Taxing Issues?

Reducing housing demand or increasing housing supply

Policy Exchange

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Introduction

There has been a debate for many years about the most economically beneficial mix of property taxes for the UK. Changes to property taxation are rare and are almost always politically contentious. This report provides a comprehensive look at British property taxation in the widest possible context and discusses the broader economic and political issues that would come into play if there were substantive changes made.

It finds property taxation in the UK is higher than all other developed countries, and already forms a high proportion of the tax base. Any significant changes to land and property taxation would likely lead to significant political problems. There is a range of academic work that identifies possible advantages for land taxes, but no country in the world relies on these as a major source of revenue.

Driving a renewed interest in land and property taxes are concerns over inequality, particularly in housing wealth, as well as issues around housing volatility. But most property taxes have a smaller impact than is claimed on volatility in the housing market, as shown by both overseas evidence and the UK's experience with the abolition of MIRAS. In terms of housing wealth, current growing inequality is a result of the rising value of land and planning permission, a result of wider policy failure rather than an inevitable feature of the national landscape.

The approach most likely to be politically and economically beneficial is therefore not to focus on land and property taxation, but to address the primary problem in the housing arena – the chronic under supply of homes. It is not to place further tax burdens on property ownership but to ensure that property ownership increases, and wealth is more widely diffused, through fixing the country's housing supply. Reversing the trend towards the concentration of wealth created by a lack of housing would have a much greater prospect of reducing inequality and boosting growth by reducing housing volatility than changes to the property tax system.

Unless housing becomes more affordable, demands for higher taxation on property will grow. This does not mean such taxation is sensible but rather that we need to address the real problems.

To do this, a minimum of 1.5 million new homes from 2015 to 2020 is necessary. In short, focus on the creation and spreading of property ownership and wealth – not its taxation.

Executive Summary

Chapter 1: The current system

The UK has the highest level of property taxation in the OECD group of developed nations, as seen in the table below. The UK's property taxation raises more than twice the average level in the OECD.

Size of property tax revenue in selected OECD countries in 2011[1]

Country	Property taxes as % of GDP	Rank for property taxation in OECD
UK	**4.1%**	**1**
USA	3.0%	7
Denmark	1.9%	14
AVERAGE OECD	**1.8%** [3]	**–**
Germany	0.9%	22
Estonia	0.5%	28

It could be argued the reason that property taxes in the UK are so high is that property is more expensive in the UK than other countries. This in turn illustrates that high property taxes can go hand in hand with high property values and are not themselves a solution to high values. Property taxes in Britain fall into different categories. First, there are taxes on occupancy: council tax and business rates. These are politically salient. They are entangled with issues of local democracy, fairness and efficiency. The forerunners of the council tax were domestic rates (unpopular) and Community Charge (even more unpopular). The rates system was believed to be creating spendthrift councils for various reasons, including the fact it was rolled up into general rents and was charged on both business and domestic properties. This led to central intervention via 'capping' spending and then the Community Charge. The Community Charge however was seen as inequitable. Council tax was a compromise across a range of criteria, including fairness, revenue, service charges (reflected in a 25% discount for single person households) and more. Council tax bills are based on a banding system with more valuable properties being charged at a higher rate, but the increase is not proportionate to the increase in value, making it a regressive tax.

While council tax is collected by local authorities, local tax and spend is not truly localised, as there is a heavy redistribution via central grant mechanisms. Only 25% of council tax revenue comes directly from local council tax receipts.

1 All the figures used in this Executive Summary are referenced in the longer report

Thus issues around council tax, localism, redistribution and council spending are deeply intertwined. Alongside council tax are business rates for commercial properties, proportionate to property value, but at much higher levels. While the average Band D (the basic band) council tax is £1,444, the average business rate levy per property is around £14,000. Revaluation of occupancy taxes is controversial and difficult to achieve. In the last 50 years just three domestic revaluations have taken place, the last one 22 years ago, and the most recent business rate revaluation was scrapped. Council tax and business rates each generate around £25 billion a year.

There are also taxes on *transfers*: stamp duty land tax (SDLT) and inheritance tax (IHT). Stamp duty raises £6 billion and IHT £2.9 billion a year. Stamp duty has steadily risen from a low single rate that was only applicable to a small number of house sales, to a larger multiple-rate system that peaks at 7%, with most homes liable for it. 2.6% of estates pay IHT, as the threshold is £325,000 or £650,000 for couples, and there are notable exemptions, such as agricultural land.

There are taxes on *capital gains*: capital gains tax. Gains on capital are taxed at 18% for basic rate taxpayers and 28% for higher rate tax payers. On the assumption that the mix of basic and higher rate taxpayers is the same among owners of property assets as it is with non-property assets, this raised £783 million in the most recent financial year, due to taxes on property.

Finally, there are taxes on *planning gain*: section 106 (S106) and the community infrastructure levy (CIL). These are taxes on the increase in land value due to the granting of planning permissions. They are used to pay for local infrastructure to support development. In 2007/8, Section 106 raised £4.9 billion, but has declined since. CIL is expected to raise £650 million a year and varies by different type of permission but not by site, whereas S106 is site specific.

Chapter 2: Strengths and weaknesses of the current system

The council tax has advantages; it is established, partially local, encourages efficiency, and is relatively inexpensive to assess and collect. That council tax is partially local helps to broaden the tax base. Councils wanting to spend more than the demographics in their area would suggest must raise taxes locally, which pushes them to be efficient. The tax's low collection costs are a further positive.

Its disadvantages are that it is regressive, uses outdated property values and, according to some critics, fails to correct land values. Council tax is a rare example where the tax rate shrinks as the object being taxed (e.g. income, consumption, property value) grows. This is most acute for very expensive properties. Given the UK's volatile and distorted land and housing market, some argue that council tax ought to reduce house price volatility, and its failure to do so should count against it.

The disadvantages of council taxes are exacerbated by the lack of revaluations. Revaluation using modern hedonic techniques could be done at as low as 1p a house. But the barrier to revaluation is political not economic. As a result, two properties now identical in value can have quite different council tax rates. There are also arguments that the single occupant 25% council tax discounts deter people from downsizing. But the annual few hundred pounds discount is dwarfed by the hundreds of thousands downsizers could gain in areas of high housing need. The discount can reasonably be assumed to have minimal behavioural effects.

Business rates are significantly higher than council taxes, which is distorting. Insofar as they tax improvements to property, they discourage investment: a negative. Again, the lack of a revaluation in recent years ensures that there are similar inequalities built into the system as for council tax.

Stamp Duty Land Tax (SDLT) benefits from being cheap to collect, and it is redistributive. However, in recent years it has begun to reach levels that discourage mobility, including down sizing. This clearly has negative social and economic implications that would outweigh revenue gains. It also has an odd structure. At certain points, a £1 rise in value leads to a very large increase in the tax owed. IHT is a redistributive tax that was originally designed to affect the wealthiest. However, it can also affect those on lower incomes who live in higher value properties. It can also distort economic behaviour (e.g. purchase of agricultural land), and is not widely supported for any but the 'very rich'.

Capital gains tax is justified as a way of distributing taxation among the factors of production. To exempt capital gains while taxing income would be inequitable and distort investment decisions. However, like all taxes, once raised above a certain point, it reduces revenue, damages incentives and is unjust. There are exemptions for primary residences and for non-domiciles. While both are distorting, the first can be justified on social and economic grounds, while the second cannot.

Section 106 and CIL can be justified as windfall development gains that do not result from risk, exertion or any other activity by landlords. These taxes fall on the value of land. Local authorities are experienced in managing them. However, capturing planning gain to facilitate more development has failed, which many see as a wider problem. There is also no way to gain value from uplift due to infrastructure projects at present, a problem with the current planning gain mechanisms. Section 106 also imposes uncertainty and transaction costs, and is opaque.

It is sometimes argued that certain types of land or property taxation could reduce house price inflation and volatility. However, no-one argues house price volatility is due to tax policy. House price growth and volatility is primarily caused by excessive credit and an unresponsive housing sector. Likewise, house prices are a function of construction costs and land values. It is soaring land prices, not volatility in the price of bricks, that cause our current high house prices and volatility. At present, land for residential purposes costs millions, as opposed to less than £20,000 for agricultural purposes. There is no reason why land should cost much more for residential development than for agricultural purposes. If land costs more in one use than another, this should lead to land transfer from one use to another until prices equalise, and more planning permissions should be granted to facilitate this. Our current system clearly fails to manage to achieve this. As a graph shows in this chapter, until the post-war period under the 1947 Town and Country Planning Act, land prices did not consistently rise and neither was the current volatility experienced. From overseas, US evidence shows planning is a key factor in house price volatility.

In terms of reducing housing volatility, a Joseph Rowntree Foundation (JRF) report notes "taxation is another possible tool for reducing housing market volatility. However, tax changes are likely to be contentious, and the evidence base from other countries is not conclusive." While planning reform *would* reduce house price inflation and volatility, at best any proposed land and property taxes *might* have this effect.

Evidence that taxation is less important than other factors in the UK is clear from the abolition of Mortgage Interest Relief At Source (MIRAS). In 1990/91, MIRAS was worth £7.7 billion for 10 million households, around £770 per home. This was equivalent to a subsidy worth 3% of the value of the property, each and every year. MIRAS was steadily reduced and then abolished in the following ten years. This did not stop the UK housing market rising 71% over that period and yet further afterward. If removing a large subsidy did not halt very rapid price rises and escalating volatility, it is difficult to argue that similar tax changes would have any effect. Of course, had MIRAS remained in place, price rises might have been higher still. But ending or curtailing price volatility will depend more on addressing the underlying planning and credit issues rather than introducing changes to property taxes. A very large tax of – perhaps – 20% of the value of a property each year would almost certainly have a notable impact on volatility, but would have huge knock on effects and is completely politically unacceptable.

Chapter 3: Possible advantages and disadvantages of land and property taxes

Proportionate land and property taxes have often been put forward as better alternatives to the current system (e.g. a 1% tax on the value of land/property). The major advantages of a property tax are that it is less distorting than other taxes, as property taxes have less impact on productivity than other forms of taxation. This is especially true if housing supply is price-inelastic, as in the UK, and land is a high share of a property's value. Property taxes have an immobile tax base and are therefore more difficult to avoid than other taxes. Some international bodies, such as the IMF and OECD, have argued for higher property taxes and correspondingly lower taxes in other areas, though most of all in countries where property taxes are very low. The UK already has the highest property taxes in the OECD.

Property and land taxes have political drawbacks. Council tax is the largest tax that most people receive a single bill for each year. The revenue raised is low compared to other, less visible taxes. Despite the fact that council tax is relatively low, recent polls have found council tax is very unpopular; it is the tax that the public most want to cut. Property taxes have a particularly negative effect on the 'asset rich, cash poor'. Finally, any additional new property or land tax would increase the costs of ownership and so reduce the value of owning a property. If there is a tax of £3,000 a year on a property, this reduces the value of owning it by £3,000 a year, which will be capitalised into a reduction of the value of the property (likely to be tens of thousands a year). Rents, however, will remain the same in aggregate, with some of the rent simply going as taxes to government. With major increases in land and property taxes would mean that as areas gentrify, many low income households would struggle to pay their rising tax bills. In effect, government would force low and moderate income people out of areas as their property became more valuable (imagine how much a council tenant in an apartment in most of central London might have to pay).

If government tries to overhaul property taxation, it must establish the value of the land and property it was trying to tax, particularly the value of land. No such clear data exists. Figures from the Royal Institute of Chartered Surveyors (RICS), estimates based on construction costs and the Valuation Office Agency all give quite different figures in this area, making it hard to plan accurately for a major revision to the system. The poll tax, the last major revaluation, was originally designed to reduce average bills, but most people's bills actually rose, making reform even more politically difficult. This lack of data makes it hard to recommend major changes to the system.

Chapter 4: Major recent suggestions for reform and issues they raise

It has been argued that council tax should be revalued and extra bands added. As property values have shifted significantly over recent decades and there are widespread anomalies in the system, this would seem sensible. But any such revaluation has been and will continue to be politically difficult for a number of reasons: first, people may believe that, as property values have risen, their bills will be expected to rise; second, those whose property has risen in value may still have low incomes; third, that losers will inevitably be more vocal than winners and the memory of the huge protests that erupted around the community charge only reinforce the potential opposition to any major changes.

Uniform property tax and a land value tax are two similar alternatives. These would replace council tax with a tax proportionate to the value of property or land, e.g. 1% of the total value. For those who want a more redistributive system, such an approach is attractive. However, this would create an immediate and highly transparent tax rise for many people, particularly as it would come as a large single bill. With land taxes, it is likely many would challenge assessed values, particularly in the first few years. It would also raise opposition to the redistributive role of central government. There is a general acceptance of existing redistribution where affluent areas pay more in council tax and obtain less from central government. A higher tax burden on more affluent areas would shift political debate as new higher land taxes in more affluent areas would reduce support for transfers.

Recouping capital gains tax (CGT) on primary residencies is another option. Currently, this would raise £9.9 billion a year. This is in fact not much more than Stamp duty, and so it seems unlikely to end house price rises. It could however have major distribution effects. Where countries apply CGT to primary homes, there are usually huge exemptions, (e.g. in the USA $250,000 per person, $500,000 per couple, and for moves caused by divorce, work and other reasons). If CGT was applied to primary residences this would strongly deter people from selling their properties and have a strong effect on those downsizing, discouraging voluntary 'efficient' distribution of homes; this is particularly important given that 35% of households have two 'spare' bedrooms. If the housing market properly functioned, capital gains would be small anyway. Finally, moves to extend CGT would attract very strong opposition from the potential losers.

Two other options have also been proposed: the Mansion tax (a levy on very valuable properties) and alterations to Stamp duty. Both are marginal. A Mansion tax could be popular in general as most people would not have to pay the tax. It would, though, be extremely unpopular with those who would expect to pay. In London and other parts of the South East, many properties that are clearly not a "mansion" would be affected due to house price inflation in the last 30 years. Stamp duty could shift from the current structure to one where you only pay the higher percentage above a certain threshold. Scotland is about to move to a more proportionate system for Stamp duty. This could be a sensible step, but, in the current economic climate, it might be prudent to wait until there are fewer urgent priorities for economic reform.

Finally, rationalising planning gain is another option. Policy Exchange has argued for replacing S106 and creating a reformed CIL. The government's New Homes Bonus, a grant accompanying new homes, could go entirely toward paying for new infrastructure, while CIL would become a site-specific levy that pays for amenities or incentives at neighbourhood plan or even more local levels, ending S106. However, such an approach would be more about encouraging development than raising revenue, rather than land and property taxation per se.

Chapter 5: Overseas land and property taxation

This chapter discusses the position in various other OECD countries. All other countries tax property, although how they do so differs widely. Most countries have a varying mixture of capital and transaction taxes, property taxes (often proportionate to values), often relating these taxes to location. In the real world, property taxation has diverged from the concept of a single land tax that is often held up as a theoretical ideal. There is no case of such a very high land tax in any country.

No OECD country taxes property more heavily than the UK. In addition, property taxation, particularly proportional taxation of property, has not had the impact that some commentators expected. There appears to be no necessary link between the type or level of taxation and house price volatility. Taiwan has a type of land tax that comes closest to the theoretical idea, yet has seen house prices soar in recent years, with a price to income ratio in Taipei of nearly 14:1, a huge gap that illustrates massive issues with housing affordability. Countries like the USA and Australia have proportional taxes on property and high levels of price volatility. Far more important factors in determining house price volatility and absolute prices are a country's planning and monetary policies (e.g. Germany, where prices in 2011 were lower than they were in 1995, builds 60% more homes per head than the UK and has tight control of the money supply).

Chapter 6: Politics of land and property taxes

The politics surrounding housing and property taxation have always been difficult. Opposition to the rates, the failure of the Community Charge and the lack of regular council tax revaluation are all only the most recent examples of the political problems inherent in making any important change in property taxation. Reforms also create difficulties in practical transition. Any attempt to improve taxation in one area usually creates difficulties in another.

The political parties all have different approaches. The Conservatives have, in recent years, largely opposed new property taxes, though some are prepared to consider restructuring taxation towards more expensive properties and wealth to pay for tax reductions elsewhere. The Conservatives introduced council tax and continue to support it, although not a revaluation. They have advocated that IHT remain a tax levied only on the very rich (and supported policies in opposition to achieve this). They have been critical of the complexity of CGT. While in Coalition, they have seen higher property taxes in terms of stamp duty and CGT, but these were pushed by the Liberal Democrats.

Liberal Democrats are broadly supportive of property and land taxation. They have opposed council tax since its inception and have consistently advocated a local income tax. They have been less keen on higher stamp duty, but never opposed it in principle, supporting a new rate of 7% on properties over £2 million as an alternative to a Mansion tax. They argue that capital gains should be taxed as income and recently reaffirmed their desire to realign CGT and income tax without indexation.

Labour has changed position slightly more than other parties. The Party originally opposed council tax, but more recently accepted the concept. Labour favour revaluation in principle but did not undertake one during their time in power. Labour has taken a consistent position on Stamp duty, supporting a higher tax rate. They recently backed Lib Dem ideas for a Mansion tax. Labour passed significant reforms to CGT, introducing a taper relief criticised as overly complex, before simplifying the tax again a decade later. They reduced the rate below income tax rather than restore indexation.

Chapter 7: Land and property taxes are a distraction from key issues

The UK already collects the largest share of GDP in property taxes amongst all OECD countries. Making any major changes to property taxes in the future will be extremely difficult. Political parties are wise to treat property tax reform with great caution given the serious political problems past reform in England encountered. There is no reason to believe that these would not recur.

In addition, while none of the current taxes on property or land are perfect, none are so intrinsically flawed that they should be scrapped. This report therefore argues that no major changes should be made to the current system of property taxation in the UK. Insofar as any changes are made, they should be small and incremental, (e.g. ending the slab structure of stamp duty, not attempting to overhaul the entire system).

Land and property taxes are seen as a way of tackling important issues such as inequality, house price volatility and falling home ownership. But these issues will be solved by genuine reform of planning to increase the supply of homes, and better monetary policy to reduce speculative bubbles. Logically, house price rises and house price volatility must emanate from these two issues. The evidence shows where excess credit and under-supply exist, taxation or subsidy can only have a limited impact.

If politicians need a target to focus attention on, we would recommend that politicians should commit to building 1.5 million homes over 2015–2020, 300,000 a year. The number of new households is expected to be 221,000 homes a year during this period, and there is a major backlog of new homes to be built, as well as a need to cater for demand as well as housing need. (As if new homes do not satisfy new demand these purchasers will buy new built homes, homes that are supposedly built for new households). As work by Policy Exchange has set out, the issue of building enough homes *is* politically soluble and would help solve an emerging major political, social and economic crisis. Policy makers should focus their attention accordingly.

1
The Current System

Immovable property comprises a sizable tax base. In most developed countries it forms a key part of most governments' revenues. However, the level of property taxation varies hugely within the OECD. Compared to other developed countries, and contrary to the impression sometimes given by the media, in the UK property tax is very high as a share of national income, as Table 1 below shows.

Table 1: Size of property tax revenue in selected OECD countries in 2011[2]

Country	Property taxes as % of GDP	Rank for property taxation in OECD
UK	**4.1%**	**1**
USA	3.0%	7
Denmark	1.9%	14
AVERAGE OECD	**1.8%** [3]	**–**
Germany	0.9%	22
Estonia	0.5%	28

As can be seen from the table above, the UK has the *highest* level of property taxation in the OECD. At 4.1% this is over twice the average level of taxation of property in OECD countries. Calls for an increase in property taxation should be put into this context. Further, the mere presence of high property taxation does not appear to have reduced house and land prices in the UK, although it could be argued a better designed system might be able to have this impact.

Property and land taxation in Britain consists of several distinct areas.

- **Taxation on occupancy** (Council tax/Business Rates).
- **Taxation on transfers** (Stamp duty Land Tax and Inheritance Tax).
- **Taxation on investment income** (Capital gains tax).
- **Taxation on gains due to planning changes** (Community Infrastructure Levy, Section 106).

Each of the taxes or levies arose in its own historical circumstances and persists for different reasons. They arose as a series of measures over time, not an overarching framework.

2 *Taxes on property – Taxation: Key Tables from the OECD*, 2011 or current latest year available

3 This is the figure for 2010 not 2011 as three countries did not yet have data available for 2011

In line with most taxation issues, land and property taxation is generally not devolved to the home nations but retained at UK level. The main exceptions to this include the Welsh and Scottish governments' authority over council tax bands and revaluation, the Scottish government's control over its own Universal Business Rate, and both countries' control over planning gain issues.

In terms of local authority discretion, they have a certain level of control around planning gain issues and set council tax rates for Band D properties in their area. This Band D rate is then used as the baseline for a (nationally required) formula to determine rates for other properties in their area.

1.1 Taxes on occupancy: council tax and business rates

Probably due to the ease of collection, taxes levied on property have existed in Britain for hundreds of years. The first was the creation of the Poor Rate, established at the local level in 1572, which taxed landowners living within each parish to support the destitute. These rates were nationalised in 1601 by the Act for the Relief of the Poor, known as the Elizabethan Poor Law Act. The most recent incarnations of such property taxes were the 'rates' of the General Rate Act of 1967, which established a rate on domestic and business property rental values in England and Wales, and the controversial and short-lived Community Charge, or as it was known, the Poll Tax, and the National Non-Domestic Rates (NNDR), also termed business rates.

The politics of taxing occupancy are extremely difficult, in part because they are entangled with issues around local democracy, fairness and efficiency. The 'rates' system that preceded the poll tax was very unpopular. Much local spending was financed by support from central government, which tried to take account of the fact different councils had different capacity for taxation and different needs for expenditure.[4] However, this meant any increase in discretionary spending over and above what central government deemed necessary and so paid for centrally meant high increases for local taxpayers. The rates were less visible, which meant that councils had less incentive to keep them low than they would the council tax. Finally, business and domestic rates operated together, and the Thatcher government ended up capping a limited number of councils' rises as it felt that councils were raising rates too high, partly hitting businesses with high tax bills, to recycle these funds toward their own voters.

The proposed solution to this was the Community Charge, brought in alongside new nationally set business rates in 1990. The Community Charge tried to force councils to be more efficient by taxing every inhabitant within a council the same amount in order to reflect local service usage per person and making business rates national rather than locally set. The idea was that a flat distribution of costs and an inability to load costs onto local businesses would mean high spending councils would have to pass on these large increases to the average taxpayer. While there were rebates, there was also a minimum charge of 20% to ensure that everyone contributed something. The problem was that while this solved the issue of profligate councils, it created a new problem, because, as critics pointed out, it made low and high income households pay the same amount, breaking the link with ability to pay. For this reason it suffered from high rates of evasion and was politically unpopular. It was quickly replaced by the current council tax regime in 1993.

4 *Local Taxes and Local Government,* The Institute for Government, 1987

The current system of council taxes and business rates are related to the capital value of residential properties and rental value of commercial properties. In England in 2012–3 council taxes raised £26bn (net of council tax benefit).[5] Business rates generated nearly the same revenue of £25bn.[6]

To set the council tax rate, a local authority decides how much revenue it needs to raise to cover costs in excess of the central government funding it receives. All properties in a local authority area will have a particular band they are placed in by virtue of their notional capital value, with eight Bands of A-H. Council tax liabilities for each band are set proportions of the amount a Band D property must pay. Therefore the local authority sets the level of tax for a Band D property so that the revenue raised from all local properties across the various bands adds up to the amount needed.

The band a domestic property is in is based on an assessment of their 1991 market values.[7] Properties constructed since then have been added to the bands according to estimates of how much they would have been valued at in 1991. Each band pays a different proportion of the amount of tax a Band D property must pay, with bands A-C that contain less valuable properties paying less and bands E–H that contain more valuable properties paying more. There is a 25% discount for households with a single occupant, reflecting the notion that council tax is in some sense related to a charge for council services and single occupant households will use fewer of these.

Table 2: Council tax bands and tax liability

Band	Council tax owed (% of Band D)	Applies to properties in 1991 that were worth…
A	67%	£40,000 and under
B	78%	£40,001–£52,000
C	89%	£52,001–£68,000
D	100%	£68,001–£88,000
E	122%	£88,001–£120,000
F	144%	£120,001–£160,000
G	167%	£160,001–£320,000
H	200%	£320,000+

Total revenue raised from council tax describes how large the 'pie' is while the bands determine how the 'pie' is cut. No revaluations of property have taken place since 1993 in England or Scotland and so properties are taxed not according to their current value but their estimated 1991 value. Though Wales had its most recent revaluation in 2005, this was unusual in that all political parties supported the measure. In England, the Conservatives made it very clear that they opposed revaluation, forcing the scrapping of the planned revaluation.

Like the rates, though council tax is generally described as a local tax, this notion is not truly accurate. The central government provides a set level of funding to local authorities based on a complicated formula that weights socio-economic and demographic factors and the ability to raise revenue as measured by the number of Band D properties.[8] Despite raising £30.1bn in gross revenue

5 *Local government net revenue expenditure: England summary 2010–11 to 2012–13*, DCLG, available at Gov.uk website

6 *Central and Local Rating Lists: Summary*, Valuation Office Agency, available online. Revenue calculated by applying multiplier to total rateable value of properties in England

7 McCluskey, W., Bell, M., and Lim, L. C. J.. "Rental value versus capital value: alternative bases for the property tax." R Bahl, J Martinez-Vazquez, J Youngman (Eds), *Challenging the Conventional Wisdom of the Property Tax:* 119–157

8 DCLG. 2012. "Local Government Financial Statistics England," No. 22

(£26bn net council tax Benefit) in 2011–12, council tax only accounted for a quarter of local government funding on average in 2009–10.[9, 10] In return for this redistribution of funds, local authorities must set their budgets in accordance with a host of centrally stipulated conditions. Due to this financing arrangement, each 1% of additional spending requires local authorities to increase council tax by between 1.8% to 7%.[11] This discourages spending but weakens the link with local voters. Central government also intervenes directly to try to hold down council tax rates. For instance in recent years central government has encouraged local authorities to avoid raising council taxes by offering those freezing council tax additional grant, equivalent to a 2.5% funding increase.[12]

Business rates are collected on the annual rental value of non-domestic properties at rates set out by the universal business rate, which is determined centrally. Even though the system is different in Scotland, rates in Britain are all in the range of 40–50% of rateable value and are indexed to inflation. Revaluation is stipulated to be conducted every 5 years, although the 2012 revaluation has been postponed until 2017 in England. It may be that the difficulties observed in council tax revaluations are spreading to business rates. Commercial and industrial properties bear a much larger burden than residential properties on a per property basis. The average tax bill for business properties in England is around £14,000, which is more than ten times the 2012 average Band D liability of £1,444.

Box 1: The difficult history of revaluation

Britain has struggled with property valuations in recent decades. Revaluations in England took place in 1963, 1973 and 1993 (based on 1991 values). Thus in the last forty years only one revaluation has taken place, over two decades ago, and there is no current discussion of such revaluation in the near future. While business rate revaluations since 1991 have occurred the most recent has also been postponed. The lesson from the Welsh revaluation seems to be that in order for England to see a revaluation an unusual degree of consensus amongst all main parties would have to occur.

Revaluations do involve costs, though this is not the main issue. The 1993 revaluation in England and Wales cost £74m in 1991, or £120.6m in 2012 terms after adjusting for inflation. If we assume that revaluations today would cost twice this amount, then revaluation costs £10 per residential property and constitutes less than a percentage point of 2012 council tax revenues after council tax Benefit. The National Audit Office found a much lower cost of just £1.81 per property (£3.24 today if we assume the figure is in 1991 pound sterling).[13] In fact, according to the LSE, by using modern hedonic techniques revaluation could be as low as 1p a house.[14] In the USA, where property taxation is less contentious, some states even have constitutional requirements that valuations for tax purposes must be up to date.

The difficulty in the UK is revaluation is a very difficult political task to undertake. This difficulty in property revaluation for taxation purposes reduces some of the proposed advantages of any land or property tax. For example, the idea price volatility can be addressed by land taxes is weaker if when prices rise, past valuations simply remain in place.

9 Economic and Fiscal Outlook December 2012, Office for Budget Responsibility. All ensuing tax receipt figures use this source unless otherwise noted.

10 Crawford, R and Phillips, D. 2012 "Local government spending: where is the axe falling?," IFS Green Budget, Ch. 6

11 DCLG. 2011. "A Plain English Guide to the Local Government Finance Settlement for 2011–12"

12 "A Plain English Guide to the Local Government Finance Settlement for 2011–12", ibid

13 Bank of England inflation calculator, available at their website

14 Private correspondence with the LSE's Professor Paul Cheshire.

Table 3: England's business rates: number, revenue and rate per property[15]

	No. of locally rateable properties	Business rates revenue 2012/3	BR per property
England	1,775,000	£25bn	£14,000

1.2 Taxation on transfers: Stamp Duty Land Tax and Inheritance Tax

Property is also subject to a series of taxes paid upon transfer. The first of these is the Stamp duty Land Tax (SDLT).[16] Stamp duty is a longstanding tax on property transactions, with the current version set out in the 2003 Finance Act. It raised £6.1bn in 2011–12. The current rates increase for both residential and commercial property. The relevant rate is payable on the entire purchase price. This creates what is termed a 'slab' structure where a small rise in prices means a large rise in the tax payable (e.g. a £1 increase in price from £499,999 to £500,000 means the tax paid rises from £14,999.97 to £20,000). This was criticised in the Mirrlees Review.[17] Whereas before 1997 stamp duty was a 1% levy and only caught a minority of properties, by 2007 it was a multi-tiered system that caught 6-in-ten homes.[18] Since then even more bands have been added by the Coalition, and the current rate schedule of residential property is displayed below.[19]

Table 4: SDLT rates for residential property

Purchase price/lease premium or transfer value	SDLT rate
£125,001 to £250,000	1%
£250,001 to £500,000	3%
£500,001 to £1 million	4%
£1 million to £2 million	5%
Over £2 million	7%

IHT is charged on property within estates exceeding £325,000 at the time of the transfer at a rate of 40% or 36% if 10% or more of the estate goes to charities. However, this can be doubled to £650,000 for a married couple or civil partnership, as a couple can divide ownership of property between them. This effectively means that joint estates can be worth £650,000 and avoid IHT as the £325,000 limit applies at the death of each spouse.[20] Various exemptions or reliefs are available and IHT can be avoided altogether by individuals not domiciled in the UK. Thus IHT can have significant effects, with the fact agricultural land is exempt from IHT clearly making it a more desirable asset to purchasers.

In 2009–2010, approximately 2.6% of estates paid IHT. It affected 21,000 taxpayers and raised £2.9bn in 2011–12.[21] 97.4% of estates therefore did not pay IHT. Of the 2.6% estates that paid IHT over 70% had a net estate between £200,000 and £500,000. Only 2% had a net estate over £2 million.[22] The average tax-paying estate in 2009–10 had around a third of its total value in housing.[23]

15 *Central and Local Rating Lists: Summary,* Valuation Office Agency, available online. Revenue calculated by applying 45p business rate multiplier to total rateable value of properties in England (£59 billion).

16 www.legislation.gov.uk/ukpga/2003/14/part/4

17 Tax by Design, Mirrlees Review, Ch. 16, p403

18 Tax by Design, Mirrlees Review, p23

19 www.hmrc.gov.uk/sdlt/intro/rates-thresholds.htm. A special 15% rate applies on property over £2 million for certain persons including corporate bodies.

20 www.hmrc.gov.uk/inheritancetax/pass-money-property/pass-home-to-children.htm

21 www.hmrc.gov.uk/statistics/taxpayers/table1-4.pdf

22 Dimensions of Tax Design, Mirrlees Review, Ch. 8, p746

23 See Figure 4, p8 in the HMRC publication Inheritance Tax Statistics 2009–10, released 31 July 2012

1.3 Tax on capital gains: capital gains tax

The other transaction tax levied on property is the capital gains tax (CGT). CGT is a tax applied to capital gains arising out of the sale of assets, which encompasses property. CGT includes an annual tax-free allowance that was aligned with income tax in 1988 by Nigel Lawson. Since 2008 the tax is levied at two rates according to one's income tax rate. Basic rate tax payers pay 18% and higher or additional rate tax payers must pay 28%. Entrepreneurs enjoy a lower 10% rate. The tax raised a total of £4.3bn including capital gains realised on non-property assets. There are two cases in which CGT is not charged on property: if the property sold is 1) a primary residence or 2) owned by a non-resident.[24] One reason why the rate of capital gains after 2008 is lower than income taxes is that it is not indexed for inflation as it was in the past, meaning that gains which are merely keeping pace with inflation are taxed. This is seen as being partially compensated for by the lower rates.

1.4 Taxes on planning gain: Section 106 and Community Infrastructure Levy

The last two taxes relate explicitly to the planning system and changes in the use of land. Section 106 in the 1990 Town and Country Planning Act formalised and legitimised a system of individual agreements developing between local authorities and developers which shifted infrastructure costs onto developers in return for planning permission being granted.[25] Section 106 constitutes a form of indirect taxation on developing land. Shifting infrastructure financing obligations onto developers increases the cost of development and reduces the amount developers will pay for land. Hence the tax ultimately falls on landowners.[26, 27] The majority of Section 106 went toward new affordable housing in recent years (for example, in London until 2008 there was a requirement that on any development 50% of new homes had to be affordable housing).

In 2007–08, Section 106 agreements were estimated at £4.9bn.[28] This has subsequently fallen in line with land values and levels of development, but no central figure is available. The Planning Act of 2008 introduced the Community Infrastructure Levy (CIL), an additional planning fee charged at a flat rate per square meter of floor space. As its name suggests, CIL charges developers on new projects for the purposes of funding infrastructure investment.[29] The charging schedule is set by local authorities in line with DCLG CIL guidance.[30] Table 5 below sets out the charging schedule for Bristol City Council, showing how there are different levies on different types of development and different geographical areas.

Though similar to Section 106 in many respects, CIL is intended to provide greater transparency, greater flexibility in the use of funds it raises, and more local choice in planning.[31] For example, in areas with sub-local authority planning, called neighbourhood plans, 25% of the CIL should go to projects chosen by the local community, (as long as it is infrastructure relating to the development). Starting from April 2014, CIL will replace Section 106 as the primary source of funding for local infrastructure spending arising from development.

24 www.hmrc.gov.uk/cnr/faqs_capgains.htm

25 Land Value and Community Betterment Taxation in Britain: Proposals for Legislation and Practice, Lichfield and Connellan (2000)

26 Private communication with Professor Alan Evans, Director of the Centre for Spatial and Real Estate Economics, University of Reading.

27 These effects require an inelastic supply of housing and high housing demand, both of which are certainly present in the British housing market. See "Understanding supply constraints in the housing market" produced by FTI Consulting on behalf of Shelter

28 www.cchpr.landecon.cam.ac.uk/Downloads/VPO3%20final%20report.pdf

29 www.planningportal.gov.uk/planning/applications/howtoapply/whattosubmit/cil

30 www.gov.uk/government/uploads/system/uploads/attachment_data/file/36743/Community_Infrastructure_Levy_guidance_Final.pdf

31 www.planningofficers.org.uk/downloads/pdf/POS_Advice_Note_S106_and_CIL_final_version_Apr2011.pdf

Table 5: Bristol City Council CIL charging schedule[32]

Development type	CIL Rate/m^2
Residential (Class C3) Inner Zone	£70
Residential (Class C3) Outer Zone	£50
Commercial (Classes B1, B2 and B8)	£0
Hotels	£70
Retail	£120
Student accommodation	£100
Residential and non-residential institutions (Classes C2, C2A, D1) and development by the emergency services for operational purposes	£0
Other chargeable development	£50

It is expected that post 2014 Section 106 will be retained for some site specific requirements (certain requirements to improve the site in the eyes of planning officials) and will remain the main method of funding for affordable housing. According to government documentation under a best-case scenario, CIL is expected to raise £6.5bn in local authority revenue over 10 years from 2016.[33] This is just £650 million a year and is substantially less than the amount raised by Section 106. CIL is expected by some in the industry to change over time as it is a newer form of raising revenue.

32 www.bristol.gov.uk/sites/default/files/documents/planning_and_building_regulations/planning_applications_and_process/CIL%20Charging%20Schedule.pdf

33 www.gov.uk/government/uploads/system/uploads/attachment_data/file/6037/1829714.pdf

2
Strengths and Weaknesses of Current Land and Property Taxes

Having examined the high overall level of property taxation and the various taxes that make this up, we can turn to an examination of the strengths and weaknesses of the current taxes.

2.1 Council tax

The primary advantages of council tax are that:

- It is an established and accepted system.
- It is one of the few local revenue-raising options for local government.
- It allows a limited amount of local accountability.
- It encourages efficiency as surplus spend over the grant requires higher tax rises.
- It is relatively cheap to operate and provides stability for households.

The first point is that the very fact council tax is established and accepted within the political spectrum is a major positive given the difficulties of property taxation.

Similarly, council tax provides a measure of devolution to local government and creates accountability to local taxpayers. While there are ideas such as income tax and consumption tax for local authorities, they would likely lead to much greater attempts at evasion and mobility to avoid tax. Unlike the USA, where states are reasonably large, the small nature of UK councils would make it quite easy to try to avoid taxation. This would be a deadweight loss to the economy as it would take time and effort away from productive activities. By contrast, if you want to live in an area you have to pay council tax, and so you are likely to try to put pressure on your council to keep it lower rather than work out how to evade taxation.

This push toward functioning local accountability is supported by the fact large increases in spending require high increases in council tax. This could be argued as a reduction in council autonomy, but it certainly reduces the incentive for councils to be profligate, particularly since business rates were nationalised in the early 1990s and so councils could not rely on squeezing local businesses. The fact council tax is cheap to collect is also beneficial, as is the fact that households know roughly what the cost will be year after year. Even if house prices rise, households don't have to worry they will not be able to afford increases in taxation on their property. (This is the other side of the argument that council taxes do not try to limit house price volatility).

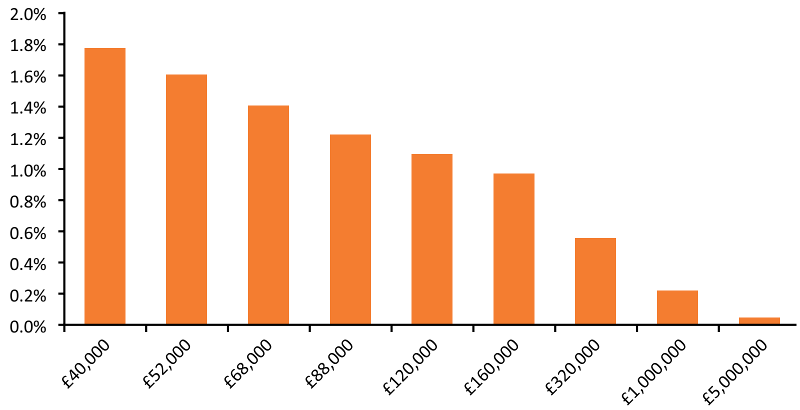
Council tax does not have overwhelming advantages. It is instead a tax that tries (and succeeds) in scoring reasonably well across a wide range of areas (acceptability, efficiency, local oversight) rather than doing very well on any single specific criteria.

The drawbacks to council tax are:

- It is regressive in that the tax rate falls as the house price rises, to which some object.
- Critics argue that it fails to correct volatility (though not that it creates such volatility).
- It uses outdated property values.

The first and clearest objection is that council tax is an example of a regressive tax, where the tax rate decreases as the amount subject to tax rises. As house prices rise, the council tax rate falls. Most taxes are either proportionate or progressive. This is shown in the table below.

Figure 1: Council tax rate as a percentage of the property's value[34]



Those in less valuable houses have a higher proportionate tax burden than under a proportional tax. As the graph above shows, the rate of tax on a £40,000 property is nearly three times as much as the rate on a £320,000 property. The level of tax increases as the property rises in value, but it does not do so in proportion. This is most acute for the limited number of very expensive properties, the most expensive of the 104,000 properties in Band H, the band that includes all properties valued at over £320,000 in 1991.[35] A property valued in 1991 at £3.2 million or £321,000 pays £2,143.30 in council taxes in Kensington and Chelsea. But at all levels the tax rate falls as the property's value rises.

As house prices tend to be positively correlated with income, council tax is also generally regressive with respect to income as well as house prices. The Lyons Review of taxation found "*a positive and statistically significant correlation between income and property value*". While each income decile saw variation in the value of property it

34 This assumes the average band D value for England and uses the set formula to calculate liability. Obviously, if the Band D is higher or lower this will shift up or down liability for all properties, but not significantly alter this very regressive relationship.

35 *Annex C; The Lyons Review*, ibid

owned, it was broadly true to say that as income rose so did property value. For example, a household just falling within the bottom 25% of the second decile in terms of income had a property value worth roughly equivalent to a household just within the top 25% of the lowest income decile. However, Lyons also noted "*a small but significant minority of low-income households are in bands F, G and H, of which over half are pensioner households.*"[36]

A second argument is that council tax is unable and not designed to reduce volatility within the UK housing market.[37] Research has highlighted the central role of housing in investment decisions, wage and price levels, economic cycles, and national financial stability, so if true this has important knock-on effects.[38, 39] It is certainly true that council tax does not have as its goal the stabilisation of the UK housing market and its wild fluctuations. But as discussed later, the ability of taxes to reduce volatility, volatility caused by wider policy failures, appears to be limited.

Council tax's disadvantages are exacerbated by the lack of regular revaluations. As noted, this is not due to cost, which some academics think could be as low as 1p per house. It is due to the politics of revaluation. Council tax is levied on outdated value bands, irrespective of how relative values have changed since 1991.[40] At that time, all Band A or Band D or Band H properties were likely to be roughly of similar value. Property prices have shifted over time and the distribution of stock has likewise changed over time. This failure means that council taxes are likely to be more regressive and disproportionate to property values.

"Council tax is levied on outdated value bands, irrespective how relative values have changed since 1991"

However, revaluations are very politically difficult. As was noted earlier, it was only the fact of political consensus that allowed Wales' revaluation to proceed in the mid-2000s. But the unpopularity of revaluation also applied to the domestic rates, meaning the gap between the last two revaluations was twenty years. Revaluations often provoke stronger reactions from the losers than the winners. This is not necessarily an issue with council tax per se, but rather a wider issue with property taxation, of which council tax is an example.

It has been argued council tax discounts for single occupants may have perverse incentives in terms of housing consumption. But a 25% reduction in council tax bills is a small £360 or so a year for an average Band D property. For most people, particularly in high demand areas, this is dwarfed by the tax-free capital gains from downsizing. A single occupant moving from an average detached to an average semi-detached property in London gains £300,000 as they move from a £751,184 to a £459,182 property. In the South East, a similar move from a detached to semi-detached average property gains £180,000 as they move from a property worth £438,891 to a property worth £259,922.[41] Even if we assume much smaller gains in the rest of the country, they will run into tens of thousands of pounds for most single occupant taxpayers. If this does not persuade people to move, a few hundred pounds a year seems unlikely to have anything more than a negligible effect.

36 *The Lyons Inquiry into Local Government,* The Stationary Office, 2007,

37 Tackling housing market volatility in the UK, Stephens (2011), JRF.

38 Saiz, A. On Local Housing Supply Elasticity (2008)

39 Muellbauer, J. Property Taxation and the Economy after the Barker Review (2005)

40 A New Tax for Local Government: a Consultation Paper, Department for the Environment green paper (1991)

41 These figures were taken from the BBC website; UK house prices: October to December 2012

2.2 Business Rates

Business Rates enjoy a much lower political profile than council tax. The comparatively higher level of taxation of businesses takes advantage of this fact and as a result, business rates raise almost as much revenue as council tax despite a far smaller tax base comprised of commercial enterprises. Consequently, non-domestic properties are taxed much more heavily relative to domestic properties. Business rates are easier to collect, as fewer businesses mean a smaller tax base.

Rateable value includes the annual rental value of improvements in its calculation and taxing this portion of value reduces output. Business rates rise due to property improvements and so this may have a negative impact on incentives, (just like any other tax on productive activity such as income tax). Postponing the business rates revaluation until 2017 will force businesses located in harder hit areas to pay taxes on their much higher 2008 valuations rather than on values that reflect the current economic conditions. This is generally seen as inequitable, though again it is an issue with revaluation, not with business rates per se.

2.3 SDLT

As Stamp Duty Land Tax (shortened to stamp duty or SDLT in the rest of this report) only arises where there is a legal transfer of ownership, assessing and collecting the tax is relatively cheap and straightforward. It may insulate against property speculation to some degree, as the higher prices are the higher stamp duty becomes.[42, 43] It is a redistributive tax, with the wealthy paying more than the less well off as a proportion of income, a principle most people support.

SDLT has some major flaws. The threshold points where the tax rates increase hugely due to a marginal increase in value of the property create a slab structure, as noted in part 1. This creates odd incentives and behaviour where people try to avoid moving from one threshold to another, as well as reducing support for stamp duty overall. More generally, transaction taxes are economically inefficient if they operate at a rate where they discourage transactions. If this stops economically beneficial activity, for instance by reducing mobility, any gain in revenue is more than outweighed by wider economic damage. One such example would be where stamp duty prevents households trapped in larger family homes moving, while simultaneously making it more difficult for those wishing to move into such properties to afford the cost of moving.

CGT and IHT

The vast majority of estates do not pay inheritance tax as the majority of people do not leave a large enough estate. The argument IHT hurts incentives more than a tax on capital or income is also hard to sustain, as it would require people to work harder so that they might leave a legacy in future than they would to earn money now. There are arguments that IHT helps allow for greater social mobility. The natural human desire to improve your children's lives is a positive, but this can lead to barriers being erected if there are no countervailing forces. IHT can to some extent be seen as redressing the fact some are born with wealthy parents who do all they can for them (in itself a good thing) and who leave large legacies to their children, while others do not.

42 Stephens (2011).

43 Aregger, N, Brown, M, and Rossi, E. 2012. "Can a Transaction Tax or capital gains tax Smooth House Prices?" Available at SSRN 1780826

However there are problems with IHT. Much of the current burden is borne by the moderately wealthy clustered near the cut-off threshold as shown by the figures in chapter 1, with 70% of estates paying IHT having a value of less than £500,000. High value estates can avoid IHT liability by hiring wealth management services to minimise the tax liabilities on their estates or by using offshore companies to purchase real estate.[44] The very act of reorganising an estate into tax-minimising asset allocations distorts optimal economic behaviour by diverting capital away from more productive uses and increases the cost of tax enforcement. Exemptions such as on agricultural land will inflate the value of this and similar assets. Finally, there is the issue of how far the state should tax voluntary transfers within families such as passing your estate on when you die. In one 2006 poll only 22% of people supported the principle of inheritance tax for anyone other than "very rich people".[45] These are notable disadvantages to weight against the positive points above.

Capital gains tax (CGT) is broadly a tax on capital just as income tax is a tax on labour, and as the tax burden should not fall only on one factor of production, it can be justified on these grounds. If no tax were levied on capital, this would encourage evasion as individuals declared labour income as capital income, as well as distort investment decisions. CGT is also a reasonably simple tax to collect. While there are issues with indexation and what the rate should be, CGT on property at a rate broadly in line with CGT in general has clear advantages. However, above a certain point, like any tax, it reduces revenue, discourages productive activity, and is unjust.

Economically speaking, the CGT exemption for primary residences and property owned by non-domiciled owners creates economic distortions. The exemption for primary residences is in line with prevailing international practice as most countries do not charge CGT on primary residences.[46] While it is distortionary, it can be justified if wider property ownership is a goal of government. Taxing any capital gains would make it less attractive to be a home owner. While for the majority it is unlikely capital gains are the only reason a house is desirable, it is certainly a benefit of homeownership. This exemption is also politically popular. However, the latter exemption for non-domiciled owners does not appear to have any economic or political arguments in its favour and may contribute to housing price instability in Britain by encouraging housing speculation by overseas buyers.

2.5 S106 and CIL

The rationale for taxing windfall gains arising from infrastructure and other development-related activities is obvious. The landowner has not had to do anything to gain a major increase in the value of his property. The tax ultimately falls not on the homebuyer or the developer, but on the landowner who sells land. The tax falls squarely on a pure 'economic rent', wealth gained without effort, and reduces land prices. It has no incentive impacts. A major attempt to raise revenue from the gains that arise merely due to bureaucratic reclassification of land is very sensible.

There is a second justification for taxing planning gain: recycling this into infrastructure or other amenities may bolster local support for development.

44 Ibid, p791

45 *Inheritance Tax Survey,* Populus, 2006

46 Oxley, M and Haffner, M. 2010. "Housing taxation and subsidies: international comparisons and the options for reform," JRF Housing Market Taskforce programme paper

Thus far, this has not gained much traction. But assuming that more development in line with what market signals indicate is something we should support (and the current housing crisis indicates this is the case), recycling planning gain helps create wider benefits. The Coalition announcing 25% of CIL should go to local people if they use neighbourhood planning, (a form of sub-local authority planning created by the Coalition) indicates that this argument is gaining traction.

On the specifics of Section 106 and CIL, they have the advantage of incumbency, in that councils are used to them. However Section 106 has been criticised as creating additional costs due to lengthy negotiations, bureaucracy, and a lack of transparency. CIL has been criticised as being too blunt and not varied enough to cope with differential land values. Section 106 and CIL may lead to market concentration as legislative complexity provides an advantage to larger developers, and uncertainty in obtaining planning permission. In particular, Section 106 requires lengthy negotiations, which both create an atmosphere of uncertainty and which adds to costs. The fact these take place behind closed doors also is unhelpful in that local people may feel excluded from the development process.

Section 106 and CIL do not capture wider area effects due to development but only focus on the immediate land. The 1973 Compensation Act allows local residents negatively impacted by public works to receive compensation, but there is no equivalent for gains in property values.[47] This may lead to an under-provision of infrastructure with the net effect of reducing overall infrastructure investment. As a knock-on effect, this may lower economic growth. It might also create difficulties in approving new development, a problem that the New Homes Bonus, a mechanism explained later on, tries to address.

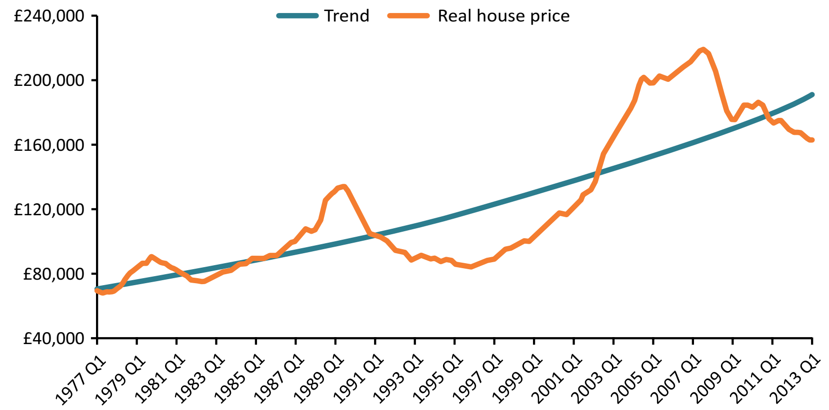
In this context, Section 106 and CIL appear to score badly. They do not appear to have reduced the political difficulties around new development, nor do they manage to effectively capture the wider gains of development. It is crucial to note a trade-off exists between the two objectives of increasing support for development and the government capturing wider gains from development. The more government captures land value increases due to attractive new development or infrastructure the less benefit goes to local residents. Given that most people move into an area because they like it, and the well documented phenomena of loss aversion, the default position of many will be that of 'no change'. So the more planning gain goes to central or local government not local people, the less it will reduce NIMBYism amongst those who live near to the proposed homes.

2.6 House price volatility and rises are not due to taxation failures

It cannot be the case a lack of taxation on property or land creates house price volatility or higher prices. But if the system is already volatile or pushing prices up, many argue a land or property tax may alleviate this. As can be seen in the graph below, the cost of housing has risen steadily over time, as well as becoming far more volatile. This is the 'real cost', i.e. adjusted for inflation, but the nominal value of house prices would be even more volatile.

47 Barker Review, Box 6.4, p119

Figure 2: Real UK house prices 1977–2013[48]



It is important to understand why house prices can rise rapidly and become volatile. If house prices rise, this is either due to construction costs or the cost of land with planning permission rising. If it is the cost of construction, little can be done. Such a rise is like a rise in the cost of petrol or food. It should at some stage be reversed given the market economy's general tendency toward greater productivity. In any case, it is unlikely that this would cause a great deal of volatility. However, in the UK, rising house prices are a result of rising land prices far more than rising costs of construction, particularly in high demand areas. The fact that land has become very expensive for residential purposes is shown in the table below. The very high cost of residential land with no housing on it is reflective of the fact all residential land has risen in value, including the value of land underneath the existing housing stock.

Table 6: Per hectare land values for different uses in different areas[49]

	Residential	Industrial	Arable
Oxford	4,000,000	1,000,000	20,995 (Oxfordshire)
Plymouth	1,500,000	400,000	19,143 (Devon)
Medway Towns	1,400,000	850,000	20,748 (Kent)
Cambridge	2,900,000	740,000	18,525 (Cambridgeshire)
Leicester	1,580,000	400,000	20,995 (Leicestershire)
Edinburgh	2,200,000	750,000	17,784 (East Lothian)
Aberdeen	2,100,000	1,000,000	16,055 (Grampian/Aberdeen)

In a functioning land and development market, house prices will be close to the cost of construction, and land value will not vary by use. Except for a handful of cases (e.g. prime central London) land will be roughly the same value across different parts of the country and for different uses. A field of land for agricultural use outside London will have the same value as a site with industrial planning permission outside Newcastle. If the market is dysfunctional or is unable to function properly, large and volatile price

48 Nationwide, *House Prices Adjusted for Inflation*, available at their website

49 VOA Property Market Report June (DQ) 2011,

differences will emerge. There is no reason that land is intrinsically more or less valuable. It is only the use to which land can be put that determines this. And in a normal market, as the price of land for one use rises, more land will switch to this use, bringing the price back down again. If this cannot happen, large gaps in price will occur.

It is important to note only around 9% of England, by far the most heavily populated part of the UK has been developed, so rising land and house prices are not due to a shortage of land in general.[50] Moreover, if there was a general shortage of land then *all* land would be expensive, regardless of its use. As the table shows, agricultural land is very cheap. The huge variations are the result of a failed planning system, which makes land supply moving between purposes very inelastic, as a range of studies have shown, particularly the Barker Review in the mid-2000s.[51] It is this limited and inelastic supply of land that creates both high prices and high volatility of our housing market. If housing was merely related to what it cost to build, house prices would be low and stable.

"It is the rising price of land with planning permission that is behind rising house prices, not rising construction costs"

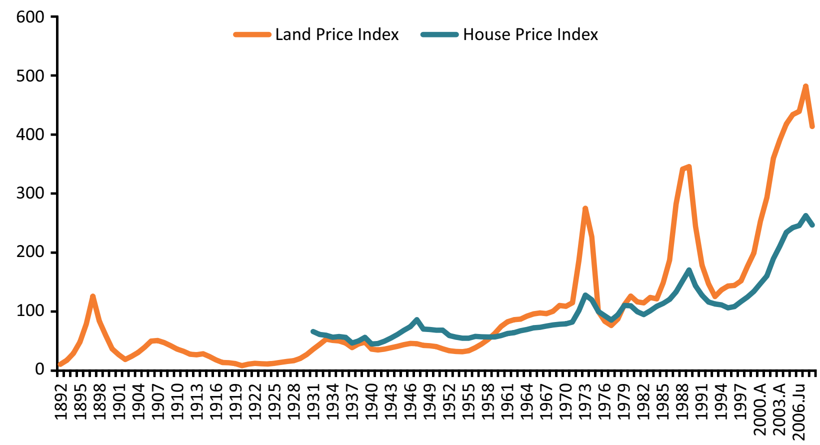
House prices would also not normally rise and become more inelastic (and so more volatile) simply because demand rises. Those who argue this are failing to understand basic economic principles. The fact there are more people in the UK, or more dual income households, or rising incomes, or older people living longer in large family homes all increase demand for almost all goods, from clothing to cars. But clothes and cars do not get more and more expensive in real terms but fall in price as their markets (broadly) function reasonably well. As demand increases, so does supply, containing any rise in price. What is different about the housing market is that the planning system does not respond by releasing more land (or even manage to increase the density of housing in existing urban areas in a politically acceptable fashion).

The value of land with a specific planning permission is essentially the value of planning permission, as land has no value except the uses to which it can be put. The value of residential planning permission has steadily risen since the 1947 Town and Country Planning Act began to have an impact. From the mid-1950s onwards as incomes rose and demand for space grew, land prices began to rise at a rapid rate as the planning system did not match this need for more residential land. The graph below shows how we have failed to release enough land over decades, resulting in a rise in constant prices (e.g. real terms). The three spikes in land prices in recent decades link to surges in house prices at these times. The general contrast between land priced before World War II, where land and house prices fluctuated at a lower level but did not consistently rise, and after World War II, where they have steadily risen, and fluctuations have got even higher, should be clear. Thus rising land values are in no way inevitable. They are largely related to the planning system we created after 1947. Given the earlier discussions about the costs of construction not rising consistently, it is the rising price of land with planning permission (including land existing homes sits on) that is behind rising house prices, not rising construction costs.

50 *Countryside Survey: Final Report—the new UK Land Cover Map*, Centre for Ecology and Hydrology, July 2011.

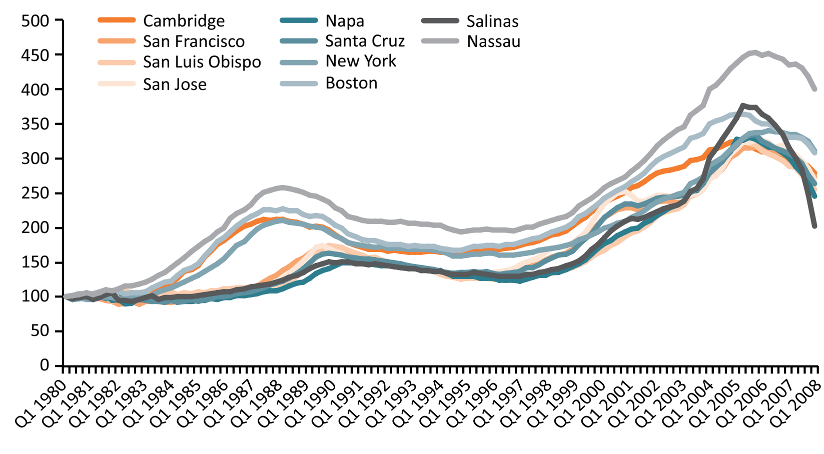
51 Barker Review (both interim and final report...)

Figure 3: Residential land and house prices at constant prices[52]



Further evidence of the importance of planning is given in the two indexes below. As can be shown, despite talk of a US bubble, the US housing bubble was massively located on the coastal states, where planning restrictions are far more prevalent, as academics such as Ed Glaeser discuss.[53] The two graphs below show how areas with the most volatile markets, which also saw very rapid rises (and then falls), are cities on the coastal states. Meanwhile those cities with low house price inflation and volatility were either areas with weak economies, or else liberal planning systems. Dallas, for example, was a flourishing city from 1980–2008, but liberal land use prevented housing costs from spiralling and housing volatility emerging.

Figure 4: Inflation-adjusted OFHEO housing price indexes – ten most volatile markets (of 147 w. data)[54]

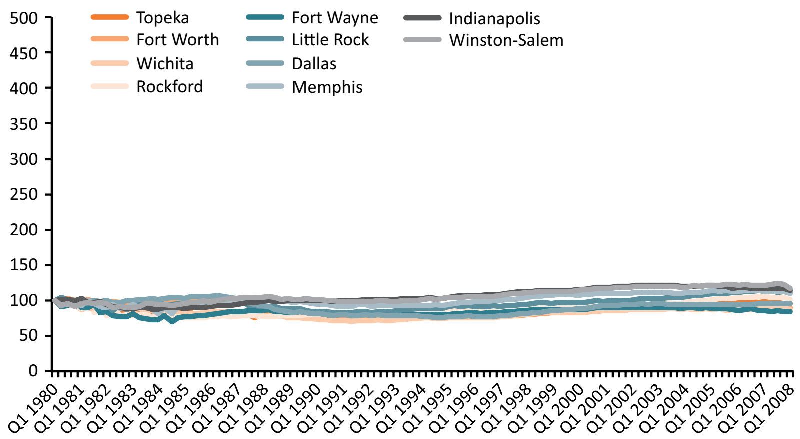


52 SERC *Policy Paper 4: Urban Containment, Housing Affordability and Price Stability – Irreconcilable Goals*, Cheshire, SERC and LSE, 2009

53 See for example *Rethinking Federal Housing Policy*, Ed Glaeser, 2008

54 Both Figure 4 and Figure 5 use data from the Federal Housing Finance Agency; *100 Largest Metropolitan Statistical Areas*, available at the http://www.fhfa.gov web page

Figure 5: Inflation-adjusted OFHEO housing price indexes – ten least volatile markets (of 147 w. data)



Planning is not the only factor in rising land prices. There is also the issue of credit, which exacerbates land price volatility. Land purchased on the open market is related to homes built for sale, not for rent. In the UK, rents too have risen over time. But prices rise faster in most cases, as these two factors interact in a particularly unhealthy fashion. People try to purchase housing to escape rising rents, pushing up house prices, which banks respond to by increasing credit and mortgage lending, increasing house prices. This makes others worry they will be unable to buy and be trapped with rising rents, and makes them try to get on the property ladder even if this is not sensible. Thus as rents rise, house prices rise as well, but in a more volatile fashion, often moving ahead of rents and falling back.

Despite the fact higher house prices are either unsustainable or reflect higher housing costs, the UK economy has become dependent on an illusory feel-good factor from house prices to support higher consumption. In reality, such housing 'wealth' can only be realised if the owner moves to cheaper housing. Government exacerbates house price volatility via policies like low interest rates, intervention in mortgage markets and other similar expansionary credit policies. These confirm the idea housing is a one-way bet, making overall increases and volatility higher, and damaging the wider economy, as high levels of household indebtedness increases macroeconomic instability.[55]

It is these issues of planning and credit that are responsible for the high and volatile cost of housing. Taxation is by its very nature a second best. It cannot tackle the causes of the problem but is an attempt to fix the problem while avoiding dealing with the underlying issues. Housing volatility in other countries does not appear to be resolved by taxation. A JRF report notes, "*Taxation is another possible tool for reducing housing market volatility. However, tax changes are likely to be contentious, and the evidence base from other countries is not conclusive*".[56] By fixing the underlying issues that cause housing costs to be high and volatile (i.e. planning and credit), this would also fix many other issues, such as increasing housing wealth inequality, limited geographical mobility, over-crowding, government spending on housing benefit and much else beyond the scope of this report.

55 Sutherland, D. and Hoeller, P. 2012. "Debt and Macroeconomic Stability: An Overview of the Literature and Some Empirics," OECD Economics Department Working Paper No. 1006. See p55 in particular.

56 *Tackling Housing Market Volatility in the UK*, Joseph Rowntree Foundation, 2011

2.7 MIRAS: UK specific evidence that taxation effects are limited

Those who support taxation of property or land accept lack of such taxation is not the cause of house price volatility. Such volatility is related to failures within the credit and planning system. But they argue that land and property taxation can reverse these effects and manage to stabilise house prices. However, as noted, the evidence from other countries on taxation of property leading to reductions in volatility is inconclusive, and we will examine again briefly later on how different tax regimes in other countries can coincide with different rates of house price rises and volatility.

The UK's recent historical experience also appears to indicate taxation and subsidies in the housing market are less important than the overall housing market framework. The UK used to have a subsidy for home-owners that was termed Mortgage Interest Relief, but was also widely termed MIRAS (Mortgage Interest Relief At Source) as this was the system that dealt with standard rate taxpayers. In 1990/1991 MIRAS was worth £7.7 billion in 1990–1991 prices and went to 10 million households, worth an average of £770 to each household.[57] The average property was worth £28,885 at the start of 1991. So in 1990/1 MIRAS was worth roughly 3% of the value of an average property.[58] Economic theory predicts this should be capitalised into house prices, and with a discount rate of 5% and no other assumptions, this subsidy would be worth over £11,000 in the lifetime of a 25 year mortgage. This is nearly 40% of the average property's value.

Over the following decade MIRAS was substantially reduced and finally abolished in 2000. If taxation of land and property alone would seriously reduce demand and volatility in the UK, the abolition of the MIRAS subsidy should have had the same effect. Similarly, if taxation has only a limited effect, the abolition of MIRAS would only have a marginal effect. In Britain from 1990 to 2000 house prices rose from an average of £59,785 to £101,550, a rise of 71%. They continued to rise after MIRAS's abolition, more than doubling to £223,765 by 2008.[59] The removal of a subsidy to homeownership worth some 3% of average values did not stabilise the system.

This is not to argue removing MIRAS was a bad idea. Retaining MIRAS would likely have increased prices yet faster, and made the system even more volatile. But the claim of those supporting land and property taxation is that they can have a major impact, and that they can seriously alleviate house price rises and volatility. That the abolition of a subsidy worth 3% of the average property each and every year, and £7.7 billion in 1990/1, the equivalent of creating an annual tax on property worth £14.7 billion now,[60] did not prevent a near quadrupling of prices, indicates that issues around planning and credit would almost certainly outweigh even serious rises in land and property taxation. To stabilise the system would appear to require action on these underlying causes, or else possibly a level of land and property taxation that is simply politically impossible. (For example, a 20% a year annual tax on property would almost certainly stabilise the housing market to a much greater degree, but it is clearly politically completely unacceptable).

57 *Table 105: Mortgage Interest Tax Relief,* UK Housing Review 2004/5, University of York

58 *UK House Prices from 1952, Nationwide*, available at their website

59 *Table 502 Housing market: house prices from 1930, annual house price inflation, United Kingdom, from 1970*, DCLG, available at the Gov.uk website

60 Calculated using the Bank of England's Inflation Calculator converting 1990 to 2012 prices

3

Possible Advantages and Disadvantages of Land and Property Taxes

3.1 Property taxation on ownership or occupancy

One economic argument in favour of property taxes is they are less distortionary than most other taxes. There is some variation in economic efficiency across different forms of property taxes (e.g. taxing land vs. land and improvements), but compared to the wide array of other taxes, property taxes tend to affect people's economic decisions less than other taxes. This case is strengthened in countries with severely constrained housing supplies, as in the UK.[61] Constrained housing supply refers to a situation where supply does not respond to higher prices by increasing quantity and, in the face of rising demand, merely results in higher prices, as discussed earlier.

Whereas a higher rate of tax on income or capital may reduce hard work or risk-taking, a higher tax on land does not have a similar negative impact. Landowners need little exertion to collect rent from land, or even property in general. Tenants must be found, and if property is taxed it must be noted that improving and maintaining a building takes effort and money. But a tax on land has fewer economic impacts than most taxes. The more land takes up as a share of property values the greater the arguments for the taxation of property become. The converse is also true. The more the value of property is just construction costs, the weaker the arguments for taxing it become. So if housing costs are closer to the cost of construction the weaker arguments around property taxation become.

Some have argued higher property taxation compared to higher taxes elsewhere allows for greater economic growth.[62] A 2010 OECD report argued taxes on property are more conducive to economic growth than other taxes.[63] An IMF working paper looking at twenty years of data for sixty-nine countries found shifting taxes from income onto property is associated with higher economic growth. This assumes that higher property taxation is offset by cuts to other growth-restricting taxes (e.g. income tax). The positive in this situation is rebalancing taxes, not an increase in net taxation. Of course, the UK already has the highest level of taxation on property in the developed world.

A second advantage of using property as a tax base is that it provides an immobile tax base that is difficult to conceal. Many taxes can be partially or completely avoided, which can lead to perverse outcomes and mean higher

61 Making Housing Affordable: A new vision of housing policy, Morton (2010)

62 See OECD. (2010) "Tax Policy Reform and Economic Growth," Tax Policy Study No. 20 or Tax policy for economic recovery and growth, Arnold et al. (2011)

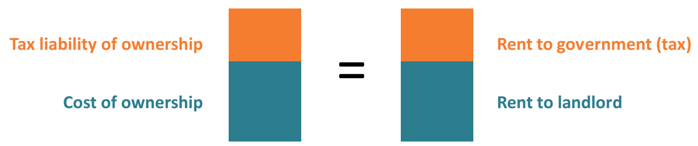
63 OECD 2010."Tax Policy Reform and Economic Growth," OECD Tax Policy Studies #20

revenues from more easily collected revenue sources, often at the cost of economic efficiency. Since property assets are easily observed and immovable, property taxation largely avoids the above complications, and would be reasonably cheap to collect. However, the UK's tax system is already moderately low-cost, with administrative costs at around £1.13 for every £100 raised, so any savings are unlikely to be huge.[64]

A potential political difficulty is as any property tax rate is raised, the price of owning a home falls. To understand how this works, imagine you are contemplating purchasing a house worth £200,000. Let us assume for the sake of simplicity that the discount rate is 5% and the ownership will stay in your family forever.[65] Now, if you know that you will be responsible for paying a tax of 0.5% each year on this property, you will take this into account when buying the property, as the tax is an additional cost of ownership on top of maintenance and other costs. A 0.5% annual tax drives down the house's value to you by roughly 9.1%, or around £18,000, as you incorporate the additional costs of the tax into the market value.[66] The value of the property is still £200,000, but as the owner has to pay tax every year to government the amount they are prepared to pay for it is £182,000, because purchasing the property entails taking on a tax liability worth £18,000. While the seller has lost out, there is no corresponding gain to the buyer. The buyer will have to pay as much in housing costs once they own the property, but some of this will go to the government rather than to the owner.

Theoretically, annual rental values and capital values are directly linked. In reality, the discounted stream of annual rents does not equal the capital value, but there is a reasonable relationship between the two.[67] The new tax may result in a nominal discrepancy between the capital value and rental value. However, this depends if the system assigns the tax to the renter or owner. If it goes through the landlord, they will pay the tax out of the rents they receive, earning less rent for themselves but keeping the cost of the rent to the renter unchanged. So the nominal value of the rent and cost of home ownership will appear to diverge if the renter pays the tax directly, but this is a financial illusion. Taxes are best thought of as an additional rent, albeit one that goes to government, which reduces the value of ownership, pushing it down without pushing rents down.

Figure 6: The rent may appear higher than the cost of ownership



Despite economic advantages around taxing land (including land values within property), annual property taxes have significant political and equity drawbacks. The single most intractable problem with property taxation is that it is one of the few taxes levied by a large bill each month and which forms a clearly payable sum over any particular year. The fact that council tax is spread over ten months rather than a single annual charge does not appear to make

64 *Dimensions of Tax Design*, The Mirlees Review, 2011

65 Discounting means that money or income in the future is worth less than it would be today. All other things being equal you would prefer to have £1 today than £1 tomorrow. This is why most people require interest to save. The rate of interest should be roughly equal to people's time preference (e.g. if most people require £1.05 next year to be as happy as £1 today the interest rate will be £1.05 and their discount rate is 5%).

66 This is calculated by subtracting the sum of the tax rate multiplied by the discount rate into the future. E.g. the first year's payment is £1,000 or (£200,000 * 0.05), the second year is £950 (£200,000 * 0.05 * 0.05), the third year is £902.50 (£200,000 * 0.05 * 0.052) the fourth year is £857 (£200,000 * 0.05 * 0.053 and so on until the taxable value converges towards zero. The sum of all these future taxes is then subtracted from the property value in the present day.

67 For a discussion on why even theoretically, capital values are not equal to the discounted stream of net annual rental values, see *Rental value versus capital value: alternative bases for the property tax*, McCluskey et al. (2008), op. cit., p10. As well as issues in this paper, in reality house prices are based on *expected* rental stream, interest rate and discount rate, which all vary hugely by individual, and reflect different preferences, and also diverge widely from expected values over time, meaning house prices are often out of line with rents.

much difference to its general unpopularity. Less visible taxes, such as VAT or income tax, engender far less public resistance, despite making up a much larger proportion of the government's tax take. For example, two polls for the Tax Payer's Alliance in 2006 and 2007 found that council tax was the most unpopular tax and the one the most people would like to see reduced. Yet at around £25 billion it is less than 5% of the total revenue of £586 billion raised by government in 2012/13, and compares to over £100 billion in VAT, an even more regressive tax, and over £150 billion in income tax.[68] Most people don't know how much they pay in income tax or VAT each year, but they do know their annual council tax bill.

"It is a truism that no one likes to pay taxes, but the means of collection is as important to public sentiment as the amount owed"

Finally it has been listed as an advantage that other forms of tax can result in changed behaviour, (e.g. reduce hours for income tax, avoiding buying heavily taxed items to avoid consumption taxes) and housing taxation cannot easily do so (the only way to avoid the tax is to move). However, this visibility and difficulty in escaping taxation combine to make it politically difficult. For example, consider the charged debates around gentrification, which are seen as changing areas from one group to another. If gentrification were to go hand in hand with higher taxation it would be even more controversial. It is a paradox that a policy that is pushed largely by the left of British politics would result in those with low incomes in areas of London that are becoming more expensive having to either pay a very large increase in taxation or move. This would be a very difficult aspect for any government to justify, particularly a Labour government.

The politics in this area is a clear violation of Colbert's famous dictum that taxation's goal is to pluck the most feathers from a goose while provoking the least hissing. It is a truism that no one likes to pay taxes, but the means of collection is as important to public sentiment as the amount owed. Recent evidence from the US demonstrates the importance of visibility on property taxation levels by demonstrating that areas with lower levels of property tax salience have higher tax rates.[69] These results may apply to an even greater extent in the UK, where the majority of tax revenue comes from low visibility taxes such as PAYE, NIC, and VAT. Any tax on land or property must take the form of a large bill, a major reason for the political problems it creates. While VAT or income tax are parts of a transaction, and the cost can be hidden within that, property or land levies are necessarily unrelated to any transaction. This may be more honest, but it also seems to make it less popular.

Another problem afflicting all forms of taxation is the way a tax relates to income and capacity to pay. Property taxation attempts to tax, either directly or indirectly, the imputed rental value of a property or the rental value on the open market.[70] But some households are 'asset rich, cash poor' individuals, such as those living in high-value housing with little to no income. The Lyons review found a small but significant number of low income households living in more valuable properties. Of these, around half were pensioners. This is a politically significant group who have made decisions in the present regulatory environment and would be negatively impacted by any new tax. In theory, this could be solved by simply delaying the cost of property taxation and making it part of IHT. The

68 *Budget 2013*, HM Treasury, 2013

69 Cabral, M.and Hoxby, C. 2012. "The hated property tax – salience, tax rates, and tax revolts," NBER Working Paper No. 18514

70 As remarked earlier, rental value and capital value should align when the property is put to its best (i.e. most highly valued) use; hence, taxing capital value or rental value can be thought to be roughly equivalent.

unpopularity of IHT, given that only 22% believe it should apply to those who are not rich, makes this more difficult in reality than on paper. Again, low income households who might have to move are being unfairly impacted by policy errors that have driven up land values, victims just as much as those who cannot afford a home that suits their needs.

A final point relates to the major difficulties of revaluation in England of existing properties. The greater the gap between revaluations, the more a property's value will change on revaluation. More frequent revaluations may reduce the number and cost of appeals, but this also increases the salience of a politically unpopular process. In the absence of revaluation, the advantages of a land and property tax weaken over time. If it is impossible to revalue properties regularly, the advantages of a land or property tax weaken. It is easy to say that this process of revaluation in the UK should be easier, but in reality a move to more regular revaluation would be a brave political step.

3.2 The size of the land and property tax base

If the government were to try to overhaul the current system it would need to work out the size of the tax base it was trying to capture. The property taxes discussed in Chapter 1 raised £64.3bn in 2011–12, excluding Section 106 and CIL and including capital gains tax on non-property assets. They accounted for just under 11.3% of government revenue.[71] Major reform that tried to expand this would have to work out how this would tax the large tax base constituted by UK land and property.

Unfortunately with the available information Policy Exchange has found it very hard to obtain an accurate figure for the capital value of land and property in the UK and so the size of the tax base, particularly of land without improvements. According to Savills, the capital value of the British property market is worth almost £6 trillion. Residential, commercial, and agricultural properties are worth £5tn, £717bn, and £250bn, respectively.[72] Residential property makes up 83% of the total value of the property in the UK. Separating out the value of improvements and land is difficult, but the balance sheet approach utilised by a recent RICS report offers a place to start. Residential property is valued at £3.9tn while the depreciated value of dwellings excluding land is £873bn.[73] This means around 22% of property value comes from the value of improvements and 78%, or £3tn, comes from the value of land. If these proportions apply to the Savills figure, land is worth £4 trillion, with the dwellings that sit on top of them worth around £1 trillion.

Another way to estimate this is that the average cost of constructing new housing is roughly £100,000 in the South East.[74] To extend an average value to the entire housing stock, much of which will be substantially depreciated and not located in the more expensive South East, we reduce this new build figure by 25% to £75,000. With 27m dwellings in the housing stock, structures contribute roughly £2.25tn to the £5tn residential property market.[75] The residual £2.75tn is the value of land, contributing 55% of total value. This is quite different from the figures above.

There is considerable uncertainty with these estimates. It is impossible to state the value of land in the UK with any real confidence without a more comprehensive assessment by government. This in turn makes it difficult to

71 See earlier references in chapter 1 and simply sum the taxes raised.

72 www.miac-acadametrics.co.uk/userfiles/file/MIACAcadametrics WebsiteHouse PriceArticle.pdf

73 RICS. 2012. "Property In The Economy 2012." RICS Research

74 Leunig, T. 2011. "Community land auctions: working towards implementation"

75 DCLG Region and Country Profiles – Environment, October 2012

recommend major changes, as any attempt to do so is necessarily using very wide ranging estimates with high chances of error. The more fundamental the reform, the more important it would be to have accurate broad figures to make any recommendations. To give one example of how this can make the politics more difficult, the poll tax originally was designed to lower the average bill, but due to economic difficulties and errors in implementation, led to higher bills for most people, making an already controversial reform impossible.[76]

76 See the Memoirs of those involved, e.g. Thatcher's *The Downing Street Years*

4

Major Recent Suggestions for Reform and Issues They Raise

4.1 Updating council tax

The previous government-commissioned *Lyons Inquiry into Local Government*,[77] a 2012 Joseph Rowntree Foundation report,[78] and the 2013 London Finance Commission report *Raising the Capital* all argued for an updating of the council tax and its bands.[79] In addition, there have been calls (e.g. in Lyons) for an increase in the number of bands to deal with the issue council tax bands level off at a low rate, meaning higher value properties are taxed very lightly as a share of value. In Wales an extra band was added at the time of the last revaluation, so Wales has bands A–I versus England's A–H.

A revaluation of the taxation could update the property value roll, reset the price bands to reflect the present distribution of housing values, and reassess the inter-band multipliers. For the medium-term, the three reports above argued for a more regular revaluation schedule to avoid large changes in tax liabilities. Revaluation involves updating the bands set at implementation.[80] Since 1991 there have been major shifts in the UK housing market, with some regions, areas and housing types rising faster than others. Again, current large shifts in housing value results from our dysfunctional housing market, not an inevitable element of any system. Demand might differ by regions, but a functioning market would account for this by releasing more land and densification of existing areas, keeping both the cost of housing and housing land stable and low.

Even if most properties moved up a band and the bands were not revalued, the majority of owners or renters might pay less than before.[81] As a simplistic example, take three properties: two in Band A and one in Band D. Assume the two Band A properties are upgraded to Band B while the Band D property moves one band to Band E. Assume bands, multipliers, and total local government expenditure are unchanged. Band A pays 67% of the Band D liability, Band B 78%, and Band E 122%. After the change the two Band B properties pay less than they did before revaluation *even though they both moved up a band*.[82] Note the multipliers did not change for this to happen. If the multipliers move this might be even more redistributive, or it could reverse this redistributive effect. This is because the multipliers are not entirely proportionate, so the move from Band D to E raised more than the move from A to B.

Politically, the difficulty is that revaluating the housing stock after such a long spell without any revaluations would face substantial political resistance. The

77 *The Lyons Inquiry into Local Government Final Report*, HMSO, 2007

78 Stephens, M. and Williams, P. 2012. "Tackling housing market volatility in the UK: a progress report," JRF

79 *Raising the Capital*, Greater London Authority, 2013

80 A New Tax for Local Government: a Consultation Paper (1991), op. cit.

81 For instance, the multipliers between bands may be revised such that more of the burden is borne by higher value properties.

82 A more detailed exposition follows. x is Band D liability. Given the relative weights, before revaluation:
Revenue raised = $2 \cdot 0.67 \cdot x + 1 \cdot x = 2.34 \cdot x$
After revaluation y is the new Band D liability. This must raise the same amount of revenue, which means:
Revenue raised = $2 \cdot 0.78 \cdot y + 1.22 \cdot y = 2.78 \cdot y$
AND SO $2.34 \cdot x = 2.78 \cdot y$
As total government expenditure is unchanged, if x=1 then y=0.84
Assuming the tax take has not risen then the tax liability has shifted as shown below:
band A ($1 \cdot 0.67 = 0.67$)but band B($0.84 \cdot 0.78 = 0.655$)
band D ($1 \cdot 1 = 1$) but band E ($0.84 \cdot 1.22 = 1.02$)
If band D was £1 and band A 67p initially, after revaluation then band E would be £1.02 and band B 65.5p. The liability has moved for the Band A now B properties downward, while for the Band D now E property upward.

housing value mix has changed substantially since the early 90s and to recalibrate the tax share so abruptly would be unwelcome. There may be a mistaken belief that higher house prices today mean higher taxes. In the run up to revaluation some of the general public may believe local government will use changes in tax liability to disguise a tax rise. Politically those who oppose any change will use such confusion to their benefit. It is naïve to imagine they would be quiet to help facilitate a policy they oppose. The last English revaluation was scrapped and there has been little interest in conducting one since. There are strong reasons politicians have evaded revaluation for so long, even if these are not based on solid policy grounds, but rather fear of political damage (particularly prompted by the memory of the poll tax). Whether a revaluation will lead to a more or equally redistributive system depends upon how the bands and multipliers are adjusted. If reforms reduce most people's tax bills this might help politically (though this benefit would only be clear after the process is complete).

There are issues around those who have benefitted from house price inflation yet have not seen their incomes rise. The Lyons Review made (among others), the point the failure to revalue properties means those who live in properties that have gone up less than the average subsidise this group. Due to the failure to revalue properties, someone living in a valuable house in the North of England is likely to be paying more into the current system. This will benefit someone living in a valuable house in London, who is paying less. Someone who owned a large house in London in 1991 will have seen it soar in value since, even if their wages have not. These households have gained wealth without exerting any effort. The problem is taxing these households in more valuable properties on non-realised gains, gains that arose from bad policymaking is likely to lead to (justified) resentment. These households cannot be blamed for their situation and in the short term may not even benefit from the rise in their potential wealth. This makes it politically difficult.

4.2 Uniform property tax

The uniform property tax is one of the most widely used forms of property tax and is advocated by a JRF report as the preferred longer term reform.[83] It taxes the capital value of land and improvements at the same rate, e.g. a 1% tax on a house worth £100,000 pays £1,000. In effect, the tax falls upon the overall market value of the property. Britain formerly had a similar tax in the Domestic Rates, which was a proportional tax on the annual rental value of land and improvements.[84] This could either take the form of a revised council tax, where the rate was set at a local level, or a national uniform property tax, where it would be set at a national level.

A uniform property tax based on capital (i.e. market) values would likely be more redistributive than the existing council tax regime. If it was merely applied to the same tax base, (i.e. domestic property) it would raise a similar amount of revenue, but would mean that more valuable properties would pay the same rate of tax, allowing a reduction in tax bills in less valuable properties. This would be a major advantage in the eyes of those who support a more redistributive tax system. Regular revaluations, and hence higher administrative costs, would be necessary to maintain the tax and ensure that increases in the value of property were accommodated. However, if a truly uniform property tax

83 Stephens and Williams (2012), op. cit.

84 Ridge, M, and Smith, S. 1990. "Local government finance: the 1990 reforms." IFS

was applied (i.e. to both residential *and* commercial properties) this would dilute the redistributive impact of such reform. As discussed earlier, business rates and council taxes currently raise roughly the same amount, despite the fact there are far fewer commercial properties, resulting in the average commercial business rates bill being ten times the average council tax bill. A true uniform property tax would hugely reduce property taxation on business and correspondingly, hugely increase the value of taxation on residential property. This would mean that almost all households would not gain and many would directly lose out from such reform. Though over time the effects would be more complex, as consumers would share with landlords the reduced costs for businesses (allowing landlords higher rents), this would be both indirect and partial.

Since the tax would also be collected in the same highly visible manner as council tax (e.g. receiving a specific bill), uniform property taxes suffer many of the same issues as council tax. The visible and distinct nature of the tax means it is likely to be very unpopular.

Perhaps most difficult of all, any property tax based on a percentage of market value would almost certainly create strong pressure for an overhaul of the existing local government financing arrangement. There is sometimes a misconception that as council taxes are regressive, poorer areas pay less than richer ones. This is false. In reality, "*some areas rely on central government for 75 per cent of their total budget: other areas which collect more council tax and are more self-sufficient only rely on government grants for 20 per cent of their budget*" while from the central government pot of pooled funds "*each dwelling in Hackney still receives £3,050, while dwellings in Windsor and Maidenhead receive only £1,544*".[85]

> "Perhaps most difficult of all, any property tax based on a percentage of market value would almost certainly create strong pressure for an overhaul of the existing local government financing arrangement"

This is an important and critical point to understand. The average Band D property will pay more in affluent areas in order to get the council services that they do because central government has decided that different councils will receive different levels of per capita funding. A more level funding arrangement would reduce the levels of tax required in affluent areas. This principle is accepted by Conservatives and other free marketeers in part because it is seen as fair, in part because council tax is seen as a less progressive tax, but also in part because the area of property taxation is a difficult compromise that all parties are signed up to. A move to a uniform property tax would mean affluent areas would raise even more revenue than at present, and poorer areas even less. This very large increase in taxation of more valuable properties would open the issue of redistribution up. Tories representing more affluent areas, and who believe Labour councils are largely profligate are likely to react by promising their constituents greater localisation and less redistribution at a national level. This allows a reduction in their levels of tax at the cost of higher taxes in poorer areas.

A national level uniform property tax would further exacerbate the need to redistribute revenues from richer to poorer areas. But even a uniform property tax at a local level would have a huge impact by changing the levels of taxation many households face. A left-wing government might shift to a uniform property tax, but a right-wing government would face pressure to reduce redistribution

85 *A Plain English Guide to the Local Government Finance Settlement for 2012–13*, DCLG, 2011

between councils. The idea that revenue is separate from expenditure is false. The two are intimately connected. It was concerns over expenditure that led to the ill-fated community charge. There is almost no way that a shift in taxation to more valuable properties would not result in political pressure within the Conservative party to reduce revenue redistribution.

4.3 Land value tax

A land value tax is a tax on the benefits or rents arising exclusively from the land and was suggested as a possible reform by Sir Winston Churchill early in his political career as a radical Liberal working with Lloyd George. There continue to be large minorities within the Liberal Democrats and Labour parties in favour of introducing such a tax, and it is official Green party policy.[86] It was the basis of a major movement in the 19th century called the 'Georgists', named after the work of Henry George, a US economist whose work Progress and Poverty argued for a huge reduction in other taxes and their replacement by a land tax.

Land values arise from the advantageousness of location. If two identical semi-detached houses are built in the same area, but one is next to a park while the other is not, the one by the park will have a higher selling and renting prices. The difference results from its higher land value, in turn caused by the proximity to a particular amenity, in this case the park.

There is a limited amount of sales or rental data on vacant land transactions. This has been cited as a major drawback of a tax based on land value. But the data limitations noted in the previous chapter should not be insurmountable as several countries, including Australia and some states in the United States, have annually or bi-annually updated valuation rolls with the value of land and improvements calculated separately. This indicates there are no technical reasons that make a land tax impossible.

Technicalities may be surmountable: a more serious problem is politics. Firstly, there is the issue of trying to fine-grain the value of land. The political difficulties associated with land and property taxation seem to be more acute in the UK. For example, trying to explain why the land on one street is worth more the one next to it and the corresponding higher valuations is likely to be difficult. For example, imagine one street is in the catchment area of a popular school and its neighbour is not. An elderly couple may resent paying for proximity to a service that has no value in their eyes but raises the value of their property.

There are also the issues already raised around property taxation. Many people live in appreciating properties without corresponding rises in income. The issue of a land value tax will open up the issues around central and local government and redistribution within the UK. In addition to these recurring issues, a move to land value taxation would result in lower house prices, as capitalisation of the tax into house prices lowers home values. The short-run impact of such change will be substantial and is unlikely to be welcomed by homeowners. Against all these problems, if there was a redistribution of the overall council tax burden through a land value tax, this would probably have the effect of reducing the bill for many households. Those with more valuable homes would pay more and those with less valuable homes would pay less.

There is finally an issue of what council tax pays for. At present, council tax is charged to those who live in a property, *not* who owns the property. It is still

86 www.carolinelucas.com/media/fair,-efficient,-sustainable-new-report-shows-strong-case-for-land-value-tax.html

loosely seen as a charge for services. It is likely a land value tax would change this and make council tax less linked to the idea of particular services and more just a general tax. This may have difficult to predict political impacts.

In the longer term, without reform the planning system will push up prices and our rather unstable monetary system will create boom and busts in land values. As increasing land value will increase tax liability under this proposed change, it seems quite likely that the public will blame the tax, not the planning system and poor monetary policy for its soaring tax bills. In addition, if this is not the case, there would be a perverse incentive for governments to push up land values as they would be a huge source of 'stealth' revenues. By creating a land value tax and relying on it for a serious share of taxes, this would have the effect of discouraging attempts to increase home ownership and reduce housing costs. Given how addicted politicians are to rising house prices, anything that adds to this problem seems to be storing up problems for the future.

4.4 Mansion tax

Included in the Liberal Democrats' 2010 manifesto, the Mansion Tax would charge 1% of property value on all properties worth over £2m. This is would apply to some 70,000 homes.[87] The tax is estimated to raise around £2bn. Such a reform would create a small group of losers. It might be well received as a largely populist measure that only taxes the wealthiest property owners. Valuation costs would also be limited by the relatively small number of properties to value.

There is a problem with a mansion tax that in some locations it would catch potentially small but valuable homes, such as three or four bedroom properties in London, that could not be described as mansions. Whatever the tax was termed, it would be hard to justify catching such properties. Some people paying will not have an income that in any way relates to the value of their property and capacity to pay the tax. As well as the direct losers, other people may be afraid that their property may eventually enter the threshold. There are the cumulative effects of taxing the 'rich' to the point where this may discourage hard work and risk. Those who own such homes have been propelled to a level of nominal wealth due to the failures of policy, and may not want to either move or be able to afford paying the tax. Again – the proliferation of such 'mansions' is the result of poor monetary and planning policy, and those who have to pay may feel justified in resenting having to pay it.

The narrow scope of the measure may make it more politically feasible, but the combination of extremely sparse data on high value property transactions and very high heterogeneity in luxury buildings would mean high collection costs. Existing taxation on wealthy households such as IHT and income tax are cheaper to collect, and already specifically address issues around inequality.

4.5 Recouping CGT on primary residences

According to the HMRC, extending CGT to the primary residence would raise about £9.9 billion before behavioural effects are taken into account.[88] Some have claimed that CGT exemptions on primary residencies are a major driver of our housing-obsessed economy. Consider the following sentence from the Guardian's Polly Toynbee; "*It would be easy to impose capital gains tax on all future rises: that 18% on any inflation in value, only to be paid on selling it, could stop another bubble*".[89]

87 www.bbc.co.uk/news/uk-politics-21745529

88 Estimated costs of the principal tax expenditure and structural reliefs, available at: www.hmrc.gov.uk/statistics/expenditures/table1-5.pdf

89 *Owners must be weaned off the house price drug*, The Guardian, Tuesday 24th 2009

In reality it seems very unlikely that removing CGT would have anything like this effect. If a transaction tax of over £6 billion (stamp duty) does not halt speculation, it is hard to see how another transaction tax of £9 billion (removing CGT) would do this. It probably would have an impact, but most people do not buy their specific property for investment reasons. They hope it will rise in value and invest in it, but they buy their home as somewhere to live. In addition, this assumes that somehow speculation is behind rising house prices (and for that matter rents). But rents and house prices are largely rising in the UK because of the planning system and an excess of credit. The most speculative element of housing, buy-to-let, already sees CGT charged on its properties.

In some countries charging CGT on primary residencies does occur, as in the USA. But this is always done within a system of major exemptions. So in the USA there is an exemption of $250,000 per person and $500,000 for couples. Further, there are exemptions for: moving for work, medical reasons, separation, divorce, the birth of twins, war, terrorism and natural disasters. Trying to charge CGT on primary residences in an acceptable way would create a lengthy set of additions to the tax code and add complexity to an already complex area. Any exemptions may lead to evasion on a very large scale. Since the tax is a one-off, behavioural change is more likely than in areas where a tax falls on an ongoing stream. This would also reduce the amount which any tax would raise.

Politically, is likely that a CGT on principal private residencies would not be well received in a country with a homeownership rate of 64.4% in 2011.[90] CGT was not applied to the 1960s to the main home to avoid controversy at a time when home ownership was just over 43%.[91] This difficulty is even before the politically thorny question of who would be exempt was discussed, which is likely to either lead to very wide exemptions or else groups being disappointed.

Levying CGT on principal private residences may also have a major impact on exacerbating the existing misallocation of housing stock. It would create a disincentive for older homeowners to downsize. A previous Policy Exchange report noted roughly 35% of UK households have at least two spare bedrooms.[92] Recent figures from the government suggest this has not changed, making it difficult to justify a politically challenging reform that decreases incentives to downsize.[93] Given numbers of older households are rising it does not make sense to discourage them from downsizing.

It is also worth pointing out that in a functioning housing market, capital gains would be very limited. There is no reason why general house prices should rise ahead of inflation. (Indeed, assuming gains in construction efficiency, they should rise below inflation.) If this is the case, there would be no real capital gains. It is the inflation of our land market (including land with homes built on them) that creates the existing rapid capital appreciation even where the property has not been improved.

4.6 Altering stamp duty

Stamp duty Land Tax could potentially be reformed in a number of ways, as laid out by the Mirrlees Review. It could be abolished completely, removing an economically harmful transaction tax. Unfortunately, eliminating SDLT would require replacing the £6bn it raises. This is a daunting task in the current fiscal environment. A more simple set of reforms would change SDLT rates from the

90 DCLG Live tables on dwelling stock

91 *Table 801; Household characteristics, tenure trend, from 1918*, DCLG, available on their website, DCLG, available at the Gov.Uk website

92 Morton, A. 2010."Making Housing Affordable: A new vision for housing policy," Policy Exchange.

93 DCLG, English housing survey 2011–12. Available at: www.gov.uk/government/publications/english-housing-survey-2011-to-2012-headline-report

present 'slab' structure to a 'slice' form with higher rates applicable only to the portion of the property's value that exceeds a given threshold, as is the case with income tax.[94] This is happening in Scotland from 2015 onward with the introduction of a new Land and Building Transaction Tax, where the higher rate will only be paid above each threshold, (much like income tax). The proposal there has been broadly supported in principle by all of the main political parties.

In addition, there is a strong case to cut back SDLT to what it was in the past, a low and reasonably small tax that was simple to collect and raised revenue without discouraging mobility. However, while this proposal is sensible, given wider economic difficulties it may not be the first priority, as its positive effects would be small and it could cost money at a time when money was tight.

4.7 Rationalising planning gain

Policy Exchange has previously argued in multiple reports that the current mechanisms on planning gain are confused and overlapping. Replacing Section 106 agreements, which are opaque and inefficient instruments for raising revenue, with the New Homes Bonus (NHB) and CIL would be useful.

As development imposes demands on the existing infrastructure in a locality, additional infrastructure required should be funded through the NHB. The NHB, which is a restructuring of the government grant to councils to take account of new development, should ensure communities can cope with new housing. The NHB should be earmarked for capital spending on infrastructure. The government should monitor and ensure that the NHB can pay for any additional infrastructure as is required. Council tax can then cover projects such as on-going infrastructural maintenance.

With the NHB paying for infrastructure, revenue raised from CIL should be used to provide an incentive for development and should go to local people wherever possible, either through a neighbourhood plan or even devolution to still smaller units. This would help share the benefits of allowing development, and reduce political issues around NIMBYism. It is also the opposite of the reasons CIL and NHB were introduced, but the two are clearly not working as they should (and this point is much more widely discussed in other Policy Exchange reports.)

CIL is now embedding itself within the planning system. A study could be helpful in informing the government post 2015, discussing how far land values are captured by the CIL and what CIL is being spent on, as well as how far local people felt that the CIL was benefitting their area. Policy Exchange has generally argued that site-specific levies are preferable to trying to set out at local authority level the CIL chargeable and there is a danger that in some areas CIL will be too high and others too low, resulting in either community resentment and attempts to block development, or else loss of viability for the developer.

94 Tackling housing market volatility in the UK, op. cit.

5
Overseas Land and Property Taxation

There are different methods of taxing property and we now turn towards wider international experience to examine how other developed countries tax property. We can then summarise the broad themes and current general direction of travel in other developed countries.

5.1 Australia

Property taxes share of GDP: 2.4%

Variation by area: High. Land value or land and improvements may be taxed, while exemptions are wide and varied. Primary residences may be exempt (e.g. Victoria) and in some areas and for certain properties no tax is levied at all (e.g. commercial property in the Australian Capital Territory).

List of taxes: Capital gains/IHT taxed within income taxation system. Capital gains on residential property exemption. GST (similar to VAT) charged at 10% on new homes purchases or land purchases from registered builders.

Other points of interest: Property taxes have seemed to take the blame when house prices fluctuate widely, even when the tax has no causal relation to the volatility. Rapid development and higher price volatility in coastal areas have put the land tax systems of New South Wales and Queensland under pressure and have raised political opposition toward these taxes. Such opposition may have been exacerbated by the higher headline rate of tax on land compared to the rate of tax needed to raise an equivalent amount of revenue using the property as a whole.[95]

5.2 Austria

Property taxes share of GDP: 0.5%

Variation by area: Medium. The basic uniform property tax is supplemented by a local property tax surcharge, which varies substantially.

List of taxes: Austria has a uniform property tax with a basic rate ranging from 0.05% to 0.2% levied at the federal level and local supplementation.[96] Property transactions are taxed by the federal government at 2% for relatives and 3.5% in all other cases. Capital gains on real estate are part of income tax but include exemptions for owner-occupied properties. VAT applies at a reduced rate of 10% on rental properties for residential purposes. There is no tax on inheritance in Austria.

95 A general source in this chapter is *'International Experience'* by R Franzsen in: Land Value Taxation: Theory, Evidence and Practice Dye, Richard F. & Richard W. England (eds), 2009

96 Taxes in Europe Database, Europa

5.3 Belgium

Property taxes share of GDP: 3.1%

Variation by area: Medium. The basic annual property tax is supplemented by a local property surcharge addition, which varies substantially. Inheritance tax also varies by region.

List of taxes: Annual property tax on the annual rental value of property, including a local surcharge. Regional governments set the tax, but rental values are determined by the central government. These values are based on notional 1975 values and are adjusted for inflation. Average tax rates for 2011 are around 45–50%. Capital gains arising from property transactions are taxed at 16.5% if sold within five years of acquisition or eight years in the case of undeveloped land.[97] Inheritance tax is complex and depends on the age of the recipient, relation to the deceased, and the region.

5.4 Canada

Property tax share of GDP: 3.5%

Variation by area: High. Local and provincial authorities administer annual property and property transfer taxes and tax rates and there is high variation between both province and municipalities.

List of taxes: Annual property taxes and property transfer taxes. Capital gains on primary residences are exempted for residents, but non-residents pay 50% as a withholding tax. There is no inheritance tax in Canada.

5.5 Denmark

Property tax share of GDP: 1.9%

Variation by area: Medium. Annual property taxes vary by municipality.

List of taxes: Annual property taxes include the municipal property tax, a municipal tax on land, and the property value tax, which is a tax on land and improvements. The municipal land tax is levied at rates ranging from 1.6% to 3.4%. The average rate in 2009 was 2.4%.[98] Revaluations are conducted centrally every other year. The property value tax levies a 1% tax on properties up to DKK 3.04m and a 3% tax on properties in excess of this value.[99] There is a property transaction tax that functions essentially as a tax on capital gains from property. Properties under 1,400 m^2, both principal residences and second homes, are exempt. Inheritance tax is charged on real estate.

5.6 France

Property tax share of GDP: 3.7%

Variation by area: Medium

List of taxes: Annual property taxation on developed land takes half of the 1978 notional annual rental value of a property as its base.[100] Undeveloped land is taxed separately based on 80% of its 1980 notional annual rental value and local authorities may increase the rate for potential building land. In addition, occupation, including owner occupation, is taxed. Buyers of immovable property must pay for the change in title to be registered. Effectively a transfer tax, principal registration duties charge 5% of the property's market value plus various flat fees.

97 Deloitte. 2012. "Belgium Highlights 2012," Deloitte Global Services Limited

98 PKF. 2012. "Denmark Tax Guide 2012." PKF International and Oxley and Heffner (2010)

99 Deloitte, 2011."Denmark Highlights 2011," Deloitte Global Services Limited

100 doc.impots.gouv.fr/aida2010/brochures_idl2010/lienBrochure.html?ud_027.html

Capital gains on non-owner occupied properties are taxed within the income tax system. A redistributive succession duty is levied on property as part of the net share of the inheritance received.

5.7 Germany

Property tax share of GDP: 0.9%

Variation by area: High. Valuation date and rates for annual property taxation vary by locality. Transfers are taxed at rates differing by region.

List of taxes: Annual property taxation varies by region and municipality both in terms of the valuation date used to generate the notional value and the tax rates. In some cases, this means that values are based on valuations going as far back as 1935. Rates range from 0.26% to 0.35% whereas areas using 1935 notional values have rates ranging from 5% to 10%. Property transactions are taxed using the declared purchase price as the base and taxed at between 3.5% and 5.5% depending on the state. Capital gains on property are taxed unless the property is sold more than 10 years after purchase.[101] Tax on inheritance, as well as on lifetime gifts, is applied to domestic property. Personal exemptions are provided according to the relationship to the grantor and real estate specifically is exempted from tax when transferred to a spouse or registered partner.

5.8 Ireland

Property tax share of GDP: 1.5%

Variation by area: Low. Property taxes are uniform across the country.

List of taxes: On 1 July 2013 the Local Property Tax (LPT) will come into effect in Ireland. Under the Irish annual uniform property tax, each property with a market value less than €1m will be assigned to a band and owners liable for 0.18% of the mid-point value of the assigned band. For properties above €1m, the first €1m is taxed at the 0.18% rate and 0.25% on the value above €1m.[102] Commercial properties are subject to a tax on their annual rental value as assessed by the Valuation Office at a rate set by local government.[103] Transfers of property are taxed at 1% for values below €1m and 2% in excess of this amount. The tax is due from the party that receives the property although transfers to a charity or between spouses are exempted. A capital gains tax of 30% applies to non-primary residences. Inheritance tax is charged at 30% above the applicable tax-free threshold. Business properties enjoy a 90% deduction. VAT may be charged at 23% in some instances on suppliers of land or buildings before first occupation.

5.9 Netherlands

Property tax share of GDP: 1.5%

Variation by area: Medium. Annual property tax rates vary across the country.

List of taxes: The market value of residential and commercial property is taxed annually at rates from 0.0423% to 0.1993%. Property transfers are taxed at 6% of market value, but residential property transfers are taxed at the lower rate of 2%. Transfers made within six months of a previous transaction or VAT charge are exempt. Capital gains from the sale of immovable property and the imputed

101 Oxley and Heffner (2010)

102 www.revenue.ie/en/tax/lpt/faqs.html

103 www.valoff.ie/FAQ.html

income from owner-occupied property are incorporated into Dutch income taxes. VAT is not charged on property. Inheritance is taxed at different rates depending on the value of the estate and the familial proximity to the deceased.

5.10 New Zealand

Property tax share of GDP: 2.2%

Variation by area: High. The annual property tax base and rates are chosen by the local government.

List of taxes: There is no tax on property transfers, general capital gains (some tax may be due on certain kinds of investments), or inheritance.[104] The Goods and Services Tax charges 15% on most types of transactions.

Other points of interest: Local governments may choose their local property tax base. Despite the popularity of land value systems up to 1985, more recently local authorities have begun switching to capital value systems. Whilst it is not clear why this trend has taken hold, some research has noted land value systems are associated with lower mean income and lower total expenditure.[105] This may suggest that increases in mean income and public service provision have played a role in this trend.

Over the past decade, local authorities in New Zealand have switched raising part of their revenue from a uniform annual general charge (UAGC), essentially a set amount charged to each property owner regardless of property value, as well as targeted flat taxes, which charge a flat rate for properties benefitting from specific government services. The UAGC is capped and can make up no more than 30% of the local tax base. The UAGC is quite similar to the UK's Community Charge.[106]

5.11 Norway

Property tax share of GDP: 1.2%

Variation by area: Medium. Local government has discretion around taxing residential, industrial, and commercial property.

List of taxes: Local property is taxed annually at rates varying from 0.2% and 0.7% and this may be levied on various combinations of residential, industrial, and commercial property.[107] Stamp duty of 2.5% is due on property transfers, though cooperatives are exempt. Capital gains, excluding those on owner-occupied housing, are taxed as part of income at 28%. Property may also be taxed under the wealth tax, which charges 1.1% of estates over NOK 750,000 and includes reductions for owner-occupied and rental housing. Inheritance over certain thresholds is taxed at one set of rates for children and another for others. Supply and leasing of immovable property are exempt from VAT.

5.12 Sweden

Property tax share of GDP: 1%

Variation by area: Low.

List of taxes: Residential and commercial properties are taxed annually using fixed charges and capped at a fixed percentage of the assessment value (i.e. roughly 75% of market value) by building type. New housing is exempt for the first five

104 www.newzealandnow.govt.nz/investing-in-nz/rules-law/taxes

105 Property taxation in New Zealand, McCluskey, Grimes, and Timmins (2002), p18

106 Franzsen (2009), p38

107 Denk, O. 2012. "Tax Reform in Norway: A Focus on Capital Taxation," OECD Economics Department Working Papers, No. 950.http://dx.doi.org/10.1787/5k9bls0vpd5d-en

years and taxed at half the regular rate for the next five years. Transfers are taxed at 1.5% for individuals and 4.5% for business entities. Stamp duty is also charged at 2% on mortgages. Net capital income is taxed at a normal rate of 30% and capital gains arising from housing are taxed at a reduced rate of 22%. Payment of this tax may be postponed if the capital is re-invested in other private housing up to a limit of 1.45m SEK. Interest is charged annually at 0.5% of the postponed tax liability. Inheritance is taxed according to recipient status at three rates increasing with the size of the estate and may include flat fees as well. The standard VAT of 25% does not apply to the supply of property before first occupation.

5.13 USA

Property tax share of GDP: 3%

Variation by area: High. Property taxes vary widely by state and by county.

List of taxes: Domestic and non-domestic property taxes are the primary source of revenue at the county and municipal level. Tax rates for both types of property vary widely, but as a general rule, non-domestic property is taxed more heavily than residential property. Real estate transfer taxes are charged by a majority of states and some county governments at rates ranging from 0.01% to 2% of market value. Property that has not served as a principal residence is subject to federal and state capital gains taxes. Federal estate state tax is payable at 40% on value exceeding $5.25m. Several states have their own estate taxes as well.[108]

5.14 The curious case of Taiwan

Taiwan is a high income country outside the OECD (Taiwan is viewed by China as a renegade province and so to avoid conflict many multinational bodies do not permit it membership). This means international data is more provisional. However, Taiwan is of interest to this report as it does have a land tax. The work of academic Tzu-Chin Lin, who works in Taiwan but maintains links with the UK academic community, is a helpful bridge to understanding the Taiwanese system.[109] Indeed, Taiwan has what might be considered the closest to the theoretical model of land taxation, with a progressive tax on land (not property), with properties being charged more on the value of the land that they sit on. In addition, to try to discourage speculation there is a variation on how much is charged depending on how long property has been held.

Yet recently the house price to income ratio in Taiwan's capital Taipei was reported at a staggeringly high 13.7:1 in 2012.[110] The fundamental issues of credit surging from mainland China, allied to an insufficient supply of new homes has far outweighed any impact of this land taxation. Any further work in the UK that does not try to undertake a more detailed study of Taiwan's experience would clearly be deeply inadequate. But what is also clear is that Taiwan has not seen a stabilisation of housing costs – and that a land tax is not a silver bullet.

5.14 Wide variation in property taxation but no economic magic bullet

This chapter is not an attempt to try to disentangle how land and property taxation operates in each country and the effect that these taxes have on the wider economy and society. This would require hundreds of pages of detailed analysis. It

108 Sources: *IRS Topic 701: Sale of your house; National Conference of State Legislatures, Real Estate Transfer Taxes; Total State and Local Business Taxes, state-by-state estimates for fiscal year 2012,* Ernst and Young

109 In particular with Alan Evans, from Reading University, who tutored Tzu-Chin.

110 Price-to-income ratio for Taipei houses at nearly 14 years in Q2, The China Post, 28August 2012

is instead a brief overview of how countries use land and property taxation. The most interesting features are that land and property taxation:

- Is ubiquitous. All countries tax property and land. Most countries however tax property and land at a lower rate than the UK.
- Varies widely. Some countries tax inheritance, others instead choose to tax property as a small annual level. Some countries have wide variation within their borders, others do not.
- Diverges strongly from theoretical land taxes. Land taxes make up either a non-existent or small part of overall property taxation.

The purpose of this chapter is to show what is happening in reality. For example, no country has created substantial land and property taxes that are close to the theoretical models. The taxation that does exist tends to be a mixture of capital gains, inheritance, and small (usually proportional) annual levies on the value of property. The creation of a full blown land tax has not occurred in any country, although of course small annual levies on the value of property capture any land uplift. In the real world, taxation on property substantially diverges from the ideal of a single major land tax.

Interestingly, the reasonably modest proportional taxation of property has *not* had the impact some argue it would have.

Along with the UK, large countries such as the USA or Australia have seen very volatile housing markets despite high levels of taxation, including in both cases quite high proportional taxation on the value of property. By contrast, Germany, a country that has largely managed to avoid property bubbles and maintain reasonable housing costs for its people, has a very low share of revenue raised by property taxes (less than a quarter of the UK), and also has very low proportional tax on often out-of-date valuations. As the table below shows, the existence of a proportional tax does not seem to have a major impact on house price rises or stabilise property swings.

Table 7: Some countries with proportional land or property taxes recent house price rises[111]

Country	Existence of proportional tax	Percentage house price change 1997–2007	Percentage house price change 2007–2013
Australia	Yes	149	12.2
Canada	Yes	65	18.3
France	Yes	139	1.1
Netherlands	Yes	102	-16.5
USA	Yes	120	-20.8

Elsewhere, Germany, which also has a moderate proportional tax, has seen very low house price rises in recent years. Indeed, house prices in 2011 were actually lower than they were in 1995.[112]

The reason behind Germany's low house price rises are a flexible planning system, (for example completing over 60% more homes a year per inhabitant as the UK using an average from 1980, 1985, 1990, 1995, 2000 and 2006),[113] and

111 Sources for house price rises are; Houses build on sand, The Economist

112 Germany; *Residential property prices, Existing dwellings; Residential property in good and poor condition; Whole country; Neither seasonally nor working day adjusted;* NCB, ECB Statistical Warehouse

113 Based on data from *Eurostat Housing statistics in the European Union 2010 and English Housing Survey. Household report 2008–09*, Department for Communities and Local Government, 2010

tight control of the money supply, until recent years exercised by the Bundesbank and after 1999 the European Central Bank. (Though of course tight monetary policies for Germany were not tight monetary policies for countries such as Spain or Ireland.) It was these policies of building more homes and sensible monetary policy that created Germany's stable land and housing market. Elsewhere, the work of Harvard professor Ed Glaeser shows how variation within the USA is due to planning restrictions. This is particularly clear in his work *Rethinking Federal Housing Policy*, where he shows planning restrictions result in higher land prices, with states and cities with flexible planning systems seeing house prices remain close to construction costs. While loose monetary policy had an impact, the scale of this impact depended on planning restrictions.

In the real world property taxation diverges somewhat from idealised versions. The belief that proportional taxation of property will eliminate housing volatility and stabilise economies is unsubstantiated. There is no clear link between the establishment of such proportional taxes and elimination of housing volatility, and some countries with limited land and property taxation (but functioning supply in particular) appear to see lower and stable house prices. This is not to say that such taxation has no impact, but it appears that this is more than outweighed by other factors.

6
Politics of Land and Property Taxes

In Britain, the politics surrounding housing and property taxation have long been difficult. The Community Charge was born out of Scottish resistance to Domestic Rates revaluation in 1985. It was this, coupled with public perception of local council profligacy, that led to the replacement of rates and the introduction of the Community Charge. As noted earlier in this report, this solved one problem – spendthrift councils – at the cost of another: a feeling of inequity. Land and property taxes are even more prone than other areas to solutions that seem preferable in one particular dimension creating new and equally or even more troublesome issues in another.

In addition to this fundamental difficulty, transitional problems are likely to make initial opposition worse, as was the case in the Community Charge. Gaps in the information needed to assess, levy, and collect the Community Charge ensured that non-payment quickly became a problem. But as local authorities redoubled enforcement efforts and raised the tax amount to compensate for the revenue shortfall, accusations of unfairness became even worse. Any attempt at major reform would throw up unexpected problems for politicians.

Even council tax revaluation has proved difficult. Council tax was initially implemented without clarity over how future revaluations would operate. A decade after council tax came into effect, the Local Finance Act 2003 attempted to update the original legislation to schedule the next revaluations and require subsequent revaluations every ten years.[114] Yet perceived negative public opinion around revaluation led to a postponement of the planned 2007 revaluation of property in England.

Attempts to capture planning gain have largely failed to extract serious revenue rather than pay for infrastructure or local amenities. The 1947's Development Charge, 1967 Betterment Levy, 1973 Development Gains Tax, and 1976 Development Land Tax (DLT), all tried and failed to create higher taxation on land than other areas.[115] DLT for example was seen as raising too little money for the large and complex levels of legislation it needed and so was abolished in 1985.

After the failure of the DLT, there was an ad hoc pattern of individual agreements between local authorities and developers that shifted infrastructure costs onto developers using existing powers. The introduction of Section 106 in the Town and Country Planning Act 1990 formalised and legitimised this system.[116] Section 106 illustrates a transition of taxation of planning gain from recognised tax to an additional formality tacitly accepted as part of the planning

114 www.legislation.gov.uk/ukpga/2003/26/part/6/crossheading/valuation-lists-and-bands/2003-09-18

115 See the Barker Review and Plimmer and McGill, 2003

116 Land Value and Community Betterment Taxation in Britain: Proposals for Legislation and Practice, Lichfield and Connellan (2000)

system. Recent developments such as the creation of CIL and the redistribution of CIL revenues to local neighbourhoods, as championed by Planning Minister Nick Boles, all point to an increasing role in more explicit links between planning permission and local community gains.

However, the relative success of planning gain capture in recent years, (successful in relation to previous measures) arises precisely because it is not a revenue raising tax – but a clear link to amenity provision to go alongside new development.

6.1 Conservative positions around land and property taxation

Conservative stances on property taxation fall into two camps. In the first group, tax reform should focus on cutting economically harmful taxes rather than creating new taxes on property. Allister Heath, the editor of City A.M. and a Telegraph columnist, argues that "*A tax on people's assets is ethically wrong, economically destructive and would damage growth and job creation, with the poor and middle classes suffering intense collateral damage.*"[117]

Similar arguments have been used to justify abolishing or at least reducing IHT, CGT, and SDLT. Those who take that view argue that the incentive effects within families are ignored by those who argue for higher taxation on land and property.

A different camp is similarly keen on tax cuts as a whole, but are prepared to consider restructuring taxation toward levies on more expensive properties and wealth in order to reduce other taxes, largely those with particularly damaging political or economic effects. ConservativeHome founder (and now Times Comment editor) Tim Montgomerie represents this view. Montgomerie has argued that "*we should tax wealth more and wealth creation less*," and has argued for a mansion tax in preference to the existing council tax regime.[118] This group argue that wealth and property taxes are the least bad option.

After 1979 when in power the Conservatives have kept property taxes low in power while not eliminating them. The Conservatives did introduce the current council tax, but as part of a series of reforms, not based on first principles. As discussed earlier, the unpopularity of rates led to the Community Charge, the unpopularity of which led to the council tax system. The goal of the council tax was to take some account of income and wealth while still curtailing the power of local councils to charge householders as much as they liked while being fully reimbursed by central grant.

Since its introduction, the Conservatives have tried to hold local authorities to account for increases in spending while opposing revaluation. In 2001, the Conservatives indicated in their manifesto that they would try to identify ways to link local council tax increases above the rate of inflation to local referenda to help rein in spending at the local level. As part of their 2005 campaign, the Conservative Party stated their intention to halve council tax bills for millions of pensioners.[119]

Before the 2010 general election, the Conservatives expressed their desire to freeze council tax for two years, scrap Labour's plans for revaluation, and extend certain powers to local people to veto large council tax increases.[120] In the Localism Act, provision was created for the Secretary of State to require 'excessive' council tax rises to be put to a referendum, which were defined in

117 *A Wealth tax would be ethically wrong and economically destructive,* A Heath, 2013 Daily Telegraph

118 *Next week George Osborne should announce the biggest ever tax cuts for working families,* T Montgomerie, 2012 Conservativehome

119 2005 Conservative Manifesto

120 2010 Conservative Manifesto

2013–14 as over 2% for most councils (unless they were in the bottom quartile of council tax charges). No councils chose to increase council tax and face a referendum.[121] On the heels of the 2005 Wales council tax revaluation, an early day motion was submitted and signed by 72 Conservative MPs calling for the government to cancel the 2007 revaluation.[122] Labour did subsequently cancel it.

During the Conservative period in power from 1979–1997 stamp duty was reduced and by 1997 it was just 1% on all transactions over £60,000. As Labour increased the number of rates and created Stamp Duty Land Tax in 2003, the Conservatives argued that the new Stamp duty Land Tax retained a slab structure which was no longer sensible with multiple levels. While still in opposition, the Conservatives announced that they would abolish Stamp duty for first-time buyers on properties up to £250,000 at the 2007 Party Conference.[123] In their 2010 Manifesto, the Conservatives expressed their intention to raise the lowest paying threshold to £250,000 for first-time buyers.

Since in Coalition the Conservatives increased the Stamp duty holiday for first time buyers up to £250,000 and extended the measure to March 2012, after which this exemption expired. Other changes to SDLT included a new 5% rate for properties over £1m and the creation of a band charging 7% for properties worth over £2m, both measures that the Liberal Democrats advocated.

Conservatives have largely pushed for IHT to remain a tax levied only on the very rich. Conservatives raised the tax-free threshold to £215,000 in the 1990s.[124] In the 1997 and 2001 Manifestos, they continued to support raising the threshold to reduce the burden of the tax on the public. At the 2007 Conservative Party Conference, George Osborne as Shadow Chancellor proposed raising the nil rate band to "take the family home out of inheritance tax."[125] The proposal had an immediate impact and prompted the Labour government to introduce a transferrable allowance for couples a week or so later.[126] However the Coalition government has not raised the inheritance tax threshold further.

In the 1988 Budget, Nigel Lawson announced that CGT would be aligned with income tax, with the basic and top rates for both taxes and thresholds all at the same position. This meant that lower rate taxpayers paid slightly less and higher rate taxpayers paid slightly more. (The previous rate on individuals had been 30%). He justified these changes on the grounds it would be economically distorting and have encouraged evasion to tax income from capital and labour differently.[127] At that time, indexation existed to ensure nominal gains that were just related to inflation were not taxed.

The Conservatives have been critical of the complexity Labour introduced to CGT (e.g. the 1998 reform of a taper relief for certain kinds of assets, relief for entrepreneurs, and other areas). The change in that rather unwieldy system to a single rate of 18% with no taper relief was welcomed. In the run-up to the 2010 elections, Conservatives took no position on CGT reform. The subsequent change to CGT, in which earners above the basic rate of income tax pay 28% on gains from capital, is widely seen as a concession to the Liberal Democrat coalition partners, with some backbenchers vocally opposing the move. The Conservatives did not push for the resumption of indexation, perhaps because CGT was still lower than the equivalent income tax rates.

121 *Council tax 2013/14 Standard Note SN/SG/6599, House of Commons,* 2013

122 www.parliament.uk/edm/2005-06/59

123 www.conservatives.com/News/Speeches/2008/02/George_Osborne_The_Principles_of_Tax_Reform.aspx

124 www.publications.parliament.uk/pa/cm199596/cmhansrd/vo951128/debtext/51128-09.htm

125 Seely (2001), op. cit.

126 Some we spoke to said that already trust law by 2007 was being partially used to obtain this result for property, as property was held in trust for people's children while the remaining spouse lived, thus reducing tax liability.

127 See his explanation in his memoirs *The View from Number 11*

6.2 Liberal Democrat positions on property and land taxation

The Liberal Democrats have generally been supportive of property and land taxation. They argue for this both as a revenue raiser and also as a way of achieving other objectives, most notably issues around fairness and efficiency. This has been demonstrated through their strong support for at least maintaining, if not increasing, overall levels of property taxation.

The Liberal Democrats have opposed council tax since its inception. In their 1987 Manifesto, the party adopted the view that a local income tax charged at rates increasing with income would be a fairer option than the Community Charge or the existing Domestic Rates. This policy objective has been reaffirmed in every manifesto for the past two decades. Unlike the other two parties, the Lib Dems have been consistently opposed to council tax and, by extension, council tax revaluation, as Sarah Teather, the relevant spokeswoman, argued in 2005:

> *"The Labour Government have been consistently in favour of revaluation until a few weeks ago, when they did a giant U-Turn, more out of political cowardice than out of ideology … It was only in contrast to the poll tax that council tax appeared to have an element of fairness and was accepted by the British people. Nearly 15 years on, it has become painfully apparent that council tax is not a fair tax. The Conservatives invented it, so it is hardly surprising that they still think it is good enough. But it is a tax that Labour should be ashamed of."*[128]

The Liberal Democrats have been less keen on higher Stamp duty than Labour, although never opposing it in principle. They have often proposed exemptions in Stamp duty to incentivise behaviour that would have weakened the tax base. In their 1992 General Election Manifesto, the Lib Dems proposed to make properties meeting new environmental standards exempt from Stamp duty.

In 2005, the Liberal Democrats advocated substantially raising the minimum property value at which Stamp duty was payable and promised to raise the £120,000 Stamp Duty threshold to £150,000. The 2010 Lib Dem Manifesto promised to create a law to close the Stamp duty Land Tax loophole for offshore trusts to ensure that the tax could not be easily evaded by the rich. A 'Mansion Tax', a tax on properties above a high value (e.g. £2 million) was adopted in the Liberal Democrat Manifesto for the 2010 election. In part due to this promise to tax valuable properties more heavily, the Coalition government created a new rate of 7% extended to properties over £2m in value, though exemptions for overseas buyers remain in place.

IHT has not featured prominently in Liberal Democrat policy agenda and the party does not appear to give priority to IHT reform. As part of the post 2010 Coalition government, the Conservatives were unable to raise the IHT threshold to £1m as promised in their 2010 Manifesto, a move that could be partly blamed on the Liberal Democrats, who would be unlikely to support such a move, as well as the difficult financial circumstances that the government found itself in.

In terms of Capital Gains, the Liberal Democrats have long held the position they should generally be taxed as income. After the 1998 Labour reform of CGT which introduced taper relief, the 2001 Liberal Democrats Manifesto argued for the closing of loopholes, the reintroduction of indexation and retirement relief, and the abolition of taper relief.

128 As argued by Sarah Teather MP in 2005. See www.publications.parliament.uk/pa/cm200506/cmhansrd/vo051019/debtext/51019-11.htm

Vince Cable in the late 2000s argued that the Labour party's lowering of Capital Gains was a mistake and argued for the system created in the late 1980s.

> *"Will he [the Chancellor] tell us what was wrong with the CGT system under the previous Conservative Government, which was introduced by Lord Lawson? That system had at its heart a very simple central principle that income and capital should be taxed on the same basis… May I commend the idea of going back to the 1997 CGT system, which was simple, made generous provision for small business, had indexation and would produce an additional tax revenue of about £2.7bn."*[129]

The 2010 Liberal Democrat Manifesto reaffirmed the desire to realign CGT and income tax. However, the Manifesto did not propose the reintroduction of indexation alongside this, though Cable appeared to endorse this in some public announcements. On top of this the party advocated charging CGT in line with income tax for individuals who used their second homes as speculative investments in order to discourage such activity. Subsequently under the Coalition Capital Gains tax was raised, though it was not brought into line with income tax rates.

6.3 Labour positions on land and property taxation

Labour has changed positions on various property tax questions more than other parties, which can either be seen as political pragmatism or lack of clarity. It opposed the council tax before it was put in place but later accepted it. While in power, it first resisted and then supported the scrapping of the 2007 England revaluation. It passed significant reforms to CGT but then scrapped most of them a decade later. Only on stamp duty have Labour regularly increased the tax take and had a consistent position (higher value properties should be taxed more).

Labour initially opposed the council tax, with their 1992 Manifesto arguing: *"We reject the Conservatives' unfair banding and discount system, which would create a property poll tax. We will modernise the valuation system to ensure that properties are fairly assessed."*[130]

By 1997, perhaps influenced by the severe difficulty which reform had caused the Conservatives, the party seemed to be prepared to accept the council tax in its existing form. In the 1997 Manifesto, Labour called for the removal of universal council tax caps while retaining some power to control excessive tax rises. Again in 2005, Labour argued council tax should be retained but reformed.[131]

Committed to revaluation by the Local Government Act 2003 it passed, the Labour government delayed the 2007 revaluation. They argued that the Lyons Inquiry reporting in 2007 on local finance should be completed before any revaluation took place. In the run up to the 2010 general election, Labour pledged not to hold a revaluation before the 2015 election. However, in the longer term, it appears that Labour still favours revaluation at some stage.

On Stamp duty, Labour steadily increased the number of rates. In 2000, the Labour government decided to maintain the existing Stamp duty tax rates on properties under £250,000 and raise rates for the higher bands. Three years later in 2003, the old Stamp duty was replaced with the Stamp Duty Land Tax in an attempt to make it fairer. The new tax was heralded by the Labour government as a modernisation removing distortions and loopholes that favoured large businesses.[132]

129 *Hansard House of Commons Debate*, 24 Jan 2008, vol 470, col 1631

130 1992 Labour Manifesto

131 2005 Labour Manifesto

132 Hansard House of Commons Debate, 1 July 2003, vol 408, col 311–34

The Labour government uprated the lowest threshold for housing but not regularly in line with house price inflation. Just before the 2005 election Labour raised the minimum Stamp Duty Land Tax threshold from £60,000 to £120,000. A few years later, the government temporarily raised the threshold for paying SDLT in 2008 from £125,000 to £175,000. The following year, this tax holiday was extended through the end of 2009. In their 2010 Manifesto, Labour offered to maintain the SDLT holiday for an additional two years and increase the rate payable for properties over £1m to 5%. The Coalition government ultimately adopted both measures and later added a new top rate of 7% on properties over £2m in value.

Labour position on inheritance tax can be summarised succinctly by Stephen Timms MP, who said in 2007 as Chief Secretary that "*inheritance tax is fair, progressive and well-targeted*."[133] However, Labour did raise the rate at which IHT was payable during its period in office. In 2004, the Labour government adjusted the nil rate band so that it would increase with inflation.[134] The following year, Chancellor Gordon Brown announced in the Budget that the nil rate band would be increased incrementally in 2005 and 2006 at a rate above inflation.

Further reforms to IHT were created in 2007 when the Labour government extended the relief for bequests to spouses and civil partners in order to make it easier for partners who wished to continue living in the family home to do so, creating the 'joint allowance' structure currently in place. This change followed a Conservative pledge to raise the nil rate band.

After stating that they would review CGT with a view to incentivising long-term investment in their 1997 Manifesto, Labour replaced indexation allowance with taper relief for taxable capital gains. The change, which took place in April 1998, allowed up to a 75% reduction in taxable gains on business assets and up to 40% reduction on non-business assets. Labour repeatedly argued that their reforms had given entrepreneurs and investors better incentives for longer-term investment.[135]

However, taper relief greatly increased the complexity of the tax and in 2007, the Labour government announced taper relief would be phased out and a single rate of CGT at 18% adopted, replacing the CGT rates aligned with income tax rates. The announcement led to charges that this would have a negative impact on small businesses and hamper entrepreneurship. This led to the introduction of entrepreneurial relief that in turn engendered criticism for complicating the tax.

133 Seely (2011), op. cit.

134 Ibid.

135 See the 2001 and 2005 Labour Manifestos for reference

7

Land and Property Taxes are a Distraction From Key Issues

7.1 Political difficulties around reform outweigh possible gains

There has been a lot of tinkering with land and property taxation in this country since the introduction of council tax and business rates in the early 90s. But there have not been wholesale changes. This area is simply seen as too difficult and unrewarding in terms of major reform.

Whichever party comes to power in 2015, it will be difficult to make any changes to taxes on property. Such taxes are very high compared to those of other developed countries. As Table 1 at the very beginning of this report showed, the UK collects the equivalent of 4.1% of its GDP in property taxes – more than any other OECD country.

There are arguments that, (like almost all taxes), the system of property taxation in this country could be improved. This has proved difficult in the past. The council tax avoided trying to create a perfect system. The aim was to find a method of local taxation that did not completely fail on grounds of revenue collection, fairness, or efficiency. Previous attempts tried to focus on particular issues and ended up creating wider problems in other areas.

The other taxes that have changed (CGT, stamp duty etc) have done so without a complete overhaul. All the current taxes have reasons behind their current rate and structure. Although some could no doubt be improved, none is without justification.

Property taxation is treated warily by politicians for good reasons. There is the acute visibility of property taxation in Britain, plus the fact that those who will lose from change are likely to be more vociferous than those who gain. Attempts to reform the system to deal with any one issue open it up to arguments that it should be reformed to deal with others. While on paper it is easy to say that those who have seen their properties rise in value should pay more in tax, these gains are not immediately realisable. In addition, while there are real concerns about wealth inequality, in terms of property these can be reversed by spreading wealth through increasing home ownership.

In addition, the changes that would be set in train due to reform would be difficult to contain. For example, reform that tried to make council tax more proportional, which would bring it into line with most other taxes, would have the likely impact of upsetting the current acceptance of large scale central redistribution of grant for councils.

It should also be noted that arguments made that land and property taxation would help to reduce housing volatility appear to be weaker in reality than in theory. The UK's abolition of MIRAS and the evidence from other countries indicate that focusing on tax and subsidy rather than the structure of housing markets as whole is misplaced.

Therefore we would recommend that no changes should be made to property and land taxation in this country. Insofar as this advice is disregarded and any changes are made, any such changes should be small and incremental, (e.g. dealing with the odd structure of Stamp duty) not a wholesale redesign of the system.

7.2 Planning and banking changes are the real solution to issues of inequality and volatility that land and property tax try to deal with

Arguing that there should not be major changes to land and property taxation does not mean that policy makers can ignore some of the issues raised in the debate. There are real problems in this country with housing volatility and wealth inequality. No one in politics should be unconcerned that the greatest driver of spreading wealth, home ownership, has fallen for the first time in sixty years. Having risen from just 23% in 1918 to 70% in 2002, home ownership has fallen to just 64% by 2011.[136] The proportion of people owning their own home is now undergoing a dramatic reversal. This is not acceptable as it is due to the failures of policy makers. Most people still want to own their own home, but they can no longer afford to do so. Rising access to home ownership was gradually spreading across the whole of UK society – a trend that has now come to a dramatic end and is now reversing. This will have serious implications in terms of wealth and wider economic inequality, as families become either part of a wealthy core or increasingly are excluded from ownership.

> "No one in politics should be unconcerned that the greatest driver of spreading wealth – homeownership – has fallen for the first time in sixty years"

Similarly, the UK economy continues to be plagued by housing volatility. The boom-bust cycle of house prices that takes place within a trend of rising prices does immense harm. There can be no denying this. But the MIRAS abolition, at a time when this was worth £7.7 billion in 1990/1 prices, was followed by the biggest boom in the UK's history. The idea that simple government intervention through the tax system will help reduce volatility and spread ownership is simply false.

If politicians want to fix the real underlying problems with the UK housing market, they need to get to grips with the real issues. As was discussed in chapter 3, rising land and house prices are related to a fundamentally broken planning system that pushes up the value of land with planning permission ever higher. This is clear from the evidence of the past 30 years. If we do not build enough homes, house prices and rents will rise.

This report has not been able to go into what has caused the rising prices, volatility, and falling home ownership in detail. These issues are discussed widely in *Making Housing Affordable*, *Cities for Growth*, *Why Aren't We Building Enough Attractive Homes*,

136 From *Table 801; Household characteristics, tenure trend, from 1918*, DCLG

A Right to Build, and various other Policy Exchange reports. Soaring rents are largely due to a lack of land for new homes. Even more rapid increases in house prices are due to a speculative bubble in house prices building on top of this as people anticipate ever rising prices and rents.

7.3 A better commitment than property and land tax reform is to reform the planning system to build 1.5 million homes from 2015 to 2020

If policy makers want to deal with issues around housing inequality and housing volatility, they must focus on fixing the planning system and ending our obsession with easy credit. These are far more worthy causes than politically difficult and economically marginal changes to taxation of property.

If politicians feel the need to set a target as political goal to rival major changes in land and property taxation, we would recommend rather than the sometimes pledged 1 million homes, they should aim to build 1.5 million homes between 2015–2020.

The reason for this is clear – 1 million homes over five years, around 200,000 homes in England, is actually a failure to keep up with predicted housing *need*, which is itself likely to be an underestimate of housing *demand*. Indeed, such language is unhelpful in many respects, as both need and demand are to some extent arbitrary. A young person living at home with their parents but who wants to leave might be seen as having a 'demand' or 'need' for housing, depending on how this is defined. They are not homeless, but they want to move out.

However, as a minimum, it is expected just to keep up with new households that are being formed, (so need, not demand), we have to build 221,000 homes every year in England.[137] Given that there has been a long and serious shortfall in housing provision, with the number of homes built in recent years at between 100,000 and 150,000, depending on how new homes are measured and which years are looked at, it seems fair to assume that making up part of this would be a reasonable goal for policy makers.

Therefore the figure of 300,000 homes a year would not be unreasonable just to keep up with need, to try to take account of some increase in demand, and to make up for some of the backlog for recent failings. We would recommend that rather than expend political capital on an uncertain set of reforms to land and property taxation, politicians should commit to 300,000 homes a year, which in turn would require major planning reform. Given the equivocal evidence on land and property taxation in tackling with key problems compared to such reforms, it would be wrong to recommend any other course of action.

137 *Household Interim Projections; 2011 to 2021,* England DCLG, April 2013

Policy Exchange

Recently the issue of land and property taxation has risen up the political agenda. This report seeks to examine what reform of land and property taxation might try to achieve, and what it could achieve in practice. It also discusses the costs and benefits of changing the system, as well as the political realities in this area.

It finds that while issues around rising housing costs and volatility are real concerns, they are best dealt with by building more homes and reforming credit to make the system less volatile. Both overseas experience and the UK abolition of mortgage subsidy MIRAS show that without fixing these issues, you will not deal with the underlying problems.

The UK already has the highest property taxation in the OECD. Major changes in this area are likely to be politically difficult, without necessarily achieving the desired goals. Therefore we recommend politicians should focus on creating a housing and planning system that can deliver at least 1.5 million new homes between 2015–2020. Without this, calls for higher property taxation are likely to increase. But the message to politicians should be to focus on the creation and spreading of property ownership and wealth – not its taxation.

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