1250	-1120	-861	-602	-342	47

Table 13

At first sight nearly everyone appears to be a winner. However, this merely reflects the fact that the increases in income tax still leave a deficit of some £11.6Bn, (see table 10), when compared with the total amount that needs to be raised in order to abolish the Council Tax altogether.

We can only get a realistic picture of how the Council Tax burden would be redistributed by considering the impact on typical households of the other taxes, (mainly VAT), that would need to be raised in order to close the funding gap.

6.2.2 Value Added Tax

One of the great advantages of using changes in VAT to finance any reductions in the Council Tax, including its complete abolition, is that it is the **broadest based** of all our existing taxes. This means that the size of anyone's losses arising from an increase in VAT are likely to be smaller than they would be with other taxes. As we indicated in section 5.3, there are some difficulties in predicting the exact yield from any increases in the rate of VAT or indeed any broadening of the tax base. This difficulty arises because nobody can be absolutely sure how the spending behaviour of the consumer will be altered by the price changes resulting from a change in VAT. The two extreme assumptions are that people will continue to spend the same amount on each type of goods as they did before, (i.e. they purchase less of them as the prices rises so as to keep their spending constant in money terms), and that they ignore the price changes and buy exactly the same volume of each type of goods as they did before. These are known as the constant spending and constant volume scenarios respectively.

Table 14 shows how the yield of VAT levied at different rates would change under each of these scenarios.

	Change in VAT yield	
VAT Change	17.5% - 18.5%	17.5% - 21.0%
Constant Volume	£4.4Bn	£15.3Bn
Constant Spend	£3.7Bn	£12.6Bn

Table 14

As can be seen, quite small changes in the rate at which VAT is charged can produce substantial increases in the total revenue accruing to the exchequer.

Based on figures for 2003/04 only the equivalent of some 66% of total consumer expenditure is, on average, currently subject to VAT. As table 15 shows, this percentage is not much altered whether one adopts the constant spending or constant volume scenario. The figure remains at sixty six point something percent.

(***Technical note:*** *in our calculations of the fraction of consumer expenditure that is VAT free we have treated items like domestic energy which carry a preferential rate of VAT as though they were two items - one subject to VAT at the full rate and the other VAT free. This has no significant effect on any of our calculations*)

	Percentage of consumer expenditure liable to VAT		
VAT rate	17.5%	18.5%	21.0%
Constant Volume	66.0%	66.2%	66.7%
Constant Spend	66.0%	66.0%	66.0%

Table 15

This result is important since it means that, in some respects, we do not need to worry over much about the difference between the constant volume and constant spending scenarios when we come to consider the effects of any VAT changes.

The most obvious effect of VAT changes on individuals and households is by way of the increased prices that people would have to pay on those items that are subject to VAT. Table 16 summarises the immediate effect on prices and the RPI of two possible changes to the rate of VAT.

	Old Price	New Price	Change	Change to RPI
VAT @ 18.5%	100	100.85	0.85	0.56%
VAT @ 21%	100	102.98	2.98	1.97%

Table 16

The change in the retail price index is smaller than the rise in price of items liable to VAT since approximately 34% of consumer expenditure is not liable to VAT.

The impact of any rise in VAT on an individual or household's standard of living might perhaps be better appreciated by considering how much VAT each £100 of expenditure actually contains. This is shown in table 17.

	VAT on £100 spent		
VAT rate	17.5%	18.5%	21.0%
Constant Volume	£9.83	£10.31	£11.46
Constant Spend	£9.83	£10.34	£11.57

Table 17

There is no doubt that VAT is intended to be a progressive tax. Given that most essential items of expenditure, like food and housing, do not bear any VAT, it probably is. However some statistics on households produced by the National Statistics Office suggest that it might not be.

This is probably a statistical freak caused by the way in which households are aggregated and segmented. For example, households are segmented according to their gross incomes. It is obvious that a household of two people who are both earning will normally have a higher income than a household of one person. Yet it is quite possible that the single person household will spend a greater proportion of their income on non essential items, and therefore pay more VAT, than a household in which a slightly larger gross household income has to support more people. We have therefore decided that we will use a constant amount of VAT for every £100 of everybody's expenditure when examining the effect of any VAT changes on individuals or households. Despite the fact that the NSO figures would suggest that households at **both** ends of the income distribution actually save a greater proportion of their incomes than do households in the middle, we have decided to use a uniform savings ratio across all income brackets. (The NSO figures for saving are potentially distorted by much the same sort of effects as the figures for gross income. If you are single and have plenty of money for essentials, you are likely to spend more on items liable to VAT as well as saving more of your income than people who are really hard up - e.g. one slightly larger income supporting two people).

With these (rather sweeping) assumptions, it is relatively easy to calculate the effects of any changes in VAT on people and households in various income brackets.

6.2.3 Combined effects of VAT and income tax on real household incomes

If we were actually trying to increase the total amount of revenue to the exchequer by raising taxes, we would undoubtedly have to consider the effect that increasing income tax would have on the aggregate disposable income or purchasing power, and hence on spending, of the population as a whole. However our aim is to achieve a situation that is more or less revenue neutral once Council Tax has been abolished. This means that the purchasing power lost by increases to income tax and VAT ought to be completely offset, on aggregate, by the gains in purchasing power from the abolition of the Council Tax. It also means that, in the long term once things have settled down and perceptions have adjusted to reality, that the **constant volume** assumption on spending is likely to be nearer the truth from a **revenue** raising perspective but that a **constant real spending** assumption is likely to be more relevant when considering the behaviour of **individuals and households**.

The **immediate** effects of any proposed changes are harder to predict than the **long term** effects. Nobody really knows whether the psychological effect of having more money in one's pocket will lead to increased spending or whether the higher prices will cause people to cut back. As we have indicated, in the longer term these effects ought to more or less counterbalance each other when we consider **aggregate** spending.

When we come to consider how to raise the extra £25Bn or so that we have indicated that we would need to raise in order to abolish the Council Tax, we find that our **plausible** options are very limited. For example, to raise the whole amount by way of VAT, the rate of VAT would have to increase to 23.24%. To raise the whole amount by way of increases to the basic rate of income tax, this rate would have to rise to 28.78%, whereas to raise it all by increasing the higher rate of tax would take higher rate tax to 61.58%. This suggests that the plausible limits within which VAT could be varied are something like between 20% and 22% and the plausible limits for basic rate income tax lie between 24% and 26%.

Table 18 shows most of the plausible whole number combinations of changes to basic rate tax and VAT which will enable us, with appropriate changes to higher rate tax, to achieve this figure of approximately £25Bn total extra yield. In this table we have chosen to use the higher rate income tax as the "balancing item" since this is the smallest yielding of the three tax elements involved.

Basic Rate IT	Higher Rate IT	VAT Rate	Extra Yield
23.00%	41.46%	22.00%	£25.00Bn
24.00%	45.81%	20.00%	£25.01Bn
25.00%	42.62%	20.00%	£25.00Bn
26.00%	39.44%	21.00%	£25.00Bn
24.00%	42.04%	21.00%	£25.00Bn
25.00%	38.86%	21.00%	£25.00Bn
26.00%	35.68%	21.00%	£25.01Bn
24.00%	38.28%	22.00%	£25.00Bn
25.00%	46.39%	19.00%	£25.01Bn

Table 18

For the reasons that we have already discussed in connection with the potentially "unfair" effect on families with only one earner, we believe that we should only examine those combinations in table 18 where the increase in higher rate tax is less than that in basic rate tax. Since we suspect that actual decreases to higher rate tax would be politically unacceptable, (although perhaps very desirable economically and in other respects), we are left with very few options. In round terms, the central options would appear to be either an increase of basic rate tax from 22% to 24%, an increase in higher rate tax from 40% to 42% and an increase in VAT from 17.5% to 21%, (which would raise an extra £24.95Bn), or an increase in basic rate income tax to 25%, an increase in higher rate tax to 43% and an increase in VAT to 20%, (which would yield an extra £25.44Bn). There is no reason of course why we should submit to the tyranny of whole numbers. An intermediate solution which would raise an extra £25.3Bn would be basic rate tax at 25%, higher rate tax at 41% and VAT at 20.5%.

Table 19 shows how the **abolition** of the Council Tax, the change in VAT rate to 20.5%, the change in the basic rate of income tax to 25% and the change in the higher rate of income tax to 41% might be expected to **change** the percentage of gross income taken by the sum of all these taxes for some sample households. (A negative number means that a household gains whereas a positive number means that it loses out.) These households are assumed to be like our "standard" two earner households where the main breadwinner brings in two thirds of the total household income.

In deriving these results, we have also assumed that all households save 8.6% of their disposable income, (table 13 showed how their nominal, disposable money incomes would be affected by increases to the rates of income tax and the abolition of the Council Tax), and spend around 66% of what is left on purchases liable to VAT, using the constant real spending assumption, (see table 15).

Gross Houshold Income	Council Tax Band							
	A	B	C	D	E	F	G	H
5000	-12.79%	-15.16%	-17.52%	-19.88%	-24.60%	-29.32%	-34.04%	-41.12%
10000	-5.74%	-6.92%	-8.10%	-9.28%	-11.64%	-14.00%	-16.36%	-19.90%
15000	-2.89%	-3.68%	-4.47%	-5.25%	-6.83%	-8.40%	-9.97%	-12.33%
20000	-1.44%	-2.03%	-2.62%	-3.21%	-4.39%	-5.57%	-6.75%	-8.52%
25000	-0.43%	-0.91%	-1.38%	-1.85%	-2.80%	-3.74%	-4.68%	-6.10%
30000	0.26%	-0.13%	-0.52%	-0.92%	-1.70%	-2.49%	-3.28%	-4.46%
35000	0.76%	0.43%	0.09%	-0.25%	-0.92%	-1.60%	-2.27%	-3.28%
40000	1.14%	0.84%	0.55%	0.25%	-0.34%	-0.93%	-1.52%	-2.40%
45000	1.43%	1.17%	0.90%	0.64%	0.12%	-0.41%	-0.93%	-1.72%
50000	1.66%	1.42%	1.19%	0.95%	0.48%	0.01%	-0.46%	-1.17%
100000	2.11%	1.99%	1.87%	1.75%	1.52%	1.28%	1.05%	0.69%

Table 19

There are, of course, many other types of household besides our "standard" one. Table 19 can only give a flavour of what would happen in practice. The overall picture would also be complicated by the impact of any changes to benefits. These would undoubtedly occur. However, since it appears to us that the overall impact of the benefits system tends to be haphazard in any case, there seems to be little point in attempting to allow for these effects in a document of this sort.

As can be seen, the main effect of a regime of this type is to make lower income households living in the more highly banded properties significantly better off. These tend to be just the sort of households who are suffering most from the "unfairness" of the current system of Council Tax. The main losers are those households in the upper income brackets living in more lowly banded property or those who currently pay no Council Tax at all. However, nobody loses in a really big way. The burden is spread around.

Note: *Further more detailed calculations on other possible changes to the tax regime and their effects of different types of household are to be found in Appendix II to this document*

6. Our proposals

Isitfair proposes that the Council Tax be scrapped in its entirety and replaced with increases to both income tax and VAT. We propose raising the VAT rate from 17.5% to 20.5%, raising basic rate income tax from 22% to 25% and raising higher rate tax from 40% to 41%.

We recognise that under Isitfair's proposals there will inevitably be less real local democracy than the already very limited amount that we have under the present system. We also recognise that this is not what most people want. However, we believe that the current problems are so urgent and acute that a **quick** solution is better than an **ideal** one. We do not believe that any of the highly desirable reforms to local government, the benefits system, or the structure of local government finance that we have discussed can be implemented quickly enough. Only by using **existing systems** can we achieve the required changes in time. This, together with the considerations outlined in sections 4 and 5, is why we have chosen income tax and VAT to share all of the burden currently borne by the Council Tax.

Although we want a quick solution, Isitfair recommends that its proposals are implemented over a three year time-scale. This will allow any losers from the changes sufficient time to adjust their budgets as well as allowing government the time to iron out any glitches that might occur in the new system. The self financing timetable that we envisage for the changes is shown in table 20.

	Basic Rate Income Tax	Higher Rate Income Tax	Value Added Tax	Band D Council Tax
Year 1	22% ➡ 23%	No Change	17.5% ➡ 19%	£1167 ➡ £833
Year 2	23% ➡ 24%	40% ➡ 41%	19% ➡ 20%	£833 ➡ £314
Year 3	24% ➡ 25%	No Change	20% ➡ 20.5%	£314 ➡ NIL

Table 20

While the "unfairness" of the Council Tax will persist during the transition period, we anticipate that virtually all of the real hardship that this causes will disappear in the first year as a result of the immediate reduction in Council Tax bills.

In framing these proposals, Isitfair has deliberately avoided any attempt to make the overall impact of the tax and benefits system any more progressive or any more regressive than it currently is. Good arguments can be made for either position. However we believe that it would be dishonest to use any changes to the Council Tax system to "smuggle in" other changes. The case for any such changes ought to be made completely separately.

Isitfair is not a political party in the conventional sense. Our sole aim is to remove the most glaring inequities of the Council Tax and to alleviate the real hardship that it causes to some sections of our society. We have framed our proposals to as to minimise so far as possible the number of big winners and big losers. By achieving this, we believe that our proposals ought to be acceptable to the losers - as well as to the winners.

Our proposals do not include any changes to Inheritance Tax or the introduction of a poll tax. We see these, along with other reforms, especially those aimed at restoring a real local democracy, as potential issues for the longer term.

We have selected VAT to finance the lion's share of the increased burden on government spending. We have done so for four main reasons:

- **Everybody** spends money so nearly everybody pays some VAT and so contributes **something,** however little to the common cause. The only way to avoid **big** losers is to ensure a **broad base** for the tax system.

- VAT is, to a considerable extent, a **voluntary** tax.. Increases in VAT are the easiest tax increases to cope with. If in difficulty, one merely makes a marginal decrease in spending. Most of the really essential items in a household's expenditure are not currently subject to VAT. Those who spend most of their income on such items, usually the less well off, will be much less affected than those who spend a large proportion of their incomes in other ways. VAT is not chargeable on major items of pre-committed expenditure like mortgages or school fees. An increase in VAT will not, unlike many other taxes, cause any real hardship at the upper end of the income distribution. VAT is probably the most automatically **affordable** of our current taxes.

- VAT is currently the nearest thing that we have to a **flat tax**. A flat tax is by definition neither progressive nor regressive. Since we are trying to **avoid** significant changes to the degree of progressiveness that we currently have, some sort of flat rate tax, like VAT, is the easiest way to achieve this.

    — Actually, because of the various exemptions, zero rates and reduced rates, VAT in its current form is slightly progressive.

- Income tax in its present form is already somewhat "unfair". The cost of living varies quite markedly between one region of the country and another. A person in an expensive place living on a given income is considerably worse off in real terms than a similar person on the same nominal income living in a less expensive place. Both however currently pay the same amount in income tax. It is easy to see that people in expensive places can, (and do), easily end up subsidising people elsewhere who in real terms are better off than they are themselves. One doubts whether many of the advocates of income redistribution or progressive taxes would regard this as "fair".

    — This effect is particularly marked for those people who just come into higher rate tax. Only by placing a relatively low share of the burden on income tax, which means that we have to place a higher proportion on VAT, can we minimise this particular source of unfairness.

    To some extent this mirrors the "unfairness" of the Council Tax being based on **national** valuations. To use these valuations for Resource Equalisation is ridiculous. Most properties are bought on a mortgage. People actually have to pay more for their housing in some areas than in others. Other things being equal, this makes them worse off than similar people in other regions. Why pile on the agony?

- The people who are most likely to be really hurt by any large price increases resulting from rises in VAT are those on low incomes. Such people are usually on benefits and most of these are, in some way, linked to prices. In particular old age pensioners, who are the biggest single class of people suffering real hardship as a result of the inexorable rise of Council Tax and the way that the burden is "unfairly" distributed ,will have their state old age pensions uprated in line with prices. This effect will in itself help to mitigate any price rises since the poorest sections of our society will, in effect, be shielded from them.

We have chosen to increase the higher rate of income tax by slightly **less** than the basic rate for five main reasons:

- The Council Tax is a regressive tax. If we are to leave the degree of the progressivenes of our overall tax system largely unaltered, then we have to replace it with other tax changes that, taken together, are equally regressive. As we saw above, VAT is slightly progressive. We need to compensate for the changes to the degree of progression caused by replacing a regressive tax with a progressive one.

  — Actually, since income tax would be progressive even if there were **no** higher rate tax, we should really be proposing a slight **reduction** in the top rate income tax to meet our objective of avoiding significant changes to the progressiveness of the overall tax take.

- Large increases to higher rate tax will create some very big losers. Some people might regard this as a "good thing". Whatever the "truth" of the matter, this is a case that needs to be made entirely separately from Isitfair's position.

- The true yield from higher rate tax is actually quite small. If higher rate tax were to be abolished altogether, (i.e. if people only paid 22% instead of 40% tax on their income above the higher rate threshold), the total loss to the exchequer in 2005/06 would be "only" £20.9Bn - which is very comparable with the amount raised by the Council Tax! The revenue raised from higher rate taxpayers, at £73.3Bn, is of course much greater. The point is that higher rate taxpayers also pay basic rate tax. Our proposals collect the lion's share of the extra income tax from higher rate taxpayers as it is. Increasing the higher rates is really a political decision. Any broadly "acceptable" rate simply does not yield enough to make its consideration worthwhile.

- As we saw above, income tax is already unfair in its distribution of the burden between one region of the country and another. It is especially unfair on those who are just starting to pay higher rate tax. Only by narrowing the gap between higher rate tax and basic rate tax can we address the increase in the unfairness that would otherwise occur from any proposal to raise income tax.

- As we saw in section 6.2.1, income tax is "unfair" in its effect on households with a single earner when compared with households containing more than one earner. By reducing the progressiveness of income tax, we also reduce the degree of the unfairness relative to what would have become had we proposed raising both basic and higher rates of tax by the same percentage.

Isitfair's proposals are deliberately designed to **over-fund** the scrapping of the Council Tax. We consider this to be necessary since we recognise that there will be knock on effects of our proposals on other aspects of government revenue and expenditure. In particular:

- The increase in VAT that we propose would result in a greater increase in the RPI than would otherwise be the case. Many government expenditures, such as pensions, the yield on indexed linked gilts and some existing means tested benefits are either directly or indirectly linked to the RPI. These extra costs need to be financed.

- The increase in VAT that we propose will probably involve <u>some</u> reduction in the expenditure liable to VAT. We need to make some allowance for this.

- Once we have eliminated Council Tax, there will be no need or case for continuing with Council Tax Benefit. None of our calculations, (such as those shown in table19), have taken CTB into account. Some people who currently receive CTB may be worse off as a result of our proposed changes, (e.g. they will definitely be paying more VAT and may even pay a little bit more in income tax). We certainly do NOT want any such people to be worse off. The government will need extra funds to relieve this particular source of hardship.

- However much we try to be "fair", there are bound to be some "hard cases". We believe that the government should have a small extra "pot" of money in order to provide transitional relief for those who lose most heavily, but, for various reasons, can not easily afford to do so.

In calculating the amount of Council Tax during the transition period as shown in table 20, we have allowed for **all** the over-funding to start in the first year. This is because we consider that this is the most likely time for glitches and real hard cases to emerge. In later years people will know what to expect. Our proposed tax changes are **predictable**.

Isitfair believes that by solving the short term problems associated with the Council Tax the government will buy itself sufficient time to address the other issues that we have highlighted in a less fraught atmosphere - which will hopefully lead to better overall solutions. We are conscious of the fact that it was only the unpopularity of the rates that led to the poll tax and only the unpopularity of the poll tax that led to the Council Tax. The government and the nation need time to consider the options and conduct a proper debate. This is just what Isitfair aims to provide.