NLGN
NEW LOCAL GOVERNMENT NETWORK

Escape from Council Tax

Curing the symptoms of failure

An NLGN Paper by **Dick Sorabji**

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New Local Government Network (NLGN) is an independent think tank that seeks to transform public services, revitalise local political leadership and empower local communities. NLGN is publishing this White Paper as part of its innovative policy projects, which we hope will be of use to policy makers and practitioners. The views expressed are however those of the authors and not necessarily those of NLGN.

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1 *Summary*

Council tax is broken. The Funding Settlement for the year beginning in April 2008 includes a government pledge to cap rises if they get near 5%. The LGA suggest that rises of 4% to 4.5% will be needed to avoid reducing services. Yet even within the 4% limit the average council tax bill would reach £1374 next year. If council tax continues to rise at this rate then by 2010 the average Council tax will be almost £1500.

Fundamental reform of all aspects of local government finance is the only long term solution. NLGN made proposals for such a reform in *Pacing Lyons: a route map to localism.* However, it has become clear that Parliamentary political parties are not able to handle a challenge on this scale.

In October 2005 the government postponed the revaluation indefinitely. Revaluation is the essential first step in any plan for tax reform. Both the Conservative Party and the Liberal Democrats in Parliament had already rejected revaluation. Sir Michael Lyons' report in March 2007 offered another chance for reform. Yet even Lyons' incremental steps to council tax reform, including the call for revaluation, were rejected by all sides.

The heart of the problem for national political parties is fear of the political price that would be paid for the first step to reform. The losers from revaluation are likely to care more than the winners.

Yet the problem will not go away. For 61% of people council tax is already a major financial worry; the second biggest concern for householders. 67% believe it is unfair, making it Britain's most unpopular tax[1]. Council tax is set to rise above inflation every year, relentlessly increasing public opposition. With every year that passes the revaluation problem becomes larger, so making reform more politically dangerous.

1 YouGov 28 August 2007 sample size 2162

Inaction will not remove the looming crisis. Yet it seems that at national level the price of reform is thought to be so large that crisis tomorrow is preferred to pain today. It is as if trapped on a runaway train the Parliamentary political parties prefer to prepare for the inevitable while sitting in first class, rather than risk jumping from the train.

In this report NLGN propose partial reform to avoid the coming train wreck. We describe:

- How to cut the size of council tax, so reducing the political problem of revaluation;
- How to revalue properties and change the future basis of revaluation so that its problems will not recur; and
- How to convert council tax into a genuine local property levy with some buoyancy, so removing pressures that drive tax bills ever upwards and creating an environment in which wider finance reform is possible.

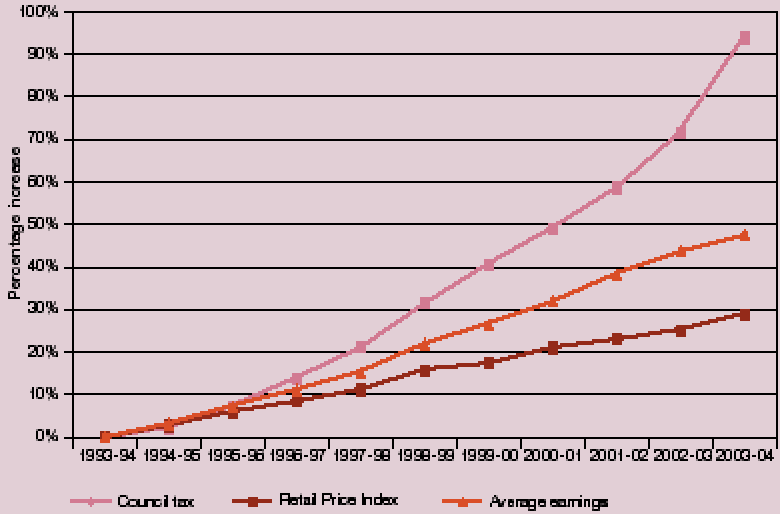
These proposals are not a solution, only an improvement. We comment on outstanding issues and ways that these might be contained. Those responsible for leading councils will be most aware of the shortcomings of partial reform. However a consequence of England's centralised state is that reluctance to reform felt in Parliament is the road block to more fundamental reform.

2 *Curing the symptoms of failure*

The immediate crisis in council tax is simple. It is too big. Council tax worked well when it raised £8.9 billion in 1993/94. By 2007/8 this had grown to £23.7 billion, a rise of 166%, triggering concerns that those on fixed incomes could not afford the constantly rising rates of tax.

A tax that had been relatively fair when the average bill for the average sized home (Band D) was £580 (In 1994/5) is too often perceived as unfair when the average bill is £1321.

Figure 1 Increases in council tax, retail prices and average earnings 1993-94 to 2003-04



Source: ODPM Balance of Funding Review

The scale of council tax locks in other weaknesses:

- Council tax is already too big to be fair;
- Annual above inflation increases are the inevitable result of the design of

council tax mainly because the tax is not 'buoyant'. Buoyant taxes can raise more money each year without raising the percentage tax rate each year;

- Local property taxes can be designed to be buoyant so long as they are based on accurate property prices;
- Redesigning council tax is only possible after revaluation so that all properties in England are taxed on their value today instead of their value in 1991;
- Today's system means that each of the 3 million homes that the government have promised to build by 2020 will be taxed on the imaginary value they might have had if they were built in 1991; and
- Today's alternative to solving the problem is to cap it. Capping council tax simply converts a local property tax choice into a national tax.

The problem of council tax being too large would have been less extreme if valuations on individual properties had been constantly updated to reflect the true value of housing. However, with every year that revaluation was postponed so it became harder to revalue.

Revaluation does not mean that council tax would increase by the same amount that average house prices have increased since 1991. Council tax bills have no connection to the actual price of homes. Instead revaluation reflects the relative cost of housing. Properties in areas that have become more desirable rise up the council tax bands. Areas that have become less desirable go down the tax bands.

It seems clear that no national government will revalue unless a method is found to do so without increasing tax bills. That is mathematically impossible without either reducing spending or increasing some other tax.

Huge and sudden reductions in services, inevitably requiring cuts to care for older people just as demand is rising would be less politically acceptable than revaluation. One-off tax increases are not easy either, although this solution was used to escape from Poll tax.

Only by making council tax smaller will it become politically possible to revalue. Only through revaluation will it become possible to change the design of the local property tax. Removing the political obstacle to revaluation requires the same change that removes the major symptom of council tax failure: we must make council tax smaller. Policies are needed that will cut the amount of money that must be raised through council tax.

3 *Creating space for council tax reform*

The first step on the route out of the council tax trap is to offset a national cut in council tax with politically viable increases in other taxes. The challenge is one of politics more than government. Three questions must be answered:

- What taxes might be used to deliver a one-off fall in council tax?
- How large would the fall total council tax take have to be to ensure that revaluation does not lead to anyone paying more because of the revaluation?
- How would the transfer from one tax to another be implemented?

To reduce the current 2007/08 average council tax (Band D) from £1321 to £999 would require a cut in council tax income from £23,700m to £17,923m, a reduction of £5777m. The two taxes most commonly suggested in debates on local government finance are sales tax and income tax. The Conservative MPs group Direct Democracy has proposed funding local government through a local sales tax. The Liberal Democrat party has argued for local income tax. These taxes could produce cuts in council tax on the scale required.

Using figures for the coming financial year 2008/09, starting in April 2008, the following sums could be raised from these taxes:

- 1% increase in VAT - £4840m
- 0.5% increase in VAT - £2420m
- New 50% Income tax band for salaries at £200,000 or more £3709.2m[2]

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2 These figures are estimated from a Parliamentary Answer given on 14th January 2003 which used a survey of personal income consistent with November 2002 HM Treasury projections. This has been updated using the average increase in earnings for the country. Directors pay has risen far more swiftly than average earnings This income is therefore an underestimate of the true position.

The income tax thresholds have been chosen so that they will only affect the highest earners in society and so that they are higher than the expectations of the majority of senior managers. The basis of this assessment is the Institute of Directors (IoD) November 2007 report that managing directors of firms with a turnover below £5m earn £65,000 basic salary, while those managing firms with a turnover up to £500m can *"expect to earn £141,440"*. Of course total earnings are likely to be higher especially in the largest companies, where for instance FTSE 100 chief executives have seen their pay double over five years to £3,175,000.

Four options show how much council tax could be reduced using a very high earners income tax rate, or increases in VAT or both.

Figure 2 All figures are based on current estimates for the coming financial year 2008/09.

Option 1 **Band D Council tax £1169**
Reduce Council tax by £205 or 15%
Funded by:

- 50% income tax above £200,000

Option 2 **Band D Council tax £1105**
Reduce Council tax by £264 or 19%
Funded by:

- 1% rise in VAT

Option 3 **Band D Council tax £1036**
Reduced Council tax by £338 or 25%
Funded by:

- 0.5% rise in VAT
- 50% income tax above £200,000

Option 4 **Band D Council tax £902**
Reduce Council tax by £472 or 34%
Funded by:

- 1% rise in VAT
- 50% income tax above £200,000

While all of these options would be fairer than today's council tax regime, we believe that the wisest course is the smallest change. Option One would ensure no net increase in tax, but a transfer in tax payments in which people pay less council tax but those on incomes over £200,000 pay slightly more.

4 *A new 'local property levy'*

With reductions in council tax it will be possible to revalue all properties in England and then apply a reformed property tax without increasing the tax bill for any resident. We recommend that the new property tax be re-named the Local Property Levy to avoid confusion with the old council tax regime. It would then be possible to replace council tax with a new Local Property Levy designed to be 'buoyant' and so reduce the underlying causes of council tax failure.

Revaluation

In the year of tax transfer funds from the one-off tax rise would be used as transitional grant to ensure that property tax was reduced on a common basis in every council in England.

Revaluation would take place in the same year. All properties would be revalued replacing their market prices in 1991 with their current market value.

Legislation would require annual revaluations for all properties in England.

It is now possible to manage annual revaluations at less cost and without the need for council officials to enter or inspect anyone's home. Annual revaluation would occur in one of two ways. Revaluations would be based on the actual sale price of a house if it were sold during that year. Where properties are not sold during the year, the revaluation would use the Land Registry data base to track property sale price changes in similar properties in the immediate vicinity during the year. These calculations can be made by the public today using free online data bases such as nethouseprices.com or houseprices.co.uk.

Where individuals did not accept a council revaluation they would have the power to appeal using the existing Valuation Office appeal tribunal procedures.

Reform

Reducing Council tax removes the symptoms of failure. Annual revaluation ensures that the problem will not recur in a form that is so hard to resolve.

Figure 3 Band range of values (at 1 April 1991)

A	Up to £40,000
B	Over £40,000 and up to £52,000
C	Over £52,000 and up to £68,000
D	Over £68,000 and up to £88,000
E	Over £88,000 and up to £120,000
F	Over £120,000 and up to £160,000
G	Over £160,000 and up to £320,000
H	Over £320,000

Within a local area, basic council tax bills for each of the different bands will differ according to proportions laid down by law. The proportions are:

band A – 6

band B – 7

band C – 8

band D – 9

band E – 11

band F – 13

band G – 15

band H – 18

So, for example, if the council tax for a dwelling in band A is £600, the bill for one in band D will be one and a half times that amount (6:9) – £900 – for one in band H three times that amount (6:18) – £1,800 – and for a dwelling in band F, the bill will be £1,300 (6:13).

However further reform is needed to give local government greater autonomy. Only increased autonomy from central funding will produce a cure for the underlying causes of the failure of council tax.

The structure of council tax was designed nationally and fixed in legislation. The new Local Property Levy would allow individual local authorities to design the structure of the tax to suit local circumstances. As a result it will be possible for councils to build in some buoyancy to their Local Property Levy and so reduce the pressure to increase tax rates.

Council tax sets eight bands (A to H) into which all properties must be placed. Property tax varies across these bands with Band H charging three times more than Band A. The number of bands, the relative rates of tax paid in each band and the property price levels to which each band applies are all set by legislation and applied to all of England.

These national rules drastically reduce fiscal autonomy for local government. In turn this reduces the scope for local people to make collective choices about the right balance between taxes and services. Proposals have been made, most recently by the Lyons report, to recognise local variations in the range of house prices by increasing the number of bands. Proposals have usually centred on splitting Bands A and H, creating four bands where there had been two. The goal has been to reduce pressure on council tax by spreading it more fairly.

However, this improvement does not address the central failing of the approach to banding. It is still a single national solution to a problem of local taxation. NLGN recommend that following revaluation and the creation of a national system for annual revaluation:

- Each council should be permitted to set its own banding structure for the Local Property Levy within the following nationally set parameters.
    - In two tier areas the county council, following consultation with district councils, would decide the Local Property Levy banding

structure for all local authorities within the county.

- All councils would be required to have at least eight bands.
- The difference between the rate for the lowest band and the highest band should be at least threefold as in the current regime

Within these nationally set rules local government would be free to decide:

- The number of Local Property Levy bands;
- The property values covered by each band; and
- The differences between the tax rates set for each band

These reforms would allow councils to tailor property tax to their area. They would reduce the scale of the local property tax. They would create space for genuine choices between differing strategies for spending and services in a community.

In these circumstances national government powers to cap local property tax rates would end.

5 *Consequences for further reform*

Partial reform of local government finance has inevitable drawbacks. Some issues are unresolved, while others can become more significant. However, bypassing the Parliamentary road block to reform solves the immediate problem and appears to be the only route to delivering any further reform.

Incentives

One issue that is not addressed is the need for councils to have more incentives for success. Rewards for success could be introduced without cutting across the need for national grants that ensure equity for poorer localities.

The VAT and income tax raised from proposals in this report could be used to reward councils that grow jobs and businesses.

- Income tax above £200,000 to be hypothecated for spending on local government only.
    - That this money be distributed as grant
    - Grant distribution would be on the basis of common amount for each person in employment in each local authority area

Linking high earners' income tax to local employment will create an incentive for councils to increase employment in their areas. The more jobs that they help to create for local people the more grant they would receive. The more local people they equip with the skills to become employees, the more grant they will receive.

A similar incentive can be designed using VAT on a regional or sub-regional basis:

- VAT increases to be hypothecated for spending on local government only.
  - The money would be distributed as grant
  - Grant distribution would be on the basis of VAT by region
  - Where groups of local authorities are working together in sub-regional economic areas with Multi Area Agreement (MAA) status, incentives could be strengthened by distributing the hypothecated grant on the basis of sales revenues in these smaller areas.

Cost Pressures

'Cost shunting', the movement of duties to local government from central government without providing the necessary funding is an international problem. The Lyons report suggested that an independent body should assess whether and how much 'cost shunting' was in the system.

A new and lower property tax creates the opportunity to introduce this reform in easier circumstances. This will reduce the inflationary pressures that have contributed to the failure of council tax.

6 *Conclusion*

Council tax is broken. This year's spending announcement for local government heralds another year of council tax increases above inflation. At this rate average bills will soon top £1500. We must not wait for the this runaway train to crash before we begin to reform.

Fear of reform will soon be outweighed by the certainty of paying a political price for inaction. This report offers a path out of the dilemma. It reduces the burden of local property tax. It creates a more responsive and buoyant Local Property Levy. It builds in incentives for councils to earn further fiscal autonomy. It creates the time for more fundamental reforms to evolve.

NLGN urge national parties to consider how they can use these recommendations to protect local people from the consequences of a nationally designed tax regime that is no longer working.