Chapter 6

Help with housing costs

This chapter of the *Review* this year focuses on two issues, as well as drawing out some key developments from the body of tables in the Compendium on help with housing costs. The chapter begins by looking back at the history of council housing subsidies, as in this edition we can publish the data for the very last year of the housing revenue account subsidy regime for England that ended in March 2012. We also provide a current estimate of the economic subsidies implicit in sub-market rents in the social rented sector. It then updates the *Reviews*' regular analysis of the composition and value of the main taxes and tax reliefs that apply for private homeowners.

The end of an era of council housing subsidy regimes

The English housing revenue account subsidy regime was abolished at the end of the 2011/12 financial year, and following a massive debt restructuring exercise (which netted HM Treasury some £7.6 billion), local authorities in England can now plan ahead with much greater freedom, although still artificially constrained by borrowing caps. Subsidy regimes do continue in Scotland and Wales, although the Welsh subsidy regime is also now due to be abolished at the end of this financial year.

The description of these financial arrangements as subsidy regimes also became more and more misleading over time, as increasingly they were a source of net surpluses to central government in England and Wales. Initially, from 1990, this took the form of a requirement to apply notionally calculated rental surpluses towards the costs of housing benefit for council tenants (see Compendium Tables 70 and 78). Since 2004 notional rental surpluses have been transferred direct to central government.

Table 2.6.1 **Private owner taxes and tax reliefs**

£m

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Taxes																		
Inheritance tax	**429**	**440**	**480**	**496**	**611**	**684**	**769**	**870**	**999**	**1,166**	**1,300**	**1,409**	**1,486**	**1,053**	**913**	**1,069**	**1,142**	**1,222**
Stamp duty	**465**	**675**	**830**	**1,065**	**1,825**	**2,145**	**2,690**	**3,525**	**3,710**	**4,620**	**4,585**	**6,375**	**6,680**	**2,950**	**3,290**	**4,040**	**4,220**	**4,905**
Gross Tax	**894**	**1,115**	**1,310**	**1,561**	**2,436**	**2,829**	**3,459**	**4,395**	**4,709**	**5,786**	**5,885**	**7,784**	**8,166**	**4,003**	**4,203**	**5,109**	**5,362**	**6,127**
Tax Reliefs																		
Imputed rental return tax relief (net)	**- 7,600**	**- 8,300**	**- 7,400**	**- 9,800**	**- 12,800**	**- 14,000**	**- 14,600**	**- 16,800**	**- 17,200**	**- 14,300**	**- 14,700**	**- 13,900**	**- 11,400**	**- 8,100**	**- 8,700**	**- 11,400**	**- 12,800**	**- 11,800**
Capital gains tax relief (gross)	**- 500**	**- 600**	**- 800**	**- 1,400**	**- 3,000**	**- 3,300**	**- 6,000**	**- 10,000**	**- 10,500**	**- 13,000**	**- 12,500**	**- 15,800**	**- 14,500**	**- 4,900**	**- 3,700**	**- 8,800**	**- 10,400**	**- 12,600**
Capital gains tax relief (net)	**- 330**	**- 396**	**- 528**	**- 601**	**- 1,287**	**- 1,416**	**- 2,574**	**- 4,290**	**- 4,505**	**- 5,577**	**- 5,363**	**- 6,778**	**- 6,221**	**- 3,234**	**- 2,442**	**- 5,808**	**- 6,864**	**- 8,316**
Total Net Tax Reliefs	**- 7,930**	**- 8,696**	**- 7,928**	**- 10,401**	**- 14,087**	**- 15,416**	**- 17,174**	**- 21,090**	**- 21,705**	**- 19,877**	**- 20,063**	**- 20,678**	**- 17,621**	**- 11,334**	**- 11,142**	**- 17,208**	**- 19,664**	**- 20,116**
Net tax position	**- 7,036**	**- 7,581**	**- 6,618**	**- 8,840**	**- 11,651**	**- 12,587**	**- 13,715**	**- 16,695**	**- 16,896**	**- 14,091**	**- 14,178**	**- 12,894**	**- 9,455**	**- 7,331**	**- 6,939**	**- 12,099**	**- 14,302**	**- 13,989**

Source: HMRC Statistics (various years).

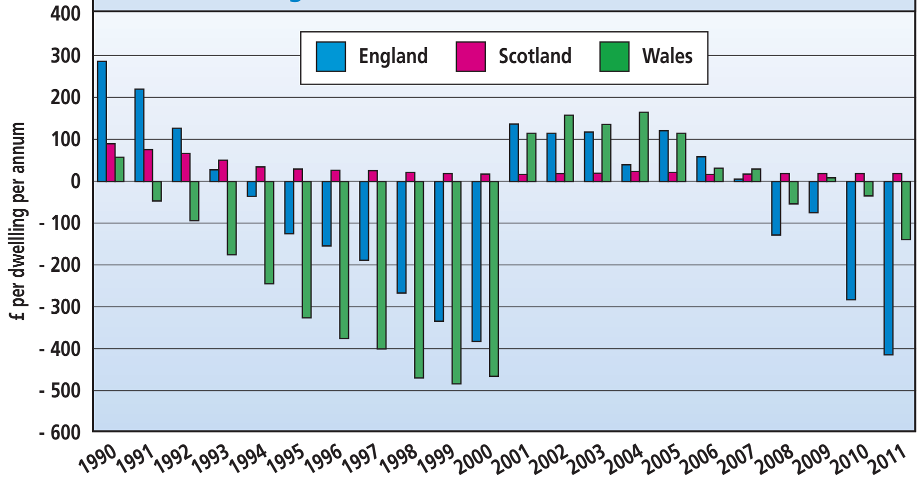
Notes: Estimates of capital gains tax relief are based on two-thirds of HMRC estimates to provide for roll-over relief. A further 35% deduction has been applied for the years from 1998/99 to 2007/08 to allow for the CGT taper relief that applied in those years. It should also be noted that the stamp duty and inheritance tax yields are for all residential dwellings, and not just those occupied by homeowners. The imputed rental return tax relief is based on the asset values and mortgage debt figures from Compendium Table 45, average mortgage interest rates, net residential yield frigures from the IPD Index and standard rates of income tax.

While the overall picture is of a move from subsidy to surplus, within that context some individual councils continued to receive positive subsidies even as these became increasingly overtaken by the surpluses generated by other councils. In that sense the national housing subsidy regimes acted as a form of rent pooling mechanism, as well as generating net surpluses for central government.

While these housing subsidy arrangements operated very similarly in England and Wales, Scotland managed to stay outside such redistributive regimes. Only a few (island) councils in Scotland have received any positive subsidy in recent years; other councils have been left to enjoy the benefits of historic cost accounting, as year-on-year rent rises generated increasing levels of surpluses above the requirements to meet debt charges and operating costs.

The net movement from housing subsidy to rental surpluses is shown in Figure 2.6.1.

Figure 2.6.1 **Council Housing Revenue Accounts: surpluses and subsidies in England, Scotland and Wales**



Source: Compendium Table 109b.
Note: Subsidies (+); Surpluses (-).

However there are a number of further factors to be taken into account in understanding the movements from subsidy to surplus, that were reversed in 2001, but then repeated. In particular the English surpluses in the years before 2001/02 related to a period when major repairs allowance (MRA) was part of the capital system. When the subsidy system absorbed MRA in 2001/02 the English HRA moved back into net subsidy, and it was only in 2008/09 that it has moved again into surplus.

In Wales MRA continues to be provided as part of the capital finance regime, and thus does not technically offset the revenue surpluses as part of the subsidy regime. However the rental surpluses do in practice get applied by the Welsh Government to offset the cash payments made to councils against their MRA provision. So for consistency between England and Wales Figure 2.6.1 (and Compendium Table 109 on which it is based) show the Welsh HRA surpluses net of the MRA provisions, and this follows the same pattern of moving from net subsidy to surplus; then this being reversed and then repeated.

More generally the low levels of subsidy and movements into surpluses in council HRAs are a consequence of relatively low levels of net investment, and the application of varying proportions of the receipts from council house sales to reduce the levels of outstanding debt. There are also the long-term advantages of having an operating account based on the historic levels of capital debt rather than current capital values.

In decades gone by when new housing was predominantly provided by councils, rather than housing associations, there was an automatic cross transfer of value with rent surpluses from older dwellings with low levels of outstanding debt effectively offsetting at least part of the much higher costs of new provision. However for the last three decades council housing investment has largely been confined to major repairs and improvements, with new dwellings being provided through housing associations. While there is now some increase in the scale of investment in new council housing, the absence of that investment over the last three decades is one of the fundamental reasons why overall debt levels in council HRA accounts were so low, and they were operating either with very limited subsidy or increasingly generated surpluses.

With the end of the HRA subsidy regime in England, and its imminent demise in Wales, council housing finances have entered a new era (Scotland apart). If there are to be no further annual subsidy or surplus transfers in the public accounts this will not, however, mean a complete end to financial support for the sector. Direct support of course continues in the form of housing benefit payments made to assist council tenants with their rent, as equally applies to the housing association and private rented sectors.

In addition both the council and housing association sectors operate in regimes where they are required to charge rents some way below market levels. While this is a deliberate policy there is in effect an 'economic' subsidy involved in the difference between the sector's social and Affordable Rents, and rents that would reflect the full market value of the social sector stock. This represents an 'opportunity cost' subsidy to social sector tenants – as invisible in its own way as the benefits of Schedule A tax relief for homeowners discussed below.

The value of those economic subsidies was discussed in this chapter in the 2009/10 edition of the *Review*. This estimated a £6.7 million economic subsidy in the form of sub-market rents in the social rented sector in 2007/08. The estimate was derived from an analysis undertaken as part of the DCLG's HRA Review that led to the housing finance reforms for the sector that have now been implemented.[1] Because overall property values are now little different to those in 2007/08, while social rents have continued to rise, plus higher Affordable Rents have been introduced for a growing proportion of the sector, the current value of those economic subsidies is now likely to be rather lower than in 2007/08. A full assessment of their current value will be included in next year's *Review*.

The net tax position of homeowners

The abolition of mortgage interest tax relief for homeowners in 2000 significantly reduced the long-standing fiscal bias in favour or owning rather than renting – one of the factors in the continuing decline of the private rented sector in the UK throughout the twentieth century.

However there is a continuing if less pronounced fiscal bias in favour of homeownership relative to private renting, as is shown by our regular analysis of the various taxes and tax reliefs that continue to apply to homeowners (Table 2.6.1 on page 80).

This shows the annual yield from the two taxes that do bear on homeowners – stamp duty and inheritance tax. Both these taxes go rather wider than just homeowners. The stamp duty figures relate to all residential property transactions, while the estimates of the yield from inheritance tax (IHT) are based on the proportion of wealth in residential property held by all individuals subject to IHT, including non-corporate private landlords.

The figures thus tend to overstate the yield that relates exclusively to homeowners. Council tax is not included as this is a tax that applies to households in all tenures, and is thus broadly tenure-neutral.

The table also shows estimates of the two primary continuing forms of tax relief enjoyed by homeowners – capital gains tax relief and tax relief on the imputed rental value of the home which the owner occupies. This imputed value was taxed until 1963 as Schedule A tax (albeit at a very low value), and was the logical counterpart (and offset) to mortgage interest relief. This was in parallel to the arrangements for private landlords as the rental value of owners' homes is an income 'in kind' equivalent to the cash income a landlord receives from tenants.

While logically mortgage interest tax relief would have been abolished at the same time as Schedule A tax, it was 37 years later that this happened. Although that did reduce the fiscal advantages of homeownership it did not remove them completely as the absence of Schedule A tax (based on realistic values) has a very substantial net value, even after full allowance is made for mortgage interest against the gross imputed rental values.

The estimates of the net value of Schedule A tax relief show it rising to just over £17 billion in 2003/04, falling back to just over £8 billion in 2008/09, rising again to almost £13 billion in 2011/12 and to almost £12 billion in 2012/13. The rise and variations in recent years predominantly reflects the decline in the value of the mortgage interest offset against the gross value of Schedule A tax, as a consequence of lower – but fluctuating – interest rates.

Table 2.6.1 also includes figures for the value of capital gains tax (CGT) relief. The gross figures are those provided by HMRC, which assume that the tax is levied at the full rate, without any provisions for the 'taper relief' that applied for the years from 1998/99 to 2007/08. Nor do they allow for 'roll-over relief' which defers the application of the tax when the proceeds from the sale of a home are fully re-invested in another home. This is typically a feature of the tax in those countries such as Sweden where the tax is applied to homeowners.

The estimated net values for CGT relief for homeowners shown in Table 2.6.1 take into account the 'taper relief' provisions of the UK GGT regime (for the years that these applied) and also make provision for roll-over relief. The estimates do not, however, make any adjustment for the potential negative impact of the levying of CGT on house prices.

While the methodology for these estimates could be refined it is robust enough to give a ball-park indication of the very substantial value of CGT relief. However it should be noted that if such a tax was ever levied it would reduce house prices; and this would in turn reduce the net income from the tax.

The credit crunch saw a decline both in the yield from property taxes and in the value of the continuing tax reliefs, followed by some recovery in the last three years. Nonetheless Table 2.6.1 indicates that the tax position for homeownership showed a £14 billion net advantage in 2012/13 – even without making any deduction for the proportion of stamp duty and inheritance tax revenues that are based on rented rather than owner-occupied dwellings.

Fiscal and regulatory imbalances for first-time buyers

If the tax advantages outlined above can be attributed to the homeowner sector as a whole, it should also be recognised that those advantages accrue predominantly to established owners: those who have either paid off their mortgage or have a mortgage that reflects only a small part of the overall value of the home they occupy. The advantages to established homeowners are, however, factored into the house prices that have to be met by new entrants to the sector.

New first-time buyers have, by definition, not as yet realised any capital gains from the newly acquired home, nor do they have anything like the prospects for capital gains experienced by previous generations of owners that, in particular, saw the sharp reduction in post-1990 interest rates factored into a one-off boost to house prices. Instead they have to meet prices that are the combined product of lower interest rates, competition from the increasing levels of investment from private landlords, and low levels of new housing supply.

As they enter the sector, first-time buyers are also disadvantaged by the combined absence of Schedule A tax and offsetting mortgage interest tax relief. For first-time buyers with a substantial mortgage would not typically be liable for any Schedule A tax, as the tax on the rental value of their home would typically be fully offset by mortgage interest relief. Rather it is established homebuyers with either a modest mortgage, or no mortgage at all, that see all the benefit of the absence of Schedule A tax, as they have little or no mortgage interest to offset against the tax.

The position for private landlords in this respect is tax neutral as they are liable for tax on their rental income, but can then offset their mortgage interest as a business cost against their tax liability. The net impact will, of course, vary from landlord to landlord, depending on how heavily they are geared with borrowing for their investments. In time, if and when they sell, landlords are also liable to capital gains tax.

There is, however, one important respect in which investors in private renting are now provided with a significant competitive advantage compared to first-time buyers. This arises from the different regulatory stance taken by government towards the mortgage market for first-time buyers and the market for buy to let mortgages for landlords.

Within the more tightly regulated mortgage market for homeowners it is now extremely difficult to secure an interest-only mortgage, unless this is very clearly backed by arrangements that will in due course pay off the capital element of the loan. Repayment mortgages – where monthly payments include an element to repay the capital debt alongside mortgage interest – now account for over 99 per cent of all first-time buyer mortgages.

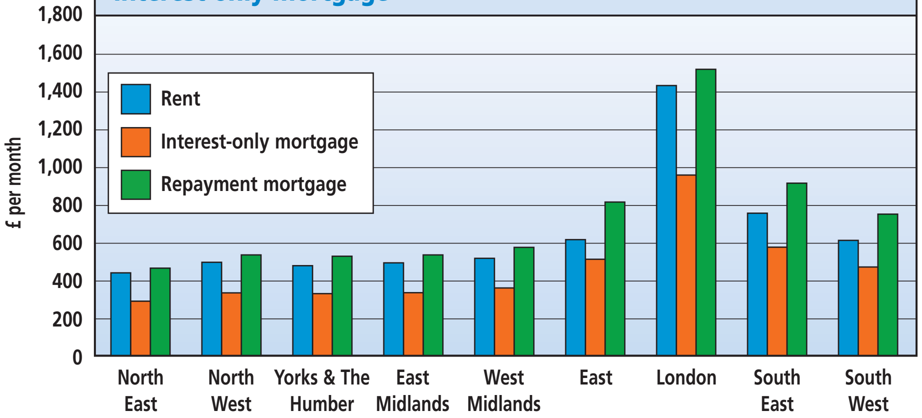
In contrast, in the unregulated buy to let (BTL) mortgage market interest-only mortgages are the norm, with no effective time requirement to ever repay the capital debt, as BTL mortgages can be readily refinanced as time goes by. Indeed there is support for landlords to keep their mortgage levels high in the form of the tax offset the interest payments provide against their rental income.

But at current interest rates the payments required on a repayment mortgage (most often over 25 years) are typically two-thirds more than the payments on an interest-only mortgage. This imbalance in the mortgage vehicles available to first-time buyers and prospective landlords gives private landlords a significant competitive advantage in the market.

Figure 2.6.2, based on average private rent and house price data for two bedroom dwellings, shows that rents currently provide close to a 40 per cent margin over the costs of a 100 per cent interest-only mortgage. This comfortably allows landlords to cover their operating costs and make a revenue return on their investment (quite apart from longer-term capital gains).

In contrast a first-time buyer, with a 95 per cent loan-to-value mortgage, would on average need to pay almost 15 per cent more than the average rent to cover the costs of a 25-year repayment mortgage. The difference is, however, less than ten per cent in London and the northern regions of England. The differences are also lower again for one-bedroom dwellings. But in all regions landlords' rents provide a substantial margin over mortgage interest costs.

Figure 2.6.2 **Renting more expensive than the costs of an interest-only mortgage**



Source: ONS house prices; Valuation Office Agency Rents 2012.
Note: Data are for two-bedroom dwellings.

While this comparison is based on dwellings of the same size in the owner-occupied and private rented sectors, it also needs to be borne in mind that – even after adjusting for region, type and size of dwelling – properties in the private rented sector tend to have a rather lower value than properties in the owner-occupied sector. It therefore tends to underestimate the rent levels likely for similar value dwellings. A landlord's margins over mortgage interest rates are likely to be higher, while on a like-for-like basis private rents may be greater than the costs of a mortgage.

This relative disadvantage for first-time buyers has arisen as a largely unintended consequence of decisions on the appropriate scope of financial regulation. There is a fairly wide consensus supporting the availability of a larger (and hopefully in time better quality) private rented sector, and providing households with the choice of renting so that they are not inappropriately squeezed into homeownership. It is less clear that there is any policy intention (or reason) to bias the choices and chances of a new cohort of younger households to make owning far more difficult than becoming a landlord.

Key Reading

Department of Work and Pensions (2013) *Annual Report and Accounts 2012/13* (see www.gov.uk/government/publications/department-for-work-and-pensions-annual-report-and-accounts-2012-to-2013).

Department of Work and Pensions Statistics (see www.gov.uk/government/organisations/department-for-work-pensions/about/statistics).

Department of Work and Pensions Housing Benefit and Council Tax Benefit, Summary Statistics, Quarterly Series (https://www.gov.uk/government/collections/housing-benefit-and-council-tax-benefit-caseload-statistics--2).

HMRC Statistics (see www.gov.uk/government/organisations/hm-revenue-customs/about/statistics).

Reference

1 Wilcox, S. (2009) *Social rents and economic subsidies. Housing Revenue Account Review Rents and Service Charges Working Paper*. London: DCLG.