

Housing, credit and the euro: the policy response

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HM Treasury produced its long-awaited assessment of the five economic tests in June, having signalled the basic decision months in advance. The Treasury sees important impediments to adopting the Euro in UK housing and credit markets, and makes some proposals for further investigation and policy. In this paper, John Muellbauer¹² considers the policy options.

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1. Introduction

The five economic tests document and the effort behind it is one of which the Treasury can be proud. It represents an impressive marshalling of business economics, economic theory and empirical evidence on this important decision. The Chancellor's advisor, Ed Balls remarked, in a lecture on the historical parallels - the return to the Gold Standard in the 1920s, the post-war devaluations and the entry and departure from the ERM - that previous decisions of similarly great moment had not been

They summarise frontier thinking in these areas, integrating the contributions by leading academic economists from around the world with the hard work of the Treasury's home team.

The document also signals a belated recognition that the government's improvements in the macro-policy framework – handing inflation targeting monetary policy to the Bank of England's MPC and the new set of fiscal rules – have not solved housing, regional and urban problems, and their capacity to impact on

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² I am grateful for Duncan Maclennan for thoughtful comments on an earlier draft, but retain responsibility for all views expressed.

properly researched. The Treasury's efforts on this occasion ensure that this mistake is not repeated.

From the point of view of an academic economist, the documents published by the Treasury cover the issues comprehensively. They are fertile ground for researchers and students interested in such issues as the monetary and fiscal transmission mechanism, the functioning of credit and housing markets and their wider implications, the implications of labour market flexibility for economic performance, and optimal currency areas.

the wider economy.

The emphasis in the March 2003 Budget Statement both on housing finance (the review by Professor David Miles) and the supply side of housing (the review by Kate Barker of the MPC) had implications for the likely outcome of the five tests. They suggested that the Treasury would argue that significant impediments to the UK's adoption of the euro lay in structural differences in housing and credit markets. And so indeed it proved. Having argued the case for many years, it was gratifying

to see not only the general case, but many of the detailed arguments accepted.

To see what the policy implications might be, it is worth quoting from the executive summary of 'The Assessment of the Five Economic Tests' (my paragraph numbering):

1. To deliver a more settled platform of stability in the future and a higher degree of convergence, the government is committed to a comprehensive programme to improve the functioning of the housing market. Building on the reforms to deliver a step change in planning policy, the government is undertaking further significant changes in the planning system, supply of housing and housing finance to tackle market failures, increase the responsiveness of supply to demand and reduce national and regional price volatility. These measures are beneficial in their own right to improve the stability and flexibility of the UK housing market and wider economy, but will also increase the housing market's compatibility with the euro area, encouraging greater convergence over time.
2. This means implementing quickly and decisively past reforms to housing supply and going further to address both supply and demand in the housing market and macroeconomic stabilisation more generally:
3. On the supply side, the government is requiring new Regional Spatial Strategies to take account of volatility in the housing market and promote macroeconomic stability as part of delivering substantial development; tough and credible measures, including intervention, where local authorities are not delivering housing numbers in high

demand areas; and exploring whether, in the medium term, achieving the government's objectives will require a system of binding local plans. The government has also commissioned a review of issues affecting the elasticity of supply in the UK, in particular to look at the role of competition, capacity and the financing of the housing building industry and possible fiscal instruments and the interaction of these with the planning system and sustainable development objectives;

4. On the demand side, through a review of the UK mortgage market to establish why the share of fixed rate mortgages is so low in the UK compared to many other EU countries and to identify ways of encouraging the market for longer-term fixed rate mortgages; and
5. At the macroeconomic level, given that housing is identified as a significant risk factor to the achievement of a sustainable and durable convergence and, in the context of the Treasury discussion paper, Fiscal Stabilisation and EMU, to consider what additional reforms and measures might help deliver wider stability in the economy, including with reference to the housing market, to create the right conditions for convergence within EMU. The government's announcement of its intention in the next Pre-Budget Report to give the Bank of England a symmetric inflation target as measured by the Harmonised Index of Consumer Prices will help ensure inflation expectations in the UK remain in line with those of the euro area.

Given the political sensitivity of some of these issues, one is tempted, on the lines of an old-style Kremlinologist, to try to deconstruct the meaning behind this text. Even if the summary does not belabour the point, it is clear that the Treasury is

concerned both about short-term transition problems and longer-term stability problems. To be blunt about the former, the worry is that the cut in interest rates following early adoption of the euro would extend the housing market and consumer spending bubble, increasing economic imbalances and economic risks.

The first four paragraphs of the policy response put most of the emphasis on the 'supply side', the planning system and on the nature of mortgage finance (ie why not more fixed rate mortgages, as on the continent). These might be thought politically relatively uncontroversial at the national level. The planning system is enormously complex and lacking in transparency. Reforming the system is likely to be a long drawn-out process, with important allocational and distributional consequences. It seems plausible that losers in the process would be more likely to punish politicians at the local level, with smaller implications for Westminster.

One problem with this identification of the 'supply side' with private sector house building is that it misses the fact that 99% of the supply side is the existing housing stock. The implication of this observation is that tax policies that lead to a more efficient use of the stocks of land and existing buildings could be far more powerful instruments to enhance the stability and flexibility of the UK housing market than changes in the land-use planning system. The other obvious problem is that, in the assessment, all housing types are implicitly regarded as all the same. However, market rental housing has a special role to play in promoting economic flexibility. Past government intervention – decades of rent controls in the presence of inflation, and the continuing tax bias against it, have caused the sector to shrink to a level surely below that generated by a market economy with a level tax playing field.

The fifth paragraph implicitly acknowledges the tax issue by mentioning 'additional reforms and measures' to enhance the automatic stabilisers and potentially serve as policy instruments in the greater role seen for fiscal policy under EMU. Following up the reference to the 'Fiscal Stabilisation and EMU' discussion paper, one finds discussion of stamp duty and other housing taxes including market value based property taxes and capital gains tax, mortgage tax relief and a consumer credit tax. The latter is comprehensively dismissed because of administrative costs, compliance issues,

compatibility with the single European market and distributional consequences. However, housing taxes are not similarly despatched. Some newspaper editors (including daily or Sunday editions of the Express, Mail and Star) have followed this trail and already begun the resistance to this potential threat to their personal life-styles with scare-stories on the coming attack by the government on 'Middle England' (otherwise known as the very rich).

In the rest of this paper, I consider briefly the three sets of potential reforms: to improve the responsiveness of new housing supply to house prices and so make the national and regional housing markets less volatile; to improve the prospects for fixed rate mortgages and so make the housing market less responsive to short-term interest rates; and to reform the tax system to allocate land and housing more efficiently, to reduce national and regional volatility and to enhance the automatic stabilisers.

2. The causes of inelastic supply by the private construction industry

There is considerable evidence (Malpezzi and Maclennan, 2001, Swank et al., 2002) that the elasticity of supply of new housing is lower in the UK than in many other industrial countries, including Eurozone countries. The Barker review of housing supply is looking into four main areas of concern: the structure and behaviour of the house building industry; capacity constraints from land, finance and skills; why private housing supply has not replaced social housing (where new-build is dramatically down from levels prevalent in the 1950s to 1979); and policy constraints including the interaction of the industry with the planning and tax systems.

On the face of it, it seems hard to argue that the UK house building industry is excessively concentrated. However, this is not to say that local or regional monopoly may not sometimes arise because of local or regional concentrations of land-banks acquired by developers³. However, competition from the existing stock and nearby locations is ever-present and limits the potential abuse.

As far as behaviour is concerned, one important factor emphasised over the years by Ball (1988, 1996) is the volatility of house prices and of the demand for new houses. In the UK, the volatility

³ *The land assembly process for large sites can, however, convey on the last seller substantial power to extract 'rent' and cause delay.*

and persistence of swings in land and house prices have made timing the acquisition and release of land banks often far more important to the bottom line of house builders than efficiency of building, issues of design etc. This has reduced incentives to innovate and adopt efficient manufacturing strategies as well as to invest in capital intensive projects which could bring such gains.

In the last decade, following Dixit and Pindyck's 1994 work on the real options approach to investment, economists have put great emphasis on the irreversibility of investment projects and the negative implications for investment of uncertainty and the high hurdle rates of return it generates. Empirical evidence suggests that uncertainty has a negative interaction effect with expected sales growth in its impact on investment (eg Bloom et al (2002), Guiso and Parigi (1999)).

For the house building industry, house price growth or the ratio of house to land acquisition prices play the same role as sales growth. Evidence of this kind would suggest a similar negative effect of higher uncertainty on the supply elasticity of new housing. Evidence consistent with the real options theory has been found by Bulan et al (2002) for a panel data study of Canadian condominium developments. They find: 'increases in both idiosyncratic and systemic risk lead developers to delay new real estate investments'. Empirically, they estimate that a one standard deviation increase in the return volatility has an effect equivalent to a 9% decline in real prices. They also find that greater local monopoly power increases the negative impact of uncertainty.

This suggests that **any** reforms which reduce the volatility of returns in housing, whether on the 'demand' side or on the 'supply' side will increase the supply elasticity of new housing. This is the second argument why the attempt to separate policies into 'supply' and 'demand' side may be overly simple.

The second set of factors examined by the Barker review has to do with capacity constraints from land, finance and skills. Once again, volatility is very important.

Beginning with skills, the economic mismanagement that exacerbated the housing crash of the early 1990s led to large-scale bankruptcies in the construction sector and the abandonment of some industry apprenticeship schemes. Capacity constraints and skill shortages were a natural consequence when housing markets recovered in the mid-1990s. And the higher level

of skill shortages in the South East building industry are themselves influenced by the high price of local accommodation.

Access to finance is likely to be affected by volatility also. There is a strong correlation, for example, between credit tightness indicators reported by banks and stock-market volatility (see Muellbauer and Nunziata (2001) for US evidence). It seems likely that, at the industry level too, credit terms offered by banks to house builders will be affected by the perceived riskiness of the industry.

Land constraints have long been argued to be a key factor in the low supply elasticity of new building in the UK (eg Malpezzi and Maclennan, (2001)). Within the US, in economic upswings, house prices in old cities such as Boston, where planning controls are tight, tend to rise relative to Southern or Midwestern cities, where land constraints are loose. This is *prima facie* evidence for the role of land constraints. The literature on planning, the supply of housing and house prices was reviewed by Monk et al (1991), while a more recent, comprehensive theoretical and empirical model-based treatment is by Bramley et al (1996). The empirical work they present suggests that the effects on housing output and house prices of relaxing planning constraints are relatively modest. One might object that their modelling is not sufficiently 'general equilibrium' in character, but broadly similar conclusions follow from national house price models (Muellbauer and Murphy (1997), Meen, (1990), Meen and Andrew (1998)). These suggest that the national price elasticity of demand is in the range -0.5 or -0.7. This means that an increase in the national housing stock of 1% results, other things being equal, in a fall in house prices of 1.4 to 2%. A 25% rise in new house building sustained over 4 years would increase the housing stock about 1% at the end of this period.

So, even if a relaxation of planning constraints were to result in such a significant rise in new housing output, the

price consequences and the implications for the volatility of prices are likely to be modest. Of course, a 50% rise sustained for 10 years would produce a 5% rise in the stock of dwellings and a more notable drop in prices of 7 to 10%.⁴ It is a fact that in the 1980s house price boom, there was a significant response of new planning permissions to higher house prices (a rise of 25% or so from 1984 to 1988). In the post 1997 boom, this response is almost entirely lacking. It seems likely that the Labour government's planning reforms, for example the direction towards using brownfield sites and lower use of greenfield sites, and the use of 'Section 106' – effectively a development tax – contributed to this lack of response.⁵ While it is true that this added to the house price boom, the overall effect is likely to have been quite small. Improving the national supply elasticity of housing is likely to make only a small contribution to stabilising the housing market, unless they had a significant impact on land price expectations.

Such calculations and conclusions, however, implicitly assume an equi-proportional rise in supply and the same price elasticity of demand across the country. However, if the price elasticity were smaller in the most economically vibrant areas, as evidence suggests, and if new supplies could be made more elastic in those areas, then bigger stabilisation benefits could come from planning reforms. The introduction noted that 99% of supply consists of the pre-existing housing

⁴ *In the short run, the effect could be a little larger, since one of the factors making for house price volatility is the perceived rate of return for house-buyers. A policy change reducing this rate of return could therefore have a somewhat amplified short-run effect on prices. As noted below, a sustained effect on land price expectations could also amplify the house price effects of supply side reforms on new build.*

⁵ *Under Section 106 of the 1990 Town and Country Planning Act, local authorities can negotiate with the developer for a proportion of the planning gain to be provided to the LA in the form of social housing, schools or other social objectives. In London, as much as 50% of the gain has been the target of some LAs. The negotiations have often been extended and complex and added to delays in the planning process.*

stock. Reducing the spatial mis-match of housing supply and demand across the UK is likely to have considerably greater benefits for reducing national house prices and volatility. I will return below to tax reforms for this purpose.

It is sometimes argued that developers and speculators hoard large land-banks, partly in the form of options to purchase, and the withholding of these from housing development was part of the reason for the more than threefold increase in average housing land prices in the South East between 1995 and 2001. This might also help explain the lack of increase of new planning permissions in the recent boom. One possible story is that the late 1980s/early 1990s house price volatility was so severe that it made developers more risk averse and so more liable to hoard land than in the mid-1980s. Another is that lower interest rates reduced the costs of hoarding land. However, real interest rates were, until recently, little lower than in the mid-1980s.

Holding land-banks is clearly part of the legitimate business strategy of house builders to maintain an even production flow. However, when expectations of future rises become widespread, the role of land prices in allocative decisions can become distorted. Value taxes on land whether in use or not, even at a modest level, can play a useful role in anchoring prices: when prices rise, the carrying costs of hoarded land rise, providing an incentive to bring such land into use, and so helping to bring supply and demand into balance. I return to this issue below.

The third area of concern of the Barker review is to understand why private new build housing supply has not replaced social housing. New-build for social housing is less than a fifth of levels prevalent in the 1950s to 1979 and has declined further under the Labour government. Indeed, virtually all the decline in total new build since the 1970s is numerically attributable to this decline – private house building having remained fairly stable. There is one very simple partial answer to the question, but beyond that the reasons are complex, and involve important and deep social policy choices. The simple part of the answer is that 'Right-to-Buy' legislation, giving sitting council tenants the right to buy their homes at discounts of 50%, took a large fraction of lower income households into owner-occupation by this route instead of via the purchase or rental of houses newly built by the private sector⁶. But there

⁶ *The longer term concerns over the sustainability of owner-occupation for RTB purchasers in the face of*

is much more to the question. One obvious way in which private new build might have compensated for the decline of social new build is via the private rental sector. The Business Expansion Scheme of the early 1990s did bring some larger investors into the rental market and, more recently, the 'financial liberalisation' of the buy-to-let market (the granting of much more favourable loan to value and loan to income terms by mortgage lenders) has brought many small investors into the market and has brought about the first (small) increase in the fraction of all tenures in this sector for many years.

Much has been written, for example in research for the Joseph Rowntree Foundation, on why pension funds and other institutional investors in the UK, unlike in continental Europe, have shied away from this sector. One simple factor is the history of pre-1980 rent controls and the perceived risk of controls being re-introduced. A second lies in the tax advantages of owner-occupation. Another is the lack of a long track record of returns data so that bonds, equities, commercial business property and commercial residential property can be fairly compared, and asset allocation decisions made that will satisfy the trustees and regulators of pension funds and charities. Given the involvements of previous governments in this serious market failure, and the hysteresis in tenure structures, there is an obvious case for some fiscal incentive, perhaps for a ten year period, to bring the resources of large institutions into private renting and build up the management expertise, skill base and experience currently lacking.

The related question of why the Registered Social Landlord, mainly Housing Association (HA), sector has had such low rates of new build in recent years needs also to be asked. On the face of it, the favourable (almost three to one) asset/debt ratio of the sector as a whole in recent years (see Startup (2003)) should have provided plenty of scope for increased borrowing and expansion. It is not clear why this has not happened. It may be that RSLs lack the incentives, experience and skills – or the regulatory framework - to engage in the entrepreneurial and necessarily risky activity of acquiring and developing land. And clearly some HAs have much less favourable asset/debt ratios than others. It may be that limited 'Right-to-Buy' legislation and the threat to force 50% discounts onto HAs as well as on councils, which would reduce future asset to debt ratios, makes expansion

adverse circumstances and the negative implications for wider economic stability have been emphasised in research for the Joseph Rowntree Trust by Duncan Maclellan.

look risky. Moreover, given the prospects of further transfers of housing from councils to RSLs, the council house discounts destroy the asset base for the future expansion of social housing.

Certainly, such large discounts for council tenants should be abandoned. They offer bad value for the general tax-payer, giving a large capital subsidy to tenants who have already had years of subsidised rents. If the objective is redistribution, alternative ways of using the funds over a wider range of beneficiaries would see far greater benefits. Furthermore, some spectacular abuses of the system, particularly in high-priced London and South East, have come to light, causing some second thoughts on the system by the Office of the Deputy Prime Minister. It would make good sense to follow Scottish practice. In Scotland, discounts have been reduced to 15-35%, with a minimum tenure of 5 years and the size of the discount increasing to the 35% maximum with length of tenure. Moreover, in pressure areas, LAs have discretion not to offer discounts. Discounts have also been extended to housing associations.⁷

One current benefit of seeing far more expansion of new build in the private and social rented sectors is that there is excess capacity in construction businesses specialising in office and apartment buildings, given the downturn in the office market. Apartment-type buildings are certainly the main locus of the rented sectors in continental Europe, and the higher densities thereby achievable help alleviate the land constraints.

It is hard to avoid the question of why, given the high levels of home-ownership in the UK and easy access to credit, and the sub-optimal size of the rented sector, the government would wish to force up the home-ownership rate further? Yet that is exactly the pre-occupation of the

⁷ I am grateful to Duncan Maclellan for this summary of Scottish practice.

current Home-ownership Taskforce. As Startup (2003) argues, reforming the system towards tenure neutrality⁸ makes better sense and is likely to lead to a more efficient allocation of resources. Indeed, moving towards market rents in the social housing sector and replacing Housing Benefit by income grants, as is the widespread European practice, should be the long-term aim.

The final topic of the Barker review of the supply of new housing concerns policy constraints, including the interaction of the planning system and the industry. Some of the issues have already been touched on. But there are others, including the zero rate of VAT on new build, compared with full VAT on conversions. This makes no sense and appears to contradict the thinking behind preferring brownfield to greenfield development.

More generally, the English land-use planning system divorces planning from economic considerations more strongly than in other countries. Indeed, Paul Cheshire regards the English system as the most extreme in the world in this regard⁹. There are various possibilities for making economic considerations more prominent in the planning process - for example, giving impacts on employment growth a high weight. Cheshire suggests using land values themselves as a signal of economic pressure. He suggests using the price gap defined as the value of land under the most price-favourable planning consent (usually housing or central city retail) minus the value under the current planning consent. If the price gap exceeds a certain threshold, he proposes that there should be a basic presumption for development so that the planners or the opponents of development would have to show that the amenity value to the community (eg if the site was one of special scientific interest) justified maintaining the current planning consent.

A second area for reform concerns the level at which planning takes place. If it is too localised, the asymmetry between the per capita costs to a small group of locals and the widespread benefits to a much larger community may be too skewed against development. Linkages with infra-structure development also call for higher than local

authority levels of planning and the longer time scale implied by infra-structure needs¹⁰.

A third area of reform concerns rules on the sharing of planning gain, as in 'Section 106'¹¹. Development taxes in general should not be excessive and the rules should be transparent, to minimise the need for complex negotiation. Many economists would argue for zero development taxes and for land or property taxes to capture some of the planning gain and the benefits of infrastructure investment for the community, as well as to provide some automatic compensation to losers from the planning process. Economists generally argue that taxes, which work with the price mechanism, are less distorting than quotas or other non-price interventions, and this is a good application of the idea.

A fourth area of reform concerns local authorities who employ no planners or have no plans and use this to obstruct development. A fifth long-term area for concern is the training and culture of planners, who often lack economic or financial skills and, in the view of some observers, too often follow a 'jobs good, housing bad' rule. A sixth concerns planning attitudes to conversions and repairs, which account for a large fraction of net additions to the housing stock. Finally, in the long run, the planning system should be transparent and predictable to reduce delay and uncertainty, which reduce the supply response of builders.

⁸ See Muellbauer (2003, p.187) on the remaining tax bias towards owner-occupancy.

⁹ In evidence to the Barker review.

¹⁰ Bramley et al (1996) and Joseph Rowntree Trust (2002a) are among many who have argued on these lines.

¹¹ See Joseph Rowntree Trust (2001, 2002b).

3. Mortgage finance

It has been hard to argue that there is a significant market failure in the UK mortgage market, though it is surprising how slow the market has been to offer fixed rate mortgages for longer terms (eg 10 years or more). On the other hand, since nominal interest rates have been in a downward trend since 1990, UK mortgage borrowers have been either wise or lucky not to have gone into long-term fixes.

The other key thought behind the review the Chancellor has asked David Miles to carry out is that the UK's floating rate mortgages increase the transmission from short-term interest rates into house prices and consumer spending. If UK households had fixed rate mortgages, as on the continent and the US, one might expect the transmission to be less. However, the US example scarcely bears this out. Not only is there a mix of adjustable rate and fixed rate mortgages in the US, and an increasing share of the former, but households on fixed rates have, effectively, a cheap option to refinance. The pre-payment risks are covered by the roughly 1% spread between 10-year mortgage rates and 10-year government bonds, given backing from Fannie Mae and Freddie Mac, and the widespread use of derivatives to hedge the risk. The consequence has been that the monetary transmission mechanism in the US has been very effective: consumer spending, mortgage refinancing and borrowing, the housing market and home equity withdrawal have remained relatively strong, despite the fall in the stock market and the rise in unemployment. In Denmark too, whose strikingly stable economy and lack of economic imbalances, was emphasised in Muellbauer (2003), fixed rate mortgages have a prepayment option and since 1996, adjustable rate mortgages have gained market share dramatically (see Lunde (2003)). Thus, while a part of the explanation of relative Danish stability, despite a liberal credit market, lies in its mortgage bond market, I do not believe it is the most important part of the story.

However, there is one feature of the Danish mortgage system discussed by Lunde, which I neglected in Muellbauer (2003). This is that the government legislates maximum loan to value ratios in the mortgage market. These are currently 80% for residential housing. This does not prevent households from borrowing more, but top-up loans are unsecured and therefore more expensive, and this acts as a powerful disincentive against excessive gearing. I have long argued that the high levels of gearing introduced in the UK as mortgage markets liberalised play an important

role in explaining the volatility of the housing market and of consumption. It would be worth investigating why legal maxima of this type, say 90% loan to value, cannot be used in the UK if they survive in Denmark despite its very open economy and efficient markets.

4. Taxation

There can be little doubt, however, that the Danish property tax system plays a key role in stabilising the economy, as argued in Muellbauer (2003). Interestingly, the Treasury's own paper on fiscal policy and EMU ranks Denmark and Sweden as the two countries with the strongest automatic stabilisers for consumption shocks, far higher than in the UK. It is little coincidence that Sweden has sizeable property taxes (and capital gains taxes¹²). Stephens (2002) has examined the somewhat unstable housing market in Finland and suggests that raising property tax rates (introduced only in 1993) from their present relatively low levels, and more frequent valuations, would assist in creating a more stable market. The Treasury paper finds the automatic stabiliser for consumption shocks in Finland currently to be far lower than in Denmark or Sweden.

I made relatively little of Denmark's land value tax charged by local authorities since the revenue it raises is small compared to the national property tax. However, it is plausible that it plays a useful role in improving the functioning of the land use planning system, by increasing the costs of land hoarding when land prices are high, so increasing land supply counter-cyclically (see above).

Taxes on imputed rent or market value have important benefits for allocative efficiency, as argued in general terms by Pines et al (1985), Berkovec and Fullerton (1992) and Skinner (1996) and by Cameron and Muellbauer (2000) in the context of the UK's council tax. In the UK context, a reform of the type set out in Muellbauer (2003) would also have distributional and macro-stability benefits. As the Treasury fiscal policy paper argues, as well as longer-term stability

¹² However, Fuest et al (2003) argue that capital gains taxes can lead to larger, not smaller price swings.

problems, the UK faces as serious transition problem in adopting the euro from the cut of 1.5% points or more in short-term interest rates that might result. Indeed, its simulations suggest that a rise of five pence in the standard rate of income tax or savage cuts in public expenditure would be needed to offset the expansionary and inflationary effects of such an interest rate reduction.

A property tax reform, particularly one in which the number of gainers would far outweigh the number of losers, could well be more attractive politically. However, there are risks since the housing market outlook is particularly difficult to judge at present and the government's 'political capital' is lower than at almost any time since 1997. Careful modelling of alternative reform possibilities reduces these risks, but they remain an impediment to action. The Treasury paper on fiscal policy gives careful consideration to the idea of a Fiscal Policy Committee to parallel the Monetary Policy Committee in a post-EMU environment, but concludes that fiscal policy should be under democratic control. I agree with this view in general terms. However, my proposal to hand to the MPC a single lever, the property tax rate, which has interest rate-like effects, to replace the lever taken away from it, is only a very limited exception to the general principle.

One possibility worth serious exploration is a land value tax not on occupied residential property but on all other sites¹³. Property tax reform for homes could then be phased in gradually, at a later stage and taking careful account of the cyclical position. The political advantage of such a land value tax, from which the huge majority of households would be exempt, but with beneficial stabilising and efficiency gains for the economy should be obvious. Details of timing and content will need careful thought. The time-scale for introduction will need to be rapid enough and the credibility of the reform sufficient to have a large impact on land price expectations to coincide with and offset the interest rate reductions associated with euro entry. In the long term, it needs to be augmented by eventually bringing taxes on housing onto a market value basis to reduce supply-demand mismatches in the UK more permanently.

5. Conclusions

The record of politicians in the sphere of housing is not good. Rent controls destroyed much of the UK's private rented sector. Mrs. Thatcher's abolition of the domestic property tax at the height of the 1980s boom and the return of property tax in the form of council tax in the depth of the 1990s bust, exacerbated volatility. The Treasury did see through the abolition of mortgage interest tax relief and has tried to use Stamp Duty (though without reforming its illogical rate structure) to take some of the recent heat out of the market. But the opportunity was missed to time needed reforms of council tax – reduce its regressiveness locally and between local authorities, increase its link with market values, and soften its impact on pensioners with low cash flows – to counteract the upswing in the housing market. At the same time, building in the social sector was reduced further and planning constraints tightened.

Implicitly the Treasury assessment of the five economic tests acknowledges the problem, and the depth of its analysis, together with the Barker and Miles reviews are very welcome. UK housing market booms and busts have profound effects on the life experiences of its citizens and cause large distributional shifts between generations. Housing market choices and their timing are often more important than career choices. Opinions differ widely on whether the recent UK house price boom will be followed by a bust, and when. It is

¹³ *Land in public ownership could not be taxed. But to ensure rational mechanisms for the use of such land, there is much to be said for a single national body to take over 'ownership' and management of such land from the diverse agencies holding land parcels*

obvious that politicians will not want to be blamed for a sharp downturn. The policy response, in current circumstances is likely to be dominated by this concern. In the long run, reforms to the planning system, the introduction of a land value tax, reform of property tax, are all desirable to improve the functioning of the economy. For the mortgage market, statutory limitations, as in Denmark, on loan to value ratios would reduce instability and have beneficial effects for the wider economy. All but significant property tax reform could be on the short-term agenda. A package of such reforms would eventually make possible reductions in Stamp Duty, which penalises labour mobility. The excellent record of the MPC in monetary policy, in contrast to the poor record of politicians internationally in the housing area, is a strong argument for handing the potentially powerful property tax lever to the MPC, especially if the UK adopted the Euro.

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