

What is the economic and distributional impact of an owner-occupied immovable property tax?

Note prepared for States of Jersey

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Introduction

This note provides an economic and distributional impact assessment of the proposal by P.G. Blampied ('Blampied proposal') to introduce a tax on owner-occupied immovable property.^[1]

The analysis in this note shows that the proposed tax has the potential to produce adverse economic impacts and that its effectiveness in addressing distributional concerns is likely to be limited. A GST does not have these shortcomings and provides considerably more certainty about its likely economic impact. Overall, and assuming that the tax is designed to raise revenues that could be used to lower the required GST rate, the introduction of the tax is likely to lead to a less efficient tax system. In addition, the current income tax and benefit system is a more effective way of addressing any distributional concerns.

The remainder of this note is structured as follows.

- Section 1 summarises the main characteristics of the tax, identifying the parameters that are key and the potential impact of the tax.
- Section 2 summarises current taxes on property in Jersey and the Blampied proposal.
- Section 3 assesses the economic and distributional impact of the tax.
- Section 4 concludes.

2

Property taxation in Jersey and the Blampied proposal

Ownership or occupancy of property in Jersey is currently subject to two forms of taxation.

- **Parish rates paid by homes and businesses**—these pay for the provision of specific **municipal** services rather than for general revenue expenditure.^[2] Rates vary depending on the rateable value of the land and by domestic or non-domestic use, and therefore incorporate to some extent the ratepayers' ability to pay (such as 'individuals in houses with lower rateable value are less well off than those in houses with higher rateable values'), as well as the volume of use of the service (such as 'businesses make greater use than private individuals of public services').
- **Income tax**—persons or bodies receiving rent from property pay income tax on the resulting profits under the Jersey income tax system.

The *consumption* benefit that residential owner-occupiers derive from inhabiting their property is therefore

untaxed, except for the element of parish rates that varies with the rateable value. The value of this benefit to owner-occupiers can be measured through the implicit rental cost of living in the property—ie, the rate at which it could be let in the market. These rental values are proposed to be taken as those established by the parishes for the purpose of parish rates.

For commercial property where the occupier of the property is not the owner, the occupier normally pays rent (or equivalent) to the owner. This rent is a business expense, and is therefore deducted before profits are calculated. Tax is paid on the profits of the business. For the landlord, tax is paid on the *profit* that is earned from the rent—ie, rental income less business expenses. At present, the tax rate on profits for both owners and occupiers is normally 20%.

For commercial property where the occupier is the owner, no rental (or equivalent) income arises, so there is no apparent tax on the notional profit made from the rental value of the property. However, in general, the profit of the owner-occupier is raised by the value of the notional profit on the notional rental income, and is therefore included in the tax base of the owner-occupier. As a result, the total tax-take is similar, irrespective of whether the building is owned by the occupier or a third party.

However, the introduction of 0/10 may change this outcome, and, for the purposes of this analysis, it is assumed that, under the 0/10 structure, the following would apply:

- profits on any rents (or equivalents) would be taxed at 20% irrespective of the ownership or residency of the organisation or person receiving the rents;
- where a 0%-taxed Jersey-owned company is an owner-occupier of its premises, its shareholders would be charged tax of 12% of the total profits due to them, or 20% of the profits distributed to them, whichever is the larger number (subject to an additional charge when the shares are sold or the company is liquidated);
- when a 0%-taxed company not owned by Jersey residents is the owner-occupier of its premises, it would not pay tax on its profits, including the notional element of profit arising from the notional rental of that property;
- when a 10% or 20%-taxed company not owned by Jersey residents is the owner-occupier of its premises, the tax rate would be 10% or 20% of the notional rental profits, through the mechanism outlined above.

Against this background the proposal appears to have the following main characteristics, broken down into the residential and commercial markets.

2.1

Proposals

2.1.1

Residential markets—owner-occupiers

It is proposed that the implicit rental value be taxed as income, at a rate of 20%. The proposal suggests that this would ensure that owner-occupiers in properties with higher implicit rental values (assumed to be more prosperous) would contribute more to the tax-take than those living in houses with lower implicit rental values (ie, the less well-off). As a further measure to make the tax more progressive for individuals, a threshold is proposed (eg, £10,000), below which the rental value would be excluded from the income tax system.

It would appear that these tax rates and thresholds would operate independently from the existing personal income tax structure, and this has been assumed in the following analysis.

2.1.2

Residential market—landlords

The proposal appears to be slightly ambiguous about the impact on domestic rental property. However, it is assumed that there is no impact on the rental market and that owners are, and will continue to be, taxed at 20% on the *profit* they receive from renting property out.

2.1.3

Commercial property

The proposal suggests that where owner-occupiers occupy property, they would be assessed for income tax at 20% of the rental value as established by the parish. This tax would be gross. In addition, for business properties, there would be no threshold. This is to ensure that companies which trade in Jersey but whose

shareholders or parent company are not resident in Jersey (and which, under the 0/10 proposals, would not pay income tax in Jersey on their profits) would be subject to some income tax.

For property that is rented, there would be no change, and tax would remain payable on profits generated from the property rental, subject to the tax office's ability to substitute current market rents for actual rents where the rent had been artificially lowered in order to avoid tax.

3 Economic impact assessment

3.1 Residential housing market

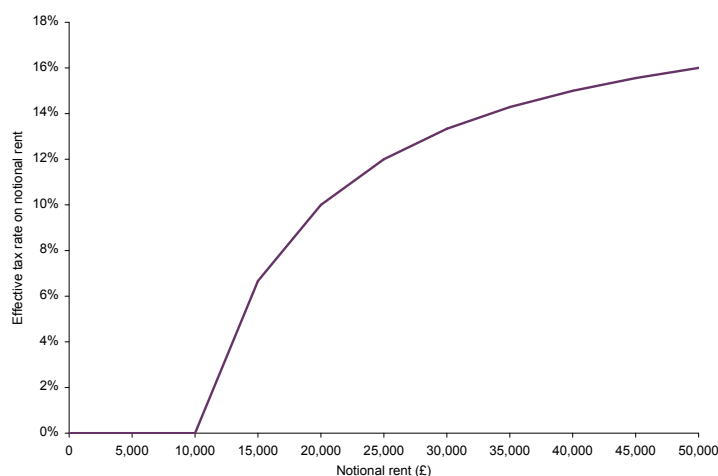
In locations such as Jersey, with a significant constraint on the supply of land, the value of land is the single largest component (perhaps around 75%) of the overall property price. Under such circumstances, a land tax and a property tax can be regarded as broadly synonymous.^[3] However, this proposal is to tax property differentially (compared with the status quo), depending on its current ownership pattern.

Compared with the current and post-0/10 taxation of housing, the Blampied proposal has the effect of increasing the tax burden on owner-occupiers and not on renters—either rent payers themselves or landlords. The following general outcome of the tax would be expected, compared with where the market would otherwise be, all other things being equal:

- house prices fall slightly, with the price of more expensive houses falling by more than that of cheaper houses;
- house prices below the threshold could even rise slightly;
- buying a house becomes slightly more expensive when the impact of the additional income tax is taken into account;
- private sector rents might be slightly lower than they would otherwise have been, reflecting (slightly) lower house prices, but not at the cheaper end of the market below the threshold.

Within this overall impact, the result of the proposed threshold is also to change the distribution of the tax burden. The setting of a threshold of a rental income of £10,000 per annum means that an owner-occupied household occupying relatively cheap housing is excluded from the tax. As a result, the effective rate of tax on the notional rental income is progressive. Figure 3.1 illustrates the relationship between the average tax rate and the notional rent.

Figure 3.1 Relationship between notional rent and effective tax rate



Source: Oxera calculations.

However, a number of problems can arise if the objective is to set a tax that mirrors ability to pay. In particular:

- the match between current income and housing value is not perfect, and although the threshold will remove many low-income households from the tax net, this cannot be guaranteed;
- the reverse problem may also occur—relatively high-income households occupying relatively low-value property will not pay any tax;
- if the tax threshold is set relative to the *property* value, couples/sharers occupying the same property will be worse off compared with single people each occupying a smaller property. This is likely to introduce some additional inefficiency into the housing market.

At the margin, a tax of this sort also has some potential adverse incentive effects, depending slightly on the details of how it is implemented.^[4] In particular:

- **actions by the owner** which affect the characteristics of the property, and therefore change its overall value, will be discouraged if the value of the property increases, and encouraged where the value of the property decreases. For example:
 - property extensions and other enhancements to the house which increase the overall value of the property may be discouraged;
 - a lack of maintenance or investment in the property, which has the effect of reducing its value or results in the value not increasing at the rate it otherwise would, may be encouraged;
- **external factors** which are beyond the influence of owners, such as changes in housing demand conditions, developments (or lack thereof) in local infrastructure, or revisions to regulation, which change the value of properties. As this alters the tax payable, this might be seen as unfair.

These factors affect the market value of properties and, therefore, potentially the level of taxation. The proposal's tax base is established via the parishes' approach to property valuation. However, depending on the way in which parishes undertake their valuation (this has not been reviewed as part of the present research), the impact of the interaction between actions by the owner and external factors may differ.

If the approach does not take into account such factors (sufficiently) or only with a time lag, then an owner-occupier property tax might not be considered particularly fair as it does not fully reflect the true consumption benefits that arise to the occupiers. After some time, the relationship between tax paid and the actual value of consumption may no longer hold.

However, if the valuation system swiftly incorporates such factors, it might introduce distortions—for example, by incentivising owners to under-invest in order to reduce the value of the property and therefore their tax liability. If this effect operates then, at the margin, the housing stock will deteriorate compared with where it would otherwise have been.

Also, if an external factor leads to a significant increase in value and this is reflected in the parishes' valuations, the owner would also be subject to a significant increase in tax liability, regardless of whether the income (as opposed to their financial wealth) increases. For a threshold to protect less well-off owner-occupiers, there needs to be a strong relationship between income and property value. In practice, this correlation is likely to be less than perfect (for example, where owners have occupied a house for a long time and the value has increased significantly over time) and external factors may affect property values differentially independent of the owner's income. This outcome may also be seen as unfair, as it increases the tax burden on households through no action of their own. At the margin, therefore, the tax could fail in its objective to increase the tax burden on the well-off relative to the less well-off since it is not possible to predict which income groups' properties would be affected by an external factor.

Although the proposed tax is explicitly designed to provide for a progressive tax burden, and it has some high-level progressive elements, there are elements of the impact of the tax that will work against a progressive outcome. There is also a risk that the tax will have some perverse incentive effects. Given that there are other ways of addressing the distributional aspects of taxation that are likely to be better targeted and contain fewer perverse incentives, the case for this type of tax on distributional grounds is not very strong.

3.2

Economic impact on businesses

As with all taxes, businesses themselves do not pay taxes, only consumers, workers or shareholders. As such, the increase in the cost of doing business in Jersey is likely to end up in one or more of the following

places:

- an increase in the price of that output—ie, consumers end up paying the tax as their real disposable income is reduced;
- a reduction in real wages if price increases are not sustainable—in particular for internationally traded output, some of the tax may end up in lower wages to maintain international competitiveness. However, because the tax on businesses that are not owner-occupied remains unchanged, increases in price, even for domestically sold output, may not be sustainable.

The increase in the cost of doing business in Jersey may also partly result in a reduced capital value of business properties—ie, the *current* owner-occupiers may also end up paying the tax and see the capital value of their premises fall (or not rise as fast), while *future* owner-occupiers pay less for their premises but pay the tax. This impact could also possibly spill over into the values of non-owner-occupied commercial property. However, the effective incidence of the tax is limited to non-Jersey-owned owner-occupiers in 0%-taxed businesses, which may limit the impact on capital values.

The impact of this proposed tax is confined to businesses operating from owner-occupied premises. For these businesses that are owned by Jersey residents, it would appear that any tax paid would be offsettable against the liability of shareholders to tax on either the distributed dividends or on the deemed distributed dividends. Assuming that the full tax at 20% of the nominal rental value is offsettable against the shareholders' current liability, then as long as the business is sufficiently profit-making such that 12% of overall profits is more than 20% of the notional rental value of the property occupied, there will be no overall impact on the tax paid by Jersey-owned businesses.

However, if the business is not (sufficiently) profit-making, the tax liability on the notional rent will be an expense that has to be paid now (even if it may reduce the future tax liability on dividends or real profits). At the margin, therefore, the tax will increase the unavoidable costs of doing business for Jersey-owned owner-occupied businesses.

In addition, the tax may have a perverse incentive to create two Jersey companies under these circumstances—one to own the property with high levels of debt, and one to run the business, as this could reduce the cash outflow to the tax office when the overall business is in a loss-making or barely profitable phase.^[5]

For non-Jersey-owned businesses in owner-occupied premises, the outcome is rather different. BDO Chartered Accountants reviewed the Blampied proposal and were asked to evaluate whether the proposed tax is likely to be creditable against (corporation) tax paid in the UK. They concluded that:

I do not feel that a tax based on 20% of actual rent or 20% market rent for non-residential Jersey property would be an admissible tax in the United Kingdom for either United Kingdom companies with a Jersey permanent establishment or in relation to dividends by Jersey companies.^[6]

For the purposes of this analysis, therefore, it is assumed that the proposed tax could not be offset against other taxes in the home jurisdiction of non-Jersey-owned companies.

For non-Jersey-owned businesses subject to this tax, the tax payment represents an additional real cost to doing business in Jersey, compared with their current position and that under 0/10.

In assessing the economic impact of taxation in Jersey, one of the most important questions regards the impact on the international and domestic competitiveness of Jersey-based businesses. The relative competitiveness of these businesses against other Jersey-based businesses (ie, Jersey-owned and non-Jersey-owned, rented premises, businesses) will deteriorate. How significant this change in competitive position will be will depend on the significance of the costs of premises within their total cost base. If the notional rental costs represent 20% of total costs, the overall cost base will increase by 4% as a result of the nominal rental income tax.

In addition, and perhaps more importantly, this increase in costs for these companies will make them less competitive internationally. To remain competitive against imports (when selling into the Jersey market) or against other suppliers in overseas markets (ie, when exporting), these Jersey-based businesses will need to reduce their costs elsewhere, including possibly reducing labour costs.

The data to estimate how serious this reduction in competitiveness would be is not available because the information on which businesses are non-Jersey-owned and who owns their own premises is not available. However, the extent of the reduction in competitiveness is directly related to the tax yield from this source.

The greater the tax yield, the more serious the likely loss of competitiveness in the economy.

In addition, if the objective of this tax is to reduce the necessary tax yield from GST (eg, to have a lower rate of GST) in order somehow to make Jersey's economy better off, this is unlikely to be achieved. The lack of creditability means that the additional tax on businesses is not exported, and is therefore likely to end up being paid by Jersey residents (or visitors) in one way or another. GST has the characteristic that it does not have an impact on the relative competitiveness of Jersey-based output in either the domestic or the export market. Compared with a marginally higher rate of GST, therefore, the economy may be worse off if the Blampied proposal is adopted.

3.3

Taxing wealth and capital gains

Although this tax proposal can be characterised as a tax on the consumption of property (ie, the rental value of occupied property), it has a number of similarities to taxing a particular kind of wealth and capital gains in the context of domestic property.

Currently there is no general capital gains tax in Jersey applied to natural persons—ie, property sellers (real or otherwise) are not liable to a tax payment on any increase in the value that might have occurred during their ownership period. The proposed tax can be seen as effectively a two-part tax on housing wealth, where the stock of housing wealth (ie, the value as purchased) is taxed and the additional capital gains are taxed prior to the realisation of any gain, because the tax will rise with the increase in the notional rental value of the property. However, unlike typical capital gains taxes, the increase in value would be established by the parish valuation system rather than through a market transaction. Moreover, under the proposed tax, the capital gains tax payment is enforced by bringing it forward and not giving owner-occupiers the choice over the timing of the payment—ie, the sale. Owners therefore pay for capital gains through a series of annual payments rather than a one-off payment at the point of sale.

In general, other forms of wealth that do not create a monetary income stream are not taxed in this way. It is possible that this could distort consumption and investment patterns at the margin.

4

Conclusion

This note has examined the economic and distributional impacts of a tax on the notional rental income of both residential and commercial owner-occupiers. For the business sector, the analysis shows that such a tax is likely to have a negative impact on the international competitiveness of Jersey export sectors, and to distort the competitive balance between domestic and international firms in Jersey. Moreover, in the residential sector, it could distort owner-occupiers' decisions to invest in and improve their properties.

The proposed tax as applied to domestic owner-occupiers is aimed at increasing the progressiveness of the Jersey tax system. Although there is likely to be an overall general relationship between the income of domestic owner-occupiers and the tax paid, there will be exceptions, and these will change over time as the pattern of incomes and value of owned property vary independently. Overall, the effectiveness of notional rental income as a tax base for achieving distributional objectives is uncertain.

From an economic viewpoint, GST is a tax with significantly better economic properties and its outcome is more certain, including its revenue-raising capacity. Moreover, the existing tax system offers more effective mechanisms to address any distributional concerns that Jersey policy-makers may have, including the income tax system and the planned income support system.

[1] Proposal sent by P.G. Blampied to Senator J Perchart, November 9th 2006.

[2] The proposal notes that the Jersey rates are significantly less than Council Tax levied on owner-occupiers of property in England. Parish rates and Council Tax are both levied in order to provide local services. In making comparisons between the two, allowance needs to be made for the scope of services (eg, waste collection and processing, and other environmental services) financed by the levies. The scope of services financed by the Council Tax is wider than in Jersey, which chooses to finance a larger share of services through other forms of taxation.

[3] Oxera (2006), 'Environmental spending and tax policies, What is the impact on Jersey?', November. <http://www.gov.je/NR/rdonlyres/3E929D68-0FB5-4D47-9EDC-1D1DD97EAF9E/0/Environmentalspendingandtaxpolicies.pdf>.

[4] This would also depend on the details of the valuation procedure (not part of this research).

[5] This could occur if the tax on the net profit of the actual rental of the property were lower than 20% of the gross nominal rental value, as

calculated by the parish.

[6] BDO Stoy Hayward Chartered Accountants (2006), 'Review of Blampied Proposal', December 21st.