TITLE
Taxation without justification: An economic analysis of the Treasury's treatment of privately rented housing

AUTHOR
Booth, Philip Mark and Beck, Rosalind

DATE DEPOSITED
9 May 2019

This version available at
https://research.stmarys.ac.uk/id/eprint/3077/

IEA Current Controversies No.68

TAXATION WITHOUT JUSTIFICATION

An economic analysis of the Treasury's treatment of privately rented housing

Rosalind Beck and Philip Booth

May 2019

Institute of Economic Affairs

Contents

About the authors

Rosalind Beck

Rosalind Beck attended Cambridge University, from where she received her first degree in social and political sciences. She then undertook a PhD focused on sex discrimination in the police service. Rosalind has also worked as a researcher in the field of mental health. She is an expert on the regulation and fiscal position of the private rented residential property sector and has written extensively on this, including a detailed report on Section 24. She has over 20 years' experience as a private landlord.

Philip Booth

Philip Booth is Professor of Finance, Public Policy and Ethics, and Dean of the Faculty of Education, Humanities and Social Sciences at St. Mary's University, Twickenham. He is also Senior Academic Fellow at the Institute of Economic Affairs where, from 2002-2016, he was Academic and Research Director. Previously, Philip has worked for the Bank of England and as Associate Dean of Cass Business School where he was also Professor of Real Estate Finance and Investment. He has written widely on investment, finance, tax, regulation, social insurance and pensions, as well as on the relationship between Catholic social teaching and economics. Philip is a Fellow of the Royal Statistical Society, a Fellow of the Institute of Actuaries and an honorary member of the Society of Actuaries of Poland.

Summary

- The private rented sector has played a critical role in increasing and improving housing provision in the UK. Around 80 per cent of private sector tenants are satisfied with their homes and satisfaction in the sector compares favourably with that in the social rented sector. This contribution has gone unrecognised: instead, landlords have been made scapegoats for a housing crisis primarily caused by land-use planning restrictions.

- The government has recently passed tax measures that discriminate against private rented housing, both as an asset class and as a form of housing tenancy. The most damaging of these measures is 'Section 24'[1] which prevents landlords entirely offsetting interest against rents before taxable profits are calculated. This move is unjustifiable and will raise rents. The Treasury's rationale for the tax change has no justification in public finance economics and it is concerning that the Treasury would make the arguments that it has made.

- As a result of Section 24, many landlords will pay huge amounts of tax as a proportion of profits. Interest rate rises are likely to cause the tax rate to exceed 100 per cent of their underlying profit in some cases. Tax will even be payable by some landlords who make a loss.

- The government has also increased Stamp Duty on buy-to-let properties. Stamp Duty in general is widely regarded as one of the worst taxes from an economic efficiency point of view. The late James Mirrlees, Nobel Prize winner in economics wrote: 'There is no sound case for

1 This refers to Section 24 of the 2015 Finance Act.

maintaining stamp duty and we believe that it should be abolished' and 'Stamp duty and business rates defy the most basic of economic principles by taxing transactions and produced inputs respectively'. The government's decision to increase Stamp Duty on buy-to-let properties will also damage the market and raise rents.

- The increase in Stamp Duty was introduced with the expressed intention of promoting buying over renting. This may happen at the margin. However, any such effects will benefit a small minority of potential purchasers who will be relatively well off.

- Increases in taxes on landlords are likely to reduce the supply of rental housing, increase rents, reduce quality and reduce the size of the 'professional' landlord sector which is most affected by the changes.

Introduction

In recent years, the private-rented sector has grown as a proportion of total housing provision. The sector has also come under scrutiny. Partly as a result of this scrutiny and popular pressure, from the 2015 Budget onwards, tax measures have been introduced which discriminate against the provision of rented property when compared either with other forms of business assets or with other forms of housing provision. Many of the justifications for these tax changes are spurious and are shown to be in this paper.

The impact of recent tax changes is likely to be to increase rents and reduce the supply of private-rented property. Indeed, they may reduce the overall supply of property. Costly measures might be taken to avoid the increased taxes resulting from the changes. The tax changes will also make the tax system more complex and could lead to penal tax charges in some situations – for example, tax rates of over 100 per cent of income or tax charges when losses are made.

This paper proposes rolling back the recent tax changes in relation to let property. It also proposes other tax reforms that will move the overall tax system for residential property towards one that will better promote economic welfare.

The role of the private rented sector in housing provision

In recent years, the government has imposed a number of tax measures that have been designed to raise costs in the private-rented housing sector. These measures could only be justified on economic grounds, if, in some way, private-rented housing caused some social harm so that measures to reduce its supply via increased taxation would raise economic welfare; but it doesn't. In the UK, as in other countries, private-rented housing is a key component of the housing market. It has increased in extent and improved in quality in the last 30 years as, after years of rent control and other government interventions, the private-rented sector has flourished.

In the 20 years from 1996/97, the number of households in privately-rented dwellings rose by 2.6 million. In the same period, the proportion of households who lived in private rented tenure, as compared with social housing and owner-occupation, doubled to 20 per cent (Ministry of Housing, Communities and Local Government 2017). In part, the increase in private rented housing leads to new stock as there is investment in conversion of non-residential buildings, new build, conversion of houses into flats, and the updating of stock that might otherwise fall into disrepair. Without this additional stock, the housing shortage in the UK would be even more acute and rents and house prices would be higher.

Despite this increase in private sector renting, the image of a private sector landlord is not uniformly positive.[2] This may be partly because private landlords own and let out properties that are amongst the oldest in the housing stock. In addition, some of their tenants are from groups who are

2 See, for example, 'A licence to rent?', Campaigns Briefing, Shelter, http://england.shelter.org.uk/__data/assets/pdf_file/0004/206779/A_Licence_to_rent_Briefing.pdf

staying in the property for a short period of time. It is, though, worth noting that the proportion of private renters in homes defined as 'non-decent' decreased dramatically between 2006 and 2016, from over 45 per cent to 27 per cent: so, there has been considerable improvement in the quality as well as the quantity of private rented housing. Although 27 per cent might still seem high, the *Decent Homes Standard* has been designed specifically as a standard that should be met by local-authority-controlled housing. It is therefore not surprising that it is met by a greater proportion of local authority housing than private rented housing.

Indeed, when data on tenant satisfaction are analysed, social renters and private renters show roughly equal levels of satisfaction with their accommodation, but social renters are more likely to express dissatisfaction or to be very dissatisfied. Social renters are also less satisfied with the repairs and maintenance carried out by their landlords (Ministry of Housing, Communities and Local Government 2017).

As will be explained, the fiscal measures implemented recently raise costs in the private rented sector and are likely to raise rents. There is no clear economic justification for the measures and, notably, the Treasury's justification for them has been spurious.

Abolition of so-called 'tax relief' for private landlords

When George Osborne, the former Chancellor of the Exchequer, announced in his Budget speech of July 2015 that he would 'restrict tax relief for financing costs for "individual" landlords', commentators were taken by surprise. One of the authors of this paper had already examined this policy, however, because a variation on it had formed part of the Green Party manifesto at the 2015 general election.[3] The proposals announced in the Budget became Section 24 of the Finance Act.

In fact, the phrase 'tax relief' was a misnomer. Landlords receive no tax reliefs. Rather, the tax position of private-sector landlords involved allowing legitimate finance costs to be deducted from income when they calculated their rental profits. Under George Osborne's proposals, finance costs would no longer be deducted from income. However, there was to be a tax 'rebate' for unincorporated landlords of up to 20 per cent of their finance costs.

It can be said that the fact that the deduction of financing costs when calculating taxable profits had historically been called a 'tax relief' by HMRC made it easier to justify the change. However, the Institute of Chartered Accountants in England and Wales (ICAEW), in their submission to the Finance Bill Committee following the Budget, declared: 'The idea that landlords will be taxed on the profit of their businesses, but not be allowed to offset the costs of creating that taxable profit is absurd, unjust and unsustainable. It overturns a fundamental, centuries-old principle of

3 See Booth, P., 'The Green interview: failed on style, but what about the substance?', IEA Blog, 27 February 2015, https://iea.org.uk/blog/the-green-interview-%E2%80%93-failed-on-style-what-about-the-substance

taxation.'[4] This change could lead to arbitrary and very high rates of effective taxation on rental income as can be seen by the example in Box 1.

Box 1: Case study

The best way to understand the effect of Section 24 is to examine how it works in practice by looking at a case study.

Caroline has been a portfolio landlord in the south of England for about 20 years. Until recently she let properties to all kinds of tenants, including those on low incomes. She had 40 flats and houses.

In 2015, her properties generated £333,000 in rent. Maintenance and other business costs totalled £113,000, and she paid £155,000 in mortgage interest. The profit from her portfolio was £65,000 and her tax bill was £15,200.[5] This left net income of £49,800.

By the time Section 24 of the 2015 Finance Act is fully implemented in 2021, her tax bill on the same profit will be £54,100 and she will have post-tax income of £10,900.

Before it was decided to partially disallow interest as a business cost, her effective tax rate was 23.4 per cent. After the reform, her effective tax rate is 83 per cent of the underlying profit. This very high effective tax rate does not arise because the profit is high and therefore taxed at a high rate in a progressive tax system. It arises simply because the portfolio of properties is partly financed by borrowing. The interest on that borrowing is taxed in the hands of those who provide the finance. Not allowing the cost of borrowing to be deducted as a business expense is therefore double taxation at an arbitrary rate.

4 See: https://publications.parliament.uk/pa/cm201516/cmpublic/finance/memo/fb80c.pdf
5 The basis of the calculations are available from the authors. The tax paid takes into account income, tax rates and relevant allowances.

If interest rates increase, the cost of the partial disallowance of interest as a business cost increases. If the business makes a loss because interest payments and maintenance costs are higher than rents received, Caroline will still face a tax charge: the tax rate on profit would be infinite. Alternatively, and more plausibly, such a small profit would be made that the tax bill would be greater than the profit.[6]

To avoid bankruptcy, Caroline has increased rents. As some tenants on benefits cannot afford these higher rents, she has had to replace them with employed people. This has led to 18 of her tenants on benefits being evicted from nine properties, on which the rents have gone up by an average of 10 per cent. In order to still have a net income of £49,800, Caroline would have to increase rents by £71,000, or 21 per cent, between 2016 and March 2020. She will not be any better off: her tenants will be worse off.

If landlords such as Caroline are not able to obtain higher rents to cover the tax levy, they face having to sell their properties, possibly in a flooded market where they have to accept low offers as others need to sell for the same reason.

6 Marginal tax rates of over 100 per cent are not uncommon. However, it is difficult to think of an example anywhere else in the tax system where an average tax rate of over 100 per cent would exist so that the tax bill would be bigger than a person’s income.

Errors in Treasury reasoning

It is disturbing that, in introducing and justifying the measure to charge tax on the financing costs of buy-to-let property, the Treasury does not appear to understand the basic principles of taxation which would be taught, for example, in an undergraduate public finance course or in the basic examinations of the Chartered Institute of Taxation. The incoherence of the measure and the reasoning behind it has been noted by Paul Johnson of the Institute for Fiscal Studies and the Institute of Chartered Accountants in England and Wales (see above), amongst others.

'Levelling the playing field' with owner-occupied housing

In introducing the restriction of 'tax relief' on buy-to-let property, the Chancellor of the Exchequer, George Osborne, explicitly argued that it would level the playing field between owner-occupied and let housing in relation to taxation: 'Buy-to-let landlords have a huge advantage in the market as they can offset their mortgage interest payments against their income, whereas homebuyers cannot.'[7]

This statement is clearly false, or at best meaningless. Owner occupiers can be thought of as owning houses and renting them to themselves. The rent that would be paid had their home been let out on the open market is often known as 'imputed rent'. Owner occupiers do not pay any tax on the imputed rent from their properties at all: such a tax was abolished in 1963. Until 1963, when owner occupiers paid tax on imputed rent, they did, in fact, receive tax relief on mortgage interest. This was intended as an offset against the imputed rent that was taxed, just as mortgage interest costs for landlords are an offset against the rent they receive before tax

7 2015 Budget speech.

is calculated. As it happens, when the tax on imputed rent was abolished, the tax relief on mortgage interest for owner occupiers remained for many years. This was an anomaly because there was no taxed income from the property against which to offset the mortgage interest. Arguably, tax relief on mortgages was kept to promote owner occupation. The tax relief was abolished in 2000.

Given that owner occupiers as such do not pay any tax at all, the question of allowing them to offset financing costs before calculating taxable income simply does not arise. There is nothing against which finance costs can be offset. The Treasury does not receive any tax from an owner-occupier who buys a property financed by a mortgage. However, if somebody buys a house using a mortgage and lets it out, tax is paid on the rental income after the costs of the landlord are deducted. It is a basic principle of tax policy that the landlord should pay tax on the rent received after deducting business costs.

Buy-to-let landlords versus share traders

In the letter TO2016/23599,[8] the Treasury repeats the argument addressed above. It also goes on to argue that tax relief is not available to those who borrow to invest in shares. This latter argument is not totally incorrect but is hardly a reasonable comparison. Firstly, any vehicle, such as an investment trust, which borrows to invest in shares can offset the cost of borrowing before determining taxable income. The situation of personal borrowing being undertaken to finance investment in shares is unusual. But, even so, this comparison is of minimal relevance. Buying houses to let is akin to creating a business with fixed capital, not akin to buying securities such as shares, and should be treated like other businesses with fixed capital.

8 See: https://www.property118.com/treasury-response-to-section-24-report-by-dr-rosalind-beck/

'Tax relief' benefits people on higher incomes

George Osborne's 2015 Budget speech and letter TO2016/23599 both assert that the offsetting of interest against rental income benefits landlords on higher incomes because the tax saved is greater for such individuals. Again, this is not true and, as an argument, would not be regarded as consistent with the basic principles of public finance.

Firstly, the ability to deduct interest payments from rental income before calculating tax is not a 'relief' against taxable income because the income that is taxed is never received by the landlord – it is paid out as a business cost to the financier of the mortgages taken out to purchase the property. Allowing the landlord to deduct interest costs on mortgages before calculating taxable income does not confer any benefit upon the landlord because the landlord does not receive as income that part of the rent used to pay interest on the loans. Not allowing the landlord to fully deduct interest before calculating taxable profits imposes an additional tax on the income that higher-rate taxpayers receive from buy-to-let properties. This is because they are charged tax on income that they do not receive: that is, they pay tax on money that is paid out to banks that finance the properties through mortgages or other forms of lending.

As is noted in the case study (see Box 1), Caroline will receive an income of £10,900. This is below the threshold for basic rate tax and well below the threshold for higher rate tax. Under the proposals, the tax paid by landlords will not depend on their income, but on the total amount they receive in rents from their properties. The equivalent for any other form of small business would be to tax turnover rather than profit. This would be an innovation in tax policy. It should be noted that the extent of landlords' tax bills will not just depend on their income but on whether they finance their properties by borrowing or equity.

Levelling the playing field with incorporated landlords

Letter TO2016/23599 also argues that the move by the Treasury to limit the extent to which finance costs can be used to determine the tax rate on rental income brings the buy-to-let sector into line with the position of incorporated landlords. The letter argues that such landlords can only obtain tax relief on interest costs that are incurred in financing housing provision at the corporation tax rate (now 19 per cent) rather than at the top marginal rate of tax. This argument is also wrong.

If let property is held within a company, the company pays corporation tax at 19 per cent on profits. Interest on let property is fully deducted before calculating the profit that is taxed. That profit is then taxed at 19 per cent. Dividends can then be paid which would be further taxed in the hands of a higher-rate taxpayer. However, the interest has been fully deducted from rental income before taxable profits are calculated and distributed as a dividend. There is, therefore, no question of any tax being paid on the interest financing costs of the property portfolio by the owners of the company. For an unincorporated landlord, the interest costs of financing the property portfolio are now not deducted before tax is calculated.

Compounding the errors

These errors of reasoning are greatly concerning because they come from the heart of the Treasury as well as the former Chancellor of the Exchequer himself. The UK has an extremely complicated tax code. One of the reasons for that is the implementation of a succession of measures designed to promote particular political objectives over a number of years by different governments. However, such measures should at least be justified and understood as deviations from public finance principles. The Treasury should not pretend that a measure removes a distortion when it does not or that it does not create a distortion when it does.

Further tax proposals have been made by a Conservative MP and former adviser to both George Osborne and Theresa May (see O'Brien 2018). O'Brien proposed that George Osborne's measure should be extended further so that landlords' legitimate finance costs would be completely disallowed before calculating the tax position of landlords for all new rented housing. As most private landlords need to take out a buy-to-let mortgage to fund a new-build or the purchase (and often renovation) of a property to rent out, this could lead to the drying up of the supply of private rented housing. O'Brien used the same justification as the Treasury had used for its 2015 Budget measure, arguing that this would level the playing field with owner-occupied housing. He also suggested that landlords should no longer be allowed to claim furnishings in a rented house as a legitimate expense, because 'owner-occupiers cannot'. Again, this ignores the fact that there is no taxed rental income against which owner occupiers could deduct such costs because the already favourable treatment of owner-occupied housing relative to private rented housing ensures that there is no tax on owner-occupation at all.

Premium rate Stamp Duty Land Tax on buy-to-let properties

Subsequent Budgets and Autumn Statements imposed further tax changes on landlords. These are arbitrary in the sense that they have been chosen to apply to specific types of business investor. The most important of these was the imposition of an additional 3 per cent Stamp Duty Land Tax levy on anyone purchasing a second home (whether it is for owner occupation or let out to tenants). This was announced in the 2015 Autumn Statement in a section which was very critical of the buy-to-let let market.[9] In announcing the measure, Osborne argued:

> And the fifth part of our housing plan addresses the fact that more and more homes are being bought as buy-to-lets or second homes. Many of them are cash purchases that aren't affected by the restrictions I introduced in the Budget on mortgage interest relief; and many of them are bought by those who aren't resident in this country. Frankly, people buying a home to let should not be squeezing out families who can't afford a home to buy.

This statement is revealing as it suggests that the then Chancellor of the Exchequer had an intrinsic preference for buying over renting. Such an intrinsic preference, if soundly grounded, could provide a justification for the differential tax treatment of rented and owner-occupied property. However, the Treasury had not previously used such an argument.

9 See: https://www.gov.uk/government/speeches/chancellor-george-osbornes-spending-review-and-autumn-statement-2015-speech. It is also notable that there was explicit discrimination against married couples in this change.

Indeed, given that almost all houses are either let or owner-occupied, the existence of any let houses must be ‘squeezing out’ buyers at the margin. This raises the question of whether George Osborne was suggesting that there should be no houses to let. Or did George Osborne simply think that there were ‘too many’ let houses and so tax discrimination against letting had to be introduced? If so, it would have been good practice to explain explicitly the criteria by which he judged that the market is producing too many let houses so that a judgement could be made about the appropriate policy response and whether, in its own terms, it had been successful when ultimately evaluated.

People rent because it is the preferable option in the situation in which they find themselves given market rents and prices. Restricting the supply of homes for rent will make renting more expensive for renters and is, indeed, likely to reduce the number of let properties and increase the number of owner-occupied houses. However, this will only allow a small number of people at the margin to purchase a home. Those marginal buyers are likely to be a non-representative subset of people. It is likely that they will be richer on average than those who rent and whose rents rise because of the reduced supply and increased costs of renting.

When it comes to the specific measure of supplementary Stamp Duty, it should be noted that this is a tax on transactions that is widely regarded as one of the most damaging taxes. As Mirrlees et al. (2011) put it in their monumental work *Tax by Design*, ‘There is no sound case for maintaining stamp duty and we believe that it should be abolished’ (p. 404) and ‘Stamp duty and business rates defy the most basic of economic principles by taxing transactions and produced inputs respectively’ (p. 405).

Tax changes that furthered the differential treatment of owned and let property continued in the 2016 Budget. This announced substantial cuts in capital gains tax. However, an exception was made for residential property.[10] Once again, this measure introduced differences in tax treatment between returns to capital derived from the provision of let residential housing as compared with returns to capital from other forms of business investment. Thus, it raises the cost of capital for the provision of housing relative to other forms of business activity.

10 This exception would only apply to let residential property and second homes, as an individual’s primary residence is exempt.

The seen and the unseen – the impact of taxes on the housing sector

It is reasonable to assume that the first-round impact of these tax measures is felt by the landlord. The underlying and longer-term impacts are more difficult to determine and will depend on a number of factors. However, it is highly likely that higher taxation will lead to landlords demanding higher rents for a given property purchase price (that is, higher before-tax, or gross, rental yields). Whilst some landlords might be willing to accept lower after tax, or net, rental yields, other landlords will have alternative uses for their capital. It would therefore be expected that landlords will exit the market, putting upward pressure on rents, assuming unchanged demand by tenants. It is difficult to think of any set of plausible assumptions which will not, other things being equal, lead to higher housing costs for tenants as a result of recent tax changes.

At the same time, it is likely that there would be a small fall in house prices, but this would be very much a second-order effect. It is possible that the changed relationship between rents (higher) and house prices (lower) might lead some former renters to buy. This is one of the government's stated objectives, but it should not be thought a good thing. If people are only buying houses because rents are artificially raised by taxes on some landlords, this reduces overall economic welfare.

Within the private rented sector, several things could happen. Those landlords who finance their property portfolio using equity or through corporate vehicles will be less affected by the tax changes and so will receive higher returns as a result of higher market rents or lower house prices. We could therefore expect a shift towards those types of landlords.

However, this result is also inefficient and wasteful: there will be incentives to create costly vehicles simply designed to reduce the tax burden of landlords. There may also be a de-professionalisation of the sector. As Kath Scanlon, research fellow at London School of Economics, has pointed out:

> The one thing you can say about people with mortgages on buy-to-let properties is that they have made a conscious decision that they want to be in the business of being a landlord, whereas people with no mortgages perhaps never made any such decision…The people who will leave the sector are likely to be at the more professional end of the small landlord spectrum and are probably not the ones who you would want to leave.[11]

These conclusions are borne out by Scanlon and Whitehead (2016). In a major survey of landlords, they find that 36 per cent of those buy-to-let landlords who expect to reduce their portfolio in the next one to five years cite tax reasons for doing so. A substantial proportion say that they will raise rents, especially for new tenants. The proportion of 'accidental' landlords has also fallen,[12] which might be worrying given that they tend to add to the housing stock by bringing to the market houses that might otherwise be empty for a period or under-occupied.

Craw (2018) has argued that there will be no impact of the tax measures on rents because homes will simply move from the rented sector to the owner-occupied sector whilst not changing the supply of houses at all.[13] Unfortunately, there are a number of flaws in this argument. Firstly, there must be a mechanism by which buying becomes more affordable relative to renting, which must involve higher rents as a first-round effect. Secondly, those who will form the group of people who buy houses if more houses move into the owner-occupied sector are not necessarily current tenants and are very unlikely to be tenants in the properties that are sold by buy-to-let landlords. Thirdly, if rented housing gives rise to lower net returns, in the long run there may simply be less investment in turning large houses

11 See: 'New Buy-to-Let tax "puts the UK out of step with how other countries approach the PRS", says Kathleen Scanlon', LSE London, http://lselondonhousing.org/2015/11/20-nov-2015-new-buy-to-let-tax-puts-the-uk-out-of-step-with-how-other-countries-approach-the-prs-says-kathleen-scanlon/

12 'A third of landlords with just one buy-to-let are considering selling up - but bigger landlords want to invest more', This is Money, https://www.thisismoney.co.uk/money/buytolet/article-5633935/Government-plan-professionalise-buy-let-working.html

13 Interestingly, Generation Rent, for which Craw works, uses exactly the opposite reasoning against right to buy: http://www.generationrent.org/right_to_buy

into homes for multiple occupation or in renovating houses for letting, so the supply of housing in total may fall.

Craw also argues that landlords affected by the tax measures will be undercut by those who will not be affected by the measures, so that rents overall will not rise. In theory, this could be true. But it is an unlikely outcome unless the supply of houses let through vehicles unaffected by the tax measures expands to offset the reduction in properties let by landlords who are affected. Even if this were so, it would simply raise the question of why tax measures are to be introduced that discriminate against one type of landlord and one type of tenancy if the effect is only to create more complex vehicles for buy-to-let property in order to avoid the additional taxes.

It is difficult to imagine a scenario whereby rents will not be higher than they would have been without these tax measures unless the changes lead landlords to create new corporate structures designed to avoid the increased tax. The tax changes have not yet had full effect and rents often do not increase until a new tenancy is started. As such, any leads and lags between the announcement of the tax measure and increases in rents will be long and complex. It is notable, however, that we have recently experienced the biggest reduction in the stock of privately-let housing since the liberalisation of the market at the end of the 1980s, though it is also impossible to know the cause of this.[14]

In summary, it would seem that the tax changes surrounding the private rented sector will be detrimental to both landlords and tenants. The changes will raise rents above those that would otherwise have prevailed and may reduce the quality of provision. It is also likely that the tax changes will lead to the private rented sector either de-professionalising to a greater extent or taking on the costs of incorporation to avoid additional taxes.

Most published empirical work in this area has been in the form of surveys rather than an analysis of empirical evidence and has been produced by the building industry or trade bodies and can only therefore be regarded as indicative. By way of example, a report published by the Residential Landlords Association (Simcock 2018) suggests:

---

14 See: Dwelling Stock Estimates 2017, England, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/710382/Dwelling_Stock_Estimates_2017_England.pdf

> The changes to Stamp Duty Land Tax with the 3% levy for private landlords is inhibiting further investment in the private rented sector. 69% of landlords reported they were discouraged in purchasing further rental properties. […] The current study found that a majority of landlords (70%) reported that the changes to mortgage interest relief would reduce their profitability as a business, with 62% of landlords reporting this would reduce their profitability by at least 20%. To mitigate the negative impact of these changes, the majority of landlords (67%) reported they would increase the rents.

This is a credible scenario, though second round effects, such as the changing of the corporate structure used by landlords, are likely to ameliorate the magnitude of the outcomes.

Conclusion

In recent years, the government has changed the tax system in a way which leads to private landlords being taxed more harshly than other forms of business. Furthermore, private rented property is discriminated against, in a significant way, as compared with owner-occupied property. The new tax system could lead to penal tax rates in some circumstances. Business costs cannot now be fully deducted from revenues before taxes are calculated. In addition, property transactions taxes have been raised with the increase being targeted on let property. The justification for these decisions by the Treasury defies any basic economic analysis.

The effect of the measures will almost certainly be an increase in rents above the levels that would otherwise have prevailed and a reduction in the supply of rented housing. In addition, it is likely that the private rented sector will de-professionalise. Alternatively, or in addition, landlords will take action to avoid the higher levels of tax, which will lead to higher tax compliance costs – costs which, again, will almost certainly be passed on to tenants. There could be an overall reduction in the supply of housing.

This critique of recent tax changes raises the question of how property should be taxed. Some of the suggestions below would, in practice, simply mean a repeal of recent measures. However, the other policies suggested would also help to create a more efficient tax system for property more generally. Specifically, the authors suggest that residential property is taxed as follows:

- Investment in property is treated like investment in any other business so that all business costs, including business finance costs, are deducted before taxable income is determined.

- There should be no discrimination, as far as is possible, between different vehicles for holding property. Thus, the tax position of property held within a corporate vehicle should be no different from the tax position of property held by an individual after all income has been distributed to the beneficial owners.
- If Stamp Duty remains, it should be charged at low levels and not charged at different rates for owner-occupied and let property.
- As noted above, Stamp Duty is a very inefficient tax and should, ideally, be abolished, even if it were replaced by other forms of property tax.
- A tax on imputed rent for owner occupiers could serve as a replacement for Council Tax and Stamp Duty. This would have the benefit of levelling the playing field between different forms of property ownership as well as between different forms of income. Furthermore, it would facilitate the abolition of two taxes that are inefficient from an economic welfare point of view (see Meakin 2016).

The recent changes to property taxation are just one aspect of an extremely complex UK tax code. The changes have made the tax code more complex and less economically coherent. A review of property taxation more generally could reduce the complexity of the UK tax system and make the system more efficient from an economic welfare point of view.

References

Craw, D. W. (2018) Do measures that discourage buy-to-let investment increase rents? London: Generation Rent.

Meakin, R. (2016) Designing a New Tax System. Chapters 9-11, in *Taxation, Government Spending and Economic Growth* (ed. P. Booth). London: Institute of Economic Affairs.

Ministry of Housing, Communities and Local Government (2017) English Housing Survey – Private Rented Sector, 2016-17. London: Ministry of Housing, Communities and Local Government.

Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and Poterba, J. (2011) Tax by Design. London: Institute for Fiscal Studies.

National Audit Office (2017) Homelessness. London: National Audit Office.

O'Brien, N. (2018) Green, pleasant and affordable: Why we need a new approach to supply and demand to solve Britain's housing problem. London: Onward.

Scanlon, K. and Whitehead, C. (2016) The Profile of UK Private Landlords. London: Council of Mortgage Lenders.

Simcock, T. J. (2018) The Impact of Taxation Reform on Private Landlords. Manchester: Residential Landlords Association.

The Institute of Economic Affairs
2 Lord North Street
London SW1P 3LB
Tel 020 7799 8900
email iea@iea.org.uk

Institute of
Economic Affairs