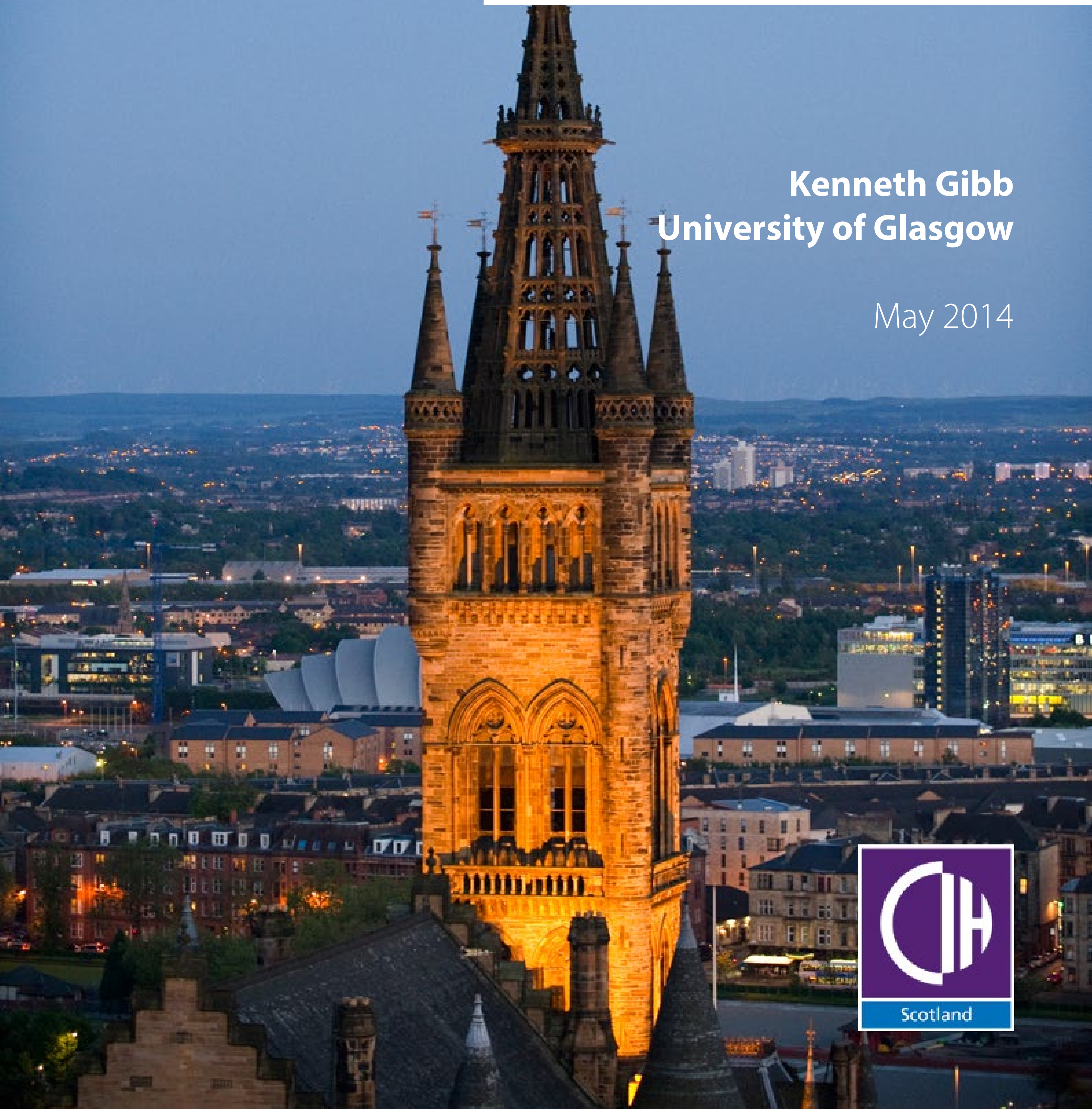
HOUSING TAXATION REFORM AND THE SCOTTISH CONSTITUTIONAL QUESTION



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Depending on what is negotiated after a 'yes' vote, there may be some degree of freedom to use fiscal policies in an independent Scotland. More generally, there will undoubtedly be scope to enact innovative tax policies for key sectors in terms of new tax regimes with efficiency, incentivising and fairness objectives. The most talked-about area in this debate thus far has been taxes on business and incomes but it also applies strongly to the case of housing.

This short paper asks what sorts of housing taxation questions might arise, and what are the principal dimensions and challenges that would have to be confronted if progress is to be made. Taxing housing better is a necessary but not on its own a sufficient requirement for improving the housing system. An independent Scotland may make that process more obviously realisable, but it will depend on post-vote negotiations. Actually, much that should be done does not need constitutional reform.

Taxing housing makes sense

Economists going back (at least) to the 1970s have argued for reforms to the UK taxation system in order to reduce the artificial distortions created by penalising (relatively) private landlords and failing to tax the investment returns to home owners. Tony O'Sullivan argued in 1984[i] that the issue came down to the economic inefficiencies and social inequities created by privileging one commodity and one tenure relative to others, and that the focus for reform ought to be on what one reasonably considered to be the greatest distortion. In a time of domestic rates (a surrogate for VAT), it could be argued that housing consumption was (roughly) sensibly taxed on the basis that the economic effects were similar to those on other commodities. The major discrepancy referred to the lack of consistency of treatment between housing (owner-occupied housing in particular) as an asset and other investment classes and also across housing tenures. Despite the oddities of the council tax (see below), I think the case remains that the greater distortion rests with housing as a form of investment.

A failure to remove this tax wedge between owner-occupied housing and the rest of the economy can lead to a number of problems:

- It reduces the user cost of housing – the investment price owners face – and thus encourages asset demand and incentivises would-be buyers to increase mortgages to the maximum they can afford
- Because of unresponsive housing supply, tax breaks are bid up or capitalised into higher house prices to the direct cost of the next generation of home buyers.
- Everybody pays for higher land costs
- The tax system contributes to the underlying volatility of the housing market and a less well-functioning regional labour market
- By opting out of widening the potential tax base, governments have less ability to lower marginal tax rates on incomes and business taxes (after all, a wider tax base could generate the same overall revenues with a lower marginal tax rate on average)
- Arguably, a proportion of personal savings and investments are channelled away from productive investment and into less productive second-hand housing, thereby crowding-out future investment and growth.

In short, housing costs more than it should, the tax base is smaller than it could be, the market is more not less volatile and the outcome is one of advantaged insiders and disadvantaged outsiders (that is, owners relative to non-owners), and this also plays out inter-generationally to the detriment of the young. This is the long-term housing market policy inheritance facing the winners of the referendum.

As a result, it seems likely that the current £7 billion net UK transfer via Barnett would not have been met from North Sea revenues in 2012-13 nor is it likely to be in 2013-14. In fact, CPPR estimates that North Sea revenues may only amount to around half this figure. The Office for Budget Responsibility's (OBR) forecasts for North Sea revenues suggest that, post 2013-14, such revenues will continue to fall well short of the £7 billion figure as, after a short period of flat revenues, OBR forecasts them to continue to decline (see Chart 2).

Housing taxation in the UK

A sensible place from which to start considering the Scottish options is to look more closely at the UK regime for taxing housing in more detail and to do so alongside the benchmark of a coherent regime as laid out recently in the Mirrlees Review[ii].

The review distinguished between consumption and asset aspects of housing and between owning and renting. While private landlords face taxes on their income and capital gains (with some offsets), all occupiers face the council tax, all purchasers pay a stamp duty transactions tax (to be modified in Scotland into the Land and Buildings Transactions Tax by the 2012 Scotland Act) and owners' residential property can feature in their estate for inheritance tax purposes. Owner-occupiers pay no asset taxes (be it on income or capital gains) on their primary residence.

Mirrlees argues that this is an inefficient system with bad outcomes:

1. There is inconsistent treatment of VAT on housing consumption and, the authors argue, a clear 'neutrality' case to tax it in line with other commodities.
2. The council tax is a hybrid (property-personal) tax wherein one in three now receive a personal discount, there is no built-in revaluation, and low value properties pay a higher proportion of property value than higher priced property (a form of regressivity).
3. Stamp duty as a tax on transactions is distortionary (it impedes mobility), it has slab effects (i.e. it taxes all of the property on the tax rate applied rather than at the margin only) and leads to gaming (i.e. pricing just below tax thresholds). They would abolish it.
4. Private landlords are treated harshly with respect to both owner-occupiers and the tax system more generally, and the opportunity is lost to incentivise savings and investment.
5. The failure to tax investment returns in the owner-occupied sector has to end and be instead integrated across tenures.

What do they suggest as policy proposals? First, they suggest a tax on the annual value of the consumption of housing services (a proposal that sounds very like the old rates). This would replace council tax and would require regular revaluation.

Second, after disposing of stamp duty, they would introduce an annual tax on estimated excess returns to housing investment regardless of tenure, to replace the current system that only taxes the rental market and second homes. Based on a Norwegian system, this would involve the calculation of a risk-free return to the current value of housing and a tax on any annual (excess) returns above that level. This would effectively do away with transactions-based realised capital gains tax. Requiring the up to date valuation of all property, the review recognised that it might make sense to apply this to the private rented sector first.

We are a long way from the Mirrlees proposals but it is a coherent and sensible way forward that might dampen house price volatility too.

Taxation of housing and the constitutional question

How might an independent Scotland play into this debate? It is widely held that housing is largely devolved. Housing policy is considerably devolved but in certain critical financial respects it is not:

- Housing benefit and housing-related social security, much the source of current controversy in Scotland, is reserved
- The mortgage market is a UK/international market and is regulated at a primarily UK or higher level
- The rules that apply to public finances, public spending classification and the wider 'rules of the game' are UK-determined by HM Treasury, with some EU influence too
- Most key elements of housing taxation – capital gains, income, VAT, inheritance tax, tax breaks and the like – are UK-based; the exceptions are council tax and the new Land and Buildings Transactions Tax (LBTT) that will replace Stamp Duty Land Tax in 2015-16
- There are also UK-initiated guarantee and other subsidy schemes such as Help to Buy 2.

Under independence, subject to the fiscal implications of the currency choices made, a Scottish Government will have considerable autonomy to reorganise its housing taxation. Even under Devo-Plus if there is a 'no' vote, one may reasonably anticipate further tax reform opportunities. If nothing were to change, under the status quo, there would be nothing to stop the Scottish Government in the future seeking to restructure local property taxes and the LBTT.

The SNP say they do plan in the long term to end property taxes and replace them with a tax on incomes for local government finance purposes. They have also stated in the past that they recognise the damaging effect of volatile house prices and that tax might contribute to a more stable housing market[iii]. There are wider questions about local government funding and the role of taxes[iv].

Personally, given that many countries use more than one local tax to fund local services, I have always thought it perfectly possible to use income-based taxes to pay for redistributive or needs based services but employ property-based taxes to fund amenity or local facility type services (i.e. employ two classes of local taxes).

A second issue concerns using taxes and other interventions to fund contributions to meeting energy emission reduction targets for the existing housing stock. There are regulatory powers on hand to promote this aspect of energy efficiency for new homes but understandable worries remain concerning the much larger existing stock, some of which is grossly inefficient in terms of emissions and affordable warmth. A combination of well-designed equity loans, deferred tax payments and tax incentives could and should play a role in making progress[v]. It is hard to see what other silver bullets might push this agenda along even when high and rising energy costs are such a political priority.

The third and perhaps most controversial area concerns land, planning and new supply. The post-war period has been littered with failure to tax land development gains. On the one hand there is the long-standing debate over the deployment of a land value tax (LVT), for either local government or for national purposes, as against previous UK failed attempts to develop a feasible and sustainable development land tax or levy. The Mirrlees Review favoured a land value tax in principle but was sceptical about its practical application. On the face of it the case for LVT is indeed in principle strong. The argument is that landowners are the ultimate beneficiaries of land development and indeed the advantages conferred by planning permission. This land-based monopoly profit or economic rent if taxed (and not the structures on it) would not deter production at the margin and would recoup some of the planning gain from granting planning permission or funding infrastructure.

While there are challenges to valuing land for the entire country, these are lessened by emerging valuation technologies, GIS and the enormous potential of mass administrative and personal digitised data (known increasingly as 'big data')[vi]. However, it is fundamentally a matter of will.

After all, Lloyd George managed to value the UK stock of land prior to the First World War. The biggest problem will be making the political case stack up and winning sufficient consensus to make progress. It should also be noted that the Mirrlees proposal on taxing excess returns, elaborated on above, is actually quite close to a land tax.

What are the main barriers to progress for Mirrlees-type reforms both at a UK and a Scottish level? First, there are basic political hurdles to overcome. Reformers need to construct a campaign that normalises the concept of fair and efficient reform of housing taxation by building a popular sense of the cost and unfairness of the status quo. They need to argue that housing taxation is done sensibly in other parts of the world with social and economic benefits to citizens but also demonstrate that the goals of reform can be achieved by a coherent phased transition that limits the costs to losers. Inevitably, the implication is of a long term phasing-in, perhaps over two Parliaments. This will require considerable political consensus on the scale of the 2003 homelessness legislation or the abolition of MIRAS (mortgage interest relief at source) – i.e. a difficult challenge but far from impossible.

The problem is of course that this will require overcoming short termism and entrenched interests. Going back as far as the Duke of Edinburgh's Inquiry into British Housing in the mid-1980s fundamental reform has proven impossible, though there have been small improvements (and also some reversals). Increasingly, people seem able to grasp the collective failure associated with the sum of individual benefits from rising house prices, i.e. unaffordability, market volatility, inter-generational social exclusion, ossifying regional labour market mobility. The trick will be converting this into individual willingness to change.

There is also a compelling argument that we will need more tax revenue (as opposed to more expenditure cuts) for medium-term deficit reduction reasons in the absence of sustained economic growth (and this will also to an extent apply in an independent Scotland[vii]).

So, higher housing-sourced taxation, a more stable housing system and a re-orientation of savings and investment into more productive parts of the economy (compared to second-hand housing) could help provide the macro and micro benefits that current housing arrangements just do not seem to offer us[viii]. Whether this vision can be achieved, or at least significant steps on the road to it, is a question for debate but constitutional change, be it independence or greater fiscal powers and responsibilities, does offer real opportunities to make significant long-term changes that will benefit the economy and society. Can we afford not to?

Conclusion

These proposals are just ideas for debate at this stage. Their net effect on the post-tax distribution of incomes is difficult to calculate until we have realistic tax parameters and essentially an economy-wide model like that used by the Institute for Fiscal Studies to work through the first round effects of a Scottish tax system. The positive case for widening the tax base through inclusion of property may turn out to be detrimentally burdensome to certain specific groups or places, even if Scotland faces lower marginal tax rates overall. The numbers need to be crunched and then we need to consider the second round behavioural effects – for example, how Scottish households might look on housing as an asset if it was taxed more normally and was less prone to asset price swings. Only then could we evaluate the economic and distributional outcomes fully.

Housing tax changes, however, will not be sufficient. Radical action will also be required to increase housing supply and make the system permanently more elastic. Consideration should also be given to counter-cyclical monetary and tax policies (again subject to post-yes vote negotiations) that seek to limit the nature of mortgage credit expansion in the boom phase, to incentivise new supply and deter speculation. Policies should also seek to encourage the quality end of corporate private 'landlordism' and rental market supply.

With social and affordable housing investment more aligned to local housing need solutions and drawing on a range of development and long-term funding routes, plus a better tenure-blind set of housing allowance welfare benefit arrangements for low-income households, the cumulative effect of these policies, alongside housing tax reforms, will be toward a more balanced and sustainable housing system, whatever the constitutional arrangements. Tax reform can help and may even contribute to desired social justice goals but it can only ever be part of the housing solution in an independent or devolved Scotland.

i O'Sullivan, A (1984) 'Misconceptions in the current housing subsidy debate', Policy and Politics, Vol. 12, pp.119-44.

ii Sir James Mirrlees (chair) S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (2011) The Mirrlees Review: Tax by Design. Oxford University Press: Oxford.

iii Scottish Government (2010) Housing: Fresh Thinking, New Ideas. Scottish Government: Edinburgh.

iv See Coopers and Lybrand Deloitte (1990) Alternatives to the Community Charge (1991) Joseph Rowntree Foundation: York.

v A policy direction promoted by inter alia the Chartered Institute of Housing

vi See Mayer-Shonberger, V and Cukier, K (2013) Big Data: A Revolution that will Transform how we Live. Work and Think. John Murray: London.

vii And would apply also unless oil revenues made an unexpected volte face in terms of most projections of earnings from oil and gas.

viii See O'Sullivan, A and Gibb, K (2012) 'Housing Taxation and the Economic Benefits of Home Ownership', Housing Studies, Vol.27 (2), pp. 267-79.