

# REFLECTIONS ON FAIRNESS AND ITS IMPLICATIONS FOR THE EVALUATION OF COUNCIL TAX REFORM

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## Introduction and summary

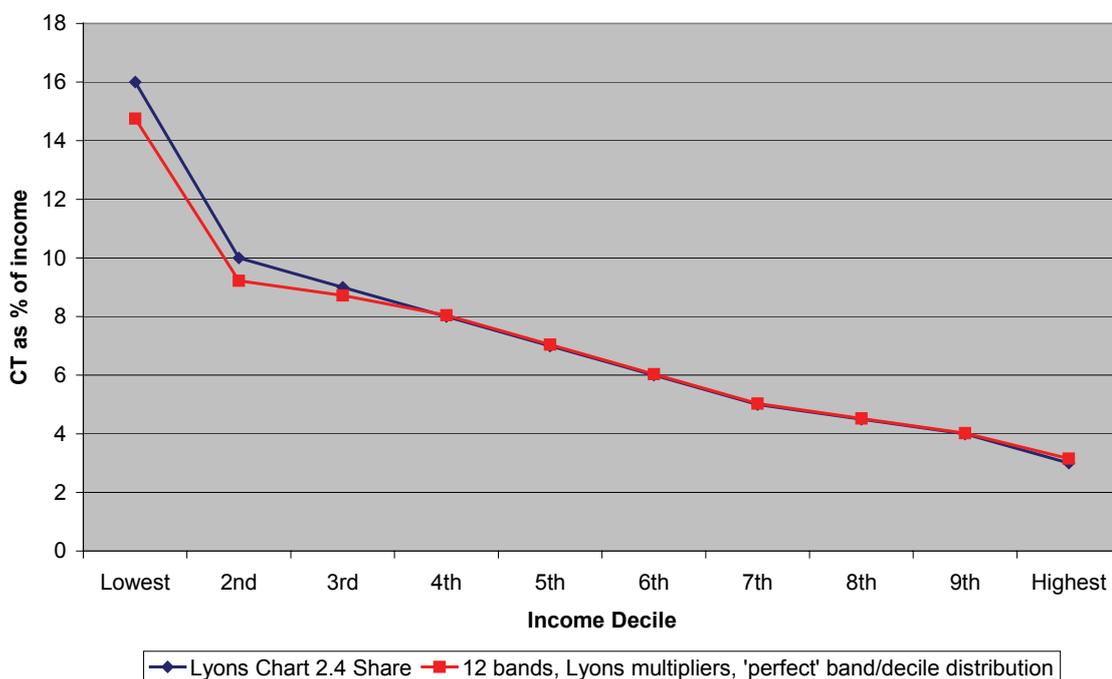
1. This note responds to the request for ‘technical’ feedback to the interim report of Sir Michael Lyons’ Inquiry into Local Government (hereafter Lyons). Its focus is the way that Lyons has evaluated the different options for reform of the Council Tax (hereafter CT) using the ratio of tax paid to income as the criterion by which to judge fairness. In particular, it examines the conclusion that “adding additional bands would appear not to have a significant impact on fairness in terms of the link to ability to pay as measured by income”. The importance of this conclusion cannot be overstated since, on the basis of it, Lyons appears to rule out all proposals for reform of the CT banding structure, concentrating all reform efforts on Council Tax Benefit.
2. We make three groups of points about this conclusion and its implications. They are:
  - That the explanation as to why adding additional bands makes no difference is wrong. It is not, as Lyons says, because “people living in houses within a specific band tend to have widely different income levels”. Rather, it is because the proposals examined by the Inquiry were modest, especially in the numbers of properties at the top who would be affected. There is nevertheless a compelling logic to the proposals, but this is not discussed in Lyons.
  - That while tax paid as a percentage of income is certainly an important criterion by which to judge CT, it is not enough to do it just for households grouped by income decile. Instead, it should also be done for households grouped by CT band, as we did in our papers arguing for reform. This view provides clear insights into to what needs to change and why.
  - That the final report should take this approach further still by examining outcomes for working age and pensioner households separately. Lyons rightly identifies changes to Council Tax Benefit as part of the overall package of reforms. CTB reform may not be enough for low income, working-age households. The final report therefore needs to consider more radical changes to the multipliers too.

## Why adding additional bands makes no difference on the chosen criterion

3. Our comments are focussed on that part of the interim report entitled ‘reform options and the ability to pay’(p71 onwards). Three important statements follow in quick succession. The first is the observation that many submissions to the Inquiry argued for extra bands on the grounds that it would improve fairness, “because it enables council tax to be more precisely linked to property value at the top and bottom”, something that was “welcomed by focus groups” (paras. 2.74 and 2.75). This is an accurate statement of the grounds on which most of our arguments for reform were based.

4. The report then at once observes that “adding additional bands would appear not to have a significant impact on fairness in terms of the link to ability to pay as measured by income” (para. 2.76). The evidence presented for this is a chart (2.4) which shows CT paid as a percentage of income for households grouped according to their level of income (that, their income decile). Since the lines drawn for each of the options considered, including the base case, all lie on top of one-another, the conclusion that none of the options makes any difference follows.
5. The flaw here is not in the arithmetic but in the explanation given for the fact that the lines are all indistinguishable from one-another, namely that it “reflects the fact that people living in houses within a specific band tend to have widely different income levels” (para. 2.77). Diagram 1 below shows the messy connection between people’s incomes and the value of the houses they live in makes little difference.
6. In this diagram, the black line is copied from chart 2.4 and effectively represents the outcomes for each of the options considered there. The red line then shows our estimate of what the picture would be if there were a 12 band structure using Lyons’ multipliers but with the properties rearranged so that the correlation between income and property band is as good as it can be (that is, all of the bottom income decile made up of A; all of H is in the top income decile, etc).

**Diagram 1: CT as a share of income, for different income groups**



7. The difference between these lines represents the greatest amount of change that would be possible if income and house values were perfectly aligned. Although there is now some visible difference between the two lines for the lowest two deciles, the overall shape of the line is still unaltered. At the top, there is no perceptible difference between the lines at all.

8. The reason why the various options show no difference when examined in this way is that the changes they represent are limited. At the bottom, they involve a reduction in CT of one sixth for half the homes in band A – about 12% of all homes. At the top, there is an increase of just one fifteenth for the 5% of properties in band G. This is compounded by the use of a chart that, because it reports its results by deciles, is quite unable to help analyse even big changes that affect just the 0.5% of properties in band H.

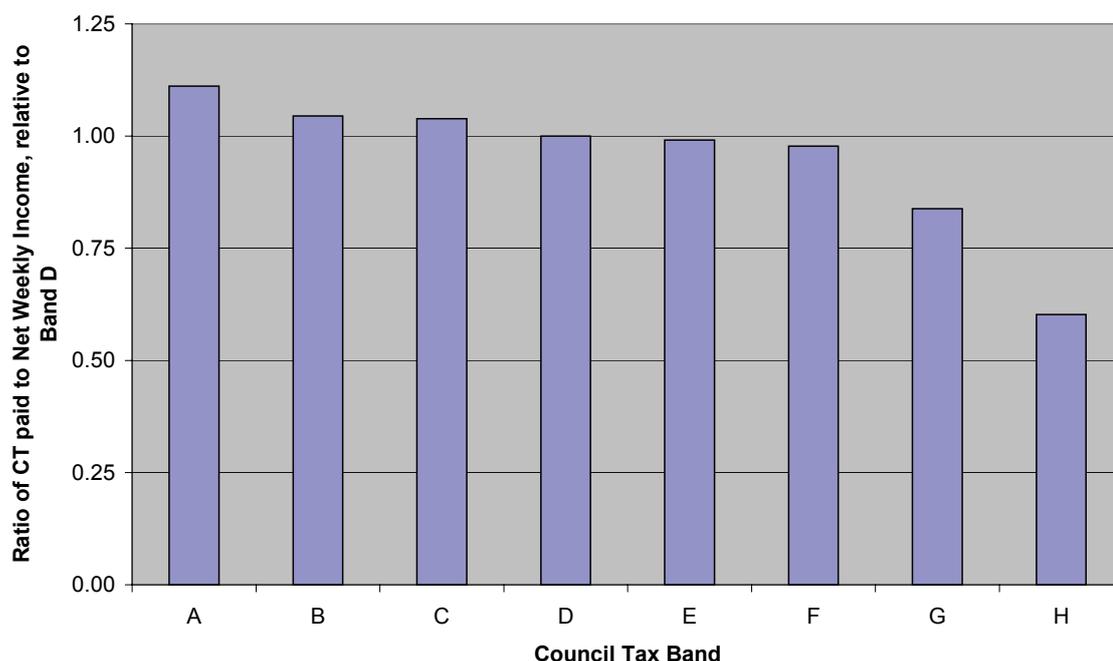
### **Different ways of measuring ability to pay and their implications for CT**

9. Lyons reports that focus groups expressed the view that “most people thought that the fairest tax is one that is related to an individual’s ability to pay, particularly meaning their income” (para. 2.51). The question of how ability to pay should be measured and, in particular, whether it is good enough to proxy it by income, is a subject in its own right. It is far from clear, for example, that two earner households with a mortgage and children would agree that ‘income’ equals ‘ability to pay’. Although this is not a question we pursue here, it is one that we hope Sir Michael will reflect upon in his final report.<sup>1</sup>
10. Our concern here is a different one. The way that Lyons uses this notion of fairness is via the average amount that CT represents as a share of income for properties grouped according to their level of income. The downward slope of the line in chart 2.4 (and in the above diagram) can be read as suggesting that CT is currently unfair because on average, the lower a household’s income, the larger is the share that CT takes of that income.
11. This, though, is not the only way that properties can be grouped for the purposes of calculating this statistic and it is not the way that we ourselves have done it in the past. Unlike Lyons’ use of income deciles, our groups comprised all the properties in each particular CT band. Diagram 2, based on our submission to the Balance of Funding Review is comparable to the diagram above and to Lyons’ chart 2.4.
12. The interpretation that we put on this evidence is that for bands B through F, the ratio of tax paid to income, averaged over all properties in the band, is more or less uniform. Clearly, the tax takes a smaller share of income for properties in bands G and H. Arguably – and we did so argue – the tax also takes a noticeably higher share of income for properties in band A. The overall conclusion we draw from this is that the heart of the CT system is basically sound, but that the ends of the system are not.

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<sup>1</sup> Having invoked the focus group view, it seems to us that Sir Michael now has to explain why logically it does not lead inexorably to a local income tax. Only under such a tax will this criterion invariably be met. Under the CT system, by contrast, there will be times when it is not met, for example when a higher income household chooses to occupy a lower value property or vice versa. In such cases, if the households are making a free choice, the logic of a property tax is that their CT as a share of income should be lower or higher as a result.

**Diagram 2: CT as a share of income, for different CT bands (relative to band D)**



13. The first question is whether it is possible for both diagrams 1 and 2 to be correct? Upon investigation, it turns out not only that both can indeed be correct but that the Lyons presentation, by income decile, will always make the tax look more unfair than the NPI presentation, by CT band. The appendix to this paper presents some simple examples to illustrate the contrasting effects.
14. Given that the two measures can both be correct, we believe Sir Michael must look at both measures in his final report. There are a number of reasons why it is essential that averages for groupings by CT band are examined.
15. First, there is a direct connection between the targets (that is these ratios and whatever their desired levels are deemed to be) and the instruments for achieving them (that is, the multipliers as well as the very structure of the bands themselves). If it is decided that the level of tax for band H properties is too low, it is clear what to do. By contrast, if it is decided that the level of tax for the top income decile is too low, it is not actually clear what to do about it.
16. Second, if there are to be changes to the structure of CT, then politicians need to be able to explain and justify them. A statement to the effect that “we are increasing the tax on properties worth more than £1m because, at the moment, they pay much less relative to their income than average” can be understood. What is being done, and why, are clear. By contrast, no politician is going to say that such and such is being done to the CT system “in order to raise the share of tax paid by people in the top income decile”. Neither what is being done, nor, more importantly, why, will be clear to anybody.
17. Third, the by CT-band approach has the merit of showing what is going on with the most valuable properties, something which an income decile approach does not.

18. Fourth, although there is always the question of what constitutes ‘fairness’ on any one of these presentations, there is a prior question of whether any particular group stands out as an exception. One virtue of chart 2.4 (and diagram 1) is that it shows just how much worse off are the households in the lowest income decile and, consequently, how important Council Tax Benefit is to dealing with this problem. Likewise, the virtue of diagram 2 is that it shows that the households in bands G and H enjoy outcomes that are not just slightly more favourable than average (as is the case for bands E and F compared with band D) but exceptionally more so.
19. It is not just splits by CT band as well as income decile that are required. The interim report attaches great importance to the issue of Council Tax Benefit. We agree that it is indeed important and we welcome the fact that the final report is going to examine it more closely. However, the issues with CTB for pensioners are very different from those for working-age. For the older group, the issues are non take-up of this benefit coupled with the level of savings that disqualifies people from this benefit. For the younger group, by contrast, the issue is the very low level of income at which a household starts to lose CTB.
20. Just as it is vital to examine tax to income ratios for CT band groupings as well as income decile groupings, so too is it important that similar presentations be developed for pensioners and working-age separately. Once again, if these show that particular groups or sub-groups face exceptional problems, or enjoy exceptional advantages, the final report should consider whether anything should be done to correct this. If that includes further changes to the multipliers or bands, so be it.

### **Conclusion: the compelling logic of Council Tax reform**

21. The logic of extra bands at the top and the bottom follows directly from our analysis of the system as presented in the second of the two diagrams. To repeat: the conclusion that we draw from that diagram is that the Council Tax system is sound at heart, but unsound at its ends. The remedy – more bands at top and bottom following the pattern already present in bands B through F – entails extending the regularities at the heart of the system upwards and downwards. Another way of putting this is that it is about completing the Council Tax system by removing the last vestiges of the Poll Tax still within it, namely the cap on how much those in big houses pay, and the floor below which the tax for those in the most modest of homes cannot fall.
22. What makes this logic compelling is that it meets the political challenge need that revaluation will inevitably throw up. Chart A2.7, showing the number of properties moving up and down one or more bands in the national update option, provides the evidence for this. For example:
  - In Yorkshire and the Humber, 19% of properties are shown as moving down a band. However, none of these properties can be among the 45% of properties currently in band A since they are already in the bottom band. The benefits of revaluation in the Yorkshire and Humber region will therefore be almost entirely confined to properties of above average value.

- In London, 35% of properties are shown as going up one or more bands. However, none of these properties can be among the 2% of properties in London currently in band H because they are already in the top band. The pain of revaluation in London, therefore, will not be shared by those properties worth more than about £1 million which were already in band H in the first place.
23. Council Tax revaluation will be hard enough politically without these glaring inequities. The remedy for both of these is more bands at the top and the bottom: revaluation, in other words, requires reform.

## APPENDIX

These three tables depict an imaginary world in which there are two council tax bands and two levels of income that households can have. In each case, the distribution of properties between bands and income levels is the same. What varies are the Council Tax multipliers.

In each case, tax as a proportion of income is measured both for income groupings and for the grouping by Council Tax Band. These are then compared as 'Lyons' ratios (for the income groupings) and 'NPI' ratios (for the band groupings). In both cases, a ratio above 100% indicates that either the lower income group (for Lyons) or the lower Council Tax group (for NPI) are devoting a higher share of their income to tax. The key point to note is that NPI ratios are always lower than Lyons ratios. At least in this simple example, the algebra proves this to be always so.

<b>Example 1</b>		Income Level 1	Income Level 2	
CT Band	CT payable	£10.00	£15.00	CT as % of income
A	£1.00	35%	15%	8.7%
B	£1.10	15%	35%	8.1%
	CT as % of income	10.3%	7.1%	
	NPI ratio	107%		Judgement?
	Lyons ratio	144%		Unfair

<b>Example 2</b>		Income Level 1	Income Level 2	
CT Band	CT payable	£10.00	£15.00	CT as % of income
A	£0.96	35%	15%	8.4%
B	£1.13	15%	35%	8.4%
	CT as % of income	10.1%	7.2%	
	NPI ratio	100%		Judgement?
	Lyons ratio	141%		Fair
				Unfair

<b>Example 3</b>		Income Level 1	Income Level 2	
CT Band	CT payable	£10.00	£15.00	CT as % of income
A	£0.53	35%	15%	4.6%
B	£1.58	15%	35%	11.7%
	CT as % of income	8.4%	8.4%	
	NPI ratio	39%		Judgement?
	Lyons ratio	100%		Fair
				Fair