HOME BUILDERS FEDERATION

Dr Vincent Cable
2a Lion Road
Twickenham
London TW1 4JQ

29 April 2010

Dear Dr Cable

VAT on New Housing

The Liberal Democrat Manifesto 2010 proposes levying a positive rate of VAT on new homes.

This would clearly represent a dramatic change of course for UK housing policy and, given the very significant undersupply of housing we already face as a nation, I am writing to you now to set out the reasons why we believe such a policy would be counterproductive for the objectives of any new Government.

In summary, VAT on new homes, even at a low rate:

- Would inevitably lead to a steep fall in private new home building from today's already historically low levels;
- With a corresponding collapse in new Affordable Housing supply;
- Leading to further job losses in the home building industry and dependent industries and sectors;
- And a damaging impact on house builders' profits in the short-medium term at a time when the industry is struggling to recover from the deepest recession for decades;
- Thereby exacerbating the already serious undersupply of housing and worsening Britain's affordability crisis;
- And because levying VAT would not result in any net additional revenue for the public sector, equalising VAT rates on new housing and housing repairs would not be revenue neutral;
- While the fall in home building and employment would cut Treasury tax revenues and adversely affect local government finances;
- And harmonising the VAT treatment of new homes and housing repairs would do little to address the multitude of different taxation, policy and regulatory treatments of the two activities.

I attach a paper explaining our concerns in more detail.

I appreciate that the complexities of development economics mean the impact of VAT on new housing is not immediately obvious. We would be more than happy to talk through this issue with you or any of your Liberal Democrat colleagues or advisors.

Yours sincerely

S.A. Baseley

Stewart Baseley
Executive Chairman

The Implications of a Positive Rate of VAT on New Homes
Home Builders Federation (HBF)
29 April 2010

The Home Builders Federation (HBF) is the principal trade association representing the interests of private home builders in England and Wales. Our membership, which includes companies ranging from major national firms, through regional companies to smaller local firms, is responsible for more than 80% of the new homes built every year.

Introduction & Summary
The Liberal Democrat Manifesto 2010 proposes levying a positive rate of VAT on new homes.

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VAT on new homes would trigger a collapse in house building
New homes represent only 10-12% of total housing market sales, so that home builders are price takers. New home prices are largely set by prices in the second-hand market. If home builders tried to add 5% or 8% VAT to sales prices, new homes would be rendered

uncompetitive with comparable second-hand properties, so that sales of new homes would fall dramatically.

Therefore, because in practice VAT could not be passed on to new home buyers, it would in effect become an additional development cost.

In the short-medium term, for homes built on land already purchased by home builders, the cost of VAT would have to come out of home builders' profit margins. As the industry is only beginning to rebuild profits after weathering the worst housing downturn for decades, this would produce further losses, with potentially serious implications for some companies.

In the longer term, however, most or all of the cost of VAT would have to be absorbed by residential land values.

For example, for a site with a land value equivalent to 20% of the gross development value (i.e. the total sales value of the dwellings) before regulatory costs, VAT at 5% would reduce the residual land value by a quarter[1]. VAT at 8% would reduce the land value by 40%, and at 17.5% by 87.5%. In the case of regeneration sites, which have a much lower land value (5-10%, or even zero or negative[2]), VAT would wipe out most or all of the entire land value before any regulatory or policy costs.

The impact on residual land values of VAT on new housing would therefore in itself undermine housing supply.

This in turn would lead to further job reductions, both directly in home building, as well as in the many industries and sectors dependent on new homes. For example, were housing completions to fall by 50,000 per year, this would reduced direct and indirect employment by some 250,000 jobs.

The reductions in home building and employment would have a negative impact on Treasury tax revenues (income tax, corporation tax, capital gains tax, SDLT, etc), and on local government finances through reductions in S106 contributions to Affordable Housing and community infrastructure.

It needs to be borne in mind, however, that the cumulative cost burden of taxation, policy and regulation imposed by central and local government and various public agencies on land values is already so onerous that many housing sites have a very low or negative land value after regulatory and policy costs, especially when taken together with the sharp fall in land values since 2007. In the industry's terminology, most residential sites are not 'viable' after policy and regulatory costs. The Government has acknowledged this situation by announcing measures in the 2009 and 2010 Budgets, and the 2009 Pre-Budget Report, to monitor and reduce this cumulative burden.

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[1] Because the price of the new homes could not be increased, a VAT rate of 5% or 8% would effectively become an increase in development costs, to be absorbed by a reduction in the residual land value available to pay the land owner. Since the land value in this example represents 20% of the total sales value of homes on the site, the cost of VAT at 5% of the sales value would effectively reduce the land value by one quarter (i.e. 5% out of 20%). For simplicity, these calculations assume the full cost of VAT would have to be absorbed by land values.

[2] A negative land value means that the total cost of developing a site, including all taxation and policy and regulatory costs, would be more than the sales value of the homes on the site.

Non viability extends to virtually all regeneration sites, almost all large strategic greenfield sites (because these sites also involve massive additional infrastructure costs), including those in the high-value south, and most brownfield sites outside the highest-value areas of the south. This situation will worsen significantly in 2013 and 2016 because the industry will from these dates have to absorb the very substantial additional costs required by the further regulatory changes then scheduled to make all new homes zero carbon from 2016.

Given that the regulatory burden already eats up a very large proportion of the residual land value (in many cases more than the entire value, generating a negative land value), absorbing the additional cost of VAT would mean that most residential sites would have no land value or a negative value. In such circumstances, land owners would not sell their land for housing development, so that no new homes would be built.

Therefore if VAT were imposed, whether at the full 17.5%, or at a reduced rate, it would mean virtually no housing site in Britain would be viable, and home building would collapse from today's already historically low levels – 2009 saw the lowest peacetime housing completions in England since 1923. Thus VAT on new homes, by seriously aggravating the already serious undersupply of housing, would worsen Britain's persistent affordability crisis.

And because a large proportion of Affordable Housing is delivered via S106 agreements on private housing sites, a positive rate of VAT on private new housing would also mean a collapse in Affordable Housing supply.

It is also worth noting that singling out the different VAT treatments of new homes and housing repairs is highly misleading. VAT is just one of many differences between the two activities. As well as a range of taxes on land acquisition and housing development, the state (central government, local authorities, various public agencies) also imposes enormous regulatory and policy costs on new housing development. Correcting the supposed anomaly between the VAT treatments of new housing and housing repairs would do nothing to address the multitude of other tax and regulatory differences between the two activities.

VAT on new homes would actually worsen the public finances

To avoid a positive rate of VAT on new homes causing a collapse in home building, the only option would be drastically to reduce the regulatory and policy cost burden in other areas (e.g. zero carbon, affordable housing, community infrastructure, building regulation standards, public open space demands, etc) to compensate for the additional development cost imposed by VAT.

But because the residential land value captured by the state through policy and regulation acts as a substitute for direct public spending in many of these areas, most notably through contributions to Affordable Housing and community infrastructure, the reduction in policy and regulatory demands necessary to avoid a collapse in home building would mean the <u>net</u> impact on the public finances of a positive rate of VAT on new homes would in itself probably be close to zero. The Treasury's gain in VAT revenue would be cancelled out by the loss to local authorities from substantial reductions in contributions to, for example, Affordable Housing and community infrastructure.

The reduction in VAT receipts on repairs would then need to be factored in and, when added to the impact of the new build policy, is likely to result in a direct net loss of revenue to the Treasury. In short, if a collapse in new housing was to be avoided, equalising the rate of VAT on new housing and repairs would be revenue negative, not revenue neutral.

The alternative to severely cutting new housing development's contributions to Affordable Housing or community infrastructure would be to abandon the 2016 zero-carbon objective for new homes. This is unlikely to be an attractive option for the Liberal Democrats.

John Stewart
Director of
Economic Affairs
29 April 2010