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A fiscal fix for a peculiarly flawed property market

The British property market is both alluring to foreign investors and peculiarly dysfunctional. One of the flaws at its heart is the council tax system, which is monstrous and unique. No other advanced country has such an unfair property tax.

For a start, it is a mystery why the UK is so attached to the value bands that applied when the tax was introduced by the Conservatives in 1991 when most nations base taxes on recent market values. This would not be hard to fix: owners can easily value their homes from Land Registry information processed by property websites such as Rightmove.

Retaining outdated bands only magnifies the system's unfair anomalies. For example, a household at the bottom of band H (for the highest value properties) — where homes are on average worth perhaps £1.2m (the equivalent of £320,000 in 1991 prices) — pays 30 per cent of the tax, as a percentage of value, paid by a household at the top of band A (lowest value properties), where the average home costs about £120,000 (£40,000 in 1991). A family in a £2.4m home pays only 7.5 per cent of the rate faced by a band A taxpayer in a £60,000 home in the same local authority.

Council tax relief, a sticking plaster for the poor, in fact traps many in poverty. From April 1 2013 hundreds of thousands of people became liable for council tax for the first time, after the Conservative-led coalition government cut by 10 per cent the amount available for relief and allowed local authorities to set their own eligibility criteria. "Council tax has overtaken credit cards as the most common debt problem in Britain," according to Citizens Advice.

Introducing a progressive element would be simple: borrow features of income tax. Making the first £50,000 of value free of tax would take hundreds of thousands out of the poverty trap. A higher tax rate for the value above £5m would tap a little of the taxable capacity of the plutocrats. Successful reform would require overcoming the inability to pay of the cash-poor and asset-rich. A good method would be to offer everyone a tax deferral in return for an equity stake in their property. Those paying cash would be offered a small discount since managing deferral incurs costs.

Suppose the tax rate was 1 per cent. For those choosing deferral, the government would register a 1 per cent gross equity stake, to be paid out at the next transfer of ownership. After 10 years of deferral, the government would own a 10 per cent stake. The combination of the discount and the prospect of having to share capital gains with the government (that is, other taxpayers) ensure many would choose the cash option.

Such a tax would encourage downsizing; which would ensure that a regular supply of properties came on to the market. This would in turn generate tax revenue. Central government should take tax deferrals on to its balance sheet and supplement local authority revenue with the annual cash equivalent of the deferred tax payments for that year.

There would be many economic benefits , not least productivity gains from better use of housing stock. Higher revenue from reformed council tax would permit cuts in the stamp duty land tax, improving labour mobility. Where there are pockets of negative equity, prices would rise. At the upper end of the market prices would fall, inducing a temporary decline in house price indices, making property more affordable for the young. With lower prospective capital appreciation, many of the thousands of empty upmarket homes owned by foreign investors would be sold or offered for rent. Upward pressure on London rents would moderate. As foreign speculators pull out, sterling should fall, shifting the UK recovery towards exports and away from consumption.

A fairer society, higher productivity and a more sustainable recovery are thereby achievable. Council tax reform deserves to be high on the agenda for voters on May 7.