16

The Taxation of Land and Property

Most taxes nowadays are levied on flows of income and of expenditure. But land and property have been taxed for centuries—certainly for longer than income—and they continue to form an important part of the tax base in most advanced economies.

There are good economic reasons for this. The supply of property, and especially land, is not very responsive to its price, which means that it can be taxed without significantly distorting people's behaviour. The ownership of land is also generally visible and easily established, which makes it relatively straightforward to identify who should be paying the tax. The fact that land and property have identifiable and unchangeable geographic locations also makes them natural tax bases for the financing of local government.

But deciding exactly *how* to tax land and property is particularly complex, because they combine a number of characteristics that each suggest different tax treatments. Take a house. It sits on land, the value of which we might want to tax because it is completely fixed and the return to it is an economic rent. But the house also provides services that are consumed by the occupier—just as a fridge or a car does. So it is natural to think that the value of this consumption should be subject to VAT. The house is also a valuable asset, whose value rises and fluctuates like those of stocks and shares. So we might see home ownership as a form of saving that should be taxed consistently with other savings. Also important is the distinction between owner-occupied and rented property. Ideally, we would want to treat these consistently. But, at present, their tax treatments are quite different in the UK, providing a clear bias towards owner-occupation.

Business property also combines characteristics that suggest different tax treatments. We would ideally like to tax the commercial use of land consistently with other uses, while treating the property built on it consistently with other inputs into the production process.

To understand how to tax land and property, it is important to keep these issues and themes distinct. To be clear:

- **Land**, whether used for business or residential property, can be taxed at an arbitrarily high rate on economic efficiency grounds.
- **Business property** is an input into the production process and, on efficiency grounds, should not be taxed.
- **Owner-occupied housing** combines the features of an investment and a consumption good, and we should consider its taxation from both these points of view.
- **Rental housing** is an investment good from the point of view of the owner and a consumption good from the view of the renter. Overall, there is a presumption in favour of taxing it at a similar level to owner-occupied housing.

In this chapter, we start with a discussion of the case for land value taxation and the practical difficulties that may pose. We contrast the strong case for taxing land values with the strong case against taxing business property. We go on to look at the taxation of the consumption value of housing and conclude that, in the UK context, council tax should be reformed so that it more closely resembles a genuine tax on the consumption value of housing. The asset-like properties of housing mean that it should also be brought into the savings tax regime outlined in Chapter 13. Finally, we consider stamp duty land tax, finding little to say in its defence.

It is worth noting two further issues that are important in the taxation of land and property, though we do not pursue them further.

First, taxes on land and property have strong historical ties to local taxation. This is, in part, due to the widespread view that such taxes are partly 'benefit taxes', a charge for the goods and services provided locally. It also reflects the immobility of property—it is clearly associated with the location. In the UK, council tax—an annual tax imperfectly related to the value of domestic property—is the main tax base for local government, though the majority of local government income comes directly from central government. A very complex system of 'equalization' exists, giving larger grants to those local authorities with a more limited tax base—where properties are less valuable—to try to ensure that, if all local authorities spent at the level judged appropriate by central government, they would all levy the same tax rate on properties of a given value. We do not explore these issues further. For the most part, the question of how to tax land and property can be separated from where the power to tax is located. For example, reforms to council tax could be accompanied by adjustments to grants that maintain the existing distribution of spending power across local governments.

Second, land and property are hugely important socially and economically. Having enough housing available to accommodate the population comfortably matters. Decisions over whether to develop land for business or housing use contribute to the structure of the economy. The impact of the housing market on the macroeconomy is great enough both to have influenced the decision not to take the UK into the euro and to influence regular decisions over interest rate policy. Changes to the tax system aimed at increasing the availability of housing and of business land have been proposed, as have changes that, it is claimed, will reduce volatility in the housing market. We note these issues below in relevant sections, but they are not the focus of our considerations. Other policy choices, in particular over the planning regime—the desirable reform of which is well outside the scope of this review—are likely to be more important in this context.

16.1. THE TAXATION OF LAND VALUES

16.1.1. The Economic Argument

Land and property should be thought of as distinct bases for taxation, although in most countries taxes are levied on the combined value of property and the land on which it is located. William Vickrey, a Nobel Prize-winning economist, argued that 'The property tax is, economically speaking, a combination of one of the worst taxes—the part that is assessed on real estate improvements …—and one of the best taxes—the tax on land or site value'.[1] Later in this chapter, we argue that there are in fact good reasons for taxing housing as well as the land on which it stands; but as far as business property is concerned, Vickrey had it exactly right.

The economic case for taxing land itself is very strong and there is a long history of arguments in favour of it. Taxing land ownership is equivalent to taxing an economic rent—to do so does not discourage any desirable activity. Land is not a produced input; its supply is fixed and cannot be affected by the introduction of a tax. With the same amount of land available, people would not be willing to pay any more for it than before, so (the present value of) a land value tax (LVT) would be reflected one-for-one in a lower price of land: the classic example of *tax capitalization* introduced in Chapter 2. Owners of land on the day such a tax is announced would suffer a windfall loss as the value of their asset was reduced. But this windfall loss is the only effect of the tax: the incentive to buy, develop, or use land would not change. Economic activity that was previously worthwhile remains worthwhile. Moreover, a tax on land value would also capture the benefits accruing to landowners from external developments rather than their own efforts. Henry George, the political economist, writing in the mid nineteenth century, argued that land taxes are equitable because the value of land is determined by community effort, not by individual effort.[2] Winston Churchill, speaking in the House of Commons in 1909, put this argument eloquently:

> Roads are made, streets are made, services are improved, electric light turns night into day, water is brought from reservoirs a hundred miles off in the mountains—and all the while the landlord sits still. Every one of those improvements is effected by the labour and cost of other people and the taxpayers. To not one of those improvements does the land monopolist, as a land monopolist, contribute, and yet by every one of them the value of his land is enhanced. He renders no service to the community, he contributes nothing to the general welfare, he contributes nothing to the process from which his own enrichment is derived.

One wrinkle in the argument that an LVT would not distort behaviour is that there is, in effect, some elasticity in the supply of land because of planning regulations. Governments in the UK and most other countries specify the uses to which particular pieces of land can be put—for example,

[1] Vickrey, 1999, 17.
[2] George, 1879.

residential, business, or agricultural. So land that is designated for agricultural use, for example, cannot be used for house building. In general, land with planning permission for residential use is much more valuable than adjacent land with an agricultural designation. In January 2009, for example, the average value of a hectare of arable farming land in south-east England was £20,000, compared with £1.3 million for a hectare of industrial land and £2.5 million for a similar area of residential building land.[3] A tax on land value might, at the margin, reduce the incentive to apply for permission to change the designation. But the scale of gains available suggests this is unlikely to be a major issue. And, in any case, planning permission is a policy variable, not a market good: a government concerned that an LVT might discourage valuable development could compensate by relaxing planning regulations so that applications were more likely to succeed. This could be done directly or achieved by giving local authorities, which generally make planning decisions, some incentive to accept applications by, for example, allowing them access to some portion of the additional receipts created by an extension of their tax base.[4]

It is worth noting in passing that a number of unsuccessful attempts have been made to capture the rents arising from *change* in designation through the introduction of 'development taxes' or 'betterment taxes', in 1947, 1967, 1973, and 1976. Each attempt has ended in failure, in large part as a result of lack of credibility over the long-term sustainability of the tax.[5] There has

[3] Valuation Office Agency, 2009.

[4] Bentick (1979) and Oates and Schwab (1997), in contrast, argue that an LVT can create a bias towards excessively rapid development: more specifically, towards land uses that deliver returns early, since returns of equal present value that accrue more slowly are still capitalized into land prices immediately and therefore taxed every year even before they are realized. This bias could be avoided by taxing the 'best use' value of the land rather than its market value (though 'best use' value would be even harder to assess); but, in any case, it does not seem to us to be a sufficient reason to reject LVT.

[5] The history is well set out in the Barker Review (Barker, 2004, box 4.2):

The 1947 'Development Charge' was the first attempt to tax windfall gains from land development. The charge was levied at 100 per cent of the excess value attributable to the granting of planning permission, relative to the existing use value on the date the development began. However, the effect of the tax was to reduce land coming forward for development, and the revenue raised was substantially lower than expected.

The 1967 Betterment Levy aimed to capture value above 110 per cent of existing use value, so as to provide an incentive to sell by allowing some development gain to be made. The charge been a clear incentive to wait for a reversal of the policy before applying for planning permission. More recent proposals to introduce a Planning Gains Supplement were worked up and consulted on in some detail but were eventually dropped in 2007 in favour of an extension to the less formal system of planning charges. These do capture some of the value uplift from granting of planning permission but, historically, have been less transparent, predictable, and consistently applied than either a national planning gains supplement or an LVT would be. Since LVT would be levied annually rather than just at the point planning permission was granted, it would not create the same incentive to delay development in the hope that the policy would be reversed. Even if the LVT were abolished again, delaying a planning application for a year to wait for its abolition would save at most only a proportion (the tax rate) of the value of having planning permission for the one extra year. Unlike with a planning gains tax, the main gain from the abolition of LVT—the removal of all future years' liabilities—would be felt whether planning permission were granted before or after its abolition, so there is no advantage to be had by waiting.

was introduced at 40 per cent with the stated intention of raising it higher. However, among other problems, the complexity of the legislation allowed many developers and landowners to avoid paying by 'establishing' that work had begun prior to the charge's introduction and again, the measure raised far less money than was initially expected.

The 1973 Development Gains Tax aimed to extend the CGT [capital gains tax] regime by taxing as income gains accruing from disposals of land possessing development potential at rates of up to 82 per cent for individuals, and 52 per cent for companies. However, rapidly changing market conditions, and a change of Government to one with different development gain ideas soon after the tax's introduction, meant that the measure had little time to exercise an influence on the land market.

The Development Land Tax was charged on each occasion of the realisation of development gain flowing from disposals of land after August 1976. The tax contained several different features to its predecessors. These include levying the charge not only on actual sales, but also on assumed disposals where development projects began on land without a preceding land sale. There were also numerous exemptions from the tax. However, the complexity of the tax led to a proliferation of avoidance regimes and resulted in the tax falling disproportionately on smaller landowners, leading to allegations of unfairness.

16.1.2. Practical Issues

The economic case for a land value tax is simple, and almost undeniable. Why, then, do we not have one already? Why, indeed, is the possibility of such a tax barely part of the mainstream political debate, with proponents considered marginal and unconventional?

One issue, no doubt, is the simple lack of political attractiveness. If a land tax is seen as a new and additional tax, then it is likely to be about as popular as any other new tax. So it should be seen as an alternative to other existing property taxes, not as a way to raise additional revenue. Moving from a property-based tax to a land-based tax would also create numerous gainers and losers. This is politically difficult. But then a major revaluation exercise just to bring current domestic property taxes up to date would also create winners and losers, which is perhaps why politicians have avoided doing it and why relative domestic property tax liabilities in England and Scotland bear increasingly little relation to relative property values.

As well as any political difficulty, introducing an LVT would also pose practical challenges. Valuing all land at an adequate level of disaggregation sounds like a formidable task. But before concluding that it is not possible, it is worth looking at how non-domestic property is valued for the purposes of business rates. There already exists a considerable apparatus designed specifically to record land and property values. The basis for valuation is a 'rating list' for each local authority, identifying every relevant non-domestic property in the area and estimating its annual rental value based on its location, physical properties, and other relevant economic conditions.[6] There are approximately 1.7 million non-domestic properties in England and 100,000 in Wales. The rating lists are compiled and maintained by the Valuation Office Agency (VOA), which employed the equivalent of nearly 4,000 full-time staff in 2008–09.[7] The rating lists are updated during their lifetime to reflect changes in properties, and new lists are compiled every five years.

We thus have a considerable machinery designed to value business properties and update those values regularly. We have, or can obtain without

[6] Properties for which the concept of a market rent is tenuous, such as public utilities, are valued using a statutory formula.

[7] Valuation Office Agency, 2009.

excessive cost, a measure of the land area occupied by each property. The Land Registry holds information on the boundaries of each property and this could be converted into area measurements. No doubt there would be some initial disputes over the size of assigned areas, but this should be a one-off transitional problem. Once the measurement of each property was agreed, it would become part of the description of that property. If we are then able to supply a land value per acre (or hectare, or square metre), it is possible to combine this with the area of the property to compute the implied land value.

The biggest practical obstacle to the implementation of a land value tax, though, is that it would require the valuation of land separate from any structure erected on it. If there were a competitive market for land, with a high number of transactions, then the value of land would be directly observable. But in most areas and sectors, the number of transactions in land (separate from any buildings thereon) is low. In the absence of a sizeable market, it is difficult to determine what the market price would be.

It is worth noting that since we are looking at taxing a rent, the figure for land value does not have to be exact—or even approximate—for the LVT to be efficient. The value of each plot of land falls by the present value of the tax imposed on it; in principle, each plot could be taxed at an arbitrarily different rate without compromising the efficiency of the tax. However, to the extent that valuations are not accurate, inequities will be created between taxpayers—just as they can be created by inaccurate valuations under the current property tax regime, but the inequities will be worse if the valuation is less accurate.

So is it possible to determine the value per acre of land given the thinness of the market? We cannot answer that for certain, but there are reasons to believe that it may not be impossible. There are some transactions to work with—enough, indeed, for the VOA even now to publish estimates of land values for residential and industrial land at some level of disaggregation (by town, for example). There are recognized methods for determining land value where the market is thin: where similar buildings are valued differently according to their location, for example, it is not hard to imagine that the difference in overall value reflects the difference in land values. We are also encouraged by the considerable international experience of land valuation—in Denmark and in various US and Australian states, for example.[8]

As Kate Barker concluded in her comprehensive review,[9]

> A national land value tax would also require additional administrative resources in order for a national land ownership and value register to be created. Given the volatility of land prices over recent years, regular valuations would be needed in order to tax accurately the underlying value of land assets. Such a system would not be impossible to envisage, however—… Denmark operates a system of nationwide land taxation. Indeed, given the information shortages concerning land ownership and land value in the UK, there are arguments for a more comprehensive land registry in any case.

A recent review of US evidence[10] suggests that successfully implementing and administering a land value tax is feasible. We are not in a position to make such a judgement for the UK, but we propose that government should study the feasibility of such a tax. As we will see below, there is a much stronger case for having a separate land value tax in the case of land used for non-domestic purposes, so the feasibility needs first to be studied for commercial and agricultural land rather than for land on which housing sits.

16.1.3. Replacing Business Rates

In the UK, business property is taxed through the national non-domestic rate (NNDR or business rates), which is levied as a percentage of the estimated rental value of the property, with reduced rates for low-value properties. It raised about £24 billion in 2009–10, more than 4% of total revenue.[11] Although locally administered, it is a national tax, with the rate set centrally and all receipts flowing into national coffers.

The business rate is not a good tax. It discriminates between different sorts of businesses—agriculture is exempt, for example. More fundamentally, from an economic perspective, business property is an input to the productive process of a company. Further, it is a produced, or *intermediate*,

[8] Japan, South Korea, and Taiwan also have experience of LVT. Andelson (2001) contains details on international experience.

[9] Barker, 2004, paragraph 4.14.

[10] Dye and England, 2009.

[11] HM Treasury, 2010, table C6.

input with the same economic properties as other forms of physical capital. As we discussed in Chapter 6, it is an important principle of the economics of taxation that an efficient tax system should not distort choices firms make about inputs into the production process, and hence that intermediate goods—those used in the production process—should not be taxed. The principal effect of business rates is that economic activity in the UK is artificially skewed away from property-intensive production.

Another effect of business rates in practice arises from the treatment of unused or undeveloped land, on which business rates are levied at reduced or zero rates. This provides a clear and perverse incentive to use land inefficiently. Indeed, this has led to a rash of garish press headlines about property owners demolishing property in order to avoid business rates. This puts the issue in rather stark perspective. If property is subject to tax and land is not, then, if the property is not being used, a tax incentive for demolition is created. If empty or unused property is taxed at a lower rate than property being used, then a tax disincentive to use it is created. An LVT avoids these problems.

Taxing non-domestic property is inefficient, and should not be part of the tax system. But abolishing business rates now that they already exist would, on its own, provide a windfall gain to the owners of business land and property. Handing out windfall gains is an inefficient use of taxpayers' money, and the distribution of these gains would be unfair: in general, those receiving windfalls will not even be the same people who were previously made worse off by business rates, since the beneficiaries will probably have acquired the property at a lower price reflecting the expected tax bill (i.e. business rates will have been capitalized into the purchase price of properties).

If business rates were replaced by an LVT, however, the windfall gains from abolishing business rates would be offset by windfall losses from introducing LVT. The offset would not be exact for individual properties: owners of highly developed properties would gain while owners of undeveloped land would lose. But in so far as the value of property is largely determined by the value of the land on which it stands, the offset will be close. And if the reform is revenue neutral, there would at least be no windfall gains or losses on average.

To mitigate transition costs, the reform should be implemented gradually, with transitional protection for those most affected, similar to what already happens with business rate revaluations. While not essential to such a reform, in our view agricultural land should be brought within the net—although much of it may be of low enough value that it would in reality be subject to little or no tax.

Given available data, it is hard to be precise about what rate of LVT on commercial land would be required to replace business rates on a revenue-neutral basis. Some basic calculations[12] suggest that a rate somewhere in the region of 4% of land value levied once a year might achieve this. One could clearly introduce this gradually whilst reducing business rates, perhaps starting at ½% of land value and rising. Ideally, such a tax would also replace stamp duty land tax on business properties, the inefficiency of which is discussed in Section 16.3.

We do not go further in our prescriptions here. We cannot say conclusively that the administrative hurdles to such a reform could be overcome at reasonable cost, but we cannot see any fundamental problems. This is such a powerful idea, and one that has been so comprehensively ignored by governments, that the case for a thorough official effort to design a workable system seems to us to be overwhelming. In particular, significant adjustment costs would be merited if the inefficient and iniquitous system of business rates could be swept away and replaced by an LVT.

We should address ourselves briefly to the question of what should be done if a move to a system of land value taxation were to be deemed politically or practically infeasible. Currently, business rates are becoming gradually less important, as they are constrained by legislation to grow by no more than price inflation, rather than with the economy and other tax bases. Hastening their demise looks attractive because of their distorting effects, but two considerations make us wary of recommending this in the absence of an acceptable alternative such as an LVT.

First, there is the undesirable windfall gain to the owners of business land and property that abolishing business rates in isolation would imply, as

[12] Following Muellbauer (2005). He recommends imposing an LVT at 2% of land value on business land whilst keeping business rates at half their current level, and estimates that this would be roughly revenue neutral. He suggests an exemption for land worth less than £20,000 a hectare, which would exclude most agricultural land.

discussed above. Second, even though business rates have many undesirable features, they are at least to some extent incident on land values. To paraphrase Vickrey, business rates are a combination of a desirable tax on the land and an undesirable tax on the buildings. If we cannot treat these two components differently, some tax on the combination may be preferable to leaving land values wholly untaxed.

16.2. HOUSING

We devote the rest of this chapter to the complex and contentious issue of the appropriate tax treatment of housing. Whilst there are not good reasons for taxing business property, there are good reasons for taxing housing. Housing has two main attributes that are relevant for tax design:

- First, by living in a house, you consume a flow of services. If we have a consumption tax such as a VAT, a reasonable presumption is that housing should in some way be covered by it.
- Second, homeowners also own a valuable asset; indeed, it is usually their *most* valuable asset. The value of the house may go up and down. In that sense, owner-occupied housing is like any other asset, and much of our discussion in Chapter 13 on the taxation of savings should apply.

The distinction between these two attributes is explicit in the case of private rented property: the landlord invests in the asset, while the renter consumes (and pays for) the flow of services. But the two attributes are just as surely present in owner-occupied housing: in effect, the owner-occupier is both landlord and tenant simultaneously. At present, the tax system treats rented and owner-occupied properties differently, creating a distortion in favour of owner-occupation. If, instead, we could treat all housing consistently both as a form of consumption and as a type of asset, such distortions could be removed. As we will see, achieving such ideal treatment in practice would be difficult. But it is important to be clear what we would like to aim for.

We take the first of these attributes—the consumption properties of housing—first. We then move on to consider how housing should be taxed as an asset.

As with business property, the taxation of land and the taxation of buildings can in principle be separated. In particular, regardless of the efficient taxation of housing as a consumption good or an asset, the land on which it stands could efficiently be taxed at an arbitrarily high rate. A 'two-tier' housing tax could tax residential buildings at one rate and residential land at a different (presumably higher) rate. Some US cities have such a tax. But we are wary of proposing this, for two reasons:

- As with business property, taking equity as well as efficiency into account leads us to think that achieving revenue neutrality in the taxation of housing (thus avoiding large windfall gains or losses on average) is a reasonable objective in the first instance. We will see that, if residential land and buildings together are taxed like other consumption, no additional tax on the land would be needed to achieve revenue neutrality.
- Since, unlike with business property, we think there is a strong case for taxing buildings as well as land, there is obvious merit in avoiding the considerable additional complexity associated with valuing and taxing residential land and buildings separately.

In what follows, therefore, we discuss taxation of the land and buildings taken together, though if an LVT could first be successfully implemented in the non-domestic sector, there may in future be a case for reconsidering its application to domestic property as well.

16.2.1. Taxing the Consumption Value of Housing

Housing can be thought of as a large consumer durable, like a very big fridge or car. When considering the taxation of most consumer durables, we start from the presumption that it would be appropriate to impose VAT on their price when new. This is because the price of the durable itself reflects the present value of the stream of services it is expected to yield. VAT paid on the newly bought good is, in effect, a prepayment on the stream of services yielded. A natural starting point is that the same approach should be applied to housing. Yet, at present, the UK, alone among OECD countries, applies a zero rate of VAT to the construction and sale of residential property.[13]

Houses differ from other consumer durables not only in size. For one thing, they last a very long time—hundreds of years in many cases. This raises two possible difficulties for imposing VAT:

- Because houses are so long lived and their consumption value may change so much over time, their up-front price may prove to be a bad approximation to the value of consumption services they eventually provide. Ideally, if a house delivered more (less) valuable services than was originally envisaged and built into the purchase price, we would like to tax (subsidize) this difference. This is true in principle for all durables, but on a much larger scale for housing.
- Imposing VAT on newly built housing might nonetheless be attractive if starting 'from scratch'. Given the UK's actual starting point, however, houses that have already been built but were not taxed at the point of first purchase will constitute the majority of the housing stock for many decades. Taxing newly built housing while failing to tax the stream of consumption services that existing housing continued to provide would be problematic. It would artificially encourage overuse of existing properties and discourage new construction, while forgoing revenue from the existing housing stock means giving windfall gains to current homeowners at the expense of non-owners. An alternative[14] would be to levy VAT both on new-build and on existing properties the next time they are sold—taxing the stream of consumption services they are expected to yield thereafter without retrospectively taxing the consumption services enjoyed to date. But this would act to discourage mutually beneficial transactions as people sought to defer the tax[15] and has the potential, like a planning gain tax, to be avoided altogether by the simple expedient of waiting for a future government to repeal the tax, before entering into any transaction.

[13] Since VAT is generally charged on refurbishing existing properties but not on building new ones, the current system also incentivizes developers to build new properties rather than redevelop derelict sites.

[14] Proposed by Crawford, Keen, and Smith (2010).

[15] Another way of thinking about this effect is that, since only housing services consumed after the next transaction would be taxed, the tax would be minimized by delaying a transaction as long as possible.

If we want to tax the consumption value of housing, therefore, it is probably best to do so at the point at which the services are consumed rather than at the point of first purchase. That suggests an annual tax related to the (consumption) value of the property.

One immediate point to note is that such a tax should not be levied on any increase in property value resulting from improvements on which VAT has been levied. To do so would involve double taxation. This could, in principle, be avoided either by zero-rating such expenditure—spending on constructing extensions, for example—or by taxing only the consumption value of the 'unimproved' property. This latter solution seems wholly impractical over the long run. It would be odd indeed to be charging tax on a property in 2050 on the basis of its condition in 2010, for example. The former solution—not charging VAT on improvements—is preferable: the guiding principle should be that only those kinds of improvements that will affect the property valuation should be zero rated (or, in other words, valuations should only take account of improvements that were zero rated). Nevertheless, it may be difficult to define and police qualifying improvements in practice. This may be an area in which we have to accept some imperfection in the system.

16.2.1.1. Council Tax

A tax related to the consumption value of a property bears some resemblance to a tax we already have in Britain: council tax. Given that we want to levy a tax on the consumption value, it makes sense to start from where we are.

Council tax is charged to all occupiers of domestic property.[16] In England and Scotland, council tax operates by placing every house into one of eight bands (A to H): the higher the band, the higher the council tax paid (see Table 16.1). The valuation bands are based on the estimated market value of each house on 1 April 1991—there has been no revaluation of properties at all in England or Scotland since the tax was introduced.[17] The ratios between the council tax bills charged for each band are set centrally, but the overall

[16] Strictly, not all occupiers—students and some other groups are exempt.

[17] Though a revaluation was carried out in Wales, and a ninth band (band I) introduced there, with effect from April 2005 (based on April 2003 property values).

Table 16.1. Council tax bands and rates in England

Band	Value as at 1 April 1991	No. of properties in band in England at March 2009 (millions)[a]	Tax rate as a proportion of that in band D	Charge in local authority setting English average band D rate in 2009–10
A	Up to £40,000	5.7	6/9	£943
B	£40,001 to £52,000	4.4	7/9	£1,100
C	£52,001 to £68,000	4.9	8/9	£1,257
D	£68,001 to £88,000	3.5	9/9	£1,414
E	£88,001 to £120,000	2.1	11/9	£1,728
F	£120,001 to £160,000	1.1	13/9	£2,042
G	£160,001 to £320,000	0.8	15/9	£2,357
H	More than £320,000	0.1	18/9	£2,828

a. Source: http://www.local.communities.gov.uk/finance/stats/data/ctbdwell2009.pdf.

level of council tax is set locally (although central government can choose to cap it) and the revenue from the tax is locally retained.

A 25% discount is applied where there is a sole occupant; second and empty homes are also subject to discounts, determined locally. A specific social security benefit—council tax benefit—is available to ease the burden of the tax on those with low current incomes. In 2009–10, council tax, net of council tax benefit, raised £25 billion and the average annual levy on a property in England was £1,175.[18]

Three things are immediately evident from Table 16.1. First, properties are heavily concentrated in the lower bands: two-thirds of all properties are in the bottom three bands, while less than a tenth are in the top three bands. Second, charges rise more slowly than values—the charge in band H is twice the charge in band D, whereas the house at the bottom of band H is worth more than four times the house at the bottom of band D. So the tax is designed to be regressive relative to its base—the more the house is worth, the less as a proportion of the value is paid in council tax. Third, the highest band covers all properties worth more than £320,000 in 1991, including

[18] Revenue figure from HM Treasury (2010); average levy from Communities and Local Government, http://www.communities.gov.uk/documents/statistics/xls/1349754.xls.

those worth many times more, while the lowest band covers all properties worth less than £40,000 in 1991. The width of the top band, and the number of properties lumped into the bottom band, highlight the failure of council tax to differentiate between properties in the same band. In addition, of course, being based on values from so long ago, current tax bills take no account of subsequent changes in price relativities and hence do not capture even the original intention of the tax.

Council tax is an unpopular tax. There are a number of possible reasons for this. It is highly visible: 88% of tax is remitted by firms,[19] so for the vast majority of people council tax is one of the only taxes they are asked to pay personally.[20] This means people overestimate its importance. It also lacks buoyancy, which means that 'increases' have to be announced each year just to keep up with inflation, let alone growth in GDP. Council tax can seem particularly onerous for the 'asset-rich, cash-poor' since, unusually, it is not linked to a pre-existing cash flow. But there is also evidence that people just find the idea of a tax linked to the value of their property unfair.[21] This seems to reflect the fact that perceptions of fairness in tax are more closely linked to the relationship of the tax to flows of income than to stocks of wealth. But, both because consumption of housing services is as legitimate a tax base as any other consumption, and because it is a good complement to current income as an indicator of lifetime income or ability to pay, this does not seem to us to be a good objection—at least not economically.

The unpopularity of council tax has been one major factor behind the unwillingness of government to undertake revaluations. The other is the fact that any revaluation inevitably creates losers and winners—and losers tend to be very vocal. This is one of the most egregious demonstrations of the 'tyranny of the status quo' as a block to desirable change. In this case, the problem only gets worse over time as relative property prices diverge more and more from the 1991 position. Part of the problem now is that a revaluation has been avoided for so long that changes in relative tax liabilities would be very substantial. But as council tax valuations approach the milestone of being 20 years out of date, the absurdity of the status quo

[19] 2006–07 figure. Source: Shaw, Slemrod, and Whiting (2010).
[20] The other being vehicle excise duty.
[21] Lyons, 2007, 226.

becomes ever more apparent. Any property tax requires regular revaluations, and this process should begin as soon as possible.

16.2.1.2. Housing Services Tax

Council tax clearly has important shortcomings, and housing is not currently subject to VAT as it probably should be. So we now propose a reform that addresses both these problems and would create what we call a 'housing services tax'.

We have already noted that the purpose of a VAT is to tax final consumption. This is generally accomplished by levying the tax when goods are initially purchased, but in the case of housing it is better achieved by taxing the flow of housing services on an annual basis. In an efficient market with no uncertainty, the market value of a house is the capitalized value of these housing services, so a tax on the flow is equivalent to a VAT on the market price when the house is new. A tax on the flow of services has the advantages that it can capture housing services that (for whatever reason) were not reflected in the initial price, and that it can be applied to the existing stock of housing with none of the transition problems associated with a VAT. Furthermore, an annual tax on housing services would be similar in operation to council tax, which would further reduce problems of transition.

In fact, a tax on housing services would bear an even closer resemblance to one of council tax's predecessors, domestic rates, which were charged as a percentage of the estimated rental value of properties. Interestingly, a reformed system of domestic rates is still in place in Northern Ireland, levied as a proportion of properties' 2005 capital values—though with various reliefs, and a cap that means that any property worth more than £400,000 in 2005 is treated as though it were worth just £400,000.

A housing services tax (HST) should be levied as a simple, flat percentage of the rental value of each property, whether it is rented or owner-occupied. According to Communities and Local Government, the average house price in England in 2009 was about £200,000 and the average council tax bill in England in 2009–10 was £1,175. This suggests that a tax of around 0.6% of property value would leave the average bill unchanged and therefore be revenue neutral.[22] If annual rental values are about 5% of capital values, that would correspond to an HST rate of about 12% of the value of housing services. However, the rate could also be increased to pay for the abolition of stamp duty on residential property transactions, discussed in Section 16.3. The volatility of stamp duty revenues makes it difficult to say reliably how much this would add to the HST rate, but it would probably still leave it somewhat below the current 17.5% VAT rate. In the long run, further increasing the HST rate towards 17.5% might make sense, but given the windfall losses that that would entail and the political sensitivity of reforms to housing taxation, we think revenue neutrality with the current regime is a more pragmatic medium-term goal.

Figure 16.1 illustrates how tax bills would change under an HST designed to replace the revenue from council tax only, while Figure 16.2 shows the effect that this change would have on house values if it were to be fully capitalized into market prices. The vast majority of properties are on the left-hand side of these graphs. For houses with a market value less than about £250,000—a large majority—tax bills would fall and house prices rise modestly. Conversely, for houses with a market value above that, tax bills would rise and house values fall. The change in value would not be significant for many properties, although a house with a current value of £1 million would lose around 6% of its value. Note, however, that single-person households would see their tax bills rise at rather lower property values than £250,000, since they currently receive a 25% discount on their council tax that is not shown in Figure 16.1.

To be clear, there are four major differences between council tax and an HST:

(a) Council tax provides discounts for single occupants and for second and empty properties. These encourage inefficient use of the housing stock (among other distortions). An HST would not have this feature.

[22] There is considerable uncertainty around this figure, however: different calculations based on various published statistics suggest different revenue-neutral rates, some higher and some lower than that used here. In any case, as discussed below, the revenue-neutral rate would have to be quite different in different years to yield the same revenue as council tax, since property prices rise and fall. For comparison, the rates levied in Northern Ireland in 2009–10 ranged from 0.55% to 0.74% of value, depending on district.

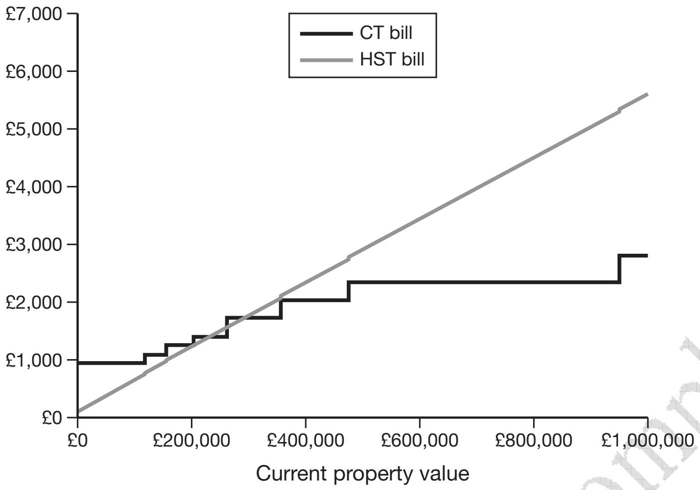

Figure 16.1. Comparing a 0.6% tax on property values with council tax in a local authority setting average band D rate in England, 2009–10

Note: Figures for council tax assume household not eligible for single-person discount and uniform growth of 185% in property prices since April 1991.

Source: Authors' calculations.

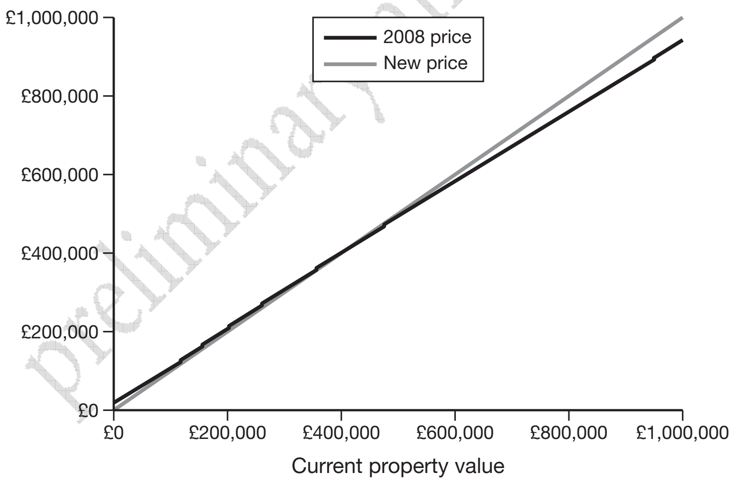

Figure 16.2. Impact on house prices of replacing council tax with a 0.6% tax on property values in 2009–10

Note: Assumes council tax rates at average level across England, no effect of single-person discounts on property prices, and uniform growth of 185% in property prices since April 1991.

Source: Authors' calculations.

(b) Council tax band rates are not proportional to band values. This unfairly and inefficiently favours more valuable properties, and particularly the most valuable properties of all.

(c) Council tax bills do not vary within bands. This again favours more valuable properties in each band. A pure HST would have taxes based on a continuous measure of value.[23]

(d) Council tax bills are based on relative property values in 1991 rather than today. This unfairly and inefficiently favours properties that have seen above-average price rises since then.

Figures 16.1 and 16.2 do not take account of (d), since we lack comprehensive data on relative house price changes. To look more closely at the kind of households that would gain and lose from the reform, we must also ignore (c), since the data on household characteristics do not contain information on the distribution of property values within council tax bands. We therefore model an approximation, shown in Figure 16.3, in which the

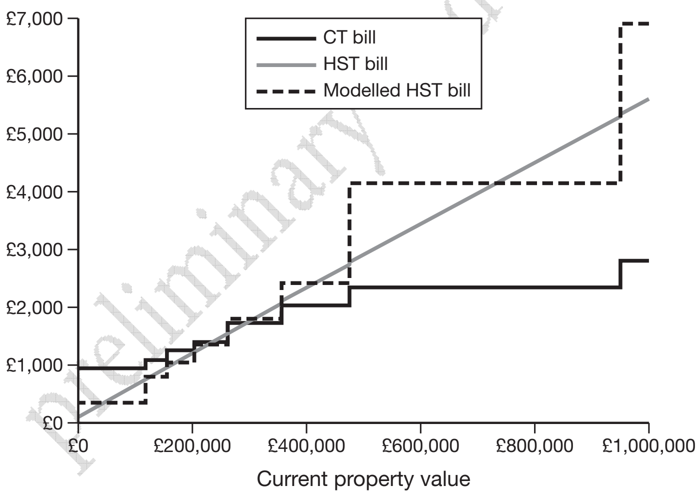

Figure 16.3. Modelled revenue-neutral reform to housing taxation

Notes: Assumes uniform growth of 185% in property prices since April 1991. Figures for council tax assume household not eligible for single-person discount.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2006–07 Family Resources Survey.

[23] There may be a case for some banding on administrative grounds, though we note that this was not deemed necessary in Northern Ireland or under the old domestic rates system.

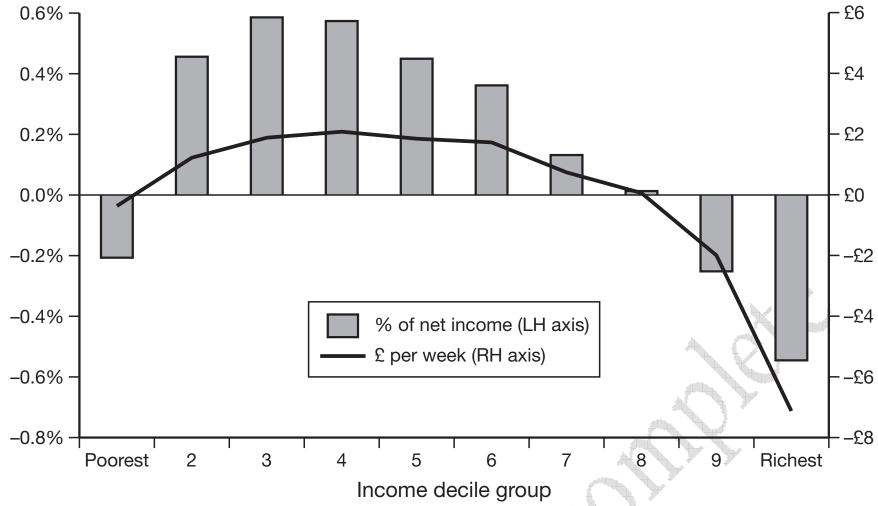

Figure 16.4. Gains/Losses across the English income distribution from modelled reform to housing taxation

Note: Income decile groups are derived by dividing all households in England into 10 equal-sized groups according to net income adjusted for household size using the McClements equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2006–07 Family Resources Survey.

tax rate for each existing council tax band is adjusted to be proportional to the value of properties at the midpoint of each band (and in which the single-person discount is abolished). The rates that achieve this in a revenue-neutral way are consistent with a tax rate of about 0.6% of value at the midpoint of each band.[24]

Overall, a reform of this type would be progressive. In general, better-off people live in more expensive houses. Figure 16.4 shows that there are gains, on average, for households in the second to eighth income decile groups, with losses in the ninth and, especially, highest income decile groups. The average loss for the lowest income decile group requires a word of explanation, however. Most of those on the lowest incomes would be unaffected by the reform, as they are entitled to council tax benefit (and, we assume, would be entitled to a corresponding HST rebate) to cover their tax

[24] The top band, band H, has no midpoint; we assume a value of £400,000 in 1991—£80,000 above the bottom of the band, which is the same distance above the bottom as the band G midpoint is above the bottom of band G.

bill.[25] Those on low incomes who are *not* entitled to council tax benefit are excluded from entitlement because they have too much financial wealth: those with non-pension financial assets of more than £16,000 are not eligible for council tax benefit.[26] The average loss for the bottom decile group reflects the fact that people with little current income but substantial financial wealth also tend to have big houses. They are low-income losers, but they may not be people we would ordinarily consider poor.

Table 16.2. Average gains/losses and numbers gaining/losing from modelled reform to housing taxation

	Average weekly gain/loss	% gaining > £5 per week	% losing > £5 per week
All-pensioner households	–£1.41	9%	13%
Of which:			
Lowest income quintile	–£0.35	4%	5%
2nd income quintile	+£0.63	9%	3%
3rd income quintile	+£0.31	11%	6%
4th income quintile	–£0.52	11%	12%
Highest income quintile	–£7.10	9%	38%
Working-age households	+£0.49	25%	12%
Of which:			
Lowest income quintile	+£0.88	14%	4%
2nd income quintile	+£2.72	34%	4%
3rd income quintile	+£2.45	36%	8%
4th income quintile	+£0.88	28%	13%
Highest income quintile	–£4.47	14%	28%

Note: Income quintile groups are derived by dividing all all-pensioner households in England, or all working-age households in England, into five equal-sized groups according to net income adjusted for household size using the McClements equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2006–07 Family Resources Survey.

[25] We assume full take-up of these benefits, which means that we understate the progressivity of the reform since most of those who do not take up their benefit would see falls in their bills.

[26] Entitlement is also reduced for those with less wealth than this: each £250 (£500 for those aged 60 or over) of assets above £6,000 is assumed to yield £1 per week of income for the purposes of the means test.

Table 16.3. Characteristics of households in England by council tax band, 2009–10

	Bands A–D	Band E	Band F	Band G	Band H
Number of all-pensioner households	4,195,000	499,000	315,000	215,000	33,000
Of which:					
In bottom half of overall income distribution	2,967,000	284,000	152,000	68,000	[a]
In bottom fifth of overall income distribution	1,163,000	134,000	80,000	40,000	[a]
Number of working-age households	13,200,000	1,514,000	811,000	558,000	82,000
Of which:					
In bottom half of overall income distribution	6,459,000	400,000	228,000	95,000	[a]
In bottom fifth of overall income distribution	2,553,000	148,000	97,000	46,000	[a]

a. Sample size too small to yield reliable estimate.

Note: Official figures for the total number of households in each band (shown in Table 16.1) differ slightly from those shown here, but they do not allow disaggregation by income or demographic group.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2006–07 Family Resources Survey.

While the reform is progressive on average, however, there would be many losers and gainers at all parts of the income distribution, as illustrated in Table 16.2.

To illustrate some of these issues in a different way, Table 16.3 provides some details of the characteristics of those currently in different council tax bands. A majority of those in bands A to D are in the lower half of the income distribution. This is true of a much smaller proportion of those in higher bands. But even so, 30% of pensioners in band G are in the bottom half of the income distribution and approaching 20% are in the poorest fifth by income.

There would clearly be a large number of losers from a reform of this kind. The losers would include those, often older people, on low incomes who live in expensive houses. This would undoubtedly make such a reform politically difficult. On the other hand, its desirability comes from the fact that those living in expensive houses are consuming something valuable that, in other circumstances, we would not hesitate to tax. Such people are unlikely to be lifetime poor, and taxing people in proportion to the full value of the property they occupy would lead to a more rational use of the existing housing stock. However, neither the politics nor the ethics are straightforward.

There are, though, a number of ways of mitigating losses from the reform. We have assumed, in the first place, that a benefit like the current council tax benefit would be maintained. This would ensure that those with very low incomes and little in the way of other savings would be protected.[27] Second, one would likely want to implement the reform over some transition period such that bills rose only gradually. The lengthy phasing-out of mortgage interest tax relief shows that reforms with potentially significant effects on prices can be achieved given an appropriate timescale. Finally, it would be possible to allow people, in specified circumstances, to roll up liabilities (with interest) either until the property is sold or until death, in order to alleviate cash-flow problems. A system along these lines operates in Denmark.

Political difficulties would also no doubt arise from the fact that a well-functioning HST would require a full revaluation of domestic properties and a credible commitment to further revaluations every three to five years (at least). But this, of course, would be desirable even if we were to keep council tax.

Any property tax—be it council tax, HST, business rates, or LVT—with regular revaluations will see the size of the tax base rise and fall as property prices generally rise and fall. If tax payments correspondingly rose and fell, some would consider that a good thing, acting as an 'automatic stabilizer' in the property market. Others would see the instability in bills as undesirable for households and the instability in revenue as undesirable for the government.

But it is not necessarily the case that tax payments would change in line with the tax base. At present, council tax rates are set locally, and we see no good reason for HST to be different. Under the current system of local government finance, bills would not rise and fall with prices. The revenue that local authorities must raise—and therefore the amount that households must pay—is simply the difference between what they wish to spend and the

[27] With no other changes, such a benefit would be smaller than council tax benefit, reflecting the fact that an HST would be more progressive than council tax. There is separately a case for reforming this benefit, perhaps decoupling it from actual bills, but a discussion of its possible reform is well beyond the scope of this book.

grant they receive from central government. If property prices rose, councils would simply reduce the tax payable at any given property value so that household bills, and the revenue generated, were unchanged. Grant from central government might be redistributed between areas if relative property prices changed, but what was gained by one would be lost by another; if total grants remained the same and total local authority spending remained the same, then total revenue to be raised from the local property tax (and so average bills) would also remain the same.

For a centralized property tax, revenues could potentially rise and fall with the property market—much as revenues from stamp duty already do.[28] But if this were thought undesirable, the government could prevent it by automatically adjusting tax rates to keep revenues on a stable path: a formula that tied the annual overall increase in payments to something like the historical long-run trend rate of house price growth might be one such revenue-stabilizing mechanism. This is similar to the current business rates formula, which allows changes in relative payments in response to changes in relative property values, but which constrains total payments to rise in line with retail price inflation even if property prices on average fall or rise significantly.

To summarize, our basic proposal is straightforward: council tax as it currently exists should be replaced by a housing services tax which would, eventually, be charged in full proportion to the value of the property—and hence would leave the majority who own less valuable property somewhat better off and those owning more valuable property worse off. We do not propose a separate tax on residential land value. Ideally, the tax rate might be set at 17.5%, since it is intended to substitute for VAT on the consumption of housing; but a more pragmatic medium-term goal might be to replace the revenue currently provided by council tax and stamp duty on residential properties, which would probably imply a slightly lower rate than this.

[28] Though note that if local property taxes were simply replaced by, say, a local income tax as the main locally controlled tax, local income tax rates would rise and fall to keep revenue at the desired level exactly as described above for local property tax rates. Thus the greater cyclicality of property tax revenues would be offset by reduced cyclicality of overall income tax revenues.

16.2.2. Taxing Housing as an Asset

Gross housing wealth in the UK stood at £3.7 trillion[29] (£3,700,000,000,000) at the end of 2008, with about £1.2 trillion of loans secured against it. Gross financial assets also stood at around £3.7 trillion.[30] In other words, housing is as important as an asset as all financial assets combined. And it dwarfs the less than £300 billion held in tax-free Individual Savings Accounts (ISAs). Seventy-two per cent of households own the property they live in.[31]

The sheer scale of the value of housing makes its tax treatment as an asset very important. To begin our discussion, it is worth summarizing two other key features of housing wealth:

- First, people's net housing wealth varies across the life cycle. Looking at the population today, people under the age of 30 tend to have small amounts of housing wealth. Even among 40- to 45-year-olds, barely 10% own a property outright (without a mortgage), compared with over 70% of 65- to 69-year-olds. Those with the greatest housing wealth on average are in their 50s—they have had a chance both to 'trade up' and to pay off their mortgages. The elderly own somewhat less housing—in part because they come from a generation where ownership was less common, relative to living in social housing, and in part because they may have 'traded down' to smaller properties.[32]
- Second, ownership of housing wealth is closely correlated with lifetime income and wealth, but not necessarily with current income. Those in their 60s own more housing wealth than those in their 30s but have lower incomes. But among retirees, those with substantial housing wealth have, on average, both higher total wealth and higher incomes than those of the same age with little in the way of housing wealth: among owner-occupiers over the age of 60, the highest-income tenth own properties worth on

[29] Not including social housing.

[30] Office for National Statistics, *United Kingdom National Accounts: The Blue Book 2009*, http://www.statistics.gov.uk/downloads/theme_economy/BB09.pdf. The household sector is 'households and non-profit institutions serving households' (hh&npish).

[31] Office for National Statistics, *Social Trends No. 39, 2009 Edition*, http://www.statistics.gov.uk/downloads/theme_social/Social_Trends39/Social_Trends_39.pdf.

[32] Numbers and statements based on our analysis of British Household Panel Survey (BHPS) data.

average almost £400,000, while those in the lowest-income fifth have properties worth around a third of that.[33]

Our concern in this section, though, is more with changes in housing wealth. The extent of gains over the past 35 years is shown in Figure 16.5, which plots real house prices since 1975. The trend line shows a real capital gain on housing of 2.9% per year. It is also clear from the figure that domestic property is an asset with a risky financial return. There are several periods of capital losses, most notably from 1989 through to 1995. House prices have also fallen since autumn 2007. Nevertheless, over the long run, there do appear to be significant, and arguably predictable, gains. Note that these gains are just part of the overall return to housing, which includes the return that comes in the form of housing services—a crucial point to which we return below.

Many factors influence house price changes. In local areas, there are unforeseen changes in local services and amenities that affect prices.

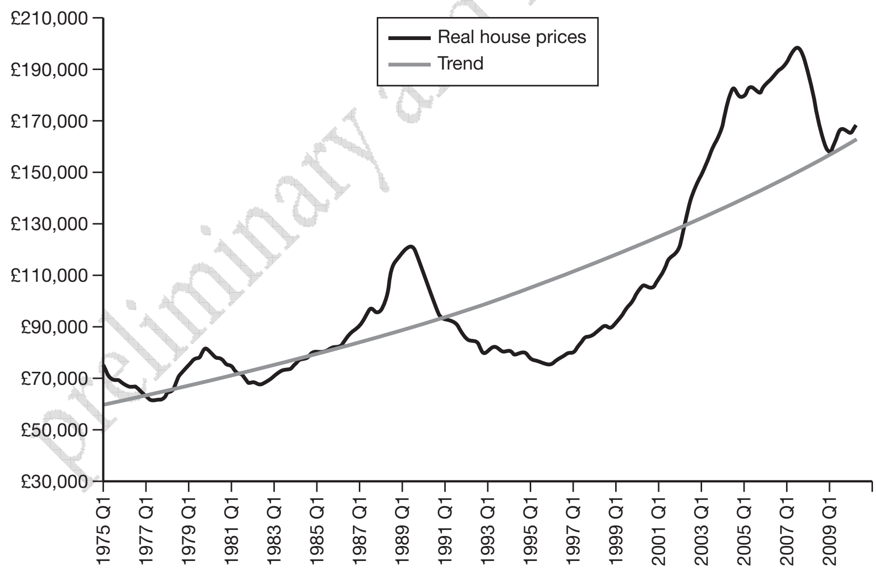

Figure 16.5. Real house prices and trend from 1975 Q1 to 2010 Q2

Notes: Prices in 2010 Q2 terms, uprated using the retail price index. Trend real growth rate is 2.9% per year.

Source: Nationwide Building Society, http://www.nationwide.co.uk/hpi/historical.htm.

[33] Our analysis of BHPS data.

Similarly, there are changes in the number of households, in the number of houses, and in lending conditions in financial markets. Given the relatively fixed stock of housing, increases in the number of households and the granting of bigger mortgages can increase both the demand for houses and their price.

House price growth has varied widely both between and within regions of the UK. Those who have been lucky—or perhaps particularly adept—in the property market have seen their wealth grow, tax free, by far more than others.

The question that we tackle here is whether and how the taxation of housing can be brought more into line with the system of taxation we are proposing for other assets.

16.2.2.1. A Rate-of-Return Allowance for Housing?

In Chapter 13, we characterized savings tax regimes according to the tax treatment of income saved, returns generated, and income withdrawn. Applied to the case of housing, the elements of this taxonomy are as follows:

- Income saved means the income used to buy (the cost of buying) the property.
- Returns generated take two forms: income from the consumption services provided by the property (either rental income received by landlords or the in-kind reward enjoyed by owner-occupiers) and any capital gain (or loss).
- Withdrawals include both the consumption services (which are, by their nature, 'withdrawn' and consumed at the same time as the property generates them) and receipts from selling the property.

Owner-occupied housing is currently subject to what we earlier described as an earnings tax or TEE tax treatment. It is bought out of taxed income, but no tax is payable on any returns or at the point of sale.[34] In contrast, housing that is bought to rent out is subject to something closer to a comprehensive

[34] Here and below we use 'owner-occupied housing' to mean principal private residences; capital gains on second homes are taxable, though there is some flexibility in designating which is one's main home.

income tax (TTE) treatment. Returns in the form of rental income and capital gains are subject to tax.

This difference in treatment creates a major bias in favour of owner-occupation, albeit less so since the tax-deductibility of mortgage interest payments was gradually removed for owner-occupiers but retained for landlords (see Box 16.1). The treatment of owner-occupied and rental property should be levelled out.

Box 16.1. The tax treatment of mortgages

The tax treatment of mortgages can be characterized in terms of the same three stages as other borrowing and saving, with the same main options for charging tax at a combination of these stages:

- **TEE—an earnings tax** simply ignores all borrowing and saving. Neither taking out a mortgage, nor making payments of interest or principal, has any effect on tax liability.
- **TTE—a comprehensive income tax** treatment of mortgages would allow full deductibility of mortgage interest from taxable income (but not add the amount borrowed to taxable income or deduct repayments of principal), just as it would fully tax interest income on savings. A comprehensive income tax thus taxes saving and subsidizes borrowing.
- **EET—a cash-flow expenditure tax** involves taxing all cash inflows and deducting all outflows, hence adding the loan to taxable income for the year when it is taken out and then deducting all payments of interest and principal.
- **TtE—a rate-of-return allowance** regime would allow deductibility of mortgage interest payments, like TTE, but only in so far as they exceeded a 'normal' rate of interest on the outstanding mortgage. (Unlike with TTE, there would be no difference in present-value terms between making interest payments and making repayments of principal. If a payment were labelled interest, it would be deductible; if it were labelled principal, it would not be deductible but, by reducing the value of the outstanding mortgage, it would reduce the stream of 'normal' interest allowances to offset against future interest deductions.)

In the UK, mortgages taken out on rental properties are given a TTE treatment: mortgage interest payments are treated as a business expense to be deducted against rental income, just like companies can deduct interest payments from their profits for corporation tax purposes. This is an appropriate counterpart to the current TTE treatment of rental housing itself.

Mortgages for owner-occupied housing were formerly also given TTE treatment. This may have been appropriate when (prior to 1963) the imputed rental income from owner-occupation was taxed under 'Schedule A' income tax; but once owner-occupied housing was itself given TEE treatment, continuing to allow mortgage interest deductibility led to a huge net subsidy for owner-occupied housing. To their great credit, successive governments responded to this by gradually restricting mortgage interest tax relief, and between 1974 and 2000 this relief was phased out entirely. The resulting TEE treatment of mortgages for owner-occupiers now matches the TEE treatment given to owner-occupied housing itself.

The current tax treatment of mortgages is therefore appropriately aligned with the current tax treatment of housing as a whole for both the owner-occupied and rental sectors. In this chapter, however, we argue for reform of the existing system, moving towards TtE taxation of rental (and, ideally, owner-occupied) housing. How should the taxation of mortgages be adjusted in line with this? Two approaches are consistent with our proposed direction of reform:

- TEE treatment—ignoring mortgages entirely in the income tax system—is certainly appropriate for owner-occupiers if owner-occupied housing continued to have TEE treatment; but it would also be a simple and viable option for mortgages on (rental or owner-occupied) properties that were given TtE treatment. Relative to the current tax treatment of mortgages, this would simply mean abolishing mortgage interest deductibility for landlords.
- For housing investment that was given TtE treatment, an alternative would be to give TtE treatment to loans secured against that property. TtE on the property would involve taxing (actual or imputed) rental income and capital gains above an allowance for a normal return on the purchase price, while TtE on the mortgage would involve deducting mortgage interest above an allowance for a normal return on the outstanding mortgage. Taking the property and the mortgage together, this means taxing rental income and deducting mortgage interest payments, as happens for landlords now, while giving an RRA against the purchase price net of outstanding mortgage. This can be thought of as an 'allowance for housing equity' regime, highlighting the parallel with the 'allowance for corporate equity' described in Chapter 17 and the 'allowance for personal equity' terminology for describing RRA in general.

TtE treatment of mortgages might be the more obvious counterpart to TtE treatment of the housing itself. But TEE has the advantage that it taxes the financial service provided by mortgage lenders. As a form of implicit charge for their services, lenders may demand more than a normal rate of interest on the mortgages they provide. Under TEE, this charge for financial services is a private matter between borrower and lender, like the provision of any other service. But under TtE, with mortgage interest above a normal rate tax-deductible, the Exchequer provides the borrower with an income tax deduction for the financial services supplied to him/her. If we do not wish the consumption of financial services to be tax-deductible—and there is no obvious reason to privilege financial services in this way—this gives a reason for preferring TEE treatment of mortgages. Other than this, we see no strong grounds for choosing between the TEE and TtE treatments of mortgages on TtE housing. The choice could be mandated by the government or left for borrowers and lenders to decide.

Neither the TEE treatment currently applied to owner-occupiers nor the TTE treatment applied to landlords seems appropriate for housing. TTE straightforwardly penalizes saving, as discussed in Chapter 13: investing in buy-to-let housing is currently discouraged by the tax system for no good reason. TEE does not discourage saving in this way. But since TEE exempts not just the normal return to capital saved but the entire return, it fails to capture any excess return that may arise as a result of sheer luck, rents earned, or effort and skill put into choosing undervalued properties and improving them. The deficiencies of this are most clearly seen by noting that a TEE treatment of all housing would entail leaving professional property investors, who make their living seeking these excess returns, entirely untaxed. If I buy a house that I then sell at profit, reinvesting, selling, and so on, under a TEE regime I would never be subject to tax despite the fact that I am clearly earning an income in this way.

We have observed that either an EET consumption tax or a TtE rate-of-return allowance (RRA) can tax excess returns while leaving the normal return to capital untaxed and therefore not discouraging saving.

An EET consumption tax treatment of housing—allowing houses to be bought out of pre-tax income and then taxing any value extracted from them (actual or imputed rental income and proceeds of sale)—is not appealing. It would mean that someone buying a house outright would have the entire purchase price deducted from their taxable income for the year. Since houses normally cost far more than a year's income, this would mean the person made a large loss for tax purposes that year, resulting either in a negative tax bill (a refund from the government) or in losses to be carried forward and set against income for several future years, depending on the tax treatment of losses.[35] Creating losses on such a monumental scale is something no tax authority would entertain as a practical proposition.

In our view, a TtE rate-of-return allowance provides the most promising avenue for reforming the taxation of housing as an asset. Recall that an RRA regime involves assets being acquired out of taxed income and only returns above a 'normal' or 'safe' rate being taxed.

Introducing an RRA for rental property would be fairly straightforward. It could be based on the existing system, taxing both rental income and capital gains; but landlords would now be able to claim an allowance for the normal return on their investment. This allowance could take one of two forms:

(i) In the purest form of RRA, an allowance of 5% (say) of the purchase price would be deductible against rental income each year. When the property was sold, capital gains tax (CGT) would be charged at the taxpayer's marginal rate on the full nominal gain.

(ii) Alternatively, rental income could continue to be taxed in full, as at present. But when the property was sold, the base price for calculating CGT would be stepped up by 5% per year (appropriately compounded).

These methods differ only in the timing of the allowance given; the government could choose between them or else allow each individual to choose for themselves. Method (ii) is equivalent to the landlord simply not claiming the annual allowance available in (i) but instead carrying it forward with interest and claiming it at the point of sale. Note that if a property yielded exactly the normal return, method (ii) would generate a CGT *refund* when the property was sold, with the same present value as the stream of taxes paid on rental income. In practice, housing has tended to yield more than a normal return in the UK, but method (ii) would still imply substantial refunds in many cases. This generation of widespread losses (albeit on a far smaller scale than with EET treatment) may be off-putting for revenue

[35] The outcome would not be this stark in all cases. Once an EET system had bedded down, those selling one house and buying another would see the sale and purchase offset each other, so they would only pay tax (or receive a refund if downsizing) on the difference in price between the two properties. If EET treatment were also applied to mortgages (see Box 16.1), those taking out a mortgage to finance a house purchase would receive a deduction only for the non-mortgage-financed part of the purchase.

authorities; on the other hand, method (ii) has the advantage of being closer to current UK practice and therefore raising fewer transitional difficulties.

To illustrate how an RRA might work, suppose it costs me £200,000 to buy a house and that the rental income from it is initially £10,000 a year. With a normal return of 5%, my RRA on method (i)—5% of the purchase cost, or £10,000—cancels out this return for tax purposes and I pay no tax. If the rent then rises to £11,000, my RRA is still £10,000, so I pay tax on £1,000's worth of housing services; if I sell the house for £220,000, I pay tax on £20,000 of capital gain. The equivalent alternative, method (ii), would be to tax the whole income of £10,000 or £11,000 each year, but only tax any capital gain above a carried-forward allowance. After 10 years, tax would be paid on any capital gain over about £126,000[36] in this case, with anything less than this treated as a loss.

An RRA could be implemented for owner-occupied housing in the same two ways as for rental housing. The calculation above would work in exactly the same way, except that instead of an actual rental income there would be an imputed rental income. So, to be clear:

(i) Imputed rental income could be taxed only where it exceeds 5% (say) of the purchase price, with CGT charged at the taxpayer's marginal rate on the full nominal gain.

(ii) Imputed rental income could be taxed in full—in effect adding the homeowner's marginal income tax rate to the HST rate—with CGT charged only on gains relative to a base price that was stepped up with interest.

Of course, it would be harder to introduce an RRA for owner-occupied property than for rental housing. The most obvious problem is that a large part of the return—the consumption services provided by the property—is received in kind rather than in cash, and is therefore difficult to value—though it is exactly what we propose to value and tax for our HST proposal above. The same valuation could be used for both purposes, although this would put an extra premium on ensuring valuations were accurate.

[36] The purchase price stepped up with interest would be £200,000 × 1.05^{10} = £325,779, so tax would be payable on gains above £125,779.

It is important to note the relationship between this proposal and the HST proposal. An HST, like a VAT, is designed to tax the consumption of housing itself. An RRA is designed to tax the consumption that a property purchase *finances*—whether that be consumption of the housing services themselves or whatever the cash from renting or selling the property can buy—but only in so far as it exceeds the consumption that the money used to buy the property would 'normally' be expected to finance. Tax is only paid in so far as a house delivers and finances more consumption than the money used to purchase it: if housing yields only a normal return, no tax is payable.

Starting from the UK's current position, method (i) looks much less attractive for owner-occupied property than for rental property. CGT already exists for rental property. But introducing it in full for principal residences might discourage people from selling their property if they believed there was a significant chance that the new tax would be abolished by a future government. As discussed in Section 16.1.1, this was a key factor undermining attempts to introduce development taxes in the past. The fact that a reform could be presented as bringing housing within a consistent tax regime applying to all assets might help persuade people of its durability, but there is little doubt that such a change could only be feasible with the sort of political consensus in its favour that currently looks very distant. Method (ii) may not suffer from this problem, since the expected CGT bill would be much smaller—indeed, negative in many cases. Rather, the downside of method (ii) is the political unpalatability of proposing to tax the annual consumption value of housing not just at the HST rate (offsetting the abolition of council tax and stamp duty land tax on average) but additionally at the homeowner's marginal income tax rate. Building a consensus around one of these options is important if we are to move towards a fair and efficient tax system. But we do not underestimate the challenges involved.

Once again, the taxation of improvements poses something of a problem. Spending on improvements is essentially additional investment in the property, generating returns in the form of higher (actual or imputed) rental income and capital gains. Strictly speaking, it should therefore be added to the purchase price in calculating the basis for a rate-of-return allowance.[37] This is similar to the current treatment of improvements to rental property:

[37] An alternative would be to treat spending on improvements as an immediately deductible expense, in effect giving EET treatment of improvements.

spending on improvements above a certain level is recorded and reported and netted off the capital gain when CGT liabilities are calculated (though note that the spending ought to be carried forward with interest, in line with method (ii) of implementing an RRA described above). However, extending this (not very heavily policed) regime from a relatively small number of such properties to the vast bulk of the population would involve very substantial additional administrative complexity.[38]

Introducing an RRA regime for rental properties would be feasible, sensible, and relatively inexpensive.[39] Introducing an RRA regime for owner-occupied housing as well would be ideal: it was surely inappropriate that the enormous returns enjoyed by homeowners during the long property boom up to 2007 went untaxed. But we recognize that this would be much more difficult and may be politically impossible in practice. Even if owner-occupied housing continued to be subject to the present TEE regime, however, bringing in a rate-of-return allowance for rental property—and, as for other assets, aligning CGT rates with income tax rates—would be a major improvement. It would bring the tax regimes for rented and owner-occupied housing much closer together, completely eliminating the bias towards owner-occupation for property that generated a normal return. It would also

[38] In particular, recall that the implicit rental income from owner-occupied housing is imputed (rather than observed), based on a valuation that may not take account of all improvements. If the return to such improvements in the form of higher implicit rental income is not taxed, the cost of those improvements should not generate a deduction against the tax on imputed income—just as we argued that improvements that do not affect valuations for the HST should not be zero rated for VAT. But all improvements will presumably affect the actual sale price of the property, so the returns to improvements will be subject to CGT at that stage and some deduction for the cost of improvements is warranted. The correct—rather complicated—treatment is for improvements that do affect valuations to be registered immediately (either deductible immediately, or added to the basis for the RRA, or carried forward with interest and netted off the capital gain) and for improvements that do not affect valuations to be ignored initially but netted off the capital gain (*without* interest being added) when the property is sold.

[39] The precise cost is difficult to estimate. If 2009–10 tax rates were applied to 2006–07 taxable property income and gains on disposal of property, total revenue would be about £3.5 billion; an RRA would only involve giving up that part of the £3.5 billion that reflects normal returns. However, as part of our overall package, we would also be increasing tax rates on property income and capital gains to align them with full labour income tax rates (including what are currently National Insurance contributions); this implies collecting more revenue from taxing 'excess' returns but forgoing more revenue by not taxing 'normal' returns.

bring the taxation of rented housing into line with (our proposals for) taxation of other assets.

16.3. STAMP DUTY LAND TAX

Before drawing this chapter to a close, we need to say something about a tax that is currently charged on residential and commercial property transactions—stamp duty land tax. In 2010–11, it is levied at rates of 0% on transactions below £125,000, 1% between £125,000 and £250,000, 3% from there to £500,000, 4% between £500,000 and £1 million, and 5% above that.[40] Unlike, say, income tax, the relevant rate applies to the full sale price, not just the part above the relevant threshold—so a house selling for £500,000 would attract tax of £15,000 (3% of £500,000), whilst a house selling for £500,001 would attract tax of £20,000 (4% of £500,001): a £1 increase in price triggering a £5,000 increase in tax liability. This is, of course, an absurd structure for any tax.

Stamp duty has a long history in the British tax system, having first been introduced in 1694. It stems from a time when few other potential taxes were straightforward to implement, whereas the transactions on which stamp duty was levied were easy to identify and to measure. But, in the modern era of broadly based taxation, the case for maintaining stamp duty is very weak indeed. As discussed in Chapter 6, transactions taxes are particularly inefficient: by discouraging mutually beneficial transactions, stamp duty ensures that properties are not held by the people who value them most. It creates a disincentive for people to move house, thereby leading to potential inflexibilities in the labour market and encouraging people to live (and for businesses to operate) in properties of a size and in a location that they may well not otherwise have chosen. The 'slab' rate structure described above is especially perverse, meaning that transactions of very similar value are

[40] The stamp duty land tax threshold is £150,000, rather than £125,000, for non-residential properties and for residential properties in certain designated disadvantaged areas. The 2010 Budget announced that the threshold would be £250,000 for first-time buyers of residential properties in the two years up to 25 March 2012.

discouraged to completely different degrees and creating enormous incentives to keep prices just below the relevant thresholds.

There is no sound case for maintaining stamp duty and we believe that it should be abolished. Simply removing it would create windfall gains for existing owners, as it will largely have been capitalized into property values; so a reasonable quid pro quo for its abolition is that a similar level of revenue should be raised from other, more sensible, property taxes. If stamp duty were phased out while our proposed new land value tax and housing services tax were being brought in, then those losing most through the latter change would be among those gaining most as a result of the former. Revenue neutrality would at least ensure no windfall gains or losses on average.

16.4. CONCLUSIONS

The taxation of property in the UK is currently something of a mess. As we have seen when considering the practicalities involved in implementing an ideal system, up to a point this is understandable. But it remains both desirable and feasible to clear up much of the mess. Our conclusions can be summarized thus:

- There is a strong case for introducing a land value tax. The priority should be to use it to replace the economically damaging business rates system.
- Council tax should be reformed to relate it more closely to actual property values: levied as a proportion of up-to-date values with no cap and no discount for unoccupied or single-occupancy properties. We have called this a housing services tax to reflect its underlying economic rationale as a tax on housing consumption to substitute for VAT.
- Taxation of rented housing should be reformed by offering landlords an allowance against the normal return to their investment (and by aligning capital gains tax rates with income tax rates, as discussed in Chapter 14). In principle, it would also make sense to move towards a rate-of-return allowance basis for the taxation of owner-occupied housing, but this may prove extremely difficult in practice.

- Finally, stamp duty land tax should be abolished and the revenue replaced as part of the housing services tax (for domestic property) and land value tax (for business property).

This is a radical set of proposals, and the changes would need to be phased in carefully. But this is also an area where the current practice is a long way from an economically rational and efficient system. Stamp duty and business rates defy the most basic of economic principles by taxing transactions and produced inputs respectively. Income tax and capital gains tax create a significant bias against the rental market in favour of owner-occupation. Meanwhile, council tax is indefensibly regressive and, thanks to spineless government refusal to undertake a revaluation, we find ourselves in the absurd position that tax bills are still based on relative property prices in 1991. Over time, this arrangement will come to be seen as more and more untenable. At some point, some government will have to grasp the challenge of making the case for intelligent reform.