Labour Land Campaign

How a land value tax would help resolve Britain's housing crisis

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The main manifestation of the housing crisis until recently has been the huge increase in house prices. This has put home ownership beyond the reach of many people. Between 1996 and 2008, house prices rose by 150 per cent in real terms. Meanwhile, the shortage of rented accommodation has pushed up rents. Thus, for many people, a decent home has become unaffordable. Furthermore, people desperately seeking to procure a home of their own have often been trapped into borrowing far beyond their means, and at considerable risk to themselves.

Now, however, the housing crisis is taking a new form. First, rising interest rates for home loans are pushing up the cost of mortgage repayments. This is creating considerable financial difficulties for many families. And it is leading to a growing number of defaults, resulting in people losing their homes. In addition, credit is less available now, so that it is more difficult for people, especially first-time buyers, to obtain mortgages unless they have a sizeable deposit. Another problem is that house prices in many areas are declining, such that some homeowners – mainly those who took on mortgages when prices were at their peak – are moving towards negative equity, owing more than their house is worth.

The causes of escalating house prices

The huge increase in house prices over the recent period was due almost entirely to rising land values, and the increasing demand for housing relative to supply. The actual cost of building houses has changed hardly at all.

One reason for the rise in land values and house prices is quite simply economic growth. Economic growth increases people's disposable income, and therefore their purchasing power. This increases economic demand for all goods and services, including housing, and therefore demand for land for housing. Since the supply of land in locations where people want to live cannot be increased, the higher demand for housing will result in higher land values and higher house prices.

Another factor is growth in the number of households. First, this is due to Britain's rising population. Second, it is because of the increasing number of single person and single parent households – a consequence of an ageing population and other social trends.

However, none of these reasons is sufficient to explain the scale of the increase in house prices.

The major reason was the huge growth in the availability of credit. This was the result of banks and other financial institutions inventing new ways of re-packaging housing debt into bond-like securities with various hedging devices, and selling them on in the world's capital markets, mainly to financial institutions seeking a steady flow of funds which it was thought mortgage repayments could provide. In other words, banks were borrowing from the world's capital markets, using their mortgage assets as security.

This allowed banks to expand enormously the amount of credit that they could make available to house buyers. Furthermore, in their drive to gain business ahead of their competitors, banks greatly relaxed their conditions for home loans in the belief that they had hedged against defaults making use of the various complex hedging devices traded on the capital markets, and were therefore prepared to take much greater risks in their lending. In particular, they allowed people to borrow much more in relation to their income compared with previous times, often without even requiring a deposit.

In short, this easy availability of credit meant that people had more money to spend on homes. This pushed up demand, and therefore prices, because, first, it takes time for builders to build new houses in response to growing demand, and second, it pushed up land values in the areas where people wanted to live, and where planning permission had been granted for building more houses.

Moreover, the higher house prices increased the value of the collateral that people could put up to take on loans using their houses as security, and therefore the amounts that they could borrow. This raised further the demand for houses, which pushed up prices even more. In other words, as long as banks made credit easily available, the rising price of housing, in effect, fed on itself.

In addition, this huge expansion of credit availability had knock-on effects on the rest of the economy, which also tended to push up house prices. As the increased funds that people had at their disposal filtered throughout the economy at large, this created new economic demand for goods and services in general. This stimulated investment to meet that demand, thus creating new employment opportunities, which led to further growth of economic demand, stimulating more investment, and so on.

In other words, it allowed the economy to grow faster than it otherwise would. The expansion of credit, therefore, not only had a direct impact on demand for housing which pushed up prices, but also had an indirect effect in that it led to faster economic growth, which pushed up land values, causing house prices to rise even more.

A further major cause of rising land values and the increase in house prices was the speculative element and tacit collusion among house builders and property developers. First, many purchasers of property, especially those buying property to let, were driven by the expectation of higher prices later, enabling them to profit from the capital gains to be had when they sold on their properties (which, in the case of buy-to-let, allowed profits to be made over and above the income from the high rents that they could charge). The profits to be had from the buying and selling of property attracted more buyers onto the bandwagon, which further increased demand. This had the effect, of course, of increasing prices all the more, so that investing in property became a self-fulfilling, one-way bet.

Meanwhile, many large landowners, including house builders, have been withholding land from the market in the expectation of making higher profits later when the land, with or without housing, was eventually sold. In London, for example, according to the Royal Town Planning Institute, there was enough land with planning permission in 2007, to deliver some 30,000 houses each year until 2016. And in some areas of the country, it has been reported that property developers have land banks likely to last until 2050.

On top of that, it was estimated in 2008 that there were some 750,000 properties standing empty in Britain – over 40 per cent long term empty.

To sum up, there is evidence that an artificial shortage in the supply of housing has been created. This, obviously, has had the effect of pushing up house prices, allowing property developers to profit at the expense of people seeking places to live.

The shortage of affordable rented accommodation

The shortage of affordable rented accommodation is also a factor that has pushed up house prices because people who might otherwise have settled for rented homes were pushed into seeking properties to buy, thus adding to the already high demand.

A major cause of this shortage has been successive governments and local authorities selling off public sector housing at subsidised prices, and their refusal to replace stocks sold off. In 2007, for example, just 251 housing units were built by local authorities, compared with 16,600 in 1990.

Private sector landlords, meanwhile, have been taking advantage of this situation by charging exorbitant rents to people unable to get onto the housing ladder, or who are stuck on waiting lists for social housing. In 2008, almost 1.7 million households were on council house waiting lists – up by 60 per cent since 2001. And once the credit crunch takes effect (see below), it is expected that this figure by 2010 will grow to 2 million – affecting some 5 million people including children. Furthermore, the number of homeless has risen to over 80,000 households. And this is a conservative estimate, since only those regarded as homeless by local authorities are counted, and it does not include people – especially young people – who are forced to stay with parents, relatives or friends, because they cannot afford a home of their own

Many local authorities now are wanting to raise funds to expand their housing stock to deal with these problems, but are hamstrung by government restrictions on their powers. A further problem is that even if local authorities were able and willing to invest in more public sector housing, they are constrained by the high cost of land. This applies also to housing associations – on which the government and local authorities have become increasingly dependent for providing social housing.

Britain's planning system and its effect on land prices

Britain's planning system has sometimes been blamed for the apparent shortage of land for affordable housing because it makes land prices higher than otherwise due to the restrictions it places on land use. If there were no such restrictions, if there were a market free-for-all, land for building, it may be argued, could be a fraction of the price it is now. Thus, if planning constraints did not exist, it is likely that land prices would tend to converge. It would make prices of agricultural land, especially in the so-called green belt areas around towns as they exist now, much higher, and the price of land already built on, eventually, lower, especially on the outskirts of towns, as supply of land for building on caught up with demand.

But it would also lead to considerable urban sprawl spreading deep into the countryside as in the United States, where planning restrictions are more relaxed. Furthermore, derelict or brownfield sites in towns would be even more of a problem than now – also a characteristic of US towns – because it costs more to develop brownfield sites, which have the extra costs of demolition and clearing, than to develop greenfield sites.

In Britain, across the political spectrum, nobody advocates a land free-for-all. And there is a general consensus that the countryside should be more or less protected for agricultural and recreational uses. How therefore may the supply of land for affordable housing be increased that is consistent with planning regulations?

Though releasing some land in a controlled way from the green belt could certainly contribute, the first priority, surely, must be to ensure the efficient use of land in towns – especially making use of brownfield sites, which are not only a waste of resources, but are often an eyesore.

By far the most effective and proven measure to accomplish this, would be the introduction of an annual tax on land values. If, unlike now, the owner of a high value site, had to pay an annual tax set at an appropriate level, whether or not he or she brought it into use for the designated purpose, there would be a powerful incentive to start developing it as soon as possible, or else sell it on to someone who will. In effect, this would increase the supply of land, and therefore tend to dampen the price of land. And derelict land in towns would soon become a thing of the past. The example of Harrisburg, in the United States (until recently), well illustrates this point.[1]

In due course, as buildings in an area came to the end of their useful lives, if there was the need, planning authorities could re-designate the land for denser housing – or if the priority were more jobs, for commercial use.

In short, Britain's planning system, alongside a system of land value tax, would go a long way towards making more land available for building on, which would help overcome the current shortage of affordable housing.

Why house prices are now tending to fall – and the consequences

The primary cause of falling house prices, which reflects falling land values, is the sudden large decline in the availability of credit. This has the effect of reducing economic demand for houses (that is people wanting houses and with means to procure them).

The reason for the decline in credit availability was the sudden drying up of funds from the world's capital markets upon which, as noted already, the huge expansion of credit in the previous period depended. This problem originated from the fact that banks, in order to retain their share of the mortgage market, or, if possible, to get ahead of their competitors – and in the belief that they had safeguarded themselves against defaults – took ever greater risks. They extended their lending to people who would likely struggle to keep up mortgage repayments, especially in the event of rising interest rates, or due to an economic downturn when borrowers were at risk of losing their jobs.

In the United States in particular, between 2001 and 2004, mortgage brokers and the like were arranging home loans for anybody and everybody, whether or not they had any collateral security or steady jobs. This was when interest rates were below 2 per cent, making such deals quite attractive to borrowers, even those on low incomes. The worst lenders were luring people on low incomes into buying houses by offering loans with interest rates starting very low for a limited period, with no indication of what would happen once the market rates of interest began to apply. When, later, interest

[1] Jerry Jones, *Land Value…for Public Benefit*, Labour Land Campaign, 2008; p. 9.

rates more than doubled, many borrowers had trouble keeping up their mortgage repayments and fell into arrears. This paved the way for a growing number of repossessions and debt write-offs.

Once this began happening on a large scale – at first, mainly in the United States, where this so-called sub-prime lending had gone the furthest – the various dealers in structured debt securities began realising that they were not such a good bet after all, and would not provide the steady income that they had anticipated. The net effect was that banks suddenly found that their access to funds on the capital markets through such mortgage-backed securities was cut off, which meant that they could no longer continue lending on such a large scale.

On top of that, banks found themselves in a liquidity crisis. In their struggle to gather funds to offset the growing number of defaults and the costs of repossessions, banks were much less willing to lend to one another, and the rate of interest on the inter-bank market shot up. At the time of writing, this had already led to the insolvency of three major banks – Northern Rock in Britain, and Bear Stearns and IndyMac in the United States. And many other banks, including in Britain, The Royal Bank of Scotland, Lloyds TSB and HBOS, would have gone bankrupt had it not been for a major government rescue operation funded by taxpayers.

In short, banks are no longer willing or able to extend their lending on the previous scale, and they are far more selective about whom they lend to – mainly restricting themselves to those who can come up with a large deposit and demonstrate long term solvency, in other words, the better-off. This has reduced dramatically the economic demand for houses, and is what is causing prices (and land values) to fall.

Furthermore, the growing uncertainty in the economy in general is having an impact on house prices. As noted above, a significant factor in pushing up house prices previously was growth of the economy in general, which was enhanced by the easy availability of credit, having the effect of pushing up economic demand throughout the economy, stimulating economic growth. Indeed, it is now being realised that most of the economic growth in Britain between the mid-1990s and 2008 was fuelled by the huge expansion of credit issued by banks to people using escalating property prices as collateral, which, as noted already, caused property prices to rise all the more, allowing banks to advance even more credit.

The trouble is that there are always limits to economic growth based more or less wholly on debt, simply because the collateral eventually becomes exhausted, and because more and more people become involved in paying off their debts plus interest. This, inevitably, is at the expense of growth of economic demand and therefore growth of the economy as a whole, which is the major problem now.

In short, the current fall in house prices (and land values) is due, first, to the reduced availability of funds for home loans, and second, to the economic downturn caused by the fact that debt is no longer growing to the same extent, which is what mainly drove economic growth during the previous period.

A major problem now is that the reduced availability of mortgage funds is deterring house builders and property developers from building more houses because of the uncertainty as to whether they will be able to sell them at a profit once they are built. Meanwhile, since local authorities are no longer prepared to invest in public sector housing – and in any case are restricted from doing so by central government – they cannot provide the stimulus for builders to build more houses, either.

Theoretically, the fall in land values, and therefore the market price of land, should reduce the cost of building new houses, because it would cost less to acquire the land required. The trouble is, as already mentioned, many of the major property developers and house builders already own the land required, so this is not a constraint as far as building houses is concerned. The problem is that, currently, it costs landowners nothing to sit on their land until economic circumstances change, and land values and property prices, start to rise again.

Thus, the housing crisis – the chronic shortage of affordable homes – continues.

The main beneficiaries of house price inflation

The housing crisis has not been a crisis for everyone. On the contrary, it has been a boon for some. Land speculators holding large land banks obviously have benefited by slowly releasing the land at inflated prices.

But the biggest beneficiaries have been banks. As prices went up, people seeking a place to live needed to borrow increasing amounts, which, of course, increased the revenue from interest, and hugely boosted the profits of banks and their shareholders. In effect, because the main element of house price inflation was rising land values, this was equivalent to banks appropriating a significant portion of the higher value of land.

Estate agents have also benefited from house price inflation because the commissions that people have to pay when selling are related to property values.

Now that prices are tending to fall, those benefits will be reduced. Banks, in particular, are losing out – which, it should be said, is a result of their own profligacy. They are having to make provisions for bad debts and cover the costs of repossessions – though, as in the past, they are likely in due course to claw these costs back through higher interest rates and fees charged to their solvent clients.

Finally, people already on the property ladder benefit at the expense of those who are not. Although everybody, including tenants, creates land value, at present, only property owners and landowners (and the beneficiaries of wills) gain from the rising value of land (especially those on the property ladder earlier, which would make their mortgage repayments, or cash outlays, much less). Meanwhile, tenants are penalised with increased rents.

A system of land value tax would end those injustices.

How a land value tax would have helped prevent the current crisis

Had a system of land value tax (LVT) been in place, the house price bubble, as it turned out to be, would never have grown to the extent that it did, and not at all had the availability of credit been properly regulated. First, the escalating market value of land, the main component in the huge increase in house prices, would have been kept under control, because the bulk of the increase in land values would have been collected as LVT. Next, it would have eliminated the speculative element that has pushed up prices, since it would have made no economic sense to withhold land from the market in the expectation of higher prices later, first because with LVT in place, such price rises would hardly have occurred, and second because landowners would have been penalised by having to pay LVT.

Furthermore, owners of land, once they had received planning permission, would have had the incentive to develop the land for housing as rapidly as possible. It would have ended the practice of house builders holding large land banks out of use for decades. In other words, it would have boosted the supply of housing, and dampened the tendency for house prices to rise.

Finally, lower land prices would have made it more affordable for local authorities and housing associations to acquire land for social housing, thus increasing the supply of accommodation at affordable rents. In addition, the greater availability of social housing would have meant that private landlords would have been less able to charge exorbitant rents, which, in fact, are quite often subsidised by taxpayers through housing benefit.

An additional effect of LVT, and if also there had been credit controls, is that this would not only have more or less eliminated house price inflation, but also would have allowed the Bank of England to lower interest rates with less risk of inflation. This would have made home loans more affordable (especially as house prices would also have been much lower), and it would have benefited business, and therefore the economy as a whole.

Moreover, LVT would have benefited the economy in other ways. In particular, it would have prevented the funnelling of money into property that creates no wealth, and have allowed more to go into savings for pensions and for genuine investment in new productive activities, upon which economic development depends, including expanding and improving the stock of housing.

The effect of introducing LVT now

Introducing LVT now would begin to address the current housing crisis head on, and would help prevent the recurrence of such crises. However, much would depend on the outcome of the current economic downturn, and how protracted it turns out to be. This should not affect the timetable for extending LVT. Indeed, the more the rate of LVT can be increased so enabling other taxes to be reduced, the more this will help overcome the economic downturn, because of the additional economic activity that that would stimulate.

But even if LVT were introduced initially at a relatively low rate, simply as a replacement for the council tax and the national non-domestic rates, this would provide some incentive to develop or release land for housing, thus increasing its supply – because unlike now, all land would be subject to the tax, including derelict land or land held in land banks. And, in due course, as the rate of LVT was raised, and other tax rates reduced, the incentive would be all the greater.

Next, there is the likely impact on house prices in the current economic circumstances to consider. As long as there is economic growth, the effect of extending LVT to replace other taxes, which would tend to depress the market value of land and therefore property prices, would be offset by the tendency for prices to rise due to the effect of economic growth on land values.

However, during an economic downturn, this is less likely. Indeed, the current economic downturn is already causing house prices to decline, and, other things being equal, extending LVT beyond replacing existing property taxes would likely add to that trend. But over time, the extent to which LVT would encourage economic growth, especially if other policies were adopted to promote economic growth, and if the revenue from LVT and other taxes were invested wisely, this would offset that effect.

None of this would be significant for people who already owned houses purely for their own accommodation. If property prices decline, for whatever reason, homeowners would get less when they sold, but would pay less for the houses that they intended to move to. Their heirs would also get less, but mostly, they, too, would not lose out because most people tend to use their inheritances for acquiring homes of their own – or for trading up into larger accommodation or moving to a better area – which would cost less.

The main problem that would need to be addressed – particularly affecting those who had stepped onto the property ladder more recently when prices were at or near their peak, and who were lured into taking out large mortgages that they now find hard to service now that interest rates are higher – is the growing number of homeowners getting into arrears and having their homes repossessed. This is likely to become more serious as the current economic downturn takes hold, and as people start losing their jobs.

One approach would be for local authorities, through a special fund created by central government, to simply take over the houses in exchange for bonds offered to banks, so that the houses would become part of the public sector housing stock. This would allow people to stay in their homes.

In addition, other measures would need to be introduced if the housing crisis is to be overcome. First, because of the urgent need for more affordable housing for rent – not just for key workers, but for all who need them – local authorities need to be granted the power and the financial resources, such as low interest loans from central government backed up by special housing bonds, to enable them to begin building council houses again. This would be facilitated by LVT, because it would reduce the cost of acquiring land for that purpose.

Second, regulations need to be re-introduced to control the release of credit into the economy, as existed in the 1950s and 1960s. This would help prevent credit bubbles from occurring, and the unpleasant consequences when such bubbles burst. (Even better would be if banks were limited to the credit released only by the Bank of England, which would allow the public to benefit from the seigniorage arising from the money created in the process, instead of private banks, as now – but that is another story.)

To sum up, LVT, together with the re-introduction of credit controls, would make booms and slumps in the housing market – and the adverse impact they have on the economy as a whole – a thing of the past. And it would end the inequalities arising from unearned wealth accumulation derived from landownership.

[Edited excerpt from Jerry Jones, *Land Value…for Public Benefit*, Labour Land Campaign, 2008; also available at www.labourland.org]