the case for a property speculation tax

a smith institute discussion paper

By Andrew Heywood and Paul Hackett

THE SMITH INSTITUTE

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Preface

This discussion paper forms part of the Smith Institute's 'policy in the making' series. It is also complements the Institute's on-going research work on the UK's housing crisis, including our report 'London for Sale: An assessment of the private housing market in London and the impact of growing overseas investment' (2012).

The paper provides a timely and thought provoking analysis of the case for a Property Speculation Tax (PST) as a possible instrument to tackle the emerging housing boom in London and other property hotspots. We have not tried to offer a definitive assessment of a PST and only touched on some of the more technical aspects surrounding possible scope of the tax and tax rates. Our intention is primarily to stimulate a national debate on what actions government can take to prevent speculation in the housing market. A PST may not be the right response, but we believe it is a fiscal tool worth further consideration and debate.

About the authors
Paul Hackett is director of the Smith Institute and has written and commented extensively on housing and related public policy matters.

Andrew Heywood is a consultant specialising in housing and mortgage markets. He is editor of the journal Housing Finance International and a visiting fellow of the Smith Institute.

Executive summary

Executive summary

- Another damaging housing bubble may be in the making, especially in London. Speculative activity, driven in high demand areas by overseas investment, is increasing at a worrying rate.

- The government urgently needs to consider preventative action to curb excessive volatility in the property market. A housing bubble would not only worsen the housing crisis but also threaten the economic recovery.

- Overseas buyers are pushing up demand (and house prices) in London where supply is constrained. They now invest over £7 billion in London property (equivalent to 39% of all mortgages loans in London).

- Around 85% of new-build properties in central London and 38% of re-sales are estimated to have been purchased by overseas buyers.

- A Property Speculation Tax (PST) would be a timely means of helping change the behaviour of investors. It can't solve the housing crisis but it could help reduce market instability and constrain the unsustainable rise in house prices in London and the South East.

- Depending on the rate, a PST could raise up to £1 billion. This revenue might be used to fund much needed new affordable homes.

- Property Speculation Taxes are used in other countries, such as Germany. They impose a high rate of tax if properties are sold quickly. The tax is tapered, with lower rates the longer the property is kept.

- A PST would exclude ordinary home-owners and longer term investors. Its focus would be on curbing speculation, but could also include second homes and empty properties.

- A PST could be applied selectively at different rates and in different housing markets. It could also be a one-off tax. Unlike the Capital Gains Tax it is tapered, not fixed. Introducing a PST would also provide an opportunity to exclude (some) residential property from CGT.

- A PST could be collected by HMRC, which already monitors most property transactions. This would make avoidance more difficult, including for overseas investors. Subject to EU and international law, HMRC could also regulate overseas buyers on the presumption that the new property was not their main homes.

- Unlike the proposed Mansion Tax, a PST aims explicitly at discouraging speculative buying and selling. A Mansion Tax also does not discriminate between homeowners and investors.

- The idea of a PST is worthy of further consideration and should be looked at as part of a comprehensive housing action plan to tackle the UK's housing crisis.

Introduction

Introduction

"Bank of England urged to damp housing market." This front-page story in the Financial Times is another reminder that instability in the housing market is a growing concern. The article goes on:

"Estate agents and surveyors have become so concerned about the dangers of another unsustainable housing boom that their trade body is urging the Bank of England to limit national house price growth to 5% a year." (Financial Times, 13 September 2013)

The impact of housing market volatility has been widely discussed in the years following the onset of the banking crisis. Since the collapse of Northern Rock in September 2007 house prices in England and Wales have fallen by 10.2%. (Land Registry, 2013). Yet at the time of writing, newspaper pundits are already speculating that the next housing bubble may be on its way following only some six months during which prices have begun to rise. The Business Secretary, Vince Cable, is equally concerned and claims he is worried about "serious housing inflationary pressures" in areas of high housing demand.

Volatility is part and parcel of a market characterised by chronic under-supply of new homes, stretched affordability, falling home ownership and in some areas large scale investment (mainly from overseas) that some have described as speculative. At the other end of the scale, some 700,000 households are believed to be in negative equity.

Speculation of a sort is almost inevitable in any market characterised by large swings in prices. In housing markets mortgage finance allows households to leverage their investment and simultaneously provides an incentive to maximise gains and avoid losses. For many households speculation takes the form of scrambling to gain a foothold on the housing ladder before prices become unattainable. The same households may then be stubbornly unwilling (or unable) to sell at a loss when prices fall, so that transaction numbers fall and the market increasingly stagnates. Households will almost inevitably attempt to secure the best performance on what is in most cases their most valuable asset.

The speculation discussed in this paper is concerned with that which goes beyond households attempting to improve the value of the house that is simultaneously a home and an asset. The speculative behaviour of interest in the context of taxation is where the investment motive predominates, where there is heavy reliance on price movements to provide profit, and where considerations of capital growth compete strongly with, or outweigh, any interest in rental income.

That speculative activity can ultimately create a bubble in a market is well-attested. Such behaviour tends to have certain characteristics;

- An upsurge in what has been described as "herd behaviour" with investors all following each other in similar behaviour at the same point in the market cycle.
- An underlying belief amongst investors that prices will rise unsupported by analysis of market fundamentals.
- Growing uncertainty as to the "real" value of real estate investment as opposed to inflated prices. (Holzhey, 2013)

London provides an example of a market that has bucked national trends with house prices now some 11% higher than in 2007. A number of commentators have argued that this is at least in part due to the impact of speculative overseas investment that is currently running at an annual rate of around 39% of the value of all mortgage loans approved for house purchase in the capital in a year.

Most of the UK debates on volatility and on the need for fiscal measures to curb speculative activity have focussed on England and in particular on London, with its international market. This report follows that focus, accepting that England represents over 80% of the UK market by value. Nevertheless, it should not be forgotten that other parts of the UK have also had issues with market instability. Northern Ireland, for instance, experienced a boom in house prices fuelled in part by investors from both sides of the North/South border. Prices rose by 33% in 2006 and by a further 31% in 2007. The following year they fell by 20% and have been falling ever since. According to DCLG data, Northern Ireland in Q3 2007 had higher average house prices than any other UK region except London and the South East. By Q3 2011 it had the lowest prices of any UK region. Over the same period Scotland and Wales have also experienced rapid if less spectacular price rises followed by sustained falls (Lloyds Banking Group, 2013).

This discussion paper examines the case for the application of a Property Speculation Tax [PST] to all, or parts, of the UK, such as London, as one of a number of measures that might lessen speculation and damp down the volatility of local housing markets. The report also assesses whether such a tax might raise significant additional revenue and whether that revenue might be deployed towards the development of much-needed additional affordable (social) housing. As the report makes clear, the PST should not be confused with the Mansion Tax, which is currently the subject of debate. Whereas the primary objective of a PST is to influence transactional behaviour, the Mansion Tax appears to function as a means to tax the high-value residential property assets of the wealthy; its role in influencing the pattern of speculative transactions across the housing market is unclear.

Section 1

What is a Property Speculation Tax?

What is a Property Speculation Tax?

A PST can be defined as a tax that aims to change the behaviour of investors. The tax seeks to eliminate pro-cyclical behaviour that may cause or exacerbate the volatility of that market in terms of extreme cyclical upswings and downturns in prices and (usually) transaction numbers. There may also be an intention to exert some control over the affordability of home ownership by limiting overall demand.

The intention to change behaviour does not exclude an additional intention of raising revenue. Indeed, PSTs usually raise revenue and this can be seen as one of their attractions. However, a tax whose main aim was simply to raise revenue from a particular group by taxing their investment behaviour rather than changing that behaviour would not be seen as a PST in this context. Thus an annual tax on property wealth might not be seen as a PST since it would not influence behaviour over the market cycle, unless the aim was to discourage investment by some or all property investors per se.

PSTs have a long history and have been introduced in various parts of the world. While it would be difficult to establish an accurate and exhaustive list, it should be noted at this stage that well-established examples of PSTs exist in Germany and in Malaysia. Singapore has recently introduced a tax on second homes. (Srivathsan, 6 June 2013) PSTs have recently been introduced in Taiwan, in China and in Hong Kong. (Swire, 2013) (Yuanyuan, 2 March 2013) (Yung, 2013). In Taiwan the residential property owners are taxed 15% on the sale price of their property if selling it within one year of purchase and 10% if selling within two years. China's tax, announced in early 2013 after renewed speculative activity in the housing market, involves a straight 20% tax on capital gains. Hong Kong has introduced a special levy on overseas buyers. Historically, PSTs have existed in a number of different markets. Austria had a PST until 2012. The New Zealand Government introduced a PST in 1973 but a successor Government abolished it again in 1979, claiming that it had become "irrelevant" (Inland Revenue New Zealand, 2013). Such examples should serve as a reminder that like any tax, a PST will not work under all conditions and may in practice have a limited useful life.

Although the form of such taxes varies widely, the German example has features that are common to a number of PSTs. Perhaps motivated by the re-unification boom in property values the tax was introduced in 1999 and taxes the capital gain on property sales where the property has been held for less than 10 years. The tax is tapered over the period but at its maximum it is equivalent to the taxpayer's marginal income tax rate. Most owner occupiers are exempt so that the tax primarily affects investors.

Although the German housing market has (until very recently) shown little price appreciation or evidence of volatility, it is difficult to estimate the impact of the PST amongst other significant factors with an effect on the housing market.[1]

The mechanism for a PST and the question of whether it would be an effective tool if introduced will be discussed later in the report. However, at this stage it is important to establish whether the English housing markets have issues of volatility and affordability that might be addressed using a PST if a suitable case could be made for the effectiveness of such a tax.

PST in other countries

The form of PSTs has varied widely. This is an inevitable consequence of different market conditions and of differing conceptions of what such a tax should achieve and how. For instance the PST in China takes the form of a 20% levy on all capital gains (Yuanyuan, 2 March 2013). In Taiwan the PST involves a 15% tax on the sales price on properties sold within one year of purchase and 10% if sold within two years (Swire, 2013). In Hong Kong the newly introduced tax amounts to 15% of the purchase price of properties purchased by overseas buyers (Yung, 2013).

PSTs are by no means always effective. The Taiwan PST is widely believed to have failed (Taipei Times, 20 August 2013). The new Chinese PST replaces an earlier levy of 1% on sale prices that had not been considered effective. The key positive attributes of such a tax appear to be that it targets the particular investor behaviours deemed inappropriate and that the rate is sufficient to alter behaviour but not create unwanted consequences, such as sudden destabilising disinvestment.

As previously stated a PST in not a panacea for solving the housing crisis. However something akin to the PST in Germany (and elsewhere) is worthy of consideration. The main characteristics of the German PST are:

- A tax on capital gains (i.e. the difference between the buying and selling price) to be levied when a property is sold. The rate should be determined by detailed analysis of the market(s) to which PST would be applied but could be in the region of 20-30%.

- There should be provision to apply the PST selectively in different housing markets. At present, a stronger case would seem to exist for applying it in

1 Information kindly provided by the Association of German Pfandbrief Banks and the International Union for Housing Finance.

London than elsewhere but detailed analysis on other markets has yet to be carried out.

- The rate of tax to be at its highest on properties bought and sold over very short periods and tapering down to nil as the period between purchase and subsequent sale becomes longer.

- The tax to exclude owner occupiers.

- The tax to be levied on capital gains regardless of the property value.

- The tax to be levied on both UK residents and overseas sellers and on both individual and corporate sellers.

Section 2

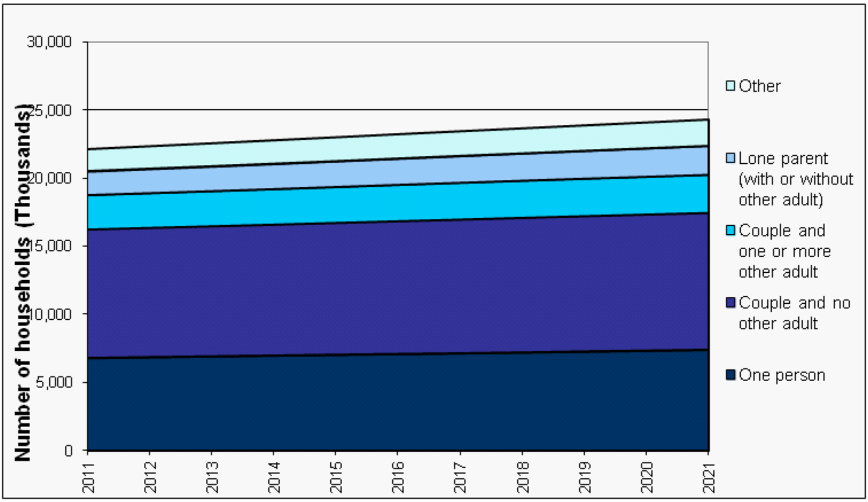
Why now: the housing crisis

Why now: the housing crisis

It is scarcely revolutionary to describe the housing market as characterised by chronic under-supply of new housing. A casual glance at the house building statistics for the post-war period is enough to suggest that all is not well on the supply front. English housing completions peaked in 1968 at 352, 540. In 2012 they amounted to just 115,340.

House building statistics do not of themselves prove chronic under-supply. They may simply reflect prevailing demand. However, the household projections for England suggest that new supply is nowhere near the levels required simply to keep up with the growth of households, let alone allow scope for replacing damaged or worn out properties, accommodate the changing balance in the size and composition of households, and take account of the shift in population towards the South.[2]

Household projections 2011-2021



Source: DCLG

It is a commonly accepted figure that new supply in England should average around 240,000 homes per year. In fact, since 2000 new completions have averaged just

2 The number of households in England is projected to grow from 22.1 million to 24.3 million between 2011 and 2021 (DCLG, 2013b). This represents an annual growth in the number of households of 221,000 – or 2.2 million (10%) over the period.

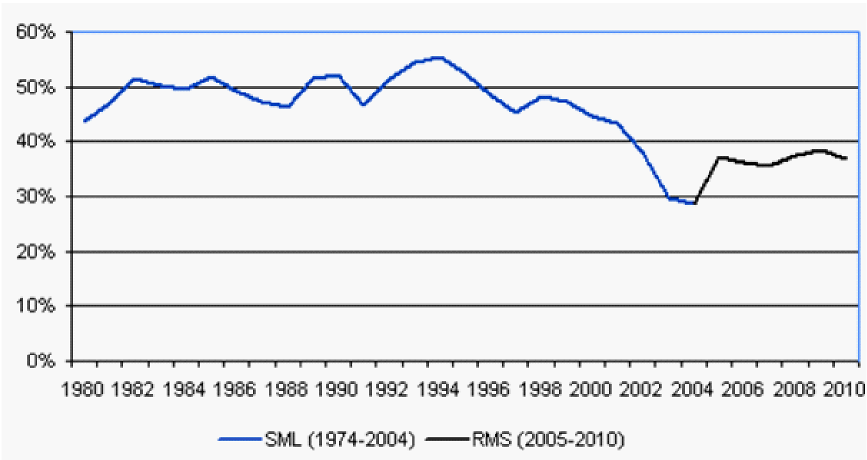
139,000 (DCLG, 2013). There are clear implications for both affordability and the volatility of the market.

Affordability

Affordability has been declining for many years. Real house price rises outstripped earnings from 1970 to 2000 in all areas of the UK except Scotland. DCLG statistics suggest that in 1970 the house price to incomes ratio was 2.58 for all buyers and 2.45 for first-time buyers [FTBs]. It peaked in 2005 for all buyers at 5.04. Since then it has reduced somewhat (although not in London) but in the depths of market downturn in 2010 it still stood at 4.96 for all buyers and 4.54 for FTBs (Heywood, 2011).

There has been a long-term decline in the both numbers and proportion of FTBs in the market:

Loans advanced to FTBs as a percent of all loans advanced for house purchase 1980-2010



Source: CML Survey of Mortgage Lenders and Regulated Mortgage Survey

In addition the proportion of younger buyers has been in decline, as has the proportion of Low-to-Middle Earners [LMEs]. While stretched affordability is in large measure a consequence of under-supply of new housing it has been exacerbated by the relatively slower growth of earnings amongst those on lower incomes and a more unequal distribution of wealth (Heywood, 2011).

The impact of increased prices relative to earnings has, of course, been exacerbated by retrenchment in the mortgage market. In the years leading up to the banking crisis there was an unsustainable increase in the amount of mortgage credit available and an excess of completion amongst lenders, leading to an under-pricing of risk. Since 2007, lenders have worked to reduce their asset bases and to increase their levels of regulatory capital. This has resulted in a precipitous cut back in mortgage lending:

Mortgage lending for house purchase 2006-2102

Year	Amount (£m)
2006	357
2007	358
2008	214
2009	134
2010	133
2011	140
2012	143

Source: CML

2013 has seen some further recovery in the level of lending with monthly lending significantly above corresponding figures for 2012. Nevertheless, with regulators enforcing policies of responsible lending and requiring enhanced levels of regulatory capital no-one is predicting that lending will return to the unsustainable levels that prevailed prior to the crisis. The Bank of England's Financial Policy Committee is reportedly considering forcing banks to hold more capital against certain types of property loans. Nevertheless, with supply constrained the impact of any significant rise in the volume of mortgage lending, such as that widely expected from the second phase of the Government's Help to Buy scheme, can be significant in promoting volatility.

According to the latest Office National Statistics figures in the 12 months to July 2013, UK house prices increased by 3.3%, up from a 3.1% increase in the 12 months to June 2013. The price increases were driven by London (9.7%) and the South East (2.6%), with house prices elsewhere rising by only 0.8% over the year.

House prices

The housing market has experienced booms and bust for over 40 years. Arguably these have increased in severity. 1971-74 was an early example with year-on-year price rises peaking at 42.4% in Q4 1972, only to fall back to a low of 4.5% in Q4 1974. In 1978 another boom began with price rises peaking at 31.6% year-on-year in Q2 1979, falling back to -1.3% in Q4 1981 (Nationwide, 2013).

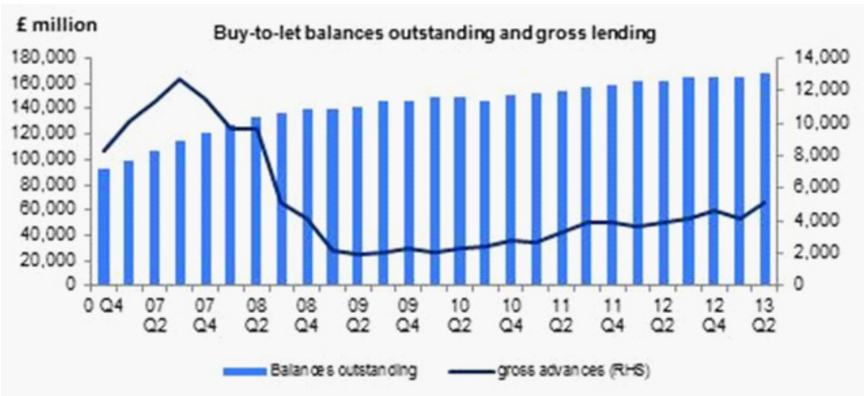
The so-called "Lawson boom" of 1988-89 (immediately precipitated by proposed changes to Mortgage Interest Tax Relief) saw price rises peak at 32% in Q1 1989. By 1990 the correction had set in with prices falling 10.7% year on year by Q4 1990 and continuing to fall until 1993 (Nationwide, 2013).

From the late nineties, prices began to rise rapidly again driven in part by the expansion of mortgage credit. As the banking crisis precipitated both housing market and broader economic slow-down prices began to fall and stagnated thereafter until signs of modest growth emerged in 2013. Activity levels also fell heavily. According to HMRC, total transactions in England were 1,405,000 in 2006. In 2012 they totalled 804,000. Mortgage approvals for house purchase fell from 1,427,000 in 2006 to 515,000 in 2008. In 2012 they still stood at only 610,000; around half of pre-crisis levels (CML, 2013). In spite of prices showing some signs of recovery in 2013, house prices in England and Wales in June 2013 were 10.2% lower than in September 2007 (Land Registry, 2013).

House price movements 1992-2012

Source: CML

Overall, the housing market is characterised by constrained supply, stretched affordability and significant volatility. These problems are not going away and may be becoming worse. In these circumstances government and its agencies should examine all options for limiting volatility and improving affordability. However, it is not clear that these problems are substantially exacerbated (outside London at least; see below) by speculative behaviour by investors, i.e. those who are trading in properties that are not their primary residence. Inevitably, homeowners will be influenced by speculative motivation in a volatile market but little evidence has been brought forward that investors, as opposed to home owners, are major players outside of the buy-to-let [BTL] market. BTL (which currently amounts to amount to around 13% of the mortgage market by value) is significant. Nevertheless, although individual landlords are undoubtedly influenced by considerations of capital growth as well as rental return, their investments are generally stable over time. DCLG data suggests that 72% of private landlords have held their properties for more than five years and 48% for more than 10 years (DCLG, 2010). In a rapidly growing sector this is not an indicator of a high incidence of rapid transactions to crystallise capital gains or avoid losses. In addition, the private rented sector has continued to grow over the period of housing market downturn since the banking crisis. In 2006 the sector housed 2.57 million households. By 2011-12 that figure had risen to 3.84 million (English Housing Survey, 2012). In addition, BTL loan balances have continued to increase over the past six years in spite of the tight constraints placed by lenders on such lending:



Source: CML

Thus it is not clear that speculation by BTL, or other investors, is the key issue for the market as a whole although that does not rule out it playing a larger role in certain local markets. Nevertheless, as already indicated, speculative action by home owners is a significant element in the volatility equation. At times of rapidly rising prices there is a strong temptation to gain an initial foothold in the market before prices go out of reach. Households already on the housing ladder will be tempted to move to larger properties while those properties are affordable and to maximise their potential capital appreciation. Conversely, although existing owners do not appear to sell in large numbers when prices fall, transaction numbers drop sharply and this may in part be due to a propensity to avoid buying a (larger) property which may depreciate in value. This behaviour is inextricably bound up with enhanced market volatility since it is essentially pro-cyclical. However, the problem for any government is the political salience of home ownership and the status of an owner-occupied home as the largest asset most households possess. It would be a brave government indeed that took a decision to put a significant tax on the transactional activity associated with home ownership, particularly 18 months before the expected date of a general election.

Although information is often anecdotal it has been suggested that certain local markets may be more susceptible to speculation and bubbles than their surrounding region. Cambridge has been mentioned in this respect:

House price rises: Cambridge and surrounding local authority areas January to March 2013

Authority	Average house price £	Annual rise in house prices
Cambridge	**360,591**	**20.7%**
South Cambridgeshire	298,975	16.4%
Huntingdonshire	220,625	13.3%
East Cambridgeshire	217,990	9.1%
Fenland	141,665	1.2%
East Anglia (March 2013)	**173,157**	**0.3%**

Source: BBC News/Land Registry

Such data is striking but does not necessarily imply speculative activity without further investigation. Nevertheless, it raises questions as to whether there could be speculative drivers at work. Cambridge has a relatively internationalised market due in part to its academic activity and high- tech industrial base. Examples of local markets such as Cambridge are worth some detailed analysis to examine whether there is a case for some intervention involving, but not necessarily limited to, a PST. More work should be undertaken to identify such local markets in the first instance.

There is thus a case for some initial consideration of the case for a PST to damp down volatility. Such a case would focus on local rather than regional markets and would assess the possible contribution of a PST to certain local markets. As noted earlier, it is also possible that a case might be made for inclusion of markets in the wider UK such as Northern Ireland but that is beyond the scope of this study.

London: a particular case

It is no accident that the housing market in London has been the trigger for much discussion focussed on the possible need for fiscal measures to curb speculative activity. The London market since the beginning of the banking crisis has exhibited some similarities to the wider national market. Transaction volumes have fallen heavily in both markets:

Housing transactions 2006 and 2012

	2006	**2012**	**percentage fall**
London	197,000	124,000	37%
England and Wales	1,405,000	804,000	42%

Source: HMRC

However, the similarity ends there. In terms of house prices London has diverged markedly from the rest of the country:

House prices, London and England and Wales

	Average price Sept 2007	**Average price June 2013**	**Percentage rise (fall)**
London	£346,116	£383,930	10.9%
England and Wales	£181,039	£162,621	(10.2%)

Source: Land Registry

Since 2007 homes have become slightly more affordable in the UK. In 2007, the average purchaser borrowed 3.16 times their income. By 2012 this had reduced to 3.05 times. In London, by contrast, the average loan to income ratio increased from 3.40 to 3.45 between 2007 and 2012. The average income of a FTB in the UK was

£34,080 in 2012. The equivalent FTB figure for London was 48,600 (with FTBs in London borrowing an average of 3.58 times their income in the first quarter of 2013 and their mortgage payments, on average, consuming 21% of their income. (CML, 2013)

The London market has diverged from the national market. However, London is not itself a unified market. Prices in Inner London have risen faster than those of Outer London. In addition, prices in the most expensive boroughs have risen faster than those in less desirable areas. The comparison between Kensington and Chelsea and Barking and Dagenham (the most expensive and cheapest London boroughs) illustrates this:

	Average price Sept 2007	**Average price June 2013**	**Percentage rise (fall)**
Kensington and Chelsea	£812,267	£1,149,283	41.5%%
Barking and Dagenham	£243,088	£219,734	(9.6%)

Source: Land Registry

This has created a situation where London is itself a market of extremes in terms of affordability with the cheaper outer London boroughs closer to national picture and Inner London and/or the most expensive boroughs on another trajectory.

The ratio of house prices to median earnings was 3.54 for England and 3.98 for London in 1997. In 2013 the ratio for England had nearly doubled, and for inner London had nearly tripled. The problem is likely to worsen, rather than improve. Savills, for example, are currently predicting that mainstream London prices will rise by 25.1% in the five years to 2017, which compares to their prediction for the UK as a whole of 18.1% (Savills, 2013b).

Ratio of median house prices to median earnings 2012

England	6.74
Inner London	9.71
Outer London	8.49
RB Kensington and Chelsea	27.78
LB Barking and Dagenham	5.04

Source: DCLG

The divergence of London from the rest of the country cannot be simply explained by domestic factors alone:

- London has been hit by the curtailment of mortgage finance as has the UK as a whole.
- Affordability is more stretched in London than elsewhere; why should London prices rise even faster?
- Homeownership in London is declining faster than elsewhere so what sustains such strong demand?
- London has a chronic shortage of new housing supply as has the country as a whole but its recent record of developing affordable housing is actually better than that of England (Heywood, 2012).

The key factor which provides an explanation for the continuing rise in London's house prices and deteriorating affordability is almost certainly investment in the London residential market by overseas investors. Ironically, it is the promise of continuously and rapidly increasing house prices driven by an ongoing imbalance in new supply and demand that makes London score highly as an international centre for inward residential investment.

It has been estimated by Savills that overseas investors have introduced approximately £37 billion into the London residential market since 2006 (Savills, 2013). The estimate for 2012 is that overseas buyers invested over £7 billion in London. To gain a sense of perspective it is worth comparing this figure with the London mortgage market. In 2012 mortgage loans for house purchase in Greater London totalled £17.97 billion. Overseas investment was the equivalent of around 39% of this figure. Clearly this represents a major increase in demand for homes in London. To make a further comparison, the Government's Affordable Homes Programme 2011-15 represents a £4.8 billion investment in c. 170,000 homes across England over a four year period. One year's overseas investment in the London residential market comfortably exceeds this total investment.

Overseas investors can be divided into three broad groups:

- European and North American buyers who may purchase to gain a residence, or for investment purposes.
- Buyers from a range of non-OECD countries who may be seeking economic security and/or a political "safe haven" from potential troubles in their own countries or regions. Of this group Russia appears to be most common country

of origin, followed by the United Arab Emirates and Singapore.
- Investors, often from East Asia, with an interest in a combination of rental yield and capital growth and who are often attracted by new-build properties.

It has been estimated that some 64 nationalities currently invest in London's housing market (Heywood, 2012).

Europeans represent the largest single group of overseas investors, accounting for almost 14% of prime London sales, mainly in the resale market. They are followed by investors from Hong Kong and China and from the Asia Pacific region. Both these groups focus heavily on the new-build market (Savills, 2013). Eighty five percent of new-build properties in central London are estimated to have been purchased by overseas buyers in 2012-13 (Savills, 2013). Permeation of the resale market in London (78% of the total London housing market) is growing too. In 2012 overseas buyers accounted for 38% of resales; up from 31% in 2011 (Savills, 2013).

Overseas investment tends to be concentrated at the top end of the market although purchases of cheaper properties are significant. UK buyers account for over 70% of new-build sales of property worth less than £450,000, but only account for just over 10% of new-build sales of property valued above £1 million (Savills, 2013). While a high proportion of overseas buyers claim to rent their new-build properties out, only c. 28% claim them as their main residence.

Overseas investors are also indirectly supporting the Affordable Homes Programme for London. With Government grant for affordable housing now increasingly limited, cross subsidy from open market and shared ownership sales becomes ever more important if affordable development levels are to be maintained. Housing associations (and some councils) are seeking to build properties for open market sale in order to provide the cross-subsidy are becoming reliant on overseas buyers to sustain demand (and prices). Some are actively marketing properties for open –market sale to potential investors in the Far East.

Clearly an influx of additional demand for housing in a market such as London where supply is constrained will tend to raise prices and stretch affordability for those lower down the income scale. Evidence for this phenomenon has been cited above. However, another real risk associated with the scale of overseas investment in London is the possible contribution to market volatility. Overseas investors are, inevitably, less tied to the London housing market by jobs, family connections, children in education etc. In addition, they are likely to have the resources to enter and leave markets more easily based on their perceptions of the relative merits of different international housing markets.

Inward investment is driven at least in part by motivations that are not directly linked to the fundamentals of the London property market but which are associated with investor perceptions of economic, financial and political developments in many parts of the world. In any case, investment on this scale into a market where supply is constrained creates the risk of a housing "bubble" which could burst suddenly should such investment be curtailed and/or if market conditions deteriorate. This could have very serious consequences for future development as well as posing a threat to homeowners and to the housing finance system.

Others have spotted the potential downside of large-scale overseas investment also. In January 2012, Vince Cable proposed that a "Mansion Tax" of 1% on the excess value of individual properties over £2 million be introduced in the next Budget (Watts, 21 Jan 2012). This proposal was later endorsed by the Liberal Democrat Annual Conference 2012, prompting the headline "Lib Dems demand £2 million Mansion Tax for the "stinking rich."" (Hope & R, 25 Sept 2012). Labour followed suit with a very similar proposal from Ed Miliband:

"Labour will re-introduce the 10 pence starting rate of tax scrapped by Gordon Brown in 2008 if it is re-elected, Ed Miliband has announced. Mr Miliband said it was a "mistake" to get rid of it and the move would send a "clear signal" his party was on the "side of working people". The move would be paid for by a new Mansion Tax on £2m properties, he indicated in a speech in Bedford." (News, 14 February 2013)

In the event the Coalition Government did not adopt the Mansion Tax proposal but concern about investment at the high-end of the market was strong enough for the Chancellor to make changes to Stamp Duty Land Tax [SDLT] in the 2012 Budget. SDLT was increased from 5% to 7% on properties over £2 million and an additional levy of 15% was introduced on purchases by corporate bodies. Agents Knight Frank have since estimated that the impact of the SDLT increase has been "almost zero" on properties over £3 million although there had been some modest dampening of interest in properties in the £2-3 million bracket. Overall, the level of overseas investment into London has continued to rise (see above). Even critics of the Mansion Tax such as Mark Field (MP for Cities of London and Westminster) have recognised that overseas investment creates problems and risks:

"I suspect a Mansion Tax would most likely drive greater numbers of Londoners from their homes, vacating even more prime, central property for the delectation of foreign buyers. In short, a Mansion Tax would exacerbate rather than fix the problem." (Field, 23 February 2013)

Overall, London would seem to be an example of a market where volatility and affordability are serious concerns and where measures to damp down excess, or speculative demand, are worth initial consideration.

Section 3

How will it work?

How will it work?

Volatility and fiscal measures

In considering the case for a PST in England and particularly in London, it is important not to suggest that such a tax could be a panacea for tackling the various causes of housing market volatility.

The causes of market volatility can be complex. Nationally, as has been seen, underlying and immediate causes of recent upswings and downturns have included:

- Chronic under-supply of new housing
- Changing demographics leading to increased household numbers
- Issues of affordability, which may in part relate to factors such as growing inequality of income and wealth.
- Changes in the supply of mortgage credit.
- Planning and land-use issues.

Thus, while fiscal measures alone may dampen volatility somewhat, they will not tackle the root causes.

Market studies usually stress the need for multi-faceted approaches to tackling volatility and almost always focus on supply issues.[3] The Joseph Rowntree report *Tackling housing market volatility in the UK* (2011) listed a range of measures that were needed:

- Measures to increase housing supply year-on-year.
- Investigation of the use of taxation measures to better manage the house-price cycle. including moving towards a counter-cyclical tax on land and property values.
- Enhanced financial capability and stronger protection for consumers.
- The development of more alternative housing options for those who do not wish to become home owners or for whom home ownership is unsafe as an option (Stephens, 2011).

Thus while fiscal measures are specifically mentioned, they were seen as part of a broader package interventions. However, in their follow-up report the authors re-iterated their support for taxation measures:

3 See for instance Saliyeva D; Housing market volatility and policy in comparative perspective, RC43 conference paper, 2013, rc43-conference.uva.nl/binaries/content/assets/subsites/.../saliyeva.pdf

"There was a welcome debate on the role of property taxation in the run-up to the 2012 budget, and some speculation that a Mansion Tax might be introduced on expensive properties. In the event a higher rate of Stamp Duty on properties sold for more than £2 million was introduced. The lack of action on recurrent property value taxation was disappointing. The Taskforce report outlined how the Council Tax could be transformed into a counter-cyclical land and property value tax in stages, beginning with revaluation, moving towards a point-value tax system and in time to full property value tax. This remains an area worthy of serious consideration." (Stephens & Williams, 2012)

Thus, although a PST is unlikely to solve the weaknesses of the housing market without recourse also to other measures, other recent research has suggested that such a tax might function as a valuable tool amongst others.

Tax rates and scope

In deciding to tax capital gains rather than simply the sale, or purchase price, the aim is to focus on behaviour that could be construed as speculative and to take account of different stages in the housing market cycle. The aim is not to discourage buyers per se and particularly not during a market downturn. Similarly, a tax that hits rapid sale and purchase hardest and excludes properties held beyond a certain period encourages longer-term investment.

The rate at which the tax would be set is crucial. For simplicity, a single rate is suggested here but more detailed analysis might produce arguments in favour of more than one rate - perhaps distinguishing between different value properties. It is important that the rate be high enough to discourage speculative behaviour but not so high as to cause rapid disinvestment, or a sufficiently drastic cut back in investment, to cause a major curtailment in new housing supply. The latter possibilities are both risks in London where rapid withdrawal of overseas investment would lead to a major and painful re-adjustment, since neither existing prices, nor current new development levels (inadequate as they are), could be sustained on domestic demand alone.

For purposes of initial discussion only, a range of 20%-30% has been suggested as being not untypical of similar types of PST in other jurisdictions and since this is comparable to current levels of Capital Gains Tax (see below). It should be noted that there is not always a simple correlation between the tax rate and the revenue raised. Research on Capital Gains Tax has suggested that raising rates can actually lead to a fall-off in tax revenue as individuals modify their behaviour to avoid the tax (Adam Smith Institute, 2008). PST resembles CGT in that both are essentially voluntary; one can avoid crystallising capital gains in order to avoid paying the tax and indeed, it is an aim of a PST to foster such behaviour.

There is a question as to whether the PST should be applied selectively and/or at different rates in different housing markets. Some might consider that London has greater need of such a tax than North West England, for instance. Such decisions would have to be made on the basis of up-to-date and detailed analysis of housing markets and by a body, or bodies, (such as the Homes and Communities Agency [HCA] or the Greater London Authority [GLA]) with real housing market expertise. At this stage the arguments are finely balanced:

- A tax levied nationally and at similar rates would be cheaper to collect and easier for taxpayers to understand and come to grips with.
- The broader the application of the tax the more revenue it might raise.
- The co-existence of different tax regimes can lead to taxpayers gaming the system by moving their activities to low-tax areas, thus further distorting markets.

But:

- Applying taxes to markets where they may not be needed or relevant can lead to unforeseen consequences.
- Applying taxes to markets where there is insufficient justification can lead to popular resentment.
- Some markets may require intervention at different tax rates than others.

Overall, the balance of argument would seem to be in favour of making provision to apply the tax flexibly in local markets, but subject to further detailed analysis. London already seems to represent a market where a speculative bubble is a real risk. Were a case to be made for intervention in London then powers to apply a PST selectively elsewhere could be needed simply to deal with a situation where investors shifted their focus to a new market to avoid the tax. There are precedents for selective application of national policies. For example, under the last Labour Government, Right to Buy discounts were reduced and provision made to apply different caps to those discounts across a range of local and regional markets. This selective approach was applied successfully by local authorities until the approach was abolished in favour of a higher national cap of £75,000 in 2012.

The question of the period over which a PST should taper from its maximum rate to nil is a complex one. It involves analysis of how long investors and other buyers hold their properties on average before selling them and the typical gains made, or expected to be made, which involves detailed analysis of house price movements. This is beyond the scope of this report but would need to be undertaken in any subsequent evaluation. At this stage, based on practice in other markets, one might cautiously posit that a taper might run out over a period of between two and 10 years, depending on market conditions and typical investor behaviour. Housing market cycles are not of a fixed length. There was a period of c. 16 years between the 1989 peak of the Lawson boom and the next peak immediately preceding the banking crisis. From the peak of the previous boom in 1979 to that of 1989 was about 10 years. The preceding peak was in 1972. It is important that any taper take account of actual investor behaviour in terms of frequency of transactions. It should also be gradual enough that there would be a sufficient disincentive to sell and profit-take for a long enough period that the risk of creating additional volatility on either side of the peak of the market cycle would be seriously diminished. In the context of the English market this might suggest a tax rate tapering down to nil over a period of between 5-10 years.

Exclusions

At first sight it may seem perverse to exclude owner-occupiers from the scope of the tax. They do, after all, exhibit speculative behaviour, particularly at times of rapidly rising prices. However, given the high level of home ownership in the UK a tax on all home owners would probably be politically impossible to achieve for any government. In addition, home owners need to move rapidly on occasions for a variety of reasons including work and family-related matters. To render home ownership more inflexible as a tenure would be to risk inhibiting labour mobility and cause a range of other problems. It would therefore seem sensible to exclude properties that are the primary residence of their owners from the scope of the PST. This still allows second and subsequent homes to be taxed as well as empty homes and homes that are rented out.

Some PSTs focus on gains relating to higher value properties. In addition, the much-discussed Mansion Tax taxes only the value of a property above £2 million. This may be acceptable where a purpose of the tax is to levy some kind of “wealth tax” on those with large assets. However, where the aim is primarily to deal with market volatility, then speculative activity should be the focus, whether it involves one or more lower-value properties or a single high value property. It has already been noted that overseas investors, while tending to focus on high value properties, are also active to a significant degree across the value spectrum. Therefore there is no fundamental reason to exclude lower value properties (BTL investors tend to buy lower-price properties than the average for a particular market), particularly if a subsidiary aim is to raise revenue.

Clearly the PST should include both domestic and overseas investors if it is to be effective. Given that residential property is also bought and sold by both individuals and corporate investors there would seem to be no reason to exclude the latter. Indeed, in 2012 land registry figures suggested that some corporate buyers from some 64 different countries had bought residential property in London.

Collection and avoidance

A reasonable riposte to anyone proposing a new tax is "how would it be collected?" Taxes that cannot be collected efficiently and cheaply relative to the revenue raised seldom have a long shelf-life. In the case of the PST the choice of collection agent would seem to include:

- HMRC
- A strategic housing body such as the GLA, or HCA.
- Local authorities

The obvious body to collect would be HMRC. HMRC already collects Stamp Duty Land Tax [SDLT], and HMRC is informed of most land and property transactions in the UK regardless of whether SDLT is due in a particular case (HMRC, 2013b). This would minimise costs and maximise efficiency.

While HMRC would collect the PST, determining rates of tax and whether they should be applied across the country, or selectively, would be a role for a strategic housing body such as the HCA, or the GLA in London. An advantage of HMRC as a collector is that its access to transaction details would make evasion of the PST, particularly by foreign investors, more difficult.

There are serious objections to either the strategic housing bodies or local authorities collecting the PST. They do not currently track all property transactions (as opposed to HMRC). There would thus be duplication of effort and expertise. In addition, a large number of individual local authority tax operations would almost certainly be very expensive relative to the revenue raised.

In summary, HMRC would seem the most appropriate body for the collection of a PST in terms of both experience and current activity.

In considering how a PST might be collected a brief assessment of the degree to which it would be avoidable is appropriate. Given that HMRC is already aware of most property transactions, avoidance would be relatively difficult. The main area where an investor might be able to use discretion in order to avoid paying tax would probably be in declaring whether the property that was the subject of a transaction was their primary residence. Clearly rules and legal precedents would be needed here as to when a property could be so designated as is already the case with CGT. The position would be more difficult in relation to overseas investors since checking would be more difficult and/or expensive. It may be that investors who were non-UK resident for tax purposes could be the subject of an automatic presumption that a UK property was not their primary residence unless they could provide evidence to the contrary. However, such a presumption would have to be fully considered in the context of EU and international law.

PST and Capital Gains Tax

Capital Gains Tax [CGT] has been a feature of the UK tax system for many years. It is levied at 18% or 28% on a range of capital gains on buying and disposing of assets, of which residential property is one class (HMRC, 2013). Unlike the PST, CGT focuses on the person as well as the property; the rates of tax depend in part on the income and corporate or individual status of the taxpayer.

Capital Gains Tax raised £4,337 million in 2011-12 (HMRC , 2013c). However, the majority of this revenue actually came from financial assets. Residential land accounted for around 14% of chargeable capital gains in 2009-10 (HMRC, 2013d). Thus the revenue raised from residential land could have been around £500-600 million depending on tax rates applied etc.

At first sight the PST mechanism and CGT appear similar. Both tax capital gains on disposal and both apply to residential property. In both cases the primary residence of a taxpayer is excluded from the scope of the tax. However, it will already have been noted that CGT applies to a range of asset classes including equities. In addition, and most importantly, CGT applies at the same rate no matter how long the asset is held, although some offsetting reliefs do apply. It can thus be said to discourage any sale where a significant capital gain has been made.

A further important difference is that CGT liability is dependent on being a UK taxpayer. The proposed PST would apply to all eligible transactions whether the seller was a UK taxpayer (i.e. resident in the UK) or not. Thus in any given market to which both taxes were applied the PST might tax more transactions than CGT.

CGT is thus a tax on capital gain by taxpayers rather than a tax to damp down speculative activity. From this perspective a PST intended to address speculative transactional activity would have a distinct role.

Private landlords have long complained that CGT discourages sensible management of property portfolios, since there is always a disincentive to dispose of properties that are less efficient or profitable. By contrast, a PST would allow disposals of residential property free of tax after a certain period had elapsed since the property was purchased. This would provide landlords with the opportunity to buy and sell properties to ensure that portfolios were composed of properties that were cost-effective to run as rental units, and that were also appropriate for the type of tenants sought by that landlord.

Successive governments have expressed a commitment to "professionalise" the private rented sector in order to raise standards. In this context the introduction of a PST would provide an opportunity to exclude residential property from the scope of CGT where a PST was in force. This would make a useful contribution towards the promotion of a more professional private rented sector.

Ensuring that CGT and PST did not apply to the same transactions would also remove the potential objections to a PST that it would represent a proliferation of similar taxes and would contribute towards an overall undue tax and administrative burden on investors.

It is of course also important to consider how revenues from the two taxes inter-relate. If PST replaces CGT the level of new revenue might in fact be very limited.

PST and the Mansion Tax

Because the debate on the Liberal Democrats/Labour Mansion Tax proposals has been closely linked to London and to the presence of overseas investors in the Capital, there is a tendency to see the Mansion Tax as proposed as a species of PST.

While there are similarities, there are very important differences. The aim of the two taxes is different. The Liberal Democrats proposal appears to be more concerned to tax what are perceived as a wealthy subset of property owners rather than to change their investment behaviour. The aim appears to be redistributive in terms of wealth rather than anti-speculative. The remark ascribed to Ed Miliband that the Mansion Tax would send a "clear signal" that Labour was on the "side of working people" would appear to confirm this (News, 14 February 2013). The fact that the Mansion Tax would target high value properties only, whereas the PST as proposed would tax transactional activity on all eligible properties highlights an important difference.

The Mansion Tax does not tax activity. It simply taxes the asset value for as long as that asset is held. The tax would effectively levy 1% of the excess value of a property over £2 million each year. This is probably not enough to discourage investment in the first place, particularly in a market with rapidly rising prices such as London. In fact it may be that the Mansion Tax would actually encourage pro-cyclical activity amongst wealthy purchasers, since holding high value property would be more attractive at a point where prices were rising and increased asset values would offset the tax whereas, on a falling market capital losses would effectively be increased by the tax although the amount of tax paid would decrease modestly as values fell. By contrast, the PST taxes transactional activity in order to discourage speculative buying and selling.

The Mansion Tax does not distinguish between owner occupiers and investors, whereas the PST as proposed would do so. This raises the possibility, already discussed by critics of the Mansion Tax, that it could cause particular financial problems for elderly home owners who were on low incomes but whose properties had appreciated in value over a long period.

Thus, although the concepts of the Mansion Tax and the PST have both been publicly discussed against the backdrop of large-scale investor activity in London, particularly in relation to high-value properties, there are important differences in their aims and approach.

How much might a PST raise?

In order to make any proper prediction of the amount of revenue that a PST might raise it would be necessary to set out precisely the scope of the tax, the rate(s) at which it would be levied and the period over which the tax would taper from its maximum rate to nil. It would then be necessary to carry out an analysis of the number of residential transactions that the tax might catch and make an estimate of the prices at which those properties would have been bought and subsequently sold. This would in itself involve modelling work to arrive at scenarios as to how the PST would influence investor behaviour in terms of the type of transactions that would take place before and after the tax was introduced. Such an analysis is clearly beyond the scope of a discussion paper.

However, it was noted in the previous section that CGT probably raises around £500-600 million p.a. from residential property. Assuming a rate of PST similar to CGT (i.e. c. 18-28%) one might make some comparative observations:

- CGT is applied across the UK, whereas the proposal in this paper is that the PST

might be selectively applied in certain markets, notably London.
- CGT applies no matter how long a property is held between purchase and sale, whereas a PST would bear most heavily on rapid sale and purchase activity, and would leave some gains exempt.
- CGT applies to those liable for UK tax only, whereas a PST would also apply to non-UK residents. This would be particularly significant in London with its high proportion of high-value transactions by overseas investors.

All this suggests that a PST might raise funds on a similar scale to CGT but that there could be significant variation depending on how the new tax was applied. Overall, a PST could possibly raise up to £1 billion in a year. However, it is not possible to be more precise without a full analysis and modelling exercise.

Hypothecation

Discussions of property taxation in the context of speculation not infrequently revolve around the question as to whether such taxation might be linked in some way to the provision of new affordable (social) housing supply. The argument, which is at first sight an attractive one, usually suggests that the fruits of speculative activity should go to alleviate the shortfall in supply that exacerbates price rises and volatility and which in turn fosters that speculative activity.

As noted above a PST might raise up to £1 billion a year. In the context of the £2.2 billion government investment in the Affordable Homes Programme [AHP] 2011-15, such a sum is significant (HCA, 2011). At current grant rates it might be leveraged into an affordable programme of £2 billion or more.

The proceeds of a PST might be hypothecated to be spent on affordable housing. However, it should be noted that hypothecation carries risks as well as benefits. For example, much of the revenue from a PST would probably be raised in London. However, London is not the only part of the country to need affordable housing and the proportion of money needed in London may not equal the amount raised. Similarly within London, a disproportionate proportion of PST revenue would come from three or four inner London boroughs (including RB Kensington and Chelsea) where overseas investors and high-value properties are concentrated. Should affordable housing investment be focussed on a borough like Kensington and Chelsea rather than an outer London Borough such as Newham, with its massive Council waiting list? There are strong strategic and tactical reasons why it should not.

A PST would raise more revenue at a time of rising prices than in a flat market. However, it is not clear that such considerations should influence the provision of affordable housing over the housing market cycle. Finally, it can be argued that it is the task of elected governments to determine public spending choices between housing and other policy priorities and that hypothecation undermines that process.

Conclusion

Conclusion

As the housing market shows signs of moving into an upward phase in its cycle and as fears of price rises and ultimately a housing bubble begin to be voiced it is a good time to be considering actions to prevent and curtail housing market volatility.

This brief discussion paper has evaluated whether a case could be made for giving detailed consideration to the idea of a PST to be levied on the capital gains of those who profit through buying and selling in a supply-constrained housing market.

The conclusion is that such a tax could have a place as part of a package of measures to tackle housing market volatility. It is not a panacea, and there is clearly a need for a more detailed assessment but it is at least worthy of further analysis and modelling in terms of its potential effects.

As such we would encourage the government to consider introducing a PST that would:

- Incentivise holding property for the longer term and provide disincentives to engage in buying and selling for speculative gain.
- Would be introduced in London and selectively elsewhere on the basis of thorough analysis and modelling of the potential impact.
- Would apply to relevant transactions undertaken by both domestic and overseas investors.
- Would raise significant revenue at a time of financial austerity in the public finances.

Investment in housing is much needed, whether it originates in the UK or overseas. All markets are characterised by a degree of speculation. Toleration of such speculation is often the price to be paid for gaining access to investment for the longer term. Yet there is a balance to be struck. John Maynard Keynes summed up the position well:

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation." (Keynes, 2007)

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The Smith Institute
Somerset House
South Wing
Strand
London
WC2R 1LA

Telephone +44 (0)20 7845 5845
Email info@smith-institute.org.uk
Website www.smith-institute.org.uk

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