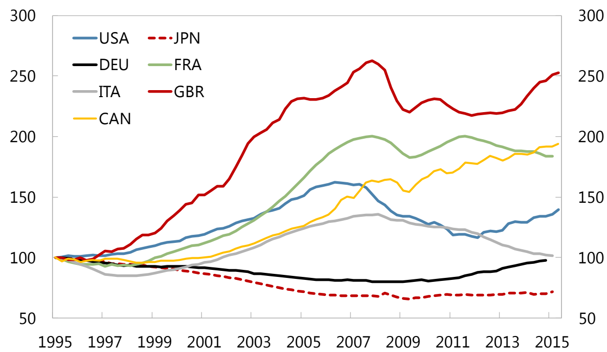
PROPERTY TAXATION AND HOUSING SUPPLY[1]

This chapter examines how tax reforms could help ease structural supply constraints in the UK's housing market. Options for reform include (i) reducing council tax discounts for single occupants to encourage more efficient use of residential properties and (ii) phasing out stamp duty land tax and replacing it with a better designed property tax.

A. Introduction

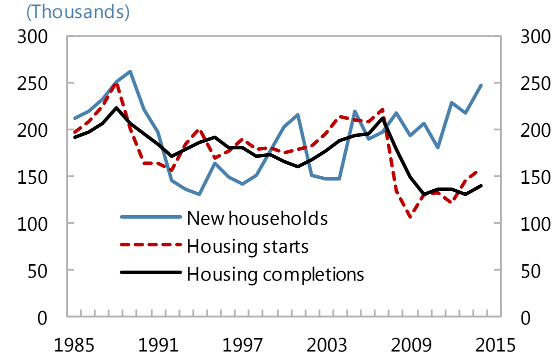
1. **The UK has experienced persistent upward pressure on house prices, in part due to supply constraints**. House prices in the UK have risen by more than in any other G7 country over the past two decades. This partly reflects restrictive planning regulations and other constraints that have long restricted supply, such that even the house-price boom of the early 2000s was not accompanied by the type of building surge seen in other countries such as Ireland and Spain. Since 2008, supply constraints have prevented housing completions from keeping pace with new household formation, adding to upward pressure on prices.[2]

Real House Price Index
(1995Q1=100)



Sources: OECD and IMF staff calculations.

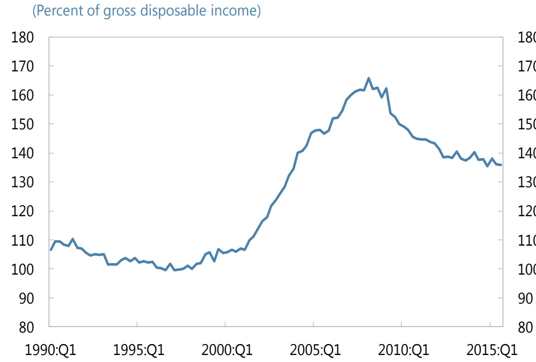
UK: Household Formation vs. Housing Construction
(Thousands)



Source: Haver.

2. **High house prices have contributed to high levels of household leverage**. High house prices have forced households to take on high levels of mortgage debt, which in turn is the main driver behind the UK's household debt-to-income ratio of 140 percent. This ratio is high compared to most other advanced economies or the UK's pre-boom (i.e., circa 2000) levels, despite some decline in the immediate post-crisis years.

UK: Household Debt to Income Ratio
(Percent of gross disposable income)



Sources: Haver Analytics and IMF staff calculations.

---

[1] Prepared by Kazuko Shirono (EUR).

[2] Many studies have identified supply constraints as a key factor contributing to the UK's strong housing market (see, for example, Hilber, 2015 and IMF, 2014).

3. Against this background, this chapter reviews the UK's property tax system, with an eye toward examining how reforms might help ease housing supply constraints. The property tax system can affect housing supply by influencing (i) incentives to make the most efficient use of the existing housing supply and (ii) incentives for local governments to approve new construction and rationalize planning restrictions. Tax reforms that ease constraints on housing supply could not only improve allocative efficiency, but also (i) support financial stability by reducing incentives for households to take on high levels of mortgage debt and (ii) lessen wealth inequality, as higher house prices have been an important contributor to wealth inequality in the UK in recent decades. The following sections review the UK's property tax system and discuss reform options that could help ease constraints on housing supply.

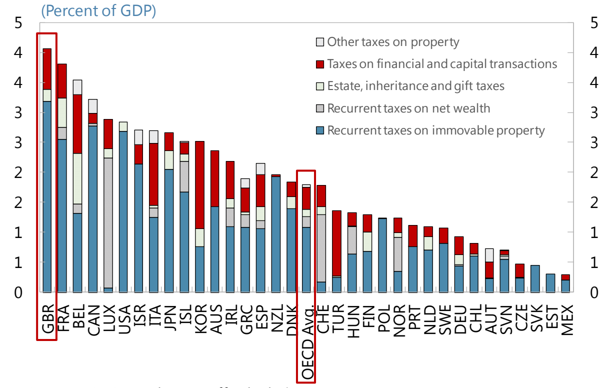
B. Property Taxes in the UK

Overview

4. Property tax revenue is relatively high in the UK. Property tax revenue as a percent of GDP is the highest among OECD countries.[3] This is also the case for revenue from recurrent immovable property tax (blue bar in the text chart). It is possible that the UK might place lower on property tax revenue as a percent of property tax values, given the UK's high property prices, especially in London. However, such an assessment is hampered by limited cross-country data on property valuations.

Revenue from Taxes on Property, 2013

(Percent of GDP)

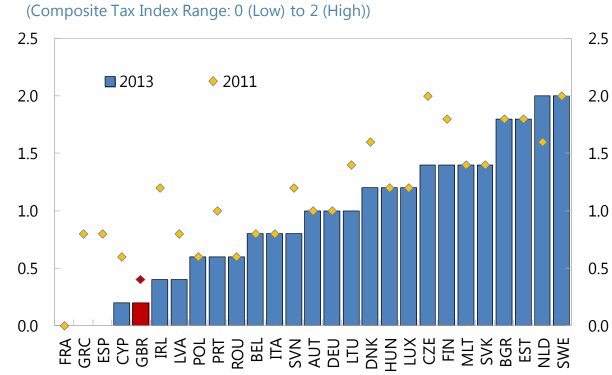


Sources: OECD and IMF staff calculations.

5. The degree of tax preferences for owner-occupied housing seems relatively limited in the UK based on some measures. A composite indicator of tax incentives for owner-occupied housing compiled by the European Commission (2014) suggests that the degree of favorable tax treatment of homeownership is low in the UK compared with other European

Tax Incentives for Home Ownership

(Composite Tax Index Range: 0 (Low) to 2 (High))



Sources: European Commission and IMF staff calculations.

[3] Taxes on property include all recurrent and non-recurrent taxes on the use, ownership, or transfer of property, including taxes on immovable property or net wealth and gift or inheritance taxes.

countries (see text chart).[4] Indeed, interest deductibility of mortgages for owner-occupied housing was phased out entirely between 1974 and 2000 in the UK. One caveat, however, is that it is not straightforward to compare tax incentives across countries, given wide differences in tax systems. More generally, the effect of the UK's property tax system on the housing market is an area of ongoing debate (see, for example, Armstrong, 2015, Hilber, 2015, and Crawshaw, 2009). In this chapter, we focus mainly on the relationship between the UK's property tax system and the supply-side of the housing market.[5]

6. The UK has various property-related tax instruments. These include council tax, business rates, stamp duty land tax, capital gains tax, and inheritance tax. These taxes comprised more than 10 percent of general government tax revenue in FY14, with council tax, business rates, and stamp duty land tax accounting for 5 percent, 5 percent, and 2 percent of total tax receipts, respectively. This section focuses on taxes on residential properties (i.e., excluding business rates, which are levied on non-residential properties).[6]

Council tax

7. Council tax, introduced in 1993, is the main source of income for many local governments. Although council tax is partly a function of property values, the authorities do not view it as a recurrent tax on property values, but as a charge for, and way of funding, local government services. Consequently, council tax has both a property value element and an individual element: the amount of council tax payable on a property depends on the valuation band to which it is allocated and the circumstances of the occupiers, such as the number of people living in the home. There are about 330 local authorities, which set council tax levels. There are eight valuation bands, and each property is assigned to a band based on its 1991 valuation. The council tax for each valuation band is defined as a fixed ratio to band D.

[4] This index is computed by combining three categories of housing-related tax instruments: (i) transaction taxes; (ii) recurrent property tax; and (iii) mortgage interest tax relief. The index ranges from 0 to 3, with higher values indicating tax incentives skewed toward owner-occupied housing and debt. The index is a weighted average of the three scores, with transaction taxes having 20 percent and recurrent taxes and interest tax relief each having 40 percent of the total.

[5] See Crowe and others (2011a), Crowe and others (2011b), and Norregaard (2013) for more general discussion of the housing market and property taxation. See also Blochlinger (2015) and Blochlinger and others (2015).

[6] Pope and Barra (2014) provide a broader review of the UK tax system beyond property-related taxes.

Council Tax Bands and Rates in England, 2015-16 1/

Band	Value as of April 1, 1991	Tax rate as a proportion of that in band D	Average band D rate in England (£)	Number of properties in band in England (thousands) 2/
A	Up to £40,000	6/9	989	5,606
B	£40,001 to £52,000	7/9	1,154	4,499
C	£52,001 to £68,000	8/9	1,319	5,008
D	£68,001 to £88,000	9/9	1,484	3,544
E	£88,001 to £120,000	11/9	1,814	2,186
F	£120,001 to £160,000	13/9	2,144	1,158
G	£160,001 to £320,000	15/9	2,473	811
H	More than £320,000	18/9	2,968	132

Source: www.gov.uk

1/ This table shows average council tax charges for dwellings occupied as a main residence by two adults before any reductions due to discounts, exemptions or council tax benefit.

2/ The data are as of September 2014.

8. **Several features characterize council tax** (Mirrlees and others, 2011). First, most properties are concentrated in the lower bands. About two-thirds of all properties are in the bottom three bands. Second, the tax is regressive relative to its base. For example, the charge in band H is set two times higher than the charge in band D while the house at the bottom of band H is worth almost five times more than the house at the bottom of band D. Third, there is no differentiation between properties in the same band. For example, band H includes all properties whose values were higher than £320,000 in 1991, including those whose values have appreciated a lot since 1991 and are worth many times more than £320,000 now.

9. **There are also exemptions and discounts.** For example, full-time students and disabled people are exempt from council tax, and vacant properties normally get some discount for the first few months for which the properties are vacant. A 25 percent discount is granted if the property is occupied by only one adult. Discounts for single occupancy are based on the view that council tax is a user fee for local government services and that single occupants should pay less because they consume fewer services than larger households. However, if one views property taxes as mainly a tax on housing services aimed at countering the difficulty of taxing such services under the VAT, then discounts for single occupancy may encourage inefficient use of the housing stock, especially single individuals consuming excess housing (i.e., an inefficiently high number of unoccupied rooms).[7]

[7] Mirrlees and others (2011) propose replacing the council tax with a housing service tax which is levied as a flat percentage of the rental value of each property, regardless of being rented or owner-occupied with no discount for single occupancy and empty properties.

10. There have been several changes in council tax recently:

- Council tax freeze grant was introduced in FY11. Under this scheme, local authorities receive a grant if they freeze or reduce their council tax in that particular year. This scheme has been extended to subsequent years, and in FY15, 240 out of 421 local authorities (57 percent of total) received the council tax freeze grant.[8]

- The central government previously set the cap on council tax increases, but the Localism Act of 2011 abolished this and made provision for bringing referendums on excessive council tax increases.

- Centrally-determined support to low-income council taxpayers ("council tax benefit") has been replaced by locally set discounts ("council tax support") from April 1, 2013.

- Starting from April 2013, local authorities were given more flexibility to scale back discounts for second homes and temporarily vacant properties. In addition, local authorities are allowed to charge a premium of up to 50 percent for houses that have been empty for more than two years. This empty home premium is charged on top of normal council tax charges.

In short, these changes have devolved more power to local government in designing the council tax.

Stamp duty land tax

11. A buyer pays the stamp duty land tax when purchasing property valued over a certain threshold in England, Wales, and Northern Ireland. The threshold is currently set at £125,000 for residential properties and £150,000 for non-residential land and properties. Stamp duty tax rates apply to the part of the property price that falls within each band, similar to the structure of income tax (see text table).

Stamp Duty Land Tax: Residential Property Rates
(percent)

Property values	Tax rate
Up to £125,000	0
The next £125,000 (the portion from £125,001 to £250,000)	2
The next £675,000 (the portion from £250,001 to £925,000)	5
The next £575,000 (the portion from £925,001 to £1.5 million)	10
The remaining amount (the portion above £1.5 million)	12

Source: www.gov.uk

12. A stamp duty reform on residential property was announced at the time of the *2014 Autumn Statement*.[9] Effective from December 4, 2014, the new rules as described above were introduced in calculating the stamp duty tax. Prior to that, the stamp duty land tax was calculated on

[8] See Department for Communities and Local Government (2015).

[9] See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/382327/44695_Accessible.pdf.

the entire purchase price of a residential house. This structure meant sudden increases in stamp duty when the price goes above the next threshold. For example, someone buying a house for £250,000 would pay £2,500 (1%) in stamp duty under the old system. If the price was £1 more, then an extra £5,000 would be charged, as 3% stamp duty is levied on the entire purchase price. This rate structure created incentives to keep prices just below the relevant thresholds. By eliminating these incentives, the new system has reduced distortions and is a step in the right direction. In addition, under the new system, all homes purchased for under £937,500 pay the same or less in stamp duty compared to the old system while some higher-value homes are more heavily taxed than under the old system.

13. **The stamp duty land tax on non-residential property continues to be levied on the entire purchase price.** For example, someone who buys a commercial property for £275,000 would pay 3 percent of the entire purchase price (£8,250). Extending the residential stamp duty reforms to the non-residential market in a revenue-neutral manner would remove these distortions and improve efficiency.

Stamp Duty Land Tax: Non-Residential Property Rates

(percent)

Property values	Tax rate
Up to £150,000 - freehold or leasehold with annual rent under £1,000	0
Up to £150,000 - leasehold with annual rent of £1,000 or more	1
£150,001 to £250,000	1
£250,001 to £500,000	3
Over £500,000	4

Source: www.gov.uk

14. **More recently, *2015 Autumn Statement* announced an increase in stamp duty land tax on additional residential properties.** Starting from April 2016, higher rates will be charged on purchases of additional residential properties (above £40,000) including buy-to-let properties and second homes.

Capital gains tax

15. **Owner-occupied houses are exempt from capital gains tax in the UK if they are the main residence of the owner.**[10] On the other hand, buy-to-let properties, business premises, land, and inherited property are subject to capital gains tax at the time of disposal of the property. There are annual exempt amounts below which capital gains tax does not have to be paid. The exempt amount for FY15–16 is £11,000 for individuals and £5,500 for trusts. Capital gains tax rates in FY15–16 are 18 percent for basic-rate taxpayers, and 28 percent for higher and additional-rate taxpayers.

[10] There are also other conditions that need to be met. These other conditions include that part of the property has not been used for business only.

Inheritance tax

16. Inheritance tax revenue is relatively small in size but growing over time due to rising house prices. Inheritance tax is due if a person's estate is worth more than £325,000 on death. The inheritance tax rate is 40 percent on estate assets above the threshold, but the rate may be reduced to 36 percent if 10 percent or more of the estate is given to charity. Transfers between spouses or between civil partners and transfers made seven or more years before death are not normally subject to inheritance tax.

17. The 2015 Summer Budget announced some changes in inheritance tax. A new transferable residence nil-rate band will be introduced from April 2017 in addition to the existing threshold of £325,000. The new nil-rate band will apply when a main residence is passed on death to a direct descendant. This allowance will increase over time and be up to £175,000 in FY20.[11] Thus, the effective inheritance tax threshold for an individual will be £500,000 and up to £1 million for some surviving spouses or civil partners by FY20.

Rent-a-room scheme

18. The rent-a-room scheme was introduced in 1992 to increase the supply of private rental accommodation. It grants an exemption from income tax on rental income up to a certain amount when a homeowner rents out furnished residential accommodation in his/her main home. The threshold has been £4,250 per year since 1997, but it will be increased to £7,500 from April 2016, as announced in the 2015 Summer Budget.

C. Property Taxation and the Residential Housing Market

19. As seen above, the property tax system in the UK has country-specific details and complexity. What are the implications of property taxation for housing supply in the UK, and what reforms may ease supply constraints and help reduce risks associated with high house prices and high household debt? This section examines these questions, with a particular focus on the two major property taxes in the UK, namely, council tax and stamp duty land tax.

Council tax

20. Some of the discounts council tax provides can encourage inefficient use of residential properties. As noted earlier, single occupants or short-term empty properties receive discounts for council tax. These discounts are likely to create incentives for home owners to keep properties unused or for single people to live in more expensive properties than they would

---

[11] The threshold of £325,000 applies to any assets passed to any individual on death and gifts in the 7 years before death, but the allowance of £175,000 applies only to a main residence passed on death to a direct descendant. The new allowance will be increased as follows: up to £100,000 in 2017-18, up to £125,000 in 2018-19, up to £150,000 in 2019-20, and up to £175,000 in 2020-21.

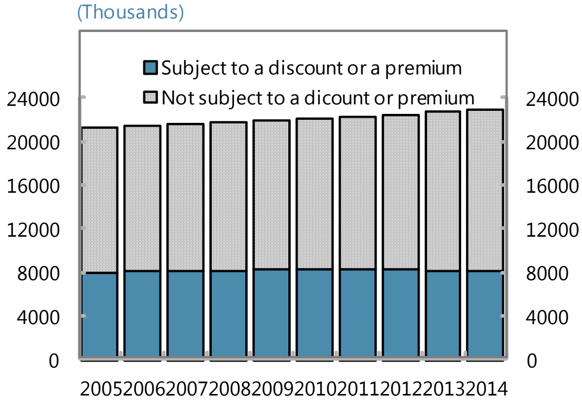
otherwise live. Reducing these discounts could potentaily facilitate more efficient use of residential properties, thereby helping to alleviate supply constraints.

21. Nearly 40 percent of dwellings subject to council tax receive some form of discount (Figure 1). This share declined slightly in 2013 when the rules for discounts for second homes and empty dwellings were modified and the empty-home premium was introduced. The number of vacant properties has been declining in recent years, and the change in the discount rules in 2013 seems to have had some impact in reducing it further. However, the number of empty dwellings is still substantial. At the same time, a large portion of discounts go to single-occupancy homes.

Figure 1. United Kingdom: Council Tax Discounts and Empty Dwellings

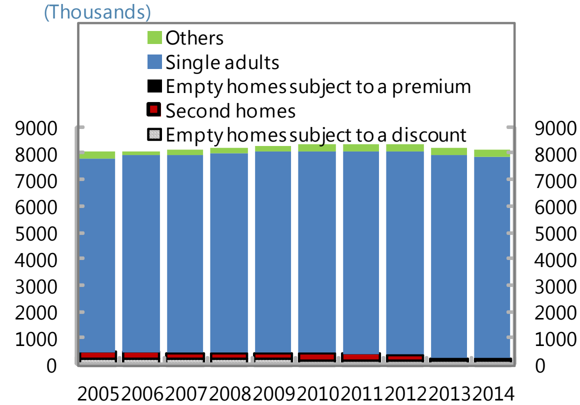
Nearly 40 percent of dwellings receive council tax discounts...

Dwellings Liable for Council Tax
(Thousands)



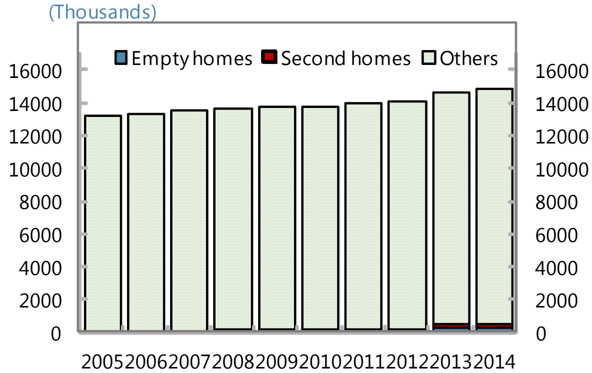
... and a large part of council tax discounts go to single occupancy homes.

Dwellings Subject to Discount or Premium
(Thousands)



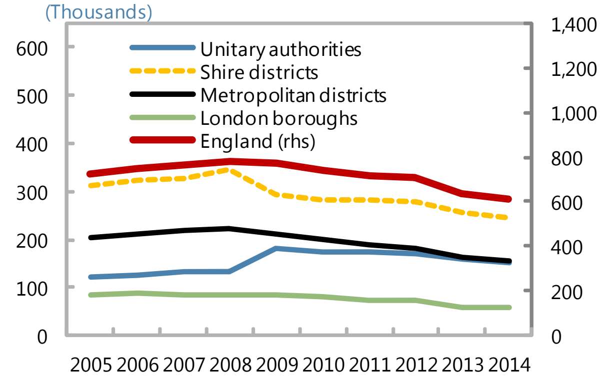
Since the change in council tax discounts rules in 2013, some councils seem to have ceased discounts for second homes.

Dwellings not Subject to Discount or Premium
(Thousands)



The change in council tax discounts rule and the introduction of empty home premium seem to have helped to reduce vacant properties.

Vacant Properties
(Thousands)

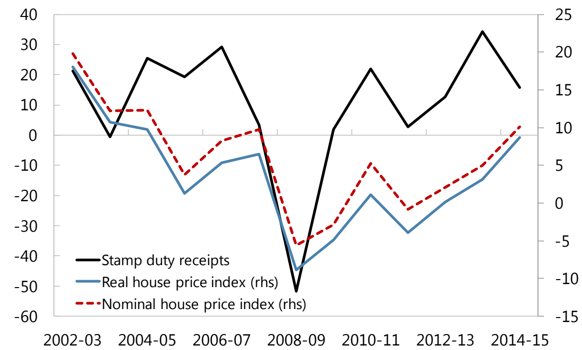


Sources: www.gov.uk/government/statistics/council-taxbase-2014-in-england, www.gov.uk/government/statistical-data-sets/live-tables-on-dwelling-stock-including-vacants

Stamp duty land tax

22. Stamp duty land tax receipts have moved roughly in line with house price developments. Stamp duty land tax receipts increase when house prices are rising and fall when house prices are declining, but stamp duty receipts tend to be more volatile, dropping by about 50 percent during the global financial crisis. This likely reflects the fact that stamp duty receipts depend not only on house prices but also the number of transactions. Stamp duty receipts' growth rate went down in FY14 despite house price growth. This may be partly due to changes in the design of stamp duty tax implemented in December 2014.

Stamp Duty Land Tax and House Prices
(Annual growth, percent)



Sources: HM Revenue and Customs, and IMF staff calculations.

23. Transaction taxes have been used to discourage short-term speculative property purchases in some countries. For example, Singapore imposed an additional buyer's stamp duty on residential property purchases in December 2011, and this measure has shown effective in reducing demand from foreigners (IMF, 2012). Hong Kong SAR also introduced a special stamp duty in November 2010 on residential properties resold within 24 months of purchases (IMF, 2013).

24. However, transaction taxes are known to be inefficient. Such taxes discourage transactions, and properties will not be held by those who value them most.[12] It also creates disincentives for people to move, thereby reducing mobility in the labor market and preventing people or businesses to live or operate in properties of a size and in a location that are best suited for them. In the UK, Hilber and Lyytikäinen (2013) find that a 2 percentage point increase in stamp duty reduces household mobility by 2–3 percentage points, which implies a reduction in mobility of about 30 percent.

25. Reducing reliance on transaction taxes could facilitate more efficient use of the housing stock and increase supply.

- More specifically, it would be desirable to gradually lessen reliance on stamp duty land tax and increasingly replace it with better-designed property taxes that tax properties as a percent of their updated values (e.g., along the lines recommended by the Mirrlees Review).

- Scaling back stamp duty land tax is likely to increase transactions and household mobility, thereby facilitating more efficient use of the current housing supply.

[12] For example, Davidoff and Leigh (2013) have found that stamp duty in Australia reduces housing turnover: a 10 percent increase in stamp duty lowers turnover by 3 percent in the first year and by 6 percent if sustained over a 3-year period.

- In addition, moving away from transaction taxes, which go to the central government, and moving toward value-based property taxes, which are collected by local governments, is likely to improve incentives for local governments to approve new residential construction (since local governments will benefit from the larger property tax base), thereby increasing housing supply.

- One common objection to such reforms is that property taxes may create liquidity problems for illiquid property owners. However, such problems could be avoided by the gradual phasing-in of higher property taxes, as this gives owners adequate time to secure any financing that may be needed (e.g., in the US, property tax payments are typically bundled with mortgage payments at the time of mortgage financing).

Other taxes

26. **Some of the recent changes in property taxation will also have housing market implications.** The recent change in the inheritance tax (threshold was increased) might have increased biases toward buying owner-occupied properties over other assets. This could increase demand for owner-occupied housing, putting further pressure on the already high house prices. However, this effect is partially mitigated by the downsizing provisions—anyone who downsizes or ceases to own a home on or after July 8, 2015 will still be able to use the allowance when assets of an equivalent value are inherited by direct descendants. In addition, the recent change in the tax-exempt threshold for the rent-a-room scheme may help increase the supply of rental rooms and alleviate the housing shortage to some extent.

D. Conclusion

27. **Property taxation in the UK delivers larger revenue as a percent of GDP than any other OECD country.** At the same time, a composite indicator suggests that preferential tax treatment of owner-occupied housing in the UK is limited compared with other European countries.

28. **However, a closer look at the UK's property tax system suggests that some areas could be reformed to reduce constraints on housing supply and thereby reduce risks stemming from high house prices.** In particular,

- ***Reducing council tax discounts*:** A large share of council tax discounts is granted to single-occupancy homes. Removing single-occupancy discounts is likely to result in more efficient use of the housing stock, and the viability of this option could be considered. Further reducing discounts for short-term empty properties is possible under the new system, and this option could be applied more if it is not used yet.

- ***Reducing reliance on the stamp duty land tax*:** The change in the stamp duty land tax announced in the *2014 Autumn Statement* is a step in the right direction, but the fundamental problem of the stamp duty land tax still remains. In the medium term, reliance on stamp duty land tax could be gradually lessened, with increased reliance on a better-designed property tax (e.g., along the lines with the Mirrlees Review). Such a shift is likely to result in more efficient use

of the existing housing stock and increases incentives for local governments to develop new homes.

29. Careful design of property tax reforms can help overcome political economy constraints. In particular, gradual phase-in of reforms may help ease transition costs and lessen opposition. Indeed, while wholesale overhaul of the property tax system may be challenging, measures adopted in recent years show that gradual changes to the system are possible.

References

Blochlinger, Hansjorg (2015), "Reforming the Tax on Immovable Property: Taking Care of the Unloved," OECD economics Department Working Papers, No. 1205.

Blochinger, Hansjorg, Balazs Eger, Bastien Alvarez, and Aleksandra Paciorek (2015), "The Stabilization Properties of Immovable Property Taxation: Evidence from OECD Countries" OECD Economics Department Working Papers, No. 1237.

Crawshaw, Thomas (2009), "Rethinking Housing Taxation: Options for Reform," Shelter, November.

Crowe, Christopher, Giovanni Dell'Ariccia, Deniz Igan, Pau Rabanal (2011a), "Policies for Macrofinancial Stability: Options to Deal with Real Estate Booms," IMF Staff Discussion Note, SDN/11/02.

Crowe, Christopher, Giovanni Dell'Ariccia, Deniz Igan, and Pau Rabanal (2011b), "How to Deal with Real Estate Booms: Lessons from Country Experiences," IMF Working Paper, WP/11/91.

Davidoff, Ian, and Andrew Leigh (2013), "How Do Stamp Duties Affect the Housing Market?," Economic Record, Vol.90, Issue 286.

Department for Communities and Local Government (2015), "Council tax levels set by local authorities in England 2015–16 (Revised)," Local Government Finance Statistics Release.

European Commission (2014), "Quarterly Report on the Euro Area," Vol. 13, No.2.

Hilber, Christian (2015), "UK Housing and Planning Policies: the Evidence from Economic Research," Center for Economic Performance.

Hilber, Christian, and Teemu Lyytikäinen (2013), "Housing Transfer Taxes and Household Mobility: Distortion on the Housing or Labor Market?" Government Institute for Economic Research Working Paper 47.

International Monetary Fund (2012), Singapore 2012 Article IV Consultation Staff Report.

International Monetary Fund (2013), "Key Aspects of Macroprudential Policy – Background Paper."

International Monetary Fund (2014), United Kingdom Selected Issues, IMF Country Report No. 14/234.

Mirrlees, James, Stuart Adam, Tim Besley, Richard Blundell, Steve Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba (2011), Tax by Design, the final report by the Mirrlees Review, available at http://www.ifs.org.uk/publications/5353.

Norregaard, John (2013), "Taxing Immovable Property: Revenue Potential and Implementation Challenges" IMF Working Paper, WP/13/129.

Pope, Thomas, and Barra Roantree (2014), "A Survey of the UK Tax System," IFS Briefing Note BN09, Institute for Fiscal Studies.