Property and land, taxation and the economy after the Barker Review

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John Muellbauer

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1 Introduction

The ratio of average UK house prices to average income or earnings now exceeds previous records; warnings from the Bank of England and the Financial Services Authority about the potential implications for stability have become frequent; homelessness is on the increase; and housing affordability is again seen as a crisis issue. There are many similarities with the late 1980s (Muellbauer, 1990). However, the macroeconomic environment is now a good deal more benign, not least because of the monetary policy framework introduced in 1997 and the greater consistency and predictability of the overall fiscal stance of the Treasury. For some time, HM Treasury seems to have taken the view that these reforms, together with the phasing out of mortgage interest tax relief, would eliminate risks of future macroeconomic booms and busts of the type experienced in the late 1980s and early 1990s. At the same time, it appears to have left issues of land use, housing, regional allocation, urban deprivation and regional inequalities largely to the Office of the Deputy Prime Minister (ODPM) – previously the Department for Transport, Local Government and the Regions.

However, the policy issue of whether the UK should join the EMU countries in adopting the Euro has been analysed by HM Treasury (HMT) in the context of the Five Economic Tests, with commendable and unprecedented thoroughness. It has served as a wake-up call in putting the issues of macroeconomic stability and the resource allocation, locational and distributional issues associated with housing and land high on the policy agenda. The Five Economic Tests Assessment concluded:

> … the incompatibility of housing structures means the housing market is a high risk factor to the achievement of settled and sustainable convergence.
> (HMT, 2003a)

In anticipation of the Five Tests, in April 2003, the Chancellor asked Kate Barker of the Monetary Policy Committee: ‘to conduct a review of issues underlying the lack of supply and responsiveness of housing in the UK’. The Interim Report was published in December 2003 (Barker, 2003) and the Final Report and Recommendations in March 2004 (Barker, 2004). These reports add greatly to the debate about housing, land and the economy and set out much valuable information. The recommendations, discussed further below, include a radical reform of the planning system with which most economists will sympathise, new development taxes and a number of other measures.

At the same time, the Chancellor asked David Miles to review the mortgage market with a particular view to analysing the preponderance of variable-rate mortgages in the UK and examining what barriers existed to the development of fixed-rate mortgages, which tend to dominate mortgage markets on the Continent and in the

US. Miles believes that the mortgage market is trapped in a less than satisfactory equilibrium: he argues that borrowers are ill-informed about longer-term mortgage costs and interest rate and other risks, and, together with mortgage advisers and lenders, are excessively focused on the level of initial monthly payments. There is heavy cross-subsidisation from many existing customers to new borrowers taking out discounted variable-rate mortgages. The recommendations of the Miles Review's Final Report (Miles, 2004) are aimed at improving the advice and information that borrowers receive, creating a fairer and more transparent pricing structure, and helping lenders fund mortgages and handle risk in a more cost-effective way. The weaknesses highlighted by Miles clearly increase the risks associated with house price volatility and are likely to have contributed to this volatility. Finally, as part of the Five Economic Tests documents published in June 2003, HMT published its discussion paper *Fiscal Stabilisation and EMU*. This noted:

> … fiscal instruments impacting on the housing market could help reduce volatility in this sector of the economy.
> (HMT, 2003b)

Carving up the examination of the issues and possible policy measures into the supply of new housing, the mortgage market and tax clearly had advantages in giving each set of investigators a more tractable problem.[1] However, the property tax issue was not analysed in depth in the HMT discussion paper, though it recurs in ODPM's examination of local taxation and funding issues in the *Balance of Funding Review*, which reported in July, but is to be examined further by Sir Michael Lyons at the request of HM Treasury. I will argue that a more holistic view of the economic issues related to housing and land use would probably not have led to the development tax recommendations of the Barker Report. Compartmentalisation is likely to have compromised the interim outcome of the *Balance of Funding Review*, which largely ignores issues of macroeconomic stability and resource allocation.

In what follows, I will re-examine property and land taxation in a wide economic perspective. Because of globalisation of international capital markets, the liberalisation of domestic credit markets and the widely acknowledged pro-cyclicality of the capital adequacy requirements agreed under the Basel II Accords, these issues are now more important than ever before. Prospects for reform are better than for many years.

2 Some criteria for reform of property taxation and the supply side

I will discuss four main criteria for property tax reform, apart from raising revenue for Government. These are to improve macroeconomic stability, to improve resource allocation, to lower economic inequality and social exclusion, and to support concerns over the environment, sustainability and other social values. It can be argued that all of these were criteria for the Barker Review too, at least implicitly. In addition, reforms should help to simplify the tax system and need to be phased in gradually to avoid disrupting long-term contracts and causing too sharp shifts in expectations. Reforms also need to be co-ordinated with essential reforms of the land-use planning system, which, in its present form, leads to some resource misallocations that can only be described as grotesque.[1] Finally, they need to be politically feasible in a society where, although each adult citizen has an equal vote, the distribution of power and influence remains very unequal.

Macroeconomic stability

Since Irving Fisher's (1933) 'debt deflation' theory of depressions, economists have been much concerned with what they now call the 'financial accelerator' (Bernanke and Blinder, 1992; Bernanke *et al.*, 1996, 1999). Asset price fluctuations transmitted to economic activity via the financial accelerator operate for both firms and households: the collateral role of property allows credit expansion and additional spending in upswings, thus fuelling booms. Asset price falls, for example in bubble collapses, can worsen downturns via a credit crunch, or even lead to Japanese-style problems of bad debts weighing down the banking system for prolonged periods. In the UK, the financial accelerator for households is even more important than that for firms and has become more pronounced since the credit market liberalisation that began in 1980 (Fernandez-Corugedo and Muellbauer, 2004, forthcoming). The higher sensitivity of UK consumption to housing wealth since 1980, as well as the greater sensitivity of housing wealth to short-term interest rates, compared with Eurozone economies, long emphasised in my research (e.g. Maclennan *et al.*, 1998, 2000), was confirmed by HMT's study on house prices and consumption (HMT, 2003c). It played a significant role in the negative outcome of the Five Economic Tests.

Further feedbacks in the financial accelerator occur via the asset base of banks. Many observers take the view that the Basel II Accords on capital adequacy ratios of banks (due to replace the original 1988 accords in 2006) are likely to increase the 'pro-cyclicality' of this phenomenon (Danielsson, 2003). This increases the need for alternative stabilisers of asset prices and so of the economy, such as property taxes.

There is also some evidence that house prices and business rents play a role in wage and price determination. Cameron and Muellbauer (2001) find, in the context of a model to explain the evolution of relative earnings of men in GB regions relative to the average for GB, that relative house prices in the previous year have significant positive effects.[2] Bowdler (2003) finds a lag of about 2.5 years between rents and consumer price inflation, though other influences on inflation are more important. This could operate via five-year lease contracts with upward-only rent reviews.

Concern with macroeconomic stability is not an arcane academic curiosum but relevant to all stakeholders in the property sector. The industry suffered disproportionately in the early 1990s' UK slump that followed the excesses of the late 1980s. The bankruptcies of many house-builders, the collapse of training schemes, plant closures in the building supply industry and unemployment of workers in the industry almost certainly contributed to the weak supply response in the subsequent upturn (see Barker, 2003, Chapter 6). Furthermore, while the domestic macropolicy environment has improved as noted above, and the international economic environment is one of low and stable inflation and so of reduced interest rate risk, these risks are far from zero.

Resource allocation

Under this heading comes a wide range of issues. Regional employment inequality, urban deprivation and the 'low-demand' inner-city areas are all symptoms of inefficiency in the allocation of resources, as well as of inequality and social exclusion. Huge differences exist between economic returns of land in different uses, which cannot be justified as 'benefits to the wider community'. Though some of the most extreme are due more to the planning system than the tax system,[3] I will argue that serious distortions come from the current tax system also. A closely related resource allocation issue is the under-provision of housing, which the Barker Reviews see as a major inefficiency. Taxation (as well as planning reform) can increase new housing supply and improve the allocation of the existing stocks of housing and land. Another resource allocation issue comes from the need for approximate tenure neutrality in the tax system, so that certain types of contracts are not arbitrarily discriminated against. Finally, since different types of taxes have different incentive effects on economic activity, a balance of taxation that puts more weight on taxes with smaller deadweight losses is to be preferred.

Economic inequality and social exclusion

Inequalities between different locations have already been mentioned. Homelessness is one aspect of low income heightened by the under-provision of housing. Affordability is an issue that currently particularly concerns the young without parents both wealthy and generous, as the Barker Review emphasises. Martin Weale (Weale, 2003) has made an important analogy between house price booms and large government deficits as transferring spending power from younger later generations to current older ones. Given the concern of economists with intergenerational accounts, and HMT's concern with avoiding large government deficits, this suggests avoidance of such intergenerational inequality as a deliberate policy goal.[4]

Most obviously, however, policy makers who include reduced economic inequality and social exclusion among their objectives would wish to avoid regressive forms of taxation (such as the current form of council tax). While means-tested benefits can be used to ameliorate a regressive tax system, the high marginal tax rates associated with withdrawal of such benefits have negative incentive and so efficiency effects.

Environment and sustainable communities

ODPM's Sustainable Communities Plan (ODPM, 2003) has several key elements: addressing the housing shortage, including affordability and homelessness; addressing low demand and abandonment; bringing social housing to a decent standard; improving the local environment; and protecting the countryside. Apart from the last two, these criteria have already been mentioned in the previous two sections of this chapter.

The next chapter will focus on an aspect of property market dynamics in the UK that has implications for stability, for regional resource allocation and for inequality and social exclusion.

3 The persistence of property returns in the UK and macroeconomic stability

The UK has both volatile and persistent property returns, as seen, for example, in the Investment Property Databank's (IPD) capital growth data on UK commercial property and the annual rate of growth of UK house prices illustrated in Figure 1. Persistence means a tendency for a change in one year to be followed by a broadly similar one in the following year.

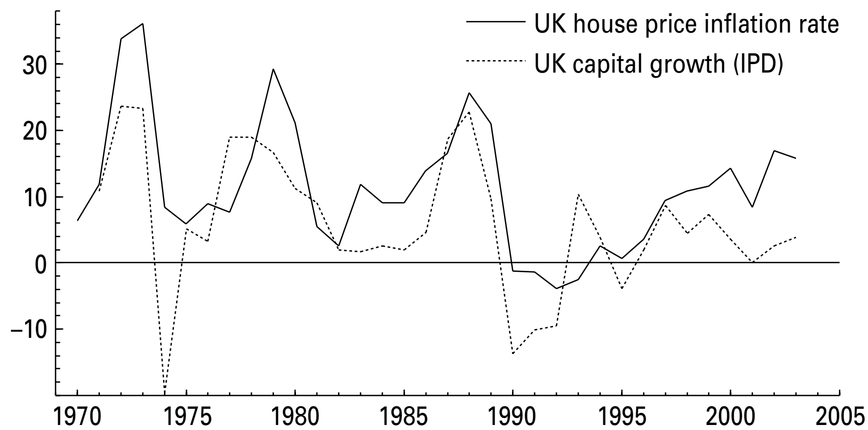
It is worth noting the correlation between the two graphs, though house price growth has been much greater since 1997. This is likely to have been the result of greater house price sensitivity to low interest rates, increased immigration, lack of new supply and the buy-to-let credit expansion.[1] The office sector has been especially weak in the last three years, probably because of the downturn in financial services and previous supply expansion. It is also worth noting that, from 1983 to 2003, residential land prices in England and Wales (excluding London) have risen 11-fold while UK house prices (including London) measured by the ODPM mix-adjusted index have risen 5.3-fold.

Studies of house prices in Anglo-Saxon or Scandinavian-style economies usually use formulations such as the following:

$$\Delta \log PH = a_0 + a_1 \Delta \log PH_{-1} - a_2 \log (PH_{-1}/P_{-1}) + a_3 \log (\text{real income}) \\ -a_4 \log (\text{housing stock}_{-1}/\text{population}) \qquad (1)$$

and other factors including interest rates. Here PH is the house price index and P is the consumer price index. They always find a_1 to be positive and statistically significant, and especially in the UK, meaning that capital gains tend to be followed

Figure 1 IPD capital growth and house price growth



by more capital gains. These studies always find $-a_2$ to be negative; indicating that, if real house prices are 'too high' or 'too low', then house prices will tend to adjust in the appropriate direction. Abraham and Hendershott (1996) call the two factors the 'bubble builder' and the 'bubble burster' respectively. Portfolio managers and analysts often use the terms 'momentum' and 'fundamentals' to describe the factors associated with the a_1 and a_2 coefficients. Equations of this type are also termed 'equilibrium correction' models (Engle and Granger, 1987; Hendry, 1995). In equilibrium, the fundamentals of income, interest rates, the housing stock relative to population and other factors determine real house prices according to equation (1); see Muellbauer and Murphy (1997) for further discussion. While extrapolative expectations may not be the only factor behind a_1, it is hard to believe that even moderately informed consumers could ignore these facts in forming their views of capital gains.[2]

The autocorrelation of IPD returns can be studied with a similar 'bubble burster', 'bubble builder' set-up (Hendershott and McGregor, 2003). Even moderately well informed investors will thus expect high returns to be followed by high returns, low returns by low returns. Hence the 'user cost' of property, which subtracts the expected rate of appreciation from the interest and other acquisition and holding costs, can be negative for long periods. Indeed, since 1968, the user cost of housing (see Figure 2) has been negative in the South 57 per cent of the time.[3] At the same time, the rate of return in housing compared with investing in a building society savings account (defined as house price appreciation plus imputed rent minus maintenance and tax costs, all as a fraction of value), has been positive and often very large for much of the same period (see Figure 3).

Figure 2 User cost for housing in northern and southern regions

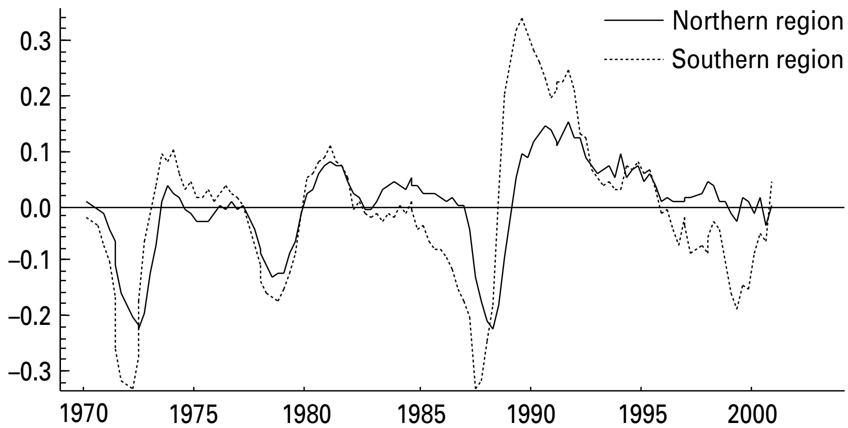
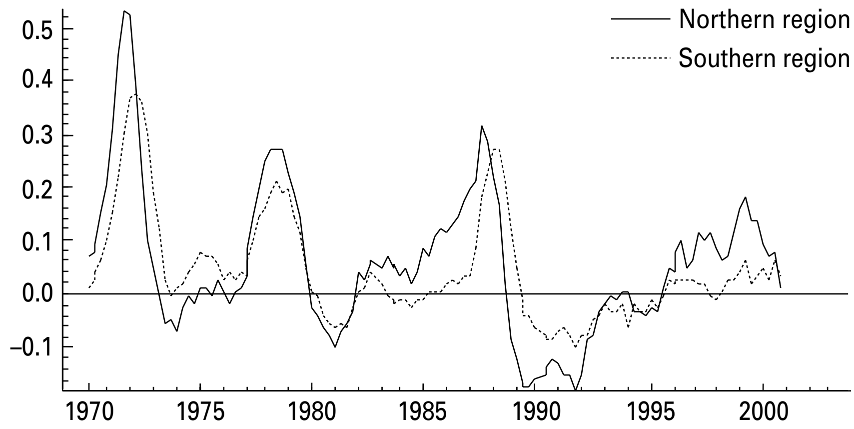


Figure 3 Rate of return for northern and southern regions



4 The design of property taxation for stabilisation

A simplified version of the real annual user cost of housing can be defined as:

$$UCC = [R + M + TR + T - \Delta PH^e/PH]\ PH/P \qquad (2)$$

where R is the nominal interest rate, adjusted for any mortgage interest tax relief; M is maintenance and insurance cost as a percentage of value; TR is transactions cost as a percentage of value; T is property tax as a percentage of value; PH is the index of second-hand house prices; P is an index of general consumer prices; and $\Delta PH^e/PH$ is the expected rate of change of house prices.

This is simplified to demonstrate the key components that drive demand for housing. It ignores elements such as the proportion of a property's value that is mortgaged, which affects the definition of the interest rate,[1] and the question of whether the marginal rate or the average rate of property tax is more relevant to the decision being made. It also leaves open the question of what is the most relevant time horizon over which the annual average of transactions costs should be taken. Transactions costs include solicitors' and estate agents' fees and stamp duty. There is some evidence that deregulation lowered the costs of the former in the 1980s. Stamp duty rates have varied considerably. It is not clear that overall transactions costs are higher now than in the early 1980s, when stamp duty was lower, though they have increased with higher stamp duty in recent years.

For the data shown in Figures 2 and 3, it was assumed that: M = 2 per cent, TR = 1 per cent and T = 1 per cent. These are quite crude assumptions. It is implausible that maintenance and insurance costs are proportional to house prices: they are likely to rise far less in house price booms such as that of the last five years. The average rate of tax T has also been far from constant: T was zero for Scotland from April 1988 to March 2002 and for England and Wales from April 1989 to March 1992, during which periods domestic rates were replaced by Mrs Thatcher's poll tax. However, it seems likely that, as the poll tax fiasco developed, many would have expected, correctly as it turned out, some kind of property tax to return. Furthermore, since such taxes were always based on outdated valuations, not indexed to house prices, T also tends to fall in house price booms and rise in housing recessions.[2] This means that the user costs shown in Figure 2 overstate the underlying costs in house price booms and understate costs in house price troughs, tending to understate volatility, perhaps by the order of 2 per cent between peaks and troughs. However, the stamp duty component of TR, which has a progressive element, is pro-cyclical. It is obvious from Figure 2 that the overall measurement errors in M + TR + T are relatively small compared to the magnitude of volatility.

Furthermore, Figure 2 uses the realised capital appreciation rather than the expected capital appreciation since we have no hard data on the latter. However, as argued above, even the best-informed market participants will have tended to extrapolate recently experienced rates of appreciation.

While the mismeasurement of the property tax rate T may not have had a large effect on measured user costs, this does *not* mean that the level and design of property taxes has negligible causal effects on house prices. At the time of the abolition of domestic rates, Hughes (1989) and Spencer (1988) argued that this abolition would lead to an appreciation of house prices of the order of 16–20 per cent. Their analysis was based on a capitalisation argument.[3] In the long run, the value of a house should equal the discounted present value of the stream of services it provides (the imputed rent) minus maintenance costs minus property taxes. In a steady state, in real terms:

$$VH = ((1 + RR)/RR)\ (IMPR - MAINT - TAX) \qquad (3)$$

where VH is the value of a house, RR is the real interest rate, IMPR is the imputed rent, MAINT is the maintenance cost and TAX is the property tax. For example, with MAINT = IMPR/3, TAX = IMPR/6 and R = 4 per cent, VH = 13*IMPR. At a real interest rate of 6 per cent, which incorporates a risk premium, VH = 8.83*IMPR.[4] The appreciation resulting from the abolition of property tax is calculated by taking the ratio of new to old VH as (IMPR – MAINT – TAX)/ (IMPR-MAINT). Under the above assumptions on MAINT and TAX, this is 33.3 per cent. With MAINT = IMPR/6, the appreciation is 25 per cent. This assumes a zero probability of any future property tax returning.

By varying the assumptions, a range of conclusions can be obtained, but it is hard to avoid concluding that the effects will be substantial. In the context of the late 1980s' house price and consumption boom, this policy shift at the height of this boom can only be described as folly in macroeconomic terms (see Muellbauer, 1987), quite apart from the regressive distributional effect of the poll tax and its huge collection costs. It was then also most unfortunate that property taxes, in the form of council tax, were brought back at the trough of the worst UK housing recession in 70 years.[5]

The lessons of this episode for how to reduce instability are obvious. Instead of abolishing property tax at the height of booms, it is far better to maintain a tax linked to current or recent house prices throughout the house price cycle and that is thus a constant proportion of capital values. Such a tax will represent an increasing proportion of the value of the services yielded by housing (imputed rent) as house prices rise. Thus, TAX/IMPR will rise and will automatically tend to choke off further appreciation as house prices rise relative to imputed rents and incomes, which imputed rents tend to follow. Furthermore, not only does this dampen appreciation of house prices, but it reduces household cash income and so the feedbacks that run from higher incomes to higher house prices, to higher consumer spending, to higher employment and higher incomes back to house prices. There is also an important expectations mechanism at work: if households extrapolate house price rises into the future, they will anticipate the greater tax burdens this will generate and so make more cautious spending and portfolio decisions.

Conversely, in property market downturns, tax to income ratios will fall and this helps to soften recessions. Evidence from Denmark supports this stabilising role. Denmark has a property tax of around 1 per cent in recent years, linked to recent market value, and indeed a progressive element, in that the marginal tax rate is higher for the most expensive properties. Denmark avoided the UK macroeconomic imbalances of the post-1996 period (excess house price and consumption growth, trade imbalances, overvalued exchange rate) despite strong income growth, falling unemployment and rising employment levels. Admittedly, Denmark's local land value tax (of which more below) and highly developed, but largely fixed-rate, mortgage market similar to that of the US, are likely to have contributed to this remarkable stability.[6] But the evidence, including the empirical evidence from the Danish Central Bank's own model, suggests an important stabilising role for domestic property taxes. It is no surprise that Denmark has the most effective automatic stabilisers in Europe, according to HMT's fiscal policy study (HMT, 2003b). Moreover, consumers know that, in extreme situations in either direction, tax policy could shift by, for example, lowering tax rates in a severe recession. Indeed, the property tax rate has been lowered in Denmark since 2001, partly in response to popular pressure, but with beneficial macroeconomic effects given the parlous economic conditions in core Euro zone economies to which Denmark has strong economic links.

There are many possible reasons for house prices to rise relative to incomes. They include lower interest rates, easing of credit restrictions – as occurred from the end of 1980 and, on a smaller scale, from the mid-1990s (see Fernandez-Corugedo and Muellbauer, 2004, forthcoming) – reduced uncertainty about income growth, inflation and interest rates, increases in the value of financial assets, higher rates of household formation relative to house-building, and higher expected and actual income growth. A sensible property tax would never remove such fluctuations, merely moderate them. A sensible rate for the UK is probably of the order of half a per cent of value. Thus, on a £250,000 house, the annual tax would be £1,250, not so very different from what many council tax payers are currently paying.[7] Note that the Danish rate of 1 per cent is in the context of significant mortgage interest tax relief, which remains in Denmark and has been abolished in the UK.

The macrostabilisation role of property taxes considered so far has been primarily from a demand-side perspective. But the supply side can also contribute in important ways. Since the stabilising role via the supply side, and resource allocation issues discussed in the next chapter, overlap, a few brief points will be made here. First, equation (1) shows the contribution of housing supply to house price determination: indeed, $-a_4/a_2$ measures the percentage change impact on real house prices in the long run of a 1 per cent rise in the housing stock, other things being equal. Numbers of the order of –2 at the UK level have been used in the Barker Review simulations of the impact of additional supply on prices. As Barker explains, the more responsive supply is to higher house prices, the less volatile prices will be, since higher prices will automatically call forth higher supply, tending to reduce prices.

The contribution of property taxes to supply can be divided into the effects on new building, considered by Barker, and discussed in detail in the next two chapters, and the effects on the allocation of the existing stock, outside Barker's brief. Since the existing stock is over 99 per cent of total supply, improvements in the utilisation of that stock have potentially large effects on prices. A property tax reform, which improves utilisation, is likely to have a gradual but one-off impact on prices, since, for many owners and occupiers, altered incentives will affect behaviour only with some delay. However, any permanent effect in increasing the responsiveness of effective supply will reduce house price volatility in the long run.

In general, taxes on property, including land, increase the incentives against keeping property vacant and under-occupied. If taxes are linked with current market values, these incentives are sharpened when property prices rise relative to incomes. For example, with higher taxes induced by higher house prices, households with spare rooms will be more inclined to rent out the space, increasing the effective supply of housing in response to higher prices. This can be especially important in periods of rising prices when otherwise the appreciation of housing, and the additional collateral this provides, makes many owners feel flush with spending power and so careless about the income streams that might be generated from renting under-utilised space.[8] Indeed, under current conditions, a fall in house prices, associated with a drying up of collateral-backed credit, may well lead to additional supply because of pressure on cash flows, just when such supply is likely to weaken the market further.

The benefits of reform here are likely to be large but hard to quantify precisely, particularly in the absence of good data on square metres of the occupied housing stock linked to the characteristics of the occupiers. The overall elasticity of total housing supply is approximately 0.99 times the elasticity of the effective existing stock plus 0.01 times the elasticity of new supply. If the elasticity of effective supply of the existing stock rose by only 0.03,[9] this would be as beneficial in stabilisation terms as a rise of 3 in the elasticity of new build, which would be widely regarded as a tremendous success if that were the eventual outcome of the Barker recommendations. Research by Meen for the Barker Review suggests that the average new supply elasticity in the UK is currently close to zero and unlikely to be higher than 0.5, Meen (2003).

Both demand-side and supply-side arguments suggest an important stabilising role for sensible property taxes indexed to house price indices. I have long argued that the council tax is not a sensible tax.[10] It is not indexed to market values (the last valuation was in 1991). It is locally regressive, with a big ‘poll tax’ element and a zero marginal tax rate for expensive houses, and regionally regressive, with locations with lower house prices tending to have higher council tax rates. There was a 50 per cent discount until March 2004 for second homes – councils now have discretion to reduce this to a 10 per cent discount. There was also an empty homes discount until 2003. And there is no postponement of the tax for pensioners (unlike in Denmark, where pensioners can delay payment until the property is sold, which very much reduces the cash-flow burden for those with low cash incomes).

It is worth commenting on a supply-side aspect of local regressiveness. Council tax creates incentives to combine adjacent small housing units, whether country cottages or flats in a Victorian house, into large single units to lower the tax bill. This not only contradicts planning guidance, which tends to favour smaller units, but goes against the grain of the increasing fraction of small or single households in the evolving demographic structure. And, because units in the rental market tend to be smaller than in the owner-occupied sector, it contributes to the overall tax bias against the rental sector.

There are many reform options, some, no doubt, being considered by the Balance of Funding Review (ODPM, in progress). For example, a mild reform might introduce more council tax bands to reduce the regressiveness of the tax, move to five-yearly revaluations as for business rates, change the funding formula for local authorities to reduce the need of the poorest local authorities to have the highest tax rates (and perhaps consider additional revenue sources) and introduce the postponement of payment option for pensioners, which should surely be popular on all sides. However, infrequent revaluations would substantially diminish the potential stabilising role of property taxes.

The Liberal Democrats have gone for replacement by a local income tax, with no property tax whatsoever. In terms of macroeconomic stability, abolishing property taxes at the peak of the house price cycle smacks of Mrs Thatcher’s blunder of 1987–89. Far more sensible would have been to propose a reformed national property tax with uniform national rates, meeting the main objections to council tax set out above. Revenue would be shared with local councils, giving them a stake in decisions, for example on development, affecting the property tax base.

One important general point needs to be made about local taxation and macroeconomic stabilisation. The central government has better access to the international capital markets and is focused on macroeconomic stability. Stability of revenue is of greater concern to local governments than central government. Property taxes linked to market prices are necessarily more volatile than income or sales taxes, indeed obtaining their automatic stabilising function by rising relative to income in upswings and falling relative to income in downswings. This suggests that they are not ideal as the main source of local revenue.[11] Given the above arguments for revenue sharing of property taxes between local and central government, local income taxes are the obvious source for the bulk of local authority tax revenue.

5 Resource allocation, user cost and tax design

The second criterion for property tax design examined in Chapter 2 concerned the efficient allocation of resources. Some locations in the UK economy, such as Bradford and Liverpool, have experienced vicious spirals of economic decline, while housing and the infrastructure elsewhere have been under pressure. While differences in the unemployment rate between regions have narrowed since the 1980s, the same is not true of activity rates (employment/working age population).[1] Indeed, these have widened in recent years. The low activity rates, particularly for men, in the poorer locations are a clear example of resource misallocation: many of these potential workers would surely have wanted to be in employment.

Another symptom of resource misallocation is in the high government expenditures on, for example, Regional Development Agencies, urban renewal projects and expensive schemes, for example, the 'deprived areas' stamp duty relief scheme and 'key worker' housing subsidies. The stamp duty relief scheme is notorious for waste. It is not only expensive to administer, but also the arbitrary boundaries by which 'deprived areas' are defined included Canary Wharf in a deprived area and put the Bluewater shopping complex into a deprived area, while a nearby competitor was outside.

For the Government itself, its ability to supply public services in the South at reasonable quality and cost has been very much hampered by the implications for hiring staff given the rise in housing costs in the South. This will have contributed to the fact that the price deflator for government services has been rising at 7 per cent per annum in the last couple of years.

The tendency of user costs to persist is one reason for the exacerbation of the regional inequalities and deprivation that are observed. One consequence of low-demand housing is often a vicious downward price spiral, where the low-demand areas become less desirable when their house prices fall. From the point of view of the user cost of housing, this increases the total costs of housing, which reinforces their undesirability. Households buying into higher-priced areas with rising prices, by contrast, will benefit from lower user costs of housing as a result of the price growth.

Similar benefits apply to the land or property costs of businesses, which can prolong investment and employment booms in the areas with high relative land prices. This failure of the price signals, as measured by user cost, to indicate scarcity values appropriately during long upswings is likely to be a significant factor in vicious spirals of decline in economic activity in the low-demand areas, as well as in over-investment and over-employment in congested successful locations. In research on

UK regional migration, Cameron and Muellbauer (1998a) found that expected house price appreciation[2] was a crucial counterweight to high house price to earnings ratios, which otherwise discourage net migration to a high-priced region. Our estimates help explain why economic activity tends to continue to be attracted to high-priced but prosperous locations.

Another reason for regional inequality and cycles of deprivation lies in the regional and local regressiveness of property taxation. The distortions of the system can be highlighted by taking Kensington (London) and Kensington (Liverpool). A three-bedroom terraced house costs around six times as much in Kensington South (KS) as in Kensington North (KN). The implied land price ratio must be around 12 to 1. KS has one of the lowest Council Tax rates; KN one of the highest in the country, 30 per cent higher than KS in 2004–5 for a band D house, though the differentials have narrowed sharply since the late 1990s. Such a terrace will be in band A in KN and in one of the higher bands in KS, say band D. Given the local regressiveness of the tax, the tax on the KN house will be almost as high as that on the KS house, despite it being far cheaper. Seen as a tax on the underlying scarce resource land, the tax rate would, on these assumptions, be around 10 times higher per £ of residential land value in KN. Research on regional migration suggests that the unskilled unemployed, who make up the bulk of the unemployed, have a very weak response to house price/earnings differentials. Encouraging the movement of skilled workers, professionals and managers to places like Kensington North, or locations nearby, is likely to reduce the local unemployment rate among the unskilled.

From this point of view, the uniform business rate (UBR) is a far less distorting tax. For example, continuing with the Kensington North and South case, suppose the business land price differential is 5:1 (while the residential differential is 12:1). Consider a business in KS with £5 million in non-land business assets and £5 million in land, and a business in KN with the same in non-land and £1 million in land. The KN tax bill is 60 per cent of the KS tax bill. Prorating UBR on land alone, the implied land tax rate would be three times higher in KN. It is obvious that, if the tax base of UBR were shifted towards land, businesses locating in the low-price locations usually associated with economic deprivation would benefit.

So far, this chapter has focused on locational resource misallocation. However, tax design can reduce other resource misallocations. As we have seen, the under-provision of housing was considered by Barker as a major efficiency loss for the economy. Also, at the end of Chapter 4, I considered the potential efficiency gains that sensible property taxation could bring through the better utilisation of the existing stock of dwellings and similar considerations apply to efficient use of land. It should be noted that the environmental benefits of better utilisation of the existing stock of housing and of land could be very considerable, especially if it brings new economic activity to old industrial land. Moreover, those concerned with the environmental implications of relaxing planning controls, as recommended by the Barker Review, should be sympathetic to measures that help to control demand, as well as making better use of stocks. A further benefit from sensible property taxation is to provide effective funding for public infrastructure investment, which sharpens the incentives for better investment decisions. The combination of planning and tax reforms has the potential to bring greater productivity improvements to the UK economy than any other area of policy change on the agenda. I will now discuss some of these issues further in the context of a specific and politically realistic reform proposal.

6 A modest reform proposal

There are four main elements to my proposal. The first is to reform the uniform business rate (UBR), shifting half the basis for valuation away from business assets to land above some minimum value per hectare.[1] The second is to exclude most farmland by, for example, exempting the first £20,000 value per hectare.[2] The third is to permit a payment window, for example, three to five years, to ease cash-flow problems, provided the tax authority has a first claim on the land holding registered at the Land Registry. Finally, the new land value tax regime should be phased in gradually.

While initially one could conceive of moving to a target of replacing around half of the £16 billion raised in 2002 from the UBR,[3] it makes sense to raise that target a little to compensate for a phased reduction and reform, for example, properly tapering of stamp duty, which currently raises around £2.5 billion from the commercial property sector, but may raise more after recent legislative changes.

Stamp duty is not a good tax. It taxes transactions and so is a barrier to mobility both for firms and households. It imposes heavy penalties on what are sometimes relatively small changes in contractual rights and obligations, from which both sides of the transaction benefit. The 'slab' system makes no sense: arbitrary discontinuities with no economic justification encourage a culture of deceit and avoidance. Indeed, for the commercial sector, largely subject to the maximum rate of 4 per cent, much energy has gone into avoidance, for example, by moving partners to transactions offshore. It seems likely that switching to a simple 2 per cent flat rate or a tapered system with a 2 per cent maximum for the commercial sector would result in a quite moderate revenue loss and so require little increase, perhaps £1 billion, in the land value tax (LVT) component of the UBR to replace lost revenue.

This suggests that, if the LVT component had existed in 2002, it might have generated around £9 billion revenue. Let us consider what the potential value of the land element of the business asset base in 2002 might have been. According to the National Income and Expenditure *Blue Book* (published annually by the Office for National Statistics), buildings and engineering works owned by private corporations in 2002 were valued at around £600 billion. The land value component is likely to have been not far short of £300 billion. To this can be added the land value of business assets held by unincorporated businesses, unlikely to amount to more than £30 billion. However, the tax base would also include unused but valuable land currently exempt from UBR. Currently, we lack good estimates of what this might be. If it includes land with planning permission for residential housing and other valuable uses, as well as land with a significant hope value of obtaining such permissions in future, it could add as much as £150 billion to the taxable land capacity, even after the £20,000 per hectare tax allowance. On the basis of a £450 billion tax base, we would then be thinking of a 2 per cent LVT. Phasing in over five years would then suggest 0.4 per cent in the first year, 0.8 per cent in the second year, rising to 2 per cent in the fifth year and beyond. There would also be an initial delay for a first valuation, giving further scope for businesses to adjust to the new system.

There are numerous benefits of the Land Value Tax element in UBR. Governments face increasing difficulties in taxing corporations and there is a pressing need to find alternative tax bases. In terms of benefits for the supply of housing land, it yields the highest holding costs of land to owners when and where land prices are highest, so encouraging release of such land when and where it matters most. The Interim Barker Report (Barker, 2003) evidence is that, in these locations and at these times, housing supply elasticities are at their lowest. The tax thus offsets these tendencies, which are part of the reason for the overshooting of house prices and the under-supply of housing. It also reduces overshooting by making user costs positive for longer: so the price mechanism functions better, producing better resource allocation and improved macroeconomic stability.

The tax falls ultimately on ownership and not on development or business activity. It captures part of the benefits accruing to land owners from public investment or the private investment of others. It thus underwrites the funding of public investment, since the rise in land values that a worthwhile project engenders will automatically generate a rise in tax revenue to fund or more than cover the costs of the project. This should encourage better public investment decisions regarding not only individual projects, but also the scale of such investment. In a sense, it automates the mechanism by which US ‘business improvement districts’ are used to finance infrastructure. The tax incorporates far better incentives than complex and expensive stamp duty relief for deprived areas. Businesses locating in deprived areas with low land values would automatically pay substantially lower taxes than at present, and without any administrative intervention, except through the basic valuation and tax collection system. Urban regeneration is likely to be more successful under these circumstances than at present, especially with support from the reform of council tax, which, as noted above, is highly prejudiced against such locations.

Several more detailed issues need to be considered. Proponents of land value taxation suggest that phasing out of UBR entirely while LVT is phased in over, say, ten years, would ultimately be cheaper in administrative costs since only one valuation system is then needed. However, it seems likely that cautious governments would not wish to commit in advance to such a large change before undertaking a smaller-scale trial. They may also argue that business rates are long established and to give up a widely accepted revenue source could be risky. Furthermore, business assets as a whole will be more correlated with ability to pay than unimproved land values and to move entirely to the land basis, even with a three- to five-year payment window, could be too radical a shift.

A second issue is whether the owner or the occupier pays. Textbooks tend to suggest this is irrelevant since land taxes will ultimately be shifted to the owner. However, credit constraints and myopia can alter this conclusion. Even more important is the transition problem. Business rates are paid by the occupier and this is reflected in leasehold arrangements between landlords and tenants. Any unanticipated change in the basis of business rates will disturb existing contractual arrangements. An increase in the land tax relative to the rate implied by the current UBR and not offset by the halving of the tax rate on other business assets will have a negative impact on the cash flows of tenants, which, with five-year upward-only rent reviews, cannot quickly be recouped in lower rents.

Third is a valuation issue. The market price basis is often seen as unfair, for example by Barker, where the market value at current planning consents includes a hope value anticipating future changes of this planning consent. Someone owning a couple of acres to keep a horse near a residential area might then have to pay significant taxes.[4] Even worse, since, under current law, anyone can apply for a change in planning consents, a sale may be forced on such an owner by a successful application by another party. A change in the law requiring the owner’s consent for any planning application would deal with this last point. The proposed tax allowance on the per hectare land value and a three- to five-year payment window also help. Another possibility is to permit settlement of tax bills in the form of land rather than in cash.[5] Some would still consider the market-value basis unfair under these circumstances, even if the owner had experienced considerable capital appreciation or had been wealthy enough to be able to afford the original purchase at a price reflecting hope value. However, fairness can sometimes be in the eye of the beholder.

The alternative of imputing market values given existing consents, excluding any ‘hope’ element, makes valuation a good deal more complex and, in my view, should be avoided if at all possible. Another alternative of taxing capitalised cash flow, if generally applied, would encourage dereliction. However, when land is already in best use, it can be helpful in solving hard-to-value cases.

There are also various technical valuation issues. In recent years, major developments have taken place in GIS-based mass valuation systems, in the computerisation of the Land Registry and the development of local gazetteers. Vickers (2000, 2002) has carried out serious research on practical experience with LVT in Pennsylvania, including valuation issues, handling appeals and the legal framework, and has considered in some detail running pilots for introducing LVT into the UK. Some will argue that land valuation is inherently more difficult than the valuation problems faced by the Valuation Office in connection with UBR.[6] However, practical experiences in countries such as Denmark, where local taxes have a land value element, and in parts of the US, suggest that the obstacles are far from overwhelming.

The property tax alternatives to UBR and LVT are not attractive. The defects of stamp duty have already been discussed. Capital gains taxes are also a relatively poor form of property taxation. They tend to discourage transactions and the release of under-utilised land or buildings, for example, in expectation of lower future tax rates or offsetting losses. They involve serious complications of rollover relief in practice and indexation. The Barker Review suggests capital gains tax on land sales has had poor revenues and has not been a good way of capturing planning gains in land values. We turn now to the Barker Review proposals in more detail.

7 The Barker Review proposals

The findings of the Barker Review are highly relevant to the property tax debate. The existing planning system is a key element in the economic malfunctioning of housing and land markets in the UK, at both a macro and microlevel. Indeed, the McKinsey Global Institute Report (1998) argued that the land-use planning system in the UK was a major handicap to UK productivity. Clearly, co-ordinated reform of the planning system is overdue.

Barker favours a wholesale reform of the planning system and the introduction of new development taxes: new planning-gain supplements (PGS) should be awarded on the granting of planning permission. She also suggests reform of Section 106 of the 1990 Planning Act. She recommends the introduction of real estate investment trusts (REITs) to bring new finance into the rental sector. More new-build social housing should be encouraged, paid for partly by the new development taxes, and registered social landlord (RSL) reforms undertaken. Affordability criteria should be introduced to guide policy. Subsidies should be extended to develop land that has been derelict for some time.

These recommendations could have major implications for the entire property sector. Planning reform is certainly welcome, but the strong emphasis on new development taxes is questionable. Indeed, the Barker Interim Report (Barker, 2003) itself outlined in detail the failure of previous development taxes.

It is important to grasp the narrow remit of the Barker Review, focused on house-building, to help explain why the Review contained no economic analysis of the effects of property taxes in general. New housing annually amounts to just under 1 per cent of housing supply. Since taxes on land or property possibly have their main effects on the allocation of the existing stocks, and on demand, consideration of land and property taxes was arguably outside the brief of the Barker Review. Thus, while much-needed council tax reform was acknowledged, it was not explored by the Review.

The Barker Review's explanation for the lack of responsiveness of new supply to higher house prices is that it is caused mostly by failure of the planning system. Skill shortages are also acknowledged. However, the suggestion that rational behaviour by owners and developers of land might hold back supply in anticipation of higher future prices was entirely ruled out, helping to explain Barker's lukewarm attitude to land value taxation. To obtain the recommendation in favour of new development taxes, Barker must be assuming that land-release incentives of a development tax for local authorities outweigh the disincentives to owners. Moreover, it must be assumed that most of the revenue will be spent on new social housing.

The focus on new taxes on development would be reasonable if it simply involved a rationalisation of Section 106, 1990 Planning Act. However, the aim appears to be to extract additional planning gain from developers for local authorities and for central government. This could constitute an impediment to development, with long delays and render marginal schemes unviable. There is, as mentioned above, a trenchant account in the Interim Report (Barker, 2003) of why previous development taxes failed. However, the Final Report (Barker, 2004) contains very optimistic assumptions about the likely success of new higher taxes. The past failure of such taxes was characterised by owners withholding land for development, expecting a future tax regime would be more favourable. This outcome seems a problem for the future too. Furthermore, there is the serious problem of against which benchmark the gain is to be measured. For example, suppose farmland with the expectation of planning approval is sold to a developer or an intermediary. The uplift in value when permission is granted may be only a small fraction of the total uplift relative to the farmland price that would apply with no expectation of planning approval. If only the last stage is subject to taxation through the planning gain supplement, one might expect a new PGS minimising industry to arise, ensuring transactions take place as close as possible to the point before the planning decision is made. However, if earlier stages were to be taxed, chains of previous transactions would have to be traced and taxed, possibly after some years had elapsed. It is likely to be quite difficult to draw the line that limits how far back this process could be taken.[1]

Moreover, if the reforms were to be poorly phased, it is possible, in the short run, that the upheaval in the planning system could slow the rate of planning approvals. Owners and developers might, at the same time, restrain development because of the new development taxes, even while demand for land rises in response to new money for real estate investment from the REITs and pension reform, permitting tax-advantaged self-invested private pensions (SIPPs) to invest in real estate. Thus, rather than stabilising the market, instability might even increase.

Since the final Barker Report, the Office of the Deputy Prime Minister, has begun to act on some of its key recommendations. The main affordability measure, which over the medium-run, will be an important criterion for regional planning decisions, has now been defined. It is to be the ratio of the lowest quartile of house prices recorded by the Survey of Mortgage Lenders to the lowest quartile of individual full-time earnings recorded by the New Earnings Survey and that survey's successor. However, since any single targeted measure can be manipulated, multiple criteria have not been ruled out.

Regional Planning Bodies and Regional Housing Boards are to be merged and the Regional Assemblies, which are to produce regional housing strategies, are meant to make planning and housing decisions to make supply responsive, in the long-run, to the gap between the actual and target affordability. An independent Advisory Unit, a kind of 'Monetary Policy Committee for new housing supply', is being considered. This, it is hoped, will increase the transparency of this process, open it to informed public scrutiny and apply pressure on recalcitrant Regional Assemblies. Substantial research is being commissioned on the determinants of national and regional affordability as defined above, so that reasonable and sustainable targets can be set.[2]

It is clear that the private sector currently has misgivings about the framework. For example, there are concerns about continuing long delays in the planning process, with multiple layers of consultation, political bargaining and screening, and currently, the ODPM having the right to intervene in the process. There are also concerns that planning may be even more micro-managed than hitherto, for example, with detailed prescriptions at local level on types and sizes of housing units, which some fear will make housing supply less responsive to changes in the price signals. And naturally, the planning gain supplement is regarded with deep suspicion.

8 Conclusions

As noted in Chapter 1, property and land values have taken on an even more important role in the economy with the liberalisation of domestic credit markets and international capital markets. Their stabilisation has therefore become an even more pressing macroeconomic issue. They also play extremely important roles in resource allocation, both between locations, for example of economic and social deprivation on the one hand and affluence on the other, and between broad objectives such as more or less housing. They also have a major influence on the distribution of purchasing power between individuals and between generations. As the realisation of these facts has become more widespread, the pressure for reforms of the planning and tax systems has grown. This paper has analysed the roles of property and land values in the economy and considered property tax reform from the point of view of the objectives of macroeconomic stability, resource allocation, economic inequality and the environment. Concrete proposals for reform of council tax and the uniform business rate have been put forward. The council tax reforms, particularly with pensioners able to defer tax, would benefit the great majority of households. With the Barker Review proposing new development taxes of unknown scale and with the recent tightening of stamp duty on the commercial sector, stakeholders in the property sector are quite alarmed about what the future might hold. Under these circumstances, the moderate proposals made here for reforming UBR and at the same time reducing stamp duty and rationalising the existing development tax, Section 106, rather than bringing in new development taxes, seem likely to meet far less resistance than one might once have expected.

Notes

Chapter 1

1 It is also worth mentioning the Allsopp Review (Allsopp, 2004) of regional and national statistics for economic policy making, which has important implications for policies with a locational dimension, the Lyons Review (Lyons, 2004) of public sector relocation out of London and the South East, and the Egan Review of the skills base for planning, which complements the Barker Review's discussions of planning reforms.

Chapter 2

1 See Cheshire and Sheppard (2004).

2 Of course, at the regional as well as national level, earnings also have far stronger and immediate effects on house prices (see Muellbauer and Murphy, 1994, 1997).

3 Consider, for example, the case of an industrial-scale sugar-beet farm in a relatively featureless East Anglian landscape, the hedgerows having been torn up decades ago. Such a farm is heavily subsidised by UK and EU taxpayers, effectively taking livelihood away from Third World sugar-cane farmers. The value of the land, despite the subsidy, in agricultural use is, as Barker shows, around one-third of 1 per cent of the value of the same land in residential use, and its amenity value, on most calculations, is only around 1 per cent of that in residential use. The welfare loss caused by the planning restrictions that bring this about is vast.

4 See Weale (2003). A February 2004 correspondence in the *Financial Times* instigated by Edward Vickers has highlighted the issue.

Chapter 3

1 The value of outstanding buy-to-let loans rose from £2 billion in 1998 to £38 billion at the end of 2003, now around 4 per cent of total mortgage loans, according to the Council of Mortgage Lenders.

2 This equation can also be used to discuss differences in the information of market participants and in views of analysts. Less well informed participants are likely to overstate the 'momentum' or 'bubble-builder' components. Analysts differ over the role of the fundamentals. Some, for example, will argue that real but not nominal interest rates play a role, though Meen (1993) has long argued for some

role for nominal rates. They therefore obtain different answers to whether and how overvalued is the market.

3 Measured using realised rather than expected appreciation.

Chapter 4

1 The appropriate rate is the weighted average of the mortgage rate and the alternative rate of return, e.g. in a savings account, where the weights are the loan to value ratio and one minus the loan to value ratio.

2 In the case of council tax, a far from proportional tax, the average rates are less relevant than marginal rates to marginal transactions, e.g. moving up the housing ladder.

3 Quang Do and Sirmans (1994) give references to the literature on capitalisation and find empirical evidence from California suggesting the appropriate real interest rate is around 4 per cent.

4 Note that here M = MAINT/VH = 1.9 per cent, T = TAX/VH = 0.95 per cent, approximately in line with assumptions made above.

5 Given the circumstances of the time, the poll tax element and the weak link of council tax with market values had some merit in not destabilising the market further, a merit that had vanished by 1997, in view of the robust upturn in the market.

6 In Denmark, house price to income ratios did rise quite notably in the late 1990s, with strong economic performance, but much less than in the UK.

7 An allowance for the first £20,000 or so would add a mild progressive element to the tax, particularly beneficial in low-demand areas, and for reducing poverty and unemployment traps. And, naturally, benefits analogous to council tax benefit would apply to the poorest households. Given short-term rent contracts in the UK, and the need for advance warning of the reform, it probably does not matter much whether landlords or tenants pay. The former is administratively cheaper.

8 As reported in the *Financial Times* of 10 May 2004, over 100,000 homes vacant for over six months are on the books of local councils in London, the South East and the East, the areas of greatest demand pressure. Some observers of the buy-to-let purchase surge argue that, while appreciation continues, some properties bought with buy-to-let mortgages are being kept empty because of the

hassle and expense of renting out relative to rents received, and the lack of flexibility in a rapidly moving market, where the owner may wish to sell at short notice.

9 This would mean that a 50 per cent rise in real house prices would bring forth a 1.5 per cent additional rise in effective supply after the tax reform, compared with before the reform.

10 For example, in articles in *The Observer* and *The Guardian* in 1997, the *Financial Times* in 1998, 2000, 2002 and, most comprehensively, in Cameron and Muellbauer (2001).

11 Unless the rate support grants from central government, currently accounting for the great bulk of local authority revenue, automatically offset these fluctuations to stabilise local governments' total revenue.

Chapter 5

1 See, for example, evidence by Andrew Glyn to the Parliamentary Employment Select Committee.

2 Measured from predicted house price appreciation from a simplified form of the 'bubble-builder'/'bubble-burster' model discussed above, incorporating factors consumers would be likely to know about, including income, local and national house prices, and interest rates.

Chapter 6

1 I focus here on the economics and the nuts and bolts of such a reform. LVT has a long history, aptly summarised by McLean (2004).

2 The exemption would apply only to contiguous parcels of land so that large owners could not use the acquisition of cheap land to reduce their overall tax liability by averaging.

3 This is about 1.6 per cent in 2002 of the values of buildings, civil engineering works and plant and machinery owned by private corporations.

4 To make this concrete, consider a five-hectare plot, which is valued at £50k per hectare because of hope value, instead of £10k per hectare on the basis only of agricultural consent. With a 1 per cent tax on the excess of £50k over the £20k exemption, the annual tax would be £1,500.

5 In the context of the example in the previous footnote, with a five-year payment window, this would involve giving up rights to 3 per cent of the landholding every five years.

6 One leading property expert takes the view that, for example, urban valuations are very hard. To illustrate their complexity, he argues that land values on one side of Oxford Street are 20 per cent higher than on the other, and twice as high at one end of the street than the other. However, one hesitates to take this as a sign of difficulty: if one expert can give such precise valuations, one could argue that a professional land agent should be able to be similarly precise.

Chapter 7

1 Given these difficulties, several observers of the scene, including myself, were surprised to find Barker recommending against the much simpler development tax measure of equalising VAT on new build (currently VAT exempt) and refurbishment.

2 Since a given affordability measure will be harder to attain when interest rates are low, it may be that one outcome of the research will be to define targets that take into account the medium-turn outlook for interest rates.

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