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Tax By Design: The Mirrlees Review

Land and property taxation

Stuart Adam, IFS

Outline

- About the Mirrlees Review
- Transaction taxes and stamp duty land tax
- Input taxes, land value taxes and business rates
- Consumption taxation and council tax
- Savings taxation and the income tax treatment of property

Not covered:

- The local dimension
- Macroeconomic aspects (dealing with bubbles)
- Interaction with planning regime and other aspects of housing policy

The Mirrlees Review

- Major review of the tax system from first principles
  - Set up by IFS under chairmanship of Nobel laureate Sir James Mirrlees
- Take as given total revenue and degree of redistribution
  - Ask how these can be achieved most efficiently
- Published by OUP in two volumes
  - *Dimensions of Tax Design*: collection of commissioned studies
  - *Tax by Design*: integrated overall vision by the editorial team
  - ➢ Focus today on Chapter 16 of *Tax by Design*
- *www.ifs.org.uk/mirrleesReview*

A progressive, neutral system

- Consider the system as a whole
  - Use the right tools for the right objectives
- Achieve progressivity as efficiently as possible
  - Personal taxes and benefits are the best tools for redistribution
  - Target incentives where they matter most
  - Take a lifetime perspective, considering income and expenditure
- Neutrality as an important benchmark
  - Tends to be simpler, fairer and less distortionary
  - Not always – but should have a high hurdle to justify exceptions

Stamp duty land tax

- Basic principle that transactions should not be taxed
  - Why impose heavier tax on properties that change hands more often?
  - Assets should be held by the people who value them most
  - Reduced labour mobility one symptom of this more fundamental problem
- 'Slab' structure particularly absurd
  - £1 increase in price can trigger £10,000 increase in tax liability
- Stamp duties should not be part of the tax system
  - But don't want to give up revenue / give windfall gains to current owners
  - So look to replace with better taxes rather than simply abolish

Conceptually, must distinguish:

- Business land
- Business property
- Domestic land
- Domestic property

William Vickrey:

> *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*

Land value taxation is economically efficient

- Land is in fixed supply
- Gains in value accrue through no effort of the owner
- Taxing land value does not discourage any desirable activity
  - Windfall loss to land-owner on day tax is announced
  - But no disincentive to buy, develop or use land

Business rates are economically inefficient

- Business property is an intermediate input to production
- Basic principle that intermediate inputs should not be taxed
  - Economy inefficiently skewed away from property-intensive production
- Business rates also have other distortionary features in practice
  - Exemptions for certain sectors e.g. agriculture
  - Zero/reduced rates for empty buildings or unused land

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Some headlines from 2009

Empty property rate tax creating a 'bombsite Britain' as owners demolish rather than pay new levy

Asda to demolish building to avoid empty property tax

A business has demolished office property comprising 52,000 square ft solely due to the impact of empty rates costs of £12,000 per calendar month

Replace business rates with a land value tax?

- And replace SDLT on business properties in the process
- On a revenue-neutral basis
  - No windfall gains/losses on average
  - Redistributes from owners of undeveloped land to owners of highly developed (and/or frequently traded) properties
- Do gradually, with transitional arrangements like UBR revaluation

Can LVT be implemented in practice?

- Key difficulty: valuing land separately from buildings
- Thinness of market makes this a real problem
  - Most market transactions are for land/property packages
- But some other countries seem to manage it
- And note that efficiency gains do not depend on accuracy
  - though fairness and scale of appeals might

➢ Merits a thorough official investigation

Taxing domestic property

- Case for land value taxation applies equally to business and domestic land
- But while there is no case for taxing business buildings, there is a good case for taxing domestic buildings
- In principle, could levy separate taxes on domestic land and domestic buildings
- But since want to tax both, a tax on combined value avoids need to value them separately

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Taxing goods and services

- Only final consumption should be taxed
  - Not transactions (stamp duties) or produced inputs (business rates)
- Presumption to tax all consumption equally
  - Not least for reasons of simplicity
- There are exceptions to this
  - Where consumption is damaging (sin taxes, green taxes)
  - Where consumption is associated with work (childcare)
- But tax breaks for necessities on distributional grounds is NOT one of them
  - More efficient to redistribute based on total income/expenditure, without distorting people’s choices between goods
  - So we propose to broaden the VAT base, with a compensation package

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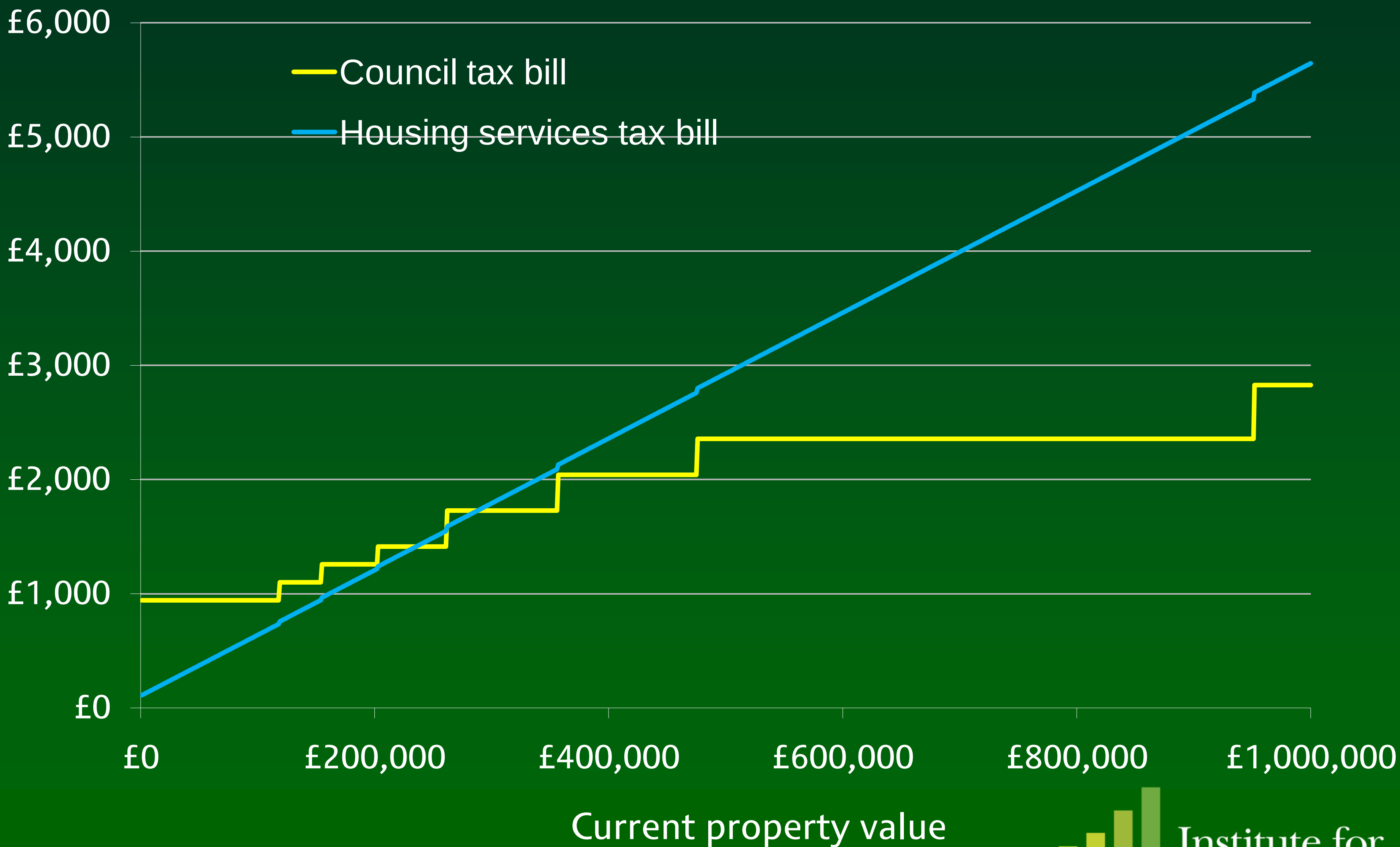
Taxing consumption of housing services

- Housing should be taxed like other consumption
  - But not currently subject to VAT
- Could either tax new build, or stream of consumption
- From where the UK starts, the latter makes more sense
- Tax the annual consumption value of housing: substitute for VAT
- Looks like a sensibly reformed council tax
  - Based on up-to-date valuations (rather than 1991 values)
  - Proportional to values (rather than pointlessly regressive and banded)
  - No discounts for single occupancy (rather than 25% discount)
- And replace stamp duty on housing in the process
  - Initially on a revenue-neutral basis

A ‘housing services tax’

Note: rough guide only – see Chapter 16 for details



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Land and property taxation: summary so far

Current, ideal and proposed treatments

	Business	Domestic
Buildings	Business rates Don't tax No tax	Council tax Tax like other consumption Housing services tax
Land	Business rates Tax arbitrarily highly Land value tax	Council tax Tax arbitrarily highly Housing services tax

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Taxing property as an asset

- Property is an investment as well as a consumption good
  - Returns are (actual or imputed) rent and capital gains
  - Should be part of coherent income tax / NI / CGT regime for savings
- Key to effective savings taxation is neutrality across:
  - Consumption today vs tomorrow (don’t discourage saving)
  - Different assets (rental vs owner-occupied; property vs other assets)
  - Different income sources (labour earnings vs return to savings)
  - Different forms of return (income vs capital gains)
  - Different legal vehicles (direct investment vs incorporation)
  - Varying inflation rates
- Current system achieves none of these: can we do better?

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Four options for savings taxation

1. Standard income tax (TTE)
   - Tax earnings and (nominal) capital income and gains
   - Like interest-bearing accounts, shares and rental housing
2. Earnings tax (TEE)
   - Tax earnings, but exempt (ignore) capital income and gains
   - Like ISAs and owner-occupied housing (and NICs in general)
3. Cash-flow expenditure tax (EET)
   - Tax relief for amounts saved; ignore returns within fund; tax withdrawals
   - Like pensions (and ‘human capital’ investments)
4. Rate-of-return allowance (TtE)
   - Tax earnings, but only tax capital income and gains above a ‘normal’ rate
   - Like Norwegian shareholder income tax

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Reforming the taxation of property income

- Current regime for rental property distorts behaviour
  - Investing in property is discouraged
  - Inflation and capital gains cause particular problems
- Current regime for owner-occupiers seems too generous
  - Enormous returns (including disguised labour) go untaxed
- And distinction creates major bias in favour of owner-occupation
  - And between each of them and many other assets
- A rate-of-return allowance alleviates all these problems

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A rate-of-return allowance for rental property

- Based on current system
  - Taxing both rental income and capital gains
- But with an allowance for a ‘normal’ return on the investment
  - EITHER deduct (say) 5% of purchase price from rental income each year; tax capital gains at full marginal income tax rate
  - OR tax rental income in full, but charge CGT only on gains relative to a purchase price stepped up by (say) 5% per year
- ‘Excess’ returns should be taxed at full labour income tax rates
  - Including full (employee + employer) NICs
  - Applies to capital gains as well as income

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A rate-of-return allowance for owner-occupiers?

- Similar, but using imputed rent instead of actual rent
  - Imputed rent is exactly what is assessed for the Housing Services Tax
- Same two implementation options now take on a different slant
  - EITHER deduct (say) 5% of purchase price from imputed rental income each year; tax capital gains at full marginal income tax rate
  - *Would people just wait for the next government to repeal CGT?*
  - OR tax imputed rental income in full, but charge CGT only on gains relative to a purchase price stepped up by 5% per year
  - *Is charging VAT + income tax + NICs rates on imputed rent each year politically realistic?*
- Retain current treatment of owner-occupied housing for now?
  - RRA for rental property alone would still be a major improvement

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Summary of recommendations

- Replace business rates (and SDLT on business property) with a land value tax
  - If land valuation proves feasible
- Replace council tax (and SDLT on domestic property) with a 'housing services tax'
  - Proportional to up-to-date values
- Introduce a 'rate-of-return allowance' for rental property
  - And perhaps owner-occupied housing in the (even) longer term

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