

5. The taxation of housing

Policy towards the housing market has been the subject of much recent debate. Concern about continued rapid increases in house prices has been a major focus: the average house price as a multiple of average disposable income per household is now at levels approaching those seen at the peak of the house-price boom of the late 1980s.¹ In its November 2003 *Inflation Report*, the Bank of England worries that ‘House price inflation has been well above earnings growth. This is clearly not sustainable in the medium term’ (page 6). This growth in house prices may be of concern for a variety of reasons, such as the inability of first-time buyers to purchase property, high levels of indebtedness relative to income and the effects of house prices on more general macroeconomic stability. Changes in house prices appear to have a larger impact on consumer spending in the UK than in other economies.²

In *Fiscal Stabilisation and EMU*³ – one of the supporting studies for the Treasury’s assessment of the UK’s readiness to adopt the Euro – much was made of the possibility of using tax instruments to stabilise the housing market and therefore the economy more generally, particularly were the UK to join the Euro and lose control over monetary policy as a national stabilisation tool. Two recent interim studies – the Miles Review of the market for long-term fixed-rate mortgages⁴ and the Barker Review of housing supply⁵ (see Box 5.1) – have looked at ways in which the economy may be made less sensitive to swings in the housing market: the first by reducing the sensitivity of consumer incomes to changes in interest rates via changes in mortgage rates, and the second by reducing the sensitivity of house prices to increased demand for housing by finding ways to increase housing supply.

¹ The Bank of England gives a ratio of just over 5 using the Office of the Deputy Prime Minister’s house-price measures and above 4 for both Halifax and Nationwide indices. These are all at or above their peak values in the late 1980s. Source: Page 7 of Bank of England, *Inflation Report*, November 2003 (www.bankofengland.co.uk/inflationreport/ir03nov.pdf).

² The Barker Review (see below) found that the correlation between private consumption and house-price inflation in the UK was 0.85, which is higher than the European average of 0.56. This correlation is merely suggestive – it could be that the UK economic and house-price cycles happen to follow similar paths whilst those in other countries are more distinct. However, if house-price swings do indeed cause movements in the overall economy, the government would have more reason to be concerned about a potential bubble in the housing market.

³ HM Treasury, *Fiscal Stabilisation and EMU*, London, 2003 (www.hm-treasury.gov.uk/documents/the_euro/assessment/studies/euro_assess03_studherefordshire.cfm).

⁴ D. Miles, *The UK Mortgage Market: Taking a Longer-Term View*, HMSO, London, 2003 (www.hm-treasury.gov.uk/consultations_and_legislation/miles_review/consult_miles_index.cfm).

⁵ K. Barker, *Review of Housing Supply: Securing Our Future Housing Needs*, HMSO, London, 2003 (www.hm-treasury.gov.uk/consultations_and_legislation/barker/consult_barker_index.cfm).

Box 5.1. Interim reviews of the UK housing market

In the 2003 Budget, the Chancellor commissioned two reviews of the UK housing market to report by Budget 2004. The first is a review of the UK mortgage market, headed by Professor David Miles of Imperial College. The second examines the supply of housing, headed by Kate Barker, a member of the Bank of England's Monetary Policy Committee. Each produced an interim report in December 2003, though policy proposals will not be published until the final reports.

The Miles Review

The scope of the Miles Review was to look at factors inhibiting the development of a long-term fixed-rate mortgage market in the UK. In 1999, over 60% of new mortgages taken out in the UK were at variable rates, compared with around 20% in the Netherlands and less than 10% in France, Germany, Greece, Spain and the USA. Virtually no new mortgages were taken with rates fixed for more than 10 years, compared with almost 80% of new mortgages in the USA. Having such a large proportion of mortgage debt at variable interest rates makes consumers' disposable income much more susceptible to changes in nominal interest rates than in countries where fixed-rate mortgages are the norm, which could hinder overall macroeconomic stability.

The interim review argues that three factors have tended to inhibit long-term mortgages being taken up more widely:

- Households attach too much weight to a low initial rate of interest relative to the overall cost of the mortgage over the whole repayment period. They do not adequately take into account the fact that low initial rates will increase after a period of time.
- Households do not value enough the certainty and stability of mortgage payments offered by a fixed rate.
- Borrowers do not appreciate that lenders finance low initial short-term fixed rates by increasing the variable rate onto which people move once this period of, say, two years has expired. This cross-subsidisation appears to be the result of consumer demands for a low initial payment rather than any anti-competitive behaviour by lenders.

The Barker Review

The remit of the Barker Review was to look at the reasons why rising house prices seem not to have encouraged developers to build more homes. Between 1971 and 2001, the trend rate of real house-price inflation in the UK has been 2.4% per year, higher than in any other EU country except Spain. Had house prices risen only in line with the European average, each first-time buyer would have paid on average some £32,000 less for their home in 2001. Despite these rises, housing supply in the UK was found to be only half as responsive to price as in France, one-third as responsive as in the USA and one-quarter as responsive as in Germany, and responsiveness fell to almost zero in the 1990s. This means that higher demand feeds through almost entirely into price increases.

The review highlights several constraints on the supply of housing:

- Land availability constraints: 69% of brownfield sites may not be immediately developable.
- Planning constraints: local authorities face few sanctions if their targets for new homebuilding are not met, so the costs of refusing permission to build (around 15% of applications for major developments were refused each year from 1996 to 1999 and 25% were refused in 2002) are small relative to the large initial costs of new homes.
- Infrastructure constraints: delays arising from the need for builders and other service providers, such as of transport and water, to interact have held up an estimated 40,000 new homes in the south-east alone.
- Risk constraints: a 1% change in house prices can generate an 8% change in housebuilders' profits.
- Failure of housebuilders to invest in new technologies.
- Shortages of skilled labour.

Given the concern about the level and growth rate of house prices, there have been calls for an increase in taxes on housing as a way to quell demand.⁶ These have been fuelled at least partly by a line in the Euro study cited above, which stated: ‘investment in housing is relatively lightly taxed compared to other investments’ (page 85). If this is true, then new or higher taxes on housing are a possibility if and when the Chancellor believes that he needs to raise more revenue.

The aim of this chapter is first to assess the extent to which housing is undertaxed. This requires careful consideration of the meaning of ‘undertaxed’ – relative to what? Even if we do suggest that housing appears to be undertaxed, we have to decide whether there are special economic reasons to justify this, such as encouraging owner-occupation. We go on to discuss possible instruments the Chancellor could use to raise the overall level of taxes on housing and property, discussing their merits and drawbacks and, where possible, analysing the potential effects across the income distribution.

5.1 Is housing undertaxed?

Housing is a curious good. For most homeowners, the past few years have provided large returns, making housing an excellent investment. Wealth levels have risen substantially – gross housing wealth was just under four times total household disposable income in 2002, higher than at any time since the peak of the last house-price boom and almost double the ratio in 1994–95.⁷ Yet housing is not just an investment good:⁸ it also provides a flow of services to people and in this sense is more akin to a durable consumption good such as a car. In order to assess whether housing is undertaxed, a sensible starting point may be to look at how housing is taxed relative to other investment or consumption goods. Even if housing did appear to be ‘undertaxed’ on either or both of these criteria, policy-makers may believe this to be justified by other objectives – for example, addressing some market failure that means that fewer people become owner-occupiers than would be socially optimal. For instance, promoting owner-occupation might be argued to increase social cohesion, giving people a greater sense of pride in their property and community, which results in greater care being taken over maintenance and repairs – this could be an external benefit of owner-occupation which might justify lower taxes on owner-occupied housing.

It is also possible to look at the level of housing taxes in other countries as a benchmark against which to assess the overall level of UK housing taxes. This may not tell us anything about optimal levels of taxation but it remains a

⁶ See, for example, J. Muellbauer, ‘Safety in property tax’, *Financial Times*, 2 July 2002 (see www.housingoutlook.co.uk/Papers/ft0702.html), or L. Elliott, ‘The richest homeowners are now ripe for plucking’, *Guardian*, 23 October 2003.

⁷ Source: Bank of England, *Inflation Report*, November 2003 (www.bankofengland.co.uk/inflationreport/ir03nov.pdf).

⁸ At least in the case of owner-occupied or holiday homes; second homes that provide rental income may be thought of as almost entirely investment goods.

useful comparison. However, it requires a careful consideration of which taxes to include and exclude as ‘housing taxes’.

In this section, then, we will look at housing taxation against both international experience and the tax treatment of other investment and consumption goods. We start with a brief review of current taxes on housing.

Current housing taxes

There are five main taxes that are wholly or partially incident on housing or housing transactions – council tax, stamp duty, capital gains tax, inheritance tax and VAT on repairs.

Council tax

Council tax was introduced in April 1993 to replace the community charge as the only locally levied tax.⁹ It is based on the assessed or imputed value of a property in April 1991, and both owners and renters are liable to pay it. Properties are divided into eight valuation bands, A to H, and council tax is levied according to band, with many people having some or all of their liability covered by council tax benefit (around 4.7 million people received council tax benefit in mid-2002). Table 5.1 details the valuation bands for England, the proportion of the band D rate that each band is liable for, and the percentage of all households in each band. Since more expensive homes are liable for a higher rate, there is some link between house value and tax liability but it is imperfect – houses worth £1 million attract only double the rate of a house worth £68,000. Whilst, on average, higher-income people do live in more expensive houses, the average increase in the council tax does not rise in proportion to the increase in incomes. Therefore the tax is regressive overall, even taking into account the fact that many low-income households will

Table 5.1. Value bands for council tax, England, March 2003

Band	Tax liability relative to band D	Property valuation as of 1 April 1991	Distribution of dwellings by band (%)
A	$\frac{6}{9}$	Under £40,000	25.8
B	$\frac{7}{9}$	£40,001 to £52,000	19.3
C	$\frac{8}{9}$	£52,001 to £68,000	21.5
D	1	£68,001 to £88,000	15.0
E	$1\frac{2}{9}$	£88,001 to £120,000	9.4
F	$1\frac{4}{9}$	£120,001 to £160,000	5.0
G	$1\frac{6}{9}$	£160,001 to £320,000	3.6
H	2	Over £320,000	0.6

Source: Table 2.2c of Office of the Deputy Prime Minister, *Local Government Finance Statistics (England) 2003* (www.local.odpm.gov.uk/finance/stats/lgfs/2003/chapter2.pdf).

⁹ Great Britain only; Northern Ireland retains a system of domestic rates.

generally receive council tax benefit.¹⁰ Anyone receiving income support or income-based jobseeker's allowance will automatically receive full council tax benefit.

According to the 2003 Pre-Budget Report, council tax is expected to raise about £19.9 billion in 2004–05 (net of council tax benefit costs).

Stamp duty on residential property

Stamp duty is a transactions tax, payable when properties of a certain value are bought. It operates at four rates depending on the value of the property – if less than £60,000 then no duty is paid, 1% of the value is paid for those worth between £60,000 and £250,000, 3% for those worth £250,000 to £500,000 and 4% above that.¹¹ Note that the stamp duty rate is applied to the full value of the property, not just the proportion above the threshold.

Whilst it is not desirable, in general, to distort people's purchase choices with a transactions tax such as stamp duty, it may be an attempt to tax housing wealth. However, there may be more efficient ways of doing this.

In 2002–03, total revenue from stamp duty on property and land was around £5.0 billion, of which more than two-thirds (£3.6 billion) came from taxes on residential property and less than one-third (£1.4 billion) from taxes on non-residential property.¹²

Capital gains tax

Capital gains tax (CGT) is payable on the nominal increase in the value of houses other than somebody's main dwelling; most house sales therefore do not attract any tax. Nominal capital gains (from all sources, not just housing) above £7,900 in any one year are counted as taxable income and added on top of income from other sources and then effectively taxed as if they were income from savings: at 10% above the personal allowance but below the starting-rate limit, 20% above that but below the higher-rate threshold and 40% above that threshold. Most CGT is paid at 40% since it is added on top of all other sources of income, and since the majority of people making capital gains in excess of £7,900 (certainly from non-housing sources) are already higher-rate taxpayers. The amount payable also declines if the house has been held for at least three years.¹³

Total receipts from all sources of CGT are only expected to be around £1.4 billion for 2004–05,¹⁴ so it is likely that the contribution from second or

¹⁰ See figure 2.2 of T. Clark, C. Giles and J. Hall, *Does Council Tax Benefit Work?*, Institute for Fiscal Studies, London, 1999.

¹¹ The zero rate extends to £150,000 for non-residential properties and (from December 2003) residential properties in certain designated disadvantaged areas. Non-residential properties in disadvantaged areas are exempt altogether.

¹² Source: Inland Revenue, www.inlandrevenue.gov.uk/stats/stamp_duty/03IR151.pdf and www.inlandrevenue.gov.uk/stats/stamp_duty/03IR153.pdf.

¹³ For more details, see S. Adam and J. Shaw, *A Survey of the UK Tax System*, Briefing Note no. 9, Institute for Fiscal Studies, London, 2003 (www.ifs.org.uk/taxsystem/taxsurvey.pdf).

¹⁴ Source: Table B9 of December 2003 Pre-Budget Report (www.hm-treasury.gov.uk/media/DBB0D/pbr03annexb227.pdf).

subsequent properties to total tax revenue is small, certainly relative to other housing taxes.

Inheritance tax

Inheritance tax is payable on the total value of an estate, though often the house will form a substantial part of that value, especially given recent strong rises in prices in some regions and declines in equity markets. Any estate with a value above £255,000 is eligible for inheritance tax at 40% on the value above this threshold. This must be paid on transfers either on death or in the three years prior. Any transfers made more than seven years before death attract no tax; transfers between three and seven years prior to death attract a reduced rate. Inheritance tax is forecast to raise about £2.8 billion in 2004–05,¹⁵ though again the exact contribution from housing is unclear.

VAT on repairs

Whilst VAT is not charged on houses themselves, it is charged at the standard rate of 17.5% on materials and labour for any repairs, extensions etc. made to houses.

Housing taxes in the UK versus other OECD economies

A useful place to start in assessing whether housing is undertaxed (or indeed overtaxed) in the UK is a comparison with other economies. A recent study by the European Central Bank¹⁶ looked at how housing was taxed across the European Union. There are wide variations in how member states tax housing, both in terms of the instruments used and the types of housing (such as rented or owner-occupied) to which they are applied. There are also a myriad of different exemptions and special clauses, most often relating to the treatment of owner-occupied dwellings for capital gains tax or special treatment (for example, for stamp duty) for first-time buyers.

Using data from *OECD Revenue Statistics 2003* (based on data from 2001), we can look at the percentage of total tax revenue in each economy attributable to property taxation. It is difficult to know exactly what to include under the auspices of housing taxes. Whilst the OECD figures do contain a figure for property taxes, it includes several items that are not explicitly levied on housing since the definition of property includes both movable and immovable property (so, for example, taxes on shares are included). We have therefore constructed two figures for the percentage of total tax from property. The first is a narrow definition which includes only ‘recurrent taxes on immovable property’ (such as the council tax in the UK) and ‘other non-recurrent taxes on property’¹⁷ (this excludes general non-recurrent taxes such

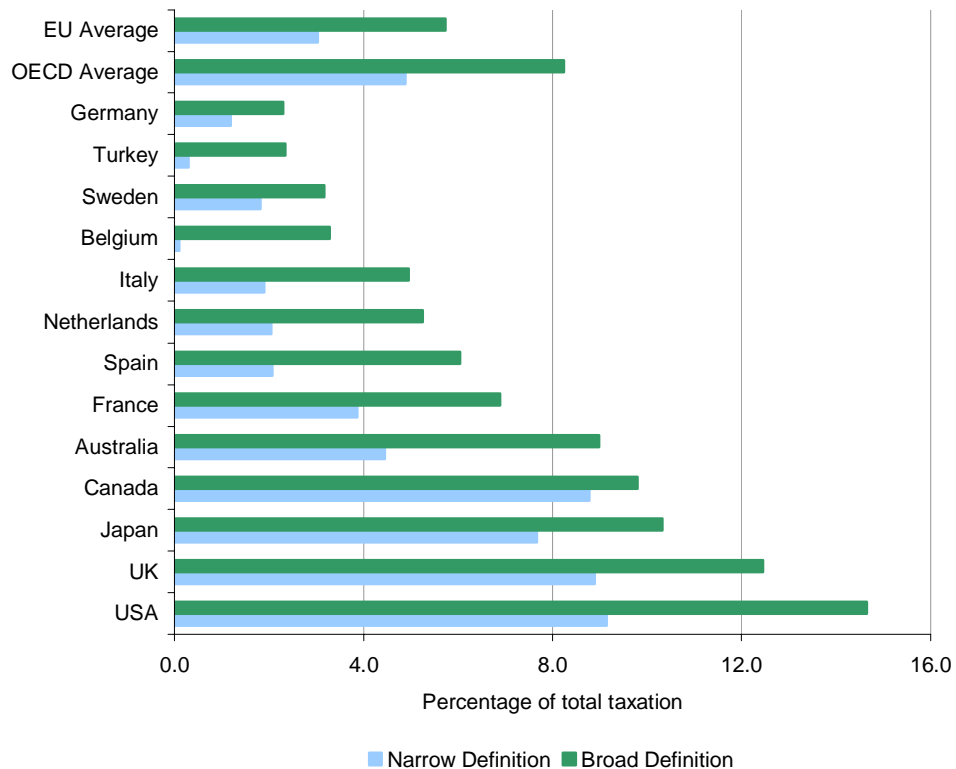
¹⁵ Source: Table B9 of December 2003 Pre-Budget Report (www.hm-treasury.gov.uk/media/DBBOD/pbr03annexb227.pdf).

¹⁶ ECB, *Structural Factors in the EU Housing Markets*, Frankfurt, 2003 (www.ecb.int/pub/pdf/euhousingmarkets.pdf). See in particular chapter 4 and table 4.1 for international comparisons of housing taxation instruments.

¹⁷ According to the OECD, this heading includes ‘taxes levied to take account of increases in land value due to permission given to develop or provision of additional local facilities by

as inheritance tax which are not specifically on property but on the whole value of an estate). The second is a much broader definition including all taxes that could conceivably fall on housing, such as inheritance tax, stamp duties, capital gains tax and so forth. The narrow definition will almost certainly exclude some taxes that fall on housing; the broad definition will almost certainly be too generous in its definition of housing taxes. Nevertheless, comparing the international rankings may still tell us something useful about which countries tax housing itself more heavily.

Figure 5.1. Percentage of total tax take attributable to ‘housing’ taxes, selected OECD economies 2001 (broad and narrow definitions)



Source: Authors’ calculations from *OECD Revenue Statistics 2003*. Note that there are 30 countries in the data-set and the OECD and EU averages are constructed using all relevant countries with the exception of the Slovak Republic and (in the case of the broad definition) Iceland for paucity-of-data reasons. OECD and EU averages are weighted according to population. All tax figures are in local currencies.

It appears that taxes on housing as a percentage of total taxation are higher in the UK than in most other developed countries, and certainly well above the OECD and EU averages. This is the case on both a broad and a narrow definition of property taxes. This does not necessarily imply that UK housing taxes are too high: apart from the difficulties in measuring housing taxes that were discussed above, the percentages are influenced as much by the level of total taxation as by the level of housing taxation. Equally, housing taxes could

general government, any taxes on the revaluation of capital and once-and-for-all taxes on particular items of property’.

be too low in other countries, or tax rates could be similar but house prices higher in the UK. We cannot use this information to conclude that there is no scope for raising taxes on housing, or at least to reform the system so that housing is taxed in a different way.

Housing taxes versus other taxes

An alternative way of looking at whether or not housing is ‘undertaxed’ is to compare it with the taxation of other investment or consumption goods. Recall that housing is a hybrid of the two types of good, but the distinction provides a natural and useful comparison nonetheless. If we thought housing to be essentially a capital investment good, then unless we wish to distort portfolio choices towards investment in housing, it should be taxed in a similar way to other investment goods. If we thought it to be essentially a consumption good, then again unless we wish to distort consumption decisions for any reason, it should be taxed akin to other consumption goods, in particular large durables. As housing is a combination of the two types of good, it is hard to reach a clear conclusion. But in any event, the way in which housing is taxed relative to other goods will affect the purchasing decisions of individuals.

Housing versus other investment goods

Table 5.2 sets out the tax treatment of various assets, looking at how contributions, interest, capital gains and withdrawals are taxed, where applicable. Taxes on contributions will generally be taxes on the income used to purchase or fund the investment.

Ignoring council tax for now, the tax treatment of principal houses as an investment good does not appear particularly favourable. It has a similar structure to the tax treatment of assets held in ISAs, in that only the initial investment, in terms of the income used to purchase it and to fund mortgage payments, is taxed (the abolition of mortgage interest relief since 2001 has equalised the treatment of contributions to housing and other investments). Neither the stream of returns – in the form of interest for ISAs (plus dividends for share ISAs and private pensions) or imputed rents for homeowners – nor the capital gain (on share ISAs or pensions) is taxed. Primary housing is indeed taxed more lightly than direct holding of equity investments, where the dividend returns and any capital gains are subject to tax, although stamp duties on housing are at higher rates (paid only if the value exceeds £60,000; stamp duty of 0.5% is payable on all equity transactions). Interest returns on non-ISA accounts are also subject to tax. However, primary housing appears to be more heavily taxed than private pension contributions, where a 25% tax-free lump sum can be taken from the final pot. There may be good reason for this, however – a favourable tax treatment of pension funds is needed to encourage people to tie up savings until retirement and commit to purchase an annuity to supplement the diminishing value of the state pension (against earnings).

Primary housing is currently less heavily taxed than secondary housing since secondary housing also attracts capital gains tax. However, in the 2003 Pre-Budget Report, the government published proposals to allow ‘pension

Table 5.2. Tax treatment of different investment assets

Asset	Income tax and NICs on contributions	Stamp duty on transactions	Returns		Income tax and NICs on withdrawals	Other taxes
			Income tax on interest / dividends ^a	Capital gains tax		
Private pension funds (employee contribution)	Exempt from income tax; not exempt from employer and employee NICs	Purchases of UK equities taxed at 0.5%	Exempt	Exempt	Taxed except for a 25% lump sum; no NICs	n/a
Private pension funds (employer contribution)	Exempt from income tax, employer and employee NICs	Purchases of UK equities taxed at 0.5%	Exempt	Exempt	Taxed except for a 25% lump sum; no NICs	n/a
ISAs	Taxed	Purchases of UK equities taxed at 0.5%	Exempt ^b	Exempt	Exempt	n/a
Interest-bearing accounts	Taxed	n/a	Taxed at 10%, 20% or 40%	n/a	Exempt	n/a
Direct equity holdings	Taxed	Taxed at 0.5%	Taxed at 10% or 32.5%, but offsetting dividend tax credit means effective rates are 0% and 25%	Taxed	Exempt	n/a
Owner-occupied housing (primary or only house)	Taxed	Taxed at 0%, 1%, 3% or 4% depending on value	Exempt^c	Exempt	Exempt	Council tax
Housing (second or subsequent house)	Taxed	Taxed at 0%, 1%, 3% or 4% depending on value	Rental income taxed	Taxed	Exempt	Council tax ^d
Other physical assets (e.g. jewellery, antiques)	Taxed	n/a	n/a	Taxed ^e	Exempt	VAT

^a Dividends are paid out of profits which attract corporation tax. The effects of this are ignored.

^b A tax credit is also paid for dividends from UK companies paid into equity ISAs. This will no longer be payable from April 2004.

Notes continue on next page

Notes to Table 5.2 continued

^c Dividends are effectively the imputed value of income from owner-occupation – this was taxed on the basis of the notional rental value of owner-occupied housing until 1963. Note that income tax is payable on income received from letting out part of a main residence while the owner resides there, although the first £4,250 per year can be tax-free.

^d Council tax would only be payable by the investor (at the discounted second-home rate) if the property were not let.

^e Jewellery, paintings, antiques and other personal effects that are individually worth £6,000 or less are exempt.

Note: For more details on each of the taxes in the table, see S. Adam and J. Shaw, *A Survey of the UK Tax System*, Briefing Note no. 9, Institute for Fiscal Studies, London, 2003 (www.ifs.org.uk/taxsystem/taxsurvey.pdf).

Source: Institute for Fiscal Studies, *Fiscal Facts* (www.ifs.org.uk/taxsystem/assets.xls).

schemes to invest in all types of investments, including residential property'.¹⁸ If this reform went ahead, the tax treatment of property held in such a way would be taxed in the same way as any other funds held in a pension scheme. In the case of secondary housing, investors would have a clear tax incentive to put their investment into their pension fund.¹⁹ However, for owner-occupied housing, there would be less of a tax advantage in holding that house in a pension fund, since owner-occupied houses are already exempt from capital gains tax. Although primary housing is currently more heavily taxed than private pension funds because of the 25% tax-free lump sum, the new rules propose to tax the benefit-in-kind generated by an investor making use of any investment held within the pension fund. In the case of owner-occupied housing, an investor would be taxed on the imputed rent they gain from living rent-free in their home.

Perhaps the most comparable assets to housing are other physical assets such as jewellery and antiques since, like primary housing, they typically yield both a consumption value and an investment value. Assets such as jewellery or antiques do not attract a transactions tax as housing does, but they do attract capital gains tax (as long as the asset is worth over £6,000). In addition, VAT is levied on other physical assets.

So primary housing does not seem to be taxed particularly favourably compared with other investment products in respect of contributions, returns and withdrawals – and even less so once council tax is taken into account. However, although council tax is levied according to the value of a house, both owner-occupiers and private renters are liable to pay it. An investor choosing between a house and another asset would pay council tax even if they did not purchase a house, because they would pay it if they were renting. This means that the decision to buy a first home is not distorted by the existence of council tax, although the choice of the size or location of the house might be.

¹⁸ Paragraph 4.2 of HM Treasury, *Simplifying the Taxation of Pensions: The Government's Proposals*, 2003 (www.hm-treasury.gov.uk/media/8692C/simplifying_pensions_421.pdf).

¹⁹ One possible impact of the reform is that large pension funds might decide that part of their investment portfolio should be invested in residential housing. This would increase demand for residential properties, leading to an increase in price. The increase in supply of properties let to tenants could also lead to a fall in rents.

Housing versus other consumption goods

If housing were treated in the same way as other durable goods, then new houses would be subject to standard-rate VAT of 17.5%. However, the government explicitly excludes the construction of new homes from VAT (see Section 5.2). This exemption does not put housing at odds with all consumption goods since there are other instances of zero-rating – for example, most foods, all newspapers and books, and children’s clothing. However, housing is the only example of a zero-rated major durable. On the other hand, housing is subject to council tax and stamp duty on transactions. It is very difficult, therefore, to compare the exact extent of taxes on the consumption element of housing with the extent of taxes on other consumption goods, especially when we bear in mind that some other large durables such as cars also attract their own unique taxes. Overall, however, the argument that housing is lightly taxed appears to hold greater weight in terms of its consumption than its investment element.

5.2 Options for reform

VAT on housing

VAT is currently charged at 17.5% on most goods, though goods such as food and children’s clothing are zero-rated. Construction of new buildings intended for use as a residential dwelling is also zero-rated.²⁰ Second-hand residential housing is specifically exempt from VAT.²¹ This creates a distortion that means that consumption will be allocated towards housing and away from other goods. There has been speculation²² that VAT may be levied on new homes such that housing would be taxed on a basis more comparable to that of other (non-zero-rated) goods. The estimated revenue effect of introducing VAT on new housing would be £4.5 billion in 2003–04.²³ The desirability of this option depends on the objectives of such a policy. If the government wishes to reduce any possible favourable tax treatment of housing as a consumption good, such a policy might be sensible. On the other hand, if the objective is to stabilise the housing market, it is not clear that levying VAT on new houses would achieve this. It would reduce the current incentive to build new houses and, given the recent review into the reasons behind the lack of housing supply, this would seem to be something that the government would wish to avoid. A large part of the housing market is made up of second-hand

²⁰ See www.hmce.gov.uk/forms/notices/708.htm#P273_17390 for more details.

²¹ Other second-hand goods which are sold by VAT-registered parties attract VAT, although special provisions are made under the ‘margin scheme’ for such goods. Second-hand goods sold by parties that are not VAT-registered do not attract VAT, which, even in the absence of the VAT exemption, would apply to the majority of residential property transactions. However, the VAT exemption on second-hand housing means that any VAT-registered party that sells a residential house (as part of the activity for which they are VAT-registered) does not have to pay VAT on that home.

²² See, for example, the BBC news website report news.bbc.co.uk/1/hi/business/3301735.stm.

²³ HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2003 (www.hm-treasury.gov.uk/media/AAB24/pbr03_trr.pdf).

housing which is a very close substitute for new housing. Any price differential caused by levying VAT on new housing could lead to increased demand in the market for second-hand houses which, given the fixed supply of these houses, would be expected to lead to higher prices. This could also have knock-on implications for rents.

Within the EU, only the UK and Greece charge a zero rate on all new homes. Several other countries do charge VAT on new homes. Some, including Belgium, Denmark, Germany, France, the Netherlands, Finland and Sweden, charge the full rate of VAT, whilst others, including Spain, Italy, Luxembourg and Ireland, charge a reduced rate.

Stamp duty

Table 5.3 shows the rates of stamp duty on property from 1997 to the present day. When Labour came to power in 1997, properties purchased at less than £60,000 were exempt from stamp duty. Properties purchased at prices above that were subject to a 1% tax on the full price of the property. Since then, stamp duty rates on properties valued above £250,000 have been increased successively, as the table makes clear.

Table 5.3. Rates of stamp duty on property, 1997 to present day

Transaction value (£000)	Before	8 July 1997	24 March 1998	16 March 1999	28 March 2000
	8 July 1997	to 23 March 1998	to 15 March 1999	to 27 March 2000	to date
0–60 ^a	0%	0%	0%	0%	0%
60 ^a –250	1%	1%	1%	1%	1%
250–500	1%	1.5%	2%	2.5%	3%
500+	1%	2%	3%	3.5%	4%

^a For non-residential properties, no stamp duty is payable on purchases below £150,000. From December 2003, properties purchased in certain disadvantaged areas will also be subject to a threshold of £150,000.

The potential of stamp duty as a fiscal stabilisation tool was discussed in the government's Euro study:²⁴ 'It might be possible to use stamp duty as a discretionary instrument to dampen housing market fluctuations by varying the rates in relation to the house price cycle' (paragraph 6.89). The idea would be to increase stamp duty when demand for housing was high and to reduce it when demand was low. This policy has been used before, in 1992, when a stamp duty 'holiday' was put into effect. The threshold under which no stamp duty was payable was increased temporarily from £30,000 to £250,000 for a period of eight months. When the 'holiday' was introduced, the number of housing transactions was on a downward trend, but during it, the number of housing transactions increased, particularly towards the end of the period.

There are a number of drawbacks to stamp duty, both in general and as a possible stabilisation tool. First, it may cause house prices to cluster around the limits for different rates – a house on the market for £250,000 would

²⁴ HM Treasury, *Fiscal Stabilisation and EMU*, London, 2003 (www.hm-treasury.gov.uk/documents/the_euro/assessment/studies/euro_assess03_studherefordshire.cfm).

attract a duty to the buyer of £7,500 whereas one sold at £249,000 would attract duty of just £2,490. This effect could be changed by making stamp duty a marginal tax rather than an average tax, charging the rates only on the value exceeding the thresholds rather than on the full purchase value. Second, stamp duty increases the cost of moving house, which is likely to have an adverse effect on labour mobility.²⁵ There is little evidence on the size of this effect, but if house prices continue to increase at rates far higher than the rates at which the thresholds for the tax are increased, the size of the effect will increase as more houses move into the brackets where higher rates of stamp duty are applied. Third, if stamp duty were used as a stabilisation tool, some people might attempt to pre-empt changes in stamp duty rates – if people expect stamp duty to rise, they may prefer to purchase prior to the rise, exacerbating the house-price inflation problem in the short run; equally, if stamp duty is expected to fall, they may put off purchases. The graph in box 6.9 (p. 86) of the EMU supporting study cited above shows the number of property transactions recorded each quarter between 1990 and 1995, a period covering the stamp duty ‘holiday’. Transactions rose from around 250,000 in the first quarter of 1992 – just after the start of the holiday period – to nearly 400,000 by the third quarter, the end of the period. However, in the fourth quarter, just after the end of the holiday, transactions fell back to less than 300,000 once again, similar to the pre-holiday level. It may well be that people who were planning to move anyway simply shifted their moving date into the holiday period, and that the number of new transactions was limited. This could induce greater short-run volatility into the housing market. Fourth, it would be crucial that changes in stamp duty were not implemented with too great a lag that they actually ended up exacerbating the housing market cycle.

The Treasury itself questions the effectiveness of using stamp duty as a fiscal stabilisation tool because of the facts that stamp duty is just one of many costs associated with moving house and that it can be financed over the lifetime of a mortgage, making a large response by households less likely.

In addition to the drawbacks mentioned above, further increases or changes to stamp duty might be politically unattractive because of the many increases that have been seen since 1997. On a practical note, varying stamp duty outside of the Budget process would require further legislation to be passed. Legislation already exists allowing the government to change certain tax rates within defined boundaries outside of the Budget process. VAT and excise duties can be changed in this way, but the legislation would have to be extended in order to include stamp duty.

Property wealth tax

A number of countries levy a tax based on the value of housing. Council tax in the UK is a tax of this sort, although the link between the value of the house

²⁵ See, for example, A. Oswald, *Why Tax People for Moving? A Non-Technical Paper on Stamp Duty*, 2000 (www2.warwick.ac.uk/fac/soc/economics/staff/faculty/oswald/revstampduty2000.pdf), or M. Andrew, A. Evans, P. Koundouri and G. Meen, *Residential Stamp Duty: Time for a Change*, Council of Mortgage Lenders, London, 2003 (www.cml.org.uk/servlet/dycon/zt-cml/cml/live/en/cml/pdf_pub_resreps_46full.pdf).

and the tax is far from proportional, and the tax paid on properties of equal value varies across local authorities. Other countries impose a tax that is much more closely related to the value of housing. Denmark, for example, levies a 1% tax on owners that is based on the market value of housing.

The advantage over the council tax of a property wealth tax that is a percentage of the value of a house is that it could act as an automatic stabiliser. When house-price growth is high relative to income growth, average tax liabilities would rise which would impact on consumption to provide a stabilising effect in the economy.

A property wealth tax could be introduced in a number of ways. One option would be to replace the current council tax. However, council tax is a local tax and the government seems to favour a movement towards local taxation, which makes this option unlikely.²⁶ A property tax could operate at a local level, but unless local authorities were constrained in their ability to increase or cut the tax, the automatic stabilising effect might be neutralised (if, for example, rates were cut as prices rose). However, the fact that council tax is a large source of local government revenue should not mean that it should not be reformed if this were the most desirable option; the implications of such a reform would simply require some careful consideration. Another option would be to introduce a property tax in a revenue-neutral way, via an offsetting reduction in income tax for example.

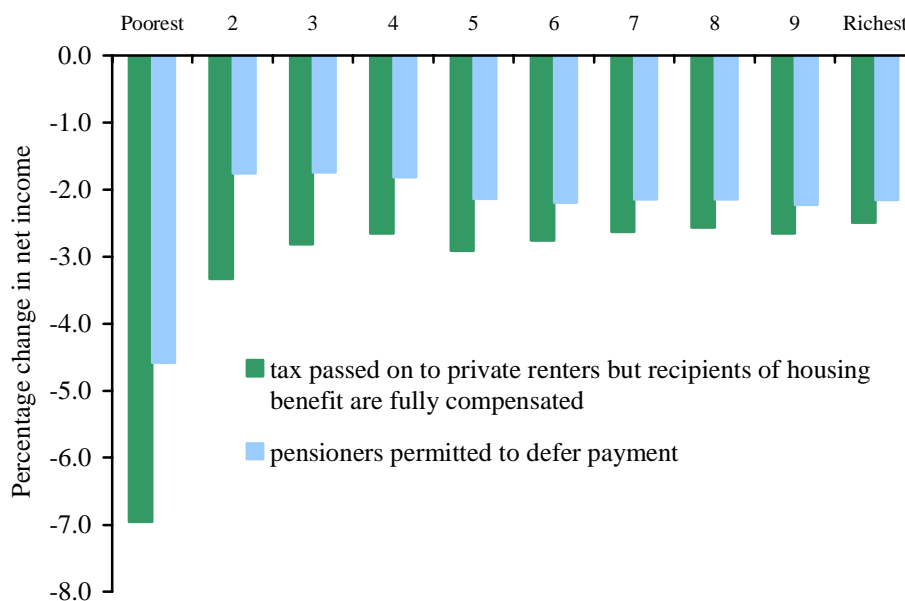
The distributional impact of introducing a property wealth tax without any corresponding changes in other taxes (including council tax) is shown in the left-hand bars of Figure 5.2. Other countries, such as Denmark, that have a similar tax levy it on owners of property. Renters pay the tax only to the extent that the tax is passed on through higher rents. We assume that a property tax is fully passed on to private renters through higher rent²⁷ and that those who currently receive housing benefit are fully compensated. We also assume that local authority renters do not pay the tax. There has been no firm suggestion from the government that a property tax is to be introduced, so the graph is purely illustrative and it should be borne in mind that the distributional impact could look very different if, for example, a property tax were introduced in a revenue-neutral way with a compensating reduction in other taxes. Figure 5.2 shows the amount of tax as a percentage of net household income for each

²⁶ The Balance of Funding Review initiated by the Office of the Deputy Prime Minister in 2003 highlights that since the late 1980s, the proportion of local government revenue derived from central government grant has increased from less than half to around three-quarters. See www.local.odpm.gov.uk/finance/balance/intro.htm.

²⁷ The data used are from the British Household Panel Survey, which asks owner-occupiers to report how much their house is currently worth. Renters are not asked this question, so in order to obtain the amount of tax that might be passed on to renters, we impute a house value for those households by matching it to an observation on house value for the owner-occupiers. Each rented property is matched to a random owned property conditional on the property being in the same region, having the same number of rooms and being of the same type (semi-detached, flat, terraced house etc.). We do not attempt to impute a value for renters who are living in houses for which there are very few owned houses of that type (for example, bedsitters).

income decile (where income is adjusted for household size). A tax rate of ½% on the value of primary residences is assumed.²⁸

Figure 5.2. The distributional impact of a ½% property wealth tax



Notes: Incomes are uprated to 2002 using RPI all-items index; house prices are uprated to 2002 using regional house price indices. The horizontal axis shows income deciles that are derived by dividing all families into 10 equal-sized groups according to income adjusted for family size. Decile 1 contains the poorest tenth of families, decile 2 the next poorest and so on, up to the richest tenth in decile 10.

Source: Authors' calculations using 2000 British Household Panel Survey data.

Except at the very bottom of the distribution, the distributional impact of a property tax shown in the first set of bars is fairly flat. The large burden at the bottom of the distribution is caused by households that are poor in terms of their income but rich in terms of their housing wealth. Although often perceived to be a problem, this is not necessarily so, because it is the distributional impact of the whole tax and benefit system that is important, and it may be desirable to tax some of this housing wealth (though the ability of cash-poor, wealth-rich households to pay any such tax might be of concern). These households are likely to include a large number of pensioner households, and also some households that have temporarily low incomes or where income is measured with error (for example, there are many difficulties associated with measuring the income of the self-employed).²⁹ It has been argued that pensioners could be allowed to defer payment of a property tax

²⁸ A tax rate of ½% is chosen as this is an amount mentioned in J. Muellbauer, 'Safety in property tax', *Financial Times*, 2 July 2002 (see www.housingoutlook.co.uk/Papers/ft0702.html). For simplicity, we ignore any tax on second homes and on business property. Such a tax would probably raise the burden at the upper end of the distribution.

²⁹ Depending on the extent of the mismeasurement of income at the bottom of the income distribution, care should be taken in interpreting the numbers for the poorest decile.

until the property is sold or out of the estate.³⁰ The second bar in each pair in Figure 5.2 assumes that pensioners can defer payment in this way. Of course, even if pensioners were allowed to defer, the tax payment would ultimately be made at some point in the future. Here, we focus simply on the current distributional impact of such a policy and we find that the pattern is slightly more progressive. However, allowing pensioners to defer payment does not eliminate the large burden at the bottom but does reduce it. This shows that there are other households that are poor in terms of their income but rich in terms of their housing wealth.

Our example property wealth tax is slightly less regressive than the existing council tax.³¹ Practical problems with a property tax include the desirability of frequent revaluations of property prices which might be costly.³² We estimate that the 0.5% property tax described in this section would have raised around £16 billion in 2002 which compares to around £16.7 billion that was raised through the council tax in 2002–03.³³ It should be noted, however, that our estimate is based on households' own estimates of the value of their house. The actual amount raised in practice would depend on the extent to which these differed from valuations for the purposes of a property tax.

Capital gains tax (on first homes)

Profits made on the sale of first homes are currently exempt from capital gains tax (CGT). There was intense press speculation in mid-2003³⁴ that this exemption might be ended in Budget 2004, largely due to the huge revenue-raising potential. Assuming no behavioural effects and ignoring any knock-on effect on the housing market, the Treasury estimates that this would raise £11.5 billion for 2003–04³⁵ at a time when margins for the Chancellor to meet his fiscal rules are reduced.³⁶ As we saw earlier, capital gains tax applies to the increases in value of other assets such as shares (though not when held in a pension or an ISA) after the first £7,900 of gains. The gains are counted on top of any other income and taxed at 10%, 20% or 40% – in practice, mainly at the top rate – though reductions apply if the asset has been held for three or more years. Since house values have increased markedly over the past few years,

³⁰ See J. Muellbauer, 'Safety in property tax', *Financial Times*, 2 July 2002 (see www.housingoutlook.co.uk/Papers/ft0702.html).

³¹ See figure 2.2 of T. Clark, C. Giles and J. Hall, *Does Council Tax Benefit Work?*, Institute for Fiscal Studies, London, 1999.

³² In Denmark, responsibility for revaluations, which occur every two years, lies with central government, which has kept extensive computer records of values since the early 1980s.

³³ Source: Table B9 of the December 2003 Pre-Budget Report (www.hm-treasury.gov.uk/media/DBB0D/pbr03annexb227.pdf).

³⁴ See, for example, R. Watts and F. Elliot, 'Chancellor looks at 40 per cent tax on all home sales', *Daily Telegraph*, 19 October 2003 (www.telegraph.co.uk/news/main.jhtml?xml=/news/2003/10/19/ntax19.xml).

³⁵ Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2003 (www.hm-treasury.gov.uk/media/AAB24/pbr03_trr.pdf).

³⁶ See Figure 2.4 in Chapter 2 for more details.

imposing capital gains tax on these increases when houses are sold would affect almost all sales.

Such a system is not unheard of elsewhere in the OECD. Sweden imposes a tax on the nominal profits from house sales, for example. In many countries, tax is levied on the sales of second homes, as in the UK, or at a reduced rate on the sales of first homes. Exemptions may apply if the home is owned for a lengthy period (10 years in Austria, for example) or if the profits are used to buy a new property (as in Spain or Portugal). Imposing full CGT on almost all sales above the £7,900 threshold would therefore be a very radical policy indeed. An alternative might be to have a higher CGT threshold for houses alone, though this would add considerable complexity to the CGT system.

Exempting cases where profits are reinvested in housing would dramatically reduce the yield of the tax. If a house remained unsold until the owner died, interactions with the inheritance tax system would need to be carefully considered to avoid taxing the value both on death and on subsequent sale. Further thought would also be required about how, for example, repairs and additions to a home are dealt with – should the tax attempt to capture value added by the owner (which should be dealt with by VAT on repairs) or merely increases from market forces? It may also be considered unfair to introduce CGT retrospectively on people who have already owned their homes for a lengthy period and who may be relying on the housing wealth to provide resources in their retirement. Compensating such people may well reduce the yield significantly whilst adding further complexity to the tax system. A further drawback would be the adverse effect on labour mobility, particularly if exemptions applied if the home was owned for a lengthy period.

5.3 Conclusions

Raising current housing taxes or changing their structure may provide an enticing way for the government to raise revenue in the future, but justifying it on the basis that housing is ‘undertaxed’ – as stated in the Euro supporting study – seems flawed. Looking at housing relative to other investment goods and looking at the UK in an international perspective, housing does not appear to be lightly taxed. It is only when comparing housing with other consumption goods that the argument holds significant weight, but even then there may be particular reasons for taxing housing more lightly. If there were moves to increase or reform housing taxation, there are various options for doing so, each with particular problems and merits.

Given the lack of consultation on what would clearly be a major policy reform, it seems unlikely that any major change to housing taxes will be announced in Budget 2004. There may be concerns that consultation on changing housing taxes could cause short-term fluctuations in the market if people anticipate that taxes are about to rise. Nevertheless, given current concerns about the state of the housing market and ways in which it can be stabilised, as well as the revenue that extra housing taxation would raise, it is possible that housing will become an increasingly attractive area for future policy changes.

Andrew Leicester and Zoë Oldfield