THE REFORM OF LOCAL TAXATION IN THE UNITED KINGDOM IN THE LIGHT OF THE BALANCE OF FUNDING REVIEW REPORT

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Abstract

Currently, local authorities in the UK raise only about a quarter of their revenues from taxes under their control. The Balance of Funding Review Report considered whether this proportion should be increased, and if so, how. This paper considers the report and possible reforms. Reasons why the balance of funding is a problem are discussed. However, there are problems with the current system apart from the balance of funding, and to solve some of these a closer link between council tax bills and property values is suggested. Whether a local income tax should be introduced as a supplement to a reformed council tax, and other possible reforms, are also discussed.

Keywords: Balance of funding, property tax, business rates, local income tax.

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The Reform of Local Taxation in the United Kingdom in the Light of the Balance of Funding Review Report

Work on the Balance of Funding Review (BOFR) started in April 2003 and its report was published in July 2004. The aim of this paper is to discuss some issues relating to local government finance in the light of its report (ODPM, 2004) and to make some recommendations for reform that might be considered by the Lyons Inquiry, which was established in the immediate aftermath of its publication. It is impossible to discuss all the issues raised by the review and this article will be selective.

The balance of funding (BOF) refers to the proportion of local authorities' revenues they obtain from taxes under their own control, rather than from transfers from central government. Currently, for revenue expenditure, about 25% of funding is raised locally by means of the one tax they do control, council tax (Annex B to the report provides some relevant data and discusses how the BOF should be measured). It is widely believed desirable to raise this proportion in line with Olson's (1969) principle of fiscal equivalence and thus move towards vertical fiscal balance:

> 'Multitiered governments in principle work best when taxes and the benefits of public spending are as closely related as possible when, that is, the citizen-voter-consumers residing in a particular political jurisdiction both pay for what they get from the public sector and get what they pay for' (Bird, 1999, p. 11).

However, there seems to be some confusion in the literature (including the BOFR report) over precisely why the BOF is a problem. This article discusses two arguments, based on gearing and accountability. It is not intended to present a comprehensive review of all the arguments. Further discussion is contained in Watt (2004) and some of the references therein.

Some remedies to the BOF problem are also discussed in this article. These are giving local authorities control over business rates, reform of council tax (CT) and a local income tax (LIT). However, there are problems with the current UK system of local taxation in addition to the balance of funding problem. In particular, CT, the one local tax, has a number of undesirable features (such as its regressive nature) and these may explain much of the discontent with the current system. Some reforms to CT are suggested which might be desirable even if they do not significantly affect the BOF.

WHY IS THE BALANCE OF FUNDING A PROBLEM?

One possible reason why the current BOF is a problem is that it leads to excessive gearing, whereby a change in local authority (LA) expenditure implies a more than proportionate change in CT bills. However, the report is not always clear on the exact nature of the link and, in particular, the discussion on pp. 20 – 1 is muddled. The link between the BOF and gearing may be elucidated using some algebra. Suppose a LA's budget constraint is given by $C = E - G(E)$, where E is LA expenditure, C is CT raised by the LA and G represents government grants, possibly a function of expenditure. The equation states that the LA's expenditure must be financed either by government grant or by CT. Differentiating, we obtain:

$$dC = dE - G'(E)dE. \tag{1}$$

So if expenditure increases, CT rises by the amount of the increase less any increase in grants that the expenditure increase entails. Multiplying (1) by E, and dividing by CdE, we obtain

$$\frac{E}{C}\frac{dC}{dE} = \frac{E(1-G'(E))}{C}. \tag{2}$$

The left-hand side of this equation can be interpreted as gearing – the proportionate effect of an increase in expenditure on CT. The equation tells us that, if $G'(E) = 0$, that is, if an increase in expenditure by LAs does not mean an increase in government grant, gearing is proportional to the ratio of expenditure to CT. So if this is 4, approximately the ratio for the UK, gearing will also be 4; that is, a 1% increase in expenditure will produce a 4% increase in CT.

Gearing may be a problem if it is significantly greater than unity. Local electors may be confused if they compare percentage increases in their LA's expenditure with the percentage increase in its CT, expecting them to be the same. Also, a high level of gearing may make CT bills highly variable. This is undesirable for a number of reasons. It makes planning by individuals more difficult. There are standard welfare economic arguments why it is undesirable to have one tax, on a fairly narrow component of expenditure and/or income, fluctuate widely in order to balance a LA's budget, when the reasons for the imbalance have nothing to do with agents' (marginal) valuations of the good or service in question.

Are there any other reasons why the BOF should be considered a problem (apart from leading to excessive gearing)? One argument is that it interferes with the accountability of LAs, which is generally considered desirable. However, it is important to distinguish between *marginal accountability* and *average accountability* (see Watt and Fender, 1999). Marginal accountability occurs when LAs finance changes in their expenditure by changes in taxes under their control. This is a feature that the current system already possesses. Average accountability occurs when LAs finance a high proportion of their overall expenditure by taxes under their control. The current system lacks this, and this is, basically, the BOF problem. The lack of average accountability may be undesirable in leading to inappropriate central government intervention in LAs' expenditure decisions. (See Watt, 2004, for further discussion of this question.)

So the BOF may be a problem for two reasons: it leads to excessive gearing, and because the consequential lack of average accountability gives rise to undesirable incentives for central government intervention.

The above algebra shows how gearing and the proportion of expenditure that LAs finance themselves are equivalent, provided government grants do not respond to LA expenditure. However, it would be possible to change the grant system to reduce gearing (while maintaining the current ratio of *C* to *E*) by making government grants depend on LAs' expenditure (this seems to be what the BOFR is suggesting on pp. 20 – 1, although this is not entirely clear). With CT currently financing 25% of LA expenditure, eliminating excessive gearing would require that a £1 increase in LA spending increase the government grants it receives by 75p, leaving only 25p to be financed by an increase in CT. This would be a large subsidy to LA expenditure at the margin. If the benefits of LA expenditure are largely internal to the LA (that is, there are minimal spillover effects of such expenditure on other LAs), then such a subsidy would lead to excessive LA expenditure from the efficiency point of view: LAs would equate the marginal benefit to themselves from extra spending with the extra cost to themselves, but since the latter is lower than the true cost because of the subsidy they have an incentive to spend excessively; this is the reason why marginal accountability is desirable. So changing the grant system in this way might eliminate the gearing problem, but would not (significantly) affect average accountability and would reintroduce the problem of marginal accountability. There is no recognition in the BOFR report that changing the grant system in this way would have this implication. The gearing problem would be solved; if this were the only reason why the BOF is a problem this would be fine, but it is generally agreed that both average and marginal accountability are desirable properties the local tax system should have. Changing the grant system to make grant depend on expenditure is hence not an appropriate solution to the balance of funding problem.

BUSINESS RATES

Another option considered in the BOFR report is the return of business rates to local control. While the report does contain some relevant discussion, it omits to mention what is probably the most important consideration in assessing whether this should be done, namely that of its incidence. (Public finance theory distinguishes between the *formal* and the *effective* incidence of a tax; the former refers to whoever has the legal obligation to pay the tax, the latter to those who are made worse off by the tax, taking into account the fact that tax changes will usually change economic behaviour and asset prices; in the paper we will generally mean ‘effective incidence’ by ‘incidence’.) The incidence of business rates is, in many circumstances, likely to be outside the LA area. For example, suppose business rates are imposed on a public corporation whose shareholders live outside the LA area, and are reflected entirely in a reduction in the corporation’s profits and payments to shareholders. This is what standard economic theory would predict (at least as far as short-run incidence is concerned). There may be cases where the incidence lies within the area, if, for example, it affects wages or self-employment incomes. It may result in higher prices in the longer run, if the lower short-run profits mean that firms exit – again, this is what economic theory predicts. So the question of the incidence of business rates is quite complex. Nevertheless, it seems reasonable to contend that the incidence of business rates is often largely outside the LA area that imposes them.

The question of incidence is important – it is well recognised that a necessary condition for a satisfactory local tax is that its incidence lies largely within the LA concerned. This is a basic requirement for efficiency – otherwise, the LA has an incentive to raise expenditure excessively, since the residents of the area only pay a fraction of the cost.

More fundamentally, it may be questioned whether there is any case for business rates at all. Property can be used either for business purposes or for owner occupation, and it would seem desirable that the tax system is neutral between these two uses. (That is, property is not allocated for tax reasons in a way different from the way it would be allocated in the absence of tax.) If property is used for owner occupation, then CT is paid. If it is used for business purposes, then inasmuch as the business generates profits, these will be taxed. The output of the business may well be taxed if it is subject to VAT, as it most likely is in the UK. So, even in the absence of business rates, the return on property used for business purposes is already subject to two taxes. Business rates mean that it is taxed a third time; if these are imposed at approximately the same rate as CT, it would seem there is a considerable bias against the use of property for business purposes.

Nevertheless, it could be argued that businesses benefit from many of the services provided by LAs (e.g., spending on transport and law enforcement) and it is therefore appropriate that they contribute to the cost of providing these services. The question of incidence is again crucial. If the benefits accrue to those in the LA area, there is no problem – we would expect the LA to make the correct decision, subject to various qualifications. But as the incidence is likely to be, to a considerable extent, outside the LA area, the question becomes more complex since we have spillovers between LA areas; economic theory would suggest some form of corrective system of transfers between LAs, but precisely how this should be done is not at all obvious.

The question of whether, and if so how, LAs should tax businesses (as opposed to individuals) is complex and a solution is not offered here. However, it does not seem that there is a compelling need to reform the current system of business rates at the moment. It might be preferable to reform other parts of LA taxation, where the case for reform is more urgent and compelling, while keeping the current system of business rates. Once these other reforms have been implemented, consideration can once again be given to reforming business rates.

COUNCIL TAX

The report's discussion of CT is limited, restricting itself to discussing various options for changing the bands. It does not consider what would seem to be a better reform, that of making CT proportional to property values. A related idea is to update the property values used for tax purposes more frequently than at present. We discuss these ideas in turn, but first discuss the case for a property tax.

The case for a property tax

The case for a property tax is powerful and here one can agree with the report. One argument for taxing property is that people derive benefits from ownership of property. Someone who owns and lives in a property derives an income in kind - sometimes called imputed income - and if it is deemed appropriate to tax income, this should be taxed as well. Someone with a more expensive property but the same money income as someone else is better off, so it would seem reasonable to tax him more. A related argument is that someone who invests a sum of money in either his own business, in property that he then rents out, or in financial assets, would in each case be taxed on the return. It would seem reasonable that if he instead invests it in property in which he then lives he also be taxed on the return. However if this is the reason for a property tax, it is not clear why renters as well as owner occupiers should pay. A rationale for taxing renters as well as owner occupiers is that it might be thought desirable to have a fairly broadly based tax on consumption, and that housing services are not essentially different from the other components of consumption that enter into this tax base.

There are other reasons for taxing property, and also for thinking that it is a good local tax. Property values reflect the effects of public spending on the infrastructure (especially transport), education, recreational facilities and so forth. It is not unreasonable that some of the returns to such investment come back to the community in the form of tax. This should promote sensible spending on the infrastructure – a LA is more likely to build a road if it generates more property tax revenue by raising property prices, but less willing to undertake investment that depresses property values. Also, it is clear where property is located, and hence easy to decide which LA should tax it. The fact that property is immobile means that the complication a LIT would face from people moving during the tax year does not arise. Evasion is also difficult – it is much easier for people to disappear from the gaze of the tax authorities than for buildings. It is a very transparent tax – people often know exactly how much CT they pay.

On the basis of these arguments we can agree with the BOFR report that there is a strong case for preserving a property tax of some form. There seems to be general agreement on this amongst commentators (e.g., Travers and Esposito, 2004).

The relationship of property values to council tax

If the case for a property tax is accepted, it might seem sensible to make taxation proportional to property values; one might have a tax rate of (say) 0.75%, so a house worth £100,000 would generate a tax liability of £750 and so forth. (The figure of 0.75% is a rough calculation of what the rate would need to be to generate approximately the same revenue as CT does now.) But the current system of CT does not have this feature; instead, 1991 property values are used to allocate properties to one of eight different bands, each of which has its own tax rate (strictly speaking, the tax rate in each band relative to that in each other band is determined by legislation; what a LA can do is raise or reduce the overall level of CT). Table 1 gives details of the bands and the different charges if the Band D tax is £1,200. The BOFR report considered various changes to the banding system, such as increasing the number of bands, changing the ratios of tax paid in the different bands to each other and so forth, but did not consider whether the banding system should be retained or abolished. The position taken here is that the banding system should replaced by a system whereby CT is proportional to property values.

Banding does not make sense. It means that some large changes in property values (e.g., from £161,000 to £319,000) have no effect on CT bills, whereas some small changes (e.g., from £319,000 to £321,000) have significant effects. If one accepts the case for a property tax, it would seem sensible that a small increase in property values have a small effect on tax, a large increase a large effect. But banding does not always have this effect. Moreover, the current system of banding means that the relationship between property values and tax is highly regressive. However cheap one's property, one's CT liability cannot fall below two-thirds of the Band D tax. (CT Benefit may modify the amount one has to pay – we discuss this later.) However valuable one's property, one cannot pay more than twice the Band D tax. This means that, in areas of the country with high property prices, people with quite modest properties are paying exactly the same as multi-millionaires living in mansions.

Arguments over the desirability or otherwise of various taxes can be divided into two broad categories: distributional and efficiency. We might ask whether a tax serves to distribute (on balance) resources towards those who are, on average, more deserving, by some criterion. We might also ask whether it promotes efficient resource allocation (potentially making everyone better off). A tax reform that has desirable efficiency and distributional effects should certainly be implemented. We argue here that changing the UK property tax system so that property taxes are proportional to property values would have desirable effects of both kinds.

Redistributional effects

If CT were proportional to property values, this would mean that those at the bottom (in the cheapest properties) would pay far less, and those at the top would pay more. There are many properties worth less than two–thirds of the average, including all those in the lowest band, Band A, which comprises 26% of properties. Someone with a property 20% of the average price would pay just 20% of the CT imposed on the average property. At the top end, the opposite would happen – those in more expensive properties would pay more tax. These effects might be considered, on balance, desirable. Also, these changes would, most likely, be capitalised in house prices. If the tax bill on a house falls, people will be willing to pay more for it and its price should rise, and vice versa. This tends to magnify the redistributional effects. Some calculations suggest that the effect on those in expensive properties could be significant. (For example, suppose someone's annual CT bill from a £1m. property rises from £2,500 to £7,500. Then assuming a 10% discount rate, the value of the property falls by £50,000 as a consequence.)

It might be considered that these redistributional effects are desirable. But there are two qualifications. One is that the magnitude of these changes would most likely generate significant political opposition, and secondly, not all those living in expensive properties should be considered wealthy and deserving of paying higher taxes. It might be desirable to mitigate the effects on such people and below we consider some suggestions for doing just that.

Efficiency effects

A reform that made CT bills proportionate to property prices would tend to raise the prices of cheaper properties and reduce the prices of more expensive properties; over time there will be effects on the supply side: the supply of cheaper properties would expand and that of more expensive properties would contract. There are several ways in which these changes would affect the efficiency with which resources are allocated: (i) There would be an increased supply of housing in the less affluent parts of the country and lower supply in the more affluent areas. This would probably mean some movement in population away from these affluent areas, hence relieving (to some extent) problems of crowding and congestion in such areas. (ii) The mix of cheaper properties relative to more expensive properties in places such as London would increase. So affordability would increase at the lower end of the market. The supply of cheaper properties is a major problem in recruiting workers in many public services in the capital (and in other expensive parts of the country), and the proposed change would make some contribution to solving this problem. (iii) The current system is biased against rental housing, which on average tends to be smaller and cheaper. Under the proposed reform, renters would typically pay lower CT and the supply of rental properties would tend to increase (renters would be willing to pay more, so the supply of properties for rent should increase). A flourishing rental sector is essential in a well-functioning economy – one reason is that it facilitates worker mobility, which is important given the inevitability of structural change.

These effects work by changing the supplies of different types of property. There is another way in which there could be efficiency-enhancing effects, because of the way CTB works. The fact that the minimum CT payment is two-thirds of the Band D rate means that many low-income families are forced to claim CTB. Although CTB does ameliorate the regressive nature of CT to some extent, it contributes to the poverty and unemployment traps. The poverty trap is where low-income workers who earn more lose benefits, increasing their effective marginal rate of tax and discouraging their work effort. The unemployment trap is where the unemployed who find work lose benefits, hence discouraging them from looking for, and accepting, work. If CT were instead proportional to property values, those in cheaper properties would find their CT bills considerably reduced. The range of income levels over which CTB would be payable would be lower, and this would ameliorate the poverty trap. Similarly, the unemployment trap would be reduced – if someone has his CT paid completely if unemployed, but pays it in full if employed, a lower CT will increase his incentive to take work. (See Clark et al., 1999, for further discussion of CTB.)

It seems, then, that a reform that made CT payments proportional to property prices will have desirable distributional and efficiency-enhancing effects. Tax reforms of this kind are rare indeed! But there are reasons for seeking to mitigate the redistributional effects, which we consider in the next section.

Reforms to mitigate the redistributive effects

If CT were proportional to property values there would be a large, negative effect on those who live in expensive properties. There are two reasons for seeking to mitigate these effects. The first is that not all those who live in expensive properties can be considered rich; many who may have been well off in the past, but have experienced a change in family or employment circumstances (for example, divorce, bereavement or redundancy) cannot be considered to be still well off. Although moving to cheaper properties may be an option for some, they still suffer because of the fall in the prices of their properties and because of the costs of moving. So poor households who live in expensive properties may be particularly, and unreasonably, hit by such a change. A second reason for mitigating the redistributional effects is political - to reduce the opposition to what are essentially desirable reforms. There are a number of ways in which this could be done; we consider three possible ways below.

(i) *Reform of stamp duty*

Stamp duty is an undesirable tax as it taxes mobility and, in its current form, has the absurd ‘notch’ property whereby an increase in the price of a property from just below to just above a threshold means that tax at the higher rate is paid on the full value of the property. Consider someone with a house worth £600,000 who faces a property tax rate of 0.75% under the proposed reform. This would mean an annual property tax bill of £4,500. The current average Band D CT bill is £1,167, so if the individual is in a LA which charges this average tax rate, then his current CT bill is no more than £2,334. However, his stamp duty bill on buying the property would be £24,000. Suppose we consider a reform of stamp duty whereby properties below £100,000 are exempt, those priced over £100,000 are taxed at 1% on the amount over £100,000 and up to £500,000, when the tax rate becomes 2%. So buying a property for £600,000 would attract a stamp duty bill of £6,000. If the owner moves house every ten years, then he would be worse off to the extent of £534 a year, still costly, but far less than what he would have suffered in the absence of the change in stamp duty.

Such a reform would reduce the cost of moving, and tend to raise the price at which those living in expensive properties can sell their properties. It would have highly desirable efficiency-enhancing effects, by reducing the cost of moving. It would also benefit many of those buying cheaper properties. Someone buying a £100,000 house would pay zero stamp duty as opposed to £1,000; although this might be capitalised into the price, there would over time be an increase in the supply of such properties over time, hence increasing the availability of cheaper property.

Cutting stamp duty in this way would be expected to cost tax revenue, although there would be an offsetting effect as the number of property transactions might be expected to increase. The shortfall in revenue might be offset by an increase in the property tax rate: more specifically, the loss in government revenue from stamp duty would be reflected in lower government grants to LAs, who would make up the shortfall in revenue by increasing CT.

(ii) Increase in threshold for higher rate tax

The income threshold at which households become liable for the higher rate of income tax (40%) has declined as a fraction of average incomes in recent years. Many households who would not be considered at all rich might find themselves paying tax at 40% and a heavy property tax if the proposal adopted here were introduced. It would seem sensible to raise the 40% threshold as a way of ameliorating this problem.

(iii) *Accruing council tax liability against the value of one's property*

Much of the anger that CT has engendered in recent years has been from elderly tax payers whose incomes have changed significantly on retirement but who continue to live in the same properties, meaning an unchanged CT liability. If such households could postpone paying much of their CT for the remainder of their lives (to be paid out of their estates), this should considerably alleviate the problem. (This proposal is made by Cameron and Muellbauer, 2000.)

Another possibility not analysed here is to reform CTB. In any case, if banding is abolished as advocated here, CTB payments could no longer be capped at the Band E rate as they are currently. One possibility would be for the scheme to continue as at present, but with the maximum amount of CT that could be reimbursed being that on a property of a certain value (which could be regionally dependent).

The uprating of property values for tax purposes

At the moment, an increase in house prices has no effect on one's CT bill – this is based on what one's house price was estimated to be in April 1991. However, if the case for a property tax is accepted, it would seem reasonable that CT payments should change as the price of property changes. There are basically two questions to consider – how this could be done in practice and what the pros and cons of such a change would be.

Annual uprating of property values could be done somewhat as follows. The actual market value of a property would be used wherever possible. (There has been extensive discussion of the desirability of doing this, and there is a strong case for basing property tax valuations on actual sales values – see, for example, Foster, Jackman and Perlman, 1980.) So when a property is sold, this would be its immediate valuation for property tax purposes. The valuation would be updated regularly, using price indices for region and type of property. However, given that many houses are not sold for long periods of time, it would be necessary to have a procedure for valuing these. So it might be desirable to have a major revaluation periodically, as is supposed to happen at the moment, but perhaps more frequently (this is what the government prescribed in DTLR, 2001). This would cover all property, and prices would be uprated using the system described above, but once a house was sold, this price would then become its property tax valuation. There could be an appeals system, whereby anyone who thought his valuation was unreasonable (i.e., exceeded its market value) could appeal.

On the question of the desirability of adjusting property tax valuations in this way: one argument is that it would be required by fairness. Someone whose property price rises is better off, and therefore it is not unreasonable to suppose that he should pay more tax. We might distinguish between a rise in property values throughout the LA area, and one that affects just a fraction of properties. In the case of the former, there is no need for taxes to rise. In the case of the latter, some property tax owners are better off than others, and these would pay relatively more tax; but this seems basically just. Consider the case of a town experiencing a disaster of some sort (it could be environmental, such as a flood, or economic, such as the closure of a major employer) that causes property prices to fall. Then if property tax valuations are linked to house prices, property tax paid in this town falls as well, and this acts as a form of insurance. This would seem to be a highly desirable consequence of adjusting valuations frequently.

Another important advantage of adjusting property tax valuations to reflect increases in property prices is that it would tend to dampen house price variations. Such variations may be undesirable for a number of reasons; for example, they might complicate macroeconomic management. Basing property tax payments on actual sales values would tend to stabilise house prices. Someone who successfully bids more for a property thereby exposes himself to an extra CT liability; this is not the case under the current system.

Clearly there will be additional administrative costs in uprating property valuations used for CT purposes every year, and it might be decided that annual adjustment was too frequent. But there is certainly a case for changing valuations more frequently than at present (every three – or five – years?) Moreover, the use of actual sales prices for valuation purposes should be encouraged. Information about price is produced automatically when a property is sold, and it would seem desirable to use such information.

THE BALANCE OF FINDING AND A LOCAL INCOME TAX

The above reforms to CT are unlikely to make a big difference to the BOF if CT remains the one tax under LAs' direct control. There are reasons unrelated to the BOF for making the changes – CT is an unfair and regressive tax, and these reforms would make it fairer and less regressive as well as having some efficiency-enhancing effects. It might be possible to use such a reformed tax to raise slightly more revenue than at present. A further point is that if the change is accompanied by a large fall in stamp duty (as advocated above), this might enable there to be an increase in revenue raised by CT – it might be that there is a upper limit to the amount of tax that can be tolerably raised by taxing housing, so if one form of tax (e.g., stamp duty) on housing is reduced this will raise the amount that can be raised by other taxes on housing (e.g., CT). Nevertheless, there is unlikely to be much room for generating much more revenue from CT. There is a consensus that the BOF is a problem, so it is then necessary to supplement it with another major source of revenue under LAs' control. We have argued against the relocalisation of business rates, so it seems that the only reasonable candidate for such a tax is a LIT. (There are a number of other local taxes that might be considered, such as congestion charges and a hotel room tax, but such sources of revenue are only likely to make a small contribution to changing the BOF.) There has been extensive discussion of a LIT and we do not propose to discuss it in any detail here. We would agree with the BOFR report that it should be considered as a supplement to CT, rather than a replacement. If a LIT were introduced in such a way, it could be accompanied by a reduction in central government grant to LAs and a commensurate reduction in national income tax. (This means that, provided that LA expenditure did not increase, there would be no need for the overall marginal rate of income tax to rise, whereas there would be if a LIT replaced CT.) The main benefit of such a change is its effect on the BOF. LAs would have two taxes under their control rather than one, and could now finance more than half of their expenditure by such taxes. One common objection to a LIT is that there would be administrative difficulties in both introducing it and running it but the general consensus is that it would be possible. The question to be confronted is whether the benefits of introducing a LIT, which would be, basically, the shift in the BOF, outweigh the administrative costs of running the scheme and the transitional costs of introducing it. (Another benefit of a LIT is that some voters who currently do not pay CT would pay a LIT, and hence would have an incentive to take into account the tax consequences of any higher expenditure they might vote for.) In further research, it would be desirable if both these benefits and costs could be pinned down more precisely.

FURTHER REFORM

The main reform advocated here is to change CT so that it is proportional to property values, with revaluations taking place much more frequently than at present to reflect changes in property values. Another reform that should be seriously considered is introducing a LIT as a supplement to a reformed CT. Although a system reformed in such a way would be a huge improvement on the current system, it would still be less than ideal. There would still be the problem of poor households living in expensive properties who would be liable for high property tax payments (although we have some suggested ways of mitigating this problem, these would probably not solve it completely). A further possibility is to put imputed income into the income tax base and to levy income tax (both local and national) on this expanded tax base (see Fender, 2004). Imputed income would be measured by applying a multiplier (say 3%) to property values – the multiplier would be intended to approximate – in real terms – the returns available elsewhere on the money. So someone with a house worth £100,000 would be assigned an imputed income of £3,000; with a marginal tax rate of 22%, his tax liability would be £660; however a marginal tax rate of 40% would generate a tax liability of £1,200. An attraction of the proposal is that if a household's circumstances change significantly, its marginal tax rate should also change, and hence the tax liability generated by the property changes. This would solve the problem of elderly households with low incomes having to pay high CT bills if they live in expensive properties.

Although including imputed income in the income tax base and imposing a LIT on this revised tax base would be desirable reforms, introducing them would be complex. The steps advocated in this article, making CT proportional to property values and introducing a LIT, are both steps on the way to such a system. Once a LIT is in place and running, and once CT valuations are based on current property values, it should not be too difficult to make the transition to such a system, should this further change be considered desirable.

CONCLUSION

This article argues for a number of reforms:

(a) CT should be reformed so that CT bills are proportional to property values. This would make the system less regressive, ease problems caused by CTB and generate an increased supply of cheaper properties.

(b) The property values used for CT purposes should be uprated more frequently than at present, possibly annually, using actual sales prices where this is possible. This would tend to stabilise house prices and provide insurance for households against shocks that alter property values.

(c) The reforms advocated in (a) and (b) need to be accompanied by measures which mitigate the effects on those who live in expensive properties, both for political reasons and because some of those who live in such properties may not have high incomes. One possibility is reforming stamp duty on property transactions.

(d) Serious consideration should be given to introducing a LIT to supplement, rather than replace, CT. But there needs to be more analysis both of the likely benefits (namely the shift in the BOF) and the costs.

(e) It is not clear whether the current system of business rates should be reformed, and if so, how. Reform of business rates is not a high priority at the moment.

(f) Over time, it would be desirable to move to a system where imputed income is included in the income tax base and a LIT levied on this expanded tax base. However, introducing this in one go would be complicated and undesirable. The steps advocated above would be useful preliminary steps that, if implemented, would make the subsequent introduction of such a scheme much easier.

These changes would have considerable and differential effects on the ability of LAs to raise revenue. Such reforms would need to be accompanied by appropriate changes in the grant system, which we do not discuss here.

It is not clear how local government taxation will be reformed. The Lyons Committee has been established to consider the matter further. If the proposals suggested here are to be introduced, it would be desirable to do a fair amount of further work. For example, one would want to know how many households would be better off, and how many worse off, and by how much. What would the tax rate need to be to generate as much revenue as at present? How would the revenue generated by each LA change, and how would grants need to change? And so forth. It is clear that there is plenty for the Lyons Inquiry (and for others) still to do.

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Band	Lower Limit (exceeding)	Upper Limit (not exceeding)	Council tax as Multiple of Band D	Tax bill if band D bill is £1,200
A	£0	£40,000	6/9	£800
B	£40,000	£52,000	7/9	£933
C	£52,000	£68,000	8/9	£1,067
D	£68,000	£88,000	9/9	£1,200
E	£88,000	£120,000	11/9	£1,467
F	£120,000	£160,000	13/9	£1,733
G	£160,000	£320,000	15/9	£2,000
H	£320,000	no limit	18/9	£2,400

Table 1: Council tax bands

(Source: ODPM 2004, p. 26 and own calculations)