# Response to the
# Treasury Select Committee Inquiry

## *The fundamental principles of tax policy*

## Submission by the
## Joseph Rowntree Foundation

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The Joseph Rowntree Foundation (JRF) is one of the largest social policy research and development charities in the UK. For over a century we have been engaged with searching out the causes of social problems, investigating solutions and seeking to influence those who can make changes. JRF's purpose is to understand the root causes of social problems, to identify ways of overcoming them, and to show how social needs can be met in practice. The Joseph Rowntree Housing Trust (JRHT) shares the aims of the Foundation and engages in practical housing and care work.

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## Introduction

JRF welcomes the Treasury Select Committee Inquiry into the Fundamental Principles of Tax Policy. We are concerned about the distorting affects of current taxation policy within the UK housing system. This submission highlights the importance of taxation policy in relation to its impact on house price volatility, people's housing tenure choices and resulting wealth inequality.

The evidence in this submission is drawn from work commissioned by the JRF Housing Market Task Force. The Task Force was convened to recommend credible policy solutions that would act to avoid extreme fluctuations between 'boom and bust' in the housing market cycle. The Task Force has reviewed evidence in a wide range of areas including housing taxation and subsidies, the distribution of wealth and increasing the supply of social housing.

## Summary

In considering the underlining principles of tax policy this submission focuses on potential reform of housing taxation in the UK as a means of achieving wider housing market stability and addressing current distortions within the tax system. The additional potential of such reforms to raise revenue and deliver a more progressive approach than the current system are also briefly considered.

The key points we make in the submission are:

- The tax treatment of housing is biased towards owner-occupation and acts to distort people's tenure choices.
- Although taxation of property currently amounts to 4 per cent of the UK's GDP, it was estimated in 2008/09 that lost revenue from not taxing home-ownership was £10.6 billion.
- Housing taxation could be a fundamental tool in levelling out the boom and bust cycle of house price volatility which could deliver wider economic and growth benefits.
- A new approach to taxing property could be more progressive across the income scale and between different local authority areas than the current council tax system.
- More equality is desirable between the tax treatments of different asset classes to promote a more level playing field between different asset classes such as housing, savings, pensions and other forms of wealth.

- Making changes to the tax treatment of home-ownership could also act as a brake on the growing inequality within the housing system. A tax and subsidy system designed with housing supply incentives in mind could have radical stabilisation and distributional outcomes, particularly if the new instruments were targeted on housing supply intended for lower income households.

**Key principles underlining tax policy reform**
We agree with IFS that a tax system should include a clear vision and be as simple, transparent and progressive as possible (IFS, 2010). OECD also argues that in the current financial context the aim of tax reform should be to reduce distortions within tax systems and to raise additional revenues from taxes without damaging economic growth (OECD, 2010).

The current housing taxation system in the UK has a clear bias in favour of home-ownership (Whitehead, 2011; Crawshaw, 2009; Wilcox, 2009). In addition to this taxation bias it is notable that current patterns of inheritance suggest wealth inequality will widen with those at the bottom of the income scale being left further behind (Appleyard and Rowlingson, 2010). This growing gap between the housing ‘haves’ and ‘have nots’ within the UK system is not simply a consequence of affordability pressures; it is also a result of the way in which gains from home-ownership are treated within the tax system. Wilcox (2009) argues that addressing the favourable tax treatment of home-ownership is likely to lead to a price adjustment within the housing market. An international review of housing and subsidy systems supports this perspective, identifying property tax reform as a way of achieving less volatile housing markets and less distortion in people’s housing choices (Oxley and Hafffner, 2010). Meen (2010) also notes how the favourable tax treatment of home-ownership distorts people’s choices away from financial assets and towards home-ownership. Thus the current system of property taxes in the UK violates the key principle highlighted by OECD (2010) of tax systems avoiding distortions in people’s choices.

Property taxes have been identified by OECD (2010) as an area of taxation reform that would be least harmful to economic growth. In addition, housing taxation reform designed with housing supply incentives in mind might also act to stabilise the housing market and improve distributional outcomes (Oxley and Haffner, 2010). Before considering the reforms that might deliver the objectives of a more progressive tax system, a more stable housing market and improved distributional impacts, it is worth dwelling a little on the desired principles of a housing or property tax system.

In addition to the efficiency and equity principles of the wider tax system, the following objectives are crucial elements of an effective property tax system (Oxley and Haffner, 2010; Hall and Gibb, 2010):

- less volatile housing markets;
- a neutral or complementary impact on local housing systems, other tenures and private developers;
- less distortion of people's choices between owning and renting;
- able to work with private funding efficiently;
- consistent with society's ideas of delivering affordable rents and prices and supporting low -income households;
- going with the grain of other related social policies relating to, for example, labour incentives, worklessness and mixed communities; and
- good value for money for the public purse.

As OECD (2010) notes, the current context surrounding public spending deficits requires a consideration of additional revenue- raising opportunities. Wilcox (2009) estimates that a failure to tax home-ownership amounted to lost revenue of £10.6 billion in 2008/09. However Oxley and Haffner argue that as property taxes currently amount to around 4 per cent of GDP in the UK (see Boadway, *et al*., 2009) care should be taken to ensure that any reforms focus on addressing housing market volatility rather than increasing the overall take from property taxation. As Wilcox (2009) notes, the downward price adjustment likely as a result of levying taxes on home-ownership could well reduce the amount of this 'lost' revenue in practice.

Oxley and Haffner (2010) identify four reforms as preferred options for generating additional investment incentives in housing and addressing house price volatility. They are:

- Additional supply incentives through **tax/subsidy enhanced contracts with private landlords**. This could include depreciation allowances which would ensure that private landlords were providing properties for low-income households. This option would require further modelling in order to establish value for money. However it could be a method of encouraging landlords to let to lower income households, particularly in a constrained local housing allowance framework. Properties would not be held in perpetuity so any modelling to develop this option would need to address both shorter- and long-term outcomes for lower income households and the housing market.

- Additional **tax/subsidy incentives for more housing investment** (through additional building, conversions and more effective use of the existing stock). This could include reducing VAT on renovations and conversions within the existing housing stock. As the current VAT system favours new-build housing, which carries a zero rate of VAT, there are trade-offs with this approach. Moves to equalise VAT rates between renovations/conversions and new-build properties might mean charging VAT on new-build housing. Further work on this option would need to be done to establish the impact on housing supply and the construction industry. Given the need to increase housing supply this may be a more medium- to long-term option which is perhaps more relevant to achieving sustainable housing to address the challenges of climate change than addressing house price volatility.

- **Stamp Duty Land Tax** (SDLT) changes that relate payments more closely to property values without banding distortions and with progression through a wide range of values, or alternatively the abolition of Stamp Duty Land Tax which might be linked to Council Tax reform and/or the introduction of a property tax.

- A **periodically levied property tax** (or reformed Council Tax) system that more closely reflected current market values (i.e. updated automatically or at set periodic intervals). This would address the preferential treatment of home-ownership within the UK tax system and the distortion this creates in people's tenure choices and preferences. The close reflection of house prices within the structure of a property tax would act as an anti-cyclical policy measure that could operate as a 'brake' on house prices and create greater house price stability within the market. In practice this reform might be linked to changes in Council Tax and/or changes in Stamp Duty Land Tax – in theory a functioning property tax system could replace SDLT since transaction taxes such as SDLT may become less necessary if the real value of house prices were taxed.

Property tax reform is argued to be most likely to address housing market volatility and reduce distortions in people's housing choices. While house price adjustments due to the introduction of revised property taxes might go some way to addressing inequality within the housing market, we accept that other reforms such as inheritance tax reform could also have far reaching re-distributional effects in terms of addressing inter-generational wealth inequality (Appleyard and Rowlingson, 2010). Appleyard and Rowlingson call for a fundamental review of the incentives and disincentives linked to different asset classes such as savings, investments, pensions and housing. They also demonstrate how the pattern of inheritance mirrors the distribution of wealth more generally, with those at the bottom falling further behind.

Capital gains tax is also an example of tax relief for home-owners which might be worthy of further consideration. However as Oxley and Haffner's (2010) review found that the impact of capital gains tax changes was likely to be debateable and risked increasing volatility, this is not pursued as a potential area of tax reform within this submission. Britain already operates a quasi property tax system through its collection of Council Tax. This tax has been described as a hybrid tax based on property values and a charge for the use of local services (Crawshaw, 2009). Crawshaw highlights how Council Tax meets the objectives of being difficult to evade and having high collection rates. However he also identifies it's potentially regressive impact – this is a major flaw of the current system albeit that this impact is cushioned by Council Tax benefit. For example the Lyons Review identified that even with the current take-up of Council Tax benefit, those in the lowest income decile still pay around 8 per cent of their income in Council Tax compared to 3 per cent in the highest income decile (Lyons, 2007). Stephens (forthcoming) also notes the imperfect nature of Council Tax since it does not accurately reflect or tax up-to-date property values and as such it fails to act as a brake on house price volatility. In addition, Stephens notes the unequal geographic impacts of Council Tax. For example current Council Tax is around 0.65 per cent of house prices in North East England but only around 0.36 per cent of house prices in London.

The Treasury itself has noted that fiscal measures impacting on the housing market could reduce volatility (Muellbauer, 2005). Reforming property tax would of course involve significant reform to local government finance systems. However we would argue that depending on the design of a property tax within the UK it could have significant benefits in terms of:

- reducing housing market and house price volatility;

- creating a more level playing field in people's investment decisions between housing and other products such as pensions, savings and investments;
- reducing the distortion in people's housing tenure choices as the tax advantages inherent in home-ownership were addressed;
- enabling households to make housing consumption choices that were less dictated by house price trends and more suited to lifecycle stages and labour market demands.

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