LVT/SVT long term implications

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Credit flows and competitiveness are in peril

Credit markets are contracting &
Yet, there is no HHs de-leveraging
Why?
A Ponzi Scheme to finance balance sheets of the Government and the Banks: roll-overs, re-negotiations

Our HCIs (in unit-labour costs, CPI & GDP-deflator adjusted terms) are the worst in the Euro area and 2nd worst in the EU27
This dynamic is not changing - in fact our competitiveness has fallen again in Q3 09
This exhausts ‘growth’ revenue hopes for the Exchequer

ECB, 2010

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So Exchequer is still in peril

Total receipts seem to be rising, but against a downward trend

Underlying tax receipts are still falling

While Exchequer surplus is deteriorating

So after 3 consecutive contractionary budgets, we know that:

- The Government no longer has room to expand tax take
- The de-leveraging of households and companies has stopped short of what is needed
- Credit markets are malfunctioning as much due to supply disruptions as due to demand

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Housing Bust Continues

- National average asking price, % change yoy
- National average asking rent, % change yoy
- 6 per. Mov. Avg. (National average asking rent, % change yoy)
- 6 per. Mov. Avg. (National average asking price, % change yoy)

Daft.ie, author own calculations, March 2010

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How unsustainable are our finances?

Not much of hope here folks:
Absent Nama: our GG Debt will be in excess of 90% of GDP by 2014.
With Nama: in excess of 133%.
With Nama & recaps: just under 143%

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But our tax structure is an even bigger drag

About the closest to Property-linked CGT, Stamps and VAT other drivers of tax revenue are Consumption-linked VAT and Excise...

A ‘Bricks&Mortar, Booze&Cars’ Exchequer?

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And it is skewed against labour

So how are we supposed to build a ‘knowledge’ economy with this sort of investment incentives?..
Induced uncertainty, noisy risk

Intra-annual variations in monthly receipts are not significantly influenced by contemporaneous property prices, across all tax headlines,

**BUT...**

... once lags are accounted for, this is not the case: 3-mo lags in property prices double significance of property prices fluctuations around the trend on CGT & VAT, triple on Stamps and almost triple on total tax revenue.

There is dramatic change in the overall volatility of house prices which is:

- **Pro-Cyclical** (higher volatility in periods of downturns and major growth);
- **Extreme** (rising more than 3.5 times min-max for previous year);
- **Permanent** (no mean reversion to long-term mean, but some mean reversion to sub-period mean, although - no stable sub-period can be identified).

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Pro-cyclicality risk

Four main sources of pro-cyclicality risk to total revenue:

1. Income Tax (low VaR, but positive)
2. Corporate tax (low VaR, but positive)
3. Stamps (high VaR)
4. CGT (high VaR)

BUT…

- No significant pro-cyclicality risk in VAT;
- Some 65% of the pro-cyclicality risk due to Income tax is captured by Stamps & CGT correlation to Income receipts;
- Some 75% of the pro-cyclicality risk due to Corporate tax is captured by Stamps & CGT correlation with Corporate receipts.

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Forecasting risk

Revenue forecast errors:

- 1-period ahead forecast errors for property-related taxes are significantly non-zero, pro-cyclical and have strong positive correlation with total revenue forecast errors (ca 66%)
- Longer forecasts are equally problematic

- There is tremendous trend-resilience in forecast errors, and no mean reversion to zero in medium term;
- This is true for both 1-period ahead forecasts and longer range forecasts;
- In the end, errors are linked to property.
LVT: counter-cyclicality effects

LVT allows more direct links between tax revenue and the longer-range valuations of fixed capital. This offers:

1. Smoother and deeper-lagged tax profile, implying lower forecasting errors;
2. Eliminating receipts dependency on transactions volume;
3. Eliminating the Scheinkman effect of transactions taxes on ‘sticky’ capital goods;
4. Eliminating the adverse effects of real-exchange-rate instability arising from habitual ‘capital & consumption’ type of goods (housing);
5. Permits cycle-smoothing for regular cycles and reduces the adverse impact of systemic crises.
Receipts Structure and LVT: summary

LVT effects on Fiscal Policy side:

- Smoothing of cycles
- Direct links between tax revenue and the LR fixed capital valuations
- Alignment of microeconomic incentives (efficiency of land utilization, Scheinkman effect on resale markets, etc)
- Delivery of macroeconomic objectives (re-balancing the relationship between construction and economic activity, real-forex impact)
- Fiscal stabilization (predictability, orthogonality to transactions markets)

Is this a ‘silver bullet’? No. But it is a good way to:

1. Impose fiscal discipline on spending (longer-range planning and policy stability) - in line with OECD 2008 review of Ireland; and
2. Increase efficiency of the markets for construction, development, housing and long-term savings

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Longer term effects of LVT: Infrastructure and Public Investment

LVT has long term economic implications in terms of stimulating infrastructure investment and aligning receipts with actual private gains due to public investment.

In the second paper, we looked at all internationally available policies used for raising revenue to finance public investment:

• land value taxes (LVT),
• property taxes (PT),
• tax increment financing (TIF),
• special assessments (SA),
• utility fees (UF),
• development impact fees (DIF), such as Development Levies (Section 48 and 49 of the 2000 Planning Act),
• joint development (JD), and air rights (AR).

We distinguished several stages of public investment –

• Pre-planning announcement;
• Planning;
• Financing;
• Implementation; and
• O&M.
Assessment framework: Dynamic Value Capture

We analysed the economic, social and political efficiency) of each policy within each of the following criteria:

**Value creation:** Timing of value accretion to the private beneficiaries (Can a specific policy capture private gains arising from early stages of public investment?)

**Value capture:** Can policy instrument provide upfront investment financing for the projects, reducing the risk on the Exchequer of financing large capex? Can policy instrument provide ongoing funding for O&M post-investment?

Overall impact of each instrument on enforcement and supervision costs and timing of revenue collection.

**Risk transfers** implied by application of each instrument
Assessment framework: 
Socio-economic questions we asked explicitly

To formally evaluate all considered alternative means for raising public investment funding we used the following main criteria:

1. Is the **cost paid** by the contributors linked to the **benefits** they receive?
2. What economic/investment **incentives** does this alternative present to the payee?
3. What overall impact on **economic development** can the system be expected to have?
4. Is the system **fair/transparency** from the point of view of contributors?
5. Are there issues of **social or inter-generational equity**?
6. Can the system address **ability-to-pay** constraints? Is it **regressive or progressive**?
7. Is the system **revenue base** broad or narrow? Is the system capable of supplying adequate revenue streams without imposing a **punitive** level of taxation?
8. Does revenue stream follow closely income growth stream (cyclicality and general economic value capture properties)? Is revenue **volatility** higher or lower than income volatility?
9. Can revenue be **scaled** to reflect increases in demand (one-off, cyclical or structural)
10. Can this tax be **avoided** internally or by **exporting** tax base to lower tax jurisdiction? What is the **cost of collecting** this tax and the cost of **compliance** with the tax?
### Table A: Summary of results for Criteria 1-3 rankings

<table>
<thead>
<tr>
<th>Criteria</th>
<th>1.1: Capture timing</th>
<th>1.2: Loops capture</th>
<th>2.1: Upfront investment</th>
<th>2.2: Post-investment recovery</th>
<th>2.3: Basic Features</th>
<th>3.1: Risk transfers</th>
<th>Total Score for Criteria 2-3</th>
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<tbody>
<tr>
<td>Land Value Tax (SVT/LVT)</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>10</td>
<td>10</td>
<td>7</td>
<td>51</td>
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<td>8</td>
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<tr>
<td>Joint Developed and Air Rights (JD &amp; AR)</td>
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<td>6</td>
<td>4</td>
<td>10</td>
<td>5</td>
<td>35</td>
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Ranked 0-10, with 10 being most efficient alternative and 0 being least efficient
Table A (continued): Summary of results for Criteria 4 rankings and overall rankings

<table>
<thead>
<tr>
<th>Criteria 4.1: Economic Efficiency</th>
<th>Criteria 4.2: Equity</th>
<th>Criteria 4.3: Revenue Sustainability</th>
<th>Criteria 1-3 cumulative scores</th>
<th>Overall ranking scores</th>
<th>Overall Rank of policy (1 being the best suited for Public Investment Financing)</th>
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<tbody>
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<td>2</td>
<td>35</td>
<td>51</td>
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</tbody>
</table>

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Fiscal and Investment sides of LVT: summary

1. LVT reduces distortionary incentives for development and land speculation;
2. Helps to reduce asset price bubbles;
3. Reduces linkages between long term public expenditure financing and the property prices and transactions volumes;
4. Improves predictability of the Exchequer revenue and alleviates pro-cyclicality of revenue;
5. Allows to price public infrastructure and social amenities investments;
6. Allows to place the true burden of public investment financing onto the shoulders of those who receive private benefits of such investment;
7. Helps to deliver more environmentally sustainable and socially equitable development;
8. Improves liquidity of property holdings for the elderly;
9. Increases life-cycle returns to investments in education, business and health;
10. Increases relative returns on more efficient use of land and buildings;
11. Promotes long term savings and pensions provisions and reduces risk of pensions default.

Thank you