# Six fiscal reforms for the UK's 'lost generation'

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The OECD recently forecast that the UK's growth rate in the first half of 2014 will be the highest in the G7 countries. However, the economic recovery remains unbalanced – too driven by a credit and house price boomlet subsidised by the government's Help-to-Buy scheme.[1] By raising prices of homes, especially in London and the southeast, Help-to-Buy defeats the purpose of extending access to housing, instilling despair in many young families. Instead, the economic recovery could have been driven by much-needed infrastructure and housing investment. This would have increased income and employment while raising future real income and tax-revenue. This article recommends creating a better fiscal rule and learning the lessons from other countries' experiences of the active use of government land banks. It also proposes another four complementary policies. Together, these six policies could generate a more sustainable recovery and fairer outcomes for the 'lost generation' born after Mrs Thatcher came to power in 1979.

## A better fiscal rule

The ratio of government debt to national income matters: interest has to be paid on the debt, and current national income is a rough proxy for the future national income that will generate the tax revenue to service the debt. But the current exclusive concern with this debt is a big mistake. The government's asset position is just as important because assets help to generate future income to service the debt, or alternatively can be sold to pay down debt. What is needed is a more comprehensive definition both of liabilities (including the discounted cost of payments under Public Finance Initiative (PFI) contracts – see Parker 2012), and of assets, including potentially income-generating physical assets. For example, roads generate revenue directly, even without road pricing or toll roads, from the taxes on petrol and licences, and indirectly from the economic activity they lubricate. The real rate of return in the UK on such infrastructure investment – for example, upgrading the A1 road in the northeast – greatly exceeds the current cost of funding such investment. Furthermore, much of government-owned land is obviously saleable and not hard to value. It makes no sense to include only financial assets in government net debt and to exclude potentially saleable land.

A fundamental announcement of the Budget should therefore state that in future the government will target the growth of better-measured government debt minus government assets, all relative to national income. Increasing government gross debt would then not be a concern if it was matched by an increase in assets, such as publicly-owned productive infrastructure and land. This better-measured debt target would discourage the accounting practices of the Gordon Brown era, when expensive PFI contracts were used to fund what was effectively public sector investment without recognising the underlying ongoing financing liabilities.[2] By including land in government assets, government 'land banking' could become a superb contributor to a well-functioning economy.

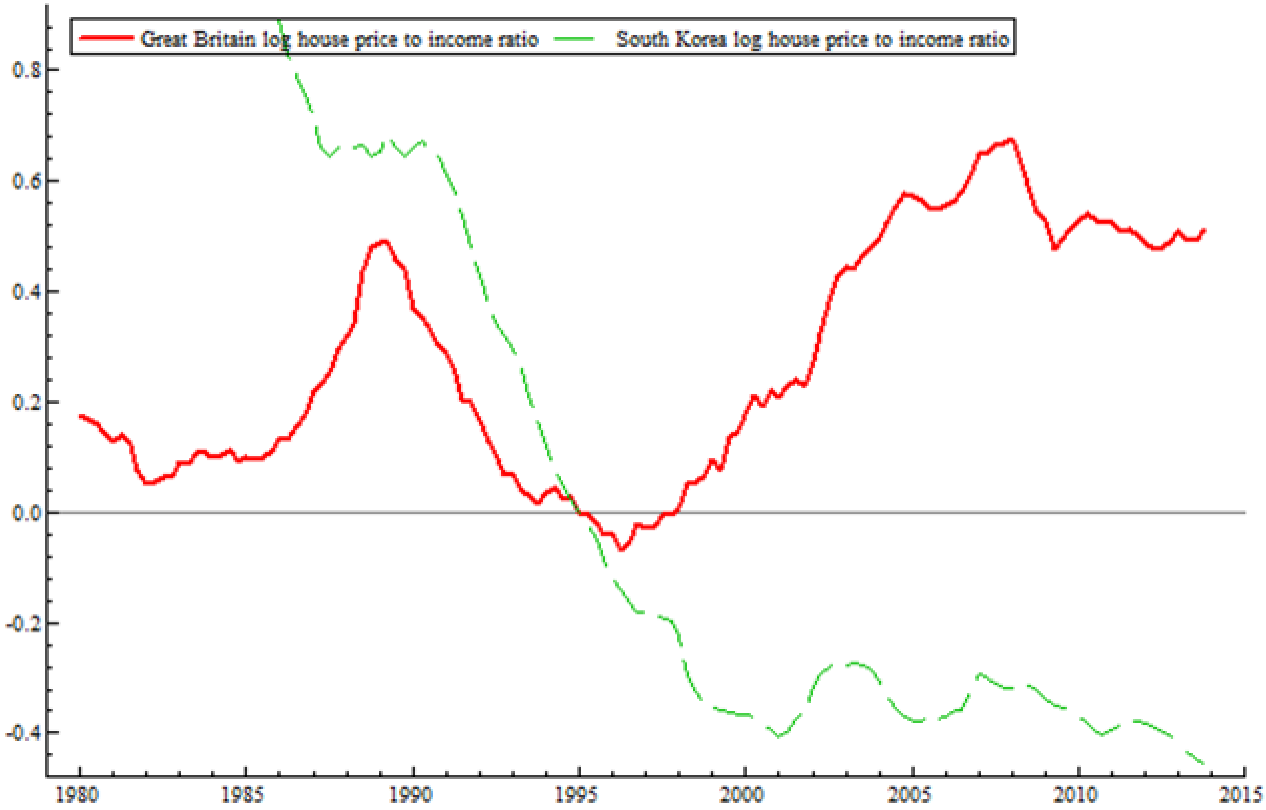
## What a Government Land Bank could do

In the US, the term 'land bank' refers to a public or community-owned entity "created for a single purpose: to acquire, manage, maintain, and repurpose vacant, abandoned, and foreclosed properties – the worst abandoned houses, forgotten buildings, and empty lots"; see Kildee and Hovey (2010). Outside the US, and particularly in countries like South Korea, Singapore, Taiwan and Hong Kong, a Government Land Bank is a national agency which can play a major role in national growth strategies, driving urban development and influencing real estate prices. The common feature is that a land bank acquires land cheaply and holds it for future housing or commercial developments. According to Kaganova (2011), the Korean Land Corporation (KLC) has a broad range of objectives[3] and activities:

"In 2007, KLC was responsible for around half of the residential development and almost all industrial land development in the country. Usually this development was in new towns, major housing developments, and industrial estates. As a part of its functions KLC developed and sold land for residential use; acquired idle and vacant land for resale; issued land debentures; reclaimed land; and developed new towns."

There can be no question but that the KLC played a major role in expanding – perhaps over-expanding – housing supply in Korea, accounting for a good deal of the difference between movements in house price to income ratios in the UK and South Korea. This is starkly illustrated in Figure 1; see Muellbauer (2012) for a discussion of the drivers of house prices and causes of house price instability. In South Korea, the ratio of house prices to income declined from a base of 100 at the beginning of 1995 to 62.3 at the end of 2013, while UK's shot up from 100 to 166.7, according to the OECD's data. The KLC made some mistakes, partly under political pressure, but the UK could learn a great deal from the comparative experiences of South Korea and others.

**Figure 1**. House price to income ratios for Great Britain and South Korea (base 1995, log scale).




A government land bank in the UK could buy land without residential or commercial planning permission for its potential for future development. This could be a source of land release for housing and other development, capturing the 'planning gain' for the taxpayer (the rise in price when planning permission is granted), as in South Korea and Singapore.[4] Future revaluation gains would bring down better-measured net debt relative to GDP, while the cash-flow from land sales would lower future government deficits. This radical step, together with better incentives for local authorities to grant planning permissions, would transform the supply of housing in the under-housed UK. Economic activity and employment prospects would improve, and 'the lost generation' of those born after 1979 would benefit. Currently, young people without wealthy and generous relatives have great difficulty getting onto the housing ladder. According to the Census, the fraction of owner-occupiers among those aged 25 to 34 has declined from 58 per cent in 2001 to 40 per cent in 2011. Intergenerational equity in the UK since 1997 (when New Labour came to power – see Weale 2007 and Barrel and Weale 2010) was more distorted by the house price boom than by the fiscal deficits accumulated under New Labour. Willetts (2010) demonstrates that at least one UK government minister is aware of the concerns of the 'lost generation'.

Four more policy steps for the UK

1. Substantially increase infrastructure spending.

2. Restrict Help-to-Buy to regions outside London and the southeast, but retain Help-to-Build everywhere to encourage house building.

3. Announce a mansion tax in which the excess of current values above £3m is taxed at 1%. Britain has the lowest property tax rates for the super-rich among advanced countries. The proposed tax rate would still be lower than in many other countries such as the US. Measures 2 and 3 would take some of the heat out of housing markets in London and the southeast. The introduction of a well-funded Government Land Bank would boost housing supply, allowing house prices relative to income to decline in coming decades, thereby helping the young and the socially excluded.

4. Take advantage of current low borrowing costs in index-linked gilts to fund more than the current government deficit, by issuing large amounts of index-linked gilts. 'Overfunding' of this kind was used in the 1980s and would save the taxpayer money in the long run. It would also have the important advantage of lifting current yields, and so reducing the apparent deficits in defined-benefit pension schemes. This should boost company investment in the real economy.

Better-measured debt in an international context

The two obvious measures of the value of public sector assets are replacement cost and present value based on the discounted present value of future returns. Early research (see Munnell 1992 for a review) suggested that infrastructure investment makes an important contribution to economic growth. But more recent research by Romp and De Haan (2005) emphasises context. For example, new public investment that alleviates existing transport and communications bottle-necks could have huge marginal returns. More generally, the larger the existing stock, the lower will be the return on new investment. Contrasting Spain and the UK, decades of high levels of infrastructure investment in Spain (often made by regional governments, e.g. in airports and roads), suggest that raising infrastructure spending in Spain would be far less productive for future income growth than in the UK. In the UK, road and rail links are starkly inadequate to the demands put on them. The same applies to housing investment, which has been long stagnant in the UK, while Spain has recently experienced a huge construction boom.

Thus, the replacement cost basis would overvalue Spain's regional 'white elephant' airports or Japan's 'bridges to nowhere' (the streams of returns to these investments are not high), while much of the UK's limited public infrastructure stock would be undervalued (the returns are very high). Moreover, the discounted present value of infrastructure depends on political and other constraints around the use of publicly-owned assets and on the government's growth strategies. For instance, France, with its large public sector, would likely have a far lower net debt or greater net asset to income ratio than the UK on a replacement cost measures basis. However, locked into a common currency, having suffered a major decline in competitiveness within the Eurozone, and with an inflexible labour market, France's poor growth prospects diminish the present value of its publicly-owned assets. International comparisons of comprehensive net debt-to-GDP ratios thus need to be treated with caution and computed on more than one basis. For decision-making at a national level, it is far better to be guided by the comprehensive net debt concept argued for in this article, even if only on a replacement cost basis, than by the conventional narrow debt measure.

Land banks in an international context

The extent to which a government land bank can solve the problems of intergenerational inequality and other deep-seated economic problems also differs from country to country. Spain and Ireland, after the huge declines in house price-to-income ratios since 2008, and with far less restrictive regimes of land release, are in a different position from the UK. So is Germany, where house price-to-income ratios still lie below levels prevailing before 2004. In the US, local community land banks have played creative roles in bringing derelict land or land under foreclosure back into use and generating urban renewal but land banking has not been used at a Federal Government level. Given the role played in some countries by manipulation of land ownership and development rights in the enrichment of corrupt political elites, good governance of a government land bank is crucial. The use of transparent auctions in purchasing land will need to be an important part of such a bank's operating procedures.[5] In the UK, where differences in land values with and without planning permission are some of the highest in the world, there is great potential for a government land bank.

The issues posed by the UK's 'lost generation' are but one manifestation of the wider global problems of the long term so cogently analysed by the Oxford Martin Commission for Future Generations (2013). The UK policy recommendations proposed in this article are fully coherent with those of the Commission.

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1 Under the scheme, the potential borrower puts down only 5% of the value of home and the government guarantees the next 20% of the mortgage lender's loan for a fee paid by the mortgage lender.

2 See Parker (2012) for a discussion of how PFI contracts are treated under different accounting conventions and the only partial recognition of PFI liabilities in recent data published by the UK Treasury.

3 The KLC was founded in 1975 and merged in 2009 into the Korean Land and Housing Corporation. Its stated objectives include: to stabilize citizens' housing life; to use public land efficiently for improving quality of life and spearhead economic development; housing construction and

development of new towns; equipping land with infrastructure; and development of industry and logistics.

4 Singapore has another advantage in this respect. Most land is in public ownership, leased to the private sector on long leases. The value of new leases sold potentially benefits from planning permissions and from public and private development expenditures in nearby locations.

5 Tim Leunig has argued very cogently for community land auctions as a way for local governments to acquire development land to relax land supply bottlenecks. This can be thought of as land banking at the local government level for incremental local additions to housing supply. Under the constraints of current fiscal rules, his proposals would be hard to finance. These constraints would be relaxed if publicly owned local land assets could be included in the comprehensive measure of national net debt proposed here. However, for larger developments, for instance of new towns, community land auctions are not at the right scale. Furthermore, increasing the range of options outside local authority boundaries weakens the monopoly power of land owners.