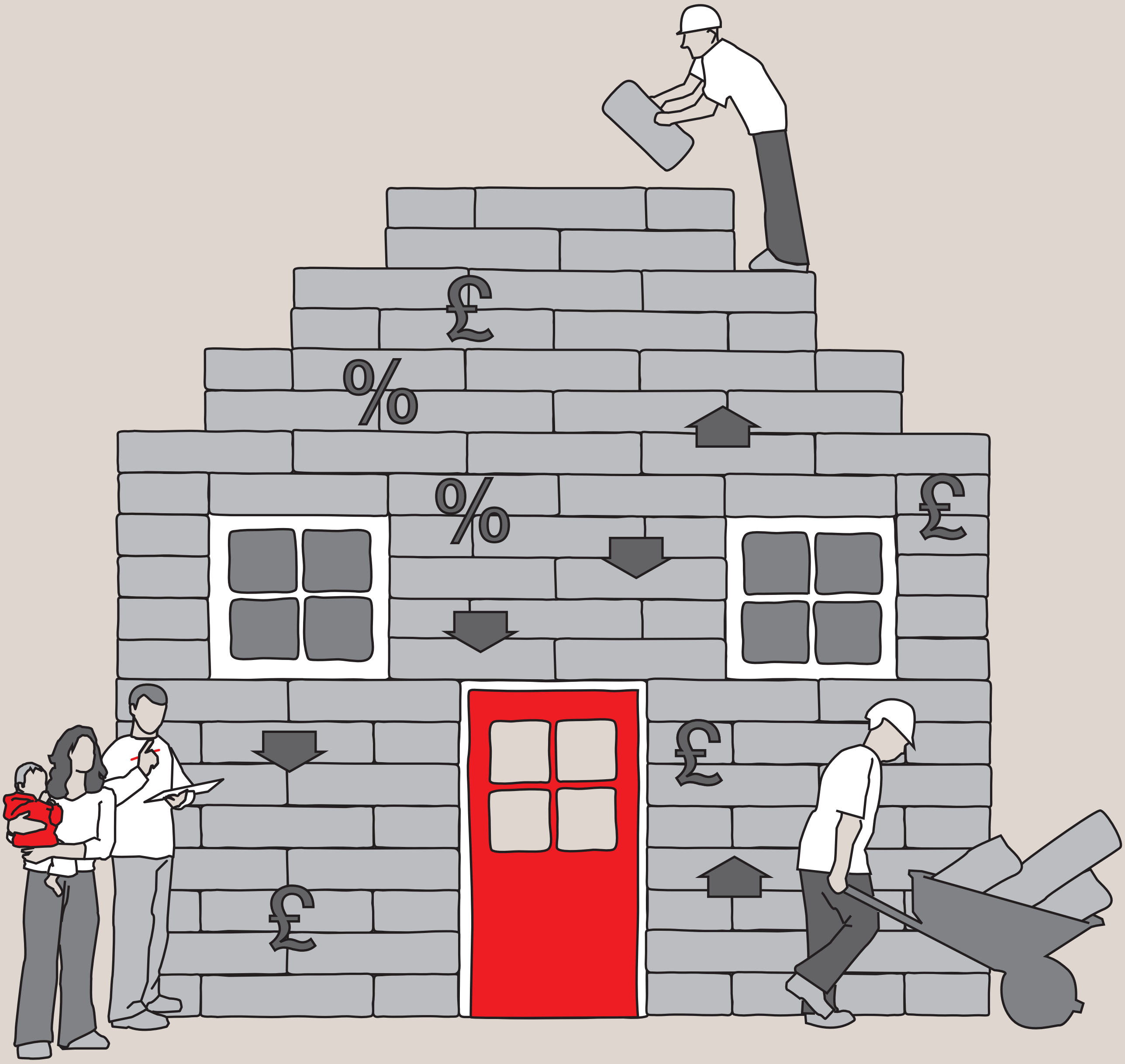
Policy: discussion paper

Rethinking housing taxation

Options for reform



Shelter

Foreword

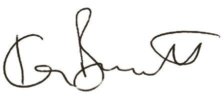
Kiem Tang

We are in the midst of unprecedented change in the housing market. House prices have plummeted, lines of mortgage credit have been all but cut off from many would-be borrowers, and thousands of households are facing mortgage arrears and repossession. The focus to date has, quite rightly, been on the immediate impact of the downturn and prevention of repossessions. But Shelter believes that the time is now right to take a step back and consider possible reforms over the long term to help avoid dramatic cycles of boom and bust in the housing market in future.

In this context, we at Shelter have turned our attention to the system of housing taxation and the role that it plays in the housing market, and indeed the wider economy. We believe it is imperative that we understand how the housing taxation system could be reformed to bring about positive change. There are many potential benefits of reforming housing taxation, which include improving housing market stability, tackling affordability pressures, ensuring that home ownership is not seen as the best and only tenure option, and addressing some of the housing wealth inequalities that are inherent in the current system.

Many will say that attempting to reform housing taxation is too complicated, too controversial, or simply too difficult, but surely we have learnt from recent experience that changes which were once unimaginable can and do happen. Over the last two years, from boom to bust, many of the mainstays of the financial system have been found wanting. As a result, we have seen banks nationalised, Bank of England interest rates reach their lowest point ever, and steps taken towards comprehensive reform of banking regulation.

We have a significant opportunity to kick-start debate about the future of housing taxation. Shelter hopes that this paper helps to frame some of the key issues as a step towards a much wider policy review.



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The views expressed in this publication are those of Shelter.

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Summary

The economic downturn has exposed serious failures at the heart of Britain's housing system. It is clear that over the past decade we have experienced an unsustainable housing market boom. This has damaged the economy and worsened people's housing outcomes. As housing and economic policies are now being reassessed in light of the economic downturn, it is vital that we take the opportunity to consider housing taxation as one of the key ways to tackle these systemic failures.

Housing taxation reform should aim to address four key problems, all of which have profound implications, not just for housing, but also for the economy more generally:

- instability in the housing market
- housing affordability pressures
- unequal tenure choices
- housing wealth inequalities.

With public debate growing about how to create a more balanced and sustainable housing system, it is critical that we consider the role that changes to housing taxation could play. The purpose of this discussion paper is to stimulate this thinking and kick-start debate, focusing on how housing taxation affects demand for housing.

Issues with current taxes

Key issues with the current housing taxation system are:

- Council tax is highly regressive. Those on low and middle incomes pay a much higher proportion of their income in council tax than those on higher incomes. Council tax rates are based on valuations that are now 18 years old, yet the housing market has changed enormously since then with prices rising more in some areas than others. Moreover, council tax discounts offered by local authorities for second and long-term empty homes encourage the inefficient use of the housing stock at a time of major housing shortages.
- There is no clear economic rationale for stamp duty and the threshold system causes inefficiencies in the housing market. The stamp duty banding system means buyers are obliged to pay the higher rates of duty on the whole of the value of their property once the thresholds for these rates are exceeded. This leads to sharp increases in the amount of duty payable at each threshold and encourages price bunching just below the threshold levels.
- The exemption of main residences from capital gains tax reinforces the taxation disparities between home ownership and private renting, and may fuel the upward spiral of house prices during housing booms.
- Inheritance tax has a significant impact on housing wealth transfers and current policy may have increased the potential for these to contribute to house price rises.
- The threshold for rent-a-room relief for the taxation of rental income is too low and presents a barrier to the supply of much needed low-cost rental accommodation. In the current economic climate many homeowners, particularly those struggling with mortgage costs, could benefit from the option to generate extra income by renting out a room in their home.

Options for reform

This paper considers a wide variety of options for reform. Some of these are intended to improve the operation of the current housing taxation system, but others would involve a more substantive restructure, replacing existing housing taxes with completely new ones. A national policy debate on the future of the housing taxation system is essential to evaluate the options in more detail and to understand the likely implications for individuals, the housing market and the economy as fully as possible.

Council tax

Ensuring that levels of council tax are in proportion to property values would improve fairness by making sure that those with high levels of housing wealth pay a greater share of tax. This could be achieved by adding extra council tax bands at the top and bottom of the scale and substantial changes to the ratios between each band, coupled with the revaluation of properties to reflect current market values. This would raise additional income that could be used to ensure that those on lower to middle incomes did not experience an increase to their charges.

An alternative to the reform of council tax would be to replace it with an annual property tax, levied each year at a fixed proportion of property values. This would have a similar effect to council tax reform in improving fairness, but could also have the advantage of acting as an automatic stabiliser on house prices. The positive stabilising impact of an annual property tax could also be achieved by reforming council tax so that it resembled such a tax or through the introduction of a land value tax in which the rental value of the land itself is taxed.

Stamp duty

Stamp duty could be replaced by a different tax such as capital gains on main residences. Alternatively, it could be reformed to act as a stabilisation tool, so that a higher rate of stamp duty would automatically be charged when house prices were rising in order to dampen demand, and a lower or zero rate would be charged when prices were falling. The Royal Institute of Chartered Surveyors (RICS) and the Council of Mortgage Lenders (CML) have also developed proposals to introduce a marginal stamp duty system, so that the higher rates of stamp duty would be levied only on the value of the property above the relevant thresholds, and not on the full purchase price as happens at present.

Capital gains tax

Capital gains tax could be charged on the gains arising from the sale of households' main residences. This would capture windfall gains from housing transactions and help to level the playing field between the attractions of owner-occupation and private renting.

Inheritance tax

Inheritance tax could be reformed so that the rate charged rises in line with a progressive banding system, as proposed by the Institute for Public Policy Research (IPPR). Alternatively, others have suggested replacing inheritance tax with a lifetime capital receipts tax, along the lines of that already operating in Ireland.

Housing tax credit

The Joseph Rowntree Foundation (JRF) has proposed a housing tax credit to help low-income homeowners and tenants. This would take the form of a means-tested flat-rate contribution to housing costs to complement the existing housing benefit system for tenants and would operate alongside the existing tax credit regime. Alternatively, a non-means-tested tax credit could be introduced solely for private renters, which would help improve the attractiveness of private renting relative to other tenures.

Ways forward for policy

The current economic crisis has thrown into sharp relief the inadequacies of the existing housing market and provides us with an opportunity to consider the broader aims and functions of housing taxation. As policy-makers consider how to reshape policy in response to the lessons of the downturn, the need for an honest debate about the role and objectives of housing taxation has never been more pressing.

Shelter believes that there is a need for a national policy debate on the housing taxation system to examine the issues covered in this discussion paper in more detail. This must result in a clear rationale and strategy for the reform of housing taxation over the longer term.

On top of the reforms discussed above, we have identified two potential reforms that are relatively modest in scope but would deliver immediate benefits. These are:

- removing the ability of local authorities to offer council tax discounts for owners of second and long-term empty properties, and
- raising the threshold for rent-a-room tax relief to £9,000 to reflect rent increases since 1997.

We believe that the Government should consider these reforms for implementation as soon as possible.

Background

Housing taxation is central to housing policy and could play a key role in tackling issues such as instability in the housing market and housing affordability pressures. With housing and economic policy under review, informed and accessible debate on housing taxation is urgently needed.

The economic crisis has highlighted just how closely the fortunes of the economy are tied up with those of the housing market. Triggered by irresponsible lending in the US sub-prime market, the credit crunch has led to a dramatic collapse in the UK housing market, impacting on consumer confidence and the wider economy. At the same time, increasing levels of unemployment have driven up the number of repossessions and one million homeowners now find themselves in negative equity.

At the heart of these developments lies a series of fundamental failures in the UK's housing system. It is now clear that we are suffering the consequences of an unsustainable housing market boom, fuelled in part by an expectation of ever-increasing house prices and a lack of alternative housing options. This both damages the economy, undermining stability and efficiency, and leads to worse housing outcomes for individuals, reducing affordability and increasing the levels of risk to which they are exposed.

One of the key ways to tackle these failures is to use the housing taxation system. Despite its complex and sometimes controversial nature, taxation is one of the most powerful tools available to influence outcomes in the housing market and in the wider economy. The Government is now reshaping its housing and economic policies in light of the lessons of the economic downturn. It is vital that we take the opportunity to consider housing taxation as an integral part of this policy reassessment.

The purpose of this discussion paper is to respond to this need by kick-starting an open and honest debate about the role and direction of housing taxation policy over the long term. The paper reviews the current housing taxation system and sets out four key objectives against which reform should be considered. It then discusses a range of options for change, before concluding with some final reflections on the considerations that should inform future policy development.

Scope of this paper

The focus of this paper is on the way in which the taxation system affects access to, and demand for, housing. It considers potential reforms across six key areas of housing taxation: council tax, stamp duty, capital gains tax, taxation of rental income, inheritance tax and housing tax credits. Although the paper focuses on the situation in England, much of the discussion will be of relevance to other parts of the UK.

The paper does not concentrate on tax measures related to the supply of housing, such as VAT on renovation or refurbishment, or the Government's planned community infrastructure levy. Consideration of this aspect of housing taxation is being taken forward separately as part of Shelter's work on housing delivery. In addition, we are considering the issue of tax avoidance and evasion by landlords through our work on the private rented sector.

Objectives of housing taxation reform

Shelter considers that housing taxation reform should aim to tackle four key problems, all of which have profound implications not just for housing but also for the economy more generally. These are:

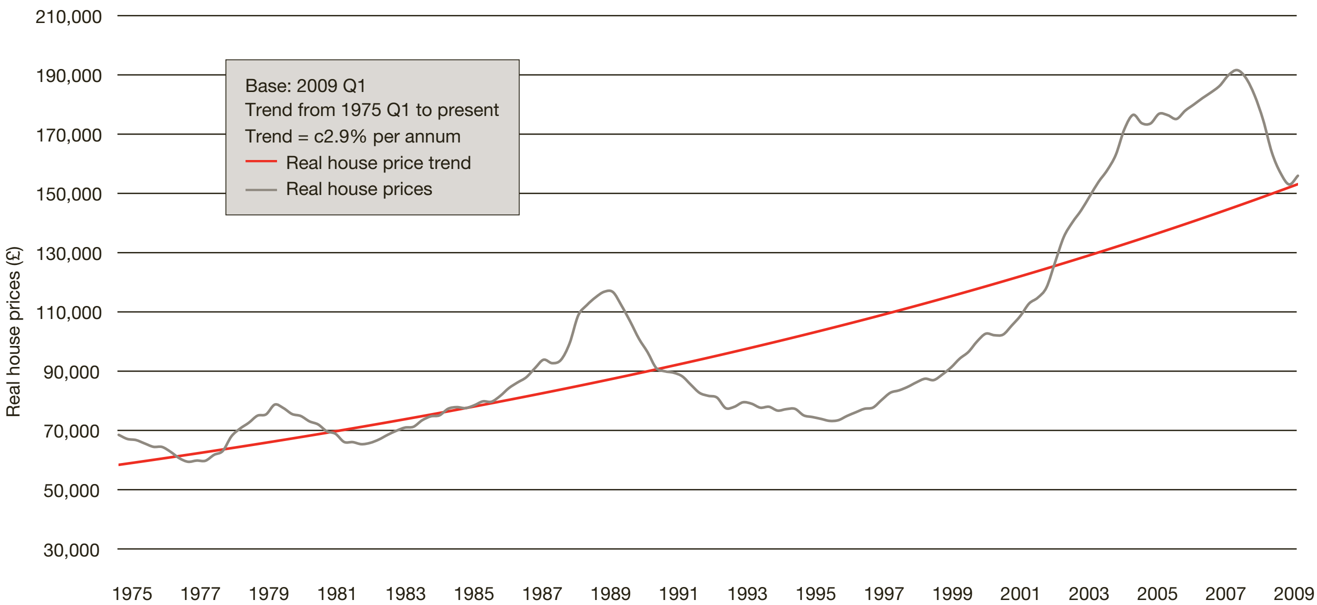
- instability in the housing market
- housing affordability pressures
- unequal tenure choices
- housing wealth inequalities.

Instability in the housing market

The average house price trend (adjusted for inflation) shows clear housing cycles, with prices peaking in the late 1970s, the late 1980s and in 2007, each followed by sustained falls. Figure 1 below illustrates these cycles. Over the past decade, low interest rates have supported economic growth and rising house prices, which have in turn facilitated increased equity withdrawal[1] and consumer expenditure[2]. Over the last two years the situation has been reversed with house prices, equity withdrawal and economic growth all in rapid decline. House prices fell by nearly 20 per cent from their peak in autumn 2007 to summer 2009, a dramatic fall by all measures.[3] Despite the recent mini upturn in house prices, many commentators are predicting further falls during 2010.

House price cycles create financial difficulties for housing consumers and lead to instability in the wider economy. Falling house prices are good news for those who have been locked out of the housing market because of high prices, but only if access to mortgage finance improves. Meanwhile, for those who bought a home towards the peak of the market, negative equity is now a reality. Bank of England figures suggest that in spring 2009 between 700,000 and 1.1 million households were in negative equity.[4] Furthermore, as economic conditions deteriorate, repossessions resulting from mortgage repayment arrears are rising rapidly and are expected to reach 65,000 in 2009.[5]

Figure 1: House prices in the UK, long-term real price trend



Source: Nationwide Building Society [online], House price statistics: www.nationwide.co.uk/hpi/historical.htm

1 Housing equity withdrawal refers to new borrowing secured on dwellings that is not reinvested in house purchase or home improvements. The Bank of England's estimates of housing equity withdrawal show steep rises over the decade up to 2007, followed by rapid falls since September 2007 as the market has slowed. See Bank of England [online], Statistics: Housing equity withdrawal, Q1 2009: http://shltr.org.uk/x

2 Stephens, M, *Housing market recessions and sustainable home-ownership*, Joseph Rowntree Foundation (JRF), July 2008.

3 Land Registry [online]: http://shltr.org.uk/y

4 Hellebrandt, T and Kawar, S, 'The economics and estimation of negative equity', *Quarterly Bulletin*, 2009 Q2, Bank of England.

5 Council of Mortgage Lenders (CML) [online], Housing and market forecasts, June 2009: http://shltr.org.uk/1j

Housing affordability pressures

The pressures of high housing costs are at the heart of the housing crisis. Recent research for Shelter found that:

- 2.2 million households spent more than half of their income on housing costs
- one million households, particularly those on low incomes, spent more than two-thirds of their income on housing
- two million households said that meeting housing costs was a constant struggle
- 400,000 households said that they were falling behind with rent or mortgage payments.[6]

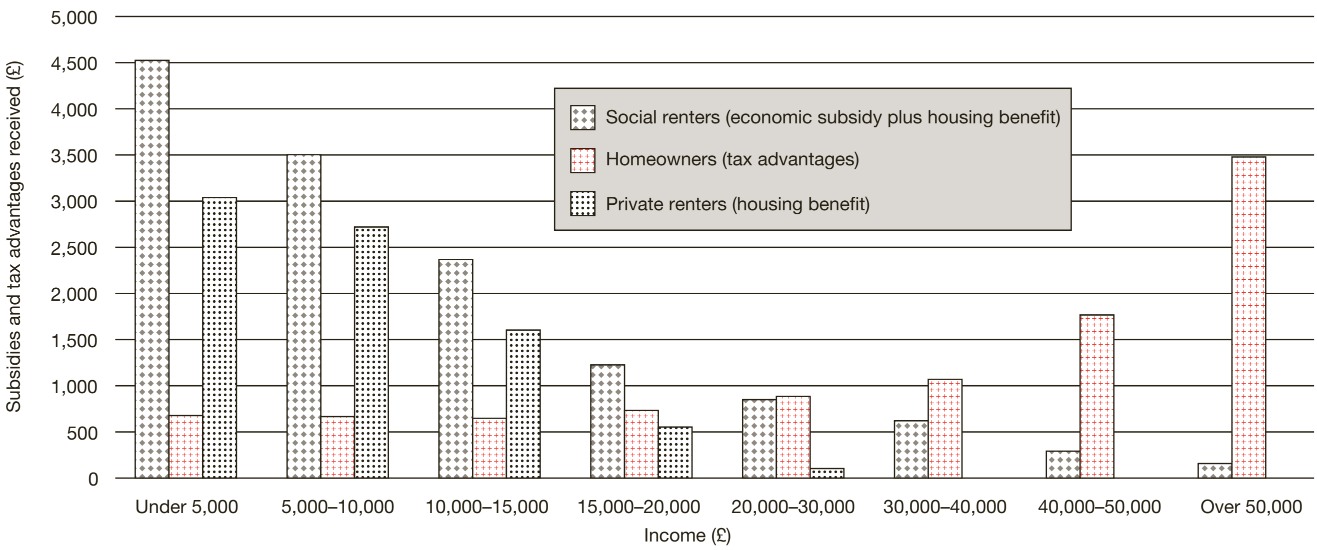
The research suggested that private renters in particular struggled with housing costs, with 24 per cent spending more than half of their income on rent. This compares with 15 per cent of households in the social sector and seven per cent of homeowners. The study also asked households in different tenures whether they were constantly struggling or falling behind with their mortgage payments or rent. The results showed that renters were under most pressure, with 18 per cent of private renters struggling and 17 per cent of social renters. Among mortgagors, 11 per cent were struggling.

Unequal tenure choices

In 2005 the Government set an aspiration to increase overall levels of home ownership.[7] A key driver of this policy was the finding that 90 per cent of households in Britain want to become homeowners.[8] In reality, however, the motivating force behind many individual choices to move into home ownership during the housing boom was the fear of being 'left behind' and missing out on the house price gains enjoyed by others. Research carried out in 2003 showed that investment opportunity was the most frequently mentioned factor attracting people to home ownership.[9]

The overall impact of taxation and government subsidy in each tenure plays an important part in framing housing tenure choices.[10] Figure 2 demonstrates that any household on the median household income of £23,300 or above is much more heavily subsidised if they are homeowners.[11] Although for incomes below £15,000 the amount of subsidy per social and private renter is relatively high, this falls rapidly when household income goes above this level. For households with incomes above £15,000, the level of overall subsidy to homeowners is greater than for private renters, and for those with incomes above £20,000 the level of subsidy in the private rented sector is almost zero, whereas the level of subsidy to homeowners rapidly increases.

Figure 2: Housing-related subsidies and tax advantages by income band and tenure



Source: Adapted from LSE analysis using DWP Family Resources Survey and housing benefit statistics.

6 Shelter, *Breaking point – How unaffordable housing is pushing us to the limit*, 2008.

7 Office of the Deputy Prime Minister (ODPM), *The Government's Response to Kate Barker's Review of Housing Supply*, 2005.

8 ODPM, *Housing policy: an overview*, 2005.

9 Smith, J, 'Understanding demand for home-ownership: aspirations, risks and rewards', *Housing Finance*, Summer 2004, CML, page 10.

10 For more information, see Hills, J, *Ends and means: the future roles of social housing in England*, Case Report 34, 2007, pages 61–64 and 81–84. The analysis in this paper adopts the Hills approach, but splits out the housing benefit subsidy provided to social and private renters, rather than including these together, to enable comparisons between the three tenures.

11 CLG, *Housing in England 2007–08*, 2009, Table 1.12.

Shelter believes that the Government should prioritise achieving better balance between housing tenure options. In particular, the situation for tenants in the private rented sector needs to be improved so that home ownership is not seen as the only tenure of choice. Although the majority of other European countries still have taxation and housing policies that favour owner-occupation, many governments are now starting to reduce the extent of this favourable treatment. For instance, in Sweden, capital gains from owner-occupation are now taxed at 30 per cent.[12]

Growing housing wealth inequalities

According to the Economic and Social Research Council (ESRC), inequality in the UK is the worst in the European Union.[13] At a total value of £2.5 trillion, housing is the single greatest repository of wealth for households in the UK, now accounting for about a third of overall wealth, compared to a quarter in 1996.[14] Before house prices started to fall, the wealth of many owner-occupiers was accumulating faster in the value of their homes than through their incomes.

The increase in house prices over the last decade has polarised wealth in a number of ways:

- The scale of the housing wealth divide between homeowners and non-homeowners has grown. The majority of those with housing assets have seen their housing wealth increase substantially; those without housing assets have seen none of this increase.
- House price rises have led to an effective transfer of wealth from younger to older generations.[15] Older generations are more likely to have benefited from relatively low house prices in previous decades and exponential house price growth over the past decade. At the same time, young people – even those on good salaries – have found it very difficult to access the housing market.
- Spatial divides have also grown: although housing wealth in the poorest areas doubled in the decade between 1993 and 2003, it increased more than four-fold in the wealthiest areas.[16]

Housing is a basic social need and a system in which access to it has become so polarised is bad for society as a whole. Unequal access to housing leads to reduced life chances and inequality of opportunity, and also prevents the most efficient use of the limited housing stock available. For instance, in comparison with previous decades, children from households with no housing wealth will find there are large parts of the country to which they will not be able to consider moving in the future.[17]

12 Whitehead, C and Scanlon, K, *International trends in housing tenure and mortgage finance*, London School of Economics (LSE), 2004.

13 Economic and Social Research Council (ESRC) [online], Inequality in the UK factsheet: http://shltr.org.uk/11

14 Office for National Statistics (ONS), *United Kingdom National Accounts: The blue book*, 2009. Housing wealth is calculated as value of residential buildings (Series CGRI, Table 10.10) less the value of loans secured on dwellings (Series NNRQ, NNRR, NNRS, Table 6.1.9).

15 Between 2000 and 2005, the largest gains in net financial wealth and the value of housing assets were experienced by households aged 55 years and over. By comparison, in the same period, younger households (aged 25 to 34) experienced a fall in net financial wealth and housing assets. See Benito, A, et al, 'The role of household debt and balance sheets in the monetary transmission mechanism', *Quarterly Bulletin*, 2007 Q1, Bank of England, page 70.

16 Shelter, *The great divide: an analysis of housing inequality*, 2005.

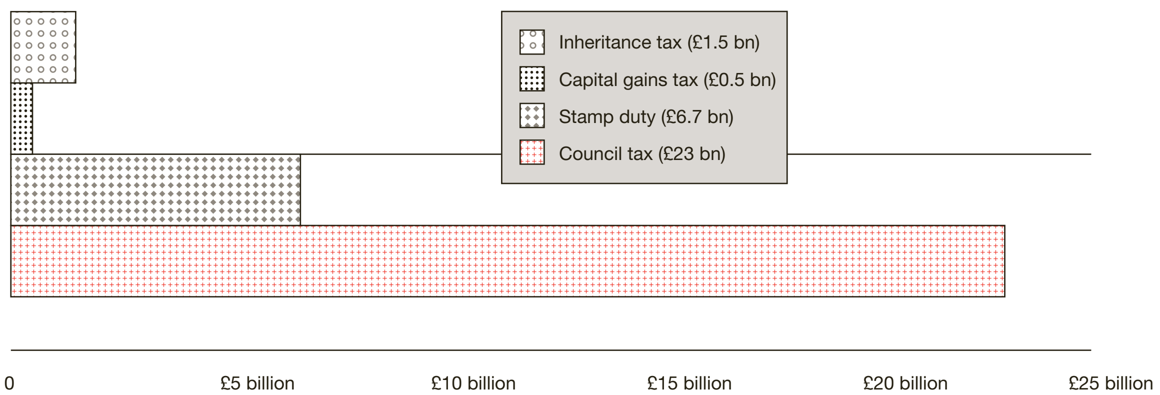
17 Ibid.

Current taxes and issues

There are numerous drawbacks with the current system of housing taxation. This chapter provides an overview of the key housing taxes and the issues relating to them.

The Government hopes to raise £496 billion from taxation in 2009/10, the majority from income tax, national insurance and VAT. Most housing taxation comes from council tax and stamp duty, which together accounted for nearly £30 billion in taxation for 2007/08 (see Figure 3). The Government's main expenditure on housing is capital spending (mainly funding for housing built for rent or sale and maintenance of existing stock – £7.1 billion[18]) and housing benefit (£13.8 billion[19]).

Figure 3: Income from property tax in the UK, 2007/08



Source: Wilcox, S, UK Housing Review 2008/09, *CIH/BSA, 2008; HMRC statistics and HM Treasury.*

Council tax

Council tax is a hybrid tax based on property values and a charge for the use of local services. It replaced the community charge (poll tax) in 1993.

Council tax has some significant advantages. First, it is difficult to evade and collection rates stand at approximately 97 per cent. Second, revenues are relatively stable, which is beneficial for financial planning by local authorities.[20] Third, taxing the occupation of housing can also help ensure housing resources are used more efficiently. However, council tax also suffers from numerous problems and calls for its reform, or for it to be abolished altogether, have come from many quarters.[21]

18 Wilcox, S, *UK Housing Review 2008/09*, CIH/Building Societies Association (BSA), 2008, Table 63: data for 2007/08.

19 Department for Work and Pensions (DWP) [online], Housing benefit and council tax benefit expenditure by local authority 2007/08: http://shltr.org.uk/1z

20 Lyons, M, *Lyons Inquiry into Local Government: Final Report*, The Stationery Office, 2007.

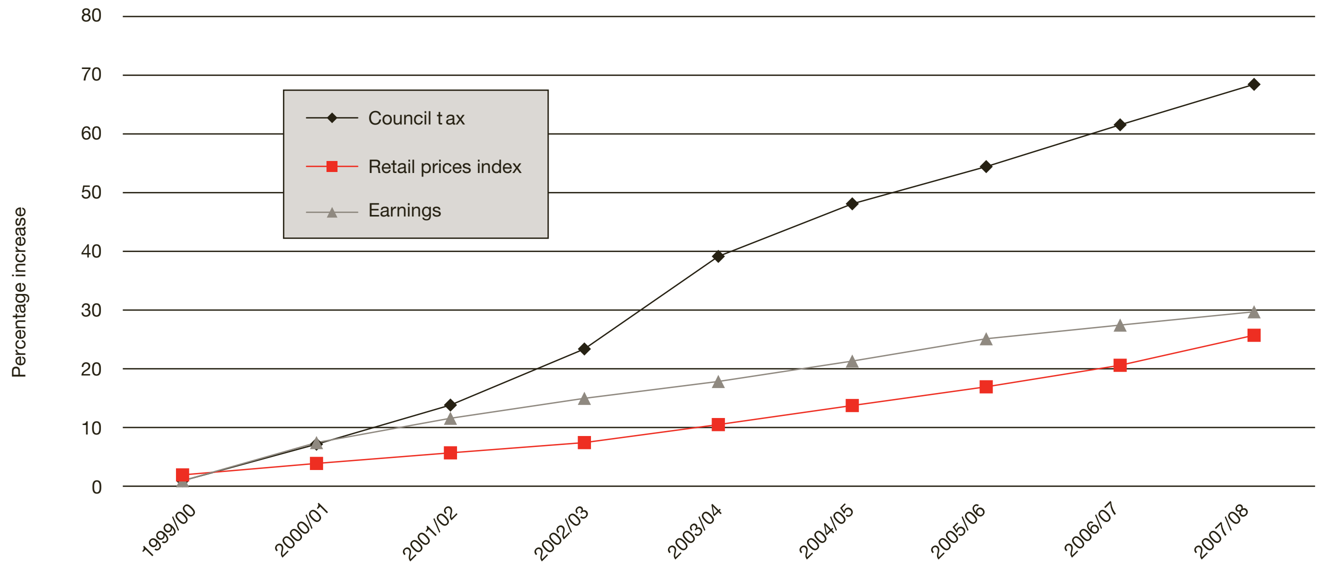
21 These include: Help the Aged, Age Concern, Is It Fair? Campaign, Taxpayers' Alliance, Lyons review, Local Government Finance review (Scotland) , Commission for Rural Communities, Affordable Rural Housing Commission, Local Government Association, New Policy Institute, Local Government Information Unit, Centre for Council Tax Reform, UNISON, Public and Commercial Services Union, and New Local Government Network.

Box 1: Council tax – how does it work?

Council tax is an annual tax on domestic property set by local authorities. The tax rate varies according to the property's value against eight bands, based on 1991 property valuations. Local authorities set the overall level of council tax by choosing a rate for Band D properties and then calculating the rates for other bands as ratios of the Band D rate. The bands and ratios are determined by Central Government and have not changed since council tax was introduced. In England about 15 per cent of local government income comes from council tax and about 60 per cent from central government grants.[22] In recent years, council tax levels have risen significantly faster than earnings or inflation (see Figure 4). Council tax benefit helps households on a low income to pay their bill.

Band	Tax liability relative to Band D	Property valuations, 1 April 1991
A	6/9	Under £40,000
B	7/9	£40,001 to £52,000
C	8/9	£52,001 to £68,000
D	1	£68,001 to £88,000
E	1 2/9	£88,001 to £120,000
F	1 4/9	£120,001 to £160,000
G	1 6/9	£160,001 to £320,000
H	2	Over £320,000

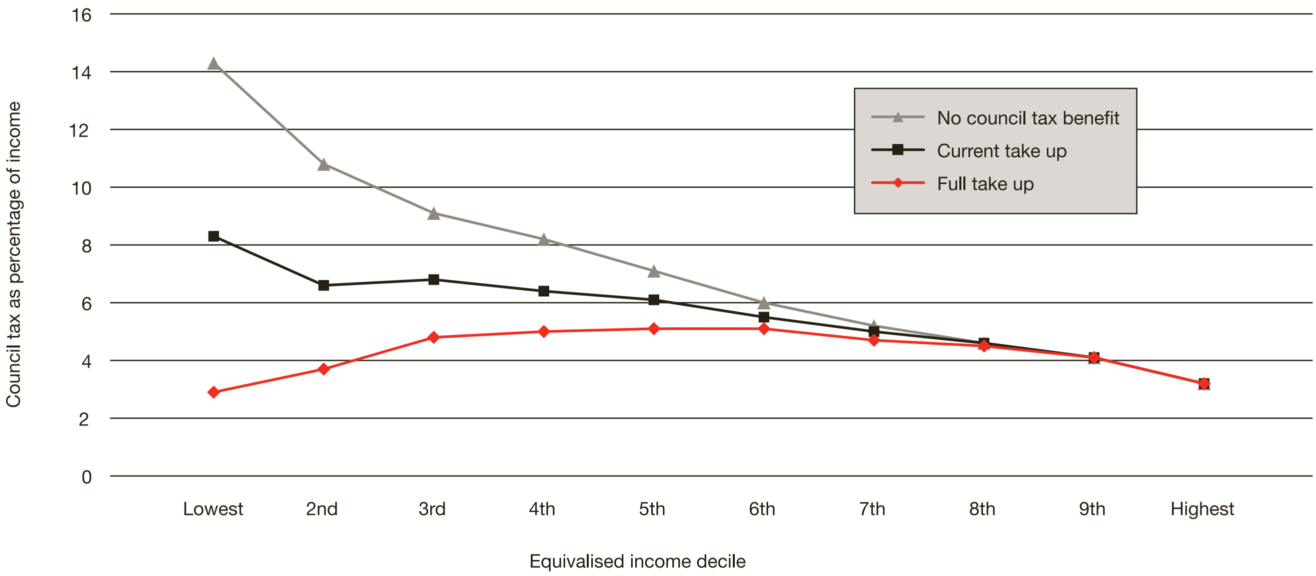
Figure 4: Council tax, earnings and price percentage increases since 1999



Source: ONS, Retail prices index/earnings statistics; CLG, Local government finance statistics.

22 Adam, S, Emmerson, C and Kenley, A, *A survey of local government finance*, Briefing Note 74, IFS, 2007.

Figure 5: Council tax as a percentage of net household income after housing costs, 2006/07



Source: Lyons, M, Lyons Inquiry into Local Government: Final Report*, The Stationery Office, 2007.*

The main problems with council tax are as follows:

- **Council tax is highly regressive**[23] – Those living in a house worth £1 million in 1991 pay only twice as much as those in a house worth £70,000 and only three times as much as those living in properties worth less than £40,000 (see Box 1 on page 13). Council tax benefit takes some or all of the pressure off those on the lowest incomes. However, as Figure 5 shows, with the current take up of council tax benefit, those in the lowest income decile still pay about eight per cent of their income on council tax, compared to only three per cent in the highest income decile.[24] Even if full take up of the benefit were achieved, the current system would still mean those on middle incomes were paying a much higher proportion of their income in council tax than those on higher incomes. All other direct taxes in the UK, such as income tax, are progressive.
- **Lack of regular valuations** – Council tax is based on 1991 property valuations, but the housing market has changed enormously since then, with house prices rising more in some areas relative to others. Revaluation of properties for council tax was postponed by the Government in 2005 for at least the life of the current Parliament. The Lyons review estimated that 3.7 million households are worse off as a result of this decision because revaluation would have caused them to move down the bands, but instead they are subsidising those whose properties have risen more quickly in value.[25] The failure to revalue over such a long period means that politically it has become increasingly difficult to do so.
- **Discounts for second homes and long-term empty homes** – Currently, 272,000[26] households own a second home and 294,000 homes are long-term empty (ie for more than six months).[27] Since 2003, local authorities have had the power to reduce the discount on long-term empty homes from 50 per cent to zero, and from 50 per cent to 10 per cent on second homes.[28] However, many local authorities continue to offer council tax discounts for these homes despite major housing shortages. Recent research for Communities and Local Government (CLG) has indicated that only around half of local authorities in England have removed the discount on long-term empty

23 Regressive taxes are those that tax a smaller proportion of wealth or income as wealth or income increases. Progressive taxes are those that take a greater proportion of wealth or income as wealth or income increases, for example income tax.

24 Lyons, M, *Lyons Inquiry into Local Government: Final Report*, The Stationery Office, 2007.

25 Ibid.

26 CLG, *Housing in England 2007-08*, 2009.

27 CLG [online], Housing Strategy Statistical Appendix 2007/08: http://shltr.org.uk/13

28 The original rationale for this discount was the assumed lower consumption of local services by the owners of such houses. Note that homes empty for fewer than six months are fully exempt from council tax.

properties; around 80 per cent of authorities have reduced the discount for second homes.[29] The research highlighted that financial considerations are key for many local authorities in deciding whether to remove the discount for long-term empty homes, but that the financial advantages of doing so are limited because the authority only retains the additional revenue for one year.

- **Poor take up of council tax benefit –** Take up stands at around 65 per cent and has been falling in recent years. Up to £1.8 billion of council tax benefit goes unclaimed every year.[30] Take up is below average among pensioner households at about 55 per cent. Explanations offered by Help the Aged include the stigma attached to claiming benefits, the complexity of making a claim, and poor administration.[31]
- **Disincentives to work and save –** The rate of withdrawal of council tax benefit when a claimant starts earning acts as a disincentive to work. When combined with housing benefit, a claimant who goes into work has their benefit withdrawn at a rate of up to 85 pence for each additional £1 earned. This represents a real barrier to tackling worklessness. In addition, under council tax rules, those with modest savings of between £6,000 and £16,000 have their council tax benefit reduced, while those with savings of more than £16,000 cannot claim at all.[32] Although the lower savings limit was increased from £3,000 to £6,000 in 2003 (and for pensioners this has risen to £10,000[33]), the upper savings limit has not been updated since 1991.

Stamp duty

Stamp duty land tax (referred to here as stamp duty) is widely criticised and in desperate need of reform. Since 1997, stamp duty rates have increased four times[34], but stamp duty thresholds have not risen in line with house price inflation. This has led to a substantial increase in stamp duty revenue generated, from around £1 billion in 1998/99 to a peak of £6.7 billion in 2007/08. Stamp duty has never before been charged on UK housing on anything like this scale (although by international standards, UK housing transaction costs are below average).[35] On the other hand, since the onset of the current economic downturn, stamp duty receipts have plunged because of falling house prices and housing market transactions. To try to stimulate the housing market, the Government has introduced a stamp duty 'holiday' for properties below £175,000, lasting until December 2009 (See Box 2).

Box 2: Stamp duty – how does it work?

Stamp duty is levied every time property or land is bought. For residential properties the rates are usually as follows:

0% – Up to £125,000[36]

1% – Over £125,00 to £250,000

3% – Over £250,000 to £500,000

4% – Over £500,000.

In September 2008, in a climate of falling house prices, a slow housing market and a looming recession, the Government announced a 12-month stamp duty 'holiday' for residential transactions up to £175,000. The 2009 Budget announced that this would be extended up to December 2009. It appears unlikely that this will have any significant impact on overall levels of housing market activity. In 1992, the threshold under which no stamp duty was payable was increased from £30,000 to £250,000 for a period of eight months; the overall impact on transactions was limited.[37]

Stamp duty is relatively simple to understand and administer. It also contributes to tenure balance, being one of the few taxes on owner-occupation. However, it suffers from a number of significant problems:

- **No economic rationale –** There is no clear economic rationale for stamp duty. In his 1997 Budget speech, the Chancellor argued that increasing stamp duty rates was necessary to promote housing market stability and 'to not allow house prices to get out of control'. However, such an approach has clearly been unsuccessful so far.

29 Roger Tym and Partners, *Application of Discretionary Council Tax Powers for Empty Homes*, CLG, 2009.
30 Lyons, M, *Lyons Inquiry into Local Government: Final Report*, The Stationery Office, 2007, page 250.
31 New Policy Institute (NPI), *The impact of council tax on older people's incomes*, Help the Aged, 2003.
32 Zebedee, J, Ward, M and Lister, S, *Guide to housing benefit and council tax benefit 2009/10*, Shelter/Chartered Institute of Housing, 2009.
33 The 2009 Budget announced that the lower savings limit for pensioners would rise from £6,000 to £10,000 from November 2009.
34 Stamp duty rates increased in 1997, 1998, 1999 and 2000.
35 Andrew, M et al, 'Residential stamp duty: time for a change', *Housing Finance*, Summer 2003, CML.
36 The threshold for stamp duty liability was raised from £60,000 to £120,000 in 2005, and again to £125,000 in 2006.
37 For further discussion, see IFS, *The IFS Green Budget: January 2004*, 2004, Chapter 5: The taxation of housing, and HM Treasury, *Fiscal stabilisation and EMU*, 2003.

- **Inefficient threshold system –** The stamp duty threshold system causes inefficiencies in the housing market. Under the current rules, buyers pay duty on the full price of their property when each threshold is reached. For instance, a house priced at £250,000 would attract a stamp duty rate of one per cent, resulting in a stamp duty bill of £2,500. By contrast, a house priced at just above the £250,000 threshold would attract a rate of three per cent, resulting in a bill of £7,500. Such differentials have a distorting influence on the market, creating price bunching at just below the thresholds. In addition, they encourage tax avoidance measures such as sellers artificially boosting the value attributable to fixtures and fittings in their properties to reduce the apparent value of the property itself.[38]
- **Barrier to mobility –** Stamp duty acts as a disincentive to move house, which has negative impacts for labour and household mobility.

Capital gains tax

Owner-occupiers' main residences are exempt from capital gains tax, while the tax may or may not be payable on investment properties and second homes, depending on the owner's circumstances.

There are two key problems with the way that the capital gains tax rules currently operate:

- **Avoidance of capital gains tax on second homes –** Capital gains tax liability can be reduced to zero for many second homeowners by straightforward tax planning. Under the current rules, taxpayers who live in more than one property can elect which property should be considered as their 'principal private residence' for the purposes of capital gains tax. A property that would not be treated as a main home on any sensible assessment, such as an occasional weekend retreat, can qualify. Generally, the rules should mean that each married couple can have only one main residence covered by the exemption; however, there are suggestions that some couples illegally evade the tax by putting a second home in the name of their partner.[39]

Box 3: Capital gains tax – how does it work?

Capital gains tax is levied on the increase in value of an asset (including property) between acquisition and disposal. The 'capital gain' is calculated as the value of the asset when sold minus the value of the asset when it was bought. There is an annual exemption (£10,100 in the 2009/10 tax year); capital gains beyond this threshold are now taxed at a flat rate tax of 18 per cent following major changes in the 2007 Pre-Budget Report. The system is now simpler in relation to property, and the taper relief system and historic indexation allowance have been abolished. The new rate is less than the previous effective rate of between 24 and 40 per cent, which applied to higher rate taxpayers once taper relief was taken into account.[40] It is unclear the extent to which recent changes to capital gains tax have reduced the levels of tax for many property investors and second homeowners and what the impact for the housing market will be.[41] There is a significant risk that additional investment incentives have been created, which could add to house price pressures in future years.

- **Impact on house prices –** The exemption of main residences from capital gains tax may be one of the factors that has fuelled the upward spiral of house prices during housing booms. During periods of rapidly rising house prices, the prospect of tax-free capital gains may skew individuals' housing decisions and encourage them to overextend themselves to get onto the housing ladder. The University of York estimates that the net value of the capital gains tax exemption for main homes, after taking into account rollover and taper relief, is £6.5 billion.[42] In addition, non-UK residents are currently exempt from capital gains tax and non-domiciled residents can avoid being taxed on UK property through the establishment of offshore trusts, which creates a further upward pressure on house prices.

38 Andrew, M et al, 'Residential stamp duty: time for a change', *Housing Finance*, Summer 2003, CML.

39 See, for example, tax advice guides on This is Money [online]: http://shltr.org.uk/16

40 Although note that some of these taxpayers would previously have qualified for historic indexation allowance too, which would have decreased the tax payable under the old regime.

41 Finance Markets [online], Property news: 'Capital gains tax boon for buy-to-let', 10 October 2007: http://shltr.org.uk/14; see also Paul Holmes PQ at http://shltr.org.uk/15

42 Wilcox, S, *UK Housing Review 2008/09*, CIH/BSA, 2008. This reflects the situation for 2007/08 based on an estimate of gross capital gains tax relief of £16.3 billion. However, from 2008/09, new capital gains tax reforms began, including the scrapping of taper relief and a new 18 per cent rate, and house prices have been in decline throughout this period. At the time of the 2008 Pre-Budget Report, the gross estimate for the exemption was calculated by the Treasury at £5.1 billion. See HM Treasury, *Tax ready reckoner and tax reliefs*, 2008.

Inheritance tax

Inheritance tax plays an important role in housing wealth transfers: an estimated 40 per cent of inheritance tax receipts (£3.5 billion) relate to residential property. The yield from inheritance tax arising from residential property has risen fairly rapidly over recent years, from £0.7 billion in 2000/01 to £1.5 billion in 2007/08.[43]

A common criticism of inheritance tax is that the threshold at which tax is paid has not kept pace with the rapid rise in house prices prior to the recent downturn. It is argued that growing numbers of homeowners with relatively modest incomes, who have never been higher-rate taxpayers, will therefore have their estates taxed at 40 per cent. Nonetheless, according to HM Revenue and Customs (HMRC), inheritance tax was paid on fewer than six per cent of all estates in 2005/06.[44]

Box 4: Inheritance tax – how does it work?

Inheritance tax is levied at a rate of 40 per cent on assets above a defined threshold (£325,000 for 2009/10) transferred on the death of an owner. If a person's tax-free allowance is not used on their death, it can now be transferred to their surviving spouse or civil partner, enabling couples to benefit from double the tax-free allowance. The inheritance tax allowance is due to increase to £350,000 for individuals and £700,000 for couples in April 2010.

A key concern is how best to tackle the role of inheritances in creating house price pressures and reinforcing inequities in access to the housing market. The International Longevity Centre (ILC) has highlighted how the huge growth in property prices has substantially increased the value of inheritances, which have doubled in the last six years. ILC research suggests that increased inheritances have mainly been recycled into property purchases creating a circular upward pressure on house prices.[45] Clearly, with house prices falling, the potential for such a phenomenon is less immediate, but when the market recovers a similar concern may re-emerge.

Rent-a-room scheme

The rent-a-room scheme was introduced in 1992 to boost the supply of private rented accommodation. It provides an exemption from income tax on rental income up to a certain threshold where an owner-occupier is renting a furnished room in their main residence to lodgers. Since the scheme's inception there has only been one increase to the threshold to the current level of £4,250 (in 1997/98), despite subsequent rent inflation of more than 110 per cent.[46]

Data from Spareroom, a website that lists flat- and house-share opportunities, suggests that the majority of rent-a-room opportunities are now above the threshold. Sixty per cent of its UK listings in 2009 to date, where the landlord was living in the property, were advertised at annual rents above the rent-a -room threshold.[47] In addition, the average annual room rent where the landlord was living in the property was £4,324, which is above the threshold.

The current threshold is too low and is likely to put people off letting out rooms due to the need for completion of a tax return and payment of income tax on the rental income. However, there are indications that with the economic downturn more people are keen to be and to take in lodgers again. The latest statistics recorded the largest annual rise in the number of lodgers in the period for which data is available. The number of lodgers rose from 150,000 in 2005/06, the lowest level recorded, to 212,000 in 2006/07.[48] According to Spareroom, the number of live-in landlords advertising rooms on its website has grown rapidly over the last four years (from 4,300 adverts in 2005 to 39,000 in 2008).

43 Wilcox, S, *UK Housing Review 2008/09*, CIH/BSA, 2008.

44 HM Revenue and Customs (HMRC) [online], Statistics, Table 12.3: Inheritance tax – Estates notified for probate: numbers and tax by range of estate for years of death, 2002/03–2005/06: http://shltr.org.uk/17

45 Lloyd, J, *Navigating the Age of Inheritance Tax*, International Longevity Centre UK, 2008; BBC News [online], 'Property prices fuel inheritances', 8 May 2008: http://shltr.org.uk/18. For an alternative view, see: Holmans, A, *Prospects for UK housing wealth and inheritance*, CML, 2008. This argues that the overall value of property inheritances is lower than expected due to improving life expectancy and other factors.

46 From 1997/08 to 2005/06, rents for properties with resident landlords increased by 75 per cent. Extrapolating rent increases to 2009/10 would increase this to 113 per cent, which would be equivalent to a threshold of approximately £9,000. See CLG [online], Survey of English Housing, Live tables: Table S503 (Trends in mean rents): http://shltr.org.uk/1e

47 Data provided to Shelter by www.spareroom.com

48 CLG [online], Survey of English Housing, Live tables: Table S563 (Numbers of tenancies): http://shltr.org.uk/1e

Options for reform

There is a wide range of options for reforming the current system of housing taxation, which need careful consideration. In doing so, Shelter believes that it is important to prioritise four aims: improving stability in the housing market, easing affordability pressures, redressing the balance between tenures, and tackling housing wealth inequalities.

Understanding the implications of reform

In looking at any taxation reform it is essential to consider in detail its potential implications. Any reform is likely to generate both winners and losers. It is important to ask what the impact will be for the different income and wealth groups and the extent to which the tax will be related to ability to pay. For instance, many taxes are progressive and are applied at a higher rate as wealth or income increases. Such considerations will have a key bearing on the levels of public support for any change.

Public support is essential if taxation reforms are to be successful. The main recommendations reached by recent independent reviews of local taxation in both England and Scotland have not been implemented and assessments of public support are likely to have played a major role in this.[49] Where potential taxation policies are theoretically attractive but unlikely to win immediate public support, consideration must be given to how this can be garnered through public engagement and debate. This is very difficult but it is of fundamental importance to take on this challenge.

It is also important to consider what the implications of any tax reform would be for the way the overall housing system operates, such as whether it would improve stability in the housing market and wider economy, promote efficiency in the use of housing stock, and increase equity in the distribution of housing resources. However, reforms could also have unintended negative consequences and penalise certain groups, and it is vital that all possible outcomes are explored, understood and weighed against potential benefits before decisions on reform are taken.

Finally, it is crucial to ask practical questions about the operation of new taxes or reforms. For instance, the complexity of administration and implementation, likely collection rates, and interaction with other taxes are all key considerations. For the Government in particular, the implication of reforms for the overall level of taxation will always be high on the list of priorities. Many of these wider implications are considered in the discussion of potential housing taxation reforms below.

In this chapter we present a range of options for reform, but our purpose in doing so is to help frame and generate the debate on housing taxation, rather than to recommend adoption of any particular proposal for change. We are conscious that there will be other possibilities that are not covered here, and would welcome further discussion and ideas.

Council tax

There are several options for reforming council tax. These range from the recommendation in the Lyons review that council tax should be retained but reformed, to more far-reaching proposals such as replacing it with a land value tax.

Council tax reform

Revaluation and the banding system

The Government could consider undertaking a revaluation of all domestic properties and using this to recalculate council tax bands and charges. In addition, the Government could ensure that valuations are carried out much more frequently thereafter, at least every five years, and valuations could be indexed to local house price indices on an annual basis.

49 BBC News [online], 'Replace council tax, says report', 9 November 2006: http://shltr.org.uk/19

Experience of revaluation in other parts of the UK is instructive. Wales used to have the same system of council tax as England; however, in April 2005, the system was revalued based on 2003 property values. The thresholds for each of the bands were increased to reflect growth in property values and a new band was added for properties worth more than £424,000. A system of transitional relief was introduced to lessen the impact for those who faced large tax increases. One-third of properties went up at least one band and fewer than one in 10 moved down a band. In Northern Ireland, a system of domestic rates based on rental values in 1976 remained in existence until April 2007, when a major revaluation took place.[50] The new charges are based on 2005 capital values and multiplier rates are set annually for each district and region. For properties valued above £500,000, the charges are capped at the £500,000 rate. A system of rate relief similar to council tax benefit continued and transitional relief is available for three years. The next revaluation will be in 2012.

A key issue is the relationship between property values and levels of council tax. The ratio between the top and bottom council tax bands in England is 3:1, but it was estimated in 2000 that this ratio would need to be around 30:1 to reflect real property values. Linking the rate of tax more closely to property values could help tackle housing wealth inequalities by ensuring that those with high levels of housing wealth pay a greater share in tax. Although the reforms in Wales and Northern Ireland mean that charges are based on more up-to-date property prices, the tax levied does not increase beyond a certain house price ceiling.

Alternatively, property charges could be levied in proportion with house prices across all house price ranges, rather than just the lower ranges. This could be achieved by adding extra council tax bands at the top and bottom of the scale and changing the ratios between the bands. To do this in England it is estimated that at least six new bands above £320,000 would be needed.[51] The resulting increase in council tax revenue from the higher bands would generate significant resources, which could be used to ensure that those on lower to middle incomes did not experience an increase to their charges.

Box 5: Recent reviews of local government finance

The Lyons review recommended that council tax in England should be fully revalued, with regular ongoing revaluations and the addition of two extra bands to improve the relationship between charges and property values. Lyons argued that, although an annual property tax was theoretically attractive and remained an option, public support would have to be established before such reform could be contemplated.[52]

In Scotland, a two-year study looking into local taxation, which ended in late 2006, came to the following conclusions:[53]

- Council tax should be abolished rather than reformed and in its place a local property tax should be introduced at a rate of around one per cent of the property value.
- Around two-thirds of households in Scotland would be either better off or no worse off with a local property tax compared to council tax, with most of the households benefiting being those in lower-income deciles and in properties in council tax bands A to C.
- There is no evidence to suggest that there is a need for taxes to be set locally, neither in principle, nor in particular to enhance local accountability. This opinion sits comfortably with the idea of a property tax charged at a fixed proportion of property value, which would be set at a national level. However, the Lyons review takes an alternative view, arguing that the ability to set taxes locally is an essential aspect of locally accountable government.
- The idea of a local income tax (see below) should be rejected, particularly as income tax already raises around one-third of UK tax receipts and it is important that wealth taxes play a greater role.

However, these recommendations were rejected and in 2008 the Scottish Government consulted on proposals to replace the council tax with a local income tax that would be set locally, but collected through the PAYE (Pay as You Earn) system.[54] The Scottish Government has decided not to introduce legislation until after the election in 2011.

50 For more information see Land and Property Services [online], Domestic revaluation and capital valuation FAQ: www.lpsni.gov.uk

51 Muellbauer, J and Cameron, G, 'Five key council tax reforms and twelve reasons to enact them', *New Economy*, Volume 2 Issue 2, June 2000, pages 88–91.

52 Lyons, M, *Lyons Inquiry into Local Government: Final Report*, The Stationery Office, 2007.

53 Local Government Finance Review Committee, *A Fairer Way*, 2006.

54 Scottish Executive, *A fairer local tax for Scotland*, 2008.

Alternatives to council tax

Annual property tax

Another approach could be to replace council tax with an annual property tax, that is, a tax where charges are made at a fixed proportion of property value each year. Crucially, an annual property tax could play an important role in acting as an automatic stabiliser to house prices.[55] If during economic upswings higher house prices lead automatically to higher taxes, a dampening effect on the economy and house prices should occur. Equally, during property market downturns taxes should fall, helping to soften recessions. For example, in recent years Denmark has had a property tax of one per cent of the property value, generating positive macroeconomic stabilisation effects.[56] An annual property tax could also encourage more efficient use of property with incentives being sharpened when property prices are high.

On the negative side, because property taxes linked to market prices are inevitably more volatile, the revenue generated by an annual property tax would be less stable. Revenues would fluctuate with house prices, whereas revenues from the existing council tax are relatively stable. If an annual property tax were to operate at a local level, local authorities would need to be constrained in their ability to increase or cut the tax, otherwise its automatic stabilising effect would be lost. This would require a substantial reform to the system of funding for local government.

If an annual property tax were introduced, it is estimated that a sensible rate for the UK could be around 0.5 per cent of the property value, paid annually.[57] This would raise roughly the same revenue as council tax, but the resulting impact across the income distribution would be less regressive.[58] Of course, the positive stabilising attributes of an annual property tax could also be achieved simply by reforms to council tax such that it resembled an annual property tax. However, in order for this to occur, reforms to council tax would need to go further than changes to the banding and ratio system.

Land value tax

Another alternative to council tax is a land value tax.[59] This is an annual tax on the market rental value of land levied at a fixed rate. As such, it is similar to an annual property tax, but it taxes the land rather than the property development that has occurred upon it. This may be fairer in the sense that the landowner can do very little to change the value of the plot of land, but might invest in the property (eg by building an extension). Land value tax is likely to promote housing development and the reuse of brownfield land, because a vacant site still incurs an annual charge. In addition, it may also contribute to macroeconomic stability. However, implementation would pose a number of potential difficulties, such as how to value land effectively.

Second and empty homes

Various proposals have been put forward to change the council tax treatment of second and empty homes:

- The Commission for Rural Communities has suggested removing second homes from the council tax regime and setting up a separate tax, with the additional resources raised being used specifically to mitigate the impacts of second home ownership.[60]
- The Affordable Rural Homes Commission has recommended that local authorities be given a power to levy an additional tax on second homeowners in rural communities where there is a disproportionate number of second homes.[61]
- The Empty Homes Agency is considering an escalating council tax on long-term empty properties. This tool has been used with great effect in some American states.[62]

As a first step, at a time of drastic housing shortage, the Government could remove the power for local authorities to offer discounts on council tax for long-term empty and second homes, apart from in exceptional circumstances such as empty homes in areas of severe housing market decline. This could raise up to £90 million in additional taxation revenue.

55 Muellbauer, J, ‘Property Taxation and the Economy after the Barker Review’, *Economic Journal*, 115(502): C99–117, March 2005; Weale, M, ‘Commentary: The housing market and government policy’, *National Economic Institute Review*, No. 195, January 2006.

56 Muellbauer, J, ‘Property Taxation and the Economy after the Barker Review’, *Economic Journal*, 115(502): C99–117, March 2005. However, in 2001 the Danish Government froze property tax and rateable values.

57 Ibid. The Danish rate of one per cent is in the context of significant mortgage interest tax relief, which has been abolished in the UK.

58 IFS, *The IFS Green Budget: January 2004*, 2004, Chapter 5: The taxation of housing.

59 Maxwell, D and Vigor, A (eds), *Time for land value tax*, IPPR, 2005; Lloyd, T, *Don’t bet the house on it: No turning back to housing boom and bust*, Compass, 2009.

60 CRC, *Evaluation of the use of reduced council tax discount from second homes by rural authorities 2004/05*, 2006.

61 Affordable Rural Housing Commission, *Final report*, 2006.

62 Empty Homes Agency, *Council Tax Policy*, 2005.

In addition, the potential for taxing long-term empty homes and second homes at a higher than standard rate could be considered.

However, a significant practical barrier to the additional taxation of second and empty homes is how to develop a robust system to identify them – since if no discounts are available the incentive to self-declare no longer exists. Without an effective solution to this problem, enforcement of any higher tax rate would be difficult. One option could be to use the mechanism for compiling the electoral register.

Support for those on low incomes

A significant concern about many of the reforms discussed above is the impact on households that are poor in income terms, but rich in terms of their housing assets. Although there is a positive correlation between income and house price value, there is clearly great variety in households' circumstances.[63] Many pensioners, in particular, live in valuable houses, but lack the cash flow to meet high tax bills. Any system that tried to link property taxation more closely with housing wealth would need to address this through the design of such a tax or through changes to the overall tax-benefit system. One possible change to the system could be to allow the accumulated debt to be deferred and then settled when the house was sold or at death – already a feature of the UK care costs system. Greater use of equity release schemes could also play an important role.[64]

Council tax benefit already plays a crucial role in ensuring those on low incomes can afford to pay their taxes. The need for a reformed version of this benefit or an equivalent would continue if an annual property tax or land value tax were introduced. Other reforms of council tax benefit that could be considered include the following:

- To improve take up, council tax benefit could be branded as a rebate rather than a benefit. Better information-sharing with the Pension Service and HMRC could enable automated delivery of such entitlements. Simpler processes and, where necessary, home visits to assist with the application forms could also help to increase take up.
- The upper savings limit for council tax benefit could be reviewed. The Lyons review recommended an increase to the savings limit to £50,000 for pensioners; others have called for the upper savings limit to be increased in line with inflation.
- The system of council tax tapers could be reconsidered with a view to improving work incentives.

Stamp duty reform

Both the Council of Mortgage Lenders (CML) and the Royal Institute of Chartered Surveyors (RICS) have developed proposals to change the way in which stamp duty works, from a 'slab structure' to a marginal system.[65] This means that only purchase values in excess of a given threshold would be taxed at the relevant rate, rather than applying the rate to the full purchase price. Moving to a marginal stamp duty system could potentially help to improve efficiency in the housing market.

RICS recommends that the Government introduces a two-tier marginal system. Under this proposal, buyers of properties bought for less than £150,000 would pay zero per cent; those buying a property for between £150,000 and £250,000 would pay a marginal rate of 2.5 per cent; and those acquiring a property for more than £250,000 would be taxed at a marginal rate of five per cent. For instance, a couple buying a house for £200,000 would pay £1,250 (that is, 2.5 per cent of £50,000, the amount by which the purchase price exceeds the £150,000 threshold).

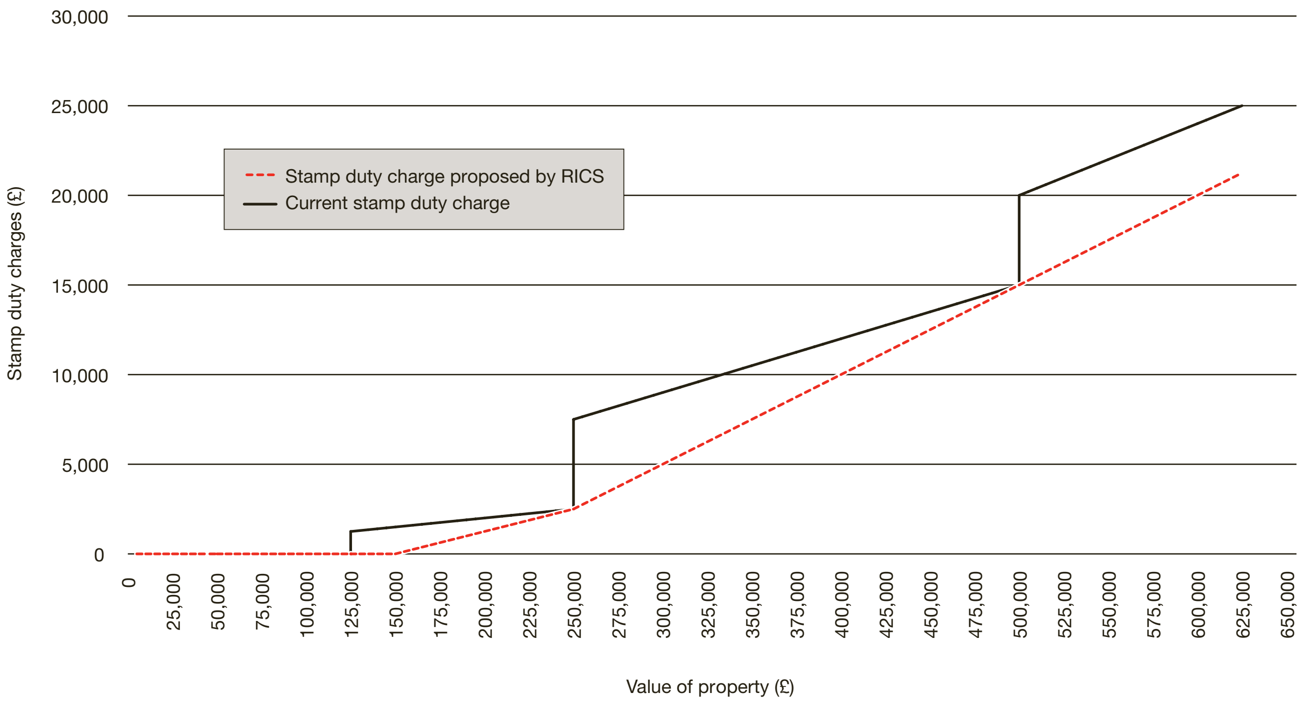
RICS estimates that its proposals would mean a cut in stamp duty charges for all those purchasing homes under £1 million, which would lead to a 24 per cent reduction in stamp duty revenue. As shown in Figure 6 below, buyers of properties valued in the lower regions of the £250,000 to £500,000 bracket would benefit most significantly. Likewise, buyers of properties in the lower regions of the £500,000 to £1 million bracket would also benefit. Those purchasing properties for more than £1 million would pay more stamp duty under the new system. However, the design of a marginal system could be different,

63 For a discussion on this, see: Lyons, M, *Lyons Inquiry into Local Government: Final Report*, The Stationery Office, 2007 or Local Government Finance Review Committee, *A Fairer Way*, 2006.

64 Adam, S, Emmerson, C and Kenley, A, *A survey of UK local government finance*, Briefing Note 74, IFS, 2007.

65 RICS, *Reforming Residential Stamp Duty Land Tax (SDLT) – A proposal by RICS*, 2006. Andrew, M et al, 'Residential stamp duty: time for a change', *Housing Finance*, Summer 2003, CML, 2003. Herbert L, *Reforming residential stamp duty land tax (SDLT)*, Public Policy Paper, RICS, June 2008.

Figure 6: Stamp duty charges, current and as proposed by RICS



Source: Based on RICS proposal for changes to stamp duty, as outlined in Herbert, L, Reforming residential stamp duty land tax (SDLT)*, Public Policy Paper, RICS, 2008.*

and it would be possible to make the impact of the changes tax revenue neutral overall while ensuring that those making low value house purchases (eg under £300,000) were no worse off than at present.

Stamp duty could also be used as a stabilisation tool: rates could be raised when house price inflation was high to dampen demand. Equally, when prices were falling, a lower or zero rate could be charged. The Treasury considered the use of discretionary variations in this way in 2003, although it noted that this approach might only have a limited impact because stamp duty is one of many purchase costs that could be spread across the life of a mortgage.[66] Alternatively, changes to stamp duty rates could be indexed to house price trends to provide people with greater certainty about the rate levels.

A further possibility for reform would be to switch the responsibility for payment of stamp duty from the buyer to the vendor.[67] This could help first-time buyers by relieving their stamp duty burden and, given that stamp duty is linked to house prices, this would partly act as a tax on capital gains.

There have been calls for stamp duty to be abolished. If all the above options for reform of the tax were rejected, this could be considered. However, if stamp duty were abolished it would be important to introduce an alternative tax to make up the lost revenue and to address the tenure balance implications of this, given that stamp duty is a tax on owner-occupation.

Housing tax credit

The Joseph Rowntree Foundation (JRF) has proposed introducing a housing tax credit to help low-income homeowners as well as tenants. This could involve a means-tested flat rate contribution to housing costs to complement the existing housing benefit system and to operate alongside the existing tax credit regime. It has also been argued that a housing tax credit could play a particularly significant role in combating employment disincentives.[68] JRF proposes that, as a first step, a regional housing tax credit system for both tenant and homeowner households could be introduced in high-cost areas

66 HM Treasury, *Fiscal stabilisation and EMU*, 2003.

67 This has been suggested by Portman Building Society: http://shltr.org.uk/1k

68 Stephens, M and Wilcox, S, *Developing safety nets for home-owners*, Joseph Rowntree Foundation (JRF), 2008.

where poverty and unemployment traps are worst. For London, the cost of a weekly £20 housing cost allowance would be about £210 million per year, of which £110 million would relate to home ownership.[69]

A key argument against the introduction of a housing tax credit is that some low-income homeowners may have considerable equity in their homes and so may not be considered a priority for extra help. A possible alternative would be to provide a non-means-tested tax credit for private renters. This approach could help address the finding that private renters are particularly struggling with housing costs and could also help to improve tenure balance. For example, in Ireland all households living in the private rented sector who pay income tax are entitled to a rent tax relief that is worth up to €1,600 per household.[70] Over the longer term, however, it may be more efficient if all support with housing costs were provided through one integrated system by way of substantive reform to the housing benefit system.

Capital gains tax reform

In a number of countries, such as Sweden, capital gains tax is applied to gains arising from the sale of households' main homes.[71] There are two main reasons for considering the implementation of a similar approach in the UK. First, capital gains tax on main residences could capture 'windfall gains' from buying and selling houses. Second, it could help to rebalance the tenure divide by acting to level the playing field between private renting and owner-occupation. Both of these factors could help reduce house price pressures. To avoid capital gains tax on main residences artifically discouraging people from moving home, a roll-over system would need to be introduced whereby gains from the sale of a home that are used for the purchase of another property are exempt from the tax.[72] This means that the tax would be payable only when there was no subsequent purchase or the owner of the property died.

In considering the option of capital gains tax on main residences, it should be noted that past changes to capital gains tax have not typically been applied retrospectively, but only to gains resulting after the date of the new rules being applied. In addition, as with stamp duty, revenue from homeowner capital gains would be cyclical, depending on the state of the housing market. If capital gains tax on main residences were to be introduced, it would be important to implement this before the current housing market cycle bottomed out, in order to capture capital gains from a future housing market upturn. In working to tackle house price pressures, the UK could also exercise its rights under bilateral taxation treaties to tax the capital gains made by non-UK residents on UK property and action could be taken to ensure that non-domiciles paid tax on UK property.

There are a number of other reforms to capital gains tax that are worth considering:

- **Tighten rules on the election of main residences** – Allowing individuals to nominate their main home rather than deciding this on the facts enables many people to reduce their capital gains tax liability to zero through straightforward tax planning. Individuals could instead be required to provide basic information that would allow their main residence to be established on the facts of the case.
- **Shorten the three-year rule** – At present, once a property has been nominated as a main home at some point in the past, it is treated as such for the last three years of ownership even if it is no longer the main home. While it is clearly reasonable to allow time for a property to be sold, especially at times when the housing market is slow, three years could be considered excessive. One option would be to reduce this to 12 months, which would be more in line with the time it takes to sell a property.[73] This would increase capital gains tax revenues and provide an incentive for owners to come to a resolution on sale earlier rather than leaving properties empty for long periods.
- **Capital gains tax on death** – The current rules mean that any capital gains arising from the death of a taxpayer are exempt from tax. The Institute for Fiscal Studies (IFS) has argued that such gains should be taxed: the existing rules can encourage people to keep hold of assets for longer than they need to and bequeath them, even if it would be preferable to dispose of the asset during their lifetime. Such a move would need to be considered in conjunction with a review of inheritance tax (see below).[74]

69 Ibid.

70 Citizens Information [online], Tax relief for tenants: http://shltr.org.uk/1b

71 See also Wilkes, G, *A balancing act: fair solutions to a modern debt crisis*, CentreForum, 2009.

72 Holmes, C, *Housing, Equality and Choice*, IPPR, 2003. Note, however, that this could still result in a disincentive to downsize your home.

73 It currently takes an average of 9 weeks to sell a property: see Hometrack's National Housing Market Survey: http://shltr.org.uk/1c

74 IFS, *The IFS Green Budget: January 2008*, 2008, Chapter 10; Capital gains tax.

Inheritance tax reform

As part of the wider debate on inheritance tax, arguments have been put forward for a lifetime capital receipts tax or a more progressive system of inheritance tax. Both of these reforms could help ensure that wealth is more evenly distributed, and so could help to alleviate house price pressures resulting from wealth transfers.

A lifetime capital receipts tax would mean that the tax charged would depend on the amount received rather than the overall value of the estate.[75] Individuals would be given a reasonable lifetime quota of wealth that could be received tax-free. Wealth transfer beyond this quota would be subject to tax, perhaps at a progressive rate. For example, recipients could be allowed to receive up to £80,000 in the form of gifts and inheritance over their lifetime without any tax liability. A progressive tax could be imposed on anything above £80,000, at rates of 20 per cent up to £160,000; 30 per cent for £160,000 to £240,000; and 40 per cent for anything above £240,000.[76]

Potential benefits of this approach would be that:

- targeting receipts from inheritance rather than the estate of the deceased would make the point about taxing wealth transfers clearer
- under the present system no tax is paid on wealth given away more than seven years before death, but under a lifetime capital receipts tax all transfers would count
- a capital receipts tax might provide people with an incentive to spread their wealth more widely so that the overall level of taxation is lower.

The principal objections to such a tax are that the revenue generated could well be lower than for inheritance tax, if estates are split up and distributed more widely to reduce the amount of tax paid (ie more recipients receiving smaller amounts would pay less tax). In addition, there are concerns that it would involve excessive extra administration costs. However, a capital receipts tax, known as the capital acquisition tax, has been in operation in Ireland since 1976, so it is clearly not administratively unfeasible or prohibitively costly.

An alternative suggestion comes from the Institute for Public Policy Research (IPPR), which remains uncertain whether the pattern of inheritance would change significantly under a lifetime capital receipts tax.[77] IPPR suggests that a progressive banding of inheritance tax would be a better alternative and proposes keeping the existing tax-free allowance, but with the first £25,000 being charged at 22 per cent rather than the current rate of 40 per cent. Estates exceeding £500,000 would be charged at a new top rate of 50 per cent. According to IPPR's estimates, 87 per cent of estates would be better off under this system and total revenue would increase by about £150 million. Matching inheritance tax rates with income tax rates would encourage people to think about inheritance as windfall income, and introducing a 22 per cent rate would help to address concerns that the current system of inheritance tax penalises the moderately wealthy.

Rent-a-room scheme

There is a strong case for uprating the rent-a-room threshold (see page 17) to reflect rent inflation. In the current economic climate, many homeowners are battling to meet their mortgage payments and many are looking for options to maximise their income. If the rent-a-room threshold was higher and the scheme better publicised, it could prove a real incentive for people to take in a lodger, and the take up of rent-a-room opportunities could increase. This could have the dual benefit of easing the pressures on housing supply by making more efficient use of housing stock, while also supporting those who could benefit from an additional source of income. The rent-a-room tax relief is also of benefit in the context of social care when foster carers continue to accommodate a person after the age of 18.

Based on the rate of rent increases, our calculations suggest that the rent-a-room threshold could be increased to £9,000 of rental income per year.[78] This is comparable to the limit for the equivalent scheme in Ireland, the threshold for which was increased to €10,000 in 2008. According to official figures, it is estimated that raising the threshold in line with inflation would cost an additional £5 million per year over and above the current cost of £120 million.[79]

75 Prabhakar, R, Rowlingson, K and White, S, *How to Defend Inheritance Tax*, Fabian ideas 623, 2008.

76 Commission on Taxation and Citizenship, *Paying for Progress: A new politics of tax for public spending*, Fabian Society, 2008.

77 Maxwell, D, *Fair Dues: Towards a more progressive inheritance tax*, IPPR, 2004.

78 Increasing the current threshold of £4,250 in line with rental inflation of 113 per cent (see page 17) is equivalent to a threshold of approximately £9,000.

79 House of Commons Official Report, 22 Oct 2008: Column 358W. Some, limited, savings would also accrue when raising the thresholds by obviating the need for the processing of self-assessment tax returns. It is estimated that had the rent–a-room thresholds been uprated in line with rental inflation 5,000 taxpayers would have been taken out of self-assessment.

Policy directions

Now is the time for debate about the housing taxation system of the future. In the current climate of economic review and reform, the objectives and components of the housing taxation system must be based on a clear rationale and strategy.

Many of the issues and options for reform addressed in this paper are controversial and will require uncomfortable and complicated debates. Nonetheless, with recent house price falls and the housing market in flux, it is imperative that we take a step back to understand how the system of housing taxation could be changed to help avoid dramatic cycles of housing market boom and bust in the future.

The potential benefits of reforming housing taxation are many and interlinked. Improving housing market stability would help to stabilise the overall economy, as well as moderating house price increases and thereby alleviating affordability pressures. Tackling affordability would help even out the balance between the tenures and ensure that home ownership is not seen as the only or best tenure option. Achieving a better balance between the tenures would help to address some of the housing wealth inequalities that are inherent in the current system.

Shelter believes that this is an opportune time to look at the role of the taxation system and its impact on demand for and access to housing. We are not alone: the IFS is also taking a step back to consider the overall taxation system and how it could be improved through the wide-ranging Mirrlees review, the final report of which is due out in late 2009.[80] Following three days of consultation and debate with a wide range of housing policy experts in June 2009, the Building and Social Housing Foundation identified reform to the role of the taxation system as one of the top priority areas for examination in UK housing policy.[81]

We believe a national policy debate on housing taxation is imperative and have set out below some of the key questions for consideration and potential ways forward for policy over both the short and longer term.

Improving stability

Improving stability in the housing market is crucial to help prevent destructive cycles of boom and bust in the housing market, to make housing more consistently affordable and to help prevent the growth of housing wealth inequalities.

We must therefore consider which elements of housing taxation could help promote stability effectively and at what stage in the housing cycle these could be introduced to maximise their impact on the future stability of the housing market. Would an annual property tax – or substantive reform of council tax based on the principles of an annual property tax – be an effective route to achieving housing market stability? Is there potential for a reformed stamp duty to play a role? What impact could reform of inheritance tax have on improving housing market stability?

Reducing affordability pressures

The most significant way in which housing taxation reform could contribute towards improving housing affordability is through increasing stability in the housing market, as outlined above. However, there are a number of reforms that could also help to ease

80 The Mirrlees review: Reforming the tax system for the 21st Century, chaired by Prof Sir James Mirrlees: www.ifs.org.uk

81 Diacon, D, Pattison, P, Vine, J, *The Future of Housing – Rethinking the UK housing system for the twenty-first century, Consultation at St. Georges House, Windsor Castle, 23rd–25th June 2009*, Building and Social Housing Foundation. October 2009.

affordability for certain groups by reducing their taxation burden. This could range from raising the threshold for the rent-a-room tax relief to reforming the council tax benefit system or introducing a new system of housing tax credits.

Crucially, debate is needed on which households should be the target of additional support through the taxation system and what the purpose of this support would be. Should additional support be non-means-tested or should it solely help those on low incomes who are struggling with their housing costs? Should support be tenure-neutral or focused on those in rented housing? Should the primary means of tackling affordability be through improving stability or through the provision of enhanced benefits or tax credits to those most in need?

Improving tenure balance

Current taxation policies are not tenure neutral; while some tax benefits for homeowners have been removed over the past few decades there is further scope for narrowing the differentials between tenures, in particular between private renting and owner-occupation.

Creating a housing tax policy that is more tenure neutral may help to dampen demand for home ownership from would-be homeowners, which could in turn reduce house price pressures. What impact would the introduction of capital gains tax on main residences have? What impact would a shift from stamp duty to capital gains tax on main residences have on the overall tax take? Could the introduction of taxation benefits for tenants play a useful role in rebalancing housing tenure differentials?

Tackling housing wealth inequalities

Unequal access to housing leads to reduced life chances and inequality of opportunity, as well as preventing the most efficient use of the limited housing stock available. Over and above measures to improve housing market stability and tenure balance, what further changes should be considered to tackle the worst extremes of housing wealth inequality? What role could improving the relationship between property values and levels of council tax play? What additional support may be required for those who are asset rich but cash poor if this is done? What opportunities are there for reforming inheritance tax to ensure housing wealth is more evenly distributed?

Conclusions

Over the last two years the economic world has been turned upside down: we have seen banks nationalised, plummeting house prices, the lowest ever Bank of England interest rates, and the onset of recession. New approaches to regulation of banking and finance that were unthinkable before are now being debated at a global level.

In this context, we have a significant opportunity to kick-start a serious and considered discussion about the future of housing taxation over the longer term. The issues raised in this paper are difficult, complex and, in some cases, controversial, but this must not prevent us from engaging in honest and open debate about them. We must also consider how public support for change can be garnered.

Shelter recognises that much more work will need to be done before decisions can be made. We call on housing professionals, economists and politicians to engage in a national policy debate on the future of the housing taxation system including the areas covered in this discussion paper. This must result in a clear rationale and strategy for the reform of housing taxation over the long term.

In Shelter's view there are also two quick wins in terms of immediate policy reforms. First, abolishing the council tax discounts offered to owners of second and long-term empty homes would remove incentives that encourage inefficient use of housing stock. Second, raising the threshold of rent-a-room tax relief to £9,000 and indexing it thereafter would remove barriers to the provision of much needed low-cost rental accommodation and provide alternative income generation options for homeowners, particularly those struggling with mortgage costs.

The current economic crisis has thrown into sharp relief the inadequacies of the current housing market, but also provides us with an opportunity to consider the broader aims and functions of housing taxation. We must be brave enough to take that opportunity.

Until there's a home for everyone

We are one of the richest countries in the world, and yet millions of people in Britain wake up every day in housing that is run-down, overcrowded, or dangerous. Many others have lost their home altogether. Bad housing robs us of security, health, and a fair chance in life.

Shelter helps more than 170,000 people a year fight for their rights, get back on their feet, and find and keep a home. We also tackle the root causes of bad housing by campaigning for new laws, policies, and solutions.

Our website gets more than 100,000 visits a month; visit shelter.org.uk to join our campaign, find housing advice, or make a donation.

We need your help to continue our work.
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