

Budget Perspectives 2014

Edited by Tim Callan

RESEARCH SERIES
NUMBER 31

June 2013



Budget Perspectives 2014

Edited by Tim Callan

**RESEARCH SERIES
NUMBER 31**

June 2013

Available to download from www.esri.ie

The Economic and Social Research Institute (Limited Company No 18269)
Registered office: Whitaker Square, Sir John Rogerson's Quay, Dublin 2

ISBN 978 0 7070 0355 9

The ESRI

The *Economic Research Institute* was founded in Dublin in 1960, with the assistance of a grant from the Ford Foundation of New York. In 1966 the remit of the Institute was expanded to include social research, resulting in the Institute being renamed *The Economic and Social Research Institute* (ESRI). In 2010 the Institute entered into a strategic research alliance with Trinity College Dublin, while retaining its status as an independent research institute.

The ESRI is governed by an independent Council which acts as the board of the Institute with responsibility for guaranteeing its independence and integrity. The Institute's research strategy is determined by the Council in association with the Director and staff. The research agenda seeks to contribute to three overarching and interconnected goals, namely, economic growth, social progress and environmental sustainability. The Institute's research is disseminated through international and national peer reviewed journals and books, in reports and books published directly by the Institute itself and in the Institute's working paper series. Researchers are responsible for the accuracy of their research. All ESRI books and reports are peer reviewed and these publications and the ESRI's working papers can be downloaded from the ESRI website at www.esri.ie

The Institute's research is funded from a variety of sources including: an annual grant-in-aid from the Irish Government; competitive research grants (both Irish and international); support for agreed programmes from government departments/agencies and commissioned research projects from public sector bodies. Sponsorship of the Institute's activities by Irish business and membership subscriptions provide a minor source of additional income.

The Authors

Tim Callan and John FitzGerald are Research Professors, John R. Walsh is a Senior Research Analyst, Claire Keane is a Research Analyst and Michael Savage is a Research Assistant at the Economic and Social Research Institute. Stuart Adam is a Senior Research Economist at the Institute for Fiscal Studies, London.

This paper has been accepted for publication by the ESRI. The authors are solely responsible for the views expressed which are not attributable to the ESRI, which does not itself take institutional policy positions.

Acknowledgements

Thanks to numerous referees for providing comments that helped to improve the papers in this volume. Many thanks to Regina Moore for ensuring the manuscript went to print under time pressure as well as Deirdre Whitaker for proof-reading.

Thanks also to Liz Coyle and Adrienne Jinks for their work in organising the conference.

Table of Contents

FOREWORD vii

Frances Ruane

1. TAXES ON INCOME: IRELAND IN COMPARATIVE PERSPECTIVE 1

T. Callan, C. Keane, M. Savage, J.R. Walsh

2. HOUSING TAXATION AND SUPPORT FOR HOUSING COSTS 25

Stuart Adam

Foreword

Frances Ruane

The annual Budget Perspectives Conference provides a forum for discussing key public policy issues of both immediate and longer-term importance. Against a continuing backdrop of major economic and fiscal challenges and a continuing fiscal adjustment under the IMF/EU programme, budgetary policy must be seen to support Ireland's return to a sustainable growth path.

This year's conference provides an opportunity for policymakers, social partners and researchers to engage on some of the major issues involved in this adjustment. The papers presented at the conference cover both macroeconomic and microeconomics issues. The conference takes place earlier than usual this year due to the announcement that Budget 2014 will be unveiled in October as opposed to the usual December date. This in turn reflects the recent introduction of measures that every EU member state would be required to submit its budget to the European Commission for scrutiny in October to ensure that it complies with EU law.

In the opening session of the conference a presentation by John FitzGerald (ESRI) examines the issue of fiscal sustainability from a medium-term perspective. It will consider how to approach the framing of medium-term fiscal policy in an uncertain environment – what would be a “no regrets” fiscal policy? It considers what should be the approach to both the 2014 and 2015 Budgets under different economic scenarios as well as the appropriate fiscal stance over the rest of the decade. Finally, it discusses some longer-term strategic issues on the public finances generally and on taxation in particular. The presentation will draw on research being undertaken for a *Medium-Term Review* to be published by the ESRI in mid-Summer 2013.

This is followed by a series of presentations on current macroeconomic issues by three experts in the area – Alan Ahearne (National University of Ireland Galway), Peter Breuer (International Monetary Fund) and Philip Lane (Trinity College Dublin). The slides from these are available on the ESRI website www.esri.ie

Turning to the microeconomic issues related to budgetary policy, the focus in this year's conference is on the issue of local property taxes (LPT), which is of

particular interest in a year when the Irish LPT comes into effect. To provide an external reference point, Stuart Adam (Institute for Fiscal Studies) presents a paper entitled “Housing Taxation and Support for Housing Costs” based on detailed analysis of the UK property tax. His paper reviews the economic rationale behind the taxation of housing and how it should be taxed, drawing on the research and analysis undertaken for the *Mirrlees Review on Taxation*. The Council Tax system in place in the UK is examined in detail, and consideration is given to various design issues, including deferral and the question of providing support for low income families with their housing costs.

Finally, recent years have seen increases in income related taxation (such as the introduction of the universal social charge) necessitated by the current economic situation. It has been argued that Ireland implemented a system of unsustainably low income taxation throughout the boom with an over-reliance on ‘transient’ taxes such as stamp duty from property transactions. Tim Callan, Claire Keane, Michael Savage and John R. Walsh (ESRI) look at the issue of Ireland’s income tax regime in a comparative European context. This research focuses on the scope for increases in income tax and examines the trade-off between equity and efficiency by comparing marginal tax rates for representative samples of workers in Ireland and in other EU countries. The paper also contains a more in-depth analysis of the UK income tax system and explores the differences between the Irish and UK income tax structures.

1. Taxes on Income: Ireland in Comparative Perspective

T. Callan, C. Keane, M. Savage, J.R. Walsh¹

1 INTRODUCTION

Ireland's fiscal adjustment has involved substantial increases in some taxes, yet tax revenues as a share of national income are still seen as low in an international context. There has been considerable debate about the relative roles of expenditure cuts and tax increases in the process of adjustment. Here we focus not on the adjustment path, but on potential long-term outcomes for the ratio of tax revenues to national income. Thus, rather than question whether the adjustment should be equally shared between expenditure and tax, or more heavily weighted to one or the other, we explore what a sustainable revenue level might be for the future, by comparing our situation with that of other EU countries. From this revenue level, the state would have to finance ongoing debt service payments, public services, and redistributive transfers. It is true, of course, that the issue of what tax level is sustainable depends also on the extent of social and political support for publicly provided services; nonetheless, it is of particular interest to compare the outcomes which have been arrived at in other EU countries.

In this paper we do not take a specific view as to the appropriate level of taxes.² This is a broader social and political choice, which economic analysis can inform but not decide. Our analysis provides information relevant to such choices.

¹ We are grateful to two referees for helpful comments. Thanks are also due to Frances Ruane and Emer Smyth for insightful comments.

We thank the Central Statistics Office (CSO) for providing access to the *Survey on Income and Living Conditions* data, on which the *SWITCH* tax-benefit model is based. We are grateful to Stuart Adam and James Browne of the Institute for Fiscal Studies, for estimates of the UK distribution of marginal effective tax rates, from the IFS tax-benefit model based on the *Family Resources Survey*. The *Family Resources Survey* is Crown copyright material and is reproduced with the permission of the Controller of HMSO and the Queen's Printer for Scotland. It was obtained from the Economic and Social Data Service and the UK Data Archive. Thanks are also due to Xavier Jara and Alberto Tumino for supplying information on marginal effective tax rates for EU-15 countries based on the *EUROMOD* tax-benefit model: see Jara and Tumino (2013) and <https://www.iser.essex.ac.uk/EUROMOD> for further details on methods, data and the *EUROMOD* model., which is maintained, developed and managed by the Institute for Social and Economic Research (ISER) at the University of Essex in collaboration with national teams from the EU member states and financially supported by the European Commission.

The authors alone are responsible for the analysis and interpretations in this paper.

² Honohan (2009) pointed towards tax and spending ratios in the late 1990s/turn of the millennium as approximating levels which were sustainable over the long term.

Following an initial look at overall tax to national income ratios, we focus on income-related taxes, which bulk large in overall tax revenue for most countries. Property taxes represent another potential revenue source, with a new Local Property Tax coming into force in the second half of 2013, and operating for its first full year in 2014. Issues relating to property taxation were analysed in Keane *et al.* (2012) and Callan *et al.* (2012). Adam (2013, this volume) also analyses the taxation of housing drawing on the recent *Mirrlees Review*, and illustrates the issue with respect to UK experience.

We compare Ireland's income-related taxes with those of other EU-15 countries. We go beyond aggregate comparisons of tax/GNP ratios to consider the micro-level structure of marginal tax rates: this has a key role in determining revenues, and also influences the trade-offs between efficiency and equity considerations. This analysis goes beyond selected examples to examine the structure of marginal tax rates for large-scale nationally representative samples of workers in Ireland and in other EU countries.

We explore these issues using a combination of macroeconomic and microeconomic perspectives. Aggregate ratios of tax to national income are examined in Section 2. A key issue here is the appropriate denominator to act as a measure of taxable capacity. For most countries, GDP and GNP are very similar, but for Ireland GDP is more than 20 per cent higher than GNP. We show how this can distort international comparisons, and suggest an alternative approach based on work by IFAC (2012) and Callan and Savage (2013), and taking into account recent work by FitzGerald (2013) on the impact of redomiciled plcs. Our approach, leads to a different view of Ireland's position in terms of overall and income-related taxes.

Last year our *Budget Perspectives* paper focused on work incentives for those who were unemployed or not at work. This year, we examine the incentives to progress (either by increasing work hours or work effort in order to earn a higher income), for those who are in employment. Section 3 looks at marginal effective tax rates facing all those who are in employment or self-employment, at various income levels. Marginal effective tax rates include withdrawal of benefits as well as income tax and social insurance contributions, as such withdrawals also affect the financial incentive to work. We make comparisons with the situation in other EU-15 countries, drawing on recent work by Jara and Tumino (2013), and complementing this with an up-to-date picture of the Irish situation based on new analysis from the *SWITCH* model. Section 4 focuses on top marginal tax rates (including employee social insurance contribution rates) in EU-15 countries, and on how the Irish top tax rate has changed over recent years. Section 5 analyses

the impact of the different direct tax policy choices made in the UK and Ireland for both marginal tax rates and the distribution of income. In this context, we can make some detailed bilateral comparisons with work done in the UK by Adam and Browne (2010). Section 6 draws together the main conclusions and some issues for further research.

A brief word on terminology may be helpful in order to avoid possible confusion. We use the term “income tax” to refer just to the statutory income tax. The terms “income-related taxes” and “taxes on income” are used to include social insurance contributions and other taxes which are levied on income – such as the Universal Social Charge. *Employee* social insurance contributions are always included in our analysis, and for some comparisons, *employer* social insurance contributions are also taken into account. When employer social insurance contributions are included, this will be clearly stated.

2 TAXABLE CAPACITY: AGGREGATE PERSPECTIVES³

2.1 Measuring Taxable Capacity

GDP is the most widely used indicator of taxable capacity in international comparisons. Ratios of tax revenue to GDP then measure the extent to which that capacity is used. For most countries, levels of GDP and GNP are quite similar. For 13 out of the EU-15 countries, the ratio of GDP to GNP was within the range 97 per cent to 104 per cent in 2011. Ireland and Luxembourg are outliers in the EU-27, with GDP more than 20 per cent higher than GNP. The difference between the two is net factor payments, outflows which are largely due to the repatriation of profits by multinational companies.

McCarthy (2004, 2010) has argued that the lower potential tax yield from net factor outflows means that, faced with a choice between GDP and GNP as a measure of taxable capacity, it is GNP which should be preferred. The Irish Fiscal Advisory Council (IFAC, 2012) reconsidered these arguments and came to the view that:

Taking either of the extremes of GDP or GNP is problematic. GDP is problematic as a measure of fiscal capacity because a euro of the excess of GDP over GNP (which is dominated by multinational profits) is likely to provide less revenue capacity than a euro of GNP. On the other hand, going to the other extreme of using just GNP puts zero weight on the revenue potential of the excess component. This suggests the value of a hybrid

³ This section draws in part on Callan and Savage (2013).

measure, where an appropriate relative value is placed on a euro of the excess component relative to a euro of GNP.

IFAC (2012)

Econometric analysis by IFAC suggested that a hybrid measure, using all of GNP and 40 per cent of the excess of GDP over GNP (i.e., 40 per cent of net factor outflows) might provide a useful alternative measure of fiscal capacity. In our view this hybrid measure is better than either GNP or GDP alone.⁴ More recently, FitzGerald (2013) analysed the impact of a rapid growth in redomiciled plcs, which are headquartered in Ireland but due to double taxation agreements, pay tax in another jurisdiction. The net effect – for reasons described by FitzGerald – is that these companies raise measured GNP in Ireland, but “...confer no significant benefit on the Irish economy in terms of employment or taxes”.⁵ Undistributed profits of redomiciled plcs are the key factor underlying this phenomenon and these show very rapid growth between 2009 and 2010

One interpretation of IFAC’s findings is that the estimates reflect the low rates of corporation tax which have been in force in Ireland for many years. In principle, it could be argued that the taxable capacity of net factor outflows is greater than that estimated on this basis. Callan and Savage (2013) note three reasons why the future taxable capacity of net factor outflows may be not much higher than that estimated from the past.

1. Effective tax rates on corporate profits⁶ are between 10 and 25 per cent in most EU countries including all the smaller countries bar Malta. Significantly higher rates are found in the five largest EU economies (Germany, France, the UK, Italy and Spain).
2. A cut in corporation profits tax was estimated by Conefrey and FitzGerald (2011) to lead to a rise in activity. If corporation tax were to rise, this would be expected to reduce the base to which the profits tax applied.
3. Moves towards a common consolidated corporation tax base, using such metrics as sales or employment, would tend to apportion more of corporation tax receipts to larger countries.

⁴ Similar results are obtained by a related approach, excluding estimates of multinational profits, and excluding taxes paid on them, from both the numerator (aggregate tax) and denominator (i.e., using GNP) of the calculated tax ratio.

⁵ In fact, as FitzGerald (2013) points out, the net effect is a negative for the Exchequer because the higher measured GNP raises Ireland’s contribution to EU funding, without any corresponding increase in Exchequer revenues.

⁶ Elschner and Vanborren (2009) using the approach developed by Devereux and Griffith (2003) to identify the effective average tax rate on corporate profits

2.2 International Comparisons: Overall Tax Ratios

Table 1 presents both the traditional comparison of aggregate tax to GDP ratios, as per the OECD, and an estimate for Ireland of a taxable capacity measure taking account of the limited capacity to tax multinational profits *and* the impact of redomiciled plcs, which do not generate tax for Ireland. As noted above, Ireland is not alone in having a lower rate of tax on multinational profits than its overall average tax rates and the extent of multinational profits declared in Ireland is in part due to a low tax regime. For these reasons we present results which take account of the low rate of tax on repatriated multinational profits (following the approach of IFAC, 2012) and the fact that no tax is payable by redomiciled plcs (as per FitzGerald, 2013). The base we use is GNP, less the element attributable to redomiciled plcs, plus 40 per cent of Net Factor Outflows (i.e., the amount by which GDP exceeds GNP).

TABLE 1 Total Taxes as a Proportion of National Income, EU-15 Countries, 2011

Country	Percentage of National Income
Ireland – GDP	28.5
Greece	31.2
Portugal*	31.3
Spain	31.6
Ireland – hybrid (see text)	33.8
United Kingdom	35.5
Germany	37.1
Luxembourg	37.1
Netherlands*	38.7
Austria	42.1
Italy	42.9
Finland	43.4
Belgium	44.0
France	44.2
Sweden	44.5
Denmark	48.1

Source: Callan and Savage (2013), based on OECD *Revenue Statistics*, www.oecd.org and CSO *National Accounts* for Ireland.

Notes: *Indicates that 2010 is the latest available year.

Using this measure, Ireland's tax to national income ratio is more than 5 percentage points higher than the tax/GDP ratio commonly used. On this measure, Ireland is no longer an exceptionally low tax country in the EU-15 context, but a moderately low tax country. Instead of a tax to income ratio 3

points lower than Spain, Greece and Portugal, it has a ratio 2 points higher than these countries and less than 2 points lower than the UK.

There is a wide range of tax to GDP ratios even within the EU-15 countries. The lowest values are in Spain, Greece and Portugal, with tax ratios between 31 and 32 per cent. Six countries (Austria, Italy, Finland, Belgium, France and Sweden) have tax ratios between 42 and 45 per cent, while the highest ratio is in Denmark (48 per cent). There is, therefore, substantial variation between countries in the set of government provided services and redistributive transfers that these societies are willing to finance – and willingness to pay also depends on the services provided. Besley (2012), in his ESRI Geary lecture, analysed some of the forces which have underpinned the development of these outcomes. Here it is sufficient to note that Ireland's tax ratio is towards the low end of the scale. Leaving aside questions of desirability, it seems possible, therefore, that a transition to a higher tax ratio would be feasible, without being classified as a 'high tax' country.

The historical experience provides further evidence on this. Our own estimates suggest that Ireland, circa 2000, had a tax to national income ratio about 3 percentage points higher than at present. During the last decade, Germany has kept the tax to GDP ratio between 35 and 37 per cent. Over the same period, the UK has operated with a tax to GDP ratio between 34 and 36 per cent. These parallels suggest that tax ratios significantly higher than those observed at present are likely to be a realistic option.

How might these results be affected by the depth of the current recession? Currently spending is elevated above normal levels, and revenues depressed, because of the severity of the recession. Thus, with a recovery, expenditure on welfare would fall, while tax revenues would rise. It is not clear, however, whether this would involve a rise in the tax to national income ratio in Ireland relative to that in other countries. Analysis of recovery paths in the forthcoming *Medium-Term Review* (FitzGerald and Kearney, 2013) will be of interest in this regard.

2.3 International Comparisons: Income Related Taxes

Next we focus on taxes relating to individual income. Broad measures of income taxes tend to include income taxes and capital gains taxes paid by corporations, but these are excluded here, as the factors driving them are quite different. In Table 2 we use the detailed OECD statistics to include income tax and social security contributions, excluding corporate income taxes. In Table 1 we made use

of a ‘hybrid’ GDP/GNP measure as we were examining taxes from *all* sources (individual incomes, company profits, consumption based taxes etc.). Net factor outflows from repatriated profits do not form part of the base for the income taxes examined now: GNP is therefore a more appropriate measure of national income to use. Thus, for Ireland, we present a figure based on GDP (as commonly shown in international comparisons) and a figure based on GNP, adjusted for the impact of redomiciled plcs (FitzGerald, 2013), which we argue gives a more appropriate comparison. For other countries a GNP-based figure would be very similar to the GDP-based results reported here, with the exception of Luxembourg, where the ratio would rise from 19 per cent to about 24 per cent.

As with the overall tax ratio, Ireland emerges as one of a group of low tax rate countries, rather than the very lowest. Using the more appropriate GNP-based figure, Ireland’s income tax to national income ratio is 17.5 per cent – about 4 per cent higher than the GDP based figure. This is slightly higher than in the UK and well above the levels in Greece and Portugal – whereas the GDP based figures suggest that Ireland has the lowest rate in the EU-15. Again, it is important to bear in mind the variety and level of publicly provided services that are available in each of these countries and that are likely to be strongly correlated with the level of income tax and social insurance that is levied on individual incomes as well as the willingness to pay such taxes.

TABLE 2 Taxes on Income of Individuals as a Proportion of National Income, 2011

Country	Percentage of National Income
Ireland – GDP	13.6
Portugal*	14.6
Greece*	15.2
United Kingdom	16.5
Ireland – GNP	17.5
Spain	18.9
Luxembourg	19.2
Sweden	21.7
Netherlands*	22.7
Germany	23.5
Austria	23.9
France	24.3
Italy	24.9
Finland	25.3
Denmark	25.5
Belgium	26.5

Source: OECD Revenue Statistics, www.oecd.org.

Notes: Taxes on individual income constructed from OECD categories 1100 (Taxes on Income, Profits and Capital Gains of individuals) plus Social Security Contributions (category 2000, including contributions by employees, employers and self-employed); capital gains tax element is then excluded.

* Indicates that 2010 is the latest available year.

3 MARGINAL EFFECTIVE TAX RATES: IRELAND IN COMPARATIVE CONTEXT

Similar average tax rates may have quite different implications for the marginal tax rates faced by individuals – much depends on the extent of exclusions from the tax base and the rate structure of the income-related taxes. Marginal tax rates are of fundamental importance in shaping financial incentives – not only the financial incentive to work, but also the incentives to engage in (legal) tax avoidance and (illegal) tax evasion. All three kinds of response can have an impact on the size of the taxable income, and a great deal of research has focused on what is termed the elasticity of taxable income. (See for example, Kopczuk, 2005 and Piketty *et al.* 2011). The structure of marginal tax rates also plays a key role in determining average tax rates, tax revenues and the nature and extent of income redistribution through the tax system

Detailed microsimulation analysis is needed to assess the impact of different tax systems on the marginal effective tax rates faced by individuals in different countries. Until recently there has been limited cross-country analysis on this topic.⁷ However, recent studies by Adam and Browne (2010) for the UK and Jara and Tumino (2013) for EU countries make it possible to undertake some useful bilateral and multilateral comparisons. In this section we focus on the broad EU-15 context, using the work of Jara and Tumino, supplemented by new *SWITCH* analysis. Section 5 will look more closely at Ireland and the UK, where more detailed comparisons are possible drawing on the work of Adam and Browne (2010) and new *SWITCH*-based analysis.

Marginal effective tax rates (METRs) measure how much of an extra euro in earnings is taken in taxes or by way of a withdrawal of benefits from the individual or his/her partner. Thus, METRs help to measure a key financial incentive to work – the incentive to increase earnings, whether via additional time, effort or skill. The proportion of an extra euro in earnings which is retained by the worker is simply (1-METR).⁸

Jara and Tumino (2013) provide an analysis using the *EUROMOD* tax-benefit model which allows us to locate the Irish systems in a wider EU context.⁹ The

⁷ Immervoll (2004) is one such study, but the data and policies in this analysis are from the mid-1990s.

⁸ This is where the METR is in decimal terms. With METR defined in percentage terms, the percentage retained by the worker is 100 minus METR.

⁹ It is worth noting that tax benefit models are based on household surveys which do not generally contain information on tax expenditures of ‘tax breaks’ which may be more strongly used by those at the upper end of the income distribution. Therefore, both *EUROMOD* and *SWITCH* do not take these into account – results shown here will therefore be comparable. For more information on tax expenditures in Ireland see Collins and Walsh (2010).

EUROMOD results for Ireland are based on a limited version of the *EU SILC* data for 2008 – before the main effects of the recession on employment. Instead, we use results based on *SWITCH*; which use the full detail of the CSO’s *SILC* for 2010, incorporating the severe effects of the downturn between 2008 and 2010. Both the *SWITCH* results and the *EUROMOD* results of Jara and Tumino include the effects of recent policy changes – up to 2010 for *EUROMOD*, and up to 2011 for *SWITCH*:

Jara and Tumino summarise the following key features for all EU countries – we focus here on the EU-15:

- Mean METR: This is the average METR for all workers.
- Median METR: This is the METR for the worker who is in the middle of the ranking from lowest METR to the highest METR.
- METR at 25th percentile: This is the METR for the worker who is halfway between the lowest METR and the median ranked worker. Thus, this is the highest METR faced by any of the 25 per cent of taxpayers with the lowest METRs.
- METR at 75th percentile: This is the METR for the worker who is halfway between the very highest METR and the middle ranked or median METR. All of the 25 per cent of workers with METRs above this must, therefore, have an METR which is at least equal to this value and more usually higher.

The distribution of marginal tax rates helps to determine the aggregate amount of revenue raised, and how the tax burden is distributed across the income distribution. Progression in marginal tax rates is a common feature internationally; but even a flat rate of tax would generate progression in average tax rates, with the extent of progressivity depending on the size of the tax free allowance or tax credit. Our focus here is not on standard measures of progressivity, but on another aspect of the marginal tax rate distribution: we compare across countries the marginal tax rates faced by individuals who are at a number of “fixed points” in the marginal tax rate distribution e.g., the median marginal tax rate, with half of earners facing a higher rate and half a lower rate; and similarly for each quarter (technically, quartile) of workers. In this way we can get a picture which captures some key aspects of the full distribution of tax rates.¹⁰

¹⁰ A more comprehensive bilateral comparison is undertaken with the UK in Section 5, using a graphical technique that takes account of the full distribution of marginal effective tax rates.

The METRs for the 25th percentile of the distribution are a good indicator of marginal tax rates on low income workers. By 2011, the value for Ireland is, at 28 per cent, the fourth lowest – but just four percentage points below the midpoint of the range of values i.e., the 32 per cent seen in France). Ireland is also fourth lowest for the median value, some 9 percentage points below the middle-ranking country (i.e., Luxembourg at 40 per cent). Conversely, the METR at the 75th percentile, a good indicator of the marginal tax rates faced by higher earners, is, third highest – and the mean METR is also above average. This indicates that higher earners face a higher disincentive to earn more (through increased work hours or work effort). This reflects the fact that when a higher proportion of the lower paid face zero or low tax rates higher taxes must be levied on those further up the income distribution to reach a given revenue target.

We will undertake some direct and more detailed METR comparisons with the UK in Section 5. It is, therefore, worth noting its location in these distributions. The UK is close to the midway point in terms of most measures shown in Table 3, except for its ranking at the 75th percentile where it has the fourth lowest value for the METR, This reflects the fact that a low proportion of the UK workforce face the higher or top rates of tax.

TABLE 3 Marginal Effective Tax Rates, Employed Population (Income Tax, Employee Social Insurance Contributions, Benefit Withdrawal), 2010

Mean METR		Median METR		METR at 25 th percentile of METRs*		METR at 75 th percentile of METRs†	
Greece	23	Greece	20	Spain	6	Spain	33
Spain	27	Spain	27	Portugal	11	Portugal	35
Portugal	27	Portugal	27	Greece	14	Greece	37
Sweden	36	IRELAND	31	IRELAND	28	UK	42
Austria	39	Sweden	36	Luxembourg	29	Luxembourg	47
Italy	39	Italy	39	Sweden	29	Italy	47
UK	39	UK	39	UK	31	Austria	47
Luxembourg	40	Luxembourg	40	France	32	Finland	49
Netherlands	40	France	41	Finland	33	France	49
IRELAND	41	Denmark	41	Netherlands	34	Germany	50
France	41	Netherlands	43	Austria	36	Netherlands	50
Finland	42	Austria	43	Italy	37	Sweden	52
Denmark	45	Finland	44	Germany	39	IRELAND	52
Germany	45	Germany	45	Denmark	41	Denmark	55
Belgium	54	Belgium	55	Belgium	53	Belgium	59

Notes: *This is the **maximum** METR faced by the 25 per cent of taxpayers with the **lowest** METRs
 †This is the **minimum** METR faced by the 25 per cent of taxpayers with the **highest** METRs

Sources: Estimates for Ireland 2011 are from SWITCH. Estimates for all other countries were kindly supplied by Xavier Jara using the EUROMOD model; these estimates are preliminary. Details of the methods and other relevant results can be found in Jara and Tumino (2013).

4 TOP TAX RATES

How does Ireland's top tax rate compare with those of other EU-15 countries? Table 4 reports the top rates of direct tax for employees (income tax together with employee social insurance contributions, but excluding employer social insurance contributions) for EU-15 countries in 2012. The rates range from 43 per cent to almost 60 per cent. A range of 47 per cent to 57 per cent covers 11 of the 15 countries. The Irish rate of 52 per cent is in the middle of this distribution. It comprises an income tax rate of 41 per cent, Universal Social Charge (which is also a tax on income) of 7 per cent, and employee PRSI of 4 per cent. A higher rate of Universal Social Charge is paid by self-employed persons with an income over €100,000 per year, bringing the top tax rate for this group to 55 per cent. This could be questioned on both equity and efficiency grounds. Horizontal equity requires the equal treatment of equals – it is not clear what difference justifies the 3 per cent surcharge on the self-employed. As for efficiency, given that the self-employed have more flexibility in terms of labour supply, and perhaps also in terms of the income/capital gains split, this would not suggest that a higher tax rate was warranted.

TABLE 4 Top Tax Rates in EU-15 Countries, 2012

Country	Personal Income Tax & Employee Social Security Contributions	Income Threshold for Top Tax Rate (Multiple of Average Wage)
	(All-in rate)	
	%	
Luxembourg	42.7	3.2
Austria	43.7	2.0
Italy	47.3	10.4
Germany	47.5	5.8
Netherlands	49.3	1.2
France	51.2	5.1
Spain	52.0	11.9
United Kingdom	52.0*	4.2
Ireland	52.0	1.0
Portugal	54.6	11.0
Finland	55.5	1.8
Denmark	56.1	1.1
Sweden	56.6	1.5
Greece	57.4	6.0
Belgium	59.4	1.0

Sources: <http://www.oecd.org/tax/tax-policy/oecd-tax-database.htm#pir>, Table 17, Top marginal combined personal incomes tax rates on gross wage for a single individual.

Notes: *Reduced to 47 per cent in 2013.

While the top rate of tax in Ireland is not unusual in an EU context, it applies to a much lower level of income than elsewhere. Table 4 shows the income threshold at which taxpayers become liable to pay at the top income tax rate, expressed as multiples of the average wage in each country. A high value indicates that few taxpayers are liable; a low value, close to 1, indicates that a substantial proportion of taxpayers will be liable to pay tax at this top rate. Indeed, the numbers of individuals liable to pay the tax are likely to be very sensitive to this ratio. Large differences could be expected between Ireland, Belgium and Denmark, which have thresholds close to the average wage, and Sweden and Finland, which have thresholds which are 50 to 80 per cent higher than the average wage. For 8 of the 15 countries, the threshold is more than double the average wage – and for 7 of these countries the threshold is set at more than 3 times the average wage. This greatly reduces the numbers of taxpayers liable to pay at this rate. In Italy, Spain and Portugal a worker can earn more than ten times the average wage before they face the top tax rate. It is worth bearing in mind, however, that it is not simply the top tax rate that matters, but all of the rates and bands. This is why the analysis in Sections 3 and 5, which capture the full complexity of the systems and their interactions with the distributions of income, provides a more comprehensive comparison of the nature of the income-related taxes in different countries.

Recent changes in UK policy have reduced the top statutory tax rate from 50 per cent to 45 per cent. A 2 per cent National Insurance contribution continues to be payable in addition. But Adam *et al.* (2013) show the need for care in assessing the top marginal effective tax rate:

Since 2010–11, the income tax personal allowance has been withdrawn above incomes of £100,000. The allowance is reduced by 50p for every pound of income above £100,000, gradually reducing it to zero for those with incomes above £118,880 in 2013–14. Losing 50p of personal allowance means that 50p becomes taxable at the individual's marginal income tax rate of 40 per cent, and therefore 20p more income tax to pay alongside the 40p that would ordinarily be payable on an extra pound of income. Thus between £100,000 and £118,880, people face paying 60p more in income tax for each extra £1 of income: in effect, the marginal income tax rate in that range is 60 per cent.

Adam *et al.* (2013)

Thus, in effect, the highest income tax rate in the UK system – even leaving aside any issue of withdrawal of benefits – is 60 per cent rather than 50 per cent. The effective 60 per cent rate remains in place after the reduction of the top statutory marginal tax rate from 50 per cent to 45 per cent.

There has been some debate in Ireland concerning a new top tax rate on incomes above €100,000 per year. We do not attempt here to give a comprehensive assessment of the costs and benefits of such a proposal, but point to two facts which are relevant to the debate

- A new rate of 48 per cent on incomes of more than €100,000 would bring the top tax rate for employees to a total of 59 per cent¹¹ (48 per cent tax, 7 per cent USC and 4 per cent PRSI). This would be higher than 13 of the other 14 members of the EU-15 group.
- The amount of revenue which could be raised, assuming no change in behaviour, was estimated by the Revenue authorities as €365 million. In the context of our earlier discussion of Ireland's tax to national income ratio it should be noted that this would amount to 0.3 per cent of GNP.

Taken together, these facts point to a rather limited scope for tax increases on such high incomes to contribute to a substantial upward shift in the ratio of tax to national income.

TABLE 5 Distribution of Income over Income Bands

Income Band	% of Gross Income in Income Band	
	% of all income	% of income above €16,500
0-10,000	21.1	
10,000-16,500	12.3	
16,500-20,000	5.9	8.8
20,000-30,000	13.8	20.7
30,000-40,000	10.4	15.6
40,000-50,000	7.5	11.3
50,000-60,000	5.6	8.4
60,000-70,000	4.1	6.1
70,000-80,000	3.0	4.5
80,000-100,000	4.2	6.4
100,000-150,000	4.5	6.7
150,000+	7.6	11.3
	100.0	100.0

Source: SWITCH, based on SILC 2010.

¹¹ As noted above, a top tax rate of 55 per cent applies to self-employed persons with incomes over €100,000, because of a higher than standard rate of USC. Unless there were an adjustment to the special USC rate for high earning self-employed, their top rate of effective tax would be 62 per cent.

When considering substantial shifts in the share of income to be gathered in income tax, therefore, it is necessary to look beyond increases in top tax rates. This reflects an essential feature of the arithmetic of income taxation. Revenue depends on average tax rates. While we usually think of average tax rates as the total tax bill divided by income, another way of arriving at the same answer is to take the simple average of the marginal tax rate on each successive euro of income. Viewed in this way, it is clear that while low marginal tax rates are desirable, low marginal tax rates on low and middle incomes also tend to depress the average tax rate on those with higher incomes as high income earners also benefit from the tax credits in place to ensure lower earners face zero or low tax rates.

Further evidence on the structure of the income tax base is given in Table 5. Statistics on the distribution of gross income usually count the numbers of persons or tax units in each income class, and report their total gross income. Table 5 takes a different approach, motivated by the fact that tiered tax rates apply to successive tranches of income e.g., a zero tax rate on the lowest slice of income,¹² a standard rate of tax on the next slice, and a top rate on all income above a certain threshold. Given that income taxes have this structure, it is of interest to know where income is located in terms of the successive slices of income from the bottom to the top. Table 5 provides two perspectives on this. We look first at the distribution of total income across all bands. About one-third of all income is in the bands below €16,500 per annum, which are currently exempt from tax. A further 30 per cent lies in the bands between €16,500 and €40,000 per annum, with 25 per cent in the ranges €40,000 to €100,000. While top income earners have a substantial share of total income, the share of that income which is itself above €100,000 is about 12 per cent.

How do these figures change if we focus on incomes above the levels currently exempted from tax by the personal and PAYE tax credits (about €16,500 per annum)? Close to two-thirds of all income excluding this “bottom slice” is in income ranges between €16,500 and €60,000 per annum. The remaining third is split almost evenly between incomes in the range €60,000 to €100,000 and over €100,000.

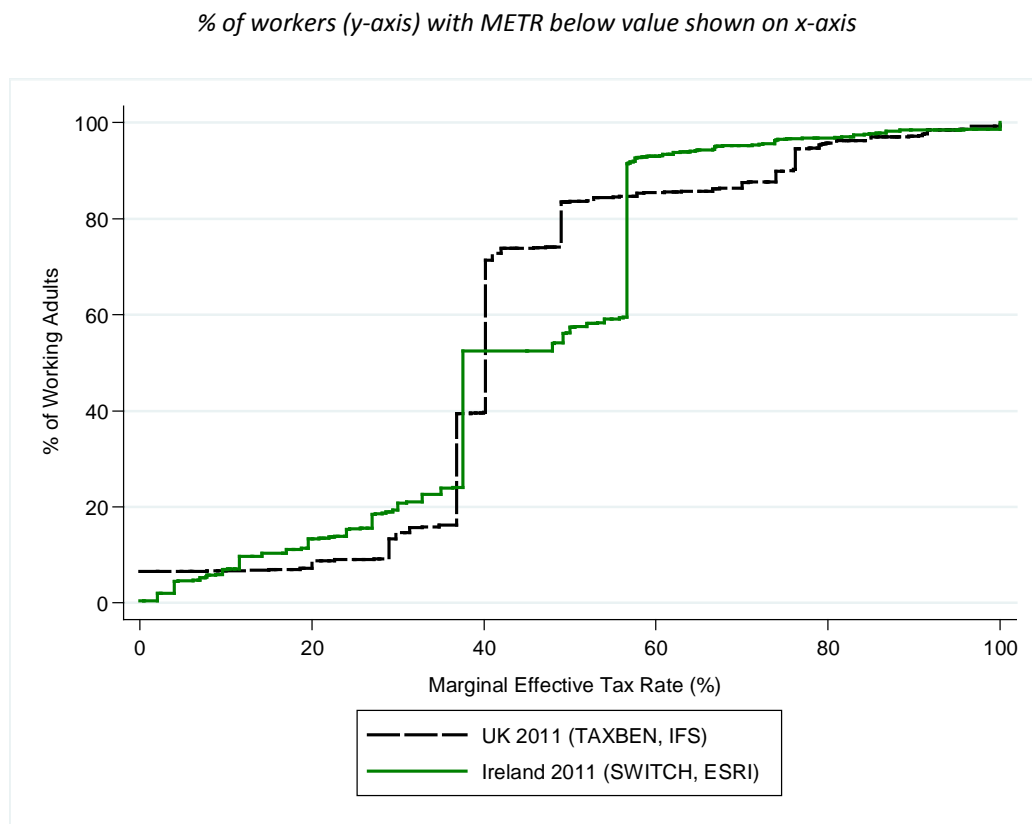
¹² This may be implemented through a tax-free allowance, or a personal tax credit.

5 IRELAND AND THE UK: ANALYSING THE IMPLICATIONS OF TAX POLICY CHOICES

We now move to a more detailed comparison of the distribution of METRs in Ireland and how they compare with those found in the UK. We choose to focus on the UK for a more detailed analysis for two main reasons. First, the links between the Irish and UK labour markets are particularly strong. Second, the UK is our nearest neighbour not only geographically but also in terms of the ratios of overall tax and income-related taxes to national income, as illustrated in Tables 1 and 2.

We now present a comparison of the distribution of METRs in Ireland and the UK, shown in Figure 1 below. In order to maintain comparability with the approach of Adam and Browne (2010), employer social insurance contributions (employer's PRSI in Ireland, employer's National Insurance Contributions in the UK) are taken into account. Thus, we measure the proportion of total labour cost (earnings plus employer's social insurance contributions) which is taken in tax and/or social insurance contributions.

FIGURE 1 Marginal Effective Tax Rates (METRs) for UK and Ireland, 2011



Note: UK estimates were kindly provided by Stuart Adam and James Browne of the Institute for Fiscal Studies using the IFS tax and benefit microsimulation model, *TAXBEN*, run on updated data from the 2008-09 *Family Resources Survey*. They refer to working adults. Irish estimates from *SWITCH* analysis for this paper.

Figure 1 above should be read as follows. For a given value of the marginal effective tax rate on the x-axis, the graph shows the percentage of workers who have a marginal effective tax rate below that level. Thus, for a given METR level (on the x-axis), if the Irish (continuous) line lies above the UK (dotted) line, a higher proportion of Irish workers have METRs below that level than is the case for UK workers. For example, comparison of the position of the Irish and UK lines at an METR of 50 per cent shows that just under 60 per cent of Irish workers face a METR of 50 per cent or lower while over 80 per cent of workers in the UK have a rate at or below this level. The vertical sections of the graphs occur where large proportions of workers face the same tax rate (e.g., the standard rate of tax, plus 4 per cent PRSI, plus USC).

The main differences are as follows. The UK has more workers on the very lowest tax rates, but for values between 10 and about 35 per cent, Ireland has a higher proportion than the UK facing rates below these levels. The biggest gap, however, occurs because about one-third of Irish workers face the top rate of income tax – leading to a marginal effective tax rate, including employer social insurance, of close to 57 per cent. This ties in with the findings shown in Table 4 – in Ireland a worker on the average wage faces the top tax rate while in the UK the top tax rate does not apply until a worker earns more than four times the average wage. The proportion of UK workers facing such high tax rates is, therefore, much lower.¹³

As seen in Section 2, income-related taxes account for a similar proportion of GNP in Ireland and the UK. While the UK tax take is of similar size, the UK system gathers this revenue in a way which tends to produce a different pattern of marginal effective tax rates as shown in Figure 1. These differences in tax structure also have implications for the distributional impact of tax policy, which we examine more closely in this section. The choice of the UK for this purpose does not mean that we are recommending a move to a UK-style system. The reason for undertaking the analysis is to begin to clarify what is involved in possible reform choices.

In order to compare the Irish and UK systems more closely, we construct a “UK-style” tax system (including employee social insurance contributions) which can be translated into the Irish context to allow for direct comparisons of the two

¹³ For both Ireland and the UK, marginal effective tax rates of about 60 per cent or higher indicate that there must be some withdrawal of benefit. Further investigation of this issue is warranted, but these initial figures suggest that benefit withdrawal affects more UK workers than Irish workers.

systems on the same population. The major features of the UK income tax system which are taken into account are:

- A personal allowance of £9,440.
- A standard rate band of £32,010, on which tax is payable at 20 per cent.
- A higher rate band of £117,990, on which tax is payable at 40 per cent.
- A top rate of tax of 45 per cent.

As regards social insurance contributions, the key elements captured in our analysis are:

- An employee contribution rate of 12 per cent, above a low threshold.
- An upper earnings limit close to £41,450.
- A rate of 2 per cent on earnings above this limit.
- For the self-employed, a contribution rate of 9 per cent between lower and upper profits limits (similar to the employee earnings limits), and 2 per cent above the upper limit.

Working and Child Tax Credits are not included in our comparison. Family Income Supplement can be seen as playing a similar role to the Child Tax Credits, though with a different structure, and FIS is therefore retained in our analysis of a UK-style system. The means-tested assistance provided by Working Tax Credit is not included in the current analysis. The Universal Benefit reforms currently under way involve a move towards a benefit approach rather than a tax credit approach for the future.

This system of income tax and social insurance contributions is used to replace the Irish income tax, employee PRSI and Universal Social Charge. There are, of course, some elements of the UK system which could not, in the time available, be included in the analysis. Chief among these is the fact that the UK system withdraws the Personal Allowance for those with incomes above £100,000 per annum: this feature of the system is not modelled in our current approach.¹⁴ The scale of the revenues involved in these features mean that they would have very limited impact on our findings.

¹⁴ There are also some smaller items which are not included. The self-employed pay a flat rate of £2.70 per week on income over £5,725 a year. The allowance for over 65s has been taken into account, but not the additional allowance for those who are aged over 75.

Money value parameters (such as allowances and tax bands) are translated into the Irish context as follows. Initially, we convert all parameters to euro values simply using current exchange rates. Given that there are differences between the Irish and UK income distributions, however, there is no guarantee that this will result in a system which has the same overall average tax rate as the initial Irish system – even though overall average tax ratios for income related taxes are similar for the two countries. In fact, this converted UK system would raise significantly higher revenues than the initial Irish system. However, we then adjust three key parameters – personal allowances, and the widths of the two bands – to ensure that the UK-style system raises the same revenue as the current Irish system. This involves an increase in the allowances and band widths to reach the following values:

- Personal allowance: €13,162
- Standard rate band: €44,632
- Higher rate band: €209,150

These values are similar to those which would be obtained by applying a PPP-adjusted exchange rate.

Direct comparison of these parameters with the existing Irish system is made difficult because the UK system still uses an allowance structure, while Ireland has moved to a tax credit structure. However, the following comparisons can be made:

TABLE 6 Key Tax Parameters: Ireland, 2013 and UK-style Tax System*

	Ireland, 2013	Ireland with UK-style System, Adjusted to be Revenue Neutral
	€	€
Value of personal allowance or personal & PAYE tax credit to standard rate taxpayer	3,300	2,632
Threshold for 20% rate	16,500**	13,162
Threshold for 40% or 41% rate	32,800	57,794
Threshold for 45% rate	not applicable	266,943

* Annual Values.

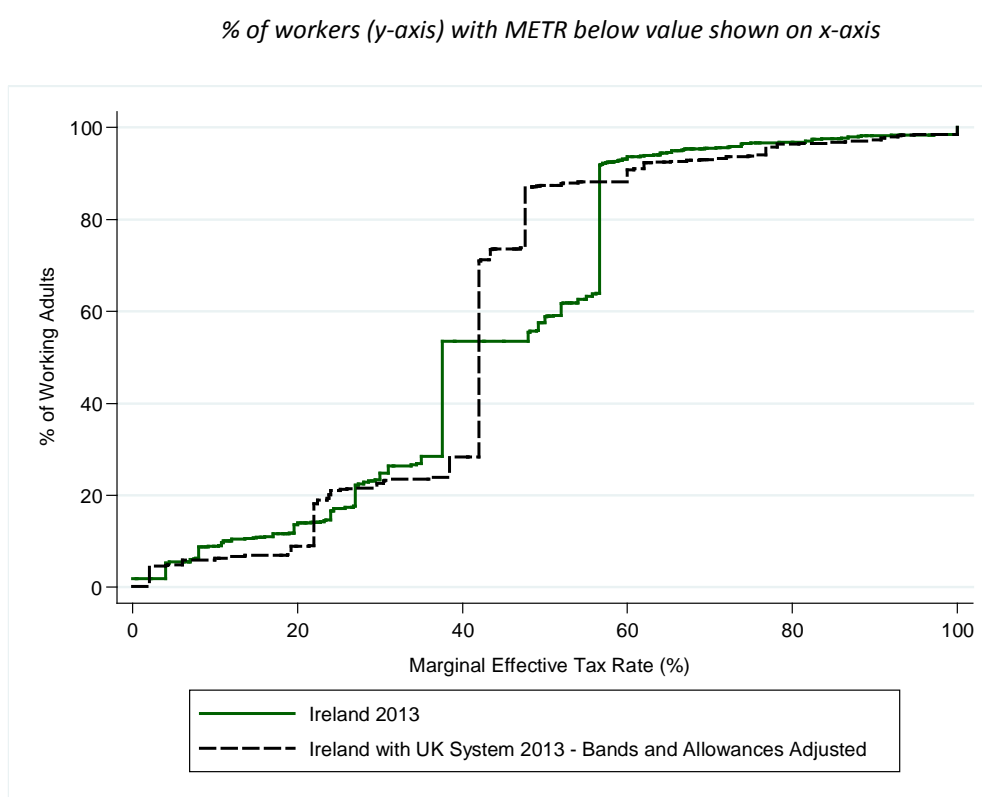
** At earnings below this level, the potential tax liability is eliminated (for employees) by the personal and PAYE tax credits.

From this comparison it is clear that the Irish system involves a higher initial allowance/credit, and a higher income threshold before standard rate tax becomes payable – by about 25 per cent. The UK-style income threshold before

the higher rate of tax becomes payable is, however, some 75 per cent higher than that for Ireland.

Figure 2 summarises the results regarding marginal effective tax rates as in Section 2. The Irish system here is 2013, and the UK-style system is also calibrated from 2013 values. But the contrast is very similar to that observed in Figure 1, with Irish marginal tax rates initially lower than those for the UK, but then rising to become substantially higher.

FIGURE 2 Marginal Effective Tax Rates (METRs) for Ireland under Actual 2013 Policy and under a UK-style Tax and Social Insurance System



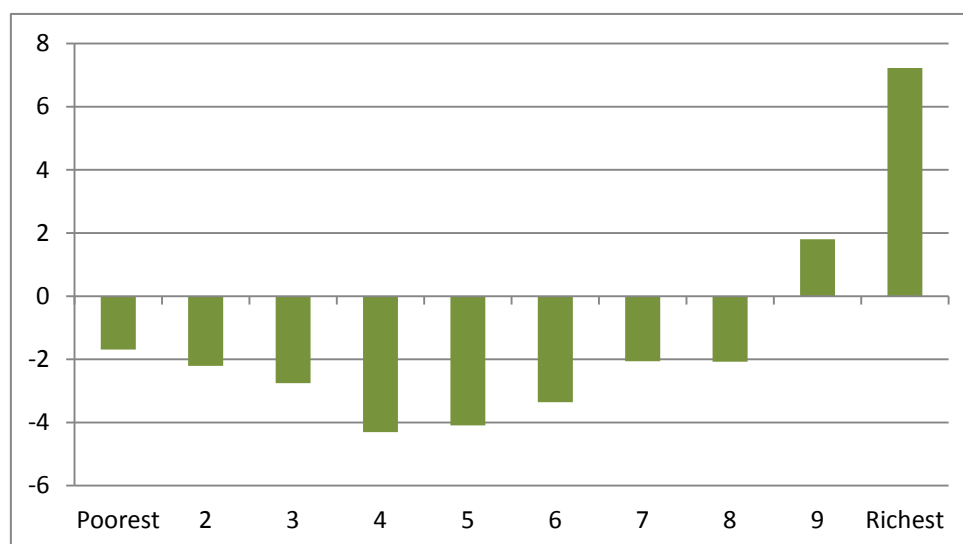
Note: Estimated using SWITCH.

The distributional consequences of the Irish and UK approaches are illustrated in Figure 3. It should be recalled that in this comparison, each system is gathering approximately the same revenue. This is done by construction in our approach, but is also true in reality, as aggregate statistics in Table 2 have shown. The Irish tax system, compared with the UK-style system, gathers less revenue from low and middle income households, and also from what might be termed “upper middle” income groups – deciles 7 and 8. The top one-fifth of households pay more in tax under the Irish system than under the UK-style system. A move from the Irish to the UK-style system would see a rise of about 7 per cent in the

incomes of the top income decile- the 10 per cent of households with the highest disposable incomes, adjusted for family size and composition.

Taken together, the results in Figures 2 and 3 provide a clear illustration of the trade-off between efficiency considerations (low marginal tax rates) and equity considerations (a higher tax burden where there is greater ability to pay). Ireland and the UK have made quite different choices on these issues.¹⁵ Many other EU countries have chosen tax systems with an intermediate degree of progressivity. Similar analyses of other EU countries would be informative when exploring potential reforms for Ireland.

FIGURE 3 Distributional Impact of Moving to UK-style Income-Related Taxes, 2013



Note: Estimated using SWITCH.

6 CONCLUSIONS

Ireland is widely perceived as having a very low tax regime, not just for corporate profits but also more generally. Our analysis finds that this view is in need of some correction. The most commonly made international comparisons are based on the ratio of tax revenues to GDP. For most countries GDP is a good measure of taxable capacity, and close to GNP; the other major measure of national income. For Ireland, the role of redomiciled plcs, as shown by FitzGerald (2013), means that close to 5 per cent of GNP is not part of the tax base at all; and the outflow

¹⁵ The two countries have also made different choices in the expenditure sphere, e.g., the provision of a National Health Service in the UK, as against a mixture of entitlements, some income-related, in the Irish health system.

of repatriated profits from multinationals, which forms about one-fifth of GDP, is taxable in Ireland as in most other countries, at relatively low rates.¹⁶ When adjustments are made for these factors, the ratio of tax revenues to a better measure of taxable capacity is higher by 5 percentage points. On this basis, Ireland has a moderately low ratio of tax to taxable capacity, somewhat below the UK, but well above that of Spain, Greece and Portugal; the standard GDP-based figures suggest an Irish tax ratio which is the lowest in the EU by a considerable margin.

Much of the gap between the tax to national income ratio in Ireland and in countries such as Germany, the Netherlands, Austria, France and the Nordic countries is due to income-related taxes. An examination of the detailed structure of marginal tax rates across the working population finds that this is due to lower marginal tax rates at low and middle income levels. The structure of Ireland's marginal effective tax rate is progressive compared with EU partners: low (or zero) marginal rates at the lower and middle income levels, and high rates towards the top. This necessarily limits the revenue generated by the income tax system, because the low marginal tax rates at low income levels apply also to the relevant "slice" of income of those with higher incomes. Thus, if Irish income taxes were to approach European levels, it is likely that marginal tax rates in low to middle income ranges would have to rise. Higher marginal tax rates on these income ranges would then raise extra revenue not just from those at such income levels, but also from those at higher income levels. Changes to top tax rates at very high income levels would have little impact on the gap in income-related taxes collected in Ireland and in most European countries.¹⁷

Ireland and the UK raise a similar proportion of national income in the form of income-related taxes.¹⁸ Detailed comparisons highlight the different choices made in the two countries as to how to raise this revenue. Ireland has lower marginal tax rates at low incomes, but a substantially higher proportion of the workforce facing the top rate of tax. The top tax rates faced by most UK workers are lower than in Ireland – and in most European countries. These differences have strong implications for the distribution of the tax burden, with the Irish system gathering less revenue from low and middle income earners, and more from those with high incomes. In exploring possibilities for future reform of the Irish tax system, there will be much to be learned from closer investigation of the

¹⁶ See Section 2 and IFAC (2012) for details on this latter point.

¹⁷ See Section 4 for details.

¹⁸ The gap in the tax to national income ratio between Ireland and the UK is driven by property taxes.

choices made in other European countries along the lines developed here for Ireland and the UK.

BIBLIOGRAPHY

- Adam, S. and J. Browne, 2010. "Redistribution, Work Incentives and Thirty Years of UK Tax and Benefit Reform", Institute for Fiscal Studies Working Paper 10/24.
- Adam, S., M. Brewer and A. Shephard, 2006. "Financial Work Incentives in Britain: Comparisons Over Time and Between Family Types", Institute for Fiscal Studies, Working Paper WP06/20.
- Adam, S., C. Emmerson and B. Roantree, 2013. "Broad Shoulders and Tight Belts: Options for Taxing the Better-Off", in C. Emmerson, P. Johnson and H. Miller (eds.), *The IFS Green Budget*, London: The Institute for Fiscal Studies.
- Besley, T., 2012. "Making and Breaking Tax Systems: The Institutional Foundations of Fiscal Capacity", Economic and Social Research Institute Geary Lecture, 19 October 2012.
- Blundell, R., 2011. "Tax Policy Reform: The Role of Empirical Evidence", *Journal of the European Economic Association* Vol. 10, No. 1, pp 43–77.
- Brewer, M., E. Saez and A. Shephard, 2010. "Means-testing and Tax Rates on Earnings" in Institute for Fiscal Studies (ed.), *Dimensions of Tax Design*, Oxford: Oxford University Press.
- Callan, T., N. Crilly, C. Keane, J.R. Walsh and Á. Ní Shúilleabháin, 2011. "Tax, Welfare and Work Incentives", *Budget Perspectives 2012*, Dublin: Economic and Social Research Institute.
- Callan, T., C. Keane, M. Savage, J.R. Walsh, 2012. "Analysis of Property Tax Options", Dublin: Department of the Environment, Community and Local Government.
- Callan, T. and M. Savage, 2013. "Tax and Taxable Capacity: Ireland in Comparative Perspective," Economic and Social Research Institute QEC Research Notes.
- Callan, T., J.R. Walsh and K. Coleman, 2007. *Work Incentives, Poverty and Welfare in Ireland*, Policy Research Series No. 60, Dublin: Economic and Social Research Institute.
- Central Statistics Office, 2011. Survey on Income and Living Conditions 2010, Dublin: Stationery Office.
- Collins, M.L. and M. Walsh, 2010. "Ireland's Tax Expenditure System: International Comparisons and a Reform Agenda", Studies in Public Policy No. 24, Dublin, Policy Institute, Trinity College Dublin, 2010, 1 – 64.
- Conefrey, T. and J. FitzGerald, 2009. "The Macro-Economic Impact of Changing the Rate of Corporation Tax," Working Paper 273, Economic and Social Research Institute.
- Department of Finance, 2012. Memorandum of Understanding on Specific Economic Policy Conditionality, Sixth Update, 20 August 2012.

- Department of Social Protection, 2012. *Statistical Information on Social Welfare Services*, www.welfare.ie
- Devereux, M. and R. Griffith, 2003. "Evaluating Tax Policy for Location Decisions," *International Tax and Public Finance*, Springer, Vol. 10, No. 2, pp. 107-26.
- Elschner, C. and W. Vanborren, 2009. *Corporate Effective Tax Rates in an Enlarged European Union*, Taxation Papers 14, Directorate General Taxation and Customs Union, European Commission, revised April 2009.
- Feldstein, M. 1995. Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act, *Journal of Political Economy*, Vol. 103, No. 3, pp. 551-572.
- FitzGerald, J., 2013. "The Effect of Re-domiciled Plcs on Irish Output Measures and the Balance of Payments" QEC Research Notes.
- Fuest, C., J. Niehues and A. Peichl, 2010. *The Redistributive Effects of Tax Benefit Systems in the Enlarged EU* Public Finance Review 38 p. 473.
- Honohan, P., 2009. Opening Address to the ESRI/Foundation for Fiscal Studies Budget Perspectives Conference, 13 October 2009. <http://tinyurl.com/blxmtp7>.
- Irish Fiscal Advisory Council, 2012. *Fiscal Assessment Report*, September.
- Immervoll, H., 2004. "Average and Marginal Effective Tax Rates Facing Workers in the EU: A Micro-Level Analysis of Levels, Distributions and Driving Factors", Paris, OECD Social, Employment and Migration Working Papers No. 19.
- Jara, X. and A. Tumino, 2013. "Tax Benefit Systems, Income Distribution and Work Incentives in the European Union", *International Journal of Microsimulation*, Vol. 6., No. 1, pp. 27-62.
- Keane, C., T. Callan, M. Savage and J.R. Walsh, 2012. "Property Tax in Ireland: Key Choices", Economic and Social Research Institute Economic Renewal Series 011.
- Kopczuk, W. 2005. "Tax Bases, Tax Rates and the Elasticity of Reported Income", *Journal of Public Economics*, Vol. 89, Nos 11-12, pp. 2093-2119.
- McCarthy, C., 2004. "Volatility in Irish Quarterly Macroeconomic Data", *Quarterly Economic Commentary*, Dublin: Economic and Social Research Institute.
- McCarthy, C., 2010. "Fiscal Adjustment and Macroeconomic Re-balancing in Ireland" Dublin: *Journal of the Statistical and Social Inquiry Society of Ireland*, Vol. XXXIX, pp.70-78.
- OECD, 2011. *OECD Economic Surveys: Ireland 2011* Paris: OECD Publishing.
- OECD, 2012. *Benefits and Wages: OECD Indicators* www.oecd.org/els/social/workincentives
- Piketty, T., E. Saez and S. Stantcheva 2011. "Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities", NBER Working Paper No. 17616.
- Wagstaff, A., E.van Doorslaer, H. van der Burg, S. Calonge, T. Christiansen, G. Citoni, U. Gerdtham, M. Gerfin, L. Gross and U.Hakinnen, 1999. "Redistributive effect, progressivity and differential tax treatment: Personal income taxes in twelve OECD countries", *Journal of Public Economics*, Vol.72, pp. 73-98.

2. Housing Taxation and Support for Housing Costs

Stuart Adam¹

1 INTRODUCTION

The taxation of housing and support for housing costs are important policy issues. They are also live issues in both the UK and Ireland, with significant and controversial reforms recently proposed, implemented or due to be implemented in both countries. This paper considers how housing should be taxed and how support for low-income families with their housing costs should be provided. It draws heavily on work done by the author and others for *Tax by Design*, the final report of the *Mirrlees Review* of taxation.² Like the *Mirrlees Review*, it uses the UK as a case study to apply principles that are intended to be relevant to any developed economy in the 21st century.

Taxation is not the only instrument of housing policy. The availability of housing in the UK is probably more influenced by the planning regime than by the tax regime. Social housing systems are a major part of the housing landscape in some countries. The regulation of credit can have a significant impact on the housing market. Policymakers sometimes try to make housing more affordable through policies such as mortgage guarantees and equity loans (such as the UK's recently announced *Help to Buy* scheme), though with heavily restricted housing supply the main effect of policies that boost demand in this way is usually to bid up house prices rather than making them more affordable overall.

There is, therefore, a place for considering how housing taxation fits into the wider framework of housing policy.³ The focus here, however, is on how housing taxation fits into the wider framework of tax and benefit policy, looking across the taxation of wealth, income, consumption and transactions.

¹ Address for correspondence: stuart.adam@ifs.org.uk. Thanks to Tim Callan, Carl Emmerson and Robert Joyce for comments on an earlier draft. Any errors or omissions are the responsibility of the author.

² *Mirrlees et al.* (2011).

³ The Barker Review of housing supply in the UK (Barker, 2004) provides a good example of this.

Tax by Design emphasises the importance of considering the tax system as a whole. The different parts of the system need to work together, with each tax used for the objective for which it is best suited: not every tax need address all objectives, as long as the system as a whole does. That is naturally difficult for a paper such as this one, examining just one part of the tax system – housing taxation – but at the very least it means analysing it in the light of how the rest of the tax system is designed. Core to this is the concept of *neutrality*: taxing similar activities similarly. In general, a system that treats similar economic activities in similar ways for tax purposes will tend to be simpler, avoid unjustifiable discrimination between people and economic activities, and help to minimise economic distortions and scope for tax avoidance. Neutrality is a sensible default option: it is not a good in itself, and is not always desirable. There are good arguments for levying higher taxes on environmentally damaging activities and providing tax advantages for research and development that brings wider spillover benefits. But given the tendency of arbitrary boundaries in the tax system to generate complexity and unintended effects on behaviour, the hurdle for departing from neutrality should be high.

How, then, should we think about housing's place in the economy? Housing has two main attributes that are relevant for tax design:

- First, by living in a house, you consume a flow of services. If we have a consumption tax such as a VAT, a reasonable presumption is that housing should in some way be covered by it.
- Second, homeowners also own a valuable asset; indeed, it is usually their *most* valuable asset. The value of the house may go up and down. In that sense, owner-occupied housing is like any other asset, and we should seek to tax it like other assets.

The distinction between these two attributes is explicit in the case of private rented property: the landlord invests in the asset, while the renter consumes (and pays for) the flow of services. But the two attributes are just as surely present in owner-occupied housing: in effect, the owner-occupier is both landlord and tenant simultaneously. At present, the UK tax system (like many others) treats rented and owner-occupied properties differently, creating a distortion in favour of owner-occupation. If, instead, we could treat all housing consistently both as a form of consumption and as a type of asset, such distortions could be

removed. As we will see, achieving such ideal treatment in practice would be difficult. But it is important to be clear what we would like to aim for.⁴

I take the first of these attributes – the consumption properties of housing – first. Section 3 then moves on to consider how housing should be taxed as an asset.

One of the problems with taxing housing – unlike most other consumption and income – is that it is not associated with a cash flow. Section 4 discusses the possibility of allowing housing taxes to be deferred for those who own a valuable home but may nevertheless struggle to find the cash to pay a housing tax as it arises each year.

In some cases, the problem is not current cash-flow but an underlying lack of resources. Governments may tax people who own or occupy a lot of housing, but they also provide help to those who need it with their housing costs – including, but not limited to, housing taxes themselves. Housing is a major component of the cost of living and it is essential that those with few or no private resources can still afford accommodation. But this support should also be designed to achieve clear objectives in as well targeted a way as possible, fitting in with principles that underlie low-income support more generally. Without taking a view on how generous support should be or how rapidly it should be removed as income rises, Section 5 of this paper examines some issues that are particularly pertinent in the design of housing benefits. Section 6 concludes.

2 TAXING HOUSING CONSUMPTION

The UK and Ireland – like all developed countries except the USA – charge VAT on the consumption of goods and services. There should be a presumption to tax consumption of all goods and services equally, not least for reasons of simplicity. Housing is an extreme example of one particular type of good: it can be thought of as a large consumer durable, like a very big fridge or car. Durables deliver a stream of consumption: the benefit of using them. The purest way to levy a consumption tax on them would be to value the stream of services delivered in a particular period and tax it. In practice, when considering the taxation of most consumer durables, we start instead from the presumption that it would be

⁴ Some might argue that there are benefits to wider society (over and above any benefits to the individual concerned) from wider owner-occupation – for example, if being tied to a particular area encouraged people to invest in the local community. But given the disadvantages of departing from neutrality, the hurdle for departures should be high: there would have to be strong evidence of large social benefits to justify differential treatment. Certainly it seems unlikely that there are social benefits of a magnitude that would justify the current degree of preferential treatment described in Section 3.

appropriate to impose VAT on their purchase price when new. This is because the price of the durable itself reflects the present value of the stream of services it is expected to yield. VAT paid on the newly bought good is, in effect, a prepayment on the stream of services yielded. Since the purchase price of new goods is observed, it is much easier to tax the purchase upfront than to try to value the stream of services each period. A natural starting point is that the same approach should be applied to housing.

Box 1: Land Value Taxation

A property can be thought of as having two components: the building and the land on which it stands. The taxation of land and the taxation of buildings can, in principle, be separated.

There is a long tradition arguing in favour of land value taxation: that is, levying a tax on what the land would be worth without any building on it. Since land, unlike buildings, is in completely fixed supply (aside from a few minor complications such as land recovered from the sea) and the tax would be payable regardless of what (if anything) was built on it, a land value tax would not affect incentives to buy, use or develop land. Unlike with other taxes, economic activity that would be worthwhile without a land value taxation remains worthwhile with it. Meanwhile the state would share in the benefit of any rise in land values (e.g., through improvements in local amenities), which occur through no particular merit or effort on the part of the landowner.

Tax by Design proposed introducing a land value tax for non-residential property, subject to confirming the practical feasibility of valuing plots of land separately from the buildings on them. However, unlike in the case of business property (discussed in Chapter 16 of *Tax by Design*), with housing there is a strong case for taxing the buildings as well as the land. It is the building, not just the land, that provides consumption services, and the disincentive to development created by taxing housing is no different from the disincentive to producing other goods created by VAT. Of course, ideally we would like to avoid discouraging economic activity at all; but most taxes inevitably do so, and the argument for a tax on residential buildings is that there is no reason for the tax system to discourage housing development less than it discourages other forms of activity.

The fact that there are good reasons for taxing residential buildings as well as residential land does not remove the argument for land value taxation. Regardless of the efficient taxation of housing as a consumption good or an asset, the land on which it stands could efficiently (though not necessarily equitably) be taxed at a high rate. A 'two-tier' housing tax could tax residential buildings at one rate and residential land at a different (presumably higher) rate. Some US cities

have such a tax. But there is a cost to doing this. If we want to tax the buildings as well as the land, there is obvious merit in avoiding the considerable additional complexity associated with valuing and taxing residential land and buildings separately.

In what follows, therefore, I discuss taxation of the land and buildings taken together. But if a land value tax could first be successfully implemented in the non-domestic sector (as proposed in *Tax by Design*), there may in future be a case for reconsidering its application to domestic property as well.

Yet the case for taxing the stream of services rather than the upfront purchase price is stronger in the case of housing than other durables. Relative to other consumer durables, the sheer value of housing and the potential scale of tax payments involved makes accepting the administrative burden of valuing the stream of services a more palatable option. But houses differ from other consumer durables not only in size. For one thing, they last a very long time – hundreds of years in many cases. Because houses are so long lived, their consumption value may change a great deal over time. Hence, their up-front price may prove to be a bad approximation to the value of consumption services they eventually provide. Ideally, if a house delivered more (less) valuable services than was originally envisaged and built into the purchase price, we would like to tax (subsidise) this difference. This is true in principle for all durables, but on a much larger scale for housing. So the economic benefits of taxing the stream of services are greater for housing than for other durables, while the practical costs are smaller relative to the amounts of tax involved.

Of course, it is not necessarily a binary choice between these two options: a government could opt for a combination, levying some VAT on new build and some tax on the stream of services, perhaps such that the combined rates equalled the main VAT rate – though this would of course involve two sets of administration.

For any particular country, the choice between taxing the purchase of new housing and taxing the stream of housing services will depend a great deal on where the country is starting from. The practical and political challenges of transition should not be underestimated, and are greatly reduced if the degree of upheaval can be minimised. And there is also a fairness angle to transition given the long life-span of housing. If existing housing has already been fully taxed on purchase then it might seem rather penal to introduce a new annual tax on the consumption services it provides: existing housing will have been taxed twice. On the other hand, if there is an existing annual property tax while new build has not

been subject to full VAT in the past then moving to a system of levying VAT only for future new build would give windfall gains to current homeowners at the expense of non-owners.⁵

The UK is starting from an unusual position: alone among OECD countries, it applies a zero rate of VAT to the construction and sale of residential property.^{6,7} It also has a large existing tax, council tax, levied annually and loosely related to property value. For the UK, therefore, it makes much more sense to leave new build zero-rated and instead transform council tax into a tax that more closely reflects the consumption value of the property. I now illustrate what this would involve.

2.1 Council Tax in Britain

Council tax is charged to all occupiers of domestic property in Britain.⁸ In England and Scotland, council tax operates by placing every house into one of eight bands (A to H): the higher the band, the higher the council tax paid – though not in a proportional fashion, as Table 1 shows. The valuation bands are based on the estimated market value of each house on 1 April 1991: there has been no revaluation of properties at all in England or Scotland since the tax was introduced.⁹ The ratios between the council tax bills charged for each band are set centrally, but the overall level of council tax is set locally (although local authorities must now seek approval in a referendum if they propose increases deemed excessive by central government) and the revenue from the tax is locally retained.

A 25 per cent discount is applied where there is a sole occupant; second and empty homes are also subject to discounts, determined locally. There are also reductions for those with low current incomes and assets, which are discussed in

⁵ An alternative, proposed by Crawford, Keen and Smith (2010), would be to levy VAT both on new build and on existing properties the next time they are sold – taxing the stream of consumption services they are expected to yield thereafter without retrospectively taxing the consumption services enjoyed to date. But this would act to discourage mutually beneficial transactions as people sought to defer the tax – since only housing services consumed after the next transaction would be taxed, the tax would be minimised by delaying a transaction as long as possible – and has the potential to be avoided altogether by the simple expedient of waiting for a future government to repeal the tax, before entering into any transaction.

⁶ Since VAT in the UK is generally charged on refurbishing existing properties but not on building new ones, the current system also incentivises developers to build new properties rather than redevelop derelict sites.

⁷ Ireland does not zero-rate new residential property, but nor does it tax it in full: it is subject to a reduced rate of 13.5 per cent rather than the standard rate of 23 per cent.

⁸ Strictly, not all occupiers: most students and some other groups are exempt.

⁹ Though a revaluation was carried out in Wales, and a ninth band (band I) introduced there, with effect from April 2005 (based on April 2003 property values).

Section 5. In 2013–14 council tax, net of all these reductions, is expected to raise £27.4 billion (€32.2 billion, some 4.5 per cent of total government revenue or 1.7 per cent of national income) and the average annual levy on a property in England is £1,045 (close to €1,230).¹⁰

TABLE 1 Council Tax Bands and Rates in England

Band	Value as at 1 April 1991	No. of properties in band in England at September 2012 (millions)	Tax rate as a proportion of that in band D	Charge in local authority setting English average band D rate in 2013-14
A	Up to £40,000	5.5	$\frac{6}{9}$	£971
B	£40,001 to £52,000	4.4	$\frac{7}{9}$	£1,132
C	£52,001 to £68,000	4.9	$\frac{8}{9}$	£1,294
D	£68,001 to £88,000	3.5	$\frac{9}{9}$	£1,456
E	£88,001 to £120,000	2.1	$\frac{11}{9}$	£1,780
F	£120,001 to £160,000	1.1	$\frac{13}{9}$	£2,103
G	£160,001 to £320,000	0.8	$\frac{15}{9}$	£2,427
H	More than £320,000	0.1	$\frac{18}{9}$	£2,912

Sources: Number of dwellings from <https://www.gov.uk/government/publications/council-taxbase-2012-in-england>; average band D rate from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/172890/Council_Tax_Statistical_Release_March_2013.pdf.

Three things are immediately evident from Table 1:

- First, properties are heavily concentrated in the lower bands: two-thirds of all properties are in the bottom three bands, while less than a tenth are in the top three bands.
- Second, charges rise more slowly than values – the charge in band H is twice the charge in band D, whereas the house at the bottom of band H is worth more than four times the house at the bottom of band D. So the tax is designed to be regressive relative to its base – the more the house is worth, the less as a proportion of the value is paid in council tax.
- Third, the highest band covers all properties worth more than £320,000 in 1991, including those worth many times more, while the lowest band covers all properties worth less than £40,000 in 1991. The width of the top band, and the number of properties lumped into the lower bands, highlight the failure of council tax to differentiate between properties in the same band. In addition, of course, being based on values from so long ago, current tax

¹⁰ Revenue figure from Table 4.7 of Office for Budget Responsibility (2013); average levy from Communities and Local Government, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/172890/Council_Tax_Statistical_Release_March_2013.pdf

bills take no account of subsequent changes in price relativities and hence do not capture even the original intention of the tax.

Council tax is an unpopular tax. There are a number of possible reasons for this. It is highly visible: 88 per cent of tax is remitted by firms,¹¹ so for the vast majority of people council tax is one of the only taxes they are asked to pay personally. This means people overestimate its importance. It also lacks buoyancy, which means that ‘increases’ have to be announced each year just to keep up with inflation. Council tax can seem particularly onerous for the ‘asset-rich, cash-poor’ since, unusually, it is not linked to a pre-existing cash flow. But there is also evidence that people just find the idea of a tax linked to the value of their property unfair.¹² This seems to reflect the fact that perceptions of fairness in tax are more closely linked to the relationship of the tax to flows of income than to stocks of wealth. But consumption of housing services is as legitimate a tax base as any other consumption, and it is a good complement to current income as an indicator of lifetime income or ability to pay; so this does not seem to be a good objection – at least not economically.

The unpopularity of council tax has been one major factor behind the unwillingness of government to undertake revaluations. The other is the fact that any revaluation inevitably creates winners and losers – and losers tend to be very vocal. This is one of the most egregious demonstrations of the ‘tyranny of the status quo’ as a block to desirable change. In this case, the problem only gets worse over time as relative property prices diverge more and more from the 1991 position. Part of the problem now is that a revaluation has been avoided for so long that changes in relative tax liabilities would be very substantial. But as council tax valuations have passed the milestone of being 20 years out of date, the absurdity of the status quo becomes ever more apparent. Any property tax requires regular and frequent revaluations, and this process should begin as soon as possible.

2.2 Moving to a Housing Services Tax

Council tax has important shortcomings, and housing is not currently subject to VAT as it should be. *Tax by Design* proposes a reform for the UK that addresses both these problems and would create what we call a ‘housing services tax’.

¹¹ 2006-07 figure. *Source*: Shaw, Slemrod and Whiting (2010).

¹² Lyons (2007), p. 226.

As previously noted, taxation of final consumption is generally accomplished by levying VAT when goods are initially purchased, but given where the UK starts from in the case of housing it could be better achieved by taxing the flow of housing services on an annual basis. A tax on the flow of services has the advantages that it can capture housing services that (for whatever reason) were not reflected in the initial price, and that it can be applied to the existing stock of housing with none of the transition problems associated with a VAT. Furthermore, an annual tax on housing services would be similar in operation to council tax, which would further reduce problems of transition.

In fact, a tax on housing services would bear an even closer resemblance to one of council tax's predecessors, domestic rates, which were charged as a percentage of the estimated rental value of properties. Interestingly, a reformed system of domestic rates is still in place in Northern Ireland, levied as a proportion of properties' 2005 capital values – though with various reliefs, and a cap that means that any property worth more than £400,000 in 2005 (in practice only a few thousand) is treated as though it were worth just £400,000.

A housing services tax (HST) should be levied as a simple, flat percentage of the rental value of each property, whether it is rented or owner-occupied.^{13,14} The average house price in England in 2012 was £256,000, according to the Office for National Statistics, and the average council tax bill in England in 2012-13 was

¹³ Economically, it is the annual rental value, rather than the capital value, of the property that is relevant. Rent represents the price of the consumption services in a particular period, whereas the capital price is the value of the asset. In a well-functioning market, the capital price will be the present value of the whole stream of future rental values. In a static economy, with constant rental values and no uncertainty, the relationship between them would, therefore, be a constant ratio reflecting the interest rate at which future rental values were discounted (for example, capital values might always be 20 times annual rental values), and taxing capital values would be equivalent to taxing rental values at a higher rate. However, this is not true if rental values are expected to change – and especially if rental values of different properties are expected to change differentially. If one property has the same current rental price as others but its rental price is expected to grow more quickly, then it will have a higher capital value than the others, so its current rental price will be a lower fraction of its capital value. In other words, rental values will be a lower percentage of capital values for properties whose rental prices are expected to rise more than others. Levying a tax as a percentage of capital value, rather than rental value, will therefore, over-tax properties that are expected to become more valuable (relative to others) and under-tax properties that are expected to become less valuable. In practical terms, however, where owner-occupation is the norm, capital values might be easier to assess than rental values. Policymakers, therefore, face a choice between what is economically preferable and what is practically preferable.

¹⁴ One immediate point to note is that such a tax should not be levied on any increase in property value resulting from improvements on which VAT has been levied. To do so would involve double taxation of improvements. This could, in principle, be avoided either by zero-rating such expenditure – spending on constructing extensions, for example – or by taxing only the consumption value of the 'unimproved' property. This latter solution seems wholly impractical over the long run. It would be odd indeed to be charging tax on a property in 2050 on the basis of its condition in 2013, for example. The former solution – not charging VAT on improvements – is preferable: the guiding principle should be that only those kinds of improvements that will affect the property valuation should be zero rated (or, in other words, valuations should only take account of improvements that were zero rated). Nevertheless, it may be difficult to define and police qualifying improvements in practice. This may be an area in which we have to accept some imperfection in the system.

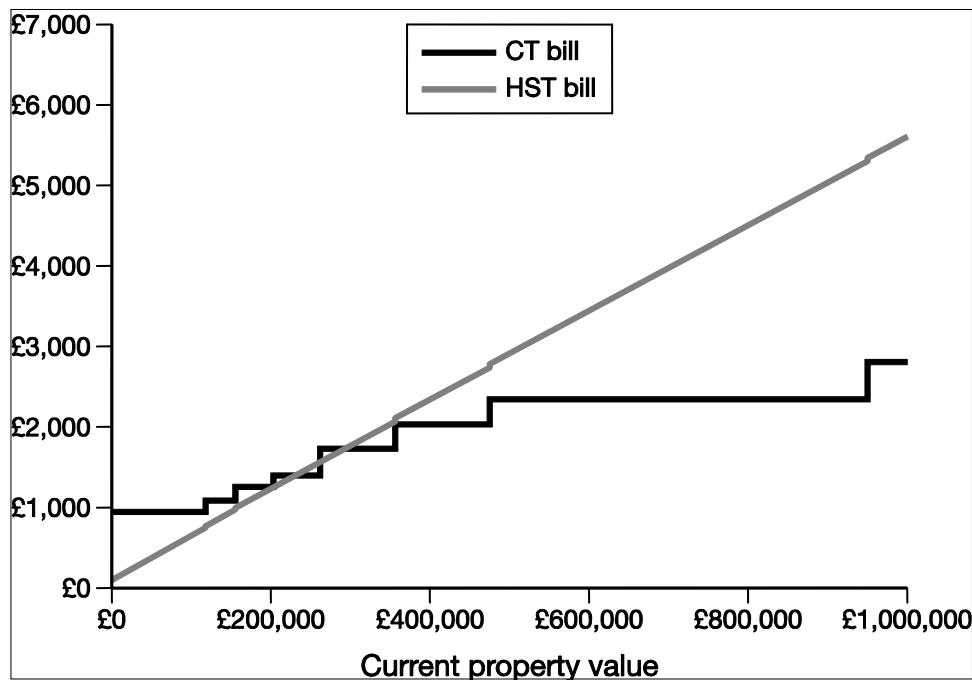
£1,201.¹⁵ This suggests that a tax of around 0.5 per cent of property value would leave the average bill unchanged and therefore be revenue neutral.¹⁶ If annual rental values are about 5 per cent of capital values, that would correspond to an HST rate of about 10 per cent of the value of housing services. However, the rate could also be increased to pay for the abolition of stamp duty on housing transactions, discussed at the end of Section 4. The volatility of stamp duty revenues makes it difficult to say reliably how much this would add to the HST rate, but it would still leave it somewhat below the UK's current 20 per cent VAT rate. In the long run, further increasing the HST rate towards 20 per cent might make sense, but given the windfall losses that that would entail and the political sensitivity of reforms to housing taxation, revenue neutrality with the current regime seems a more pragmatic medium-term goal.

Tax by Design modelled the effect of introducing an HST to replace the revenue from council tax alone in 2009–10. Figure 1 illustrates how tax bills would change. For houses with a market value less than about £250,000 – a large majority – tax bills would fall. Conversely, for houses with a market value above that, tax bills would rise. Note, however, that single-person households would see their tax bills rise at rather lower property values than £250,000, since they currently receive a 25 per cent discount on their council tax that is not shown in Figure 1. These would probably be reflected in generally modest changes in property values.

¹⁵ Average house price from Table 23 of Office for National Statistics, *House Price Index, March 2013* (<http://www.ons.gov.uk/ons/rel/hpi/house-price-index/march-2013/stb-march-2013.html>); average council tax bill from Communities and Local Government, *Council Tax levels set by local authorities in England: 2013 to 2014* (<https://www.gov.uk/government/publications/council-tax-levels-set-by-local-authorities-in-england-2013-to-2014>).

¹⁶ There is considerable uncertainty around this figure, however: different calculations based on various published statistics suggest different revenue-neutral rates, some higher and some lower than that used here. In any case, as discussed below, the revenue-neutral rate would have to be quite different in different years to yield the same revenue as council tax, since property prices rise and fall. For comparison, the rates levied in Northern Ireland in 2012–13 ranged from 0.59 per cent to 0.79 per cent of properties' 2005 value, depending on district. Ireland's new local property tax is set somewhat lower than this, at 0.18 per cent.

FIGURE 1 Comparing a Proportional Tax on Property Values with Council Tax (CT) in a Local Authority Setting Average Band D Rate in England, 2009-10



Note: Figures for council tax assume household not eligible for single-person discount and uniform growth of 185 per cent in property prices since April 1991.

Source: Mirrlees *et al.* (2011), Figure 16.1.

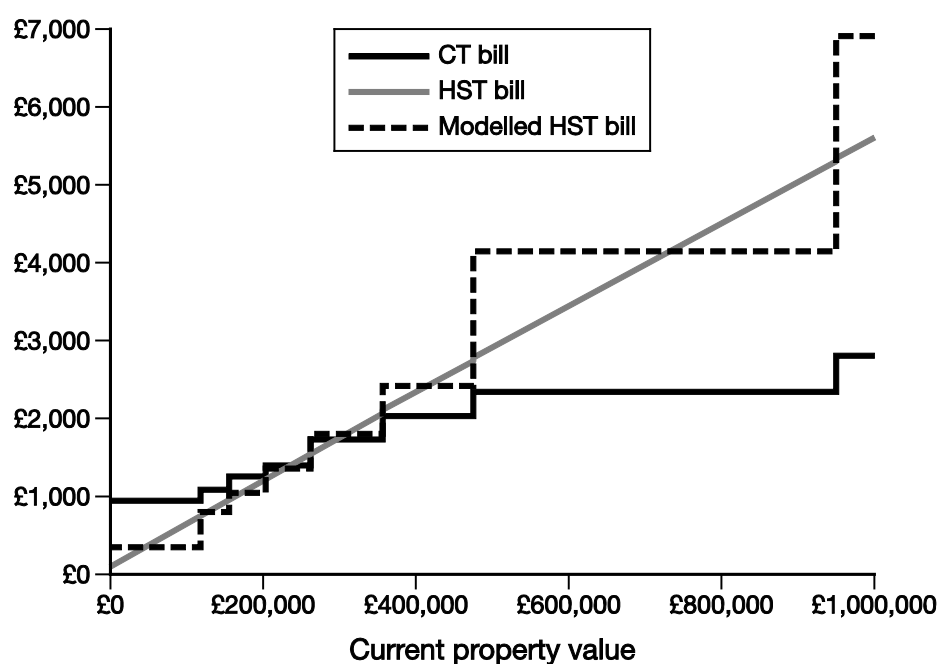
To be clear, there are four major differences between council tax and an HST:

- (a) Council tax provides discounts for single occupants and for second and empty properties. These encourage inefficient use of the housing stock (among other distortions). An HST would not have this feature.
- (b) Council tax band rates are not proportional to band values. This unfairly and inefficiently favours more valuable properties, and particularly the most valuable properties of all.
- (c) Council tax bills do not vary within bands. This again favours more valuable properties in each band. A pure HST would have taxes based on a continuous measure of value.¹⁷
- (d) Council tax bills are based on relative property values in 1991 rather than today. This unfairly and inefficiently favours properties that have seen above-average price rises since then.

¹⁷ There may be a case for some banding on administrative grounds, though note that this was not deemed necessary in Northern Ireland or under the old domestic rates system. The approach taken in Ireland's new local property tax, with a large number of relatively narrow bands and tax charged as a percentage of the mid-point of each band, seems like a reasonable, pragmatic approach.

Figure 1 does not take account of (d), since we lack comprehensive data on relative house price changes. To look more closely at the kind of households that would gain and lose from the reform, we must also ignore (c), since the data on household characteristics do not contain information on the distribution of property values within council tax bands. We therefore modelled an approximation, shown in Figure 2, in which the tax rate for each existing council tax band is adjusted to be proportional to the value of properties at the midpoint of each band (and in which the single-person discount is abolished) in a revenue-neutral way.¹⁸

FIGURE 2 Modelled Revenue-Neutral Reform to Housing Taxation



Notes: Assumes uniform growth of 185 per cent in property prices since April 1991. Figures for council tax assume household not eligible for single-person discount.

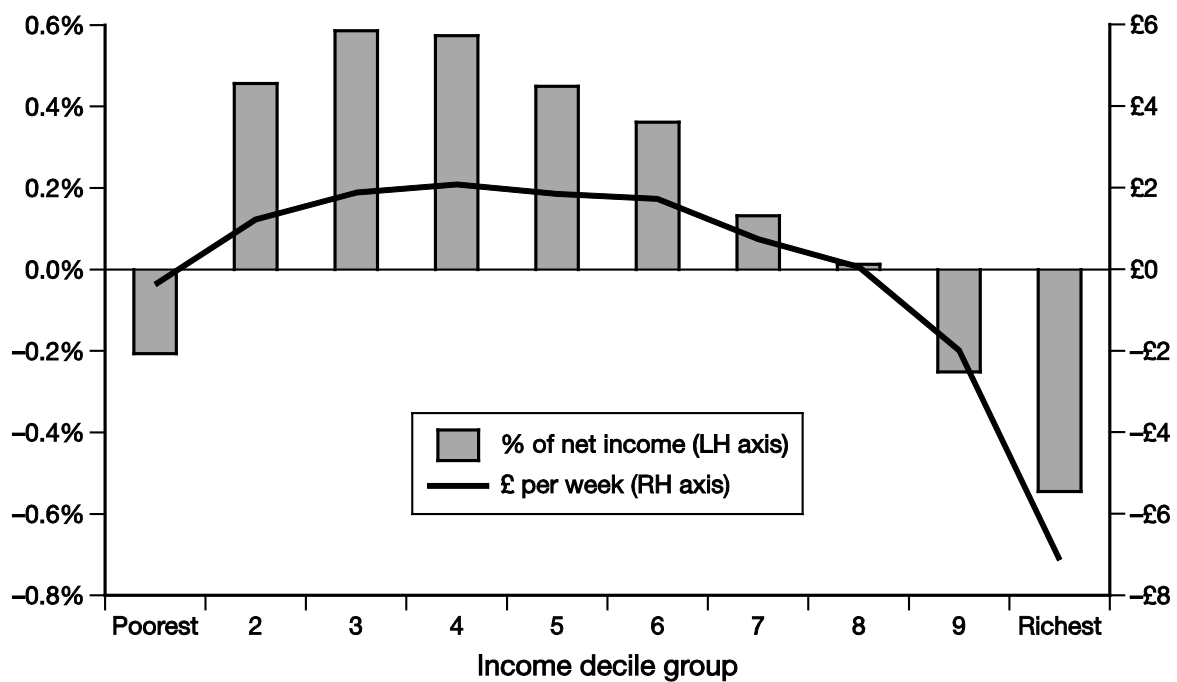
Source: Mirrlees *et al.* (2011), Figure 16.3.

Overall, a reform of this type would be progressive. In general, better-off people live in more expensive houses. Figure 3 shows that there are gains, on average, for households in the second to eighth income decile groups, with losses in the ninth and, especially, highest income decile groups. The average loss for the lowest income decile group requires a word of explanation, however. Most of those on the lowest incomes would be unaffected by the reform, as they are entitled to council tax support (and, we assumed, would be entitled to a

¹⁸ The top band, band H, has no midpoint; we assumed a value of £400,000 in 1991 – £80,000 above the bottom of the band, which is the same distance above the bottom as the band G midpoint is above the bottom of band G.

corresponding HST rebate) to cover their tax bill.¹⁹ Those on low incomes who are *not* entitled to council tax support are excluded from entitlement because they have too much financial wealth: those with non-pension financial assets of more than £16,000 are not eligible for council tax support.²⁰ The average loss for the bottom decile group reflects the fact that people with little current income but substantial financial wealth (and therefore not eligible for benefit) also tend to have big houses. They are low-income losers, but they may not be people we would ordinarily consider poor. These are issues to which I return later in the paper.

FIGURE 3 Gains/Losses Across the English Income Distribution from Modelled Reform to Housing Taxation



Note: Income decile groups are derived by dividing all households in England into ten equal-sized groups according to net income adjusted for household size using the McClements equivalence scale.

Source: Mirrlees *et al.* (2011), Figure 16.4.

While the reform is progressive on average, however, there would be many losers and gainers at all parts of the income distribution, as illustrated in Table 2. Housing consumption is far from perfectly correlated with current income, and while most of those in the lower council tax bands are in the lower half of the income distribution, a sizeable fraction of those even in the highest bands, especially pensioners, have low current incomes.

¹⁹ We assumed full take-up of these benefits, which means understating the progressivity of the reform since most of those who do not take up their benefit would see falls in their bills.

²⁰ Entitlement is also reduced for those with less wealth than this: each £250 (£500 for those aged 60 or over) of assets above £6,000 is assumed to yield £1 per week of income for the purposes of the means test.

TABLE 2 Average Gains/Losses and Numbers Gaining/Losing from Modelled Reform to Housing Taxation

	Average weekly gain/loss	% gaining > £5 per week	% losing > £5 per week
All-pensioner households	-£1.41	9%	13%
<i>Of which:</i>			
Lowest income quintile	-£0.35	4%	5%
2 nd income quintile	+£0.63	9%	3%
3 rd income quintile	+£0.31	11%	6%
4 th income quintile	-£0.52	11%	12%
Highest income quintile	-£7.10	9%	38%
Working-age households	+£0.49	25%	12%
<i>Of which:</i>			
Lowest income quintile	+£0.88	14%	4%
2 nd income quintile	+£2.72	34%	4%
3 rd income quintile	+£2.45	36%	8%
4 th income quintile	+£0.88	28%	13%
Highest income quintile	-£4.47	14%	28%

Note: Income quintile groups are derived by dividing all all-pensioner households in England, or all working-age households in England, into five equal-sized groups according to net income adjusted for household size using the McClements equivalency scale.

Source: Mirrlees *et al.* (2011), Table 16.2.

There would clearly be a large number of losers from a reform of this kind. The losers would include those, often older people, on low incomes who live in expensive houses. This does not undermine the logic of the reform: those living in expensive houses are consuming something valuable that, in other circumstances, we would not hesitate to tax. Such people are unlikely to be poor over their lifetimes, and taxing people in proportion to the full value of the property they occupy would lead to a more rational use of the existing housing stock. However, the existence of these losers would undoubtedly make such a reform politically difficult, and the concern over those living in expensive houses but without accessible cash with which to pay the tax is a genuine one. Simply appealing to the underlying fairness of the reform does not explain how they are supposed to pay the tax. Some options do exist: most obviously moving to a cheaper house, but also other possibilities ranging from formal equity release to taking in a lodger. But these options are limited and not always suitable, so there may be a case for an additional targeted policy response. Sections 4 and 5 of this paper explore two such responses that relieve the need to make the annual payment when cash is short: allowing deferral of payment (appropriate when the concern is current cash-flow) and forgiving the liability completely, as with the current system of council tax support (appropriate when the concern is the taxpayer's underlying ability to pay: not everyone living in a valuable property has high net wealth).

Political difficulties would also no doubt arise from the fact that a well-functioning HST would require a full revaluation of domestic properties (whether carried out by officials, as previously in the UK, or self-reported as with Ireland's new property tax) and a credible commitment to further revaluations at least every three to five years (perhaps with valuations updated annually according to local average house price indices in between revaluations). Each revaluation creates winners and losers according to whether particular properties have risen or fallen relative to the average. But this adjustment, of course, would be desirable even if we were to keep council tax.

Any property tax with regular revaluations will see the size of the tax base rise and fall as property prices generally rise and fall. If tax payments correspondingly rose and fell, some would consider that a good thing, acting as an 'automatic stabiliser' in the property market. Others would see the instability in bills as undesirable for households and the instability in revenue as undesirable for the government.

But it is not necessarily the case that tax payments would change in line with the tax base. At present, council tax rates are set locally, and there is no obvious reason for HST to be different: the fact that property has an identifiable and unchangeable geographic location makes it a natural tax base for the financing of local government. Under the current system of local government finance, bills would not rise and fall with prices. The revenue that local authorities must raise – and, therefore, the amount that households must pay – is simply the difference between what they wish to spend and the grant they receive from central government. If property prices rose, councils would simply reduce the tax payable at any given property value so that household bills, and the revenue generated, were unchanged. Grant from central government might be redistributed between areas if relative property prices changed, but what was gained by one would be lost by another; if total grants remained the same and total local authority spending remained the same, then total revenue to be raised from the local property tax (and so average bills) would also remain the same.

For a centralised property tax, revenues could potentially rise and fall with the property market – much as revenues from stamp duty land tax already do.²¹ But if this were thought undesirable, the government could prevent it by

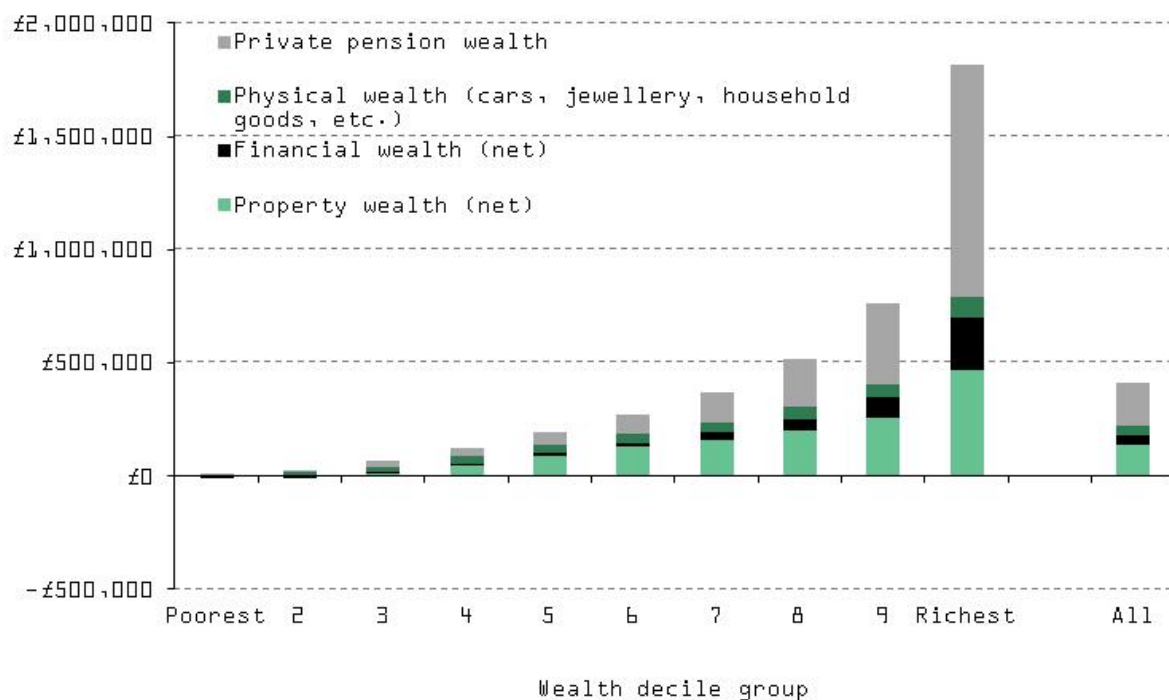
²¹ Though note that if local property taxes were simply replaced by, say, a local income tax as the main locally controlled tax, local income tax rates would rise and fall to keep revenue at the desired level exactly as described above for local property tax rates. Thus, the greater cyclicity of property tax revenues would be offset by reduced cyclicity of overall income tax revenues.

automatically adjusting tax rates to keep revenues on a stable path: a formula that tied the annual overall increase in payments to something like the historical long-run trend rate of house price growth might be one such revenue-stabilising mechanism.

3 TAXING HOUSING AS AN ASSET

Housing is an investment as well as a consumption good. In 2008-10 British households owned, on average, £136,000 of housing (net of mortgages), accounting for a third of their total wealth. Only pensions were bigger, at 46 per cent of wealth. Indeed, as Figure 4 shows, the middle 40 per cent of households (the 4th to 7th decile groups) have more net housing wealth than pension wealth, on average; but the richest decile group's pension rights are more than twice as valuable as their housing.

FIGURE 4 The Distribution and Composition of Net Household Wealth in Britain, 2008-10

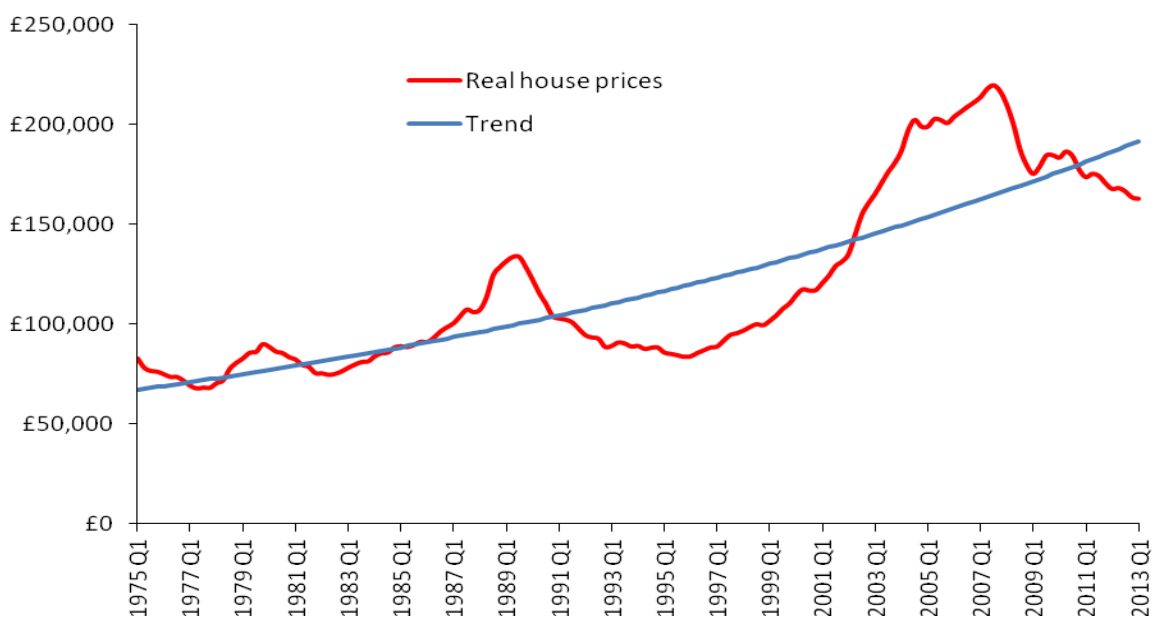


Note: Deciles are derived by dividing all households into 10 equal-sized groups according to their wealth.

Source: Figure 3 of ONS *Wealth in Great Britain Wave 2, 2008-2010* (Part 2) (<http://www.ons.gov.uk/ons/rel/was/wealth-in-great-britain-wave-2/2008-2010--part-2-/report--chapter-2--total-wealth.html>), divided by number of households from volume 1, page 4 of the *Wealth and Assets Survey User Guide* (<http://www.ons.gov.uk/ons/guide-method/method-quality/specific/economy/wealth-and-assets-survey/wealth-and-assets-survey---user-guidance/index.html>).

Figure 5 plots real house prices in the UK since 1975. It is clear from the figure that domestic property is an asset with a risky financial return. There are several periods of capital losses, most notably from 1989 through to 1995 and in the period since the autumn 2007 peak. Nevertheless, over the long run there are significant gains, with the trend line showing a real capital gain on housing of 2.8 per cent per year. Note that these gains are just part of the overall return to housing, which includes the return that comes in the form of housing services – a crucial point to which I return below.

FIGURE 5 Real UK House Prices and Trend from 1975 Q1 to 2013 Q1



Notes: Prices in 2013 Q1 terms, uprated using the retail prices index. Trend real growth rate is 2.8 per cent per year.

Source: Nationwide Building Society, http://www.nationwide.co.uk/hpi/datadownload/data_download.htm.

Many factors influence house price changes. In local areas, there are unforeseen changes in local services and amenities that affect prices. Similarly, there are changes in the number of households, in the number of houses, and in lending conditions in financial markets. Given the relatively fixed stock of housing, increases in the number of households and the granting of bigger mortgages can increase the demand for housing and therefore its price. House price growth has varied widely both between and within regions of the UK. Those who have been lucky – or perhaps particularly adept – in the property market have seen their wealth grow, tax free, by far more than others.

As with housing consumption, housing investment should fit coherently with a strategy for the tax system as a whole. But while in broad terms it is clear that

countries levy VATs to tax consumption, the framework for taxing assets is less clear and countries rarely adopt a wholly consistent approach.

There are a number of different kinds of tax on assets:

- Taxation of the net income flows associated with assets – the money used to buy an asset, the return generated by the asset and the sums extracted from the asset (in other words, the income tax and capital gains tax (CGT) treatment of savings).
- Taxation of stocks of assets (wealth taxes).
- Taxes on the sale and purchase of assets (transaction taxes such as the UK's stamp duties).
- Taxes on gifts and bequests of assets (wealth transfer taxes such as the UK's inheritance tax).

This paper does not discuss wealth transfer taxes. The arguments over the merits of wealth transfer taxation are complex and conceptually difficult (see Chapter 15 of *Tax by Design* for a discussion) but there is little to say about transfers of housing except that, if a country adopts a wealth transfer tax, there is no reason to exclude housing from it.

In what follows, I focus primarily on the appropriate income tax and CGT treatment of housing. I then briefly examine taxes on housing wealth and taxes on housing transactions, arguing that both are flawed ideas.

3.1 The Income Tax and Capital Gains Tax Treatment of Housing

The key to effective savings taxation is achieving neutrality across a variety of margins, including:

- *Consumption today versus consumption tomorrow.* Saving is deferral of consumption. Other things being equal, the government should aim not to penalise people for consuming tomorrow rather than today – that is, it should avoid discouraging saving.
- *Different assets.* Avoid distorting which assets people choose to buy. This includes the choice between rental and owner-occupied housing, as well as between housing and other assets.
- *Different income sources.* Taxing returns to saving differently from labour earnings provides opportunities to avoid tax by disguising earnings as investment returns, ranging from small company owners paying themselves

dividends rather than salary to the controversial use of ‘carried interest’ in the private equity industry, as well as the simple expedient of using one’s effort in ways that generate high investment returns rather than taxable earnings (such as working to identify good investments or to spruce up a property to increase its price).

- *Different forms of return.* Taxing capital income differently from capital gains again creates scope for avoidance and distorts behaviour such as whether investors seek income or capital growth in their investments and whether businesses choose to distribute their profits or reinvest them to build up the value of the business.
- *Different legal vehicles.* The legal framework for an investment – whether a landlord buys a property directly or through a property company or other vehicle, for example – should not be a decision taken for tax reasons.
- *Varying inflation rates.* Even modest inflation rates significantly increase the effective tax rate on the real returns to saving. When inflation rates vary over time, a tax system that does not allow for inflation discourages saving to radically different extents at different times.

The current UK tax system achieves none of these. *Tax by Design* argues that it could do much better.

Savings tax regimes can be characterised according to the tax treatment at three stages of the life of the asset: first, the income used to buy the asset; second, the returns generated by the asset (such as interest, capital gains or distributable profit); and third, the funds extracted from the asset (such as when funds are withdrawn from an account or an asset is sold). We describe each stage in the life of the asset in which savings are invested as taxed (T) or exempt from tax (E).

Applied to the case of housing, the elements of this taxonomy are as follows:

- Income saved means the income used to buy the property (which is equal to the cost of buying).
- Returns generated take two forms: income from the consumption services provided by the property (either rental income received by landlords or the in-kind reward enjoyed by owner-occupiers) and any capital gain (or loss).
- Withdrawals include both the consumption services (which are, by their nature, ‘withdrawn’ and consumed at the same time as the property generates them) and receipts from selling the property.

Using this framework, we can distinguish four archetypal approaches to taxing saving, and locate the UK's current tax treatment of housing within them.

1. **Earnings tax (TEE).** In this case, labour earnings are taxed (T) irrespective of whether they are then saved, and any saving thereafter is ignored: there is no tax on returns to saving (E) and no tax on withdrawal of funds (E). This is generally how social security contributions work – they are levied only on labour earnings and simply ignore savings. In the UK, it is also how income tax and Capital Gains Tax (CGT) treat tax-privileged Individual Savings Accounts (ISAs). And it is how owner-occupied housing is treated: it is bought out of taxed income, but no tax is payable on any returns or at the point of sale.²²
2. **Standard income tax (TTE).** As with the earnings tax, savings are made out of taxed income (T). But this time all returns – (nominal) capital income and capital gains – are taxed (T). No further tax is due when the savings are withdrawn (E). In the UK, this is the tax treatment applied to ordinary interest-bearing accounts and shares held outside ISAs. It is also how rental housing is taxed, with tax levied on landlords' net rental income and capital gains.
3. **Cash-flow expenditure tax (EET).** An expenditure tax involves giving a tax deduction for income that is saved rather than spent (E). Nor is there any tax levied as returns accumulate (E), until the funds – representing a combination of principal and returns – are extracted from the asset ready to spend, at which point they are taxed (T). Taxing the cash people receive (from earnings or withdrawn from savings) less what they put aside for the future amounts to taxing income used for consumption at the time it is spent. This is broadly how private pension saving is taxed.²³
4. **Rate-of-return allowance (TtE).** Under the rate-of-return allowance (RRA) system recently devised by the Danish economist Peter Birch Sørensen, savings are made out of taxed income (T), but only some returns to those

²² Here and below, I use 'owner-occupied housing' to mean principal private residences. Capital gains on second homes are taxable, though there is some flexibility in designating which is one's main home.

²³ Subject to some limits and complications, such as the ability to withdraw 25 per cent of the fund as a tax-free lump sum in the UK. Note that EET also describes the implicit tax treatment given to time spent investing in 'human capital' rather than working. There is no tax levied on the earnings forgone to undergo (say) education or training, since those earnings simply do not arise (E); and the returns to this investment in the form of greater skills etc. are not taxed (E) until they are monetised as earnings, at which point the higher earnings an individual commands by virtue of his or her extra skills give rise to correspondingly higher taxes (T).

savings are taxed (t): the RRA is an amount equal to a 'normal' (risk-free) return on the purchase cost of the asset, which can be deducted from actual returns on the asset (investment income or capital gains), with tax levied only on any remaining 'excess' returns. No further tax is due when the savings are withdrawn (E). This has never been implemented in the UK, but has been introduced in Norway for taxation of shareholders.

If combined with equalisation of statutory tax rates across all forms of income and capital gains, and if those tax rates are stable, it can be shown that consistent application of either an EET or TtE tax base can achieve neutrality in all the dimensions mentioned earlier. In fact, EET and TtE are closely related. For any given investment, they yield the same present value of tax payments: all that differs is the timing, with EET giving upfront tax relief for the amount saved and TtE giving an equally valuable stream of tax allowances each year. In both cases, saving is not discouraged since there is no net tax levied on saving that yields just a 'normal' return (the return needed to make saving in that asset worthwhile).²⁴ But in both cases, the government captures a share of any returns in excess of that (with the remainder of the excess still enough to make the investment attractive); and since each *additional* £1 of return is taxed at full labour income tax rates regardless of the form it takes, there is no scope for reducing tax liabilities by converting income from one form to another.

TEE achieves neutrality across all these dimensions except that, since it leaves even 'excess' returns untaxed, it is not neutral across different forms of income: tax can be avoided by converting taxed labour income into untaxed capital returns. TTE explicitly departs from neutrality between consumption today and tomorrow, but it also makes neutrality difficult to achieve across most of the other dimensions (because of problems such as failure to index for inflation and the need to tax capital gains when assets are sold rather than when the rise in value occurs, neither of which turns out to cause problems for the other approaches discussed).²⁵

The difference in tax treatment between owner-occupied housing (TEE) and rental housing (TTE) in the UK creates a major bias in favour of owner-occupation, albeit less so since the tax-deductibility of mortgage interest payments was

²⁴ In well-functioning capital markets, the return available on risk-free assets (excluding any implicit charge for financial services that may be built in via interest rate spreads) will be equal to the return required to induce people to save an extra £1 and to the marginal time value of money (the interest rate used to make present value calculations) for everybody. In normal times it might be approximated by the interest rate on government bonds (gilts).

²⁵ These properties of the different systems are explained in Chapter 13 of *Tax by Design*.

gradually removed for owner-occupiers but retained for landlords (see Box 2 below). The treatment of owner-occupied and rental property should be levelled out. Ideally, the taxation of owner-occupied and rental property should be aligned, not only with each other, but with the taxation of other assets as well. Clearly it is impossible to make the treatment of housing consistent with all other assets when other assets are not treated consistently with each other. Ultimately what is required is a coherent, unified approach to the tax treatment of all savings. Such an approach is proposed in *Tax by Design*, but is beyond the scope of this paper, where our focus is specifically on housing. But in any case, when seeking to align the taxation of different assets, the priority should be to achieve neutrality between assets that can most easily be substituted for each other, and owner-occupied and rental housing are presumably closer substitutes for each other than they are for other assets.

Neither the TEE treatment currently applied to owner-occupiers nor the TTE treatment applied to landlords seems appropriate for housing. TTE straightforwardly penalises saving: investing in buy-to-let housing is currently discouraged by the UK tax system for no good reason, to an extent that varies arbitrarily with the rate of inflation and with particular distortions in the taxation of capital gains. TEE does not discourage saving in this way. But since TEE exempts not just the normal return to capital saved but the entire return, it fails to capture any excess return that may arise as a result of sheer luck, rents earned, or effort and skill put into identifying undervalued properties and improving them. The deficiencies of this are most clearly seen by noting that a TEE treatment of all housing would entail leaving professional property investors, who make their living seeking these excess returns, entirely untaxed. If I buy a house that I then sell at profit, reinvesting, selling, and so on, under a TEE regime I would never be subject to tax despite the fact that I am clearly earning an income in this way.

We have observed that either an EET expenditure tax or a TtE rate-of-return allowance (RRA) can tax excess returns while leaving the normal return to capital untaxed and therefore not discouraging saving.

An EET expenditure tax treatment of housing – allowing houses to be bought out of pre-tax income and then taxing any value extracted from them (actual or imputed rental income and proceeds of sale) – would in principle avoid the problems of both TTE and TEE, but in practice is not appealing. It would mean that someone buying a house outright would have the entire purchase price deducted from their taxable income for the year. Since houses normally cost far more than a year's income, this would mean the person made a large loss for tax

purposes that year, resulting either in a negative tax bill (a refund from the government) or in losses to be carried forward and set against income for several future years, depending on the tax treatment of losses.²⁶ Creating losses on such a monumental scale is something no tax authority would entertain as a practical proposition.

Tax by Design, therefore, argued that a TtE rate-of-return allowance provides the most promising avenue for reforming the taxation of housing as an asset in the UK. Recall that an RRA regime involves assets being acquired out of taxed income and only returns above a 'normal' (risk-free) rate being taxed.

Introducing an RRA for rental property would be fairly straightforward. It could be based on the existing system, taxing both rental income and capital gains; but landlords would now be able to claim an allowance for the normal return on their investment. This allowance could take one of two forms:

- (i) In the purest form of RRA, an allowance of 5 per cent (say) of the purchase price would be deductible against rental income each year. When the property was sold, CGT would be charged at the taxpayer's marginal rate on the full nominal gain.
- (ii) Alternatively, rental income could continue to be taxed in full, as at present. But when the property was sold, the base price for calculating CGT would be stepped up by 5 per cent per year (appropriately compounded).

These methods differ only in the timing of the allowance given; the government could choose between them or else allow each individual to choose for themselves. Method (ii) is equivalent to the landlord simply not claiming the annual allowance available in (i) but instead carrying it forward with interest and claiming it at the point of sale. Note that if a property yielded exactly the normal return, method (ii) would generate a CGT *refund* when the property was sold, with the same present value as the stream of taxes paid on rental income. In practice, housing has tended to yield more than a normal return in the UK, but method (ii) would still imply substantial refunds in many cases. This generation of widespread losses (albeit on a far smaller scale than with EET treatment) may be off-putting for revenue authorities; on the other hand, method (ii) has the

²⁶ The outcome would not be this stark in all cases. Once an EET system had bedded down, those selling one house and buying another would see the sale and purchase offset each other, so they would only pay tax (or receive a refund if downsizing) on the difference in price between the two properties. If EET treatment was also applied to mortgages those taking out a mortgage to finance a house purchase would receive a deduction only for the non-mortgage-financed part of the purchase.

advantage of being closer to current UK practice and therefore raising fewer transitional difficulties.

To illustrate how an RRA might work, suppose it costs me £200,000 to buy a house and that the rental income from it is initially £10,000 a year. With a normal return of 5 per cent, my allowance on method (i) – 5 per cent of the purchase cost, or £10,000 – cancels out this return for tax purposes and I pay no tax. If the rent then rises to £11,000, my allowance is still £10,000, so I pay tax on £1,000's worth of housing services; if I sell the house for £220,000, I pay tax on £20,000 of capital gain. The equivalent alternative, method (ii), would be to tax the whole income of £10,000 or £11,000 each year, but only tax any capital gain above a carried-forward allowance. After ten years, tax would be paid on any capital gain over about £126,000²⁷ in this case, with anything less than this treated as a loss.

An RRA could be implemented for owner-occupied housing in the same two ways as for rental housing. The calculation above would work in exactly the same way, except that instead of an actual rental income there would be an imputed rental income. So, to be clear:

- (i) Imputed rental income could be taxed only where it exceeds 5 per cent (say) of the purchase price, with CGT charged at the taxpayer's marginal rate on the full nominal gain.
- (ii) Imputed rental income could be taxed in full – in effect adding the homeowner's marginal income tax rate to the HST rate – with CGT charged only on gains relative to a base price that was stepped up with interest.

Of course, it would be harder to introduce an RRA for owner-occupied property than for rental housing. The most obvious problem is that a large part of the return – the consumption services provided by the property – is received in kind rather than in cash, and is therefore difficult to value – though it is exactly the same valuation that is needed for the HST proposal set out above. The same valuation could therefore be used for both purposes, although this would put an extra premium on ensuring valuations were accurate.²⁸

²⁷ The purchase price stepped up with interest would be $£200,000 \times 1.0510 = £325,779$, so tax would be payable on gains above £125,779.

²⁸ As with the HST (see footnote 13), the taxation of improvements poses something of a problem. Spending on improvements is essentially additional investment in the property, generating returns in the form of higher (actual or imputed) rental income and capital gains. Strictly speaking, it should therefore be added to the purchase price in calculating the basis for a rate-of-return allowance (though an alternative would be to treat spending on improvements as an immediately deductible expense, in effect giving EET treatment of improvements.) This is similar to the current treatment of improvements to rental property in the UK: spending on improvements above a certain

It is important to note the relationship between this proposal and the HST proposal. An HST, like a VAT, is designed to tax the consumption of housing itself. An RRA is designed to tax the consumption that a property purchase *finances* – whether that be consumption of the housing services themselves or whatever the cash from renting or selling the property can buy – but only in so far as it exceeds the consumption that the money used to buy the property would ‘normally’ be expected to finance. Tax is only paid in so far as a house delivers and finances more consumption than the money used to purchase it: if housing yields only a normal return, no tax is payable.

Starting from the UK’s current position, method (i) looks much less attractive for owner-occupied property than for rental property. CGT already exists for rental property. But introducing it in full for principal residences might discourage people from selling their property if they believed there was a significant chance that the new tax would be abolished by a future government.²⁹ The fact that a reform could be presented as bringing housing within a consistent tax regime applying to all assets might help persuade people of its durability, but there is little doubt that such a change could only be feasible with the sort of political consensus in its favour that currently looks very distant. Method (ii) may not suffer from this problem, since the expected CGT bill would be much smaller – indeed, negative in many cases. Rather, the downside of method (ii) is the political unpalatability of proposing to tax the annual consumption value of housing not just at the HST rate (offsetting the abolition of council tax and stamp duty land tax on average) but additionally at the homeowner’s marginal income tax rate. Building a consensus around one of these options is important if we are to move towards a fair and efficient tax system. But the challenges involved should not be underestimated.

level is recorded and reported and netted off the capital gain when CGT liabilities are calculated (though note that the spending ought to be carried forward with interest, in line with method (ii) of implementing an RRA described above). However, extending this (not very heavily policed) regime from a relatively small number of such properties to the vast bulk of the population would involve very substantial additional administrative complexity. In particular, recall that the implicit rental income from owner-occupied housing is imputed (rather than observed), based on a valuation that may not take account of all improvements. If the return to such improvements in the form of higher implicit rental income is not taxed, the cost of those improvements should not generate a deduction against the tax on imputed income – just as we argued that improvements that do not affect valuations for the HST should not be zero rated for VAT. But all improvements will presumably affect the actual sale price of the property, so the returns to improvements will be subject to CGT at that stage and some deduction for the cost of improvements is warranted. The correct – rather complicated – treatment is for improvements that do affect valuations to be registered immediately (either deductible immediately, or added to the basis for the RRA, or carried forward with interest and netted off the capital gain) and for improvements that do not affect valuations to be ignored initially but netted off the capital gain (without interest being added) when the property is sold.

²⁹

This is the same kind of consideration that has undermined attempts to introduce development taxes in the past.

Introducing an RRA regime for rental properties would be feasible, sensible, and relatively inexpensive.³⁰ Introducing an RRA regime for owner-occupied housing as well would be ideal: it was surely inappropriate that the enormous returns enjoyed by homeowners during the long property boom up to 2007 went untaxed. But this would be much more difficult and may be politically impossible in practice. Even if owner-occupied housing continued to be subject to the present TEE regime, however, bringing in a rate-of-return allowance for rental property and aligning CGT rates with income tax rates would be a major improvement. It would bring the tax regimes for rented and owner-occupied housing much closer together, completely eliminating the bias towards owner-occupation for property that generated a normal return. It would also bring the taxation of rented housing into line with *Tax by Design's* proposals taxation of other assets.

Box 2: The Tax Treatment of Mortgages

The tax treatment of mortgages can be characterised in terms of the same three stages as other borrowing and saving, with the same main options for charging tax at a combination of these stages:

TEE – an earnings tax simply ignores all borrowing and saving. Neither taking out a mortgage, nor making payments of interest or principal, has any effect on tax liability.

TTE – a comprehensive income tax treatment of mortgages would allow full deductibility of mortgage interest from taxable income (but not add the amount borrowed to taxable income or deduct repayments of principal), just as it would fully tax interest income on savings. A comprehensive income tax thus taxes saving and subsidises borrowing.

EET – a cash-flow expenditure tax involves taxing all cash inflows and deducting all outflows, hence adding the loan to taxable income for the year when it is taken out and then deducting all payments of interest and principal.

TtE – a rate-of-return allowance regime would allow deductibility of mortgage interest payments, like TTE, but only in so far as they exceeded a 'normal' rate of interest on the outstanding mortgage. (Unlike with TTE, there would be no difference in present-value terms between making interest payments and making

³⁰ The precise cost is difficult to estimate. *Tax by Design* estimated that, if 2009–10 tax rates were applied to 2006–07 taxable property income and gains on disposal of property, total revenue would be about £3.5 billion; an RRA would only involve giving up that part of the £3.5 billion that reflects normal returns. However, the overall reform package would also involve increasing tax rates on property income and capital gains to align them with full labour income tax rates (including what are currently National Insurance contributions); this implies collecting more revenue from taxing 'excess' returns but forgoing more revenue by not taxing 'normal' returns.

repayments of principal. If a payment were labelled interest, it would be deductible; if it were labelled principal, it would not be deductible but, by reducing the value of the outstanding mortgage, it would reduce the stream of 'normal' interest allowances to offset against future interest deductions.)

In the UK, mortgages taken out on rental properties are given a TTE treatment: mortgage interest payments are treated as a business expense to be deducted against rental income, just like companies can deduct interest payments from their profits for corporation tax purposes. This is an appropriate counterpart to the current TTE treatment of rental housing itself.

Mortgages for owner-occupied housing were formerly also given TTE treatment. This may have been appropriate when (prior to 1963) the imputed rental income from owner-occupation was taxed under 'Schedule A' income tax; but once owner-occupied housing was itself given TEE treatment, continuing to allow mortgage interest deductibility led to a huge net subsidy for owner-occupied housing. To their credit, successive governments responded to this by gradually restricting mortgage interest tax relief, and between 1974 and 2000 this relief was phased out entirely. The resulting TEE treatment of mortgages for owner-occupiers now matches the TEE treatment given to owner-occupied housing itself.

The current tax treatment of mortgages is therefore appropriately aligned with the current tax treatment of housing as a whole for both the owner-occupied and rental sectors. In this paper, however, I argue for reform of the existing system, moving towards TtE taxation of rental (and, ideally, owner-occupied) housing. How should the taxation of mortgages be adjusted in line with this? Two approaches are consistent with our proposed direction of reform:

TEE treatment – ignoring mortgages entirely in the income tax system – would certainly be appropriate for owner-occupiers if owner-occupied housing continued to have TEE treatment; but it would also be a simple and viable option for mortgages on (rental or owner-occupied) properties that were given TtE treatment. Relative to the current tax treatment of mortgages, this would simply mean abolishing mortgage interest deductibility for landlords.

For housing investment that was given TtE treatment, an alternative would be to give TtE treatment to loans secured against that property. TtE on the property would involve taxing (actual or imputed) rental income and capital gains above an allowance for a normal return on the purchase price, while TtE on the mortgage would involve deducting mortgage interest above an allowance for 'normal' interest on the outstanding mortgage. Taking the property and the mortgage together, this means taxing rental income and deducting mortgage interest

payments, as happens for landlords now, while giving a rate-of-return allowance (RRA) against the purchase price net of outstanding mortgage.

TtE treatment of mortgages might be the more obvious counterpart to TtE treatment of the housing itself. But TEE has the advantage that it taxes the financial service provided by mortgage lenders. As a form of implicit charge for their services, lenders may demand more than a normal rate of interest on the mortgages they provide. Under TEE, this charge for financial services is a private matter between borrower and lender, like the provision of any other service. But under TtE, with mortgage interest above a normal rate tax deductible, the Exchequer provides the borrower with an income tax deduction for the financial services supplied to him/her. If we do not wish the consumption of financial services to be tax deductible – and there is no obvious reason to privilege financial services in this way – this gives a reason for preferring TEE treatment of mortgages. Other than this, there are no strong grounds for choosing between the TEE and TtE treatments of mortgages on TtE housing. The choice could be mandated by the government or left for borrowers and lenders to decide.

3.2 Taxing Housing Wealth

Housing is a major component of household wealth, and if one wanted to tax wealth it is hard to see any reason to exclude housing from the measure of wealth. But equally, housing is only one component of wealth, and it is hard to see a principled reason why one would want to tax housing wealth without taxing wealth in general. Taxing people whose wealth was in housing more heavily than equally well-off people whose wealth was held in different forms would seem both inequitable and liable to distort people's choice of assets as people put their wealth into less penalised forms in order to avoid a tax charge.

In practical terms, a wealth tax is not appealing. In the case of owner-occupied housing, valuation poses similar difficulties whether we want to tax (imputed) income flows or capital values. However, for many other assets the associated income flows can be observed and measured much more easily than the assets themselves can be valued: such assets include (among others) rental property, pensions, unquoted shares, unincorporated business assets, and 'human capital'. Furthermore, some kinds of financial assets, particularly those held disproportionately by the wealthy, can be moved overseas to escape taxation. As Hills *et al.* (2013) note, "In some countries a recent abandonment of taxes on wealth has come about, at least overtly, because of the difficulty of collecting the tax in a world of mobile capital." So a tax on housing wealth alone would be problematic, while a broader-based wealth tax would pose serious practical difficulties compared to taxing income flows.

Even in principle, however, the case for a recurrent (for example, annual) wealth tax is weak.³¹ The stock of wealth and the return to wealth are closely related. If all savings earned the same rate of return, a tax on the stock of savings would in fact be exactly equivalent to a tax (at a higher rate) on the return to savings. If the rate of return is 5 per cent, then either a 1 per cent tax on wealth or a 20 per cent tax on the return to saving will raise £1 for each £100 of savings (1 per cent of the £100 wealth or 20 per cent of the £5 return, respectively). The difference in principle between a tax on assets and a tax on asset returns, therefore, lies entirely in how they treat assets that yield unusual returns. To continue the above example, if I am lucky enough that my £100 earns a 10 per cent return, then a 20 per cent tax on that return will raise £2 from me, whereas a 1 per cent wealth tax will still raise £1 regardless of the return I earn. It is hard to think of any reason that we would not want to levy more tax on assets that yield higher returns: such high-return assets are precisely the ones that people will buy even if they are more heavily taxed, so focusing the tax on those assets would be less distortionary. A wealth tax discourages me from saving, but it taxes me no more if I manage to earn extremely high returns on my savings. It is therefore inferior to a tax on asset returns. Indeed *Tax by Design* goes further: as discussed above, it argues in favour of exempting a ‘normal’ return to savings but taxing ‘excess’ returns (for example, through a rate-of-return allowance). A wealth tax would therefore be a move in exactly the wrong direction.

3.3 Taxing Housing Transactions

The final kind of tax on assets I consider is taxes on transactions: specifically, the stamp duty land tax (SDLT) that the UK government levies on property transactions. Both the UK’s current coalition government and its Labour predecessor have repeatedly turned to increasing SDLT as a revenue raiser. Charged at a flat rate of 1 per cent on property sales above £60,000 (half of all sales) when Labour came to power in 1997, it is now charged on sales above £125,000 (just over half of sales) at rates rising from 1 per cent on sales up to £250,000 to 7 per cent on sales above £2 million.³² This transformation of stamp duty is illustrated in Figure 6. While still providing only a small share of revenue, that share has grown dramatically, pushed by rapid property price rises up to 2007 as well as rate increases. Stamp duty revenue from residential property rose from £0.8 billion (0.26 per cent of total government revenue) in 1997-98 to a

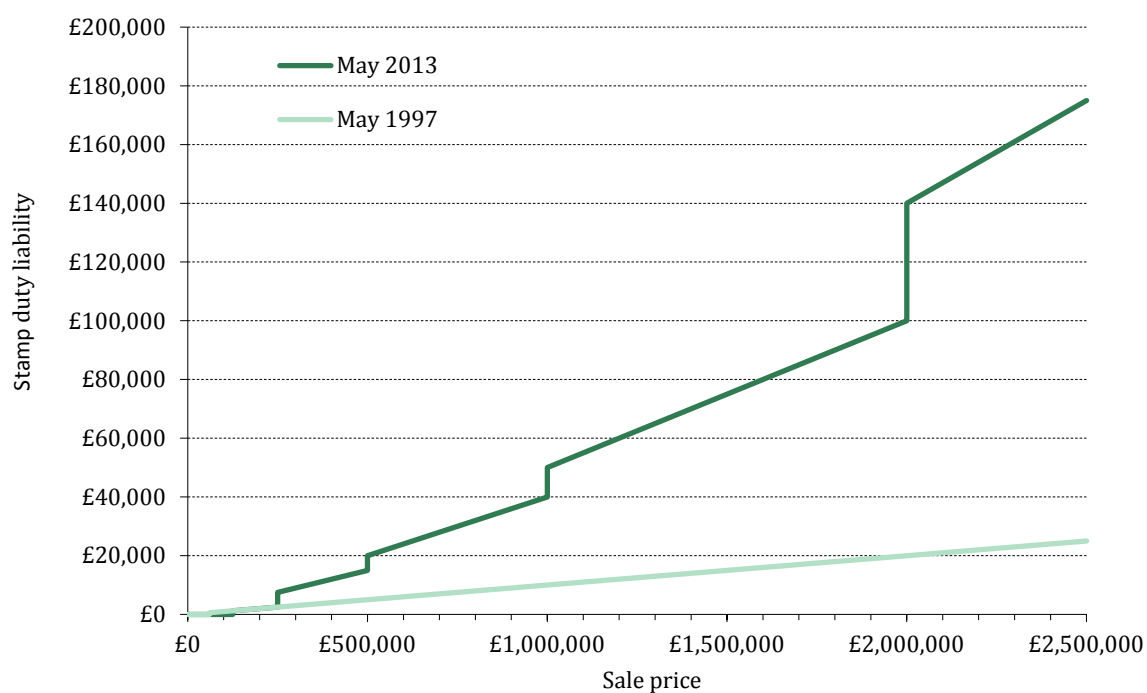
³¹ A one-off wealth tax raises different issues, discussed in Section 9.9 of Adam, Emmerson and Roantree (2013).

³² Proportion of sales liable to stamp duty from HMRC Statistics table 16.5 (<http://www.hmrc.gov.uk/statistics/transactions/table16-5.pdf>; 1997–98 figure from archived version at http://webarchive.nationalarchives.gov.uk/20070108133141/http://www.hmrc.gov.uk/stats/survey_of_prop/table16-5.pdf).

peak of £6.7 billion (1.22 per cent of revenue) in 2007-08, and in 2011-12 stood at £4.2 billion (0.74 per cent of revenue).³³

Stamp duty has a long history in the British tax system, having first been introduced in 1694. It stems from a time when few other potential taxes were straightforward to implement, whereas the transactions on which stamp duty was levied were easy to identify and to measure. But in the modern era of broadly based taxation, the case for maintaining stamp duty is very weak indeed.

FIGURE 6 Stamp Duty Land Tax Rates in the UK



SDLT is a strong contender for the UK's worst-designed tax. Its structure is especially perverse because (unlike, say, income tax) the relevant rate applies to the full sale price, not just the part above the relevant threshold. So a house selling for £2,000,000 would attract tax of £100,000 (5 per cent of £2,000,000), whilst a house selling for £2,000,001 would attract tax of £140,000 (7 per cent of £2,000,001) – a £1 increase in price triggering a £40,000 increase in tax liability. That is, of course, an absurd structure for any tax. Transactions of very similar value are discouraged to completely different degrees and there are enormous incentives to keep prices just below the relevant thresholds. At a bare minimum,

³³ Source: Residential stamp duty revenues from HMRC Statistics table 15.2 (<http://www.hmrc.gov.uk/statistics/stamp-duty/table15-2.pdf>); total public sector receipts from HM Treasury, *Public finances databank December 2012* (http://www.hm-treasury.gov.uk/psf_statistics.htm).

the UK government should move away from this 'slab' structure for SDLT, as the Scottish government is proposing to do with its newly acquired autonomy over the SDLT system for Scotland.

But there is a more fundamental flaw with SDLT. One of the most basic tenets of the economics of taxation is that transactions taxes should be avoided. There is no reason to impose a heavier tax on those properties that change hands more often. Assets should be held by the people who value them most: the effect of a transactions tax such as SDLT is to discourage mutually beneficial transactions. If a family in a small house want to move to a larger one (because they are having children, for example) while a neighbouring family in a large house want to move to a smaller one (perhaps because their children have grown up and left home), SDLT might discourage them from buying each other's houses, leaving both families worse off. At a macroeconomic level, one manifestation of this is to reduce labour mobility, as people are discouraged from moving to where suitable jobs are available. The introduction of a 7 per cent SDLT rate on transactions above £2 million has taken the discouragement of mutually beneficial transactions to new heights of absurdity: the average SDLT bill for sales subject to this rate was expected to be around £270,000³⁴ – more than the UK average house price. In other words, if the two parties to the transaction decided not to go ahead, the tax they saved would be enough to buy an entirely new house and still have money left over.

There is no sound case for maintaining stamp duty; it should be abolished. Simply removing it would create windfall gains for existing homeowners (removing the tax on property transactions would increase the amount that future buyers were willing to pay for properties, making them more valuable); so a reasonable quid pro quo for its abolition is that a similar level of revenue should be raised from other, more sensible, property taxes. If stamp duty were phased out while our proposed housing services tax were being brought in, then those losing most through the latter change would be among those gaining most as a result of the former (except if some high-value properties are traded relatively infrequently). Revenue neutrality would at least ensure no windfall gains or losses on average.

³⁴ Budget 2012 estimated that the introduction of the 7 per cent rate would raise £235 million in the absence of behavioural response (page 23 of http://cdn.hm-treasury.gov.uk/budget2012_policy_costings.pdf) and that “...there are currently around 3,000 residential property transactions per annum at over £2 million” (<http://www.hmrc.gov.uk/budget2012/tiin-2138.pdf>). That would imply an average tax increase of around £78,000 per property. If a tax rise of 2 percentage points (from 5 per cent to 7 per cent) corresponds to an average tax rise of £78,000, that implies that the full 7 per cent tax bill would be $(7/2) \times £78,000 = £274,000$ – though the degree of rounding involved (particularly in the 3,000 figure) means that this figure should only be considered approximate.

4 DEFERRAL OF HOUSING TAX PAYMENTS

Housing has important advantages as a tax base. Ownership is generally visible and easily established, which makes it relatively straightforward to identify who should be paying the tax. Its immobility makes taxes on housing difficult to escape. And the supply of (and demand for) housing is not very responsive to its price, which means that taxing it does little to distort people's behaviour.

But owner-occupied housing also has disadvantages as a tax base. In particular, the fact that the housing income/consumption takes the form of a stream of services rather than a cash flow both makes the income/consumption flow difficult to measure and means there is not necessarily any cash from which to pay the tax. This latter problem leads to the familiar concern around how housing-rich, cash-poor people are expected to pay the tax.

In principle, allowing deferral of housing tax liabilities in certain circumstances has much to commend it. It can address the concern that people may not have the cash-flow with which to pay the tax, without giving expensive blanket exemptions that encourage people to tie up their money in illiquid forms as a way of getting support.

The purpose of offering deferral is to deal with situations where the taxpayer is not permanently poor – they own a valuable property, after all – but rather lacks the liquidity (cash) to pay the tax right now without resorting to radical measures such as having to sell the home and move somewhere else. Those whose difficulty in paying the tax reflects an underlying lack of resources, rather than a temporary lack of cash-flow, should receive outright support for their housing tax (and perhaps their housing costs more generally) as part of the general system of benefits for those whose resources are insufficient to cover their needs, discussed in Section 5 below.

It is crucial that any deferral be with interest. This maintains the present value of the tax liability, so that there is no overall cost (or benefit) to the government – and so that a taxpayer who could afford to pay the tax upfront gets no great benefit from deferral. If the problem is lack of current cash-flow, essentially the government's role is to provide a loan of the tax liability. Such government-provided loans should be on as close as possible to a commercial basis. Giving interest-free loans to people who might be perfectly well off would be a costly and inefficient use of taxpayers' money, and would encourage people (including those who do not really need loans) to take advantage of the scheme and profit from as large a loan, for as long a period, as possible. The government's exposure

could potentially be large. If deferral is with interest, there is less (if any) incentive for taxpayers to take it up unnecessarily, and there is less (if any) net long-term cost to the government if they do so. The government can, therefore, afford to be more relaxed about the conditions under which deferral is offered.

The minimum requirement for deferral to be allowed should be that the taxpayer has equity in the property itself, which essentially acts as collateral for the loan. Deferral would therefore be an option exclusively for homeowners.

The government needs to ensure that the tax is paid eventually: an obvious approach is to stipulate that the tax can be deferred only until sale of the property (at which point payment would be made from the proceeds of sale) or death (at which point the deferred property tax becomes a charge on the estate, much like inheritance tax).

Beyond that, it is not clear what (if any) other restrictions are needed. One obvious question is whether deferral should be available to anyone with equity in the property, or only to those who would demonstrably find it difficult to pay the tax upfront. In principle, this ought not to be a sensitive decision. Where people could afford to pay the tax upfront it is clearly less important that they should have the option of deferral, and indeed the option might not be widely exercised even if it is available. But at the same time, since the deferral is with interest and is secured against the property, there should be little cost to the government of offering it even where it is not strictly necessary.

The argument that governments could be relatively relaxed about offering deferral rests on the twin pillars of charging interest on the deferred liability to maintain its present value and securing it on the property to ensure eventual payment. But even with those provisions in place, governments might be reluctant to forgo current revenue for the promise of future revenue if they think there is a significant chance that the future tax payments will never materialise. One source of risk is that people might find clever ways to (legally) avoid or (illegally) evade the tax. But this risk should not be overstated. Property taxes are relatively robust to evasion, precisely because the property is immobile: unlike financial assets, houses cannot be moved to a tropical tax haven, and vesting ownership there would still leave the government the ultimate sanction of repossessing the property in lieu of unpaid tax.

Perhaps the bigger risk is policy uncertainty: might a future government forgive these deferred liabilities? One could certainly imagine circumstances in which there would be political pressure to do so. This might be especially pertinent if a future government reformed (or even abolished) the property tax: would they really insist on payment of liabilities that had arisen under the old regime – particularly one that had been replaced presumably because it was considered flawed? If there were a significant risk of deferred liabilities being forgiven in future, there would be a genuine expected revenue cost to the policy. The perception – accurate or otherwise – of such a possibility would also reinstate the problem of people having an incentive to take maximum advantage of the opportunity to defer, thus increasing the amount of revenue at stake.

What this highlights is that political consensus – always valuable in the interests of policy stability but always difficult in the context of electoral competition – is particularly important in this area. A policy of deferral might have little chance of success if the main opposition party were already promising to forgive the liabilities if they won the next election.

Some perceived policy uncertainty is probably inevitable. One response to this would be to stipulate a maximum period of deferral, so that the payment is triggered on sale of the property, death, or (say) 10 years, whichever comes first. That would reduce the horizon over which policy uncertainty is a factor while still giving people some time to arrange their affairs so as to extract cash from their property (or otherwise find the money). But it might also increase the pressure for liabilities to be forgiven, when cases arise of people with interest-augmented liabilities coming due after 10 years and still no cash-flow with which to pay the tax – perhaps pensioners who are now even more frail than 10 years ago and would find it even harder to leave their homes.

Another response might be to charge a higher interest rate for deferral – an interest rate that reflects not just the time value of money (the opportunity cost of capital) but also the chance that the deferred tax might never need paying. That would hardly be ideal. Interest rates that reflect the time value of money are, broadly speaking, observable on financial markets and objectively quantifiable. The risk of future policy change, in contrast, is highly subjective. It would be difficult for the government to know what interest rate to charge – and even more difficult to make the decision transparent, since it would be politically sensitive (to put it mildly) for a government publicly to assess the probability that it might lose office and/or that a future government would decide its policy was mistaken. Also, it would lead to the unfortunate outcome that people would be deciding whether to pay or defer their housing tax according to whether they

thought the probability of the tax being forgiven in future was higher or lower than the government had incorporated in the interest rate.

It is difficult to say how concerned governments should be about relying on the revenues being delivered later. A cautious government implementing such a policy for the first time might, therefore, start off by restricting it to a relatively narrow group of taxpayers – only those who do not have enough current income or liquid assets to pay the tax – and by erring on the side of a slightly higher interest rate to make deferral a less attractive option for taxpayers (and a better investment for the government), perhaps with a view to relaxing these conditions somewhat if the scheme works well and becomes widely accepted as a permanent part of the fiscal landscape.

5 SUPPORT FOR HOUSING COSTS

Housing taxes are just one part of the cost of housing that people face, along with rent or mortgage payments, domestic energy and water bills, and so on. In thinking about what (if any) relief from housing taxation should be provided for low-income families, the answer should be part of a broader framework for how the government provides support for such families with their housing costs more generally.

While there are other – not mutually exclusive – conceptions and purposes of the benefit system, one of the central functions of means-tested benefits is to provide a ‘safety net’ for those with low resources relative to their needs: a minimum income at least to prevent outright destitution. Since housing is one of the basic essentials for subsistence, along with food, clothing, etc., it makes sense for the safety-net benefits to include some provision for housing costs.

Of course, there may be other ways in which the state ensures provision of housing for those in need, such as a system of social housing. In the UK, some social housing is let at below-market rents. But social housing is not provided for all those with low incomes; and even below-market rents would be out of reach for many of those with no private resources, so the benefits system still has a major contribution to make.

In 2012-13, three parts of the UK benefit system provided low-income families with support explicitly for housing costs:

- Housing benefit (support for rental costs), paid to 5.0 million families at a cost of £23.8 billion (€28.0 billion).
- Support for mortgage interest (an element within various out-of-work benefits), paid to 0.2 million families at a cost of £0.4 billion (€0.5 billion).
- Council tax benefit (a rebate of council tax liability), paid to 5.9 million families at a cost of £4.9 billion (€5.8 billion).

I do not make any judgement here about how generous support for housing costs should be – whether it should cover housing costs in full or only a fraction of them and, if related to an assessment of ‘reasonable’ housing costs, what level is ‘reasonable’. Nor do I make any judgement about how rapidly support should be withdrawn as income rises. These judgements have important implications for the cost of the support, the degree of redistribution achieved, and its effects on claimants’ work incentives. There is a trade-off to be made between redistribution and work incentives: between giving people more support directly and encouraging them to earn more themselves. Economics has much to say about quantifying these trade-offs and about how redistribution can be achieved with the least possible cost in terms of work incentives and economic efficiency.³⁵ But ultimately one’s stance on how far income should be redistributed, what loss of aggregate income is acceptable to do so, and how housing support should be prioritised against competing uses of funds, require value judgements that it is not my role to make. Questions of the appropriate generosity of support and speed of withdrawal are also not particularly specific to support for housing costs.

Instead, I will focus on two aspects of the design of housing support that apply regardless of how generous it is and how rapidly withdrawn: first, how housing support, and particularly the means test, should be structured and fit alongside other elements of support for those on low incomes; and second, whether maximum housing support (i.e., before means testing) should be related to each recipient’s actual housing expenditure or to what the government judges would be appropriate housing expenditure for a family of that type.³⁶

³⁵ See, for example, Adam, Brewer and Shephard (2006) and Chapters 3 and 4 of *Tax by Design*.

³⁶ There are other aspects of support for housing costs that I do not discuss here. These include whether the support should take the form of a benefit or a tax exemption/rebate (or rent rebate in the case of social housing); and whether help with rental costs should be paid to tenants or direct to landlords – an issue of some current concern in the UK.

5.1 The Structure of Support and the Means Test

Housing benefit is expensive, costing the UK government £23.8 billion (1.5 per cent of national income) last year. It is also responsible for some of the weakest work incentives in the UK benefit system. Above a certain (low) income level, it is reduced by 65p for each £1 of net income until entitlement is exhausted. Both of these have become increasingly problematic over the past 20 years as rapid growth in rents has increased the level of support provided and the amount to be lost by moving into work. There is no easy solution to this. Reducing maximum entitlement relative to rent levels risks causing real hardship among people who may have no other way to afford housing. Clearly making housing support universal would be prohibitively expensive, and even means-testing it less aggressively would increase its already high cost still further while extending means-testing (with its associated practical drawbacks as well as its high effective marginal tax rates) to more people. Yet the status quo is not appealing either. These are difficult political decisions for governments.

One improvement that can be made, however, is to minimise the damage that means-testing does by making the withdrawal of housing support fit in better with the withdrawal of other support. At present, the weakest work incentives in the UK tax and benefit system are caused by the simultaneous withdrawal of several strands of low-income support (along with income tax and National Insurance contributions). A plethora of overlapping benefits also makes it harder for people to know what they are entitled to (let alone what they would be entitled to if their circumstances changed) and increases hassle for claimants and administrative costs for government.

The basic purpose of all the different means-tested benefits and tax credits is to provide support for families with high needs and/or low resources. The logical approach is therefore to make a single integrated assessment of a family's needs and a single integrated assessment of its resources, and compare the two. *Tax by Design* (amongst others) therefore argued that, rather than each element of support being a separate benefit with a separate means test, there should be a single integrated benefit, with maximum entitlement consisting of various components (a basic element plus amounts to cover any relevant additional costs such as housing, children or disabilities) and a single means test to withdraw support as income rises. This need not necessarily imply a higher or lower cost to the government, or any particular pattern of winners and losers. But integration would be an opportunity to make the design of the whole system simpler and more coherent and to eliminate the very weakest work incentives that currently arise through arbitrary interactions between different parts of the system.

To its credit, the UK government is about to embark upon such a course (at least for those of working age) by integrating six existing means-tested benefits and tax credits, including housing benefit, into a single ‘universal credit’. This is arguably the biggest restructuring of the UK benefits system since the 1940s. There is plenty of potential for mistakes with such a radical reform – the decision not only to exclude council tax benefit but to localise it instead looks questionable, for example, and there is always a danger of problems with major IT projects – but the broad thrust of integration is to be applauded and has the potential to bring real benefits.

Tax by Design also argued that, where two income-related benefits (or indeed taxes) are not integrated, one useful guideline which can help avoid the highest effective tax rates is to make the income assessments sequential rather than simultaneous: in other words, to calculate one of them on income measured after the other, rather than using the same income measure for both. The UK currently uses a mixture of sequential and simultaneous assessment. But the decision to means-test universal credit based on after-tax income, so that the overall effective marginal tax rate faced by someone both paying tax and facing withdrawal of universal credit is less than the sum of its parts, is a welcome one.

This naturally leads on to the question of what measure of resources should be used for the means test. Clearly earned income should be included; the previous paragraph suggests that this should be after-tax earnings, and that income from one stage benefit should be counted as income for means-testing another. A more difficult question is how savings should be treated.

Entitlement to housing support and other means-tested benefits in the UK depends not only on claimants’ current income, but also on their financial assets. There may be a case for means-testing on the basis of assets as well as current income. Although it has the disadvantage of discouraging saving among those who think they might have low incomes in the future, one could reasonably argue that we should not provide benefits to wealthy people even if their current income is low.³⁷

³⁷ That is not to say that the way that financial assets enter the means test for housing benefit in the UK is sensible. At present, the first £6,000 of savings (£10,000 for those over the pension credit age) are ignored – a threshold which, unusually, is not automatically indexed to inflation. Above that level, every £250 in assets above this level (£500 for those over the pension credit age) is assumed to provide an income of £1 a week for the purposes of the means test – implying an assumed rate of return of over 20 per cent per year for non-pensioners. Savings of more than £16,000 eliminate entitlement altogether, creating a potentially large, sudden drop – a ‘cliff edge’ – in support for exceeding that level of savings. For retirees a good starting point would be for the benefit system to be neutral between annuitising a pension pot (with the income scored against the benefit) or the pension pot directly being assessed.

The current UK practice of counting only liquid assets – excluding housing, other physical assets and pension rights – seems less defensible. If two people have the same pattern of income and consumption over their lifetimes, but one chooses to keep their savings in cash and shares while the other chooses to save in pensions and housing, it is not clear that the latter is fundamentally worse off or more deserving of support if he or she falls on bad times. Nor is it clear that we would want to encourage people to take the latter course of action.

However, it does seem likely that the person whose savings are tied up in pensions and housing will be less able to manage bills such as housing costs if they unexpectedly fall on bad times, and the state may want to step in and help. The logical response might be to give them, rather than outright support, a loan to cover their immediate needs, secured against their valuable but illiquid assets. That is, in fact, precisely what deferral of housing tax liabilities, discussed in the previous section, would do. Treating the value of housing equity like other assets in the means test for support for housing costs, but offering loans/deferral instead to those with valuable housing but little short-term cash, might thus be the best approach. In the absence of a system of loans/deferral, disregarding illiquid assets in the means test, while unsatisfactory, is probably inevitable.

5.2 Actual Versus ‘Reasonable’ Housing Costs

A useful and intuitively appealing approach to benefit design is to think of the principle of compensating people for disadvantages they face that are beyond their control, so as to give them equal opportunities, but not compensating people for the consequences of choices they freely make.³⁸ That is an approach that is consistent with many aspects of benefit (and other) policy in practice. On that basis, the case for relating the level of entitlement to support for housing costs to the actual amount people spend on their housing is stronger if those costs are beyond the recipient’s control than if their housing expenditure is a free choice.

While occupying some housing is essential, the level of housing expenditure is a matter of choice for many people, especially in the long term: most people have some choice over the size, quality and location of the property they live in. To the extent that people can choose their housing arrangements, it would make sense for the government to judge what is a ‘reasonable’ level of housing costs for

³⁸ In the theoretical redistribution literature these are known as the ‘principle of compensation’ and the ‘principle of responsibility’: see, for example, Roemer (1998) and Fleurbaey and Maniquet (2007). This approach is not without its difficulties: for example, when people’s characters and preferences are partly innate, it is not always clear what aspects of behaviour are freely chosen.

claimants in particular circumstances and then provide support at (or related to) that level, irrespective of claimants' actual housing expenditure. After all, few would argue that benefits should be more generous for those who spend more on food or clothes: while some food and clothing are essential, people who choose more expensive food or clothes cannot expect the taxpayer to pay the extra cost. Instead the benefit system provides a level of income that is judged to be (in some sense) adequate to achieve a certain minimum standard of living and recipients are left to decide how much to spend on food, clothing, etc., and face the consequences in terms of how much they have left for other things. The same might be done for provision for housing.

However, not everybody can freely choose how much they spend on housing. Those in social housing are generally allocated a property rather than choosing it themselves, and may not have the option of moving to a cheaper one. Even for those who in principle could choose to live elsewhere, moving can be costly and difficult. Moving quickly can be particularly difficult, while benefits are there partly to support people who are in immediate and perhaps unexpected need even if in the longer run their situation might ease. To the extent that people's housing costs are (in the relevant time frame) fixed and beyond their control, it would make sense for the government to provide support related to those actual costs: those housing costs are part of their basic needs.

In reality, people's housing costs are neither completely fixed nor a completely free choice. While it will vary in some ways that the government could observe and potentially build into the entitlement rules – for example, covering actual housing costs for (say) the first few months on benefit and 'reasonable' housing costs thereafter, or cover actual housing costs for those in social housing and 'reasonable' housing costs for those in the private sector – how much choice people have over their housing costs will also vary across the population in ways that the government cannot observe.

Furthermore, some elements of housing expenditure are more flexible than others, so the issue might be better framed as *which* housing costs are to be treated as fixed and which as chosen:

- If the government viewed the property people lived in largely as a fixed need rather than a choice, that would presumably mean that any property tax liability that went with the property also formed part of their fixed need and so benefit entitlements should be related to people's actual property tax liability; but what about, for example, domestic energy and water costs? To some extent those costs are determined by the property: some houses are

simply more expensive to heat than others, for example. Yet people may also have some limited control over, for example, conserving water, avoiding heating their home more than necessary, or investing in insulation. So should benefit entitlements be related to each household's actual water and energy costs (in effect, exempting low-income households from these charges) or should entitlements be set at an overall level that simply takes some account of 'reasonable' water and energy costs?

- Conversely, if the government viewed the property people lived in largely as a choice and wanted benefit entitlements to make an allowance for 'reasonable' housing costs, what factors should determine what is 'reasonable'? As a starting point, they might vary housing support according to family structure, on the basis that larger families require bigger, more costly, properties. But what about, for example, varying it geographically? Again, this depends on how far the area people live in is viewed as just another free consumption choice. Even if people can choose the particular property they live in, can they be expected to move to a cheaper part of the country if they have (say) family or labour market reasons to live where they do? Or is living in an expensive area a luxury for which people on benefits, like everyone else, should have to pay themselves?

It is clear that neither fully fixed nor fully flexible housing costs looks like an adequate description of reality. Relating support to actual housing costs gives claimants an incentive to spend more on housing at the taxpayer's expense; providing a fixed level of support irrespective of actual costs opens up the possibility of real hardship for those with higher housing costs that they cannot easily reduce. Policy in this area requires a delicate balance to be weighed, with no unambiguously 'right answer'.

Historically, support for housing costs in the UK was largely based on people's actual housing costs. In particular, housing benefit entitlement was based on claimants' actual rent (subject only to relatively high caps in the private sector) and council tax benefit based on their actual council tax. Support for mortgage interest (by far the smallest of the three, as shown above³⁹), was less clear-cut: while related to the actual size of the outstanding mortgage (subject to a cap), used an assumed interest rate rather than an actual interest rate.⁴⁰ But over

³⁹ The small caseload of support for mortgage interest partly reflects low take-up, but also the fact that non-workers are more likely to rent than to own their properties, while many pensioners own their homes outright and so have no mortgage costs.

⁴⁰ Actual water and energy costs were not covered. One could think of the broader safety-net benefits as intended partly to cover some such 'reasonable' costs, though that is not explicit.

recent years a series of reforms has somewhat weakened the link between entitlements and claimants' actual housing costs.

First, in the mid-2000s the then Labour government decided that housing benefit should cover a 'reasonable' level of rents – varying by location and family structure – rather than actual rents, so that claimants would face the true marginal cost of housing (they would pay the cost of living in a more expensive home or keep the saving from living in a cheaper home) instead of being incentivised to choose a more expensive property at the taxpayer's expense. However, the policy was only ever partly implemented and there has since been a gradual retreat from this principle. Social renters (who satisfy the means test) continued to have their actual rent covered in full, while private renters now once again have their actual rent covered subject to a cap.

Within this basic structure of housing benefit there have been some significant recent changes in the level of support provided:⁴¹

- The cap on rents that can be covered has been reduced from the 50th percentile (median) of local rents to the 30th percentile: that is, housing benefit will now fully cover rents in the cheapest 30 per cent, rather than 50 per cent, of properties in the area.⁴² In many areas that is a significant cut, and the lower cap means that claimants' actual rents are less relevant in determining their benefit entitlement.
- However, from this year the cap will be uprated annually in line with the Consumer Price Index (CPI) inflation measure rather than reflecting how local rents change. Thus, bizarrely, in (say) 2020 housing benefit will cover at most what it would have cost (in real terms) to rent a property at the 30th percentile in 2012, regardless of what it actually costs in 2020.⁴³ Why the level of housing support in 2020 (and, for that matter, 2050) should depend on what local rents were in 2012 is unclear.
- In addition to the cap based on the 30th percentile of 2012 rents in each area, there is now also a nationwide cap on housing benefit in the private sector, ranging from £250 per week for a one-bedroom property to £400 per week for a four-bedroom property, thus limiting the extent to which the benefit

⁴¹ For more analysis of these reforms, see Joyce and Phillips (2013).

⁴² More precisely, it is not the 30th percentile of all properties in the area, but the 30th percentile of non-housing-benefit private sector rental properties with the relevant number of bedrooms (that is deemed appropriate for a family of that composition) in the area.

⁴³ As a further complication, uprating in 2014 and 2015 will be by 1 per cent in nominal terms rather than by CPI inflation, except that 30 per cent of the saving from this real-terms cut will be recycled to uprate the cap with CPI inflation in areas with the highest growth in rents. The cap will revert to the 30th percentile of local rents if that is ever lower than the previous year's cap uprated with CPI inflation.

system will cover the cost of renting in a more expensive area (in practice, certain parts of London).

- The only significant change to housing benefit in the social rented sector has been to cut it by 14 per cent (or 25 per cent) for working-age claimants occupying a property with one more bedroom (two more bedrooms) than the government thinks is necessary given their family composition. One in three (some 660,000) working-age claimants of housing benefit in the social rented sector are affected by this. It has been dubbed the ‘bedroom tax’, though the government argues that it could better be described as abolishing the ‘spare bedroom subsidy’.

These reforms have two things in common. First, they all reduce the generosity of housing benefit. Second, they all weaken the relationship between the level of housing benefit and people’s actual rents, in favour of capping support at levels the government regards as ‘reasonable’ for families in particular circumstances.

While there have been some explicitly temporary increases in the generosity of support for mortgage interest since 2008, the main permanent change is that, since 2009, eligibility has been limited to two years for those claimants (a minority) receiving jobseeker’s allowance (the main unemployment benefit). So people who are unemployed for an extended period with a mortgage to pay no longer have those housing costs covered at all: it is not clear what those who are unable to find a job despite their best efforts are expected to do. Of course, these are homeowners, so they do have a big asset, but the mortgage means that their net housing wealth – their housing equity – is lower than ownership of the property might suggest.

More significantly, given the large number of people affected, the government has also reformed the support provided to help low-income families with their council tax bills. Until this year, entitlement to council tax benefit for those with few or no private resources was simply equal to their actual council tax liability (subject to some minor complications). However, from April 2013 this national system of council tax benefit was abolished and replaced with a requirement for individual local authorities in England to set up their own schemes for providing support for council tax. Local authorities were free to design schemes as they saw fit, subject only to the restriction that pensioners must continue to be entitled to support on the same basis as before.⁴⁴ The additional grants given to local authorities in recognition of this extra responsibility was only 90 per cent of what

⁴⁴ The Scottish and Welsh governments were free to make their own policies, with no central government restrictions. In practice both ultimately chose to continue the previous system essentially unchanged, at least for the first year of the policy. For more information and analysis of this reform see Adam and Browne (2012) and www.counciltaxsupport.org.

the old council tax benefit would have cost, though local authorities were free to spend more or less than that amount on their council tax support schemes. Some local authorities have chosen to maintain the previous system essentially unchanged, financed by savings made elsewhere in their budgets; but most have adopted schemes that are less generous in some way. Localisation of council tax support means the end of a national after-tax income safety net: the generosity of support for low-income working-age families with their council tax, and how it relates to their actual council tax bills, is now a matter for local authorities.

6 CONCLUSIONS

The taxation of housing needs to fit in with a coherent design for the tax system as a whole. Housing consumption should be taxed like other consumption – subject either to VAT when new or to an equivalent tax levied on the stream of services it provides. As savings vehicles, owner-occupied housing and rental housing should be treated as similarly as possible, and preferably in line with a consistent approach to savings taxation across all assets. There should be no place for transaction taxes.

Measured against this benchmark, housing taxation in the UK is currently something of a mess. Given the practical political obstacles to implementing an ideal system, up to a point this is understandable. But it remains both desirable and feasible to clear up much of the mess. The principal reforms required can be summarised thus:

- Council tax should be reformed to relate it more closely to actual property values – levied as a uniform proportion of up-to-date rental values with no cap and no discount for unoccupied or single-occupancy properties. *Tax by Design* called this a housing services tax to reflect its underlying economic rationale as a tax on housing consumption to substitute for VAT.
- Taxation of rented housing should be reformed by offering landlords an allowance against the normal return to their investment (and by aligning capital gains tax rates with income tax rates). In principle, it would also make sense to move towards a rate-of-return allowance basis for the taxation of owner-occupied housing, but this may prove extremely difficult in practice.
- Finally, stamp duty on housing should be abolished and the revenue replaced by part of the housing services tax.

Ending the regressivity of housing taxation with respect to property value would reduce the problem of people lacking the cash-flow to pay the tax. Nevertheless, it would remain an issue for some. Particularly if political consensus could be

achieved to bolster the long-term credibility of the plan, there would be a case for allowing homeowners – or perhaps only those who demonstrably lack the liquidity to pay the tax – to defer payment (with interest) until sale of the property or death. Those who lack both current income and assets should be entitled to financial help towards their housing tax, and indeed towards their housing costs more generally – preferably as part of a larger integrated benefit rather than requiring a separate set of procedures and a separate means test. But it is difficult to judge how far that entitlement should be related to their actual housing costs, giving them an incentive to spend more on housing at the taxpayer’s expense, and how far it should reflect a view of what is ‘reasonable’ for them to spend, opening up the possibility of real hardship for those with higher housing costs that they cannot easily reduce.

This is a radical set of proposals, and the changes would need to be phased in carefully. But this is also an area where current UK practice is a long way from an economically rational and efficient system. Stamp duty defies the most basic of economic principles by taxing transactions. Income tax and capital gains tax create a significant bias against the rental market in favour of owner-occupation. Meanwhile, council tax is indefensibly regressive and, thanks to successive governments’ refusal to undertake a revaluation, we find ourselves in the absurd position that tax bills are still based on relative property prices in 1991. Over time, this arrangement will come to be seen as more and more untenable. At some point, some government will have to grasp the challenge of making the case for intelligent reform.

REFERENCES

- Adam, S., M. Brewer and A. Shephard, 2006. *The Poverty Trade-Off: Work Incentives and Income Redistribution in Britain*, Bristol: The Policy Press.
- Adam, S. and J. Browne, 2012. “Reforming Council Tax Benefit”, IFS Commentary no. 123, London: Institute for Fiscal Studies (<http://www.ifs.org.uk/publications/6183>).
- Adam, S., C. Emmerson and B. Roantree, 2013. “Broad Shoulders and Tight Belts: Options for Taxing the Better-Off”, Chapter 9 in C. Emmerson, P. Johnson and H. Miller (eds.), *The IFS Green Budget: February 2013*, London: Institute for Fiscal Studies (<http://www.ifs.org.uk/publications/6562>).
- Barker, K., 2004. “Delivering Stability: Securing Our Future Housing Needs (http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/consultations_and_legislation/barker/consult_barker_index.cfm).

- Besley, T., 2012. The Geary Lecture, *Making and Breaking Tax Systems: The Institutional Foundations of Fiscal Capacity*, Dublin, Economic and Social Research Institute October 19th.
- Crawford, I., M. Keen and S. Smith, 2010. "Value Added Tax and Excises", Chapter 4 in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles, and J. Poterba (eds.), *Dimensions of Tax Design: The Mirrlees Review*, Oxford: Oxford University Press for the Institute for Fiscal Studies (<http://www.ifs.org.uk/mirrleesReview>).
- Fleurbaey, M., and F. Maniquet, 2011. "Compensation and Responsibility", Chapter 22 in K.J. Arrow, A.K. Sen and K. Suzumura (eds.), *Handbook of Social Choice and Welfare*, Vol. 2, Amsterdam: North-Holland.
- Hills, J., F. Bastagli, F. Cowell, H. Glennerster, E. Karagiannaki and A. McKnight, 2013. *Wealth in the UK: Distribution, Accumulation, and Policy*, Oxford: Oxford University Press.
- Joyce, R. and D. Phillips, 2013. "Tax and Welfare Reforms Planned for 2013–14", Chapter 7 in C. Emmerson, P. Johnson and H. Miller (eds.), *The IFS Green Budget: February 2013*, London: Institute for Fiscal Studies (<http://www.ifs.org.uk/publications/6562>).
- Mirrlees, J., S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles, and J. Poterba, 201., *Tax by Design: The Mirrlees Review*, Oxford: Oxford University Press for the Institute for Fiscal Studies (<http://www.ifs.org.uk/mirrleesReview>).
- Office for Budget Responsibility, 2013. , March 2013, Cm 8573, London: TSO (<http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2013/>).
- Roemer, J. E., 1998. *Equality of Opportunity*, Cambridge, Mass.: Harvard University Press.
- Shaw, J., J. Slemrod and J. Whiting, 2010. "Administration and Compliance", Chapter 12 in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles, and J. Poterba (eds.), *Dimensions of Tax Design: The Mirrlees Review*, Oxford: Oxford University Press for the Institute for Fiscal Studies (<http://www.ifs.org.uk/mirrleesReview>).



The Economic & Social Research Institute
Whitaker Square
Sir John Rogerson's Quay
Dublin 2, Ireland
+ 353 1 863 2000 www.esri.ie
ISBN 978 0 7070 0355 9