



The Taxation of Property
A Report by Europe Economics

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EXECUTIVE SUMMARY

- 1 This is a Europe Economics Report for the Campaign to Protect Rural England (CPRE). The CPRE asked Europe Economics to assess a number of options for taxing land and development against the following important objectives:
 - (a) Efficient use of environmental resources, in particular
 - Efficiency in use of existing housing stock
 - Efficient renewal and re-use of structures currently on land
 - Redevelopment of land previously used for structuresbut also efficient use of water, power, and other natural resources.
 - (b) In pursuing efficiency, not neglecting the needs of the disadvantaged, in particular addressing affordability issues.
- 2 Because of the very significant development gains made on the granting of planning permission, tax levels on housing and development in the UK are very unlikely to be a factor in the relatively high level of UK house prices. Similarly, it is unlikely that further rises in taxes on property would raise house prices.
- 3 Though planning will be the main instrument guiding development will be the planning system, taxes have a role
 - (a) in reducing unnecessary loads upon the planning system;
 - (b) in guiding what sorts of development comes forward seeking planning permission;
 - (c) in guiding how development occurs on sites after planning permission is granted; and
 - (d) in influencing the wider environmental footprint of development.
- 4 The role of planning is to ensure that non-commercial factors are given their proper weight, rather than to replace commercial judgements. Planning will tend to be most useful in reflecting *local* factors. Broad *principles*, of whether, say, brownfield development is to be preferred to greenfield development, though they will be important in local planning decisions, can be more efficiently dealt with at an economy-wide level by using taxes to guide the Market to one form of development rather than another, then allowing the Market (to a large extent) to determine which particular commercial ventures and which companies are most efficient at delivering the required quality.

Summary Assessment of Particular Taxes



	Development Gains Tax	VAT on new build @ 17.5%	Reduced VAT on brownfield new-build	Contam. Land Credits	Abolish CGT	A new Unused Sites Tax	Raise Stamp Duty Thresholds	Stamp Duty Reliefs	Low-income housing credits
Efficiency in use of existing housing stock	No direct effect	Positive	Little effect	Little effect	Positive	Positive	Ambiguous	Positive	Little effect
Efficient renewal and re-use of structures currently on land	No direct effect	No further effect to existing provisions	Little effect	Little effect	Positive	Positive	Little effect	Positive	Little direct effect
Redevelopment of land previously used for structures	Ambiguous	Negative	Positive	Positive	Positive	Positive	Little effect	Positive	Little direct effect
Other environmental efficiency	Positive	Positive	Little effect	Negative	Little effect	Little effect	Positive?	Positive	Little effect
Affordability	Ambiguous	Little effect in short-term; negative in longer-term	Little effect	Little effect	Positive	Positive	Positive	Positive	Positive
Feasibility	Achieving political feasibility a considerable challenge	Feasible	Feasible	Feasible	Unclear — possible impacts beyond study's scope	Probably feasible	Feasible	Feasible	Practical feasibility uncertain



Conclusions

- 5 The key conclusions of this study are that, to best achieve the goals set out above given current political constraints:
- (a) **A tax or other form of charge on development gain should only be attempted if a widespread and sustained political consensus around it can be achieved.**
 - (b) **VAT should be introduced on new build** — at the full rate (17.5 per cent) for greenfield development and at a reduced rate (probably 5 per cent) for brownfield development. (We recognise this is unlikely to be feasible to do this alongside the introduction of a development gains tax.)
 - (c) **Consideration should be given to equalising the capital gains tax treatment of housing and non-housing investment**, so as to remove the capital gains tax distortion in favour of investment in primary housing. (We recognise that such consideration would need to take into account additional factors that go beyond the scope of this study.)
 - (d) **A new unused sites tax should be introduced**, taking the form of a land value tax imposed on empty homes or brownfield sites left idle for more than a set period.



1 INTRODUCTION

- 1.1 The taxation of housing and land is currently a high-profile political issue. Some recent important discussions have included the following.
- (a) The 2003 Treasury assessment of the Five Economic Tests for membership of the euro included a discussion of the use of various housing taxes to stabilize the housing market and thereby ease UK membership of the euro.
 - (b) The sharp rise in house prices since 1998 has stimulated many calls for the extension of stamp duty on housing, and in mid-2003 there was intense press speculation that the capital gains tax exemption on the profits on sales of personal residences might be ended in the 2004 Budget — largely due to the significant revenue-raising potential of such a reform.
 - (c) The March 2004, Final Report of the Barker Review of Housing Supply proposed a form of development gains tax.
 - (d) In the campaign for the June 2004 local elections, the Liberal Democrats made their key policy the abolition of Council Tax and its replacement by a local income tax.
- 1.2 Although interesting in themselves, these discussions have tended to focus on specific goals, such as the stabilising of consumption, the raising of revenue, the facilitating of greater housing supply, or the fairness of the tax system, and have included only limited discussion of broader environmental implications. Hence the Campaign to Protect Rural England commissioned Europe Economics to produce this present study, assessing a number of relevant tax options in terms of key economic, environmental and social objectives.
- 1.3 In particular, this study considers the following taxes and tax reliefs:
- (a) Development-related taxes, such as
 - Development gains taxes
 - VAT on greenfield versus brownfield development, or on renovation versus new build
 - Contaminated land credits
 - (b) Property investment-related taxes, such as
 - Capital gains tax
 - Land taxes
 - (c) Tax reliefs to encourage affordable housing, such as
 - Special stamp duty relief schemes



- Low income housing tax credits

1.4 These will be assessed against the following objectives:

(a) Efficient use of environmental resources, in particular

- Efficiency in use of existing housing stock
- Efficient renewal and re-use of structures currently on land
- Redevelopment of land previously used for structures

but also efficient use of water, power, and other natural resources.

(b) In pursuing efficiency, not neglecting the needs of the disadvantaged, in particular addressing affordability issues.

Current Housing and Development Taxes

1.5 At present there are five main UK tax measures falling on housing:

- (a) capital gains tax;
- (b) council tax;
- (c) inheritance tax;
- (d) stamp duty; and
- (e) VAT on repairs.

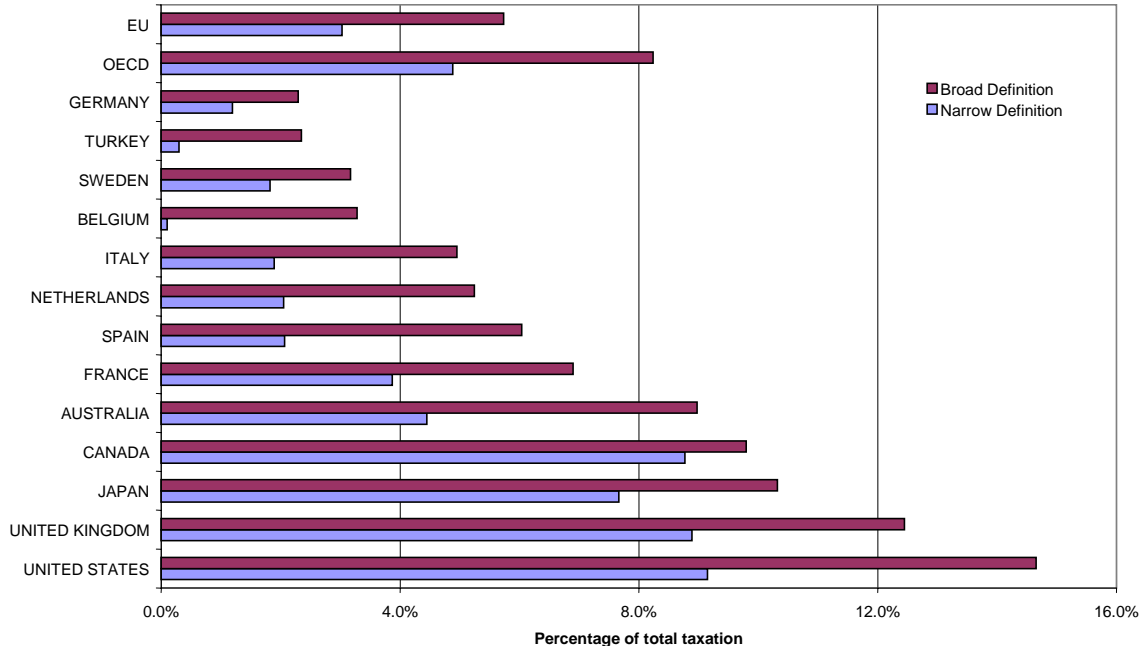
1.6 The January 2004 Institute for Fiscal Studies (IFS) Green Budget included a comparison of UK taxation of housing with that in other OECD economies.¹ This compared the proportions of total tax attributable to housing taxes in 2001, on both a narrow definition including only “recurrent taxes on immovable property” (e.g. UK Council Tax) and “other non-recurrent taxes on property”, and also on a broad definition including all taxes that could fall on housing, such as inheritance tax, stamp duties, capital gains tax, etc. The IFS results are shown in Figure 1.1.²

¹ Institute for Fiscal Studies (2004) *The IFS Green Budget: January 2004*, London: IFS.

² This is Figure 5.1 from the IFS study.



Figure 1.1: Percentage of total tax take attributable to “housing” taxes, selected OECD economies 2001 (broad and narrow definitions)



Source: IFS

- 1.7 Figure 1.1 illustrates that the UK tends to derive a higher proportion of its total tax take from housing than other OECD economies, with only the US taking a higher proportion of taxes among these comparators. As the IFS points out, one should be careful before jumping rapidly to the conclusion that UK housing is too highly taxed — for example, tax rates might be similar in the UK to those in other countries but UK house prices higher, and the percentages above are influenced by the total tax take as well as the housing tax take. If, say, other economies used higher effective income tax rates than the US and the UK, that would tend to place them among the “lower” housing tax countries in Figure 1.1.
- 1.8 Furthermore, the choice of other taxes reflects a judgement about the appropriate balance of housing and other taxes, and it could be that countries that take a lower proportion of taxes from housing have made the wrong judgement. Or perhaps the UK and other countries have the right rates given their circumstances. England is the most densely-populated large country in the EU.³ It might be argued that it is appropriate that taxes here should be a higher proportion of total taxes (or even higher in absolute terms) than

³ According to UK government figures, 10–11 per cent of England is built up. Of major European countries, only the Netherlands has a higher population density than England, but only 9.3 per cent of the Netherlands is built up. (Source: CPRE).



elsewhere because the externality costs associated with development are likely to be higher when land is scarcer.⁴

- 1.9 In addition to taxes on housing there are a number of other financial measures incident on development, including negotiated agreements associated with the granting of planning permission (such as creating a play area or open space, improving drainage facilities, road access, etc.) and Contaminated Land Credits (explained below).

Land prices and residual values

- 1.10 Land prices depend principally on “residual values” — the amount of money developers have left over once planning, financial, and construction costs are subtracted from the expected final value of a development.
- 1.11 For example, housing land prices represent the amount (in a competitive market) which a housebuilder can afford to pay for development land.
- 1.12 An important implication of this is that it is not high land prices that drive high house prices. Quite the reverse. It is high expected house prices (determined almost entirely by willingness-to-pay in the second-hand market, as we have discussed elsewhere)⁵ that drive high land prices.

Do housing and property taxes raise house prices?

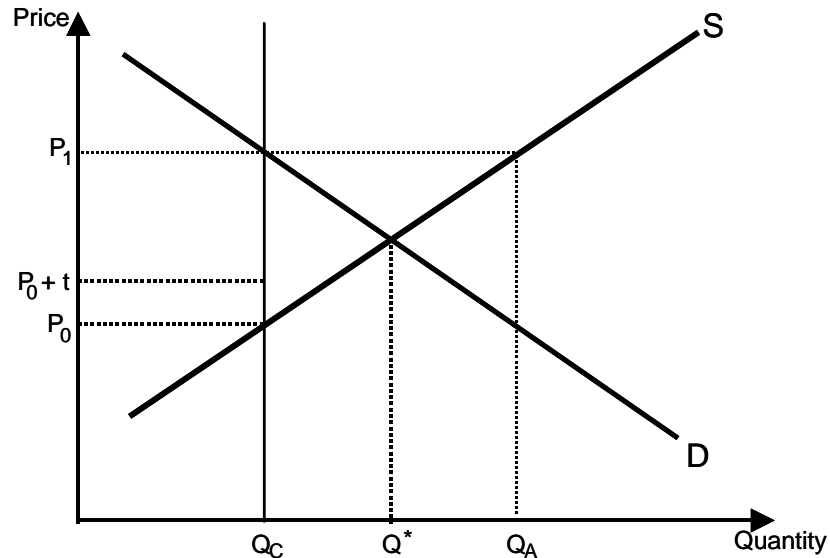
- 1.13 It might be tempting to conclude from Figure 1.1 that the UK tax system tends to raise the cost of UK housing compared with other goods and services, but this does not necessarily follow. One reason why not can be seen in Figure 1.2.

⁴ The Barker Review Interim Report implies that we should not consider the environmental impact of her suggested housebuilding programme particularly significant, since “only” 1.5 per cent extra of the available undeveloped land in South-East England might become built up. (Page 135, Barker, Kate (2003) *Securing our Future Housing Needs, Interim Report*, Norwich: HMSO. Hereafter “Interim Report”.) Even if this figure is right, the fact that 1.5 per cent seems like a “low” number should not dazzle us. It is very hard to say exactly how much extra building changes the nature of a landscape, but it is clear that the landscape affected is far larger than the actual area covered over. It should also be pointed out that an argument along these lines could be repeated many times. Who notices that one extra slice of salami has gone from the sausage, until suddenly half the sausage is gone?

⁵ See Europe Economics (2004) *A Basis on Which to Build*, London: CPRE. Particularly Section 3.



Figure 1.2: Planning constraints and taxes



- 1.14 In Figure 1.2 the vertical and horizontal axes represent the price and quantity of housing. The line marked “D” is demand for housing. The line marked “S” is supply of housing. In an unconstrained market the equilibrium (i.e. the point at which demand equals supply for a given price) would be at Q^* .
- 1.15 The 1947 Town and Country Planning Act nationalised property development rights in the UK, which are now managed through the planning system. Although the circumstances surrounding the introduction of this system were special to that era, there are a number of important reasons why development continues to be managed in this way. In particular, development imposes costs and benefits on relevant stakeholders that would not be parties to a market transaction.
- 1.16 For example, if a landowner builds houses on a wood, then the visual amenity of those living near the wood is affected, as are recreational opportunities (e.g. children might play in the wood). In addition there might be broader environmental consequences (for example if the wood were the habitat of rare flowers, or the nesting place of birds that local people enjoyed seeing in their gardens). Costs and benefits of this sort (i.e. those that do not fall on parties to a transaction) are known as “externalities”. A further class of externalities are public infrastructure strains. Although directly attributable costs of development can be charged to a developer, more nebulous issues (e.g. increased strain on local hospitals or local schools) are not typically costed into development.
- 1.17 One aim of the planning system is to give a voice to these other concerns. However, a natural consequence of taking into account such externalities is that there might be less development than would be chosen by a market ignoring such externalities. This might mean that instead of the market quantity, Q^* , the planning system constrains development



(quite properly, when it is doing its job well) to a point like Q_C , thus raising the price to P_1 , with the consequence that desired supply exceeds demand.

- 1.18 At Q_C those wanting housing are prepared to pay P_1 for it, while those supplying housing would be willing to do so at any price above P_0 . This means that developers gaining permission to build and supply houses are paid strictly more for their houses than is necessary to induce them to supply that amount. Hence imposing a tax on the supply of housing of anything less than the difference between P_1 and P_0 does not tend to reduce supply or raise the price. For example, a tax of t would leave the marginal supplier still with a windfall gain of $P_1 - P_0 - t > 0$.
- 1.19 Hence to the extent that planning constraints bind (i.e. to the extent that the planning system imposed ceiling of Q_C is to the left of Q^* , rather than to the right) taxes that are not too high (i.e. that are not more than $P_1 - P_0$) will not be distorting and will neither raise prices nor reduce supply.
- 1.20 The Final Report of the Barker Review of Housing Supply investigated whether raising housing taxes would remove the incentive for developers to offer land for planning permission (i.e. whether current taxes already absorb all the planning gain illustrated in Figure 1.2), and concluded that, even if taxes were to rise, “there would remain substantial development gain for landowners selling land for residential use”.⁶ This tends to suggest that current tax levels are not greater than $P_1 - P_0$ in Figure 1.2, and hence that the relatively higher levels of housing tax paid in the UK compared with elsewhere in Europe may well not tend to raise the cost of UK housing compared with other goods and services.
- 1.21 It should also be observed that at P_1 , without any taxes the suppliers will want to offer Q_A of housing, so that $Q_A - Q_C$ will not be granted planning permission (either because planning permission is formally sought and refused, or because, although the landowner would like to develop, permission is not formally sought because it would clearly be refused). This is more than the gap $Q^* - Q_C$, illustrating that the quantity of planning permission not granted is not a good measure of how restrictive the planning system is compared with a market solution — typically in a planning system much *more* land would seek planning permission than would actually be developed under an unrestricted market. Conversely, with taxes up to $P_1 - P_0$ the amount of land seeking planning permission would fall, but without any fall in the amount of land granted such permission.

So why does it matter what sort of housing or development taxes there are?

- 1.22 The main instrument guiding development will be the planning system. However, taxes will have a role

⁶ Page 81, Barker, Kate (2004), *Delivering Stability: Securing our Future Housing Needs, Final Report*, Norwich: HMSO. Hereafter “Final Report”.



- (a) in reducing unnecessary loads upon the planning system (allowing it to work more efficiently) — e.g. by reducing the number of “optimistic” planning applications;
 - (b) in guiding what sorts of development comes forward seeking planning permission — e.g. the proportion of development on brownfield sites;
 - (c) in guiding how development occurs on sites after planning permission is granted — e.g. whether houses are refurbished or demolished; and
 - (d) in influencing the wider environmental footprint of development — e.g. by affecting how much pollution a factory generates.
- 1.23 Planners face considerable information problems compared with markets, and efficiency will be greater if, as far as possible, the Market can determine which firms are best at delivering the required quality of housing and development. The role of planning is not to replace markets in making commercial judgements. Rather, it is to ensure that non-commercial factors are given their proper weight. Planning will tend to be most useful in reflecting *local* factors. Broad *principles*, of whether, say, brownfield development is to be preferred to greenfield development, though they will be important in local planning decisions, can be more efficiently dealt with at an economy-wide level by using taxes to guide the Market to one form of development rather than another, then allowing the Market (to a large extent) to determine which particular commercial ventures and which companies are most efficient at delivering the required quality.
- 1.24 Where there are externalities, the tax system can make decision-makers reflect those externalities in their choices. So-called “Pigou” taxes are those designed so that, once the tax is taken into consideration, decision-makers make the socially optimal choice. (An example of a Pigou tax might be a tax intended to address carbon emissions, such as the Climate Change Levy.) In practice, in the case of housing and development policy-makers will tend to lack sufficient information to achieve the Pigovian ideal of the tax exactly offsetting the marginal external cost for every complex local circumstance, and planning offers an important supplementary tool. Nonetheless, the tax system can play a useful role.
- 1.25 Similarly, although planning can and does play a role in assisting the vulnerable and disadvantaged with their housing needs, it will usually be fiscal measures that are most useful in addressing issues such as affordability or the provision of affordable housing.
- 1.26 The Final Report of the Barker Review of Housing Supply suggests that the low sensitivity of UK land and housing supply to prices means that taxes will not influence behaviour.⁷ Insofar as this is true, it is a strong argument for taxing land and housing highly compared with other factors such as capital or labour, since taxing those more price sensitive factors will tend to distort economic decision-making and undermine efficiency. However, an

⁷ Page 74, Barker, Kate (2004) *Final Report*.



alternative response might be to argue that low price elasticities of land and housing simply mean that the taxes that need to be imposed to modify behaviour are relatively high. In the case of other relatively price-insensitive products where externalities are important (e.g. petrol) the arguments policy-makers have used to justify imposing very high rates of tax (sometimes in excess of 400 per cent of pre-tax value) have been that these high tax levels are required to affect behaviour.

Problems with the current system

1.27 In assessing the tax options we discuss below, we shall have special regard to three potential flaws in current tax arrangements:

(a) **Current taxes may not appropriately reflect externalities associated with development.** Above we have suggested that it is appropriate that the tax system does not attempt *fully* to reflect development externalities, because the complexity of local circumstances makes this impractical and planning offers an important supplementary tool. However, it is plausible that the current tax system does not reflect *enough* of such externalities to keep down pressure for over-development in greenfields and too little development in urban areas, thereby over-loading the planning system.⁸

(b) **Planning gives rise to considerable regulatory rents in the form of windfall planning gain, arguably inadequately captured by taxes.** The Barker Review remarked upon the significant gains that developers make when land is granted planning permission for housing. For example, the Interim Report notes (in Table 7.1) that in Spring 2003 agricultural land had values of some £865–£7,534 per hectare in North-East England, while residential land had a value of £1.15m–£1.26m per hectare.⁹ Such huge gains lead to a number of problems for the planning system, including:

- *“Optimistic” applications.*¹⁰ Because the returns to obtaining planning permission are so great, there will be a tendency for landowners to apply even when their land is most unlikely to be granted permission, since if they were to be lucky, the financial rewards would be hugely more than the costs of making an application. This tends to clog up the system — with more chaff it is difficult to identify the wheat.

⁸ Quantifying the “correct” level of externalities, and assessing how well the planning system functions to reflect them, falls outside the scope of this report. We proceed on the assumption that the externalities implied by the functioning of the planning system are the correct ones. Our concern here is how best to tax, taking the operation of the planning system broadly as given.

⁹ Page 115, Barker, Kate (2003) *Interim Report*.

¹⁰ These are also sometimes known as “speculative” applications. We prefer the term “optimistic” here to emphasize that we are talking about optimism about whether planning permission will be granted, rather than financial speculation.



- *Lobbying effects.* With such high rewards, there are great incentives for developers to spend considerable resources in an attempt to influence policy-makers. From a social point of view such efforts are unproductive, and represent a deadweight cost of regulation. It also means that there may be a tendency for the companies to be granted planning permission that have the most efficient and effective lobbying and public relations departments, rather than those with the most efficient and highest-quality development projects.

(c) **The tax system may create perverse incentives to leave sites to dereliction or unnecessarily destroy existing structures.**

Options not Considered

- 1.28 This report is about taxes and tax reliefs. Measures such as reform of planning rules or changes to housing benefit might have significant further impacts on the objectives set out above, but fall outside the scope of this study.
- 1.29 Even among tax measures, however, there are many other ideas for taxes and reliefs that are not covered in this report. That is not because these ideas are not important or necessarily because the tax proposals would not be superior to those considered here. Rather, it is because the focus of this report is on tax options that have been proposed recently by policy-makers, or which might realistically be implemented as policy within the next few years, given the current state of politics and the views of key opinion-formers.
- 1.30 One very important example is that we shall not discuss the possibility of abolishing Council Tax to replace it with a Local Income Tax. The two main parties still appear to consider local taxation politically too dangerous for significant structural reform — although there may well be limited reforms (such as an increase in the number of bands) and valuations are long obsolete. The ODPM-commissioned Balance of Funding report, published on 20 July 2004, recommended that council tax should be retained but reformed, and that local income tax “should proceed on the basis that it is a supplement to, not a replacement for, council tax”.¹¹ These conclusions arguably reinforce the view that politicians are wary of radical reform in this area.
- 1.31 Similarly, there are other objectives that some readers might think important, but which will only be touched on tangentially in this report, if at all. For example, the stabilisation of house prices might be thought best judged in terms of its impact on consumption and the macro-economy, but here instead is treated as important mainly insofar as volatility in house prices undermines the efficient use of the land and structures and undermines affordability. Other readers might consider that the formal incidence of taxation (which will be the focus of our discussion) is irrelevant and that the main objective of choosing taxes

¹¹ Paragraph 5.59, p51, Office of the Deputy Prime Minister (2004) *Balance of Funding Review—Report*, Wetherby: ODPM publications. See also the subsequent Lyons Inquiry, under Sir Michael Lyons, <http://www.lyonsinquiry.org>.



should be, as famously put by Jean Baptiste Colbert, finance minister to Louis XIV: "so plucking the goose as to get the most feathers with the least hissing." Although these alternative perspectives have merit, we believe that the objectives chosen here are important ones that deserve their full weight in policy debate.



2 DEVELOPMENT-RELATED TAXES

- 2.1 One important group of taxes are those that steer development, encouraging or discouraging landowners from bringing forward land, and steering developers between land of different classes.
- 2.2 This section discusses three types of development-related tax measures:
- (a) Development gains taxes;
 - (b) Differential VAT rates;
 - (c) Contaminated land credits.

Development Gains Taxes

- 2.3 A development gains tax is incident on the capital profit a landowner makes when land is granted planning permission for development. Recommendation 26 of the Barker Review Final Report suggests that

Government should use tax measures to extract some of the windfall gain that accrues to landowners from the sale of their land for residential development.

Government should impose a Planning-gain Supplement on the granting of planning permission so that landowner development gains form a larger part of the benefits of development.¹²

- 2.4 As set out in Section 1, there are significant windfall gains associated with the obtaining of planning permission, leading to many strains on the planning system, including optimistic applications and lobbying efforts.
- 2.5 Taxing development gains would tend to reduce the incentive for optimistic applications or socially wasteful lobbying efforts — *without reducing the incentive for needed development*. As Figure 1.2 illustrates, provided that a development gains tax is not so high as to remove entirely the rents from obtaining planning permission, it gives Society the opportunity to capture these windfall gains of regulation, which can then be devoted to socially important uses such as cutting other taxes or healthcare or education, or even used to build social housing or grant other reliefs discussed later.

Previous development gains taxes

- 2.6 Since 1947 there have been four previous development gains tax systems.

¹² Page 87, Barker, Kate (2004) *Final Report*.



- 2.7 The 1947 Town and Country Planning Act (TCPA) nationalised UK development rights, which were purchased by the government from landowners for £300m (equivalent to some £10bn today), and as an integral part of this system a “Development Charge” of 100 per cent was levied on the excess value attributable to the granting of planning permission, relative to the previous use value on the date development began.
- 2.8 This system reflected the logic of nationalised development rights. Since the landowner no longer owned these rights, he could not expect to profit from their application. However, the effect of the tax was to reduce land coming forward for development, as landowners had little incentive to do so and on the contrary speculated that the tax might be eventually abolished. They were right. In December 1952 the Conservatives repealed the financial provision of the TCPA, ending the Development Charge.
- 2.9 Despite this, the powerful logic that, with development rights nationalised (and indeed paid for) private landowners should not gain from development, has driven policy-makers to attempt several other development gains taxes.
- 2.10 The Labour Government’s Land Commission Act of 1967 introduced a “Betterment Levy” at 40 per cent of the difference between the development value when land was sold, leased or realised by development, and 110 per cent of its previous use value. The Conservatives abolished the Betterment Levy after they returned to government in 1970.
- 2.11 In December 1973 the Conservatives announced proposals to introduce a Development Gains Tax, altering the basis on which tax was charged on “substantial” capital gains arising on the disposal of land or buildings with development value or potential, with the tax being charged at the point at which a building (other than one used for residential purpose) was first let following “material development.” The rates were up to 82 per cent for individuals and 52 per cent for companies.
- 2.12 However, Labour returned to government in 1974, before the Development Gains Tax was able to have any significant behavioural impact, and modified the Conservative proposals, instead introducing a Development Land Tax from August 1976. This was charged on each occasion of the realisation of development gain flowing from disposals of land after the start-date, with the tax falling not only on actual sales, but also on assumed disposals where development projects began on land without a preceding land sale. The rate was reduced to 60 per cent after the Conservatives returned to power in 1979, and the Development Land Tax was abolished in the Finance Act of 1985.

Could a development gains tax work this time?

- 2.13 Previous development gains taxes were widely regarded as failures. Although there may have been issues of design, complexity, and perceived unfairness, the fundamental problem with a development gains tax is that landowners will speculate against political developments. Given the huge profits to be made by waiting until a tax is abolished before developing, it is questionable whether any sort of development gains tax is feasible in a democracy, where governments and policies may change.



- 2.14 For example, a 60 per cent tax on the development gain on a hectare of agricultural land that cost £865 and would be worth £1.15m with residential planning permission would leave the developer with £460,000. For illustrative purposes, suppose that the appropriate discount rate for holding on to land is 10 per cent. At that rate, it would take ten years before this £460,000 would be worth more than £1.15m. A typical Parliament lasts about four years. Hence, even if the value of land would not be expected to rise in the meantime, a land speculator who waited more than two full Parliaments before such a development gains tax was abolished might be better off. Thus a very natural consequence of a development gains tax is that landowners and developers that can afford to wait do not bring their land forward for planning permission, preferring to wait (for many years) to see whether the tax is abolished (as has happened in the past). (For example, the 1967 Betterment Levy was expected to raise £80m in its first year. Instead the offering of land for development fell so dramatically that the levy raised only £15m.)
- 2.15 The Barker Review and Chancellor Gordon Brown suggested that they would consult with other political parties to see whether a consensus could be arrived at, presumably in an attempt to circumvent the problem described above. Both major British political parties have attempted to introduce a development gains tax in the past, so a consensus cannot be altogether ruled out. However, it may seem unlikely in a dynamic democracy such as that in the UK, in which there are not decades-long coalitions but instead governments change quite regularly and in which coalition governments are rare, that any political leader today can promise what his party will do in ten-years time on such a contentious issue.¹³
- 2.16 Another question to bear in mind here is how much longer the current system of nationalised development rights will survive. Recent years have seen a number of interesting proposals for a radical reform of the way in which development is controlled, with the creation of private development rights and trading in development permits.¹⁴ Such proposals are not yet sufficiently worked out to be implemented and still seem unlikely to be practical for more than a decade (even if they ultimately do prove a desirable reform route — which is not yet obvious), but they do present the possibility that the timescale of commitment required for a development gains tax to be credible might potentially overlap with a radical overhaul of the whole system. Whether this means that commitment to a development gains tax would be more credible (since the tax would only be required to be sustained for a decade or so) or less credible (since sustaining the tax would seem to carry little benefit if the whole system were to be transformed anyway) is

¹³ An example of how development gains tax remains politically contentious is provided by the article by John Gummer, MP, former Secretary of State for the Environment, in The Smith Institute's recent (2004) pamphlet "Building sustainable communities — capturing land development value for the public realm". In his essay, Gummer offers what he calls "the moral argument against a development levy". Gummer takes the view that private property rights are undermined by regulation, and that taxing the resulting gains is inconsistent with policy adopted in other areas (he gives the example of a regulation requiring tighter fire safety regulations raising the profits of smoke alarm, fire extinguisher, and rope ladder manufacturers — no-one suggests a levy on the higher profits arising from this sort of regulation). It is also noteworthy that a number of the other essays in that pamphlet, though supporting the principle of development gains taxation, do not support the form of scheme proposed by Barker.

¹⁴ Some readers may be familiar with analogous proposals for tradable permits in carbon emissions or other forms of pollution.



unclear. But it should be understood that the powerful logic whereby nationalised development rights seem naturally associated with a development gains tax may not survive forever.

- 2.17 Although we have identified a number of difficulties associated with development gains taxes per se, a more fruitful way to garner development gains and direct development to the most appropriate sites may be through auction mechanisms rather than development taxes. In principle, and if well-designed, an auction mechanism might perhaps command wider public support than a tax, and add to the efficiency with which developmental and environmental goals are served by the planning system (for example by enabling development gains charges to differ significantly between regions). Such auction mechanisms would not be taxes as such, and implementing such a system would entail wider planning system reforms and many issues of detail that fall outside the scope of this report. Nonetheless, we suggest that auction mechanisms should at least be considered as a possible alternative way forward.

Assessment

Development Gains Tax

Efficiency in use of existing housing stock	No direct effect, but potentially reduced tendency to apply for unnecessary new development might encourage more efficiency in use of existing stock.
Efficient renewal and re-use of structures currently on land	Little direct effect.
Redevelopment of land previously used for structures	Ambiguous. Possibly some tendency to undermine marginal re-development because of reduced post-tax development gains. On the other hand, reduced load on planning system might speed planning decisions and lead to reduced costs of obtaining planning consent.
Other environmental efficiency	Positive. Better reflection of negative development externalities in private agents' development decision-making, and possibly better planning choices in general because of reduced load on the system.
Affordability	Ambiguous. Reduced development might increase house prices in the long-term, but increased planning efficiency might reduce time and costs, thereby increasing responsiveness of housing supply to prices and reducing periods of low affordability.
Feasibility	Political feasibility would be a considerable challenge, since a long-term consensus in favour would be difficult to achieve or sustain.

Differential VAT Rates

- 2.18 Many important products such as food and children's clothing are zero-rated for Value-Added Tax (VAT) purposes. Construction of new houses is also zero-rated, while second-



hand residential housing is specifically exempt from VAT. This VAT treatment will tend to distort consumption towards housing and away from other goods — most of which attract the standard rate of VAT of 17.5 per cent.

- 2.19 Although VAT is not charged on the construction of new houses or the sale of second-hand houses, it is charged at the standard 17.5 per cent rate on materials and labour for any repairs, maintenance, or improvements (RMI) made to houses. However, there is favourable treatment for conversion of existing buildings into residential dwellings. There is a reduced VAT rate of 5 per cent on the conversion of residential property, or for converting a non-residential building into residential use, and a zero rate for selling a residential building that has been converted from non-residential use.
- 2.20 The current favourable tax treatment of conversions may generate positive externalities, justifying the reduced VAT rate. It will tend to encourage development in under-utilised urban space and the more efficient use of existing structures. That might tend to encourage urban renaissance and higher density occupancy, increasing the efficiency of land and natural resource use.

Impose VAT on new build at 17.5 per cent?

- 2.21 The lower VAT rates for new build compared with RMI will tend to distort the market away from refurbishment and towards new build because the cost of acquisition plus refurbishment must be around 17.5 per cent less than the cost of land for refurbishment to compete. This will tend to favour new build and the abandonment or destruction of existing dwellings — an inefficient use of the existing housing stock.
- 2.22 Furthermore, because house extensions carry 17.5 per cent VAT, there will be a tendency for those buying new houses to purchase larger properties than they would in the absence of VAT, driving an inefficient use of land and undermining affordability (since larger properties are more expensive). If it were not for the differential VAT treatment, such people could purchase relatively small dwellings initially and then extend them over time as their circumstances changed (e.g. if they had children).
- 2.23 Other people will, instead, move when they want a larger dwelling (purchasing a dwelling that was originally built new at the larger size and hence was zero-rated for VAT), rather than extending their existing property, undermining the development of communities and leading to deadweight transactions costs as unnecessary house changes are made.
- 2.24 Harmonising the VAT treatment of new build and RMI would remove this distortion and improve the efficiency of use of the existing housing stock. One way to harmonise the VAT treatments of new build and RMI would be to impose VAT on new build at the standard 17.5 per cent rate. At first sight this would appear to be a politically unattractive option, since in the past when VAT has been imposed on products prices have risen (typically by the full level of the VAT rise), and with house prices already widely considered problematically high measures that would raise prices yet further might seem infeasible.



- 2.25 However, given a clear announcement and a sufficient lag before the measure came into force, the discussion around Figure 1.2 suggests that imposing VAT on new build might not have this effect. Instead, the cost of the tax would be factored into the price that a house-builder could afford to pay for development land, in a competitive market, and thence into a downward pressure on land prices. In short, the consequence of such a tax, once it had been fully anticipated in behaviour, would be lower windfall profits for landowners obtained planning permission — albeit through the indirect route of passing tax costs through house-builders — rather than higher house prices.
- 2.26 Even if the effects of such a tax were not fully anticipated in all land purchases, since 90 per cent of transactions are for VAT-exempt second-hand houses, it is factors determining willingness to pay for a second-hand home that would determine short-term movements in house prices (and at the margin those particularly interested in a new home will be able to wait until land purchased at prices reflecting the new VAT regime came on-stream — relevant here since the lag might only be, perhaps, three years), so that in this case the effect of VAT imposition would be to reduce house-builder profits, rather than raise prices.
- 2.27 The Barker Review Final Report considered the impact of imposing VAT on new homes on landowner willingness to offer land for development, modelling explicitly development decisions in the North-East of England. Its conclusion was that, on average, “[e]ven in the presence of VAT, and in a region of relatively low land and house prices, there would remain substantial development gain for landowners selling land for residential use.”¹⁵
- 2.28 The Final Report considered that the introduction of VAT on new build would be an inferior way to capture such rents to the introduction of its recommended Planning Gains Supplement.¹⁶ However, if the arguments above are correct, and development gains taxes are not politically feasible in a democracy, then the arguments of the Barker Review might be taken to imply that VAT on new housing could be an important “second best” option, worth serious consideration.
- 2.29 In addition, a key concern of the Barker Review was how to increase (significantly) the supply of new houses, and this appears to have affected the attitude taken to the imposing of VAT on new build.¹⁷ As has been discussed elsewhere, the consensus belief, reflected by the Barker Review, that the UK does not build sufficient new houses to keep up with the growth in the number of households is demonstrably wrong, and beyond this notion the Barker Review offers little additional grounds for justifying a significant increase in new supply.¹⁸ Thus this argument against imposing VAT on new build is not considered important here.

¹⁵ Box 4.3, p81, Barker, Kate (2004) *Final Report*.

¹⁶ Paragraph 4.65, p83, Barker, Kate (2004) *Final Report*.

¹⁷ For example, it is an issue discussed explicitly in paragraphs 4.56 to 4.60 of the *Final Report* – pp.81ff.

¹⁸ For example, see Europe Economics (2004) *A Basis on Which to Build?* London: CPRE.



2.30 If VAT were to be introduced on new build, it would be natural at the same time to review the operation of stamp duty (discussed below).

Would VAT on new build be reversed?

2.31 Above we have argued that no development gains tax could be credible in a dynamic democracy. Why would VAT be any different? Wouldn't landowners just wait, in the same way as for a development gains tax, until the policy was reversed? We offer 3 important reasons why we believe that there would be more credibility for VAT on new build than for a development gains tax:

- (a) A development gains tax would be a special tax applied to land. In contrast VAT is applied to many products. Being subject to VAT is the norm, so once products have VAT applied at the standard rate the logic of consistency will tend to maintain that new status quo.
- (b) VAT is well understood and the collection and the associated administrative procedures are well developed. This means that there would be unlikely to be transitional problems of design undermining support for the scheme.
- (c) Under European Union treaty obligations, once VAT is imposed on a zero-rated good it cannot be removed. Hence the reversal of an imposition of VAT on new build would have profound wider implications and is most unlikely to be attempted.

VAT favouring brownfield development?

2.32 At present, VAT does not distinguish directly between greenfield and brownfield development. One possible variant on the proposal discussed above might be to levy VAT only on new houses built on greenfield sites, while having a reduced rate of 5 per cent for brownfield housing development. This would create greater incentives to switch out of greenfield and into brownfield development.

2.33 There would be two key advantages to such incentives:

- (a) The negative externalities associated with brownfield development will typically be lower than with greenfield sites. For example, brownfield sites are unlikely to contribute positively to landscape character, and they are unlikely to be appropriate recreation areas.
- (b) There are also likely to be positive externalities associated with brownfield development, such as urban renewal and regeneration.

2.34 Since the negative externalities associated with brownfield development are less, and the positive externalities greater, the arguments of Section 1 suggest that efficiency would be enhanced if brownfield development carried a lower tax rate than greenfield development, as well as being regarded favourably by the planning system.



- 2.35 The *Final Report* points out that EU VAT law might imply that if VAT is applied to greenfield new build, it might not be possible to maintain zero-rating of brownfield development. However, a 5 per cent reduced rate should not face the same problems.

Assessment

VAT on new build

Efficiency in use of existing housing stock	Positive. Increased incentives to renovate and refurbish rather than to demolish and new-build.
Efficient renewal and re-use of structures currently on land	No further effect to existing provisions.
Redevelopment of land previously used for structures	Would discourage redevelopment of brownfield land.
Other environmental efficiency	Positive effect, since reduced tendency for socially unnecessary moves and more use of extensions.
Affordability	Little short-term effect (especially if it were announced well in advance), but in the longer term may mean a higher trend rate of growth in house prices.
Feasibility	Practically and politically feasible.

VAT at a reduced rate (e.g. 5 per cent) on brownfield development

Efficiency in use of existing housing stock	Little effect.
Efficient renewal and re-use of structures currently on land	Little effect.
Redevelopment of land previously used for structures	Clear incentive to switch into redevelopment of brownfield land.
Affordability	Little effect.
Feasibility	Practically and politically feasible.

Contaminated Land Credits

- 2.36 The 2001 Budget introduced a 150 per cent tax credit for the costs of cleaning up contaminated land. This tax credit, the Contaminated Land Credit, was designed to lower the effective cost to developers of building on contaminated brownfield land that would otherwise be unprofitable to develop.
- 2.37 One advantage of the Contaminated Land Credit is that it encourages the use of brownfield sites and tends to increase the efficient re-use of previously developed land.
- 2.38 However, the Contaminated Land Credit might also have some negative consequences. First, some developments that would take place anyway without this tax credit will be subsidised, so there is a deadweight cost to the Exchequer. Subsidising those developments that would take place anyway tends to distort resource allocation (through the distortionary impact of the required taxes) without any substantial benefit. Second,



from a dynamic point of view, in the future landowners and developers may have less incentive to keep their land clean because they know they do not need to pay for the costs of cleaning the pollution. (In fact, since the credit is 150 per cent of the cost, there is the danger of accidentally creating positive incentives to pollute.)

- 2.39 The length of time that land has lain derelict can be seen as a proxy for the difficulty of re-developing a site — albeit an imperfect one. The longer a site has lain derelict, the higher the probability that the pollution on this land may not be cleaned without the tax credit. This leads to one possible solution of the problem of unnecessary subsidy, as in Recommendation 25 of the Barker Review Final Report:

Government should consider the extension of the contaminated land tax credit and grant scheme to land that has lain derelict for a certain period of time. This should be done on the basis that extra public money levered into the market through such a scheme would encourage genuine new investment in brownfield remediation, and not simply subsidise development that would take place in any case.¹⁹

- 2.40 Because land that would be developed without the tax credit is less likely to lie derelict for a long time, the recommendation makes it less likely that a tax credit is granted to developments that would take place anyway. However, there are also some disadvantages. One such is that there would be an incentive for landowners to unnecessarily keep their land polluted. If land would be developed without the tax credit and it had lain derelict for a period of time, the landowner may want to keep the land polluted until it qualifies for the tax credit.
- 2.41 It might be possible to modify the proposals to address this problem. One such modification would be to link the credit rate with the length of time that the land has lain derelict continuously. This would reduce the incentive to keep land polluted unnecessarily. However, there is the danger of ever-increasing complexity in the system chasing incentives problems the system itself has created.

Time limit on credits?

- 2.42 Given the negative long-term consequences for incentives of contaminated land credits (in particular, the reduced incentive not to pollute), it might be important that such credits should be available only for a strictly delimited period (e.g. five years), after which they will lapse. Alternatively, they might not be made available on land which is not already contaminated. How credible such “commitments” would be is unclear, however, for there would be a time consistency problem — although it would be desirable, from an incentives point of view, for today’s government to promise that, tomorrow, such credits would not be available, when tomorrow comes there will be clear incentives to employ such credits once again to help clear up the contamination then faced. Our suspicion is

¹⁹ Page 75 Barker, Kate (2004) *Final Report*.



that this problem is unavoidable and that the system should be designed so as to be sustainable in a stable form over the medium term.

Assessment

Contaminated Land Credits

Efficiency in use of existing housing stock	Little effect.
Efficient renewal and re-use of structures currently on land	Little effect.
Redevelopment of land previously used for structures	Clear incentive to increase redevelopment of brownfield land.
Other environmental efficiency	Negative impact, because of reduced incentives to control pollution (in lieu of other policy).
Affordability	Little effect.
Feasibility	Politically feasible. Practical problems minimising distortions caused.



3 PROPERTY INVESTMENT-RELATED TAXES

3.1 One of the Treasury studies on the Five Economic Tests for membership of the euro remarked that

investment in housing is relatively lightly taxed compared to other investments.²⁰

3.2 If this is true then it might be causing investment to be distorted into the housing market, potentially causing excess volatility. As we have argued in a previous report, excess volatility in house prices would tend to undermine supply efficiency, by driving developers to hold larger idle landbanks than would otherwise be necessary and by reducing the responsiveness of new supply to price changes.²¹ This would have consequences for the efficient use of land and structures and be damaging to affordability.

3.3 However, in the study for its *Green Budget 2004*, the IFS compares taxation of housing with that of other investment options and concludes that “primary housing does not seem to be taxed particularly favourably compared with other investment products in respect of contributions, returns and withdrawals — and even less so once council tax is taken into account.”²²

3.4 However, the IFS does note that

(a) “primary housing is indeed taxed more lightly than direct holding of equity investments”;²³ and

(b) although they do not attract stamp duty, other mixed consumption/investment products such as jewellery do attract VAT.

3.5 It might be disputed whether the IFS comparisons driving their conclusion that housing is not under-taxed are really appropriate — which would perhaps explain the remark from the Treasury report. In particular, amounts that can be invested with tax advantages into ISA's (the IFS study's key comparator) may be relatively modest compared with those some people wish to put into housing. The current annual ISA allowance is £7,000, of which £3,000 can be invested into cash, and from 6 April 2006 this cash allowance will be reduced to just £1,000 a year, with the overall allowance falling to £5,000. In the context of gradually paying off a mortgage these sums may not be very dissimilar to those invested in housing. However, if the relevant comparator were investment of a lump-sum, for example from an inheritance (which might potentially be tens of thousands of pounds), primary housing may offer tax advantages over other possible large-scale investments (such as equities), as we shall see below.

²⁰ Page 85, HM Treasury (2003) *Fiscal stabilisation and EMU*, Norwich: HMSO.

²¹ See Europe Economics (2004) *A basis on which to build?*, London: CPRE.

²² Page 68, Institute for Fiscal Studies (2004) *The IFS Green Budget: January 2004*, London: IFS.

²³ Page 65, Institute for Fiscal Studies (2004) *The IFS Green Budget: January 2004*, London: IFS.



Capital Gains Tax

- 3.6 Profits made on the sales of primary residential dwellings are not, at present, subject to UK capital gains tax (CGT). Although not all countries have such an exemption (for example, Sweden imposes a tax on the nominal profits from house sales), it is quite natural that such an exemption should apply, particularly because not doing so might undermine labour mobility, as can be seen from a simple numerical example.
- 3.7 Suppose that someone buys a home for £200,000, which then rises in price to £400,000. If he sold the home to himself, it would not be appropriate to charge him CGT, since his “gain” has not been realised (there is no cash). But suppose, instead, that he sold his £400,000 house and bought an identical £400,000 house across town so that he could move jobs. Once again, it would seem inappropriate to tax him on that, since it seems very similar to the case in which he sells it to himself (in fact, we could devise a thought experiment in which he sold his house to the person whose house he bought, so that they simply swapped houses and jobs).
- 3.8 On the other hand, given that other important asset classes, such as shares, do attract CGT it can be argued that the exemption on primary dwellings creates a bias in favour of housing investment as opposed to other forms of investment that do attract CGT. For example, if the stock market is rising at 10 per cent per year and so are house prices, and someone has £100,000 to invest, we might imagine him choosing to buy a £200,000 house rather than the £100,000 house he might otherwise get, noting that on the 10 per cent gain on his £100,000 investment in the house is not subject to CGT. This might seem to bias investment into residential property in a rising market — potentially very significantly, since most CGT is paid at 40 per cent. The solution would appear to be to find some way to identify the £100,000 “invested” in the house, as distinct from the other £100,000 of mere “living costs”, and tax the capital gains on that.
- 3.9 However, this is anything but straightforward, as the “living costs” component will reflect all sorts of unobservables and preferences that differ across the population. Any such measure is bound to be imperfect and introduce its own distortions. The real question is whether these new distortions are better or worse than the distortions generated by the current system.
- 3.10 It is possible to devise plausible alternative approaches to address the bias without undermining mobility. For example, one alternative approach would be as follows.
- (a) Pick an appropriately “normal” base year. For that year, calculate for given categories of age and family size of the buyer what proportion of family income is spent on housing. This gives us a base figure for consumer durable expenditure on housing.



- (b) Then formulate an index of durable consumption (washing machines, cars, etc.), excluding housing, again stratified across the population. These figures could come from the Family Expenditure Survey.²⁴
 - (c) This index, plus the base "consumer durable expenditure on housing" figure can give a "tax-allowable durable consumption expenditure on housing" figure for everybody. Anything people spend on their housing in excess of this is deemed "housing investment".²⁵
 - (d) This "housing investment" figure is then converted to a proportion of the house which is subject to capital gains assessment.
- 3.11 For example, suppose that your "tax-allowable durable consumption expenditure on housing" is £150,000, and you spend £200,000 on a house. Then £50,000 of your expenditure is deemed investment, i.e. one quarter of the value of the house. Then, if the house is sold later at £400,000, you are deemed to have made £50,000 of capital gain, since the investment component of your house is one quarter of its value, i.e. £100,000 and you "invested" £50,000 originally. This £50,000 gain is subject to capital gains tax.
- 3.12 Though such allowances are not unusual in the tax system, it might be doubted to what extent the purported "bias" mentioned above actually exists and whether the added complexity involved in the proposed reform would really be worthwhile. CGT only raises about £1.5bn per year, and mainly serves to protect the income tax base by preventing companies from paying sophisticated workers in capital gains rather than straightforward income. In the case of shares, for example, many people avoid CGT by being careful only to realise capital gains of below the CGT threshold. It would be much more difficult to avoid paying CGT on the gains from a primary residence (because it is much more difficult to sell off a house piece-by-piece) and hence housing might rapidly become the dominant source of CGT, with investment being biased away from housing by CGT.²⁶

²⁴ Note that this would need to be an index of *expenditure*, not of *prices*. The prices of many manufactured consumer durables might naturally fall over time, during a period in which aggregate expenditure on consumer durables rose.

²⁵ Note that regional differences in house prices would be catered for automatically because the allowable figure depends on income, and regional differences in house prices largely reflect regional differences in incomes.

²⁶ For example, the IFS estimates that imposing CGT on primary residences would have raised £11.5bn in 2003/4, over 80 per cent of all CGT receipts (see Institute for Fiscal Studies (2004) *The IFS Green Budget: January 2004*, London: IFS).



3.13 However, an advocate of such a CGT reform might respond that housing is not a socially productive form of investment anyway; that externalities mean that there will be over-investment in housing; that investment returns on housing will ultimately be captured by landowners and developers who obtain planning permissions (but who should not have a property right to such gains as they are supposedly nationalised); and that ultimately the quantity of housing is not a function of the amount invested in it but rather the amount permitted by the planning system. On this line of reasoning there is little social loss from biasing investment away from housing, provided only that housing's role as a consumer-durable (a source of housing services) is maintained, and provided that the level of "tax-allowable durable consumption expenditure on housing" is set sufficiently generously to ensure that labour mobility would not be undermined by economic conditions that changed more rapidly than the tax system.

Abolish CGT?

3.14 An alternative way to remove the investment distortion, if it exists, would be to abolish CGT altogether. CGT exists mainly to protect the income-tax base, but other countries do this without a CGT. For example, New Zealand has provisions in its income-tax rules to count as income capital-gains schemes adjudged to be designed simply to avoid income tax.²⁷ EU member states without UK-style CGT include the Netherlands and Belgium (actually, in Belgium the only thing close to CGT is a tax on land), with Poland only introducing CGT in 2004. Given that some other EU member states and other countries with English-style legal systems do not have CGT, it seems likely that abolishing CGT would be feasible.

3.15 Such a scheme might remove the distortion of investment into housing without adding complexity to the tax system. Doubtless it could raise additional issues, falling outside the scope of this report, but given that many commentators regard the significant swings in house prices in the past two decades as having had a significant speculative component, the costs of encouraging investment in housing should not be considered negligible. Equalising the capital gains tax treatment of housing and other investment should surely be under active policy consideration — whether via abolition of CGT or the introduction of a housing consumption limit to the capital gains allowance.

²⁷ See, for example, Burman, Leonard E and White, David (2003), "Taxing Capital Gains in New Zealand" *New Zealand Journal of Taxation Law & Policy*, 9(3), pp355–386.



Assessment

Abolish CGT and replace with anti-avoidance income tax rules

Efficiency in use of existing housing stock	Improved. Less idle stock since abolition should reduce speculative investment in housing. Also potentially less volatility in house prices should improve matching of housing allocation with those who most value “housing services”.
Efficient renewal and re-use of structures currently on land	Increased. Less land-banking because of reduced house-price volatility.
Redevelopment of land previously used for structures	More efficient. Less land-banking because of reduced house-price volatility.
Affordability	Improved, since reduced speculation-induced volatility in house prices mutes peaks and reduces tendency to bankruptcy at market troughs. Also reduced real interest rates because of reduced risk premium.
Feasibility	Political feasibility unclear — possible additional impacts beyond the scope of this study.

Land Value Tax

- 3.16 One proposal that has recently attracted interest is shifting away from property taxes and towards a land value tax. For example, John Muellbauer proposes reforming the Uniform Business Rate, shifting the valuation away from business assets to land above some minimum value per hectare.²⁸
- 3.17 A land value tax (LVT) would charge each landholder a portion of the assessed site-only value of the unimproved land.
- 3.18 One of the main arguments used to support LVTs is that such taxes do not distort the market as much as other taxes. The supply of land is fixed, unlike labour or capital, so a tax on land cannot act as an incentive to reduce the level of this factor of production.
- 3.19 Supporters also justify LVT on equity grounds, by equating the tax to a fee for protection of land ownership — one of the main roles of any state.
- 3.20 LVT was historically associated with the Liberal Party and the Barker Review Interim Report noted that today’s Liberal Democrat Party still has a land value tax advocacy group Action for Land Taxation and Economic Reform (ALTER), whose submission to the Review argued that a land value tax “would serve to make housebuilders concentrate on

²⁸ See Muellbauer, John (2004) “Property and land, taxation and the economy”, paper for the Joseph Rowntree Foundation.



producing more plentiful and better quality housing suited to today's needs, rather than seeking to profit from speculative land value appreciation".²⁹

- 3.21 Perhaps crucially, LVT has also been attractive to less mainstream groups, who argue that the natural world was originally the common property of all persons, and therefore the LVT should not be seen as a tax, but simply the collection of rent on behalf of the true owners (the Community).³⁰ The quasi-communist form of this argument and the sense that, if accepted, it might have wider application that would threaten many other property rights, may have been important in keeping land-value taxation, at least in the UK, as a politically marginal idea in recent decades. However, the tax does not have to be regarded in this way, and can be defended on altogether more pragmatic grounds.
- 3.22 An LVT would act as a disincentive to leave land vacant, encouraging productive use of land since there is a holding cost associated with owning the land. This incentive to use the land is greatest for those sites that are of greatest value. These will typically be located near to existing amenities, in urban centres for example. Someone owning a vacant plot in the city is likely to face a larger land-tax liability than if the plot was in the country. Developers will have a greater incentive to make productive use of sites with large land values. The highest holding costs of land to owners will be where land prices are highest. However, the areas where land prices are highest are exactly the areas that the *Interim Report* identifies as having the highest housing supply elasticities.³¹
- 3.23 Similarly, there will be a greater incentive to upgrade the existing building stock, to generate greater value from a given site. In contrast, a property tax acts as a disincentive to property enhancements. A run-down property faces a lower property-tax bill than a modern, well-developed structure; the LVT does not distinguish between the two types of properties in determining the tax liability. The mechanics of the land tax may actually encourage property upgrades, increasing the value of neighbouring land sites (therefore increasing the tax base, and thus reducing the landowner's share of the total tax burden — though this effect may be small). It is also argued that local authorities will have an added incentive to undertake investments that increase the value of land, thus increasing their tax base; advocates argue that it is fair that land-owners share with the community some of the enhanced value to their wealth that arises from public ventures that raise land values.

²⁹ Paragraph 7.24, p117, Barker, Kate (2003) *Interim Report*.

³⁰ This is very redolent of the sentiments of the Digger movement, illustrated in the lyrics of the famous left-wing folk song by Leon Rosselson, *The World Turned Upside Down*: "We come in peace' they said, to dig and sow; we come to work the lands in common and to make the wastegrounds grow; this earth divided, we will make whole; so it will be a common treasury for all / The sin of property, we do disdain; no man has any right to buy and sell the earth for private gain; by theft and murder, they took the land; now everywhere the walls spring up at their command".

³¹ See Table 2.3, p44 Barker, Kate (2003) *Interim Report*. The associated text of the Interim Report states (in paragraph 2.17) that "[p]erhaps unsurprisingly, the supply of housing in the South East appears to be among the least responsive", but this is straightforwardly false. Table 2.3 gives the average elasticity for England from 1973-2002 at 0.3, while the high-priced areas of South East England and Greater London are 0.5 (considerably above the English average) and 0.8 respectively.



- 3.24 An LVT appears to have desirable incentive properties for using vacant sites close to existing amenities, and encouraging the upgrading of the existing stock. One concern is that the land-value tax increases pressures to develop all land; there may be added incentives to develop on greenfield sites which would also be subject to a holding tax.³² Also, the LVT may lead to “concrete jungles” in urban areas, since the holding costs mean fewer land-owners are willing to maintain open spaces.
- 3.25 There might also be considerably increased pressure on planning authorities to grant planning permission, since it might seem very unfair for people to be taxed on land and then denied permission to use that land productively. In particular, there might be conflict between planning and taxation authorities concerning how useful it would be to develop a particular site. Land value and planning permission are so intimately connected that, for a site that currently lacks development permission, an assessment of land value and an assessment of the likelihood of planning permission eventually being granted are almost the same thing.³³
- 3.26 As above, some thought would also have to be given to the appropriate treatment for contaminated land or land with derelict buildings. If such sites have the same land valuation as equivalent greenfield sites, developers are likely to prefer developing on the greenfield site since it will be cheaper. Planning controls and (or) other incentives may still be necessary to steer development towards brownfield sites.
- 3.27 The extent to which LVTs lead to increased affordable housing is uncertain. Property taxes, including land taxes, generally increase the incentives against keeping property vacant. Both taxes are likely to realise more efficient utilisation of the existing housing stock. A tax linked to current market values means that these incentives strengthen during a property-price boom, since the tax liability rises. For example, as property values rise, households are more likely to rent out spare rooms to help meet their increasing property (or land) tax bill. In this way, such taxes might help reduce house-price overshooting.
- 3.28 There are a number of practical problems that any shift to an LVT would have to overcome. Once a land value has been determined, LVT would be relatively cheap to administer because much less effort is required to track land ownership than to track, say, income or sales transactions. But critics argue that it is difficult, if not impossible, to value land, particularly in city centres. Thought would also have to be given on how to treat “hope” value: the fact that the market price of land may reflect a hope that planning consents will change in time. Undeveloped land may have a higher hope value than already developed sites (since the associated costs of changing the land’s use will be lower); this could lead to a situation where the incentive to utilise undeveloped land, because of the holding costs, is greater than the incentive to utilise existing developed

³² This problem could be reduced if agricultural land were exempted from the LVT.

³³ Technically-minded readers might note that this is likely to give rise to complex game-theoretic issues.



sites. One option is to use imputed market values that exclude any hope value, but this would be a difficult exercise. However, the difficulties of valuing the tax base (land) are perhaps overstated, given that a number of other jurisdictions have used land taxes, e.g. Denmark, Pittsburgh, and various Australian cities. Vickers argues that existing property valuers favour the status quo, and thus are prone to exaggerate the difficulties of possible changes in the tax base.³⁴

- 3.29 Second, some parties may complain that the tax is unfair. As with any change in tax, there will be winners and losers. In the short-run, an LVT might reduce the value of land because of the increased holding cost of land. Opponents of the tax may argue that it is more regressive than a property tax, since the value of land will typically be less dispersed than the value of properties. They might also worry that it will create incentives for developers to seek a change in the planning designation for sites they do not own, as this will increase the holding cost to the existing landowner, which may prompt a sale. This again reinforces the importance of not just contemplating the merits of a land-value tax in isolation; the planning system would remain important if policy goals such as efficient use of land are to be realised.
- 3.30 A change to an LVT may also create genuine difficulties during the transition period. Some landowners will face a significantly higher tax bill. The greater the frictions preventing a redistribution of land ownership, the greater the problem. High stamp duties might increase the objections to an LVT, since parties with a limited ability to meet their tax liability because of cashflow constraints will face high costs transferring the assets to those better placed to meet the tax liability.
- 3.31 An LVT would run somewhat counter to the standard British tradition of taxation in recent centuries. Typically British taxes are applied to *activities* (e.g. obtaining income from working; purchasing something; placing a car on the road), rather than *states* (e.g. a Graduate Tax for being a graduate). Taxes of states include notorious failures such as the Elizabethan Window Tax and the Poll Tax, and in recent years where there have been alternatives (e.g. a choice between Student Loans and a Graduate Tax) taxes on states have tended to be avoided. However, the notable exception is the Council Tax, and replacing Council Tax with an LVT might be feasible were it not that:
- (a) significant reform of local government taxation is regarded by the major parties as politically risky; and
 - (b) those who do argue for reform of the Council Tax tend to base their case on issues such as the unfairness of low-income people who live in high-value accommodation being forced to pay high taxes — arguments that would apply with equal force against an LVT;

³⁴ Vickers, Anthony JM (2003) "A blueprint for smart tax in Britain" Lincoln Institute of Land Policy working paper.



- (c) An LVT would be a tax on notional value, and hence based on subjective expert opinion, rather than market transactions, which would inevitably give rise to significant practical difficulties and accusations of unfairness.
- 3.32 Although introducing a new full-blown LVT would raise issues of practice and principle, and is most unlikely to be politically feasible, and although is unlikely to be feasible to replace Council Tax with an LVT over the next few years, there is another area in which an LVT might have a role — as a tax on property left idle.
- 3.33 On 20 May 2004 housing minister Keith Hill announced government plans to grant councils powers to seize and rent out property left empty for a long period. It was estimated that this might affect up to 300,000 properties. As he expressed the issue: “We will not tolerate houses sitting empty, becoming magnets for vandals and anti-social behaviour, at a time when there is a shortage of homes in some parts of this country.”
- 3.34 Although such empty homes do raise social and other issues, for the government to seize and rent out private properties is expensive, undermines property rights, and may lead to accusations of injustice in certain cases (e.g. opponents of the measure pointed to cases in which properties are idle for some time because of bereavement). One way to fund such expensive interventions would be to impose a land value tax on homes left officially empty for more than a set period. Alternatively, it might be possible to put back the period at which a seizure occurs by initially imposing the tax without seizure, to provide additional incentives for use.
- 3.35 If this principle is viable in the case of housing, it might be extended to brownfield land also, in the form of an “Unused Sites Tax”. Again, it would seem appropriate to exempt agricultural or other country land, since this is arguably “in use” even in fallow periods.
- 3.36 The issues raised above about the difficulties of assessing value and the undermining of property rights would still apply, but would be arising anyway through the process of seizure. An Unused Sites Tax would seem to create few additional difficulties as it is a less drastic form of intervention than that already proposed.



Assessment

An Unused Sites Tax

Efficiency in use of existing housing stock	Positive, since reduced incentives to leave homes empty beyond the period at which the tax applies.
Efficient renewal and re-use of structures currently on land	Positive incentives to redevelop because costly to leave land idle beyond the threshold time period.
Redevelopment of land previously used for structures	Positive incentives to redevelop because costly to leave land idle beyond the threshold time period.
Affordability	Improved, since more efficient use of the housing stock might tend to reduce house price volatility and reduce periods of low affordability.
Feasibility	Politically and practically feasible, given that it appears feasible to seize and rent out empty properties, and imposing a tax on such properties would be a less drastic step.



4 AFFORDABILITY-RELATED TAXES AND RELIEFS

- 4.1 “Affordability” refers to the financial burden for householders in supplying their housing needs. Thus, although most discussions of affordability revolve around house prices or the level of interest rates, other key factors include incomes and taxes, tax reliefs and benefits.
- 4.2 Affordability comes naturally into prominence at times when (as now) house price inflation outruns wage inflation. The debate should logically concern the affordability of residential accommodation rather than of buying a house; focusing on ability to purchase without reference to ability to rent misses a large part of the debate that should take place.
- 4.3 Another key discussion point in these debates is “affordable housing”. When we talk of “affordable housing” we shall mean relatively small, “no-frills” housing that is, nonetheless, fit-for-purpose (e.g. large enough to meet housing needs).
- 4.4 As we shall see, there are also important connections between affordability issues and the tax measures discussed earlier, in particular because in some cases it has been suggested that the receipts from other taxes on housing or development should be “hypothecated” (i.e. specifically dedicated) to measures designed to aid affordability.

Stamp Duties

- 4.5 Stamp duties are taxes paid on certain transactions. In the case of housing the stamp duty regime was modified in December 2003 with the introduction of Stamp Duty Land Tax (SDLT). When a property is purchased or leased, the buyer is liable for SDLT. This is payable as illustrated in Figures 3.1 and 3.2.

Table 3.1: Stamp Duty Land Tax Rates on Land Purchases from 1/12/03

Rate	Land in disadvantaged areas		All other land in the UK	
	Residential	Non-residential	Residential	Non-residential
Zero	£0 - £150,000	All	£0 - £60,000	£0 - £150,000
1 per cent	Over £150,000 and up to £250,000		Over £60,000 and up to £250,000	Over £150,000 and up to £250,000
3 per cent	Over £250,000 and up to £500,000		Over £250,000 and up to £500,000	Over £250,000 and up to £500,000
4 per cent	Over £500,000		Over £500,000	Over £500,000

Source: Inland Revenue

**Table 4.2: Stamp Duty Land Tax Rates on New Leases from 1/12/03**

Rate of duty on rent	Net present value of rent	
	Residential	Non-residential
Zero	£0 - £60,000	£0 - £150,000
1 per cent	Over £60,000	Over £150,000

Source: Inland Revenue

- 4.6 In addition, Stamp Duty Reserve Tax is payable on purchases of shares at 0.5 per cent on the amount or value of the consideration given for the transfer.

Stamp Duty thresholds

- 4.7 In March 2004 Nationwide produced a study arguing that first-time buyers should not pay Stamp Duty on properties worth less than £150,000, because changes in the thresholds have not kept pace with rises in house prices.³⁵
- 4.8 In 1993 only 18 per cent of first-time buyers paid stamp duty, compared with over 75 per cent today, with the average first-time buyer now paying £1,070 in Stamp Duty. According to Nationwide's figures, the number of first-time buyers is at its lowest level for 20 years, and a rise in the stamp duty threshold would help with affordability.

Stamp Duty reliefs

- 4.9 Stamp Duty Land Tax carries special reliefs for purchases in "disadvantaged areas", as illustrated in Table 4.1. This Disadvantaged Areas Relief aims to encourage the regeneration of the most deprived areas of the UK. There are around 2000 such areas in the UK eligible for this relief. Non-residential buildings enjoy more tax relief than residential buildings. Only residential buildings valued between £60,000 and £150,000 will be taxed differently in disadvantaged and non-disadvantaged areas, and the differential is 1 per cent. However, non-residential properties in disadvantaged areas can be fully exempted from SDLT.
- 4.10 This relief tends to increase the incentive for non-residential versus residential development in disadvantaged areas.
- 4.11 The impact of Disadvantaged Areas Relief on the price of residential buildings may not be significant. The level and scope of the tax exemption granted to residential properties by Disadvantaged Areas Relief is limited. Only residential buildings valued between £60,000 and £150,000 will be taxed differently in disadvantaged and non-disadvantaged areas, and the differential is 1 per cent. The tax rates differential, 1 per cent, is less than the tax

³⁵ Nationwide (2004) "Regional stamp duty report", 4 March.



rates of SDLT, which range from 1 per cent to 4 per cent. Therefore, this relief tends to decrease the cost of residential buildings in disadvantaged areas; however, the price reduction arising from Disadvantaged Areas Relief cannot offset the price increase arising from SDLT.

- 4.12 In addition, there is a Reconstruction Relief, tending to encourage brownfield regeneration by reducing the cost of brownfield reconstruction. However, the impact of this relief on encouraging reconstruction may not be substantial since its scope is limited. The scheme applies only to transactions of land and properties in acquisitions aiming at reconstruction of the acquired company, a small part of brownfield sites on which there are buildings that need reconstructing. Because many residential building reconstructions do not include property transactions, it is unlikely that these residential building reconstructions can qualify for this tax relief, therefore this relief may not affect the price of residential buildings and the affordability of households significantly.

Assessment

Raising Stamp Duty Threshold

Efficiency in use of existing housing stock	Ambiguous. Reduced transactions costs in moving might mean a) better matching of living locations with jobs, and hence reduced commuting distances; and b) more rapid house sales, so fewer empty homes. But, reduced transactions costs might encourage socially inefficient moves because of other distortions in the tax system (e.g. VAT on extensions, as discussed above).
Efficient renewal and re-use of structures currently on land	Little effect.
Redevelopment of land previously used for structures	Little effect.
Other environmental efficiency	Possibly reduced commuting distances, as above.
Affordability	Improved, since reduced costs of moving.
Feasibility	Practically and politically feasible.
Wider economic benefits	Possibly improved functioning of the labour market through enhanced labour mobility.



Stamp Duty Reliefs

Efficiency in use of existing housing stock	Increased incentive, with Disadvantaged Areas Relief, to use housing in areas in need of renewal that might otherwise lie idle.
Efficient renewal and re-use of structures currently on land	Some effect possible from reconstruction relief.
Redevelopment of land previously used for structures	Positive effects.
Other environmental efficiency	Possible spillovers into development of disadvantaged rural areas, and possible urban regeneration.
Affordability	Possibly significant positive effects from Disadvantaged Areas Reliefs.
Feasibility	Practically and politically feasible.

Low Income Housing Tax Credits

- 4.13 Since the Tax Reform Act of 1986, the United States has had a Low-Income Housing Tax Credit (LIHTC) for the acquisition, rehabilitation, or new construction of rental housing targeted to lower-income households — programmes now worth some \$5bn.
- 4.14 Affordable housing or urban regeneration schemes always have funding gaps: costs greater than economic value upon completion. The cost of funding the gaps is significant.
- 4.15 In December 2003, during a visit to the US it was reported that Deputy Prime Minister John Prescott was considering plans to give developers tax credits if they recycle the kind of former industrial land considered ideal for new housing. Such relief would mean cuts in corporation tax and other forms of taxation without the need for upfront state subsidy. The Prescott proposals were intended to complement plans to give government agencies and councils returns from a new development gains tax, as discussed above — possibly with some proportion of the receipts from a development gains tax hypothecated to low income housing tax credits.
- 4.16 One of the more developed proposals for a UK low-income housing tax credit is the “Housing and Regeneration Tax Credit” (HART credit). This would be a pound-for-pound reduction in income tax payable by an investor, and is designed to work with mixed-use, mixed-tenure and mixed-income projects. Sponsors would compete for the credits from a government agency, and winning sponsors would then sell the credits for cash to an investor. Market competition would determine the price of the credits. Advocates suggest that the government agency should have an annual sum of £250 million available for England, and that the money involved should complement, rather than replace, current grants and subsidies for affordable housing.



- 4.17 A HART tax credit scheme would have several advantages:
- (a) First, the Government's expenditure for this scheme is fairly predictable since it is capitated and allocated. At the national level, HART credits would be capitated at £5.00 annually per head (£250 million).
 - (b) Second, the tax credits could be fully granted to those developments that would help urban regeneration or housing affordability. There would be a number of eligible areas (e.g. areas of affordable housing shortage) throughout the UK. Only three kinds of properties in eligible areas would qualify for a HART credit: residential homeownership, residential rental, and retail (mixed-use development is enabled and encouraged).
 - (c) Third, the risk of development would be transferred from the government to developers because tax credits could only be earned after completion. Also the government's total expenditure for affordable housing or urban regeneration would tend to be lower since the government would need to invest less upfront.
 - (d) Fourth, the price of tax credits would be determined competitively. This would tend to subsidise the maximum number of developments for a given sum of expenditure. It might also lead tax credits to be granted to the most efficient developers. Both these effects would increase efficiency.
- 4.18 However, a HART credit scheme might also face significant practical difficulties. It would be difficult for credit-allocators to verify building costs of properties and hence difficult to grant the tax credit to the most efficient developers. Allocators could only use indirect ways to identify the most efficient developers. In practice, allocators may favour developers requiring tax credits as a minimum percentage of total cost of developments, or those requiring minimum tax credit for developments. But granting tax credits to developers requiring the lowest percentage of total cost of development gives each developer an incentive to demonstrate high development costs, which may favour the most inefficient developers; while granting tax credits to developers seeking the lowest tax credits biases applications towards cheaper development projects with lower economic value. Combining the two approaches (e.g. by setting an upper limit for the sum of the HART credit or the percentage of total cost that the HART credit represents) may help alleviate some concerns but perverse incentives would remain.
- 4.19 The HART credit scheme might help the Government realise policy goals such as urban regeneration or affordable housing, but practical difficulties might limit its usefulness.
- 4.20 A perhaps simpler alternative would be to start by setting required minimum standards, then conduct an auction such that the winners are those bidding to provide the most affordable housing for the given subsidy. But this approach, like any scheme to provide housing credits, is likely to generate deadweight losses because of the difficulty policy-makers have in observing accurately when affordable housing schemes would have been put in place even without these subsidies. In the case of auctioning the credits, those



most likely to make the lowest-cost bids are also those most likely to have built the affordable housing with or without the credit.

Assessment

Low Income Housing Tax Credits

Efficiency in use of existing housing stock	Little effect.
Efficient renewal and re-use of structures currently on land	Little direct effect.
Redevelopment of land previously used for structures	Little direct effect.
Other environmental efficiency	Little effect.
Affordability	Positive effects on building of affordable housing.
Feasibility	Unclear. Still a number of implementation issues to be resolved.