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Disrepair in the private rented sector in Scotland: a review of policy options in reserved areas

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Disrepair in the Private Rented Sector in Scotland: a review of policy options in reserved areas

by

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Contents

1	Introduction	1
2	A review of the taxation status quo	3
3	Recent taxation and benefit reforms and proposals	9
4	Findings from interviews with key informants	17
5	Conclusions	25
References		31

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1 Introduction

In June, 2002, the authors (at the Department of Town and Regional Planning, University of Sheffield) were commissioned by Communities Scotland, acting on behalf of the Scottish Executive, to undertake research to identify policies to improve the state of repair and quality of Scottish private rented housing, with a particular focus on policy options in areas where legislative powers are reserved to the UK Parliament, that is, taxation and benefits. This research would form part of the ongoing examination of housing in Scotland that is being undertaken by the Housing Improvement Task Force (HITF), established by the Scottish Executive in March, 2001.

Two points about the research methods need to be borne in mind. First, the research that we were contracted to undertake was to be qualitative in nature, consisting of interviews with a selection of key informants who, in a variety of ways, are involved with, or have an impact on, the Scottish private rented sector. The sample of interviewees was not intended to be statistically representative, but to cover a spectrum of different respondents from across the sector. Second, the policy proposals arising from the research were to be indicative rather than quantified, since the relatively short timescale of the research precluded any economic modelling or simulations of the effects of specific policy changes.

It was recognised that a number of important issues needed particularly to be taken into account in the research. The first of these was the nature and scale of the impact of any changes to taxes and benefits on landlords' economic incentives and their behaviour. The second was the extent to which any changes would accrue only to the private benefit of landlords themselves or would generate wider social benefits in the form of improved housing and neighbourhood regeneration. A third factor was the differential tax treatment accorded to 'trading landlords' as opposed to 'investment landlords'. Finally, it was recognised that the proposed pilot projects using amended Housing Benefit rules, to provide 'shopping incentives' to tenants and to amend the structure of local reference rents would impact upon any recommendations made, as would recent suggestions that capital gains by companies might be subject to corporation tax on an accruals (that is, on an annual, ongoing basis) rather than on a realisation basis. These developing agendas and the relevant consultations taking place on these changes are acknowledged in this report (Department for Work and Pensions, 2002; Inland Revenue, 2002a, 2002b).

The purpose of this report, then, is to present the conclusions and recommendations of the research. The detailed data derived from the interviews has not been included here. This is necessary in order to preserve the anonymity and confidentiality of our respondents, without whose cooperation this report would not have been possible.

The report concentrates primarily on possible reform to the tax and benefit systems, as required by the research brief. Other matters, such as the use of improvement grants, are brought into the discussion where relevant, but are not covered in detail in their own right.

The report is in five chapters. Chapter Two briefly sets out the current taxation status of private landlords in the UK. Chapter Three reviews recent proposals for reform of the tax and benefit systems inasmuch as they affect some private landlords. Chapter Four presents a summary of the views of our respondents as put to us at interview. Finally, In Chapter Five we draw some conclusions from this and previous research, and set out our own key principles both for a framework for recommendations and for a framework for reform.

2 A review of the taxation status quo

(a) The policy background

The Government's view is that primary responsibility for property condition lies with the owner of the property. Rent deregulation in 1988 was expected to raise the level of rents on deregulated lettings and hence generate adequate returns to landlords, which it was thought would allow them to carry out proper repair and maintenance and thus fulfil their responsibilities. At the same time it was hoped that higher returns from rented housing would encourage new landlords into the sector. A new supply of good quality properties managed by professional landlords is seen by Government as an important route to improving the overall quality of the sector. However, a recent paper (Bramley *et al*, 1999) has estimated that the price elasticity of supply for private rented housing could be as low as 0.1, indicating that a 10 per cent rise in rents would elicit only a 1 per cent rise in the number of properties supplied (which would be around 1,600 properties in Scotland and around 20,000 in the UK as a whole). Bramley *et al* conclude from this that to generate significant new supply into the sector will require 'tax subsidies' to landlords. As new supply may be one way of raising the overall quality of housing in the sector, this finding is pertinent to the present research.

With respect to existing landlords, one of the major problems in eliciting greater spending on repair and maintenance in the sector is that market signals do not appear to operate in a straightforward way. There is little detailed evidence from Scotland, but the available evidence from England suggests that rents are not directly related to the state of repair of dwellings (Crook *et al*, 1998, 2000; Crook and Hughes, 2001). Except at the 'top end' of the market, rents are not statistically related to repairs. Landlords can thus get as much rent for a dwelling in poor as in good repair. The state of repair is however related to capital values, with the best maintained dwellings having much higher values. This means that rates of gross rental return (rental income as a proportion of the capital value of the dwelling) are in fact higher amongst the worst dwellings (since their capital value is relatively low while their rents are not). Furthermore, since spending on repairs and maintenance is greater amongst the best dwellings, this means that rates of *net* rental return (rental income less costs, as a proportion of the capital value of the dwelling) are also higher amongst the worst dwellings.

This suggests there will be significant problems in achieving better conditions at the 'bottom end' of the market where many of the most vulnerable households live. This is especially the case because there is also evidence that capital values are not rising amongst the very worst dwellings, including those that are multiply occupied. Hence, these landlords are not only unlikely to recoup repair expenditure through increased rents, but are also unlikely to do so through increased capital values. These market effects will tend to inhibit landlords of the worst dwellings from undertaking repairs. Moreover, the overall effect on the private rented stock will be amplified, because the worst dwellings are much more likely than those in a better state of repair to be owned by landlords with an investment motive who take a more strictly

commercial approach to their properties and are, therefore, more likely to respond to these 'perverse' market signals (the better condition properties are more likely to be owned by those with non-investment motives for being landlords who are less likely to respond to market signals – see below). With both gross and net rental returns working out higher for poorly maintained properties, the market does not appear generally to reward repairing landlords (Crook *et al*, 1998, 2000).

It is clear, therefore, that the economic environment within which landlords operate is a crucial factor in considering the likely impact of changes in taxation and in social security benefit regulations. For example, restricting the payment of housing benefit when dwellings are below standard will not necessarily increase landlords' ability to undertake repairs. Repair expenditure will not automatically be recouped in higher rent (indeed rental income may fall if there is a lower number of occupants after improvements are carried out) and landlords may be as likely to leave the sector as to carry out the repairs that are needed, reducing the accommodation available to those in need.

The market environment is likewise also crucial in relation to the deployment of grants and loans. Loans may be a useful way of assisting landlords to undertake repairs, especially where they can be secured on capital values and where landlords can expect values to increase. However, in areas where capital values are static or falling and rents unlikely to rise, grants are likely to be more useful to lever expenditure than loans.

Before going on to look at some recent reform proposals, we first outline briefly the current circumstances with respect to taxation of landlords.

(b) The taxation status quo

It has been argued that "[i]n comparison to most other business activities, landlords have been treated ungenerously with respect to tax breaks" (Garnett, 2000; see also Wood, 1990, 2002 on the relative tax position of landlords and private renting; also Shelter, 2002). This inequity is said to relate to three areas of taxation: income tax or corporation tax, capital gains tax, and value added tax. A key point here, is the question of whether landlords' income, for tax purposes, is treated as investment income or income from the carrying on of a trade. In addition, there may be other areas of concern, relating to stamp duty and inheritance tax.

(i) Taxation of income and profits

With respect to income tax, individual landlords are taxed under Schedule A, which relates to property income arising from ownership of, or interest in, land or other real property. This is classed as investment, not trading, income. Before 1963, owner-occupiers were taxed on the same basis and paid tax on the 'imputed rent' which, as landlords, they theoretically received from their investment in their own home. Since that time, owner-occupiers have not been taxed on their imputed rent, putting them at a relative advantage to private landlords. Against their taxable income, however, landlords are entitled to claim certain revenue and capital allowances.

On the revenue side, a landlord can offset against taxable income ordinary expenditure on maintenance and repairs, as well as insurance and management costs and the cost of servicing any loan taken out to purchase a property. Also,the costs of major repairs to reinstate a worn out or dilapidated

asset are usually deductible. However, smaller, individual landlords who do repairs to their own property in their own time may be at a disadvantage here compared to company landlords in that they are not allowed to offset against taxable income the value of their own time as legitimate maintenance expenditure (although if they did, they might then need to declare this as earned income). On the other hand, individual landlords who let a room in their own home may receive gross rental income of up to £4,250 tax-free, under the 'Rent a Room' scheme, though they cannot then claim tax relief for any of their letting expenses.

Capital allowances permit the cost of assets to be written off against the taxable profits of a business, in lieu of depreciation charged in a firm's accounts, which is otherwise not allowed for tax purposes (Inland Revenue, 2002c). Here, private landlords are treated less favourably than landlords of some industrial and agricultural property, who may claim an allowance against taxable income for the depreciation of their real asset. Depreciation allowances are not allowable against residential property (or indeed against most commercial property), including against any costs of carrying out improvements, although the depreciation of furniture and furnishings in the property, and equipment such as refrigerators, is deductible. Landlords may choose to treat improvements as capital items on their balance sheets and make an annual depreciation allowance in their income and expenditure account. Depreciation of buildings is generally not, however, deductible under tax law and capital allowances are not provided. The reason for this is that real property is an enduring asset for which a depreciation allowance would be inappropriate (although some buildings do benefit from capital allowances, such as commercial properties in Enterprise Zones).

However, as part of the Government's urban renewal measures, since May, 2001, 100 per cent capital allowances have been available to individual and company landlords for capital expenditure on conversion of spaces above older shops, or other commercial premises, into flats for rent, or for the renovation of an existing flat which has been empty for at least one year.

(ii) Taxation of capital gains

Capital gains tax (CGT) is payable on the transfer of an economic interest in an asset, in the case of real property either through the sale of the property or the transfer of a lease. The position of private landlords in relation to CGT is less favourable than either owner-occupiers or other businesses. Most owner-occupiers do not pay CGT when they sell their main residence. In general, businesses do not pay CGT as such, but they are liable for corporation tax on their trading profits, which may include the net gains on the sale of real assets. Unlike most other businesses, however, private landlords cannot benefit from certain capital gains tax reliefs, such as 'roll-over' relief and 'taper' relief. Rollover relief is available when the proceeds from a property sale are reinvested in property, either through purchase of an additional property or improvement of a property already owned. Taper relief was introduced in 2001 to replace indexation allowances, and is used to offset purely inflationary rises in the value of an asset. However, it is only available to individuals, not to businesses, since it applies specifically to CGT rather than to corporation tax.

In contrast to owner occupiers, private landlords are not exempt from CGT on the net gains realised on the sale of a property. In contrast to most other businesses, private landlords cannot claim rollover relief because rented properties (both residential and commercial) are not considered by the Inland

Revenue to be 'assets used for the purposes of a trade' and, therefore, are not eligible for the relief. For the same reason, individual landlords cannot claim the higher rate of taper relief that most other businesses can claim on the proceeds from a property sale, although they are eligible for the lower 'non-business' rate of taper relief.

(iii) Value Added Tax

Value Added Tax (VAT) is a tax which businesses have to charge when they supply goods and services in the UK. Supplies of goods and services which are subject to VAT are called taxable supplies. The normal rate of VAT is 17.5 per cent, but certain specified supplies are taxed at 5 per cent and others at 0 per cent, although for VAT purposes, the latter remain 'taxable supplies' (under EU directives, it is not possible to extend the list of goods and services that are zero rated) If the value of a firm's taxable supplies is over a specified threshold (currently £55,000 a year), the firm must register for VAT, and charge and account for VAT on all its taxable supplies. Businesses have to charge the appropriate rate of VAT on the goods and services they provide. They are then able to reclaim the VAT they pay on any goods and services they acquire in the course of their business. They pay over to HM Customs & Excise (or reclaim) the net difference between the output VAT they charge their customers and the input VAT they have paid their suppliers.

Certain goods and services, however, are exempt altogether from VAT, and are called exempt supplies. The letting of residential property is exempt from VAT. However, repairs, maintenance and improvements to buildings are standard-rated (17.5 per cent) and VAT will normally be payable by a private landlord on any such work undertaken. Because lettings are VAT exempt, landlords cannot recover the VAT which they have paid.

The normal tax rates have been recently amended in order to encourage neighbourhood regeneration. In the case of renovations of dwellings that have been empty for three years or more, the VAT rate is reduced to 5 per cent. A reduced rate of 5 per cent also applies when an existing residential property is converted into a different number of dwellings (for example, converting a house into flats or bed-sits) or when a non-residential property is converted into a dwelling or dwellings. ('Relevant' housing associations are exempted by a special rule from payment of VAT on building work to convert buildings to residential use from other uses.)

(iv) Stamp Duty

Stamp duty is normally payable by landlords and others on purchase of a property, where the cost of the property is more than £60,000. The normal rate of duty is 1 per cent on property between £60,000 and £250,000; 3 per cent between £250,000 and £500,000 and 4 per cent over £500,000.

As a further initiative in the drive to regenerate areas of economic and social decline, the Government has introduced recently a stamp duty exemption scheme. In disadvantaged areas, all property sales and lease premiums under £150,000 have been exempted from stamp duty since 30th November, 2001. The term 'disadvantaged areas' includes around 135 postcode areas in Scotland. Under the second phase of this scheme, it is proposed to abolish the £150,000 limit for all non-residential property transactions in a qualifying area, subject to State Aids approval. Purchases, under a single contract, of six or more separate residential dwellings in a disadvantaged area will qualify as

'non-residential' for these purposes, thus allowing landlords to buy, for example, blocks of run-down terraced housing for investment purposes.

(v) Summary

Taxation rules are complex and much will rest on an individual's or a company's circumstances. However, in general, private renting as a housing tenure appear to be less favourably treated than owner-occupation because landlords are liable to pay CGT on the sale of properties, a liability of some magnitude in view of sustained historical real house price growth. They also pay tax on their rental income, whereas owner-occupiers do not pay tax on their 'imputed rent'. Private landlords, as a group, are also less favourably treated than other businesses, in part because they are not usually considered by the Inland Revenue to be trading, which excludes them from certain allowances and reliefs, and in part because they are precluded from reclaiming the VAT element of repairs and maintenance expenditure, since rented housing is VAT-exempt. (Although the absence of VAT on rents is also a benefit to landlords – and to tenants, on the assumption that landlords could pass on some of the VAT if it was levied – since it keeps rents lower than they otherwise would be and boosts demand.)

This overview has been necessarily brief, but has set the scene for a discussion of recent proposals for policy reforms. In part three, we look at some of these. In particular, we discuss some specific proposals for reform of the tax system to benefit private landlords, followed by examination of policies to increase the size of the UK private rented sector and bring in new landlords and good quality properties, and, finally, attention is given to suggested reforms to the Housing Benefit system.

3 Recent taxation and benefit reforms and proposals for reform

(a) Introduction

The purpose of this chapter is to set out some frequently suggested tax and benefit reforms which could help to improve the position of private landlords. We wish to stress that inclusion of a reform proposal in this chapter does not imply our support for that proposal. Indeed, as will become clear, we have included here some proposals which run counter to our own views, as set out in our conclusions in Chapter 5. This is in order to make the discussion as comprehensive as possible.

(b) General taxation

(i) Taxation of income and profits

Capital allowances

Numerous analysts have suggested that private landlords be offered the opportunity to claim capital allowances to offset the acquisition cost (and any subsequent improvement expenditure) of their properties against taxable incomeIt has been suggested, also, that landlords be allowed to offset against taxable income contributions to a 'sinking fund' for the financing of future repairs and maintenance. For discussion purposes these two reforms are considered together here.. Notwithstanding the Inland Revenue view that housing is an enduring asset, it has been argued that the introduction of allowances is justified because, at present, most other businesses enjoy this tax allowance and extending it to private landlords would create a more level fiscal playing field. Moreover, capital allowances might be particularly effective because they are an 'up-front' form of subsidy, have a high profile and so are psychologically effective, and the rate of the allowance can be varied according to market circumstances, either nationally or locally. However, a disadvantage would be that, with respect to other investors, capital allowances would represent an open-ended financial commitment for the Government, since the allowance could not be cash-limited.

Clearly, a further result of the introduction of capital allowances would be to boost returns and yields on private renting. However, it has been argued that the increase in returns would not be sufficient to close the 'yield gap' between private renting and other investments, particularly given the relative risk/liquidity profiles (see for example Crook *et al* 1995; Crook and Kemp, 2002). However, the yield gap may have shrunk in recent years, since volatility in the stock market has made equities relatively more risky than hitherto, and as a result has made property relatively more attractive. In current market circumstances, therefore, the introduction of capital allowances might produce a further increase in competitiveness for private renting that would possibly be sufficient to reach the 'hurdle' rate of return which research shows is required by institutional investors (Crook and Kemp, 2002).

In fact, a precedent exists for the application of capital allowances to private renting. From 1982-84 they were available to 'approved' private landlords providing assured tenancies under the Housing Act 1980. At that time, they proved to be particularly effective in persuading organisations to take part in the 'approved landlord' scheme and their withdrawal led to a decline in participation in the scheme (Kemp, 1988)

Since May 2001, moreover, as reported in Chapter Two, 100 per cent capital allowances have been available for conversion into flats of space above shops in traditional shopping streets and similar locations, or for renovation of an existing empty flat in such a location. Capital expenditure on the property which is incidental to the conversion or renovation work may also be considered as qualifying expenditure.

Furthermore, targeted capital allowances are currently being used to encourage other socially desirable investment. For example, the Budget 2000 made permanent the recently introduced policy of allowing the purchase of plant or machinery by small and medium-sized businesses to qualify for a 40 per cent first-year capital allowance (the normal rate is 25 per cent). For the period 1st April, 2000 to 31st March, 2003, the first-year rate is 100 per cent, if the equipment purchased is information and communication technology.

Some questions arise from the discussion above. First, what is the likelihood of capital allowances being extended to landlords for the purchase of residential property? Second, what rate of capital allowance do landlords, or their representatives, believe to be necessary to bridge the yield gap, or to boost rental income to a sustainable level? Recent research has determined that total returns on private renting (rental returns plus capital gains) are competitive with other investments, but that there is a significant risk factor relating to the timing of purchase and sale of properties (Crook *et al*, 2002). Third, what would be the impact on existing landlords' repair and maintenance activity? It has been suggested that the tax allowance should be limited to company landlords who are more likely to keep their properties in good repair and who are financially more transparent and publicly accountable. Fourth, what would be the impact on new supply coming into the sector, either through existing landlords expanding their portfolios or through new landlords entering the sector, particularly institutional investors and company landlords? We discuss these questions in Chapters 4 and Fiv5.

(ii) Taxation of capital gains

There are two possible scenarios here. One would be for the Government to bring private landlords into line with owner-occupiers and abolish CGT on disposal of a housing asset. If necessary, this exemption could be tied to reinvestment in residential property ('rollover relief'), with 'final exit' capital gains being taxed as at present (RICS, 2002). Qualifying investment could include investment in the repair and maintenance of other properties. The second scenario is that the Government could remove CGT exemption for owner-occupiers, thus bringing them into line with private landlords. This would have the effect of reducing demand for owner-occupied housing and, hence, boosting demand for private renting, raising rents and rental income. However, this second scenario seems politically unlikely at present, despite the fact that it would reduce owner-occupier demand in places such as London and the South East of England, lower house prices and, hence, ease the affordability problem there.

The question arises, therefore, as to the likelihood of the Government extending exemption from CGT to private landlords. If so, what impact is it likely to have on landlords' returns and on their repair and maintenance activity? What would be the effect on the supply of privately rented housing? It has been argued that the effect of the removal of CGT liability would be indeterminate in the short run, since it would increase returns but, possibly, encourage some existing landlords to liquidate their assets (e.g. Crook *et al* 1995). However, in the long run, non-taxation of capital gains would lead to a clear increase in returns and supply.

(iii) Value Added Tax

The main area of proposed reform in relation to VAT has been to reduce or remove the anomaly between the construction of new housing, which is exempt from VAT, and repair, renovation or improvement of existing properties, on which VAT is payable at the standard rate of 17.5 per cent (RICS, 2002).

A question which arises here is how significant a disincentive to repair is VAT. What rate of VAT would be sufficient to encourage landlords to invest in repairs and maintenance (currently, there are only three rates: 17.5 per cent, 5 per cent and zero) Would VAT reform have any impact on the supply of private rented housing?

(iv) Stamp Duty

Little attention has been given by analysts to reform of stamp duty. However, it offers one further way of improving landlords' rates of return and encouraging greater repair and maintenance activity. One idea would be to waive stamp duty when a landlord buys a property to let, on condition that the property is in good repair when subsequently sold, otherwise, the duty foregone being recouped from the sale proceeds. While this would not ensure repair and maintenance was undertaken in the interim, it would encourage landlords to bring properties up to an acceptable standard at the time of sale. As a long-term measure, therefore, it may have a significant impact. However, there could be significant administrative costs involved in monitoring the condition criterion.

(c) Corporate landlords, housing investment trusts, and tax transparency

Another important reform proposal is connected with the desire to increase the proportion of the private rented stock owned by corporate landlords and the amount of funding provided by the main financial institutions (Crook & Kemp, 1999, 2002).

The limited national survey research undertaken on the supply side before rent deregulation was introduced in 1989 showed that the majority of the sector was owned by individual landlords, with small portfolios which they managed themselves in their spare time. Moreover, landlords who had invested for commercial reasons owned only slightly more than half of the sector. Many others had become landlords due to negative equity causing them to postpone selling their home when they moved to another, or by accident (for example, through inheritance), or to house employees, or for a wide range of social and personal reasons. The net result was that landlords who were likely to respond on a strictly commercial basis to market signals, such as higher rents, owned only a small proportion of the sector. Furthermore few landlords were large enough to realise economies of scale in management and maintenance:

hence their costs per dwelling were high. Few were large enough to spread market risk through regional and market segment diversification: hence they faced higher market risks. Finally, although the evidence was limited, most landlords in the market at the time of deregulation were dependent on their own private equity, and did not draw in investment funding from the main City institutions. Most landlords bemoaned the rates of return they were earning, less than half the stock being owned by landlords who thought their rent adequate, or that it was sufficient to cover repairs and give a reasonable return. The then Conservative government took the view that bringing in new corporate private landlords could help transform the sector, improve returns and lead to higher standards.

The Conservative government took two key steps to achieve its objectives of increasing the number of corporate landlords and the amount of 'City' funding.

The first step was to use the Business Expansion Scheme (BES) to provide tax incentives to individual equity investors for a limited, five-year period, between the tax years 1988-89 and 1993-94. Individual (but not corporate) investors in BES companies could offset the value of their investment against their tax liabilities at their marginal tax rate, up to an annual limit of £40,000. Neither were they liable for capital gains tax on disposal of their BES shares. In effect, the Government underwrote the risk that might otherwise have prevented investors entering the market.

£3,000m was invested in 903 assured tenancy companies under the BES scheme and these companies acquired 81,000 dwellings. However, many of these companies were launched in the anticipation of shareholders making significant capital gains through increases in house prices and had only a short-term investment horizon. Moreover, the rental rates of return being earned by all these companies were not competitive. Although the largest companies achieved higher income (net rental) returns than the small ones (illustrating the presence of scale economies), these were below the benchmark returns required by companies for a long-term future. Meanwhile, the tax expenditure (tax income foregone in tax relief to investors, etc.) incurred in relation to the BES assured tenancy companies was very substantial, equating to approximately £20,000 for every dwelling acquired.

Thus, the objective of having BES companies demonstrate to individual equity investors and also to financial institutions that private renting could provide competitive returns was not likely to be realised. Nor was the objective of establishing a larger corporate sector through this means likely to be realised.

In order to create a larger corporate sector and also to provide a basis for securing long run equity and debt funding from the major financial institutions, the Government launched a further initiative in 1996 designed to facilitate investment, with tax structures attractive to institutions, such as pension and other 'gross funds', who pay no tax on their income from directly owned property. Housing Investment Trusts (HITs) were designed to facilitate the involvement of City institutions in private renting, not through direct ownership, but through the purchase of shares, which would be subject to lower rates of corporation tax and to relief from capital gains taxation. Whilst HITs are not fully tax transparent (see below) it was hoped that their structure would encourage the major institutions not only to buy shares in HITs but also to lend them significant sums of debt.

However, HITs have not so far proved attractive to the institutions. This is for a wide range of reasons. Although there is much greater understanding of the sector and somewhat more willingness to provide equity and debt funding than in the past, important barriers still exist. These include market risk, the small scale of existing portfolios and the difficulty of assembling new ones, the high costs and poor quality of property management, and the lack of market information. As a result, investors require a higher rate of return on residential than on commercial property – in part to reflect the higher risks and costs, but in part to reflect novelty.

There are also difficulties connected to the specific structure of the HITs themselves, including the fact that they are not fully 'tax-transparent'. A tax-transparent company is one where the company is not subject to tax on income or gains. Instead, if the investor is a taxpayer, then he or she will be subject to tax on income when profits are distributed and gains when disposing of shares in the company. Certain non-taxpayers, e.g. pension funds, charities etc., would not be subject to tax. The effect of a tax transparent vehicle is to put the investor in the same position as if they had invested directly in the assets held by that vehicle and it therefore enables investors with different tax profiles to invest collectively without the imposition of tax on non-taxpayers. Hence, if a pension fund had acquired shares in a HIT, it would pay no tax on income it received from the HIT.

A HIT was never fully tax transparent but was virtually tax transparent. A HIT was designed to suffer corporation tax at a rate which was very close to the rate of Advance Corporation Tax (ACT). Therefore, where income was distributed (at that time with the benefit of a tax credit) non-taxpayers could reclaim the ACT which meant that they suffered very little tax. However such virtual tax transparency was lost in 1997 when due to unrelated reforms, gross funds and charities were prevented from reclaiming ACT on dividends. They are also complex vehicles to structure and to administer. For all these reasons, no HIT has yet been launched.

Attempts have been made to set up indirect residential investment vehicles outside the HIT structure, including limited partnerships and property unit trusts, but these are very few in number to date.

Although the HITs policy was introduced by the last Conservative Government, the current Labour Government in Westminster has been no less committed to the overall objective of expanding the supply of good quality private rented housing managed by responsible and prudent corporate landlords. It has recognised that the potential to achieve an expansion of funding by major financial institutions exists, but is not likely to be realised in the immediate future, given that perceptions of risks are not reflected in investment returns. The Government has taken steps to enhance investors' and landlords' confidence in the current deregulated framework and to secure the reputation of responsible investors by ensuring action is taken against irresponsible landlords and tenants. It has also examined the arguments put forward for creating greater tax transparency to foster institutional investment, but has rejected artificial tax reliefs that create short-term distortions without attracting investment in the long term. Research suggests that any government anxious to attract more institutional investment will need to find effective ways of grafting this new structure of provision onto the existing one (Crook & Kemp, 2002).

(d) Housing benefit 'conditionality'

Recent research on the relationship between investment returns and conditions suggests that the market is not providing rational investors with sufficient incentives to carry out improvements and repairs in the worst dwellings. It raises the question of whether enforcement action against landlords of properties in poor condition is necessary (whether or not allied with financial assistance) to encourage them do so.

In addition to the existing powers local authorities have to compel landlords to do repair work, additional enforcement powers have been proposed. These include:

- A statutory duty on landlords to keep their property in a fit condition
- The introduction of mandatory licensing for all houses in multiple occupation (already introduced in Scotland) and the licensing of all types of private rented property in areas of low demand
- The introduction of a restriction on Housing Benefit payments where a property is below some minimum standard

Those who have proposed these (and similar) changes have indicated that they would need to be operated in parallel to be most effective (see, for example, the Government's proposals for England in its White Paper on Housing of 2001). However, there may be administrative costs involved in enforcement and particular difficulties where, for example, the landlord is resident abroad.

The evidence from recent research in England suggests that introducing a new statutory duty on landlords to keep their property in a fit condition could help towards improving the worst accommodation. Such a duty (including that related to the new approach to standards and the Law Commission's recommendation about lease reform in England) could persuade some landlords to increase their spending on repairs and maintenance, although in some cases this might be at the expense of spending on property that is already fit. However, landlords are often unaware that their property is unfit. This suggests that, unless both the deficiency and the statutory duty are drawn to their attention, landlords of unfit property may not take the necessary remedial action. Moreover, unless the cost of the additional works can be fully or partially recovered in a higher rent, the result may be to reduce the supply of rented accommodation.

Similar considerations would apply to the introduction of licensing, accompanied by minimum standards, for houses in multiple occupation and for all rented property in low demand areas. The evidence from England suggests that some HMO landlords can be expected to seek to raise rents in order to fund higher repairs expenditure. Some would not convert their dwellings into HMOs in the first place, while others would convert existing HMOs into self-contained flats. Thus, to some extent the introduction of licensing can be expected to reduce the supply of HMO accommodation. (HMO licensing has, of course, already been in place in Scotland for the past 18 months) Similar considerations are likely to apply to property in low demand areas. In these areas in particular landlords are unlikely to be able to recoup expenditure through increased capital values, whereas they may be able to do so elsewhere.

Such outcomes would not be fully consistent with the objectives behind the 'single room rent' provisions for single people under 25 in the Housing Benefit scheme. Quite apart from the supply of HMO accommodation, research suggests that the introduction of the single room rent has restricted the ability of a minority of landlords to spend money on repairs and maintenance when letting accommodation to young people under 25 on Housing Benefit (Kemp & Rugg, 1998).

This raises the question of whether the introduction of a minimum property standard restriction in the Housing Benefit scheme (including direct payments to landlords), would be an effective means of improving the worst accommodation. Research in England shows that Housing Benefit recipients are over-represented in the stock in the greatest disrepair. Although a majority of landlords in a recent survey (including those of the worst property) thought such a restriction would be a good idea, they may prove to be less keen if they find that it applies to their own property. It would reduce their rental revenue on unfit properties.

The research suggests that landlords would respond to such a restriction in a variety of ways. Some would improve their unfit property. Others would reduce maintenance on them in order to minimise the impact on their net yield, though in the case of HMO accommodation this strategy will not be possible if mandatory licensing is introduced. Others will try to let their accommodation to people who are not on Housing Benefit. Meanwhile, properties that are not occupied by Housing Benefit recipients would be unaffected by the restriction.

Thus, the introduction of a Housing Benefit property condition restriction (when combined with HMO licensing) would probably improve the quality of some of the substandard stock in the private rented sector. But it would also be likely to reduce both the supply of such accommodation and the willingness of landlords to let what remains to Housing Benefit recipients. It would also considerably raise the difficulties for local authorities of administering what is already a complex benefit scheme.

Nonetheless the Government in Westminster has committed itself to considering measures (linked to licensing schemes) to restrict payment where properties are below standard in order to address the problems of unscrupulous landlords abusing the benefit system and providing poor accommodation. It is also keen to ensure that the Rent Service Agency ensures that determinations of rents for Housing Benefit purposes takes consistent account of all circumstances in low demand areas where there may be very few private tenants paying rents themselves, unaided by benefit.

(e) Summary

This chapter has provided an overview of the current taxation status quo pertaining to private landlords and has briefly set out some recent proposals for reform, while raising a number of questions that need to be considered. Using these questions as a basis, a number of face-to-face interviews with key informants were undertaken in September and October, 2002. Chapter 4 sets out some of the key findings from those interviews.

4 Findings from Interviews with Key Informants

(a) Introduction

In this chapter, we present the detailed findings from the interviews with key informants. The views reported below are the respondents', rather than our own – and this includes views and opinions that are at variance with what is feasible under current taxation policy and European directives on VAT. At this stage, no comment is made on the views expressed by respondents. However, in Chapter Five, we present our own conclusions and recommendations, based on this evidence and on our knowledge of the private rented sector more widely.

The interview sample was drawn from across the spectrum of organisations that have connections to the sector. It was not intended to be statistically representative in any way, but to elicit a range of opinions that would add depth to the analysis. The results set out below, therefore, are indicative of the views of those with intimate knowledge of the sector, but cannot be taken to be representative of the sector as a whole or of any constituent part of it. The views and opinions reported in this chapter are not those of any one respondent but are an amalgam of all responses.

The detailed data derived from the interviews have not been included here. This is in order to preserve the anonymity and confidentiality of our respondents, without whose cooperation this report would not have been possible. However, key findings, anonymised and agglomerated, are reported below.

It was frequently commented that many of the taxation, benefit and other issues that this report addresses are not unconnected and, therefore, that a holistic approach to reform is necessary. While the discussion of conclusions in Chapter 5 of the report takes a holistic approach, for clarity of presentation in this summary of findings, the issues have been dealt with individually. Before reporting on each issue, however, we briefly discuss the specific characteristics of the Scottish private rented sector, as perceived by our informants.

(b) The nature of the Scottish private rented sector

Our discussions with key agents confirmed that there are many similarities between privately rented housing in Scotland and in the rest of the U.K., but there are also some noteworthy differences. These relate to the market, to tenants, and to landlords' characteristics. They primarily centre around rural/urban differences and help to define a distinctly Scottish private rented sector.

As elsewhere, Scottish private renting is a heterogeneous sector in a number of dimensions. First, there is a clear distinction between the sector in larger

urban areas – Edinburgh and Glasgow being the most obvious examples – and smaller urban and rural areas. These differences relate to rent levels and property values, which tend to be higher in larger urban areas, and the rates of increase in property prices, which are also greater in urban areas. However, unlike in England, the pronounced concentration of the population in the major conurbations coupled with the sheer extent of the rural areas means that many people live remote from urban centres of any size, making rural circumstances more significant. The variation in landlords' revenues from rents and capital gains from property price rises is not, though, reflected in a corresponding variation in their repair costs. A central heating system or new roof costs about the same in the Highlands as it does in Glasgow or Edinburgh, making property improvement relatively less affordable for rural landlords.

Second, in areas of high demand, such as Edinburgh, landlords are less likely to wish to rent to tenants in receipt of HB, while in other areas, such as those experiencing economic restructuring, HB tenants form a significant part of the market. In rural areas, meanwhile, the private rented sector assumes enhanced social importance due to the relative scarcity of RSL properties, which tend to be concentrated in urban locations. In rural areas, households are often looking for a long-term tenancy and thus favour estate properties over others. Tenants' rising expectations and aspirations are also important.

Third, like landlords in the rest of the U.K., many Scottish landlords are small-scale and part-time, and came into the sector 'by accident', through inheritance or because they have moved out of an area for employment reasons and wish to temporarily let their home. Many small landlords' main concern is to cover their ongoing mortgage and other costs from rent, while looking to capital gains for longer-term returns. But there are also some distinctly Scottish landlord characteristics. In rural areas, especially, many landlords operate as 'quasi-social' landlords, letting properties for a variety of reasons, not simply to gain the maximum return. This is particularly so with the large rural estates, where concerns about local community cohesion and social welfare can play an important part in landlords' letting strategies and pricing policies.

These characteristics of Scottish private rented housing help to frame the following discussion of tax and benefit reforms and other issues.

(c) Reform of taxation rules

(i) Income tax and corporation tax

There was widespread support among the respondents for the view that landlords are being subjected to taxation rules that put them at a disadvantage to other groups, particularly other businesses. Related to this is the differential taxation treatment of landlords' income from residential 'investment' properties – classified as 'unearned' – compared to that of landlords 'trading' in residential properties. It was proposed that landlords' investment income be no longer treated as 'unearned' and, therefore, that residential property income no longer be taxed under Schedule 'A'. It was argued that this change would automatically precipitate many of the beneficial changes discussed below. For example, landlords would be entitled to capital depreciation allowances on improvements to their properties, which themselves would be classified as business, rather than non-business, assets and hence attract rollover relief on capital gains tax on disposal of the property.

A key issue facing landlords was felt to be the way that expenditure is addressed in accounting and, hence, in taxation terms. Although repairs are fully allowable against taxable income and depreciation is allowed on furniture and fittings, how improvement expenditure is addressed within the tax system depends on whether it is revenue expenditure and attributed to the profit and loss account, or is capital expenditure and put on the balance sheet and subject to depreciation on via the income and expenditure account (see IR Tax Bulletin 53 on some of these issues). This in turn depends on the facts of each case and on previous case law. Moreover, landlords' position has worsened recently, since some concessions related to the repairs element of improvement were withdrawn in 1998/99, although it is still possible, in some very limited circumstances, to convince the Inland Revenue to treat some improvement as repairs and hence achieve deductibility. A related issue is how large landlords with tens of dwellings allocate their annual bill from builders between repairs and improvements.

Accelerated capital allowances – ten years or shorter – were seen as more likely to make an impression on the backlog of repairs and to provide a realistic time horizon for landlords' investment decisions. Indeed, there could be significant psychological, as well as physical, effects on the sector as landlords' sense of grievance at being 'over-taxed' and 'under appreciated' becomes diminished. This could lead to a greater impact being achieved by tax allowances than might be expected from purely economic reasoning. One respondent suggested that there could be accelerated tax relief for landlords similar to proposals made with respect to contaminated land relief, such that the qualifying expenditure attracts 150 per cent relief irrespective of whether it is revenue or capital and where it appears in the accounts. Such tax relief could, it was suggested , be limited to smaller properties.

There was a strong feeling that anyone who manages their own properties should qualify as a business and that there should be no more onus on landlords to prove their business status than on other entrepreneurs. There was, also, a feeling that any tax allowances should be universal, and not be restricted, for example, to landlords of a minimum size. Nor was it felt that there should be a minimum number of properties under improvement to qualify for allowances, as this would exclude small-scale landlords, as well as some larger, rural landlords, whose projects often consist of single dwellings and where it is sometimes necessary, for management reasons, to undertake serial, rather than parallel, improvements. However, it was recognised that allowances may need to be conditional upon verifiable improvement expenditure, for example, or linked to landlord accreditation. By imposing such conditions, the measures may be made more politically palatable.

Larger landlords were seen as possibly more likely to be incentivised by tax allowances, and this could have a disproportionately beneficial effect in rural areas where large estate landlords are prominent. Indeed, it was suggested that there is some policy inconsistency in that there are 100 per cent capital allowances available to create flats above shops, but nothing comparable is available to landlords in specifically rural areas.

(ii) VAT

There was a widespread feeling among interviewees that VAT could be an obstacle to repairs and improvements in private rented housing. It was seen, by many, as both inefficient and inequitable.

Because letting of residential property is exempt from VAT, landlords are unable to reclaim VAT paid out to contractors and suppliers in the course of repair and improvement work and for other services. This irrecoverable cost, therefore, was perceived as a disincentive, which may have the effect of dampening repair and maintenance activity. It was alleged that it further erodes economic efficiency in that it encourages avoidance behaviour, such as artificial restructuring of companies to take advantage of the *'de minimis'* rule on partial exemption, employment of 'direct labour' on whose wages no VAT is payable, in place of contractors, and the deferral of repairs in the hope that the local authority carries them out under an enforcement notice and subsequently recoups the cost from the landlord, because, unlike the landlord, the authority is exempt from VAT on the work. Finally, it was said that VAT might also increase inefficiency because it increases the propensity to resort to the black economy, whose use would be reduced if landlords were able to reclaim VAT.

Like capital allowances, VAT was also perceived as inequitable in that most other businesses, because they pay 'output' VAT are able to reclaim 'input' VAT. This was notwithstanding the recent reduction in the VAT rate from 17.5 per cent to 5 per cent to encourage increased housing supply, such as where the number of dwellings in a property is increased, or where commercial properties are converted to residential use. However, there was no enthusiasm among respondents to see VAT levied on tenants' rents. It was also alleged that a further inequity may arise between rural and urban areas, in that newly built housing, which is zero-rated for VAT, usually provides work for urban firms and employees, while renovation, on which VAT at 17.5 per cent is levied, is more likely to employ local workers. This may mean that, overall, rural firms and employees are less likely to be engaged, thus skewing expenditure towards urban areas. Finally, it was thought that reform of VAT may chime with public sensibilities on the environment, inasmuch as most people are likely to prefer the renovation of existing dwellings, where possible, rather than the building of new ones, especially on greenfield sites.

(iii) Stamp Duty

While it was recognised that, following recent changes, in large parts of the country Stamp Duty on house purchases is rarely paid, it was still seen as a 'transactions cost' affecting economic activity; one that increases costs and reduces private landlords' output. Moreover, it was said to tend to encourage behaviour motivated by taxation, rather than market, considerations. Landlords are treated unfavourably compared to other businesses, which do not have to pay an equivalent tax on their acquisitions of capital equipment. If landlords were to be exempted from Stamp Duty on property bought to let, however, it was recognised that verification would be required to ensure that the owner did not occupy the property themselves. But a minimum letting period was not supported, again on the grounds of equity with other businesses, that are not subject to a similar rule on the use of their own capital. Opinions were divided on whether exemption should be linked to property condition. For some, making exemption conditional upon good condition was seen as counter-productive, since it may discourage landlords from buying poor properties to

improve them. Others argued that such a condition ought to be imposed, and that it could be done, perhaps, by setting a minimum capital value in a particular area. There would be no need to impose an upper limit on capital values, it was suggested, because landlords would not buy the most expensive properties, due to the lower rates of return they produce. However, this contradicts the empirical evidence on returns, and a cap on exemption possibly would be necessary to target public expenditure at the appropriate market segment.

(iv) Inheritance tax

In a similar way to stamp duty, inheritance tax (IHT) was seen by some respondents as taking working capital out of residential letting businesses and hence reducing the capacity of landlords to keep their properties in good repair and up to modern standards. This particularly applies where the business passes from one generation to the next, which is often the case with rural estate portfolios. Once again, the situation was compared unfavourably with other business sectors, especially agriculture, where there is 100 per cent IHT relief. It was seen as a tax on the value of the assets rather than on the income or profitability of the business, and not 'logical', if the aim is to encourage landlords to stay in the sector for the long run. However, it was argued that relief from IHT would be a relatively easy reform to implement, since it would represent tax income foregone at some unspecified future date, rather than an immediate negative impact on Treasury revenues. The real issue here, however, may be the unusually favourable treatment offered to agriculture, for historical reasons, which is not available to most other businesses.

(d) Reform of housing benefit rules

There were several issues raised with respect to the application and impact of housing benefit rules: the role of rent officers in determining housing benefit payments for particular properties; the effects of imposing 'conditionality' on housing benefit payments; and, how housing benefit payments could be related to property condition.

For a number of reasons, many landlords prefer not to let their properties to housing benefit recipients. The administrative 'hassle' associated with housing benefit is seen as excessive, both in securing a determination and receiving the benefit at the start of a tenancy and in being vulnerable to overpayment recovery up to several years after a tenant has left. To some extent, housing benefit tenants are also perceived as being less likely to respect the property. Nevertheless, many landlords rely on housing benefit tenants to occupy their properties, especially in areas of low demand, which includes many rural areas. It was argued that rent officers tend to set reference rents that are below the open market rent for the property. More importantly, it was felt by some interviewees that the administratively determined reference rents are barely affected by the quality or condition of the property, neither in the sense that improved properties attract higher rents than the local reference rent, nor that poor properties attract below-reference rents. It was felt, therefore, that there is little incentive for those landlords who operate mainly in the housing benefit segment of the market to improve their properties. In some parts of the country, this can be the majority of landlords. It was argued that this did not, however, necessarily put landlords off improving their properties, since the better the property, the 'better' the tenant and improvement would allow the landlord to steer away from the housing benefit segment and instead operate

in the open market segment, or perhaps move into the student rental market. This suggests that, if the housing benefit segment of the market is to be significantly improved (for example, by the use of capital allowances or through grant action), then eligible rents need to rise to reflect the higher quality of the property if the supply of properties to housing benefit recipients is not to be adversely affected.

There was widespread concern about making the payment of housing benefit conditional upon the dwelling reaching a satisfactory level of quality. It was forecast that this would prove to be administratively difficult and would complicate an already complex system. Moreover, it would threaten tenants with a reduction in supply, while possibly being open to challenge by tenants under human rights legislation. There are dangers in linking entitlement to housing benefit to the landlord's status or the property's condition. An approach is needed which does not single out housing benefit claimants nor stop landlords letting to them.

Instead, it was suggested that 'conditionality' should be operated in a positive way, by allowing increased variability in rent officer determined rents, so that the poorer properties in low demand areas attract lower rents and thus the 'market' is used to address the over-supply of dwellings, while in the better properties the landlord achieves higher returns and is rewarded for supplying a high quality dwelling. One way forward could be through the use of landlord accreditation schemes.

(e) Grants, accreditation, licensing and new supply

Notwithstanding the possibilities for tax and benefit reform discussed above, there was a view that improved standards are more likely to be achieved through grants, as they can be better targeted and 'policed'. They can also address disrepair in areas where landlords make so little profit that tax measures are unlikely to have much impact (which is many areas outside the large urban centres). Grants were also believed to offer greater flexibility to target public money on specific localities, and could be used to lever in other capital, either private or public (for example, through the Housing Market Renewal Fund). Finally, it was suggested that grants could be linked to accreditation to provide a positive incentive to landlords to improve their properties.

As noted above, there was some acceptance that landlords need to work within an accreditation scheme if they are to benefit from public subsidies. Local authorities were seen to be best placed to operate these schemes, although nationally set standards for accreditation would be welcomed.

A specific issue was the fact that licensing in Scotland has not developed well and implementation has been slow despite the strong advocating of this as a way forward during the debates prior to legislation. It was seen to have become a very complex initiative with mandatory standards being very inflexible, which was making difficulties for good landlords but not addressing the worst.

With respect to new supply, there was one view put forward that Housing Investment Trusts are "dead in the water". The HIT tax rules were too complex,

it was thought, and financial institutions were not consulted appropriately prior to implementation. However, encouraging more institutions into the sector was still seen as important, as they would bring with them a longer-term view and more professional management and maintenance practices. A suggested vehicle for this might be limited partnerships, although Government concerns about how these might develop would have to be addressed.

An alternative, or perhaps complementary, view was also put forward. In this perspective, and with the likelihood that institutional investment in the sector will not occur in the near future, the role of the smaller landlords ought to be more appreciated and supported. As one respondent put it, “we need to encourage the landlord with one house to have three”. Smaller landlords were seen as being able to offer, perhaps, a more locally responsive and more customer-oriented service.

(f) Summary

There was widespread concern that there are a number of disincentives facing private landlords that arise through the operation of the tax system. It was thought by a number of interviewees that many of these could be addressed if landlords were to be treated for tax purposes in the same way as other businesses. However, the mechanism for converting landlords’ increased incomes into better quality housing was not clearly identified and it was accepted that any tax incentives might need to be linked to quality in some way. VAT was frequently seen as a major issue, with anecdotal evidence put forward of its engendering distortions and avoidance behaviour. Stamp duty was not seen as a major issue in many areas, due to the low value of properties. However, when payable, it was thought that it does represent a loss of working capital that could impact on repair activity. For long-term private landlords, such as estates, inheritance tax can force sales of properties and loss of capital. It was argued that there should be exemption for let property, as there is for agricultural businesses, for example.

Reform of the housing benefit regulations to tie eligibility to property condition was not generally supported as a means of improving quality, and was felt to represent a potential threat to tenants’ security of supply and access to the sector. However, greater variability in the eligible rent levels determined by rent officers, so that better properties attracted ‘reference plus’ rents while poor properties were only eligible for ‘reference minus’ rents, was seen, by some, to be a way of both rewarding good landlords and targeting those who keep their properties in poor repair. In addition, such a reform would eliminate the possibility that public money was being used to subsidise bad landlords.

Two perspectives on increasing the supply of private rented housing were put forward. For some, institutional investment holds out the prospect of more professional management and maintenance in the sector. For others, a key aim is to value more highly and encourage existing small landlords, who may provide a more personal service than large landlords. Housing Investment Trusts need to be simplified, it was suggested, or a new investment vehicle devised, to attract institutional investors. Smaller landlords may be encouraged through tax incentives and being treated as ‘proper’ businesses. However, tackling the backlog of poor repair may require greater use of local authority

grants on the one hand and enforcement action, on the other. Both tax incentives and grants may need to be linked to landlord accreditation and/or licensing schemes to ensure prudent use of public money.

5 Conclusions

(a) A framework for discussion

In the last chapter we presented, largely without comment, a synthesis of opinions from the key people in private rented sector policy and practice whom we interviewed. In this final chapter we reflect on those opinions and present our own views on the use of tax and benefit policies to bring about improvements to the private rented housing stock. We conclude that tax and benefit changes can have a role in improving the stock, but must be taken as part of a programme of coordinated measures addressing problems in different parts of the sector. The focus of the discussion is the sector in Scotland, but many of the conclusions would apply equally well to the rest of the UK.

We are aware that policy in this area continues to develop and that there are a number of recent consultation documents and Westminster government proposals which impinge on this discussion. For example, the consultation documents on Stamp Duty and on Corporation Tax reform and the proposed trials in pathfinder areas of housing benefit reforms. Until these consultations and pathfinder trials are complete, however, their results and implications for policy cannot be known with certainty. Our discussion, therefore, acknowledges these initiatives but we do not explicitly take them into account when arriving at our conclusions and recommendations.

Our conclusions have been shaped by the information gathered to date as well as by five key factors:

1. the nature of the incentives that encourage landlords to carry out repairs and to do improvements;
2. the extent to which landlords react to market signals and are likely therefore to respond to these incentives by spending more;
3. distinguishing between making tax changes to create more equitable and efficient treatment of the taxation of rents and capital gains and making changes to taxation to subsidise landlords;
4. distinguishing between making changes on tenure grounds and making changes on the basis of the spill-over benefits that can be secured for area regeneration;
5. the importance of minimising ‘deadweight’ loss of economic efficiency, while maximising the additional spending on repairs and improvements flowing from any changes and avoiding any tendency to foster ‘moral hazard’ by providing tax changes related to properties that are in poor condition and hence unintentionally but perversely incentivising landlords to under-invest in repairs simply in order to collect these tax reliefs.

If financial incentives have little effect on spending, any positive impact of tax and benefit changes on repairs spending is likely to be marginal and therefore

the costs of introducing such changes will result in some private benefits but little desirable social effect: there would be significant deadweight loss to the economy. What limited evidence is available from earlier research suggests that, with respect to landlords who act simply as profit-maximisers, incentives will have to be large to have any impact. Elasticities of supply with respect to price are very low, suggesting that general tax changes will have to lead to a very big impact on income and willingness to spend on repairs if they are to generate even modest extra spending. If they do not, the tax changes will lead to a deadweight loss since economic efficiency will be eroded through misallocation of social resources. On the other hand, landlords who have motives for letting property which are other than purely commercial are likely to be already keeping their properties in reasonable condition, and therefore the additional social benefit which might result from extra spending as a result of general tax incentives would be small. An alternative approach, perhaps, would be to target any tax changes so that they are only accessible in the event of specific socially beneficial expenditure being incurred.

These efficiency issues do not necessarily mean that no tax changes should be made. They may be desirable on horizontal equity grounds so as to ensure that landlords are taxed on a similar basis to equivalent economic agents (either owner-occupiers on the one hand or standard businesses on the other). Moreover, the current system may itself be producing economic inefficiency in the form of a significant misallocation of social resources, arising from the unequal treatment of similar economic agents. For example, the taxation of capital gains raises landlords' cost of capital relative to owner occupiers, so that rents need to be higher than they would need to be under an equitable tax regime.[1] 'Second-best' economic theory would suggest that, as a result, efficiency might be increased if the tax regime was made more equitable. There may be, therefore, a case both in equity and in efficiency for treating landlords' and owner occupiers' capital gains on an equal footing.

Many of those interviewed argued, moreover, that the current system does introduce such distortions. For example, because landlords' after tax profit and loss accounts are adversely impacted by the lack of depreciation allowances for improvement spending, less is spent on improvements than is socially efficient. It was also argued that this distortion leads landlords to sell good condition properties in order to raise capital to undertake improvements that cannot be generated by post-tax income on poorer properties. If their post-tax incomes were better, they would need to sell fewer properties to raise the cash for improvements, and the private rented sector might draw closer to its socially optimal size.

But there are reasons relating both to the nature of the private rented sector and to the structure of the tax system that may negate these factors.

First, landlords' willingness and ability to spend on repairs depends on clear market signals and also on their response to them. The available evidence suggests, however, that market rents are not consistently related to property condition. Tenants appear to give priority to other factors rather than property condition and may be unwilling to spend a high proportion of their limited budgets simply to obtain a better-repaired property. Thus landlords may simply not be able to get extra rent having done repairs or made improvements. It is this, not the lack of capital allowances for improvements that results in little spending or leads them to sell other properties to raise cash for necessary expenditure. Similarly, failures in capital markets may lead them to sell parts of

[1] Compared with some other countries (e.g. Australia, Canada and USA) the UK does not face the opposite position where private renting is a tax shelter arising from accelerated depreciation and/or the non taxation of capital gains and resulting in a lower cost of capital, especially for high rate taxpayers, and leading to 'below-market' rents in competitive markets (see Wood, 2002).

their portfolio, rather than borrow against the increased property value that evidence shows does result from improvement spending (except in the most run down neighbourhoods).

Moreover, the available evidence from England also shows that landlords without commercial investment motives own a large proportion of the private rented sector. It is unlikely that they will respond solely to market signals. That they tend to own the better property suggests that their willingness to spend is shaped more by other factors. In England and, it can be assumed, in Scotland, those who have predominantly investment motives do in fact own the worst stock and, by inference, are more likely to respond to market signals. But here the major constraint on more spending lies in the lack of clear market signals in the pricing of condition in rents.

This suggests that the lack of clear market signals, inefficiencies in capital markets, and the nature of the current ownership of the stock may be having more impact on spending than the current structure of the tax system. If this is the case, changes in the tax system will either have to produce very major changes in post tax incomes or be subject to significant ‘policing’ to ensure that the uptake of, say, capital allowances is conditional on spending to meet socially desirable standards. The former is unlikely and the latter would introduce more regulation in a market where risk arising from controls and regulation has tended to increase required rates of return.

Secondly, there are technical reasons why the tax system may be unable to accommodate some desired changes. For example, European Union VAT rules preclude the extension of zero-rating to residential lettings or to their repair and improvement, and income tax principles are being increasingly harmonised with accounting standards, which may limit the ability to treat some landlords differently to others in tax terms.

A similar analysis can be made of the potential impact of ‘conditioning’ the payment of housing benefit to cases where private tenants occupy dwellings of an acceptable standard. There is no evidence to suggest that this will lead to increased spending on below standard dwellings because the necessary spending is unlikely to lead to higher rents, thus making it worthwhile. Apart from the extra administrative costs of policing such a system, there is instead a significant risk that landlords will stop letting to such tenants or get out of the market altogether. Indeed, the evidence from this research confirms that, currently, where landlords who are letting a property in the ‘housing benefit sub-market’ do improve the property, the shortfall between the housing benefit payment and the higher rent the landlord wishes to charge is such that the property moves out of the sub-sector and into the ‘open market’ sub-sector of private renting. Whether the proposed pilot experiment to encourage tenants on housing benefit to ‘shop around’ using a flat rate standard allowance based on local rents will lead to a clearer relationship between conditions and rents will depend a great deal on whether (primarily) short stay tenants value (and are willing to pay for) the attributes of good physical standards more highly than current market rents suggest they do now. Subject to the existing restrictions in relation to above market, local reference, and single room rents, tenants in receipt of housing benefit have no incentive at the moment to shop around in relation to rent levels as any change in what they pay is fully reflected in their benefit. Moreover, as very many have their rents paid direct to their landlord, they often have little or no idea of the rent being charged for their accommodation. Existing restrictions on rent eligible for benefit payment

already considerably reduce what tenants receive in relation to the rent charged (see, for example, Kemp and Rugg, 1998, with respect to young tenants) and flat rate allowances for each area might leave many of them better off whilst also giving them the potential opportunity to bargain with landlords over what rent they pay. Whether they will bargain in relation to conditions is by no means certain.

(b) A framework for reform

In the light of this it is unlikely that taxation changes alone can deliver the improved standards that are desired. They are unlikely to improve yields significantly, will have little incentive effect on repairs spending, whilst risking significant deadweight loss since such changes will be hard, if not impossible to target. Pursuing higher standards through enforcement action and grants is likely to be more effective in producing socially desirable outcomes at the least cost in public expenditure, including tax expenditure, compared with taxation changes.

This does not mean that changes in the tax system could not produce desirable outcomes as far as housing standards are concerned provided they are used as part of a package of measures which address specific segments of the sector. A possible approach might consist of three elements.

(i) Introduce tax changes to stimulate new investment in good quality new and existing stock by large efficient operators. These could compete with poor quality stock at the bottom end of the market so that the owners of the latter either go out of the market or improve their dwellings, including by enforcement-led, grant-aided action.

(ii) Since it will take some time for large operators to emerge and to have a significant impact, it is also important to consider introducing tax changes for landlords of the existing stock which are likely to have a beneficial impact on improvement spending and on the acquisition of good quality stock.

(iii) Since it will also take time for the owners of the worst dwellings to improve them or to quit the market in the face of competition from new operators, other approaches would be needed to deal with these properties. In those sub-markets where there are few economic signals (in the form of increased rents or capital growth) to make spending worthwhile, a different approach will be needed, covering a combination of enforcement, grants, and action related to the housing benefit regime.

These three approaches might include a series of measures. In suggesting these we are not commending some of the recommendations made by our respondents, generally because they would have the effect of excessively distorting the market, but in two areas the reasons are more specific. First we believe that the introduction of capital or depreciation allowances is inconsistent with the fact that, unlike plant and machinery, residential property is an enduring asset. It is appropriate to allow depreciation on furniture and fittings – as these wear out – but not the building itself. Expenditure on repairs to maintain the asset is a legitimate expense for tax calculations but not the acquisition or improvement of the asset itself. Second, the proposals related to VAT must be consistent with EU law – hence it is impossible to make residential lettings or repairs zero-rated.

Having set aside these two proposals, the following should be considered as part of a package of measures.

1. The creation of a fully tax-transparent investment vehicle to attract institutional funding to invest indirectly in new or existing good standard property. Such a vehicle could be based upon the HITs legislation, but with fewer prohibitive rules, including those that prevented limited trading;

2. The provision of roll-over relief for capital gains for companies and individual investors selling residential properties but reinvesting the proceeds to buy additional good standard properties or to improve the quality of existing private rented dwellings. This will foster an active programme whereby landlords dispose of poor property and replace with better. However, it would require tax rules to be amended so that residential properties were treated as ‘trading assets’. The question of the future form of rollover relief is one which is raised in the recent consultation document (Inland Revenue, 2002b) and the outcome of the consultation exercise will clearly have implications for this recommendation. In addition, the proposal in the consultative document to tax capital gains on an accruals basis within corporation tax should be evaluated in terms of its impact on landlords’ ongoing ability to finance improvements.

3. The reduction of stamp duty on bulk transactions. Currently stamp duty prohibits the purchase of existing portfolios or new estates when each individual property is below the threshold but the value of the portfolio as a whole exceeds it. The development of large portfolios is desirable on the grounds of creating economies of management and maintenance. The existing postcode exemption could be amended to cover purchase of below standard dwellings and their subsequent (audited) improvement.

4. Reducing repairs costs by addressing some of the VAT problems and making the VAT rate on repairs 5 per cent and not 17.5 per cent. If this reduction were not limited to specific cases there would be a large deadweight loss. One option would be to limit this only to cases where the management of below standard properties is transferred to housing associations or accredited private landlords, or only to cases where private rented property is owned by accredited private landlords. .

5. The amendment of the operation of the housing benefit scheme in ways that do not add to the layers of complexity nor harm low-income tenants. Two initiatives should be explored: first, eliminating direct payments where landlords operate unlicensed HMOs (were a licensing scheme to be introduced nationwide); second, requiring the Rent Service to take greater account of property conditions when validating market rents for housing benefit purposes. Both these changes, however, should await studies in the pathfinder areas of the impact of the proposed standard local allowance on market rents and their relationship to conditions.

6. Voting additional public expenditure to improvement grants so that this can be tied to enforcement action on the worst properties and create the spill-over benefits that foster area renewal. If enforcement action is unsuccessful, poor condition properties can be transferred to RSLs or to accredited private landlords either to manage or to acquire. Grants have the virtue of being easier to target, conditions can be policed, and grants have a greater incentive than tax changes in markets where conditions do not result in higher rents or increased capital values.

Finally, it should be noted that there is a tension between the generally universal principles upon which the UK tax system is founded, which dictate that tax rules should apply equally across the country, and the fragmented, localised nature of housing markets, including the private rented sector. It follows that national tax changes are inevitably going to be something of a 'blunt instrument' in dealing with housing improvements at a local level, where the nature of the local housing market is key. Therefore, an approach that combines national tax and benefit rules with local flexibility about the use of grants and enforcement is likely to be most successful in achieving specific outcomes on the ground.

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