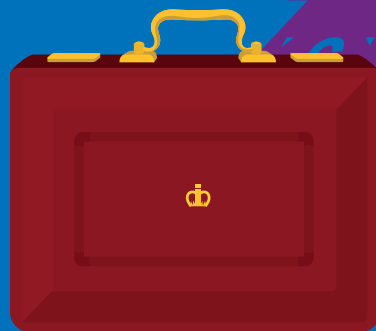




Reimagine property taxes



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kpmg.com/uk/reimaginepropertytaxes

Let's reimagine

Our tax system encourages investments in homes, rather than capital and R&D, creating a vicious circle that contributes to the UK's low productivity; whilst the way we fund social care penalises those unlucky enough to suffer from long-term conditions and their families.

Mark Essex presents an elegant solution that could improve housing affordability, infrastructure investment, economic productivity and our social care system.





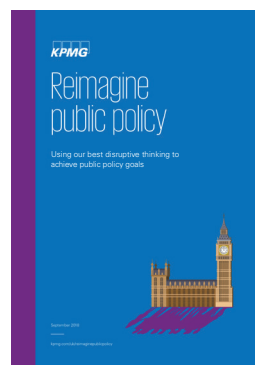
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The UK's housing market, its approach to business investment, its demographics, and its system of social care are suffering from long-term, structural problems. And these are becoming ever more acute – threatening to make our country a less competitive, less productive and less fair place. But we have the levers to address these challenges, shifting the dynamics to transform our downward spiral into a virtuous circle. And I want to propose a mechanism to pull on those levers.

Reimagine public policy

Using our best disruptive thinking to achieve public policy goals



Public policy faces challenges in the form of technology, demographics, geopolitics and changing consumer behaviour. Disruptive thinking is needed to escape the unattractive trade-offs between quality and the price the nation can afford. We think solutions need to be bigger, bolder and more imaginative.

Our report contains our best Reimagine policy ideas, including:

- removing the need for any family to choose between heating and eating
- using a new approach to taxation that improves housing affordability, infrastructure investment, economic productivity, and our social care system
- harnessing the innovative spirit of the UK regions to build the next global city
- empowering patients to take control of the way they use the NHS – and reduce costs
- structuring sentencing and prisons to improve outcomes and reduce costs
- incentivising local government by sharing the benefits as well as the costs of investing in future generations.

Read our report at:

kpmg.com/uk/reimaginepublicpolicy.html

We publish these ideas to stimulate debate so please contact us **ukfmpsmarket@kpmg.co.uk** and share your own.

Let's start with the
essentials of what's
going wrong



Unaffordable housing

Residential property is ever more expensive, rising far faster than wages. Average house prices rose 43 percent to £228,000 over the nine years to June 2018¹. And during that period, average cash earnings have risen by just 10.5% – leaving property increasingly unaffordable².

Government's efforts to make housing more accessible by subsidising those closest to the housing market – using schemes such as Help to Buy – have pumped yet more money into the market, adding to the upward pressure on prices.

But, the central problem remains unaddressed: the proportion of English householders aged 35-44 who own their own homes has fallen from 72 percent to 52 percent since 2007³.

Low business investment

The rampant housing market also affects the wider economy. How?

With interest rates on the floor, and mortgagees able to borrow up to nine times their deposit, the consistently high returns to be made in property make it the asset class of choice.

This, in turn, starves infrastructure and businesses of investment.

For individual homeowners, it is almost always better to sink cash into property than to invest in shares or small businesses. Not only are profits reliable, but they're also untaxed – at least on the primary residence. In the UK today, by far the best way to build up assets to pass onto children is to work your way steadily up the housing market.

As a result, between 2005 and 2017 the UK had the lowest gross fixed capital formation as a percentage of its GDP of any G7 country: we are not investing enough in our businesses, technologies, R&D and infrastructure⁴. And the results of this underinvestment can be seen in UK workers' productivity, which is about 25 percent lower than those of their peers in the US, France and Germany⁵.

Inequitable social care funding

Yet whilst a third of all households own their hugely valuable homes outright⁶, many find that much of their value is swallowed up in old age by the uncapped charges levied for social care. As a result, many find themselves unable to leave a legacy for their children – simply because they were unlucky enough to suffer from a long-term, debilitating condition in their later years. And government has no dedicated funding stream to pay the ever-rising social care bills for non-homeowners – a problem set to grow as our population ages unless the decline in home ownership can be reversed.

The problems with the UK housing market ... and beyond

- We have too much money flowing into housing, and not enough into business investment and development.
- An ever-growing slice of the population shut out of home ownership; and a proportion of those who do make it onto the property ladder deprived – in a random and unpredictable way – of their children's legacy.
- Our government faces fast-rising social care costs, without any dedicated mechanism to fund them.
- Tax revenues from workers and businesses are undermined by the UK's low productivity and slow growth, whilst the government lacks the tools to take a share of the proceeds of the country's fast-rising property values.

Let's reimagine how we approach this problem



A solution

What if government were to abolish inheritance tax and stamp duty, but instead to levy capital gains tax (CGT) on individuals' primary residence – deferring collection of CGT until people died or exited the housing market?

That looks bold; let's walk through the concept and its implementation, and consider how to address the obvious challenges and complexities.

According to property specialists Savills, the value of UK homes – excluding new construction – rose by £1,476bn over the last decade⁷. CGT stands at 28 percent; so if levying the tax were to leave the market unaffected, it would have generated a massive £413bn over that period.

Allocating funding

In reality, the market would react by reducing housing investment; indeed, one of the reform's goals would be to reduce the relative attractiveness of the housing market and thus divert funds into business development and R&D.

But even if the rate of house price growth dropped by a quarter, that leaves an average of over £30bn per year – more than enough to abolish both stamp duty on primary residences, which produced £5.2bn in 2016-17⁸, and inheritance tax, which generated £4.8bn in that year⁹.

Of course, the potential revenue from taxing house price gains is only converted into cash receipts at the point the capital gain is realised, i.e. the property is sold. In the early years of the policy, there would be a delay between the potential revenues being generated and the cash being received; this could be bridged by borrowing against the expected future receipts, and unwinding that borrowing as the receipts come in.

So of the potential £30bn, after we deduct the cost of abolishing inheritance tax and stamp duty that leaves roughly £20bn. The government could allocate a portion of the remaining cash – perhaps £8bn per annum – to UK-wide infrastructure projects; by improving public services and connectivity, this would stimulate economic growth and help ameliorate any downward pressure on house prices. With current government spending on transport, waste, water, energy, communications and flood defences totalling £16bn¹⁰, an extra £4bn would make a big difference; the other £4bn could boost spending on public infrastructure such as schools and hospitals.

Meanwhile, with primary residences exempt from stamp duty, people would be able to move home without paying a tax that averaged £7,900 in 2016-17¹¹ – leaving them with more cash in their pockets. It should also permit people to move house more easily, reducing the barriers to their buying more suitable properties as their circumstances change. This would, in turn, increase labour mobility and reduce the number of people living in homes too big or small for their needs.

Funding social care

Linked to this reform, the government could choose to cap people's liability for social care costs – guaranteeing that charges never exceed a third of the value of their home. And even a capped charge would raise large sums.

In 2015-16, public spending on adult social care was £16.4bn¹². With about £12bn of CGT receipts remaining to cover the bulk of those costs, it seems reasonable to assume that capped social care fees would bring the total figure up to equal or exceed our current spending on social care.

We can check this with a rough calculation. In 2016, 70,000 people aged over 65 died of conditions linked to dementia, Alzheimer's and senility alone¹³. Given that 75% of this age group are homeowners¹⁴ and that the average home is worth £228,000¹⁵, a third of their property at the point of death was worth about £4bn.

Of course, some of these people won't have accessed public social care, and some won't be the sole owner of their homes – but patients suffering from these conditions represent only a small fraction of the total receiving care. Add in capped charges on all those homeowners receiving care for other health problems, and the total raised should plug the £4.4bn gap.

With this system in place, even those who spend decades in receipt of residential social care would be able to pass on over a third of their homes' value to their offspring: their children would receive two thirds of the property's sale price, less 28 percent of the money received by their parents via rises in their homes' value over their lifetimes.

Meanwhile, those homeowners who never need adult social care would leave for their children over two-thirds of their homes' value – plus, of course, benefiting from zero stamp duty and inheritance tax, along with greater infrastructure investment.

The delivery mechanism

The system for deferring CGT payments would, of course, need careful development. In essence, those selling one house to buy another would simply roll over their CGT liability – totalling 28 percent of the increase in value since purchase – as a charge on their new property. This could be repeated through their lives until people either die, or sell up and exit the housing market – typically to leave the country or move into residential care.

Sums held as a charge on property would be subject to an interest rate, set by government to balance competing objectives. This rate would need to be high enough to encourage people to settle up when they have the opportunity to do so – perhaps downsizing when the kids leave home – and to ensure that inflation doesn't whittle away the value of the charge in real terms.

But government would also recognise the need to win public support for the policy – so deferring the charge would have to be affordable for most working families, enabling people to keep on moving up the housing ladder without punitive interest charges.

Some further changes would be necessary. For example, ownership laws would require amendment to make clear that people couldn't endlessly defer payment by passing properties directly to their children before they die.

And it would be important not to levy CGT on any rise in a home's value created by refurbishments and extensions rather than the rising housing market: people have already paid tax on the money they spend on home improvements. So surveyors would be required to put a value on any substantive building works, with that sum knocked off homeowners' liability for CGT.

Change without a shock

Governments have always fought shy of levying CGT on primary residences – not least because they fear that a major shock to the housing market could be economically damaging as well as politically unpopular.

But with payment deferred until people leave the housing market, there would be no sudden impact.

Over time, investment capital could be expected to spread out from the housing market into more productive sectors – helping to rebalance the UK's skewed economy. But in the short and medium term, homeowners would see their tax payments falling – particularly during the pain points of house moves and bereavements.

Many people would see the sense in shifting the burden of taxation from labour and business activity towards unearned increases in asset value; and everyone would recognise the value in being able to guarantee their children a legacy, whether or not they need social care in their later years.

Meanwhile, the money freed up for greater public infrastructure investment would itself bolster economic growth and house prices. And here there's another virtuous circle – for the imposition of CGT on homes would guarantee the government a decent share of the house price rises created by those investments.

Benefits all round

Over the scheme's early years, the government would end up with a lot more 'IOUs' in the form of deferred payments than actual cash. But in time, very large sums would start to come through; and in the meantime, the government could borrow against those future revenues to fund social care, infrastructure spending, and the abolition of stamp duty and inheritance tax.

Incrementally, the higher tax rates on property returns would pull money out of that market, slowing house price growth to more sustainable levels.

And as that cash finds its way into R&D, capital investment and business growth, we should see the UK's productivity start to rise again – pushing up earnings.

Aided by an additional £8bn a year for infrastructure spending and a £10bn cut in inheritance tax and stamp duty, this dynamic should see wage growth tick upwards.

Eventually, house price growth and wage increases could meet in the middle. And meanwhile, we'd all be benefiting from a more productive economy, greater labour mobility, lower taxation during our lifetimes, and the guarantee of well-funded social care that leaves us able to pass a legacy onto our children. What's not to like?

Contact

To discuss this piece in more detail feel free to contact the author.



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