

## LVT AND THE HOUSING CRISIS OF A GENERATION

'There is no finer investment than bricks and mortar'. But bricks and mortar, whether constituting the walls of a house or standing on their own in a builders' yard, do not appreciate in value. As every homeowner knows, they deteriorate and constantly need repair and maintenance. They are a liability. But if bricks and mortar – and all the other building materials that go to make a house – are not a good investment, how is it that house prices continually rise and are, in fact, a fine investment?

A property has two components – the building itself and the land or site on which it is constructed. The building itself deteriorates over time. Like any other manufactured good, its value cannot exceed the new-build replacement cost and is likely to be less than this depending on its age. Therefore any profit arising from an increase in a property's value (in real terms) must originate from the site or land element; it cannot arise from the building. Indeed, depending on its age, the building itself will have depreciated in value. Anyone who cannot see this or does not accept it need read no further.

### THE HOUSING CRISIS

House prices in the United Kingdom have increased faster than in most other countries. Since 1980 UK house prices have increased by around ten times compared to around four times for the OECD and Euro area. In a capitalist economy the justification for rising prices is that they bring forth increased supply. But in the United Kingdom, despite decades of continuous house price inflation, the number of houses built every year has been steadily falling.

On average, house prices are now almost seven times people's incomes. No matter how hard young people work it is becoming more and more difficult for them to save up and buy a home of their own. Rates of home ownership have been falling for more than a decade, from a peak of 71% of English households in 2003 to 63% in 2013/14. More families are renting from private landlords. It is estimated that there are now more than nine million renters in private rented accommodation, including almost 1.3 million families with children. Renting can be incredibly unstable, with soaring rents, hidden fees and eviction a constant worry. One third of private homes fail to meet the *Decent Homes Standard*.

Many parents now find that their adult children cannot afford to buy a house even though they have successful careers. Such children often live at home well into their 20s and 30s. Better-off parents use their money (including their own household equity) to help their children 'get on the property ladder'. Those with poorer families have no such support. They have to live elsewhere, in all probability where job opportunities are less attractive. This is unfair, socially divisive and damaging to the country's economic well being.

Declining investment in social housing and rising council house rents saw Housing Benefit expenditure triple from £3.8 billion in 1986-87 to £12.2 billion in 1997-98. During the same period claimant numbers fell from 7 million to 5.5 million. Despite further cuts in Housing Benefit entitlement and claimant numbers falling to 4.8 million Housing Benefit has more than doubled since 1997-98 to its present level of £25 billion. Despite a fall in the number of claimants the cost of Housing Benefit has soared. This reflects the vertiginous rise in property prices and rental levels.

Many observers see the housing crisis as being caused by inadequate supply. We need to build more houses, they claim. Other factors, too, are mentioned. People are living longer, which

means that their houses are 'off the market' for longer. Couples now break up more often, leading to more single households. The increasing number of cash buyers – such transactions have doubled since 2005 – reflects the rise of buy-to-let purchasers. Many of these buy-to-let investors are individuals who – at other times – might have seen equities or other stock exchange investments as desirable but now regard investing in residential property as the way to make the most of their money.

### INADEQUATE SUPPLY AS THE MAIN CAUSE

If, as many maintain, the acute housing crisis has come about through the failure to build enough houses, we should expect to find obvious evidence of this in the statistics for population growth and housing construction. But this is not the case. The population of the UK is some 64.8 million. Ten years ago, in 2005, the population was 60.4 million. There are therefore 4.4 million more people in the country than ten years ago. The actual number of new homes constructed in this ten year period, as shown by Government statistics, was approximately 1.85 million. This was equivalent to one new dwelling per 2.4 persons. It does not suggest a serious supply problem. In London, where the housing crisis is at its most acute, the supply argument has some force. Over the last ten years London's population has risen by 1.1 million (from 7.5 million in 2005 to 8.6 million currently). New dwellings completed during this period (all London boroughs) totalled 217,000. This is equivalent to five persons per new dwelling. However, it would be wrong to conclude from this that London is bursting at the seams. Despite the growth in recent years, caused in part by immigration, London's population is still less than it was in 1939.

The supply argument assumes that, as with other manufactured items, houses are elastic in supply; we can solve the housing crisis simply by building more houses. This is, of course, true as far as the building itself is concerned. Building materials and building labour are freely available. But a building cannot be divorced from the land on which it rests. But the land is fixed in supply. As buildings cannot be constructed without land, this attribute of inelasticity of supply attaches not just to the land but to the building as well. For practical purposes, therefore, houses are largely fixed in supply. Bidding higher prices for them can but have one outcome; it must drive up the price. If, as seems likely, the housing crisis is primarily one of price, the imposition of a property tax, which would lower prices considerably and take the steam out of the market, has obvious attractions.

### LVT IN PRACTICE

LVT, as envisaged here, would be purely a residential property tax akin to the old schedule 'A' income tax, under which the taxpayer was assessed on the notional annual rental value of his house. However, under LVT the taxpayer would only be assessed on that part of the house's annual rent which related to the site as distinct from the building.

As the purpose of LVT would not be to raise additional government revenue but to halt the rise in house prices, it would be a feature of these arrangements that an individual's LVT liability would be deductible from his mainstream income tax bill. Ideally, LVT would be set at a level below the income tax liability of the average person gainfully employed. Such a person would therefore be no worse off in cash terms; he would recoup his LVT by deduction from his income tax liability. This right to recover the LVT would be restricted to one's main residence. There would be no right of set off in respect of second or third homes. These would become

expensive to own. LVT would also be payable in respect of empty properties. These would become expensive to hold out of use for a long time. In the black economy income is undisclosed and the individual pays much less tax than he should. Such individuals would not have enough income tax to recoup their LVT. They would end up paying a substantial amount of tax.

As already explained, LVT would be assessed on the annual rental value of land, excluding the building. Residential building land is rarely rented separately so it will not be possible to assess the land's rental value from objective market rental data. The annual rental value will have to be calculated or imputed from residential property rents in the market place. A reliable way of doing this does exist however.



Take as an example a modern three-bedroomed house with garage in a typical, popular location in the South East with good transport links and within commuting distance of London. The property is modern having been built 15 years ago. Then, it cost £150,000. Now, it is valued at £500,000. The property is let, the annual rent being £18,000 (£1,500 a month). The re-building cost for fire insurance purposes is approximately £200,000 based on RICS building cost indices. This rebuilding cost is the maximum value the building (as opposed to the land) could have. In reality, some deduction should be made for depreciation or wear and tear, but for present purposes this is ignored. The building's value

is therefore at most £200,000. The balance of the property's value, i.e., £300,000, is therefore attributable to the site. This site value of £300,000 is equivalent to 60% of the total value of the property. It follows therefore that 60% of the market rent must be attributable to the underlying land. The annual rental value of the land would then be assessed at £10,800, i.e., 60% of £18,000.

#### LVT'S EFFECT ON THE HOUSING CRISIS

LVT in its full blown form, i.e., where the whole of the annual land rent was taken in tax, would lead to significantly lower house prices. Just how far residential property prices would fall as a result of LVT is difficult to say. But in the South East site values are reckoned to be on average 50% of the total property value. In the illustrations in the previous paragraph the land accounts for 60%. On this reckoning, property prices under LVT could well be half what they are today in the South East.

LVT would also reduce property rents. The rent a property commands is determined by the rate of return the landlord expects on his investment. If the value of the house, i.e., his investment, is much lower, so, too, would be the rent. Rents could well halve - in the South East, at least - and would then be affordable. Indeed, under LVT much of the attraction of buying over renting would disappear. As well as making property affordable and rents acceptable, LVT would also improve the supply of housing. It would do this in three ways. First, there are an estimated one million empty properties in the United Kingdom. LVT would make it very costly to hold these out of use. Many of them would have to be sold, rented out or put to use. Second, under LVT it would be much more expensive to own second or third homes. Many of these would have to be sold, thus becoming available for purchase by local people.

Third, LVT would cut the ground from underneath the phenomenon of 'house hoarding', i.e., the occupancy of accommodation in excess of one's needs. Present arrangements encourage 'house hoarding' as a larger - and hence more valuable - property will produce a bigger tax-free capital gain for its owner than a smaller one. Under LVT there would be no prospect of a capital gain, let alone a larger one. Housing would become a commodity like cars, washing machines and fridges. Because of ordinary wear and tear a building would be expected to fall in value over time - significantly so if it were not properly maintained.

Two other benefits both linked indirectly to the housing crisis should also be mentioned. First, with much lower market rents it is reasonable to expect considerable savings in the cost of Housing Benefit, currently some £25 billion. Second, most properties are bought with a mortgage. Total property lending to individuals is a staggering £1.3 billion. If we assume that half of this is attributable to the site or land value, then the credit resources released by LVT could be upwards of £600 billion. Such a sum made available to finance productive investment in goods, services and infrastructure would make an appreciable difference to our economy.

Every economic crisis since the early 1970s has had as its root cause a speculative property (i.e., land) boom and imprudent property lending to finance it. Each crisis has been more serious than the previous one. And now, with interest rates close to zero the property bubble continues to inflate. Eventually, of course, it will burst. With conventional economic solutions running out, the implications for the economy and indeed our political stability are cause for great concern. ■