

*PROPERTY TAX:
PRINCIPLES AND POLICY OPTIONS*

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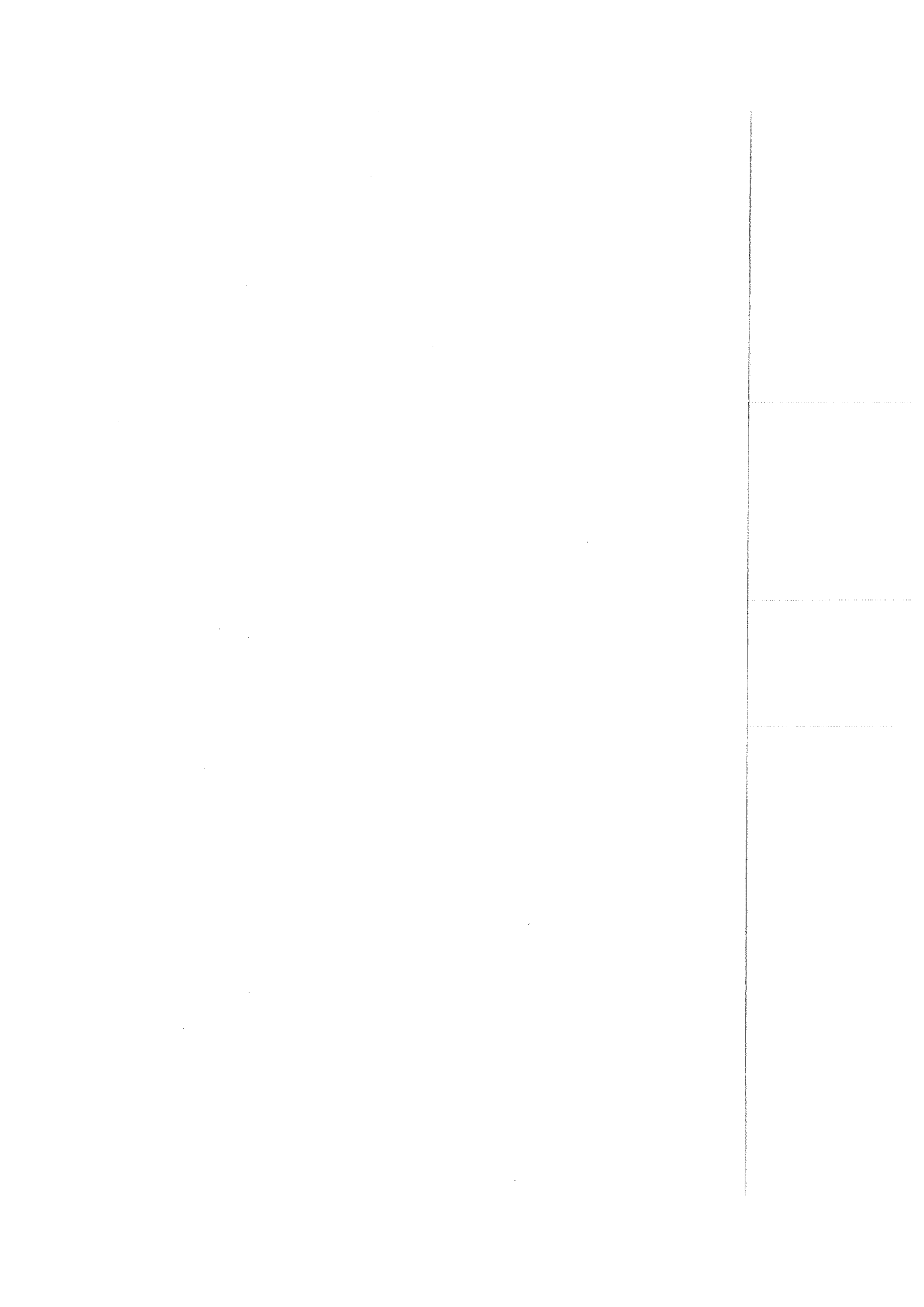
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GENERAL SUMMARY

Context and Objectives

The introduction of a property tax which would raise substantial revenue is a key feature of several recent proposals for tax reform. But property taxation itself has long been a contentious issue. Much of the debate has been about issues such as the relationship between a property tax and ability to pay, effects on the overall progressivity of the tax system, the size of the potential revenue and the extent of income tax reductions which could be financed by such revenue.

Such issues can only be dealt with fully by detailed investigation of specific schemes. The debate on tax reform and property taxation has been hampered by the lack of such investigations. This paper aims to fill that gap. It examines the potential revenues under several alternative schemes of property taxation; it also analyses the relationship that tax liabilities under the different schemes would bear to "ability to pay" as measured by cash incomes.

The tax reductions which such property taxes could finance form the critical element of the rationale for the introduction of a property tax: it is argued, for example, that reductions in income taxes would improve the incentive to work and stimulate employment. A property tax which was used simply to raise revenue would *not* gain such advantages; indeed, it would involve similar economic disadvantages to those associated with any increase in taxation. For this reason a brief examination of one out of a multitude of possible income tax reductions which could be financed by a property tax is also undertaken. But the important differences between alternative property tax schemes arise on the revenue side: for any given level of property tax revenue, precisely the same package of income tax cuts could be financed. Thus, the main focus in this paper is on the potential revenues, distribution of liabilities, and possible changes in effective marginal income tax rates associated with different property tax schemes.

Conceptual Issues

The implications of basic principles of taxation and of past experience are taken into account in the choice of options for detailed empirical analysis. The strongest argument for the use of a property tax to broaden the tax base is that owner-occupied residential property represents a major source of income (albeit not in cash form) which is not taxed at present. Broadly speaking, an outright owner-occupier is better off than an individual with an identical cash income who is renting similar accommodation because he or she does not have to pay rent. The situation of owner-occupiers with mortgages is more complicated, but a similar advantage still arises. Owner-occupiers, therefore, have a non-cash income equal to the rental value of their properties. This "imputed rent" or "imputed income from owner-occupation" is not at present subject to income tax.

One possible reform of the income tax system would be to include this income as taxable, and lower tax rates on a revenue-neutral basis. The available evidence suggests that this would reduce the economic distortions imposed by the tax system. For a variety of reasons, such a scheme might be regarded as undesirable. It might be seen as perpetuating an inequitable balance between PAYE and non-PAYE sectors because it would establish a close link between tax payable as a result of ownership of residential property and the amounts of income tax being paid at present. Apart from this, it might be seen as posing greater presentational difficulties, or administratively more complex than a property tax (though the informational requirements for administration would be quite similar).

If taxation of imputed income from owner-occupation were ruled out for any of these reasons, it might be argued that a property tax could provide a proxy for such a procedure. But this has important implications for the design of a property tax. First, it suggests that the tax should be aimed at raising additional revenue only from owner-occupiers. Rented residential property, for example, already gives rise to an income which is, in principle, subject to tax; thus, a property tax applied to rented property should not be expected to raise additional revenue, though it might play a role as a withholding tax. Second, this rationale for a property tax suggests that it should bear some relationship to cash incomes: for this reason, a number of possibilities regarding rebate schemes are investigated. Third, it implies that rental or capital values would form the appropriate base of the tax (rather than, for example, square footage or number of rooms). For practical reasons, self-assessed capital values seem to be the most appropriate base. Fourth, it suggests that net tax liabilities should be lower

for mortgagors than for those owning a property outright. One way of achieving this would be through mortgage interest tax relief. Basic principles also suggest that property tax revenues should be used to reduce other taxes on a general basis, but that property tax payments should *not* be allowable as a credit against income tax liabilities.

Past Experience

Past experience with local authority rates has cast a long shadow on the issue of property taxation. While the record does show that it was possible to raise substantial revenues from domestic rates, it also shows that rates were particularly unpopular. Three main features appear to have contributed to their unpopularity: unfairness in the relative valuations which arose because of the lack of a general re-valuation of property; a heightened perception of the tax which resulted from the infrequent billing procedure; and the lack of a clear link between rates and "ability to pay".

A new property tax would have to pay particular attention to each of these issues. Could self-assessment of capital values overcome the problems of valuation, if appropriate penalties were introduced to make "honesty the best policy"? Could a closer integration of a general property tax with income taxes allow taxpayers to pay in a more convenient way? (Experience with Residential Property Taxation is of limited value in this context, since it requires the tax authorities to identify a small number of relevant cases rather than requiring a return of the capital value of the accommodation from every taxpayer.) These are essentially questions of administration and implementation. But the relationship with ability to pay is more amenable to the form of analysis undertaken here, and is given particular attention.

Data and Analytical Framework

The data used in the empirical investigation were drawn from the ESRI Survey of Income Distribution, Poverty and Usage of State Services. This was a nationwide survey of more than 3,000 households, undertaken in 1987. It included information not only on incomes from various sources, but also on housing values. Interviewers' and respondents' estimates of housing values were shown to be in broad agreement; US evidence has also indicated that owners' ratings of their property values tend to be reliable.

A property tax based on self-assessed capital values of owner-occupied housing was analysed. Results are presented on a household basis, to take account of the possibility that incomes (or, indeed, property tax bills) would be shared to some extent by different "tax units"

within the same household: most often, this possibility would arise when adult children who had left full-time education were still living with their parents. The results therefore document the direct effects of a property tax on households. Possible falls in house values consequent on the tax, or broader economic effects associated with parallel reductions in income taxation were not taken into account, and would be more difficult to capture in a formal analysis. It is important to realise that the behavioural effects of shifting taxes from income to property form an important part of the rationale for a property tax; but in comparing alternative forms of property tax, a concentration on the revenue side is justifiable.

Empirical Analysis of Policy Options

Four basic forms of property tax were analysed. First, inclusion of imputed income from owner-occupation in the income tax base. Second, a simpler property tax at a flat percentage rate on all owner-occupied property, without any rebates for those on low incomes. Third, a property tax which would apply only to properties valued above a certain limit, and applying only to the excess of property value above that limit. Fourth, a property tax with an exemption for those on the lowest incomes, and a reduced liability ("marginal relief") for those on incomes slightly above the cut-off point.

The first of these provides a benchmark for evaluation, since taxation of imputed income from owner-occupation gives the strongest rationale for a property tax. It was estimated, on the basis of 1987 property values and income tax rates, that the aggregate revenue would be just under £400m: the rise in property values since then would tend to increase that figure, but falls in income tax rates would tend to reduce it, as would any fall in property values induced by the property tax itself. Almost 60 per cent of the revenue would come from the top 30 per cent of the cash income distribution; as against about 7 per cent from the bottom 30 per cent, reflecting the progressivity of the income tax structure.

Compared with this benchmark, a simple property tax (at a rate of 1.5 per cent) gave rise to a similar revenue, but gained much more of it from low income groups, and rather less from the top income groups. Substantial numbers of low income groups would be affected by a simple property tax: almost 140,000 households with size adjusted incomes below £56 per week would stand to pay at least £5 per week (or about 10 per cent of their net income) in property tax.

The third option (which essentially provides a "property value allowance" for property tax purposes similar to the personal allowance for income tax purposes) would greatly reduce the aggregate revenue: the reduction was about two-thirds, for the particular scheme examined, even though it involved a higher rate of property tax. Furthermore, substantial numbers of low income households would still be affected by the tax. The current Residential Property Tax (RPT) avoids this feature by having a high income exemption limit as well as a property value threshold; but this combination results in a very small revenue yield. The analysis shows that even a substantial reduction in the property value threshold above which RPT is payable would not yield enough revenue to finance major tax reforms.

A property tax with an income exemption limit and marginal relief gave rise to a pattern more similar to the benchmark of taxation of imputed income. The particular income limit examined would reduce the total revenue by about one-third, to about £235m. Although the total revenue would be lower than under taxation of imputed income, the distributional pattern would be quite similar: about 60 per cent from the top 30 per cent of the income distribution, and about 3 per cent from the bottom 30 per cent. The modified scheme would reduce the liabilities of the bottom 30 per cent of the distribution to one-tenth of the level which a simple property tax would imply. There would be a cost in terms of incentives: effective marginal tax rates would rise by 20 percentage points for a substantial number of taxpayers. About 60,000 of these would already be on the standard rate; a further 20,000 to 25,000 would be receiving "marginal relief" under the income tax code, which involved a marginal tax rate of 60 per cent in 1987. Other forms of property tax rebate for those on low incomes might, therefore, be preferred. Deferral of payment until the sale of the property (or other transfer of ownership) might provide such a route.

A brief examination of reductions in income taxes which could be financed by property tax revenue was undertaken: more detailed analysis is undertaken elsewhere (Callan, 1991). Substantial rate reductions could be financed either by a property tax with income exemption limits, or even more substantial reductions by taxation of imputed income from owner occupation. The particular package of rate reductions analysed led to small net (and gross) effects on the lower half of the income distribution, negative effects for the upper middle reaches, and positive effects for the top 10 per cent of the distribution.

Conclusions

The present study has examined in detail some of the main options available in terms of property taxation. Until now, debate on the introduction of a property tax as part of a tax reform package has lacked the basic information which this analysis provides. The analysis has clarified the available options in terms of potential revenues, rebate schemes and implications for the overall income distribution and work incentives. Further debate can now draw on these results, to establish whether a suitably designed scheme can attain a satisfactory compromise between the advantages and disadvantages of a property tax in financing tax reforms.

Chapter 1

INTRODUCTION

The issue of a property tax¹ is central to the debate on tax reform in Ireland. The introduction of a property tax which would raise substantial revenue is a key element of the reform programme envisaged by the Commission on Taxation. This principle has also been supported by the National Economic and Social Council (NESC, 1985, 1986, 1988 and 1990) which has specified some elements of the structure of the property tax it favours. The arguments of the Commission on Taxation and the National Economic and Social Council have been echoed in the political arena: the rhetoric of "widening the tax base and reducing tax rates" has entered the political culture.

Despite this broad consensus on the importance of widening the tax base, the issue of property taxation has been a contentious one. Much of the attention has been focused on the question of whether or not a general property tax should be introduced. But debate on this question has been hampered by the lack of a detailed analysis of policy options in this area. This paper aims to fill that gap by analysing the impact of a number of forms of property tax. The analysis highlights some of the key choices which would have to be made if a general property tax were to be introduced. The overall objective here is not to recommend a particular course of action, but to show the strengths and weaknesses of the various options; the flaws to be seen in some options may, however, be serious enough to rule them out. The results can also be used to help to shed further light on the question of whether a general property tax should be introduced.

In the absence of cross-party agreement on the introduction of a general property tax there has been an understandable lack of specific proposals from political parties. (Spring, 1988, is an exception, considered in Section 5.5.2). To a significant extent, reticence on the details or even the principle of a property tax can be explained by reference to the

¹The term "property tax" is used here to refer to an annual charge levied on property owners. The question of the appropriate coverage and base for the tax is dealt with in Chapter 2. For the moment, it is sufficient to note that the term "property tax" is intended to refer to a tax which is more general in its application, and raises substantially more revenue, than the existing Residential Property Tax: this is in line with widespread usage of the term.

unpopularity of the last major tax on domestic property: rates. Some of the reasons why rates were a particularly unpopular way of raising revenue were peculiar to the rating system: most notably, the absence of a general revaluation since the mid-nineteenth century meant that the relationship between rateable values for two properties could be very much out of line with their current values. But other problems are more fundamental to property taxation in general: in particular, the fact that "the value of the property a person lives in may bear little relationship to his ability to pay" (NESC, 1985, p.71).

This link between the potential property tax liabilities and "ability to pay" as measured by cash incomes is given particular attention in the analysis which follows. At a conceptual level, this includes identification of the implicit marginal income tax rates imposed by alternative "waiver" or "exemption" schemes designed to bring property tax liabilities into line with ability to pay. At an empirical level, it involves examination of the magnitude of the tax liabilities over the entire income distribution. The empirical analysis is based not on hypothetical examples, but on a large-scale nationally representative sample of households: the ESRI Survey of Income Distribution, Poverty and State Services. The Survey gathered information on the respondents' and interviewers' estimates of the values of dwellings in addition to the detailed data on incomes from employment, social welfare and other sources which permits the analysis undertaken here.

The structure of the paper is as follows. It begins by reviewing the conceptual issues involved, in order to clarify the principles underlying alternative forms of property taxes. National and international experience with the taxation of residential property are then briefly reviewed. The basic characteristics of the dataset used for the analysis are set out, focusing in particular on the data on housing values. Empirical analysis of alternative schemes is then undertaken, which shows the net revenue yields and the distribution of tax liabilities. The final chapter draws together the main findings, assesses their implications for the policy debate, and indicates some questions which might fruitfully be addressed by future research.

It is perhaps useful to clarify at the outset that the paper does *not* deal with the local taxation aspects of property taxes. Many of the issues considered here are, of course, relevant to the use of property taxes in local authority finance. It would also be possible to envisage schemes which would be very similar to those considered here, but would allow local variation in property tax rates. Such variation, however, raises the issue of

whether householders in similar circumstances (in terms of income and property values), and receiving similar local services might face quite different property tax bills. The system of rates gave rise to such differences, which contributed to its being perceived as unfair. McDowell (1990) notes that local variations in property tax rates could also lead to efficiency losses, as new buildings might tend to be concentrated in low tax rate areas while older buildings were not maintained in high tax rate areas. Thus he concludes that the feasibility, economic optimality and political acceptability of a locally variable property tax are open to question. This issue of local variation in property tax rates, and other issues which are specific to the debate on local authority finance (e.g., the relationship between central and local authorities; equalisation grants to take account of differences in the balance between resources and needs) are outside the scope of the present paper. Conversely, the national property tax examined here is not subject to the difficulties on which McDowell concentrates.

Chapter 2

CONCEPTUAL ISSUES

2.1 Introduction

Would the present Irish tax system be improved by the introduction of a property tax? Several elements are needed for a comprehensive answer to this question: criteria for an improvement in the tax system; specific information on the structure and rate of the property tax; information on associated reductions in other taxes; identification of the incidence of the change in taxes; and consideration of the wider economic effects of the changes. This chapter concentrates on the first two of these elements. It begins by outlining the principles used in evaluating tax systems; describes some of the main features of the current system relevant to the issue; and assesses the arguments for and against a property tax in the light of these elements. The implications for the design of a specific property tax structure are then examined. Later chapters deal with the other issues; the final chapter draws together the different elements to throw new light on the overall question.

2.2 General Principles

The general criteria used to evaluate tax systems include equity, efficiency and, not unimportantly, the ability to gain revenue with reasonable costs of collection, whether borne by the collecting agency or the taxpayer. Reasonable administrative and compliance costs are often taken to imply that the tax system should be relatively simple; alternatively, this may be regarded as an independent goal, to ensure widespread acceptance and fairness in the operation of the system.

Conventionally, two aspects of equity are distinguished. Horizontal equity requires that persons who are in all relevant respects identical should be treated identically. The definition of what constitute "relevant" aspects may be a matter of disagreement,¹ though "the spirit of the principle can be illustrated by examples where agreement is clear e.g., taxes should not be discriminatory according to hair colour or religion" (Atkinson and Stiglitz,

¹Kay's (1990) survey of tax policy argues on this and other grounds that the usefulness of the concept is very limited.

1980, p. 353).² Vertical equity requires that taxes should be related to ability to pay.³ This is usually taken to be some measure of economic welfare, most often cash income; but non-cash income may also be relevant, as will be seen.

Efficiency considerations can be summarised as requiring that taxation be designed to have minimal effects on the allocation of resources which would be arrived at by a full set of perfectly competitive markets. This may conflict with equity or "redistributional" objectives, since the market-determined distribution of income may not be regarded as equitable. But if there are alternative means of producing a desired degree of redistribution, the principle of efficiency requires that this be done in the way which least distorts the allocation of resources.

2.3 Current Tax Treatment of Residential Property

A full examination of taxes and subsidies related to housing is outside the scope of the present paper. NESO (1988) provides a recent survey, while Irvine (1984) deals with some of the issues in greater depth. But some of the critical equity and efficiency aspects of the introduction of a property tax can be illustrated by focusing on the current tax treatment of owner-occupied housing, and on some possible alternatives.

Table 2.1 shows a simplified version of the current tax treatment of three families which helps to clarify the issues involved. The first two families, labelled "renter" and "owner-occupier", are identical in all respects save the following: one has chosen to spend £50,000 on purchasing a house outright, while the other has chosen to live in an identical rented house, investing the £50,000 in savings. For simplicity, assume that there is no inflation⁴; the rented accommodation costs £2,500

²Atkinson and Stiglitz identify three interpretations of the principle. The first, that it is simply a corollary of utility maximisation, is shown to be incorrect. For present purposes, the differences between the other two interpretations, namely that it is an independent principle of justice applicable to end-states, and that it is a safeguard against capricious discrimination, restricting policy instruments, are not of major importance.

³This interpretation, rather than one in terms of "benefits", is accepted by the Commission on Taxation (1982) and Atkinson and Stiglitz (1980).

⁴As the Commission on Taxation (1982) makes clear, tax liabilities under the current structures are affected in undesirable ways by inflation. For example, capital gains tax applies to real gains, while interest is taxed on a nominal basis. Thus, with inflation, a mortgagor who invested in equities which showed real capital gains of 5% would be better off than a mortgagor receiving real interest of 5% or an outright owner. These effects are ignored here in order to concentrate on serious differences in the treatment of families with identical real circumstances which would remain even if the system was adjusted to cope with inflation.

per year; and the return on savings is also £2,500 per year.⁵ It is easy to see that the real incomes of these families are the same. The family which rents its house has an additional cash income of £2,500 per year. But the owner-occupiers have the very real benefit of not having to pay rent for their accommodation, which amounts to the same real value. This is what is called the "imputed income from owner-occupation". It is a non-cash income, but constitutes a very real benefit, as the example makes clear.⁶

The principle of horizontal equity suggests that these families should have identical income tax liabilities. This could be achieved in a number of ways. One would be to include imputed income from owner-occupation in the income tax base. This would treat income from different sources identically. Making rent payments allowable against income tax would also achieve this result; but would favour expenditure on housing, whereas the system which taxed imputed income would be neutral as between expenditure on housing and other forms of expenditure, as noted by the Commission on Taxation (1982).

At present, imputed income is not treated as part of the tax base. Furthermore, mortgage interest relief is allowable, in part, as a deduction from taxable income.⁷ The implications of this may be clarified by extending the example. Suppose, for simplicity, the owner-occupiers take out a 100 per cent mortgage, at an interest rate equal to that payable on deposits.⁸ And suppose that the marginal income tax rate is 30 per cent. The mortgagors still receive the benefit of rent-free accommodation. But the return on their savings is 5 per cent, while the cost of their mortgage is allowable against income tax. A full calculation of the incomes and tax liabilities for the three sets of families (Table 2.1) shows that while each of

⁵Inflation would, of course, lead to a divergence between rent and nominal interest. The relationship between rent and capital values may also be affected by the tax system's favouring of owner-occupation as well as specific incentives such as "Section 23". Depreciation expenses borne by owner-occupiers, and the division of such "wear and tear" expenses between landlords and tenants are also ignored. The figures in the table are intended to illustrate some basic points about the current tax treatment of housing, rather than to provide precise figures.

⁶Another way of viewing the imputed income is as the rent which the occupier pays to the owner; the fact that the owner and occupier are the same person means that this is not a cash payment, but its existence is none the less real for that.

⁷For the purposes of the example, full tax relief is assumed; the fact that 80 per cent of interest qualifies for tax relief does not change the fundamental points at issue.

⁸Introduction of a spread between the deposit rate and the mortgage rate would not change the essentials, but would complicate the arithmetic.

the families has identical real pre-tax incomes, those who own their houses outright or with a mortgage would have lower tax bills and higher post-tax incomes.

Table 2.1: *Current Tax Treatment of Owner-Occupation: Some Illustrative Calculations*

	<i>Renter</i>	<i>Outright owner</i>	<i>Mortgagor</i>
	£	£	£
(1) Interest income	2,500	0	2,500
(2) Other income	10,000	10,000	10,000
(3) <i>Cash income</i> = (1)+(2)	12,500	10,000	12,500
(4) Basic allowances	5,000	5,000	5,000
(5) Mortgage interest relief	0	0	2,500
(6) Taxable income = (3)-(4)-(5)	7,500	5,000	5,000
(7) <i>Tax</i> = 30 per cent of (6)	2,250	1,500	1,500
(8) Housing costs (rent/mortgage interest)	2,500	0	2,500
(9) <i>Net income</i> after tax and housing costs (for an identical house) =(3)-(7)-(8)	7,750	8,500	8,500

Note: Each tax unit begins with the same total resources, including £50,000 for investment. The outright owner invests £50,000 in a house. The mortgagor purchases a £50,000 house with a loan, and invests the £50,000 with a bank. The renter rents a £50,000 house and invests the £50,000 with a bank. The example is adapted from the Commission on Taxation (1982), Table 13.

As the Commission on Taxation (1982) indicated, removal of mortgage interest relief would not eliminate the fundamental distortion. It would favour those with outright ownership, or those mortgagors who had large equity stakes in their homes. Inclusion of the imputed income from owner-occupation in the income tax base would remove the distortion. Alternatively, allowance of expenditure on rent as a deduction for income tax purposes would remove the distortion: but in a way which favoured expenditure on housing over that in other areas.

Taxation of imputed income has been seen as difficult to justify: see for example, the *Second Report* of the Commission on Income Taxation (1959). In more recent times, the Commission on Taxation's initial judgement was that it would be difficult to obtain general acceptance for

the re-introduction of tax on the imputed income of owner-occupiers. Thus, its *First Report* (1982) opted for the elimination of tax relief on mortgage interest, to be replaced by a more selective scheme to aid first-time buyers in the early years of their mortgages. The *Fourth Report* of the Commission (1985a) takes an approach which is more closely in line with its analysis. It proposes a local or national property tax, which can in part be regarded as a proxy for inclusion of owner-occupiers' imputed incomes in the tax base.

Are these considerations of any relevance to tenants? The basic criterion here is whether or not a full market rent is being paid. Private or local authority tenants paying less than the full market rent can be regarded as having a non-cash income equal to the market rent less the actual rent paid. There is an exact parallel with owner-occupiers: they pay a zero rent, so that their non-cash income is equal to the full market rent. The existence of the non-cash income is partially recognised by the tax code: rent-free accommodation provided by an employer is subject to income tax as a "benefit-in-kind".

In the case of local authority tenants a distinction may be drawn between those paying the "maximum rent" and those on "differential rents" which are related to their incomes. The "maximum rents" set by local authorities are related to historic costs, and do not reflect the market rents which could be commanded. Thus, there may often be an implicit subsidy even to tenants paying such rents. Differential rents provide for explicit rent reductions related to income, designed to assist those on low incomes, but contributing to "poverty trap" phenomena of high implicit marginal tax rates on those low incomes. While streamlining of this system may be desirable, or a more radical move towards a unified national housing benefit (see NES, 1988, Chapter 14) these questions can be separated to some extent from the issue of property tax considered here.

A second major element of the current tax treatment of residential property is that capital gains on a principal residence are exempt from capital gains tax. Taken in conjunction with the exemption of imputed income from owner-occupation from income taxes, this artificially inflates returns on investments on housing compared with other investments, and leads to an over-concentration of resources in housing (Irvine, 1984).

2.4 Property Tax: For and Against

In this section, arguments for and against the introduction of a property tax are considered in the light of the principles outlined earlier and the nature of the current income tax system. The idea that a property tax would

represent a widening of the tax base (which would allow efficiency gains through reductions in tax rates) has been widely accepted. The main economic basis for this idea is that income in general is subject to tax, while the non-cash income from owner-occupation is not subject to tax. The non-taxation of imputed income under the current system can be regarded as:

- (i) creating economic inefficiencies: it encourages individuals to spend more of their income on housing services than they would do if the tax system was neutral between housing and other forms of expenditures. It also encourages owner-occupation as a form of tenure as against renting:⁹ the distortion of this choice also gives rise to economic inefficiencies.
- (ii) giving rise to an horizontal inequities between owner-occupiers and mortgagors, on the one hand, and those renting their living accommodation, on the other.

Honohan and Irvine (1987) indicate that taxation of the imputed income from owner-occupation would give rise to efficiency gains. But if, for whatever reason, taxation of imputed income is ruled out, a case could be made for a property tax as a "proxy". This idea can best be illustrated by an example. Consider an owner-occupier living in a house valued at £50,000, and paying a standard rate of tax of 29 per cent. If the imputed income is taken as 5 per cent of the property value, then taxation of imputed income would give rise to an additional liability of £725 per year. This sum could also be raised by a property tax at the rate of 1.45 per cent (i.e., the "imputation rate" of 5 per cent, multiplied by the tax rate of 29 per cent). But how closely would a property tax proxy an income-imputation procedure over the full range of incomes? Three main issues arise:

- (1) *Treatment of low income tax units:* The structure of the income tax system is designed to produce low or zero liabilities for those on low incomes. This structure would still apply if imputed income from owner-occupation was included in the tax net, but in terms of a broader income

⁹Even when other subsidies and tax expenditures are taken into account, owner-occupation is, on balance, favoured by the tax system over the private rented tenure.

concept. A property tax is, by its nature, unrelated to cash income and, if it was to proxy taxation of imputed income, would require adjustments (described in Section 2.5.4) which would have the side-effect of altering the effective income tax rate structure.

- (2) *Proportional or progressive rate structure:* The existing income tax structure is progressive (average rates of tax rise with income). Inclusion of imputed income would make it progressive in terms of a wider income concept. Most discussions of a property tax assume a single proportional rate. Even with a progressive rate, income exemptions or a property value allowance, its effect in terms of overall tax progressivity is not certain. This difference is empirically investigated in Chapter 5.
- (3) *Treatment of mortgage debt or mortgage interest:* With income imputation, the correct approach would be to allow mortgage interest fully as a deduction from the imputed income.¹⁰ With a property tax, one consistent approach would be to allow a deduction from the property value corresponding to the mortgage outstanding i.e., would calculate the tax corresponding to the occupier's equity stake in the dwelling. An alternative, favoured by NESC (1990), is to allow mortgage interest as a deduction *at the standard rate of tax*, if there is a flat-rate property tax: this could be set to achieve the same financial results for taxpayers at or above the standard rate as a property tax levied on their housing equity.

Other arguments have also been made for a property tax, but they are less persuasive. Some might argue for a property taxes as a way of charging for property-related services provided by local or central authorities: but it is not clear that the cost of services received would be related directly to the value of property, and similar services would also be received by those in rented accommodation. This argument also raises

¹⁰The Commission on Taxation (1982) proposed a consistent approach whereby nominal capital gains due to inflation would not be taxed, and only real mortgage interest/ interest income would be taxed.

more general questions about the balance between user charges and tax-financed services. Others would see a general property and/or land tax as a way of encouraging efficient utilisation of real property. This raises the question of why property is to be singled out in this way; in any case, taxation of imputed income from owner-occupation would of itself lead to more efficient utilisation of residential property. Finally, a property tax is sometimes thought of as a proxy for a wealth tax, since housing wealth constitutes a substantial portion of most household's wealth. But if wealth is to be taxed, it is not clear why other forms of wealth would not also be included. To some extent, the appeal of these other arguments is related to the fact that owner-occupied housing is so lightly taxed at present, with no liabilities arising under income tax or capital gains taxes. If imputed income from owner-occupation was charged to tax, it would be difficult to justify a property tax on any of the other grounds indicated.¹¹

What are the main arguments against a property tax as a proxy for taxation of imputed income from owner-occupation? One argument made by the Commission on Income Taxation (1959) was that non-cash income arose not only from owner-occupied housing, but also from durable goods. If the non-cash income streams arising from other durable goods, including luxury items such as yachts, could not be taxed, it was argued, why should a necessity, such as housing, be singled out. Another version of this argument can be couched in terms of the economic analysis of the "second best" i.e., a world in which it is not possible to formulate policies which will achieve maximum efficiency, so that the choice is between alternative "second best" policies. The commonsense answer to this argument is that if it is not possible to tax income streams from durables other than housing, one must still choose between the option of taxing the imputed income from housing or not taxing it. In either case there will remain an economic distortion; but since housing bulks so large among the items giving rise to non-cash income streams, it seems plausible that the inclusion of imputed income from housing will be less distortionary. The analysis of Honohan and Irvine (1987) broadly confirms this intuition, showing that a switch in the tax burden away from labour and towards housing would give rise to smaller efficiency losses from the tax system.

¹¹For example, it would no longer be possible to argue for a property tax as a proxy for a wealth tax. There might, however, be other arguments for a wealth tax.

Three other arguments might also be adduced against the introduction of a property tax. One is that it would not be related to "ability to pay": much of what follows is concerned with investigating that proposition, and examining alternative schemes which would bring the liabilities from a property tax into line with ability to pay. A second is that the broader effect of a property tax would be a fall in capital values which, it might be argued, would bear unfairly on existing owner-occupiers. A third argument is that introduction of a property tax would leave insufficient encouragement for owner-occupation. Each of these arguments will be considered in the final chapters. For the moment, it is sufficient to note there is a relationship between the latter two arguments: the greater the fall in capital values, the easier it would be for first-time buyers to become owner-occupiers.

2.5 Issues in the Design of a Property Tax

2.5.1 Coverage

The first issue arising in the design of a property tax is which property should be included. We have seen that there is a strong case for a tax on owner-occupied residential property, which produces an income which is not charged to income tax at present. But what about other forms of residential property, such as houses or apartments which are let out by landlords to tenants? Or should the tax be extended to commercial, industrial or agricultural property?

The incomes which arise from the use of these other forms of property are, in principle, subject to income tax. Thus, the argument which is used to justify a tax on owner-occupied residences does not apply here. The Commission on Taxation's (1985a) recommendations favour a property tax on "all residential, commercial and industrial property (excluding land)". But the Commission recognises that "property tax should be allowed as a credit against income tax liability where the property is used to generate income charged to national income tax".¹² NES (1985) comments that rather than crediting property tax in full against corporate income tax, it would be simpler and more logical to exclude commerce and industry from

¹²The Commission's proposal that property tax on rented dwellings should be levied on tenants (the occupiers) appears to represent a departure from this principle: the rent paid by them forms taxable income in the hands of the landlords. The rationale may be that the effective incidence of the tax will be determined by adjustment in the gross rent.

the property tax; unless it is seen as a "backstop" method of taxing enterprises which are not in the income tax net without adding to the burden on those already included.

The consultants' report to NESC (1985) favoured an even more comprehensive property tax on dwellings, commercial and industrial property, farm land, public buildings and all other immovable structures.¹³ The Council, however, appeared to lean towards a residential property tax on owner-occupiers, justified by the arguments concerning imputed income of owner-occupiers. Here, too, the focus will be on this narrower form of tax for which there is stronger justification.

2.5.2 Base

NESC (1985) considers the choice between three different forms of property tax base: capital value, rental value, or a measure of area such as floorspace. As regards floorspace, it is clear that this would give rise to substantial anomalies: luxury city-centre flats would then be liable to less tax than basic council houses, and valuable suburban properties might incur liabilities no greater than much less valuable farmhouses. Thus, the basic choice is between rental values and capital values. Since owner-occupation is the dominant form of tenure, NESC (1985) argues that:

for most households, capital value is something of which they have direct experience. People take an interest in the prices which properties in their area fetch when sold, and have an idea of the market value of their house. By contrast, for most people, the rental value of their house has no real meaning. With capital valuation the basis of valuation would be better understood and hence the tax itself perceived as more equitable than would be the case with rental valuation. (NESC, 1985, p. 74).

As against this, it is noted that capital values are more volatile than rental values; but that experience in the many countries which use systems based on capital valuation suggests that this does not pose insuperable difficulties. If this were a major concern, a property tax might be related to the *average* value of a property over a number of years.

¹³"We have already noted that the previous rating system was characterised by many exemptions, and that this may have contributed to a feeling that this was unfair. It seems to us, therefore, that there is everything to be said for taking as a starting point the principle of a comprehensive property tax, to be levied on land and buildings in all sectors of the economy." (NESC, 1985, p. 73).

Another element of the tax base is the question of whether the total value of the residence would be considered taxable, or just the "equity stake" of the owner-occupier, i.e., the total value *less* any mortgage outstanding. Alternative resolutions of this issue were noted in the general discussion of the relationship between property taxes and income imputation above. Here we simply note one issue which would become of greater importance if property taxes were to be levied on the equity stake of home-owners. The distinction between endowment and repayment mortgages would become a more important issue than at present. Endowment mortgages are used at present to maximise the interest element of mortgage repayments in order to attract greater tax relief.¹⁴ But under a property tax on equity in home-ownership, endowment mortgages would be used to a much greater extent as a legitimate means of tax avoidance. By maximising the mortgage debt, they would reduce the net property tax payable: in an extreme case, an endowment mortgage for 100 per cent of the value of a dwelling would reduce the property tax to zero (or would lead to the property tax being offset by tax relief on the mortgage interest, if this was how mortgage debt was taken into account). Such an arrangement would make sense for an individual investor if the net of tax return on the endowment mortgage, together with the reduction in annual property tax liability it gave rise to, exceeded the net of tax interest payments required on the mortgage. The fundamental reason why this distinction matters is that life assurance linked savings are treated more favourably by the tax system than most other forms of savings: this issue may best be left for a broader consideration in that context.

2.5.3 Valuation procedure

The inequities of the outdated rateable valuation structure were a major cause of the dissatisfaction with rates. The difficulties of achieving a complete re-valuation, and maintaining up-to-date valuations were also much emphasised. For owner-occupied residential property there is, however, an obvious alternative form of valuation: self-assessment. As noted in the previous sub-section, capital values are within the direct experience of most householders.

¹⁴Tax relief on life assurance premia for the endowment policy is of much less importance, particularly after recent Budgetary changes which have reduced the relief, in effect, to 12.5% of the premium.

One of the major difficulties of the Residential Property Tax was that it required identification of a small number of relevant home-owners and taxpayers. Identification of the relevant target at reasonable cost in these circumstances would be expected to cause difficulties in policing self-assessment. But with a general property tax this becomes much less difficult: a return of house value could simply be required on all income tax forms. Other arrangements would, it is true, have to be made for those whose income does not come to the attention of the Revenue Commissioners, such as long-term social welfare recipients.

2.5.4 Tax relief for those in need?

Should some form of property tax relief be provided to those on low incomes? If the aim of the property tax is to proxy the effects of including imputed income from owner-occupation in the income tax base, then the answer is yes. But if the aim of the property tax is to gain revenue from groups who are thought not to be paying their fair share of income tax, then income-related relief may reduce the desired impact of the tax. In this section, some straightforward ways of linking property tax liabilities to income are considered; some of these are further analysed in Chapter 5. The problems posed by the conflicting considerations outlined above are reconsidered in Section 2.6.

One response to the fact that a simple property tax does not take account of ability to pay is to make the tax payable only if income exceeds a certain figure: technically this is called an income exemption limit. This is an attractive idea at first sight: all tax units with low incomes are exempted from paying the tax, while those with incomes above the limit pay the full amount. But this combination of circumstances leads to a "trap" in which increases in gross income lead to falls in the tax unit's disposable income after income and property taxes when they bring the income just over the exemption limit. The point can be most clearly demonstrated by an example. Suppose the income exemption limit is £5,000 per year, and a single person, without children, earns £4,999 and lives in a dwelling which would attract a property tax liability of £500.¹⁵ Given these circumstances, the person would be exempt from property tax. But if income rose by £2 the taxpayer would find himself or herself £500 worse off; an increase of £500 would still leave him or her worse off. An

¹⁵If the property tax rate was 1.5%, this would imply a house value of £33,333. For simplicity it is assumed that there is no mortgage on the house: the main features of the example would carry through in the presence of a mortgage.

increase in income of almost £900 would be required to make him or her as well off, after allowing for income tax and PRSI.¹⁶ Thus, over certain ranges of income, the effective marginal income tax rate would exceed 100 per cent.

The usual response to this problem with income exemption limits is to taper the relief so that the full tax does not become payable immediately on passing the limit: "marginal relief" is allowed on incomes which are not far above the income exemption limit. For example, the full property tax rebate allowed to those with incomes under the limit could be reduced by 20 pence for each pound by which income exceeded the limit. In effect this means that persons eligible for relief under this sliding scale are faced with an additional tax on income of 20 per cent. An extra pound of gross income would lead to a certain amount of income tax and PRSI; but it would also lead to an increase in property tax of 20 pence. The seriousness of the problem may be seen as depending on the numbers affected, and on the income tax rates they already face. These may range from zero, to over 100 per cent for those in receipt of Family Income Supplement. If the income exemption limit for property tax purposes was close to the existing exemption limit for income tax purposes, the effective marginal tax rate could rise towards 80 per cent.

A property value exemption limit is sometimes seen as a way around this trade-off between assistance to the least well off and the imposition of increases in what may already be high effective marginal income tax rates. Thus, properties below a certain limit would not have to pay property tax; while tax would be payable on dwellings above that limit. If there were a simple correlation between income and property values, such a scheme might have some attractions. But households with low cash incomes do not all live in properties with low values. Furthermore, a simple property value exemption would lead to a distortion in the housing market: houses previously valued just above the limit would become less attractive than houses valued just below it. A property value exemption limit which also functioned as an allowance, so that property tax was only payable on the excess over the limit, would avoid this type of distortion. But an allowance would greatly reduce the revenue gained from a property tax: it would apply not just to low-income taxpayers but to all taxpayers.

¹⁶If mortgage interest relief ensured that the taxpayer was not subject to income tax before or after the change, then an increase of just over £500 would be sufficient.

Other schemes for linking property taxes to ability to pay can also be envisaged. One might think, for example, of exempting some or all social welfare recipients. This would, however, raise the question of horizontal equity. Why should those with low incomes from other sources be less favourably treated? Furthermore, such a change would increase the incentive to move into a social welfare category which is treated in this way.

Copeland and Walsh (1975) note that in the US several states operate schemes to reduce the impact of property taxes on the less well off. Some include a multiplicity of conditions (age, income, wealth and residency) to determine eligibility and/or the portion of property tax which will be rebated. They also examined the UK Supplementary Benefit conditions, later turned into Housing Benefit, and much modified in recent years.

An alternative proposal for linking property tax to liability to pay has also been mooted. The liability could be deferred until a change in ownership through sale or inheritance, when the tax would become due.¹⁷ The liability would, therefore, attach to the property so that the occupier would not be forced to realise the asset (and move residence) in order to pay. This idea has parallels in terms of capital gains taxes becoming payable when realised rather than as they accrue. In the context of capital gains taxation the main drawback of this realisation-based tax, as noted by Auerbach (1991), is that it gives an incentive to hold on to assets which have appreciated in order to defer tax liabilities without any interest charge: charging of interest would require the calculation of accrued gains on an annual basis which the realisation basis is designed to avoid.¹⁸ But in the context of a property tax, liabilities could be calculated annually, and interest charged on deferred liabilities to be paid on transfer of the property.

If this approach were feasible, it would have certain advantages. For example, an elderly person who might have insufficient cash income from which to pay a property tax might otherwise be obliged to move. But if the property tax bill could be deferred,¹⁹ the individual would have the option of remaining in the same dwelling and letting the property tax bill be dealt with by the proceeds of a sale after his or her death: this would allow an

¹⁷Aspect magazine, October 1988, pp. 14-15.

¹⁸Auerbach proposes a scheme which would overcome these informational difficulties to achieve, *ex ante*, a uniform tax rate on capital gains.

¹⁹Depending on the interest rate, an annual property tax liability of 1.5% of the capital value could reach the total value of the property in 20 to 30 years.

elderly person to choose to stay in an established social milieu; but would retain some incentive for moving into accommodation of a size and type commensurate with their current needs.

Further consideration needs to be given, however, to the identification of the group to whom property tax deferral would be offered as an option; and to the precise point at which the tax would become payable under such a "deferral" scheme. For example, the group of those eligible might be defined entirely in terms of income; or might be age-related as well. The logic of the scheme would suggest that if a couple were deferring property tax, continued deferral should be allowed after the death of one spouse; but the tax would become payable if inherited by children who did not also qualify. Would it be possible, however, for the tax to be deferred indefinitely if successive owners each qualified for the deferral option?

Both the Commission on Taxation (1985a) and NESCS (1985) agreed that a property tax should be modified to take into account ability to pay in cash terms. The Commission on Taxation emphasised that relief should be provided through the social welfare system:

We content ourselves with endorsing the principle of a waiver scheme for those on low incomes, to be operated through the social welfare system. The type of scheme to be introduced should be the one which most effectively and efficiently ensures that cases of hardship are relieved. The precise scheme depends on the level of property tax that is charged. (Commission on Taxation, 1985a, p. 51).

This gives no indication, however, of how the fundamental difficulties with income-related exemptions or waivers are to be resolved.

NESCS (1985) endorsed a more concrete rebate structure, with the following characteristics:

- (i) the rebate would be linked to the payer's income and tax payable;
- (ii) the rebate scheme would have a redistributive rationale;
- (iii) the scheme would be determined and implemented in the context of overall national policies on tax and benefits and uniform national criteria;

- (iv) the scheme would be on a sliding scale to prevent the emergence of poverty and unemployment traps.

Specific schemes along these lines are examined in Chapter 5 below.

2.5.5 Tax unit

One of the features of Residential Property Taxation (RPT) which has attracted considerable criticism is that the incomes of all household members are taken into account in determining whether the owner is liable for RPT. The Commission on Taxation (1985a) commented that it saw no reason to depart from the basic tax unit it proposed (husband, wife and children under 16 years) in a property tax. It is true that, as the Commission notes, the issue of the unit of taxation would become irrelevant if there were no income threshold: it is only when incomes matter that the question of "whose incomes?" arises. But since the Commission itself favours some form of waiver scheme, the unit of taxation does matter.

If a rebate was related to the income of the tax unit containing the owner of the dwelling, some obvious possibilities of tax avoidance would arise. For example, a parent on a low income might already live in the household, and ownership of the property be given to him/her. With income rebates related to the income of the tax unit containing the owner, this procedure might eliminate the property tax liability *in toto*. NESG (1985) suggests a rebate related to household income, which would exclude such avoidance techniques.

More fundamentally, avoidance arrangements involving rents below market rates could be designed, e.g., family members or neighbours could arrange "house-swaps", with peppercorn rents, so that there would be negligible income tax from rent receipts, and no property tax liability because the properties are not "owner-occupied". In order to avoid such distortions, occupiers of residential property who were paying less than the market rent (including those with rent-free tenure) would have to be charged on the benefit they enjoyed relative to the full market rent. Alternatively, the property tax could be extended to rented residential property, as a form of withholding tax on the rental income.²⁰ The

²⁰This raises the question of whether the legal incidence of the tax would be on the landlord or on the tenant. In a competitive market this would not affect the effective incidence; but imperfections in the rental market would need to be taken into account if this approach were to be adopted. A number of methods of using property tax to counter evasion of tax on rental income could be considered.

informational requirements for the two approaches are similar: in order to establish whether or not a full market rent is being paid, one would need to know the value of the property.

2.5.6 Relationship with income tax

A final issue to be discussed here is the relationship between a general residential property tax and income tax. It is sometimes argued that property tax payments should be allowable as a deduction against taxable income or as a credit against income tax. Neither procedure makes sense if a residential property tax is being used to proxy the imputation of income from owner-occupation. The underlying reason for such suggestions may be that reductions in income taxes would be necessary to make a new property tax acceptable. This could be achieved, however, by reductions in income tax rates and increases in bands. Such a shift in the balance of taxation would improve work incentives and would be justifiable; but this differs fundamentally from proposals to make property taxes allowable in some way against other taxes.

There are, however, implications for the treatment of mortgage interest by the tax system. If the property tax is based on the total value of a dwelling, rather than the equity stake of the owner, then mortgage interest should be allowable in some form. If imputed income was subject to progressive income taxation, mortgage interest would be allowed in full at the top marginal rate. But under a flat-rate property tax, which is separate from the income tax system, it would be appropriate, as NESC (1985) argue, to allow the full amount of mortgage interest payments at the standard rate of tax.²¹

2.6 *Property Taxation via Comprehensive Income Taxation*

Having considered the main issues in the design of a property tax to proxy imputed income, it is useful to return to the idea of taxing imputed income directly, i.e., adding imputed rent to the income already regarded as taxable. A rate of property tax of 1.5 per cent could be derived from a rate of return on housing (say 5 per cent)²² and a standard tax rate (say 30

²¹Under a comprehensive revamping of the tax code to deal with inflation, only real mortgage interest would be allowable, and only real interest receipts would be taxed.

²²This might be regarded as an approximate real rate of return. Ideally the tax code would be revamped to make appropriate adjustments for inflation; but even without such adjustments it is not clear that taxing nominal returns would be possible or preferable.

per cent).²³ The information required by the income tax authorities to implement a property tax is simply the capital value of the dwelling. But with this information, it would be possible to impute a rental income which could be added to cash income and taxed under the income tax structure. Using the illustrative figures given above, 5 per cent of the property value would be added to the income of the owner, and the total income would then be taxed under the income tax structure.

This procedure would avoid the necessity for an elaborate system of refunds, which raised marginal income tax rates above existing levels. Tax-free allowances (and/or income exemption limits, if they were to be retained²⁴) could be adjusted to reduce the impact of taxation on the low paid. Income would also be taxed at progressive marginal rates. A householder with a low or medium income would face a lower additional tax bill than a householder with a very high income, for any given house value. Under a property tax, each would face the same bill, even if the property tax itself had a progressive rate structure.

Perhaps the main disadvantage of taxing imputed income in this way is that if the balance between income taxes on PAYE taxpayers and the self-employed and farmers is not generally agreed to be equitable, then the addition of the imputed income from residential property to the income tax base may be seen as perpetuating an inequitable balance. A simpler residential property tax based wholly on property values may then be regarded as preferable. But this brings us back to the question of whether or not there should be some form of reduction or relief of property tax liabilities for those on low incomes. Such reliefs would, by bringing the liabilities under a property tax more closely into line with income, be subject to similar objections from those regarding the PAYE sector as paying "more than its fair share" of income tax. A property tax with income-related relief could, however, be regarded as providing a compromise between a tax on imputed incomes (which would make the additional liabilities very closely related to income) and a simple property tax without reliefs (under which liabilities would not be affected by incomes). While income-related relief would reduce or eliminate the property tax liabilities of those taxpayers who could reduce their incomes

²³This is the approach adopted by the Commission on Taxation to derive the appropriate rate of property tax.

²⁴The Commission on Taxation recommended abolition of exemption limits in the income tax system.

to sufficiently low levels as well as those whose incomes were genuinely at such levels, it would not tie property tax liabilities so closely to income as a tax on imputed income.

If some incomes have been artificially reduced for income tax purposes, would it be possible to distinguish these from genuine cases of hardship through the social welfare system? If it were possible, then property tax liabilities for those on genuinely low incomes could be offset by a payment made through the social welfare system. The assessment of farm income made by the social welfare system for smallholder's assistance does differ from taxable farm income. Thus, so far as farm incomes go, this system might provide a way of identifying those in need of relief from property taxes. The social welfare system deals with rather smaller numbers of other self-employed persons.²⁵ Thus, it may not provide a complete solution to the genuine difficulties which arise in this area.²⁶ Indeed, it is unclear whether it would be possible to devise a completely satisfactory solution: there may be a trade-off between provision of property tax relief to those in genuine need and the spill-over of this relief to those not in such need. It is important to recognise, however, that this is not a problem which is peculiar to property taxation: it is also faced by existing income tax and income support arrangements.

2.7 Conclusions

The general principles of taxation (equity, efficiency, and capacity to gain revenue with reasonable costs of collection and compliance) were outlined. In terms of property taxation, the implication is that the overall balance of taxes and subsidies should not unduly favour one form of tenure over another, or encourage a greater use of resources in housing than is socially optimal. This leads to very strong arguments for taxation of owner-occupied residential property, because it represents a major source of income, albeit not in cash form, which is at present exempt from taxation. Such a move would accord with the principles of horizontal

²⁵In cases of "urgency or hardship" a payment may be made under the Supplementary Welfare Allowance; and the Commission on Social Welfare (1986) notes that some independent tradesmen and fishermen qualify for Unemployment Assistance on a similar basis to those with low farm incomes.

²⁶The question of whether some form of means-tested property tax rebate could be useful might, however, be worth further investigation.

equity and efficiency. The relationship with vertical equity or "ability to pay" will be examined in more detail in Chapter 5, and depends on the precise specification of a property tax.

Arguments for a more general property tax, which would apply to non-owners of residential property, or to other forms of property, are less compelling. They do not have the same rationale in terms of including an untaxed source of income. Rented property gives rise to an income which is already, in principle, subject to tax.²⁷ Agricultural property, and industrial and commercial property also give rise to incomes or profits which are taxable. A separate case may be made for taxation of property (in terms of benefits derived from services which are not readily charged for, or the efficient utilisation of land). But in what follows, we concentrate instead on taxation of the residential property of owner-occupiers, for which considerable justification has been shown.

Several features of the design of a property tax were considered. Capital values were seen as the most appropriate tax base. They would allow for the use of self-assessment valuation procedures. Considerable attention was devoted to tax relief for those in need, which would strengthen the link between the liability and the ability to pay. This also raised the question of the appropriate unit on which such an income criterion should be based: possible behavioural responses to narrow definitions of the income unit provided strong arguments for a household basis. While this is a departure from the unit used in income taxation generally, it is not surprising to find that the taxation of housing, which is, by definition, shared by households, should involve this wider unit. Property taxes of the kind most usually discussed (i.e., on the total value of the house, rather than on the owner's equity stake) would require some form of mortgage interest tax relief; but property tax would not itself be allowable as a deduction from taxable income or a credit against income tax payments. Instead, it would allow a more general reduction in income tax rates or widening of tax bands.

²⁷Special incentives, generally known as "Section 23" have, in the past, given away a significant portion of this tax base. The 1991 Budget has indicated that this relief will end in 1992. Eliminating the relief is the appropriate way of recapturing rental income in the tax base, rather than making property tax payable by renters or landlords over and above their income tax liabilities.

Chapter 3

PREVIOUS EXPERIENCE

3.1 Introduction

There is considerable experience of different forms of property taxation in Ireland. In this chapter, previous experience with property taxes is examined to see what lessons it holds for the design of property taxes.

3.2 Irish Experience: Schedule A

Owner-occupied residential property in Ireland was assessed to income tax under the provisions of "Schedule A" of the tax code until 1969. The amount of income assessed was given by the rateable valuation of the dwelling. Schedule A also applied to the owner or landlord in the case of rented dwellings, land and business premises including farms; but appropriate adjustments to income under other schedules meant that abolition of Schedule A would have limited effects on the actual taxes levied in such cases.

The Commission on Income Taxation (1959) in its *Second Report*, argued for the abolition of Schedule A. As 'far as land and business premises were concerned, the main arguments were that no net revenue was generated by Schedule A; and that a simpler, clearer system would result from its abolition. The arguments concerning owner-occupied residential property were, however, quite different (Commission on Income Taxation, 1959, pp. 42-3):

- (1) "One of the strongest reasons for not taxing home-ownership is that, notwithstanding theory, no income as normally understood, is derived from it. The asset does not of itself provide a fund of income out of which tax may be paid..."
- (2) The principle of income from durable assets, if accepted, would be equally applicable to furniture, yachts or jewellery. It was seen as undesirable to accept the principle and apply it only to a "necessity" such as housing.
- (3) Noting various exemptions and allowances designed to encourage savings and investments, the Commission argued that "a tax provision which encourages home

ownership is not less commendable. Home ownership develops a sense of responsibility, and it promotes the social virtues."

- (4) "Valuations of property are (for historical and other reasons) lacking in uniformity throughout the country, and inequities must result from using valuations under the Valuation Act as a measure of "income" for tax purposes.
- (5) "It has also to be considered that the home-owner has to pay local rates and to maintain and repair his house."

The government's response, in the White Paper on Direct Taxation (1961) dealt cogently with the first three of these arguments. The first argument, it was shown, did not take a broad enough view of the "ability to pay" principle. "The owner-occupier enjoys a very real financial benefit as compared with the taxpayer of equal income who is subject to the inescapable burden of rent. It is this benefit... which is taxed under Schedule A." Countering the second point it was argued that the difficulty of taxing other durable assets did not invalidate the charge on residential occupation. On the third point, the government pointed to the broad range of policies encouraging owner-occupation, including mortgage interest relief, which ensured that the balance was, even with Schedule A, strongly in favour of owner-occupiers.

The latter two arguments were not dealt with by the government's response; but they are of little relevance in current circumstances. Rates on domestic dwellings were abolished in 1978; and recent proposals for property taxes have, recognising the defects of the rating system, been based on the idea of a new framework, whether of self-assessment or general revaluation of property.

Schedule A was, however, abolished in 1969. The Commission on Taxation (1982) cites the 1968 Budget Speech announcing the decision to emphasise the fact that "the abolition of the tax on notional income from owner-occupation was not justified on grounds of principle, but rather was due to the fact that it was a convenient and cheap method of giving tax relief".¹

¹Commission on Taxation (1985) p. 134.

The amounts of revenue raised by Schedule A on owner-occupied residences were not very large. The cost of the Commission on Income Taxation's (1959) recommendation for abolition of Schedule A as applied to owner-occupiers of residential property was estimated at about £300,000. The 1969 Budget indicates a figure of less than half a million pounds. Even allowing for inflation, these did not constitute large sums of money in the context of total income tax revenue. This reflects the fact that the rateable valuations on which Schedule A assessments were based did not coincide with the true annual rental values of owner-occupied accommodation.

3.3 Irish Experience: Rates

Liability to property taxation through the rates system was determined by the application of a rate poundage, fixed by the relevant local authority, to a rateable valuation. Rateable valuations were, in principle, related to the rental values of properties. However, there was no general revaluation for rating purposes since the Griffith valuation in the mid-nineteenth century. As a result, major disparities in relative valuations remained uncorrected for many years. This was one element in dissatisfaction with the rates as a tax. As Copeland and Walsh (1975) emphasised, it weakened the link between the amount of the tax and ability to pay, and created horizontal inequities between taxpayers. New properties tended to be fully valued, while older, more valuable properties were left with valuations which did not reflect their full value. A sliding scale of exemptions for new properties did not remove this distortion, and narrowed the base of the tax. Local variation in rate poundages could be seen as an advantage in terms of allowing effective local democracy; but also had the disadvantage that tax liabilities for similar persons could vary, despite similar levels of local services. There were also local variations in the application of rates "waivers" for those on low incomes. Furthermore, rates were payable in large lump sums which tended to place a burden on ratepayers' cash flows and heightened perceptions of the tax.

Hederman-O'Brien (1990) and O'Donoghue (1990) chart the official response to the perceived problems with rates. An Inter-Departmental Committee on Local Taxation was set up in 1961. It produced three interim reports (1965, 1967 and 1968) and a final report in 1972. "Failure to reach agreement at official level led to no specific proposals being put forward in that final 1972 report. Instead, there was the commitment to undertake 'a comprehensive reorganisation of the entire financial relationship between

the state, the local authorities and other local bodies”'. (O'Donoghue, 1990, p.347). One result of this process was that health charges were removed from the rates. The analysis of Copeland and Walsh (1975), undertaken at the request of the Minister for Local Government, suggested reforms designed to deal with the main problems: revaluation to remove unfairness in relative valuations², a streamlined and nationally uniform rebate system, and arrangements for a collection system involving more frequent instalments and smaller amounts. Despite these suggested reforms, rates on domestic dwellings were abolished after the 1977 election, in which Fianna Fáil promised immediate abolition, while the outgoing coalition government promised 50 per cent remission of rates on domestic dwellings. Despite later recommendations by the Planning Board, the *Fourth Report* of the Commission on Taxation (1985a), and NESC (1985), a general tax on owner-occupied residential property was not reintroduced. Hederman-O'Brien characterises this as a chronic failure of the political system to achieve improvements on the foot of analysis.

Given that the unpopularity of rates may have played a large role in the failure to institute a widespread property tax on domestic dwellings, it is worthwhile to consider which of these problems would persist under a national property tax. Problems arising from local variation in rate poundages and services would no longer be relevant. The problems which arose from rateable valuations could be dealt with by greater use of self-assessed capital values as the basis for a property tax, with penalties to ensure that honesty would be the best policy. One would expect that a payment system involving smaller, frequent payments could be devised. Difficulties concerning low income households could be met by some of the methods discussed in Section 2.3.4 above. This is not to say that a new property tax would be popular; but such a design would ensure that it did not share many of the unpopular features of rates. Accompanying the change by a reduction in income tax rates and/or widening of income tax bands would also improve its acceptability.

3.4 Irish Experience: Residential Property Tax

The Commission on Taxation (1985a) in its *Fourth Report* gave a concise account of criticisms of the design of the Residential Property Tax (RPT) introduced in 1983. In the present context, the most serious of these are:

²Copeland and Walsh argued that capitalisation of differentials in rates did not mean that allowing differences in relative valuations to persist would be preferable to a revaluation.

- (i) the fact that it applies only above an income threshold gives an unfair advantage to those who can legally arrange that their income accrues in a form which ensures that the threshold is not exceeded;
- (ii) the fact that it applies only to houses above a property value threshold distorts the housing market;
- (iii) it does not apply to durable goods other than housing, and
- (iv) the income threshold is based on a household unit, wider than the normal unit of income taxation.

The implications of point (iv) have already been discussed in Section 2.3.5 above. Point (iii) was also discussed in the context of the Commission on Income Taxation's opposition to taxation of imputed income under Schedule A. The Commission on Taxation's (1985a) response to this argument is very clear. Given that other durables have to be excluded because of administrative difficulties in taxing the services they yield, "the issue which has to be decided is whether the tax system will be fairer if housing is included or excluded. We believe that since housing accounts for a large proportion of personal capital assets it is better to impose a property tax on housing, regardless of the treatment of other consumer durables". (Commission on Taxation, 1985a, p. 59). The Commission's comment on point (ii) is that a property tax should apply to *all* houses: houses of lower value should attract less tax but should not be excluded completely, with waiver schemes protecting those on low incomes. There remains a problem with the first point, if income can be arranged to fall even below the low thresholds usually envisaged for income-related waiver schemes: this has been discussed in Section 2.5.4. These criticisms are reflected in the high controversy-to-revenue ratio which obtains for the Residential Property Tax. (See Section 4.4 for details of the revenue raised).

3.4.1 Marginal relief under the Residential Property Tax

The form of marginal relief under RPT for those whose income is just above the income exemption limit deserves some attention. It can be shown that the numbers affected by this form of marginal relief are small, and the implicit additions to marginal tax rates are also small. But it is important to understand that these features are closely linked to the low yield from

the scheme and would not carry over if the RPT marginal relief scheme were used in conjunction with a more general property tax designed to raise substantial revenue.

The RPT scheme does not use a constant marginal relief withdrawal rate, i.e., the effective marginal income tax rate varies across households, depending on their potential full liability to property tax. For households with incomes between £26,000 and £31,000 in the initial year (i.e., incomes which exceed the property tax income exemption limit by less than £5,000) the property tax payable is calculated as:³

$$\text{RPT} = (\text{House value} - \text{£}65000) \times 1.5\% \times \frac{(\text{Annual income} - \text{£}25000)}{5000}$$

The effective marginal income tax rate is therefore:

$$\text{MTR} = \frac{(\text{House value} - \text{£}65000)}{5000} \times 1.5\%$$

The reason why this scheme does not give rise to substantial rates of tax for many people are two fold. First, not many people fall into the relevant category: earning £26,000-£31,000 and with houses valued over about £65,000 in 1987 terms. Second, for those who do, the typical liability is small in terms of the £5,000 marginal relief band. This is because the tax applies only to the excess over the property value exemption limit; a feature which severely restricts the amount of revenue raised by the tax. For example, the tax on a £100,000 house in 1987 would have been about £450. A household with an income just below the limit would have a zero liability; a household with an income of £5,000 more than the limit would have the full £450 liability: this means a tax rate of about 9 per cent over that £5,000 range of income. If this structure of marginal relief for low incomes applied in the context of a general property tax, without a property value exemption or allowance, then many more people would be affected, sometimes quite severely. For example a liability of £900 on a £60,000 house would give rise to a marginal income tax rate of 18 per cent if full

³For simplicity, the values of the exemption limits in the initial year are used: indexation results in slightly higher figures but does not change the structure of the tax liability and marginal tax rates.

relief from the charge were withdrawn over a £5,000 range. If this range was at or just above the income exemption limits for income tax purposes, it would affect large numbers of people.

3.5 International Experience

Given that much of Ireland's administrative structure was inherited from its experience as a part of the United Kingdom, it is not surprising to find that the UK taxation of residential property has been very similar to that in Ireland. Schedule A operated also in the UK, but was abolished in 1963, despite the fact that the Royal Commission on the Taxation of Profits in Income had concluded in 1955 that the tax was justified and recommended its continuance.⁴ Rates persisted until more recently, with similar misgivings about the fairness of the system. Their replacement by a poll tax did not, however, provide a solution the problem, as recent political events have shown.

In a broader context, the small proportion of Irish tax revenue gained from property taxes is not particularly unusual, as Table 3.1 shows. While the OECD and EC averages show a slightly greater role for property taxes than in Ireland, there are many countries in which property taxes yield an even smaller portion of total tax revenue than in Ireland. On the other hand, property taxes are substantially higher in Australia, Canada, Japan, Switzerland, the UK and the US. As Dowling (1979) points out, however, the combination of low property taxes and low social security taxes *is* unusual: this is counterbalanced in Ireland by particularly high taxes on goods and services. NESC (1985) also notes that the imputed income from housing is taxed in the Netherlands and Switzerland.

⁴King and Atkinson (1980).

Table 3.1: *Composition of Tax Revenue in OECD Countries, 1986*

Country	% of Total Tax Revenue from Taxes on:			
	Income & Profits	Social Security & Payroll	Property	Goods & Services
Australia	55.6	5.9	8.0	30.5
Austria	26.8	37.7	2.4	32.1
Belgium	40.4	33.6	1.9	24.0
Canada	45.9	13.7	9.4	29.7
Denmark	56.2	3.6	4.7	35.4
Finland	51.9	9.0	3.1	35.8
France	18.2	44.7	2.7	29.4
Germany	34.5	37.2	4.8	25.2
Greece	17.5	34.2	3.1	45.4
IRELAND	36.1	15.9	3.9	44.1
Italy	37.9	34.8	2.7	24.6
Japan	45.7	29.8	10.9	13.4
Luxembourg	43.2	26.2	6.2	24.5
The Netherlands	27.7	42.5	3.6	26.0
New Zealand	70.5	1.0	1.7	26.9
Norway	36.1	22.2	2.1	38.8
Portugal	21.2	28.1	1.9	48.0
Spain	25.2	39.1	3.2	32.0
Sweden	42.8	29.5	2.8	24.8
Switzerland	41.2	31.6	8.4	18.8
Turkey	39.0	12.8	3.3	31.5
United Kingdom	38.2	17.9	12.9	30.9
United States	42.4	29.8	10.3	17.5
<i>unweighted average:</i>				
OECD Total	38.9	24.2	4.9	30.0
OECD Europe	35.2	25.9	4.1	31.7
EC	33.0	29.2	4.3	32.5

Source: *Revenue Statistics of OECD Member Countries, 1965-87*

3.6 Conclusion

Past experience with rates shows that it is possible to raise substantial revenues from taxes on property, as does the current experience of many other countries. Experience also shows that property taxes can prove particularly unpopular. Three main features of rates appear to have contributed to their unpopularity: unfairness in the relative valuations which arose because of the lack of a general revaluation of property; a heightened perception of the tax which arose from their being large and infrequent bills; and the lack of a clear link between rates and "ability to pay". Each of these features therefore warrants particular attention in the design of a property tax, if the unpopular and undesirable elements of rates are to be avoided.⁵

⁵The experience with Wealth Tax is also relevant here. Sandford and Morrissey's (1985) analysis found that lack of adequate preparation led to flaws in the design which were partly responsible for the success of the campaign for its repeal.

Chapter 4

REVIEW OF THE DATA

4.1 Introduction

The data for this study are drawn from the ESRI Survey of Income Distribution, Poverty and Usage of State Services. The structure and content of this survey, together with a wide range of checks indicating its reliability, have been set out elsewhere. (Callan, Nolan *et al.* 1989, Callan, 1991). For that reason, only a brief outline of the relevant aspects of the survey is given here, concentrating on the additional information on housing values not yet described elsewhere. The characteristics of the sample in terms of housing tenure, distribution of house values, and joint distribution of house values and income are set out. A simulation of the Residential Property Tax in operation at the time of the survey allows a limited external check on the reliability of the housing values. The implications of these data checks for the later microsimulations of policy options are pointed out.

4.2 Basic Data

The Survey of Income Distribution, Poverty and Usage of State Services, conducted by the ESRI in 1987, interviewed more than 3,300 households. It gathered detailed information on incomes from all sources: employment, self-employment, social welfare and other sources. Where possible, each adult in the household was interviewed individually in order to obtain the most accurate and reliable information possible. The sample has been reweighted to take account of a deliberate overrepresentation of large households¹, and to ensure that it is nationally representative in terms of age and socio-economic group of the head of household and urban-rural location. Extensive checks against external information sources have then shown that the sample produces reliable national estimates of a wide range of key variables, including, for example, the numbers of social welfare recipients on major schemes, aggregate income tax revenue², costs of tax reliefs on mortgage interest, life assurance and medical insurance premia.

¹The Electoral Register was used as the sampling frame: since this is a list of individuals, the probability of a household being selected was proportional to the number of individuals it contained.

²The income tax paid by self-employed and farmers may be over-predicted (see Callan, 1991); possible implications if this is so are noted later.

The Survey also gathered extensive information on housing tenure and housing costs. The distribution of households by housing tenure is compared with that from the CSO's Household Budget Survey in Table 4.1.

Table 4.1: *Distribution of Households by Housing Tenure*

<i>Tenure</i>	<i>HBS 1987</i>	<i>ESRI 1987</i>	
	<i>%</i>	<i>Weighted %</i>	<i>Estimated National Total ('000s)</i>
Owning outright	41.3	45.2	455.0
Owning with mortgage (incl. tenant purchase)	35.4	34.4	346.5
Rented from local authority	13.9	14.6	147.3
Other	9.2	5.9	58.5
Total	100.0	100.0	1,007.3

Source: CSO Household Budget Survey 1987, Vol. 1, Table 4.

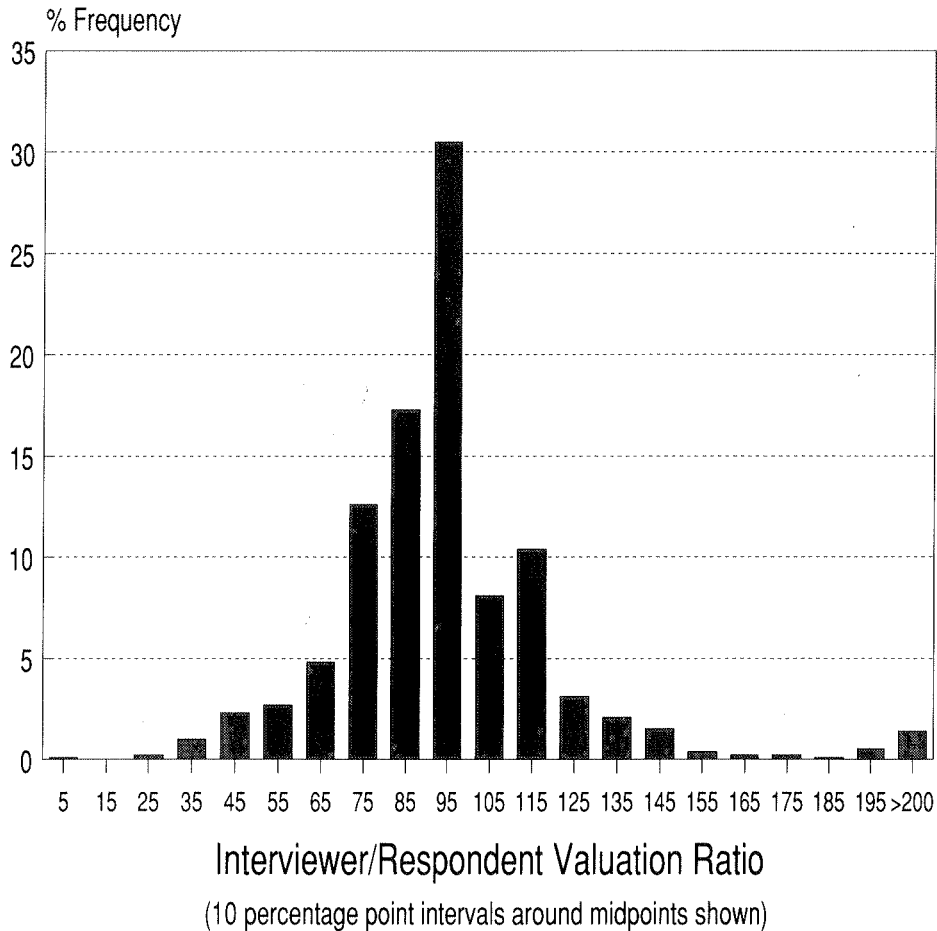
The broad picture given by the ESRI estimates is correct. Almost 4 out of 5 households are owner-occupiers, with over half of these households owning their property outright. About 1 household in 7 is rented from local authorities. The main difference between the ESRI and CSO figures is that the proportion of dwellings owned outright is somewhat overstated in the ESRI survey, while the proportion privately rented (the bulk of the "other" category) is correspondingly understated. This may reflect the underrepresentation of private rented accommodation (such as student "bedsits") in the electoral register.

For purposes of property tax analysis the value of the dwelling is obviously of critical importance. Two distinct estimates of the value of the accommodation were sought in the ESRI survey. First, interviewers were asked for their estimate of the market value of the accommodation. Second, respondents were asked the same question. Interviewers were briefed on the importance of answering the questions in this order, so that their responses would not be influenced by the respondents' own estimates of house prices. Interviewer responses were received in all but a handful of cases. Over 92 per cent of owner-occupiers also gave an answer to the question.

The non-response was often related to the special problems in valuing farmhouses, which are not commonly sold separately from the farm, and residences attached to shops or other business premises. The basic guideline in such cases, where direct valuation of the living accommodation was difficult, was to seek to establish the total value, and then the value of the farm or business premises *without* the living accommodation.

In general, there is good reason to expect owner-occupier's valuations of their own property to be reasonably accurate: these are values of which many people have experience, and there is no particular incentive to misrepresent the true value in a survey response.³ In the US, Kish and Lansing (1954) found that self-assessed values were on average 4 per cent above the independently assessed values; Kain and Quigley (1972) found that owner-assessed values were on average just 2 per cent above the values given by independent appraisers. In the ESRI survey, the difference was somewhat greater, as might be expected given that the interviewers were not qualified appraisers: respondents' estimates were on average about 6 or 7 per cent greater than the interviewers' estimates. Much of this average discrepancy, however, reflects differences in the opinions of interviewers and respondents at relatively high values, where the respondents would be expected to have greater knowledge. Respondents estimates were, on average, just over 4 per cent higher for houses which they valued at below £50,000. But for houses valued by respondents between £50,000 and £70,000 the discrepancy rose to 13 per cent; and for houses valued above £70,000 the respondents' estimates were on average 28 per cent higher. Thus, in later analysis, respondents' own valuations are used where possible. For those cases where respondent's valuations are not available, interviewers' responses were used as the best available proxy.

³Tax schemes based on self-assessment must, however, use "carrots" or "sticks" to ensure accurate assessments.

Figure 4.1: *Ratios of Interviewers' Estimate to Respondents' Estimates of House Values*

The relationship between interviewers' and respondents' estimates shows a considerable degree of consistency, given the inherent difficulties faced. Figure 4.1 shows the distribution of the ratio of interviewer to respondent estimates: a value of 100 would indicate agreement, while a value of under (over) 100 implies that the interviewer regards the property as less (more) valuable than the respondent. In almost 4 out of 5 cases, the ratio falls within the range 70 to 120 per cent, i.e., the interviewer's estimate is no more than 30 per cent below, or 20 per cent above, the respondent's estimate. An alternative perspective is that in 3 out of 4 cases,

the difference between the two estimates is less than 30 per cent *and* less than £10,000. In almost 9 out of 10 cases the difference is less than 30 per cent *or* less than £10,000.

No attempt has been made to update the reported residential property values for the sharp rise in house prices in the late 1980s. Thus, in terms of the current policy debate, the static revenue yields estimated here can be safely considered to be on the conservative side.

4.3 *Distribution of Residential Property Values*

The distribution of house values measured, where possible, by respondents' estimates and in other cases by interviewer estimates, is now examined. Table 4.2 shows the basic distribution.

Table 4.2: *Distribution of Residential Property Values for Owner-occupiers*

<i>Value (£'000)</i>	<i>% of households</i>
<10	7.2
10 < 20	24.0
20 < 30	31.4
30 < 40	19.0
40 < 50	9.5
50 < 60	4.4
60 < 80	3.4
80 < 100	0.8
> 100	0.3
<i>Total</i>	100.0

About 3 out of 5 houses were valued at less than £30,000 in 1987, with 4 out of 5 valued at less than £40,000. While the general rise in property values will have substantially altered the average value, it seems likely that the skewness of distribution will have been substantially increased: the general opinion is that price increases have been greatest for high-value houses.

The extent to which a simple property tax would be related to ability to pay depends on two factors. First, the extent to which those on low incomes rent their accommodation rather than own or purchase it; and secondly, among those who are owner-occupiers, the relationship between incomes and house values. It is this latter link which we examine at this

point. To what extent are high house values associated with high incomes, and low house values with low incomes? One approach to this question is given by Table 4.3.

Table 4.3: *Joint Distribution of Income and House Values for Owner-Occupiers*

Gross household income per week	House value					
	<£10,000	>£10,000 <£20,000	>£20,000 <£30,000	>£30,000 <£40,000	>£40,000 <£60,000	>£60,000
< 100	24.1	63.2	51.8	21.0	9.5	8.1
100 < 150	7.0	35.7	30.9	13.4	5.8	2.6
150 < 200	4.2	18.6	31.9	11.3	7.7	2.3
200 < 250	2.6	18.6	37.6	16.1	8.2	3.1
250 < 300	2.1	15.3	21.4	16.3	9.9	3.8
300 < 400	1.5	14.3	30.0	22.8	15.8	9.1
400 < 500	0.7	7.5	16.5	18.5	12.1	7.2
500 < 600	0.4	3.2	8.9	13.4	9.1	3.4
>600	0.1	2.0	9.8	12.1	10.2	12.6
Total	42.7	178.3	238.6	144.9	88.2	52.4

Note: Cells show estimated number of households ('000s) based on ESRI Survey

The table shows a broad association between higher incomes and higher housing values, but with a considerable degree of variation around this broad trend. Substantial numbers of low income households own accommodation of values at and above the average market value. The fact that almost 19,000 households are estimated as having houses valued above £40,000 but incomes below £100 per week is particularly striking. Who are these households? A closer examination of the composition of these cells shows that over one-third of the households are headed by a retired person, while a quarter of the households are headed by a woman engaged in "home duties". A further 25 per cent of the households are either farm households or headed by a self-employed person. Thus, taken together, 5 out of 6 of the households fall into these categories, leaving an estimate of just over 3,000 in other categories (ill, disabled and unemployed - there are no households headed by employees with incomes below £100 per week and houses valued above £40,000). Another perspective is provided by a marital status breakdown: 45 per cent of the households are headed by a

widow or widower. To some extent, therefore, this composition analysis supports the stereotype that those with high value houses and low incomes tend to be the elderly and widows; but it also draws attention to the fact that substantial numbers of self-employed and farmers also fall into this category. These results are clearly relevant to the issue of whether income-related relief should be given, and if so, in what form: an issue taken up again in Chapter 5.

Table 4.4 gives a slightly different perspective on this issue, by choosing cut-off points on housing values and gross household income which divide households into groupings of 20 per cent on each scale, i.e., ignoring the house value dimension, the income cut-offs define 5 groups of equal size, and ignoring the income dimension, the house value cut-offs define the 20 per cent of households with the least valuable homes and so on up to the 20 per cent with the most valuable homes. Thus if there were no relationship between incomes and housing values, we would expect to find 4 per cent of households in each cell of the table. But in fact we find that the top quintile of households has almost twice that many cases in the top house value category; and similarly for the bottom category. Just under 24 per cent of households are in the top two income categories *and* in the top two house value categories, while 22.6 per cent of households are in the bottom two categories of income *and* housing values (against an "expectation" of 16 per cent in each).

Table 4.4: *Quintiles of Gross Income and House Values*

Gross household income per week	House value					Total
	<£20,000	>£20,000 <£25,000	>£25,000 <£32,000	>£32,000 <£42,000	>£42,000	
< 110	7.4	4.4	3.3	2.7	2.2	20.0
110 < 196	5.9	4.9	4.1	3.0	2.0	20.0
196 < 291	3.4	4.8	5.2	3.7	2.9	20.0
291 < 441	2.3	3.8	3.9	4.7	5.4	20.0
>441	1.0	2.0	3.6	5.9	7.5	20.0
<i>Total</i>	20.0	20.0	20.0	20.0	20.0	100.0

Note: Cells show estimated proportion of households (%) based on ESRI Survey

4.4 Residential Property Tax: A Re-assessment

The liability of each tax unit in the survey to Residential Property Tax was estimated for two reasons. First, to provide an external check on the coverage of the survey at high levels of income and housing values; second, to provide some new evidence on RPT itself. The data described above were used to provide a measure of the value of the principal private residences of owner-occupiers. Gross *annual* incomes of the tax units were measured using the ESRI model of the Irish tax and benefit system (Callan, 1991). The most important features of RPT are captured by this analysis:

- (1) Properties valued below an exemption limit (of £69,971 in 1987) were not liable to the tax.
- (2) Properties valued above this limit were subject to a tax of 1.5 per cent on the excess of the value over this limit
- (3) Those with low incomes were exempt from the tax
- (4) Marginal relief was afforded to those with incomes which did not exceed the income exemption limit by more than £5,000.

Two differences between the actual RPT and that modelled here should, however, be noted⁴:

- (1) The incomes which are used to determine exemptions and marginal relief are those of the tax unit which contains the owner(s) of the property. The income of other household members, which is included for calculations of actual RPT liability, were not taken into account in this analysis.
- (2) The property value which is used as the basis for calculations here does not include second residences, which were included for the actual RPT.

⁴There is also a third difference, but of much less importance: the abatement of the tax for taxpayers with incapacitated children is not taken into account. The more general abatement for *all* dependent children was not in operation at the time of the survey, because of the abolition of tax allowances for dependent children.

Each of these two factors would suggest that the simulated liabilities should be below the level of the actual liabilities in 1987. If evasion of the property tax was a serious problem, however, one might expect that the simulated liabilities would be higher.

The estimated numbers of tax units liable to the tax, and the aggregate amount of tax liabilities are reported in Table 4.5. The actual number of cases assessed to the tax in respect of valuations on 5 April 1987, and the aggregate amount of tax received from them are also reported. This is a more appropriate comparison than the "net receipt of tax" during 1987, which includes a significant amount of tax in respect of previous years, and does not include cases which paid the tax in 1988. A further small number might also be expected to pay the tax in 1989 or later years, on the basis of the pattern of figures shown in the Revenue Commissioners Reports.

Table 4.5: *Residential Property Tax: Actual and Estimated Receipts, 1987*

<i>No. of cases ('000s)</i>		<i>Net Receipts</i>	
<i>Actual</i>	<i>Estimated</i>	<i>Actual</i>	<i>Estimated</i>
5.2	7.1	£1.75m	£3.55m

Memorandum Item: Budget estimate of receipt from RPT, 1984 was £3m

Sources: Revenue Commissioners *Annual Report* 1987, Table 73 and 1988 Table 65.

The estimated figure is about twice the actual figure. The "actual" figure may itself be an underestimate, because of lags in assessment and payment of more than one year. But the estimated figure may also err on the low side, because of the exclusion of second residences and the fact that incomes of persons in the household outside the tax unit of the householder (typically, adult children) are not included for purposes of income exemption calculations. It should also be remembered that the number of sample cases on which the estimate is based is very small. Despite all these *caveats*, some tentative conclusions may be offered. First, it confirms suggestions that the collection of the liabilities under RPT gave rise to difficulties; developments since 1987 are not included in this analysis. Second, the absolute magnitude of the amounts of revenue which might have been gained by more effective enforcement would not have been very large: even a doubling of the tax take would represent an increase of no more than £2m.

4.5 Conclusion

Data required for analysis of property taxation were collected in the ESRI Survey of Income Distribution, Poverty and Usage of State Services. The relevant aspects of those data were described in this chapter. The distribution of the sample by housing tenure showed a slightly higher proportion of owner-occupiers than indicated by the CSO's Household Budget Survey; but the degree of overrepresentation seems unlikely to pose major problems for the analysis. Owner-occupiers' estimates of the value of their accommodation were obtained in over 92 per cent of cases. Interviewer estimates were used where respondents' own estimates were not available; the relationship between interviewer and respondent estimates (where *both* are available) suggests that this involves a slight downward bias in the value of those properties. Taken together with the fact that no updating to take account of the post-1987 property boom has been implemented, this means that the static revenue estimates in the next chapter should be taken as erring on the conservative side.

The distribution of residential property values showed a heavy concentration in the range £10,000-£40,000, which contained about 3 out of every 4 owner-occupied houses. Recent increases in property values may have increased the degree of dispersion somewhat, as well as shifting average values upwards.

The relationship between house values and gross household incomes is not a simple one. There is a broad association between higher household income and higher house values, but there is also considerable variation about that trend. This variation makes the issue of "ability to pay" an important one in the design and implementation of a property tax.

Chapter 5

MICROSIMULATION ANALYSIS OF POLICY OPTIONS

5.1 Introduction

This chapter explores the effects of alternative forms of property taxes, based on self-assessed capital values, on government revenue, the distribution of income, and effective marginal income tax rates. The analysis starts with the benchmark of including imputed income from owner-occupation as taxable income: for convenience, this is referred to as "comprehensive income taxation".¹ A number of different property tax options are then compared with this benchmark, starting with a simple property tax, with no exemptions for low incomes or low property values. Then income exemption limits and marginal relief are considered, followed by property value exemption limits or allowances. Each of these analyses concentrates purely on the property tax itself; but compensating tax reductions are an essential element of the rationale for introducing a property tax. The concentration on where the property tax revenue comes from arises from the fact that the main focus is on the design of the property tax itself, rather than on how the tax reductions are made. But Section 5.6 does provide an illustration of a combination of a property tax with income tax reductions.

In terms of the design issues regarding property taxes discussed in Section 2.3, all of the property taxes examined here share the following characteristics:

- (a) *Coverage*: only owner-occupied residential property is included;
- (b) *Tax base*: capital values are used as the base for the tax;
- (c) *Valuation procedure*: self-assessed values are used; it is assumed that enforcement mechanisms are sufficient to ensure that realistic values are reported;

¹Truly comprehensive income taxation would include much else besides imputed income from owner-occupation; but the term comprehensive income taxation is used here as a convenient shorthand for the inclusion of imputed income in the income tax base.

- (d) *Tax unit*: the tax bill is sent to the legal owner, and any income exemption scheme is based on the tax unit containing this person;
- (e) *Relationship with income tax*: the property tax bill is not allowable for income tax purposes, but mortgage interest tax relief is retained at the 1987 level (90 per cent of qualifying interest, up to a maximum of £4,000 for a married couple).

The major item of variation between the schemes concerns the presence, absence or nature of income exemptions, marginal relief for incomes above such exemptions, property value exemption limits or allowances. Items (a) to (c) in the above list are relatively straightforward: the tax is to be based on self-assessed capital values of owner-occupied property, as a proxy for taxation of the imputed income from owner-occupation. The treatment in item (e) reflects the fact that the model was designed initially to deal with the system then in operation, and a "tax credit" option of allowing full mortgage interest relief at a standard rate of tax has not yet been implemented. However, this is not likely to impart a major bias to the results.

5.2 Unit of Analysis and Incidence of a Property Tax

The implications of item (d) in the above list warrant rather closer examination. As noted earlier, the use of a narrower tax unit for income exemption purposes could lead to within-family transfers of property to low income tax units, e.g., parents or children of the present owners. Such behavioural responses are not taken into account in the analysis. In practice, elimination of such tax avoidance measures may require the use of the wider household unit for income exemption purposes. This is one reason why research on this topic at household level would be of considerable interest.

The analysis could simply trace the legal incidence of the tax as specified by item (d). This would mean that the whole effect of the tax would be attributed to the tax unit of the owner. But the effective incidence of the tax will be influenced by a number of other factors. One of the most important is that several tax units may live in the same household. If the whole effect is attributed to the tax unit of the owner, then other tax units within the household would be treated as unaffected by the tax. But the non-householder tax units may be affected. The commonest form of

multiple tax unit household is that in which adult children have completed full-time education. Many of these have independent incomes, either from employment or social welfare. They may at present make a contribution towards the running costs of the household, and may be induced to raise (or initiate) such a contribution by the introduction of a property tax. Analysis of the incidence of the tax at household level would therefore be of considerable interest. Administrative data are not well suited to this sort of analysis; but survey data of the type collected by the ESRI Survey of Income Distribution, Poverty and Usage of State Services are ideal for such purposes. They allow calculation of the effects at both tax unit and household levels. The results presented here focus on the analysis of direct effects of a property tax at *household* level; results of analysis at tax unit level will be reported where appropriate.²

The effective incidence of a property tax will also be affected by a number of other factors. Two of the most important are:

- (1) *Changes in capital values:* The introduction of a property tax will lead to a reduction in house prices. This will lead to capital losses for owner-occupiers, and will also lead to some reduction in their property tax bills. It may also make it easier for new purchasers to finance entry into owner-occupation;
- (2) *Broader economic effects:* The prices of other goods and services will also be affected by a property tax. One might expect incomes and employment in building trades to be adversely affected, with compensating growth in other areas. Effects of this type would take place even in a full employment context. A further important consideration is that the shift from taxation of income towards property (or, alternatively, the broadening of the income tax base to include income from owner-occupied property) would allow a reduction in income tax rates which it is widely thought would stimulate employment.

²The basic analysis was, in fact, conducted at tax unit level; the household level results were derived by aggregation of tax units within each household.

Reductions in capital values could be considered within the broad analytic framework established here: the concluding chapter discusses this issue again.³ The broader macroeconomic effects are, however, more difficult to capture.⁴ It is important to emphasise, however, that a revenue-neutral package is envisaged, so that the introduction of a property tax would be offset by reductions in other taxes, usually thought of as income taxes.

5.3 Taxation of Imputed Income ("Comprehensive" Income Taxation)

The strongest justification for a tax on owner-occupied residential property is that it would serve as a proxy for taxation of the imputed income from owner-occupation.⁵ In order to examine how closely various property tax schemes proxy this goal, a simulation of the taxation of imputed income is considered here; this will also allow investigation of whether taxation of imputed income would offer a more satisfactory resolution of problems arising from property taxes being levied on those with low cash incomes.

For simplicity, a 5 per cent rate of return on housing is assumed, both here and in the derivation of a rate of property tax. (As noted earlier, at a standard rate of tax of 30 per cent, a property tax rate of 1.5 per cent would then give the same yield from standard rate taxpayers as an imputed income based on 5 per cent of the house value). Under the current tax system, in which nominal returns are taxed and nominal mortgage interest is allowed for tax relief, the rate of return might be approximated by the nominal mortgage interest rate: about 11 per cent. Under a reformed system, which taxed only real interest and allowed real interest payments for relief, the real rate of return would be more appropriate. With inflation standing at present at around 3 per cent, this would imply a return of 8 per cent. But a real rate of return of around 5 per cent might be closer to a long-term average, and more appropriate for use in this analysis. Imputed income from housing in this section is therefore calculated as 5 per cent of the capital value. This income is added to the gross incomes of owner-occupiers in the sample⁶ in order to assess the direct effects of including imputed income in the income tax base.

³The likely extent of the fall in house prices induced by a property tax would have to be offset against the actual rise in house prices since 1987, from the point of view of the potential revenue.

⁴The analysis undertaken here should be thought of as parallel to that suggested by Dilnot, Kay and Keen (1990) in their methodology for the attribution of taxes.

⁵Thereby allowing a reduction in income tax rates and/or widening of tax bands.

⁶The imputed income is added to the income of the tax unit containing the owner-occupier.

The first important result is the aggregate revenue which such a change would raise: almost £400m in 1987 terms.⁷ Almost 600,000 households would be directly affected, leaving 400,000 not directly affected. Table 4.1 showed that about 200,000 households are not owner-occupiers, so this means that approximately 200,000 owner-occupying tax units would find that inclusion of their imputed income from owner-occupation did not lead to a tax liability. These tax units are, and would remain, below the income tax exemption limits.⁸

The distribution of the tax liabilities across income ranges may also be examined: this is of considerable interest, since a major concern about property taxation is how it would bear on those with low cash incomes. Taxation of imputed income offers a benchmark for evaluation of the effect of different forms of property tax in this area. The survey-based analysis can quantify the distribution of tax liabilities, showing the numbers affected and the aggregate tax take from different income groups. Table 5.1 reports the results for income groups ranked by income adjusted for family size and composition⁹: these income groups divide the population of households into ten groups of equal size.

⁷The standard rate of tax in 1987 was 35 per cent, with higher rates of 48 and 58 per cent. Cuts in income tax rates since then would reduce the potential revenue gain from inclusion of imputed income in the income tax base.

⁸Other tax units within the household might be liable for income tax, but their liabilities would not be affected under the scheme examined.

⁹The needs of households of different sizes are allowed for by counting 1 for the head of the household, 0.66 for a spouse and 0.33 for all dependent children. These figures reflect the ratios implicit in some of the main social welfare payments at the time.

Table 5.1: *Direct Effects of Including Imputed Income from Owner-Occupation in the Income Tax Base ("Comprehensive" Income Tax)*

Adjusted net income ¹ (£ p w)		% of households	Numbers paying > 50p p w ('000s)	Aggregate Revenue £m p a
More than	Less than			
	39.09	10.0	7.2	3.2
39.09	48.57	10.0	24.1	10.9
48.57	55.77	10.0	39.5	13.7
55.77	63.81	10.0	43.6	16.8
63.81	73.02	10.0	59.2	27.1
73.02	83.64	10.0	73.5	43.0
83.64	95.82	10.0	76.6	46.0
95.82	112.94	10.0	77.2	56.3
112.94	138.82	10.0	90.6	76.1
138.82		10.0	89.0	99.5
<i>Totals</i>		100.0	580.5	392.6

Note: 1. Adjusted net income = net income per equivalent adult. Equivalence scale defined by 1 for head of household, 0.66 for spouse, 0.33 for children.

It can be seen that the numbers affected and the aggregate tax take in the lowest income group is very small. Significant numbers are affected in the second and, more particularly, in the third lowest income group: the total number affected in the bottom three income groups is just over 70,000 (about 12 per cent of the total of those affected), and 7 per cent of the total revenue is raised from the bottom 30 per cent of the cash income distribution. By contrast, over 25 per cent of the revenue would come from the top 10 per cent of the cash income distribution, and almost 60 per cent from the top 30 per cent of the distribution. An increase in basic personal income tax allowances of £250 would not greatly reduce the numbers paying some tax; but it would have a major impact on the *amounts* of tax paid. It would reduce the yield of the tax by about one-third, and the yield from the bottom decile by about two-thirds.

5.4 A Simple Property Tax Analysed

The simplest property tax is a straightforward tax of a given percentage rate on owner-occupied residential property, without any

exemptions, allowances or waivers. The results of such a tax are now set out, and may be compared with the benchmark of "comprehensive" income taxation.

The first important result from the survey-based analysis is the yield from such a tax. The 1987 ESRI Survey suggests that a 1 per cent property tax rate would raise approximately £250m. The most appropriate tax rate, if the tax is designed to proxy taxation of imputed income from owner-occupation, can be seen as the product of the rate of return on housing and the standard rate of tax.¹⁰ As noted earlier, a real return of 5 per cent might be seen as a reasonable working approximation. With a standard rate of tax of 30 per cent, this would imply a tax rate of 1.5 per cent. A tax rate of 1.5 per cent is used for illustrative purposes in most of the later analysis here. The predicted yield from this tax is about £370m.

Approximately 4 out of 5 households would be directly affected by such a property tax.¹¹ The households "not affected" by a residential property tax applied to owner-occupiers comprise those who are renting from local authorities or private landlords, or receiving their accommodation rent-free.

A major concern about this simple form of property tax is that it would create substantial hardship for those with low cash incomes. The survey-based analysis can quantify the problems faced by a distributional analysis, showing the average and aggregate tax take from different income groups. Table 5.2 reports the results for income groups ranked by income adjusted for family size and composition.

¹⁰The imputed income from housing can be measured by the rate of return times the house value; application of the standard rate of tax to this income gives the required tax bill. But if the base of the tax is to be the capital value, the rate of tax must be the product of the rate of return and the standard tax rate.

¹¹Owner-occupation is the form of tenure for about 80 per cent of households in the sample and in the country.

Table 5.2: *Direct Effects of a Simple Property Tax*

<i>Adjusted net income¹</i> <i>(£ p w)</i>		<i>% of</i> <i>households</i>	<i>Numbers ('000s) paying:</i>			<i>Aggregate</i> <i>Revenue</i> <i>£m p a</i>
<i>More than</i>	<i>Less than</i>		<i>£1-£5 p w</i>	<i>£5-£10 p w</i>	<i>>£10 p w</i>	
	39.09	10.0	19.0	30.7	12.4	23.2
39.09	48.57	10.0	17.0	34.1	14.4	25.5
48.57	55.77	10.0	19.1	38.6	9.1	24.1
55.77	63.81	10.0	16.6	43.8	13.2	28.2
63.81	73.02	10.0	14.3	45.4	18.9	31.3
73.02	83.64	10.0	14.2	41.5	29.5	40.3
83.64	95.82	10.0	9.1	45.1	36.1	42.9
95.82	112.94	10.0	6.2	43.5	36.3	44.1
112.94	138.82	10.0	6.6	39.3	46.4	52.1
138.82		10.0	1.9	28.7	59.8	59.9
<i>Total</i>		<u>100.0</u>	<u>124.0</u>	<u>390.7</u>	<u>276.2</u>	<u>371.5</u>

Note: 1. Adjusted net income = net income per equivalent adult. Equivalence scale defined by 1 for head of household, 0.66 for spouse, 0.33 for children.

These results show that substantial numbers of low income households would be directly affected by a simple property tax. For example, almost 140,000 households with size-adjusted incomes below about £55 per week would stand to pay at least £5 per week in property tax. About 35,000 of these would pay more than £10 per week. At such low income levels, these sums would constitute substantial proportions of net income. Low income families face losses of the order of 10 per cent of their net income, as against 4 or 5 per cent for those in the top half of the distribution. On the other hand, about two-thirds of the total revenue comes from those in the top half of the income distribution. These results bring us naturally to an examination of how income exemption limits might affect these calculations.

5.5 Variations on a Theme

5.5.1 Income Exemption Limit and Marginal Relief

The discussion in Section 2.5.4 showed that an income exemption limit without marginal relief would create or exacerbate a "poverty trap"

for those on low incomes. For this reason, an income exemption limit scheme with marginal relief is examined here. The exact parameters chosen were:

(a) *Income exemption limit:* This was set equal to the income exemption limit for persons aged 65 or over, which was £3,150 per annum in 1987/88.¹²

(b) *Marginal relief rate:* For incomes above that limit, relief was withdrawn at the rate of 20 pence in the pound. Thus, tax units benefiting from marginal relief faced an effective increase in their marginal income tax rates of 20 per cent.

Table 5.3 documents the simulation of this scheme. The results for the property tax with income exemption limits may first be compared with the results of a simple property tax without income exemptions. The first feature to note is the overall revenue from the tax with income exemptions is estimated at £235m. This represents a fall of about £135m, or over one-third, from the revenue derived by a simple property tax. The scheme does reduce the number of low income households directly affected by property tax to much smaller proportions.¹³ The total number of households directly affected falls to just under half a million; so about 300,000 households benefit from a total exemption.

¹²The age-related income exemption limit was, and still is, slightly above the level of the old age contributory pension.

¹³This is so despite the fact that the tax system and income exemption scheme do not take account of the number of children in the tax unit; while the income criterion used to rank households in the table does so.

Table 5.3: *Direct Effects of Property Tax with Income Exemption Limit Compared with Tax on Imputed Income from Owner-occupation*

Adjusted net income ¹ (£ p w)		% of households	Numbers paying more than 50p p w ('000s)		Aggregate Revenue £m p a	
More than	Less than		Property tax ²	Tax on imputed income ³	Property tax ²	Tax on imputed income ³
	39.09	10.0	2.0	7.2	0.4	3.2
39.09	48.57	10.0	9.1	24.1	2.3	10.9
48.57	55.77	10.0	14.3	39.5	4.1	13.7
55.77	63.81	10.0	23.6	43.6	7.8	16.8
63.81	73.02	10.0	49.2	59.2	17.1	27.1
73.02	83.64	10.0	64.3	73.5	25.6	43.0
83.64	95.82	10.0	73.5	76.6	34.0	46.0
95.82	112.94	10.0	73.6	77.2	37.3	56.3
112.94	138.82	10.0	88.1	90.6	47.9	76.1
138.82		10.0	88.7	89.0	58.6	99.5
<i>Total</i>		<u>100.0</u>	<u>486.7</u>	<u>581.4</u>	<u>235.0</u>	<u>392.5</u>

Notes: 1. Adjusted net income = net income per equivalent adult. Equivalence scale defined by 1 for head of household, 0.66 for spouse, 0.33 for children.

2. Property tax with an income exemption limit and marginal relief for incomes above the limit.

3. Imputed income from owner-occupation included in the income tax base.

About 100,000 fewer households would be affected by a property tax with an exemption limit, as against "comprehensive" income taxation, as illustrated in the table. Most of these would be in the lower or lower middle reaches of the income distribution: about 45,000 of the households in the bottom three deciles, and a further 30,000 in deciles 4 and 5. The total tax take, at £235m, would be about £160m lower than if imputed income from owner-occupation were taxed. About £21m of this would be from the lowest three income groups, with a further £19m from the next two groups. Thus over £120m of the difference would come from the top half of the income distribution, reflecting the progressivity of the existing income tax rate structure as compared with a flat-rate property tax. The property tax

with income exemptions does, however, come closer than a simple property tax to the effects of taxing imputed income with respect to the lower reaches of the income distribution.

The results on a tax unit basis show some interesting differences from the household based calculations. The liabilities attaching to tax units in the lower half of the size-adjusted tax unit income distribution are somewhat lower than the corresponding figures for households; and the liabilities attached to the upper deciles are somewhat higher. But the overall shape of the distribution of liabilities is quite similar.

What of the effects of the income exemption scheme on marginal income tax rates? The tax unit level of analysis is used here, since the exemption has been modelled on a tax unit basis; if, instead, the exemption limit and marginal relief referred to household income, a household basis would be required. Table 5.4 reports the numbers of tax units experiencing an increase in the effective marginal income tax rate, classified by their initial income tax rate: a rise in the marginal tax rate from 60 to 80 per cent might cause more concern than a rise from 0 to 20 per cent. The table shows that over 90,000 tax units would benefit from marginal relief provisions. Most of these (about 60,000 tax units) are paying income tax at the standard rate: thus their effective marginal income tax rate rises from 35 per cent to 55 per cent. For those also paying full PRSI, the effective rate is over 60 per cent. A further 23,000 tax units are receiving marginal relief under the income tax code: their marginal tax rate rises from 60 per cent to 80 per cent.¹⁴ A lower marginal relief rate, of say 10 per cent, would reduce the impact on incentives: but it would greatly increase the number of persons affected.

¹⁴Not all of those eligible for marginal relief may actually be affected by it: it seems likely that many such incomes do not come to the attention of the Revenue Commissioners, e.g., those with contributory old age pensions and a small additional interest income.

Table 5.4: *Marginal Relief and Effective Marginal Income Tax Rates*

<i>Income Tax Rate (before change) %</i>	<i>Numbers experiencing 20 percentage point rise in effective marginal income tax rate¹ ('000s)</i>
0	11.2
35	58.1
48	0.5
58	0.3
60 ²	23.2
<i>Total</i>	<u>93.3</u>

Notes: 1. i.e., numbers benefiting from marginal relief above property tax income exemption limit.

2. Receiving marginal relief under income tax code.

The marginal income tax rates calculated above do not take account of any withdrawal of social welfare benefits (such as Family Income Supplement) or of medical card entitlements. The withdrawal of property tax rebates would exacerbate the high tax rates faced by those on Family Income Supplement; but a detailed consideration of these problems and of policy options in this area is outside the scope of the present paper.

5.5.2 Property Value Exemption Limit and Allowance

A property value exemption limit cum allowance is sometimes suggested as a means of making property tax more closely related to ability to pay, while avoiding the implicit marginal income tax rates associated with income exemption limits. A brief examination of this structure indicates its flaws. First and foremost, a property value allowance greatly reduces the tax take. For example, a property value allowance of £25,000, together with a tax rate of 2 per cent, as suggested by the leader of the Labour Party (Spring, 1988) was examined.¹⁵ The revenue from this combination was £146m. Furthermore, about £15m in aggregate was raised from about 60,000 taxpayers with incomes below £48 per week.

The present Residential Property Tax has the essential elements of this structure: no tax is payable if the property value is below a particular threshold, and the amount of tax payable is a percentage of the excess of the property's value over that threshold. The analysis undertaken here

¹⁵The Spring (1988) proposals also contained a higher 3 per cent rate of tax on the excess over £100,000; but this would generate very little additional revenue.

shows that these features greatly restrict the potential revenue; RPT combines these features with an income criterion which restricts the potential revenue much further. Thus, even quite substantial reductions in the property value threshold at which RPT becomes payable would not generate sufficient revenue to allow major reductions in income taxes.

5.6 Shifting Taxation from Income to Property

Thus far, the uses to which property tax revenue could be put have not been taken into account. But reduction in income tax rates is widely seen as the goal which would motivate the introduction of a property tax and, indeed, formed a major part of the economic rationale for its introduction discussed in Chapter 2. Detailed analysis of base-widening, rate-reducing packages will be conducted elsewhere: this paper concentrates on the revenue aspects of a property tax, since it is in terms of total revenue and its distribution over income ranges that alternative forms of property tax differ. But the introduction of a property tax should be seen in terms of its contribution to a tax reform package with long-term implications, rather than as a short-term measure concerned wholly with raising total tax revenues. A brief consideration of the overall effects of introducing a property tax and reducing income tax rates is therefore in order here.

The property tax with relief for those on low incomes described earlier was shown to generate revenue of £235m. Here, one package of income tax reductions which this could finance is examined. It is estimated that, in 1987 terms, a reduction in the top rate of 6 percentage points, a reduction in the higher rate of 5 percentage points, and a reduction in the standard rate of 3 percentage points would cost about £250m. The distributive effects of this package (which has a net cost of about £15m) are analysed in Table 5.5 below. Its direct effects on net incomes are broadly neutral on the lower half of the cash income distribution; negative for the upper middle reaches of the distribution; and positive for the top decile in particular.

Table 5.5: *Shifting Taxation from Income to Property*

<i>Adjusted net income¹</i> <i>(£ p w)</i>		<i>% of households</i>	<i>Property Tax with Income Exemption Limit and Marginal Relief</i>		
<i>More than</i>	<i>Less than</i>		<i>Aggregate Loss</i>	<i>Aggregate Gain</i>	<i>Net Gain (+) or Loss (-)</i>
	39.09	10.0	0.3	0.1	-0.1
38.09	48.57	10.0	1.8	0.6	-1.2
48.57	55.77	10.0	3.1	1.0	-2.1
55.77	63.81	10.0	5.2	1.5	-3.7
63.81	73.02	10.0	10.6	2.8	-7.9
73.02	83.64	10.0	15.6	4.4	-11.2
83.64	95.82	10.0	18.0	6.0	-12.1
95.82	112.94	10.0	15.2	11.5	-3.7
112.94	138.82	10.0	12.9	15.4	2.5
138.82		10.0	5.7	61.0	55.3
<i>Totals</i>		<u>100.0</u>	<u>88.5</u>	<u>104.3</u>	<u>15.8</u>

Note: 1. Adjusted net income = net income per equivalent adult. Equivalence scale defined by 1 for head of household, 0.66 for spouse, 0.33 for children.

The inclusion of imputed income from owner-occupation for income tax purposes would allow more substantial cuts in income tax rates. It was estimated, for example, that a cut of 8 percentage points in the top rate, together with cuts of 4 percentage points in the standard and higher rates could be financed on this basis. The "shape" of the distributive effects would, however, be quite similar. Further consideration of income tax cuts financed by widening of the income tax base is undertaken elsewhere (Callan, 1991).

5.7 Conclusions

Empirical analysis of four basic policy options was undertaken. First, inclusion of imputed income from owner-occupation in the income tax base; second, a simple property tax without any income exemptions or waivers; third, a property tax with an income exemption and marginal relief; and fourth, a property tax with a property value exemption limit/allowance.

The strongest argument for a property tax is that it would proxy the taxation of imputed income from owner-occupation. Thus, the first policy option analysed gives a useful benchmark against which to compare the others. The simple property tax gave rise to a similar revenue, but gained much more of it from low income groups, and rather less from the top income groups. Substantial numbers of low income groups would be affected. A property value exemption limit cum allowance greatly reduced the aggregate revenue, even when the property tax rate was raised. Furthermore, the problem of property taxes falling on those with low cash incomes was not avoided. The property tax with an income exemption limit and marginal relief gave rise to a pattern more similar to the benchmark of taxation of imputed income.

A brief examination of reductions in income taxes which could be financed by property tax revenue was undertaken: more detailed analysis is undertaken elsewhere (Callan, 1991). Substantial rate reductions could be financed by revenue from a property tax. The package of rate reductions analysed led to small net (and gross) effects on disposable incomes the lower half of the income distribution, negative effects for the upper middle reaches, and positive effects at the top of the distribution.

Chapter 6

CONCLUSIONS

6.1 Principles and Experience

The main objective of this paper has been to move beyond general arguments for or against property taxation to an in-depth investigation of specific schemes of property taxation. This does not presuppose that a property tax is desirable; but it helps to clarify what is at issue in objections to a property tax, and whether a suitably designed scheme could satisfy some of the objections commonly levelled at property taxes. Before proceeding to the analysis of detailed schemes, however, the implications of the basic principles of taxation and the lessons of past experience with property taxes were reviewed.

There are strong arguments for taxation of owner-occupied residential property, because it represents a major source of income not taxed at present. The basic principles of efficiency and horizontal equity would be better served by such a reform of the current income tax system. Arguments for a more general property tax, which would apply more broadly than to owner occupiers of residential property, are less compelling. They do not have the same rationale in terms of including an untaxed income in the tax base. For example, rented property gives rise to an income which is already, in principle, subject to tax. Thus, the analysis in this paper has concentrated on the taxation of owner-occupied housing.

Several features of the design of a property tax were considered. Capital values were seen as the most appropriate tax base. They would allow for the use of self-assessment valuation procedures. Considerable attention was devoted to the issue of tax relief for those on low incomes, designed to strengthen the link between the liability and the ability to pay. This also raised the question of the appropriate unit on which such an income criterion should be based: possible behavioural responses to narrow definitions of the income unit (such as transfers of property between members of the same family in order to eliminate liability to the tax) provided strong arguments for a household basis. While this is a departure from the unit used in income taxation generally, it is not surprising to find that the taxation of housing, which is shared by households, should involve

this wider unit.¹ Property taxes of the kind most usually discussed would require that the existence of mortgages be associated with a reduction in net liabilities. One way of achieving this aim would be through a form of mortgage interest tax relief; but property tax would not itself be allowable as a deduction from taxable income or a credit against income tax payments.

6.2 Analytical Framework and Data

A property tax based on self-assessed capital values of owner-occupied housing was analysed. Results were presented on a household basis, to take account of the possibility of income-sharing (or sharing of property tax bills) between multiple tax units within the same household. Some analysis of second round effects in terms of reduced house prices may also be possible. But broader economic effects may be more difficult to capture in a formal analysis.²

The data used for the analysis were drawn from the ESRI Survey of Income Distribution, Poverty and Usage of State Services. This included information not only on income sources and labour market participation, but also on housing values. Interviewer and respondent estimates of housing values were shown to be in broad agreement, with over 90 per cent being within either 30 per cent or £10,000 of each other. US evidence suggests that owners' ratings of their property values are reliable, when compared with those of independent assessors.

6.3 Policy Options

Empirical analysis of four basic policy options was undertaken. First, inclusion of imputed income from owner-occupation in the income tax base; second, a simple property tax without any income exemptions or waivers; third, a property tax with an income exemption and marginal relief; and fourth, a property tax with a property value exemption limit/allowance.

The first of these provides a benchmark for evaluation, since taxation of imputed income from owner-occupation gives the strongest rationale for a property tax. It was estimated, on the basis of 1987 property values and income tax rates that the aggregate revenue would be just under £400m: the

¹The income exemptions in the empirical analysis of Chapter 5 did, however, refer to the narrower income tax unit, but no behavioural responses were allowed.

²The size of income tax cuts which could be financed by property tax revenue is estimated, and can be used to gain some idea of the extent of incentive effects on labour supply.

rise in property values since then would tend to increase that figure, but falls in income tax rates would tend to reduce it, as would any fall in property values induced by the property tax itself. Almost 60 per cent of the revenue would come from the top 30 per cent of the cash income distribution; as against about 7 per cent from the bottom 30 per cent, reflecting the progressivity of the income tax structure.

The simple property tax (at a rate of 1.5 per cent) gave rise to a similar revenue, but gained much more of it from low income groups, and rather less from the top income groups. Substantial numbers of low income groups would be affected by a simple property tax: almost 140,000 households with size adjusted incomes below £56 per week would stand to pay at least £5 per week (or about 10 per cent of their net income) in property tax. A property value exemption limit cum allowance would greatly reduce the aggregate revenue: the reduction was about two-thirds, for the particular scheme examined, even though it involved a higher rate of property tax. Furthermore, such a scheme does not remove the burden of property taxes from those with low cash incomes.

A property tax with an income exemption limit and marginal relief gave rise to a pattern more similar to the benchmark of taxation of imputed income. The particular income limit examined would reduce the total revenue by about one-third, to about £235m. Although the total revenue would be lower than under taxation of imputed income, the distributional pattern would be quite similar: about 60 per cent from the top 30 per cent of the income distribution, and about 3 per cent from the bottom 30 per cent. The modified scheme would reduce the liabilities of the bottom 30 per cent of the distribution to one-tenth of the level which a simple property tax would imply. There would be a cost in terms of incentives: effective marginal tax rates would rise by 20 percentage points for a substantial number of taxpayers. About 60,000 of these would already be on the standard rate; a further 20 to 25,000 would be on receiving "marginal relief" under the income tax code, which involved a marginal tax rate of 60 per cent in 1987. Other forms of property tax rebate for those on low incomes might, therefore, be preferred. Deferral of payment until the sale of the property (or other transfer of ownership) might provide such a route.

A brief examination of reductions in income taxes which could be financed by property tax revenue was undertaken: more detailed analysis is undertaken elsewhere (Callan, 1991). Substantial rate reductions could be financed either by a property tax with income exemption limits, or even more substantial reductions by taxation of imputed income from owner occupation. The particular package of rate reductions analysed led to small

net (and gross) effects on the lower half of the income distribution, negative effects for the upper middle reaches, and positive effects for the top 10 per cent of the distribution.

6.4 Issues in Implementation

A number of issues arise in the implementation of a property tax or taxation of imputed income. First, there are some general issues concerning the administration and enforcement of such a tax. As noted in Chapter 3, collection costs for the existing Residential Property Tax are high in relation to revenue because of the need to identify a small number of taxpayers for whom the tax is relevant. With a more general property tax it might be possible to make the declaration of the value of residential property a requirement on the claim for tax free allowances; failure to comply could then be sanctioned by limitation of income tax allowances; and payment could be made through the income tax system, to avoid large infrequent bills for property taxes. A number of other suggestions for penalties to ensure that timely and accurate assessments of property values would be returned were given by Dowling (1979).

A second practical issue concerns both income exemption limits and, more fundamentally, inclusion of imputed income in the existing income tax base. If it is possible for some people to arrange their affairs so as to reduce their incomes for tax purposes, or if the balance between PAYE taxpayers and others is perceived to be inequitable, then the introduction of income limits, or taxation of property *via* the income tax system may also be seen as inequitable. A simpler residential property tax based wholly on property values may then be regarded as preferable. The analysis of those with low incomes and high property values showed that while the elderly and widowed formed a large part of this group, there were also significant numbers of farmers and other self-employed persons in this situation. There is a trade-off here between provision of rebates to those in genuine need, and the use of a property tax to gain revenues from persons whose income tax liabilities do not reflect their true resources. The social welfare system may be in a better position to resolve this dilemma than the tax code.

The third main issue is that the existing tax treatment of housing is, to some extent, capitalised in the present values of housing. Introduction of a property tax would therefore lead to capital losses. Comparison of the two systems as if from a *tabula rasa* may show that a system with a property tax is preferable; but the distribution of the capital losses which would arise because the tax reform must start from the pre-existing

situation may be deemed unfair. Feldstein (1976) argues for pre-announcement of large changes in tax rules, with long lags, in order to allow capital values to adjust slowly. But this carries heavy political costs and might in the case of property taxes lead to pressure to reverse the decision. If a property tax must be implemented suddenly, some consideration should be given to the distribution of capital losses. The size of the change in prices remains uncertain; but a simple partial equilibrium calculation would suggest that it could be significant.

6.5 Further Research and Conclusions

The issue of capital losses is one area where further analysis would be useful. Apart from the size of the fall in prices, the question of what is the impact of the losses on real living standards also arises. Those who remain in the same accommodation may not experience a real loss of living standards; while for those who are moving up the housing ladder, or trying to gain the first rung on it, the change in prices may be an advantage. The main losses would then seem to be concentrated on those moving to less valuable accommodation, or those inheriting residential property. If an individual's life-cycle consumption plan does not involve selling a house, other than to trade up to a more valuable property, nor taking out a larger mortgage on an existing property in order to overcome liquidity constraints, then there would seem to be no loss of real consumption possibilities over his or her lifetime.

Another area for further research is to examine the effects of property taxes on the distribution of a "semi-comprehensive" income measure, i.e., cash income together with imputed income from owner-occupation. While it is unclear what exact rate of return should be imputed to housing assets, a number of procedures could fruitfully be used. One would be to use a number of rates of return within a plausible range; the appropriate property tax rate could then be derived as the product of the rate of return and the standard income tax rate. The direct effects of a property tax on the distribution of income including imputed rent could then be analysed.³

Despite the fact that further research questions have been raised, the analysis undertaken so far has clarified the role that a property tax could play in widening the tax base and allowing reductions in income tax rates. Until now, debate on the introduction of a property tax as part of a tax

³The full rate of return would include increases in the house price, which might be taxed instead under capital gains. Thus a rate of return which reflected simply the rental value might be used, if it were envisaged that capital gains would not be taxed, or would be taxed separately when realised.

reform package has lacked the basic information which this analysis provides. Further debate can now draw on these results, to establish whether a suitably designed scheme can attain a satisfactory compromise between the advantages and disadvantages of a property tax in financing tax reforms.

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