Residential Property Taxation

Highbury Group on Housing Delivery

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Introduction

This review does not seek to explain the operation of each tax that can affect the supply and price of housing, nor to go into detail of the changes proposed by academics and think tanks to each individual tax. The aim is to take an overview and to add some perspective which has been missing from some proposals. Hopefully we can consider all relevant taxes in aggregate – as suggested by Kate Barker at the Highbury Group the last time we had a detailed discussion on one aspect – taxation to encourage better use of housing stock.

See useful short guides by the Office for Budget Responsibility for details on each tax and recent changes [Tax by tax]

The debate has moved on considerably in the last decade.

We used to spend interminable hours looking at the subsidy and taxation balance between tenures [Ermisch and Hills]. In particular, we would argue about the implied subsidy to ownership from the absence of tax on imputed rent for the owner occupier, a tax on the estimated benefit received for their investment. Whilst some still argue the point, this debate has faded away as the associated tax relief on mortgage interest paid has been removed, and no one wants to bring that back. We have also changed our taxation terminology to speak of income in terms of monies received rather than hypothetical benefits from investments. In my own work the purchase price for a property (and the premium part of a lease) equate to an upfront payment for the net rent[1] in perpetuity or for the lease term for that property. We do not always call the purchase of a flow of benefits an "investment" where the beneficiary is the user. Would a long-term season ticket be an "investment"? But where the purchase leads a flow of actual income (e.g. buy to let) then clearly this is an investment and the net income is taxed. One of the characteristics of taxation is that there are few hard and fast definitions, that's why we need the political process to draw a line, and why Finance Acts take up so many pages.

A second characteristic of British housing taxation is that we have been at it for centuries. Many ideas have come and gone[2] but a rather odd collection remains. There is no coherent logic to what we have, but in many regards it works. In fact the combination of administrative ease of collection with hitting households where it hurts least or is perceived to hurt least seems to be the abiding strength. Studies of what happens in other countries can help stimulate creative thinking but in the case of housing taxation I think all it shows is that we have already tried that, and there is little to learn. For an excellent round up of the position in other European countries see [Whitehead].

A third characteristic of housing taxation is "taxation capitalisation". House prices are determined by what house buyers are able to afford. An increase in spending power of a household caused by a reduction in taxation will mostly lead to an increase in the amount that the household is able to pay for its housing[3]. And vice versa. The ratio of spending power to price paid (the standard

[1] Net rent is rent after void losses, operating costs such as maintenance, and reserve contributions for future major renewals.

[2] Window Tax led to unsustainable unintended consequences, though I observe we have wonderful Georgian architect to thank for it (fewer but bigger windows).

[3] In my studies of the national housing market, I observe that more than 80% of households will pay as much as they can afford (often by foregoing some other expenditures for a few years). This is in contrast to simplistic supply and demand economics where a buyer of goods seeks the lowest price. I have also been

affordability ratio) changes very little, and is closely related to the cost of basic commodities such as food, fuel, clothing and transport leaving a proportion to spend on housing remaining from taxed income[4]. The other major factor in absolute price levels is the cost of money (both real and nominal interest rates), which have been on a long-term downward trend and reduced further by monetary policy immediately following the Global Financial Crisis and then the Covid pandemic. Hence we have seen, to date, a steady increase in housing asset values. On an aggregate level housing supply has a very small impact on prices, so small that setting housing targets for local plans based on affordability ratios is a logical nonsense in my view.

Taxed income is the key and for this reason we have to look at all taxes that affect households. Using the OfBR economic outlook [Economic and fiscal outlook] for 2022/3, and estimating taxes paid by corporates, the table below sets out all material taxes on households:

Table 1

Tax 2022/3	Paid by households £bn	%
Income tax	245.5	36%
National insurance	179.0	26%
Value added tax	123.3	18%
Council tax	41.9	6%
Other taxes	22.7	3%
Property transaction taxes3	17.1	2%
Capital gains tax	15.0	2%
Alcohol duties	12.7	2%
Tobacco duties	10.9	2%
Inheritance tax	6.7	1%
Insurance premium tax	6.0	1%
Vehicle excise duties	5.7	1%
Air passenger duty	2.9	0%
Stamp taxes on shares	0.9	0%
	690.2	100%

The £690bn represents 80% of tax receipts, businesses pay the rest c. £300bn, and government receives about £94bn more from fees, charges and other receipts.

A change in Inheritance tax might affect house prices a bit, but not as much as a change in Income tax. Neither would change affordability ratios.

This is a broad but workable simplification of "Taxation Capitalisation". The next most significant tax dynamic is behavioural change. Changes in Alcohol or Tobacco duties would probably change consumption of these, rather than change house prices. Total spending power and house prices would be unchanged, so again no change in housing affordability.

struck by the corollary of a minority but tangible number of low-income households deciding to live in cheap poor quality inadequate housing, making the conscious decision to pay as little as possible so that they can afford better education for their children or provide financial support to other family members.

[4] In other counties the cost of education, or of health services/insurance, and/or of the taxes needed to provide a much more generous state pension, leave a reduced "after-basics" disposable income compared to the UK, and thus lower absolute house prices and relative to gross income e.g. Germany, France, and USA.

Finally, by way of introduction we need to be precise in our aim to reform housing taxation. We need to be careful to distinguish between measures which increase (or reduce) taxation overall, from measures which redistribute the tax burden without changing the total tax take. Some aims for reforming housing taxation that I have heard include:

- Increasing the quantum of new housing supply
- Increasing the affordability of new and existing housing supply
- Improving the effective use of existing and new supply
- Recovering excessive asset value growth
- Ensure the rich pay a fairer share and the poor pay less
- Reducing the intergenerational divide

In looking at these it is Important to distinguish between reform which increases overall tax take, and reform which reshapes and redistributes existing tax take.

I will address these in the conclusion.

Before that conclusion I will consider current debates about reform of some of the taxes that relate more to housing.

In recent response to government consultation we, the Highbury Group collectively, have stated **Council tax** should be replaced by a **progressive value- based land and residential property tax**, and **Stamp Duty Land Tax** should be replaced by a **capital gains tax** on residential property sales. In undertaking this review I now conclude we are on the wrong track.

Council Tax

Thirty-two years ago, after much dissatisfaction with the old system we abolished Domestic Rates (a form of proportional tax broadly based on ability to pay) and replaced it with Thatcher's bete noire, the Community Charge (broadly the cost of local services per person). The Council Tax introduced in 1993 was a deliberate melding of these two principles – payment for use + ability to pay. It has survived thirty years which must say something about its durability. But it has more recently be criticised as a regressive tax in respect of property values.

The gross disparities between payments for example by an occupier of a one bed flat in Leeds being similar to that of a 4-bed house in Kensington are not completely the fault of Council Tax design. The main reason for this disparity (often quoted but only really applies to about ten authorities) is because those authorities have very high business rates income, large incomes from charges for services eg parking, and low demands for social care. In that CT is the "top-up" for local government funding those minority authorities need only charge a low CT.

Some argue that a higher Band is needed for properties above Band H (as has been implemented in Scotland and Wales). But much of that is political posturing rather than practical tax gathering. The amount that would be raised in a typical area (I have used Gloucester County authorities) is a paltry £85k on top of a total of c £480m, or 0.02% gain. Hardly worth the cost of change in most of England.

Two recent papers from Bright Blue [Cheshire] and IPPR [Murphy] revise the idea of a proportional property tax to replace CT.

We discussed this at Highbury Group in 2012. From a housing affordability point of view or improvement in supply the change has no effect, but we did consider, on a theoretical footing, whether a rate that was set each year nationally could dampen house price variability. Within a reasonable range of pressures on house prices it could be adjusted as a function of the previous year HPI dampening the next year's HPI. But of course, that would depend on politicians making difficult decisions, and on time, which is not our experience of political economy.

The Bright Blue paper seems to ignore the Taxation Capitalisation effect. Though it does raise the important point of the possible benefit of separating taxation for services run by local authorities but where the service standard and the resources available are set by national government (e.g. education) where perhaps a national tax rate should apply, from those services (and taxation rate) more under the control of the local authority. Academically correct, but at a cost to the perception of local democracy in my view.

The IPPR paper recognises the Taxation Capitalisation effect, and therefore little or no change on housing affordability, but rather muddles that by also claiming that the increased spending power of lower income/wealth households would boost the economy, arguing that the propensity to spend is lower for the higher income/wealth households who would have a reduction. But, of course, there would be a trade-off between increased spending power and taxation capitalisation. I would argue most would go into increased house prices and rents for lower income/wealth households and that this effect would grow over time.

But what are we trying to achieve here? Council Tax collection is based on residential property values, but it would be some stretch to say that its purpose is to impact on house prices. It is not in pure terms a Property Tax. It is a tax or charge for local services. A historic comparison would be the Hat Tax in the late 18th early 19th century. National Government needed increased income for the European wars. It had no intention to alter fashion. The tax was collected by ability to pay – rich people had more hats. But you can imagine the unintended consequence. Similarly, the Brick Tax to pay for the American War of Independence. Not a good tax[5].

I would argue that Council Tax is reasonably well constructed for its purpose:

- It is a key element in local democracy – no taxation without representation. Losing the link to the cost of use of services would be a blow to democracy.
- It is a "fair" balance between use of services and ability to pay.
- It is easy to collect (97% collection rate is amongst our highest for our tax types).
- It is rarely challenged as values are placed in Bands and are backdated (taking changes in current value differentials into account) to 1991 values.
- And very important form my experience of running Council services, it can be accurately predicted.

One change that has been suggested is that a levy on the higher CT Bands could raise finance for growth in infrastructure. I have looked at the potential in Gloucestershire.

[5] Rich people built in stone and suppliers increased the size of bricks to reduce the tax paid. So government introduced a threshold, above which higher taxes were paid for larger bricks, and this is why most bricks are now 2015x103x65mm! The tax was abolished in 1850.

Table 2

Band	£pa each now	Extra Band	Plus a levy
D	1,900	1,900	1,900
E	2,322	2,322	2,522
F	2,744	2,744	3,244
G	3,167	3,167	4,167
H	3,800	3,800	6,800
I	-	4,433	11,933

This would raise £25m extra in the county for infrastructure – say a new station or a new secondary school. It would affect 20% of households but I think it would be a hard sell politically.

More importantly, on a macro level, I do not think we need increased public spending (through increased taxation) on infrastructure. As a nation we are spending about the right amount on public infrastructure to renew the old, to improve efficiency/productivity of our infrastructure, and for population growth requiring more infrastructure.

Our challenge is to get more private investment into the nearly 50% of our infrastructure that is corporately owned. We are not doing well here and are potentially subsidising through risk reduction on future utility and service charges. But then we are at a stage where there is money from the markets to invest but not enough projects that provide a reasonable return, and infrastructure in private companies is no different. Changes needed here are in a completely different context to Council Tax.

Capital Gains Tax

We have never had a Capital Gains Tax on primary residence.

It would need a review of indexation. Gordon Brown traded inflation adjust gains, which were complex to administer, for a lower CGT tax rate. We would need to bring that back in, as otherwise CGT would become an inflation tax for the average household.

The mechanism would need to differentiate between real growth in values (with allowance for improvements made) and inflation. This is a tricky territory. In my own work on housing market dynamics, it is clear that CPI and HPI are underlying opposites. Once other rising tides or bigger influences are removed (e.g., applying zero income growth as a parameter) then CPI at 1% would imply HPI at -1%[6]. But a recognition of this would mean little or no real growth if gains are adjusted by HPI, therefore no tax take.

CPIH is a bit of a fudge between these two. A better metric than RPI but a possible deflator. We would need a very much higher tax rate than income tax rates to make Housing CGT deliver as a replacement say for Stamp Duty Land Tax. That would go a long way from the theoretically ideal convergence of IT, CGT and Corporation Tax rates. Anything materially different between these rates creates a gaming of the system.

[6] I can go into the economics of this if HG members would wish at a later date.

Furthermore, a Housing CGT would need to recognise losses. Treasury (like those of us running local government) would avoid replacing a "steady and growing" tax with one that would fluctuate wildly with the housing market and even lead to negative tax in times of recession – just when a stable baseline in public resources is essential.

Finally, a Housing CGT would be perceived as a disincentive to down-sizing.

Overall, I think CGT on primary residence is a poor substitute for what we have.

Inheritance Tax

This is a tiny part of the tax scene. See Table 1. It only applies to a small part of the population but is a useful addition to the taxation of those with wealth. It is quite easily avoided though inertia and the difficulties of making such decisions in old age, or for your elders, means that many do not.

A dramatic change on IHT rules would have little effect on the housing market. For example a doubling of the tax take would reduce house prices by less 2% and that would be mainly in the upper half of the distribution. Might be useful but doesn't motivate me much!

One potentially useful suggestion is to replace inheritance tax with a tax on life time receipts of gifts from others (usually parents and grandparents) with a threshold that would enable a more equitable distribution of these intergenerational transfers, in that those receiving more than the threshold and with a higher tax rate would pay most of the tax. See [Atkinson]. Whilst there may be more social justice in this proposal, the amounts are relatively small, and the redistribution would have little effect on the housing market and probably no effect at all on housing affordability.

Stamp Duty Land Tax

This is the other tax that is getting criticism.

Apparently, it is a disincentive to job mobility. Whilst I can see the argument it is very hard to see this effect in the real economy. The main reason for what I believe is a small negative externality, is that most of us move the most for jobs before we become home-owners or before children arrive. After that we move mostly within 5 miles and very few move out of the local commuting zone. Given the geographical stability at this home buying middle stage in life, there will be little impact on job mobility if SDLT were abolished for residential transactions of primary residences.

It is quite a progressive tax, though simplified by a "slab" structure. And it is now, along with surcharges and Annual Tax on Enveloped Dwellings, a useful tool for dealing with property ownership being used for tax avoidance either through companies here or abroad – which are often owned by UK residents.

SDLT has some other "plusses" too.

- It is extremely easy to collect and administer with nearly a 100% collection rate from UK resident property buyers. You cannot legal own the house you are buying (cadastral record) without paying the tax.

- It can easily be switched on and off. Recent SDLT holidays were intended to boost activity and asset values in the Covid recession. In the end (with hindsight) it need not have been so dramatic, given that lower interest rates proved more effective. The holidays, and ending of holidays, came at a price of overload and slump for the housing market conveyancing world (surveyors, mortgage providers and solicitors). Nevertheless, being a tax on transactions, it was much easier to adjust than an annual tax.
- Being a tax on the buyer it does not have the perception of being a dampener on downsizing.
- It has loads of fiscal drag, and increased tax take, as value growth pushes properties into higher tax rates without having to change the rules.
- Finally, it is only marginally affected by downturns in value and activities. This is in complete contrast to CGT.

It is an archaic form of tax, but I would keep it!

Business Rates (Non-Domestic Rates)

This is perhaps not strictly in the remit of a Residential Property tax review. But it comes up frequently at Highbury Group. And some group members have contributed to some excellent work on its defects and proposing remedies. See [Aubrey] and [Dixon].

The more I look at this tax, and mostly I concentrate on Housing, the more I think it is not ideal. In my view we should tax the profit of businesses and companies rather than tax their inputs[7] such as land and buildings. But two things push against this:

- It must be fair that businesses/employers contribute to local services such as education and social care. [NB. Most business pay the full direct cost of some other local services such as waste collection and recycling rather than through rates now.]

- Putting the macro total of Business Rates (£30bn pa) on to Corporation tax (£65bn) would bump up the Corporation Tax rates to 28% which is well above the Income Tax rate average of 23% and would increase the gaming of the tax system compared to the proposed Corporation Tax rate increase (under debate again) to 25% for 2023/24.

We are probably going to keep Business Rates alongside Corporation tax but reducing it to a tax on the land value rather than the building seems to have merit to me.

Private Rental Sector

This could be a subject on its own. One point is worth mentioning here. A recent tax change[8] for private landlords (Buy to Let or accidental landlords) was a positive move in the direction of

[7] And conversely, I think we should tax people and households on their spending, income and wealth. Pragmatically it would be a mix but with emphasis on that order.
[8] Individuals on higher income tax rates are no longer able to claim mortgage interest relief at those higher rates.

harmonising the taxation treatment of income from lettings between taxation of individuals and of companies.

S106 replaced by a Levy?

This definitely is a subject on its own. We could still argue that planning obligations are not a tax but a use of resources following a "community " decision to allow a planning gain, and thereby mitigate the impact of that development. Strictly speaking this is not taxation nor a use of public subsidy.

The idea of replacing most of s106 obligation with a standard levy would bring the treatment of unearned land value uplift capture into the realm of public funds, as it would be a form of taxation. There are many problems with this proposal:

- The concepts of mitigating impact of development are very different from those of tax collection. I suspect the current levy proposal will not survive that debate.
- Many commentators [for example Baxter] overestimate the potential for land value uplift capture by taking the value of residential land from the National Accounts. This is an error. The accounts follow the accounting convention of depreciation of physical assets, which is shown as very high given the age of our buildings, leaving a very high residual land value. A better estimate is in the work of the Wealth Tax Commission [Advani] who show the residential land element to be about 12% to 13% of all household wealth.
- Most people who want a simplification of the often contentious and time consuming S106 negotiation process have little experience of the heterogenous nature of development proposals. They vary enormously in a way that can't be captured efficiently by a standard levy, even if set at a Local Planning Authority geographical level[9].
- Even at an LPA level a standard levy will have a reduced overall capturing effect as lower value developments (even with a threshold below which levy would not apply) would have to contribute more and thus make some unviable, and the much higher potential of capture on higher value developments would be capped at the levy.
- The setting of a levy would still require financial viability assessments (at a plan level rather than scheme by scheme) but these will be notional and thus even more open to argument about the, high sensitivity, assumptions used.
- The ability of a development scheme to pay a levy is actually non-linear[10] with respect to gross development value (per dwelling or square metre). A standard flat rate levy will capture less because of this point as well.
- Finally the levy would not "do away with" S106 negotiations (and scheme level financial viability assessments) which will be needed anyway for the mitigating obligations that might be needed but which are outside the levy definition of affordable housing and infrastructure (which by nature would have to be the more universal and generalist elements).

Having said that, we still need to improve our ability to capture the uplift, and in the context of a review of taxation I estimate that in time a tax will be needed. This is because the unearned uplift will grow in a double leveraged way until it reaches a point where more will be available than

[9] In fact one of the strongest proponents of a levy within the industry is the Berkeley Group who stand to gain dramatically, through their competitive land buying power, by the introduction of a standard levy.

[10] My own work, eg for Scottish Government, shows a more efficient formula would be a quadratic equation based on £psm of output vale, with a fixed minimum threshold to introduce fiscal drag. But with most people still struggling to understand the arithmetic of a financial viability assessment, I don't think the industry is ready for this yet!

needed (for affordable housing and infrastructure). We already see signs of LPAs wondering what to spend the money on (and perhaps too many Pelican crossings or roundabouts being installed in some places).

Meanwhile S106 is beginning to be seen as a money tree. More and more local authority costs (including maintenance of footpaths!) are being funded through uplift capture, and at the expense of affordable housing provision. Even the Residential Property Development Tax (a fund to help with recladding costs) will eventually be a form of uplift capture rather than a tax on developers' profits. This is a bizarre muddling of concepts (and responsibilities). I expect we will see more of these ad hoc anomalies before we introduce a sophisticated tax to capture uplift. Perhaps we will get there in ten to twenty years.

What are we trying to achieve? A conclusion?

In our discussions at Highbury Group, I have heard many reasons given for reforming residential property taxation. I have listed them in shorthand below:

- Increase quantum of new housing supply
- Increase affordability of new and existing housing supply
- Increase effective use of existing and new supply
- Recover excessive asset value growth
- Ensure the rich pay a fairer share
- Reduce intergenerational divide

This review of Residential Property Taxation hopefully sheds some light on the better ways to achieve these. My analysis would lead to the following:

Increase quantum of new housing supply

This begs a question: How much extra new supply do we need? We have a declining growth rate in new household numbers and demolition rates do seem to need to increase. I would say we should study this question carefully. Meanwhile I fail to see a tax measure that would increase supply, other than more taxation to increase the size of the GLA/Homes England grant allocations.

Increase affordability of new and existing housing supply

This begs a second question: How much more affordable housing (or subsidy) do we need? The evidence is that grant allocations are not being taken up, and indeed are beginning to be repaid. Registered Providers make increasing use of other sources especially lower debt costs, S106, cross-subsidy from market sales, and the exponentially increasing surpluses from historic stock. And For-Profit providers are now bringing in substantial private equity. With grant rates hovering about 10% to 15% of affordable housing costs of provision, and with the potential for reducing grant requirement, I fail to see why we would need additional taxation.

Increase effective use of existing and new supply

This is an important goal with many facets, perhaps simplified to "more efficient use of space". But we have looked at measures that might achieve this and so far have not found

any that do not have unintended consequences (or fail to recognise what people want to pay for). We should keep looking!

Recover excessive asset value growth

This might be the biggest goal. Certainly, there is a strong sense that housing price growth has given an unfair advantage to the older generations.

But I would argue that we should look to the wider taxation system than just property taxes. The main reason for this is that the house price rises are a result of both lowering of global interest rates, and of the deliberate policy instrument to lower interest rates to maintain or increase asset values in times of recession and crisis. It would be counterproductive for monetary policy tools to be undermined by a property value gain tax.

Ensure the rich pay a fairer share

Much the same point as above. There are some progressive ideas for a general income taxation overhaul. See [Atkinson] who suggests making income tax rates “slope” slightly steeper with lower rates at the lower income end as well, abolish income tax thresholds, and most importantly introduce different (higher) rates for unearned income (eg from financial investments). I would go further than that and suggest a third rate which would be to treat property income (mainly Buy to Let rents and Air BnB) as though it were a company tax structure within the individuals tax return.

The call for Council Tax to be a more progressive Property Tax is in my view misguided. As at tax for local services it is fit for purpose.

Reduce intergenerational divide

It is possible that reforming the individual (and household) income tax regime, and possibly with the addition of a lifetime gifts system instead of inheritance tax, we could do better. I don’t think Property Taxes are the answer. But we must keep looking.

Future topics for Highbury Group to explore

Throughout this review I have touched on topics that could be explored in more depth by the Highbury Group.

These are:

- How much new supply is really needed now?
- How much stock of affordable housing do we need?
- How is the financing of affordable housing changing?
- How taxation to capture land value uplift might work?
- What ideas could we bring to the table to make better use of existing stock?
- What could we design to reduce the intergenerational divide in housing?

And if people would like some more “techy” discussions, I could contribute on:

- CPI versus HPI dynamics.
- Concepts of imputed rent and mortgage interest relief on owner occupied housing.
- VAT on new supply and on rent and imputed rent.
- Model of house prices as determined by household disposable income after basics.

- The role of For-Profits in funding Affordable Housing.
- Is housing investment at the expense of investing in productive industries?

Let me know.

Pete

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