SCOTTISH LAND COMMISSION
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The housing land market in Scotland: A discussion paper

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LAND LINES
A series of independent discussion papers on land reform issues

Background to the ‘Land Lines’ discussion papers

The Scottish Land Commission has commissioned a series of independent discussion papers on key land reform issues. These papers are intended to stimulate public debate and to inform the Commission’s longer term research priorities. The opinions expressed in the papers are those of the author and do not necessarily reflect those of the Commission.

This, the first paper in the series, is looking at how the public sector could intervene to improve the operation of the land market and increase the supply of land for new housing.

About the Author

Laurie Macfarlane is an economist and writer based in Edinburgh. He is currently Economics Editor at openDemocracy, and an Associate Fellow at the Institute for Innovation and Public Purpose at University College London. Prior to this Laurie was Senior Economist at the New Economics Foundation, the UK’s leading think tank promoting social, economic and environmental justice. He is the co-author of the critically acclaimed book ‘Rethinking the Economics of Land and Housing’, and he has written extensively on issues of land, housing, financial reform and inequality.

Summary

Keywords

Land; housing; development; policy; taxation; inequality.

Background

The failure of housing supply in Scotland to keep up with demand has been the subject of intense public discussion for several years. Many commentators are now openly talking of a “housing crisis”, and this has profound socio-economic implications in both urban and rural areas and has the potential to act as a constraint on long-term economic growth. With the price of land accounting for a substantial and growing proportion of the cost of a new home it is clear that land economics is at the heart of this crisis. In order to address this many commentators now recognise a clear need for the public sector to intervene in order to improve the operation of the land market.

This paper provides an overview of how the market for housing land currently operates in Scotland, and identifies the various types of ways in which the public sector could seek to intervene in the land market in order to increase supply.

Main findings

- House prices have risen dramatically in Scotland in recent decades, far outpacing growth in incomes. The driving force behind rising house prices has been increasing land prices.
- The way the land market operates depends largely on the laws, institutions and political history of particular nations, and so varies widely. In Scotland, the key characteristics are a reliance on the private sector operating on a speculative model to deliver new house building; a legal framework that allocates the uplift in the value of land resulting from planning permission to landowners rather than public authorities; a liberalised mortgage credit market; a taxation system that is highly favourable to land and property; and a paucity of publicly available information on land values and ownership.
- This system has resulted in an under-supply of housing and escalating housing costs, which in turn has undermined living standards, exacerbated economic inequality, and stifled productivity growth and output.
- Policy options to improve the supply of land for housing include public land value capture, compulsory sale orders, a new housing land development agency, tax reform, and greater market transparency.
- Intervening in the land market would have a number of long-term economic benefits including a more productive and dynamic economy; a fairer and more inclusive society; improved living standards; and healthier public finances.

Contents

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1. INTRODUCTION

Scotland is in the grip of a housing crisis. For many years living standards have been squeezed as housing costs have risen faster than incomes. Levels of homeownership have been falling for a decade – particularly among young people. There are nearly 150,000 people on the waiting lists for social housing, while the government spends nearly £2 billion a year helping those who cannot afford to pay their rent.

How did we get here? A common explanation is that housing supply has failed to keep up with demand. However, this is more accurately a symptom of the problem – to get to grips with Scotland's housing crisis, policymakers need to tackle the root causes. The housing market is complex and multifaceted, but at the root of the problem lies a dysfunctional land market. Land is the primary input into house building, but the unique features of the land market are often poorly understood.

Without bold action, the pressures of population growth and demographic changes will only add to Scotland's housing problems. But the consequences go far eyond a housing shortage: issues such as deepening inequality, social exclusion, intergenerational divides and an underperforming economy can all be linked to a dysfunctional land market. Fixing the land market is therefore essential not only for tackling the housing crisis, but also for creating a fairer, more efficient and more sustainable economy.

This rest of this paper is structured as follows:

Section 2
Provides a brief overview of how the market for housing land currently operates in Scotland, and how this has effected house prices;

Section 3
Examines the symptoms of a dysfunctional land market and makes the case for reform;

Section 4
Identifies the various types of ways in which the public sector could seek to intervene in the land market in order to increase supply, drawing on examples from elsewhere in the world; and

Section 5
Concludes with a discussion on the long-term economic effects that could be expected if interventions of this type were to be implemented in Scotland.

In considering the paper readers are particularly invited to reflect on the following key questions:

1. What are the key factors that have prevented housing supply in Scotland from keeping up with demand? Are the issues outlined in section two the most important ones or are there any other major factors that have contributed to the problem?

2. What are the socio-economic effects associated with the current operation of the housing land market? Are the issues identified in section three the most relevant or is the housing land market contributing to other socio-economic problems in Scotland?

3. How could the public sector intervene to improve the operation of the housing land market? Are the options identified in section four appropriate or are there other approaches that should be considered? Are there any relevant international examples?

4. Are there any economic risks might arise from intervening in the land market in the ways outlined in section four?

2. THE HOUSING LAND MARKET IN SCOTLAND

In recent decades house prices in Scotland have increased dramatically, far outpacing growth in incomes. Figure 1 *(below)* shows an index of how nominal house prices have changed since 1971 in Scotland compared with the UK and four other major advanced economies.

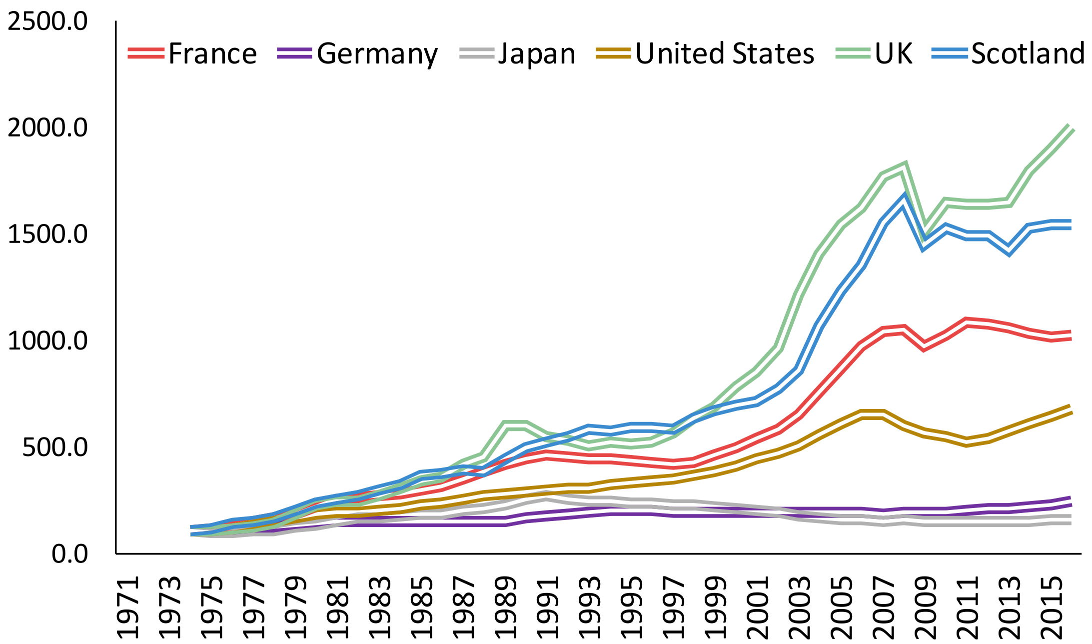

Figure 1. Nominal house prices (Index, 1971 = 100)
Source: OECD (n.d.), Nationwide (n.d.)

It is clear that rapid house price inflation has not been an inherent feature of advanced economies. So why have house prices risen so rapidly in Scotland and the rest of the UK?

The price of a property is made up of two distinct components: the price of the building itself, and the price of the land that the structure is built upon. Figure 2 *(page 4)* shows how the value of these two components have evolved in the UK since 1995 (data for Scotland alone is not available). The value of land has increased dramatically, from just under £1 trillion in 1995 to £5 trillion today.

The driving force behind rising house prices has therefore not been increasing building costs, but increasing land prices. This is consistent with international evidence that suggests that house price volatility is primarily driven by land values (Knoll et al., 2014, p. 31). While average figures disguise significant regional variations, the trajectory of house prices has been upwards for many decades across both urban and rural Scotland.

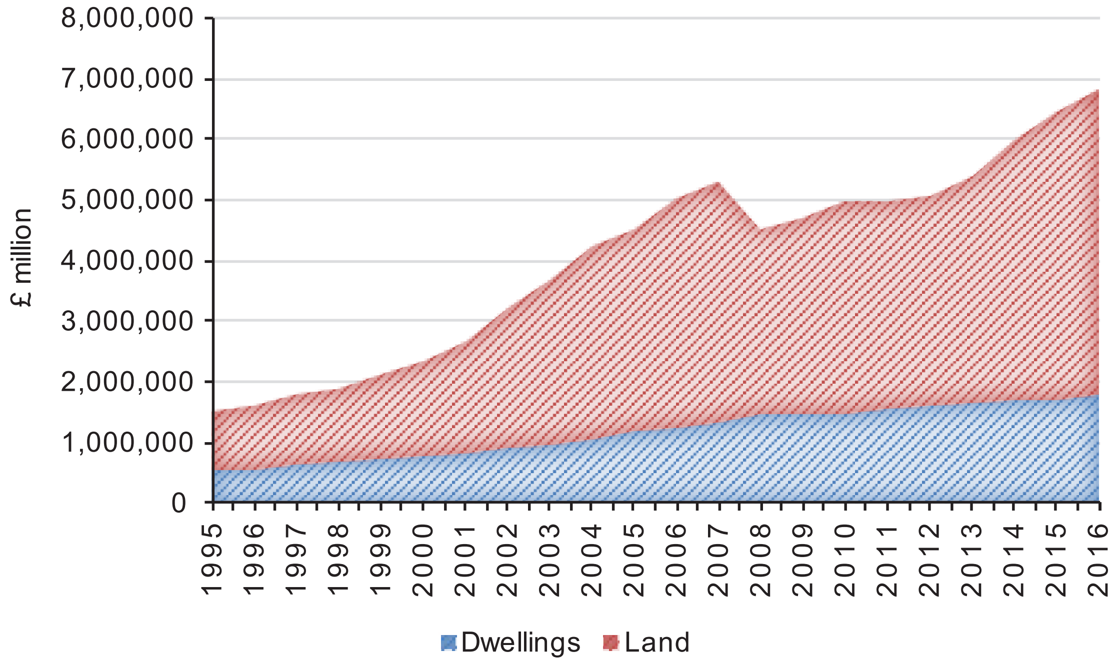

Figure 2. Value of dwellings (excluding land) and the value of land in the UK
Source: Office for National Statistics (2017)

The key to understanding why house prices have risen so much in recent decades therefore lies in the land market. Often land is thought of as simply another commodity that can be owned, bought and sold much like any other. However, land is not just another good or service. Land's unique properties – scarcity, permanence, irreproducibility, immobility – mean that the land market does not function particularly well and is replete with failures (Balchin et al., 1988). The supply of land cannot easily be increased or expanded to meet greater demand, and market price signals cannot always be relied on to efficiently guide decisions over what land should be used for (Cheshire, 2013). Even the most market-orientated states implicitly recognise this, and impose non-market regulatory controls on land use.

The way the land market operates depends largely on the laws, institutions and political history of particular nations, and so varies widely. In Scotland, the housing land market has evolved over time. Today it is characterised by a number of distinct features.

2.1 Housing development and the land market

Throughout much of the twentieth century the state played an active role in housing supply through large scale house building programmes. Combined with the ability to purchase land at low cost, this proved to be an effective means of keeping supply up and house prices under control. However, in the late 1970s the state began to withdraw from housing supply, and councils were forced to sell their housing stock under the government's 'Right to Buy' policy. Since then, the decline in state house building has only partially been offset by private sector house building. The rate of new house building has never returned to the levels witnessed when the state played a more active role.

In the ten years leading up to the financial crisis, an average of more than 23,000 new houses were completed each year. At the time, this was widely recognised to be insufficient: in 2007, the Scottish Government stated that housing supply needed to increase to 35,000 new houses per year in order to reverse declining affordability (Scottish Government, 2007).

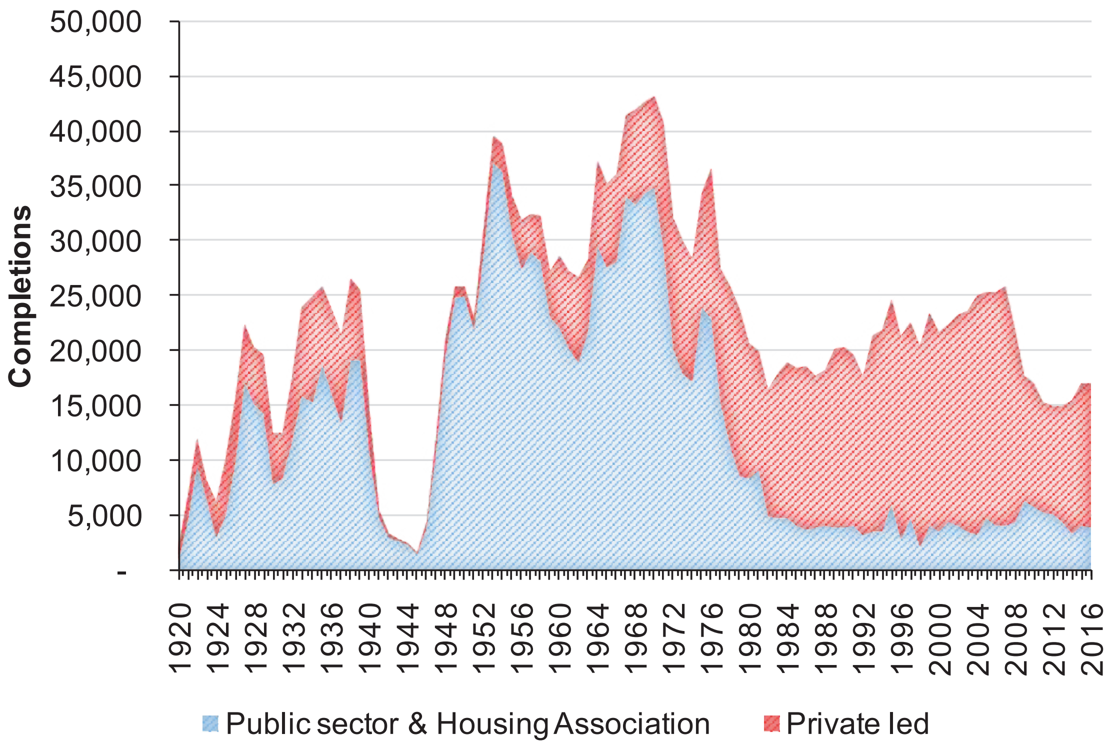

Figure 3. New house building in Scotland
Scottish Government (2017a)

Since 2008 new house building has averaged around 17,000 per year – a significant drop on pre-crisis trends. In 2015, the independent Commission on Housing and Wellbeing recently recommended that the Scottish Government should adopt a national target for new house building of 23,000 new houses per year in order to address current shortages and meet future demand. (Commission on Housing and Wellbeing, 2015).

But despite widespread consensus that we need to build more homes, the private sector has not responded by increasing supply. Often this is attributed to a failure of the planning system, which is widely accused of being overly restrictive. While ongoing reform of the planning system is necessary in Scotland, the focus on planning tends to overlook other more significant factors which would continue to constrain house building even if the planning system were to release more land for development.

The foremost of these is the development process itself, and the reliance on the speculative model of house building to build new homes. The speculative, or 'current trader' model of house building is a cyclical process of raising finance, buying land, securing planning permission, constructing the homes and finally selling them (Callcutt, 2007). The developer is said to be acting speculatively, because they are not building for a known purchaser or at a known price, but with the intention of selling on the open market to whomever is prepared to pay the most. Several important features of the British housing system are the product of this model.

Because development is risky, uncertain and requires a lot of capital, developers prioritise strategies that can reduce their risk, such as buying land allocated for housing by the planning system, holding strategic land banks, financing each scheme separately, and seeking to dominate localised new-build markets to reduce competition.

Because land acquisition is usually the largest single cost, and often the first one to be incurred, the price that the developer pays for the land determines much of what happens later in the process. In a competitive market, the developer that makes the most bullish expectations of sales prices, and/or projects the lowest costs, will typically be able to offer the landowner the most and secure the site. A residual valuation methodology is typically employed to arrive at an offer price, which involves estimating the final sales value that the developer expects to get from the new homes, and then subtracting all of the costs expected to be incurred in building them, to leave a residual amount. The price offered by the developer for the land must come from this residual value.

Once land has been secured, developers cannot risk undermining prices in a local market by releasing too many homes at once. To do so would risk lowering the value of the land that the developer has already invested in. This in turn would erode the developer's profit, and if profits fall too far the scheme may be deemed 'non-viable' which would see construction halted. In the worst-case scenario, a developer may go bust. This business model makes it inherently difficult for developers to deliver a step change in the number of homes being built, because it relies on land prices remaining high which, in turn, incentivises the slow release of new homes.

This system also means that the development process is highly cyclical: when house prices fall, developers suspend land acquisition and cut build-out rates swiftly to reduce expenditure and avoid selling into a falling market. When house prices are rising, developers must compete to secure suitable land, driving greater volatility in land prices.

The primary beneficiaries of this system are not developers, who expose themselves to considerable risk, but landowners who benefit from escalating land prices and who face little incentive to release land onto the market quickly.

2.2 Land acquisition and compensation

In modern economies, especially in urban environments, the value of a piece of land depends on what can legally be built on it, and the infrastructure and amenities in the surrounding area. The granting of planning permission typically brings about a large increase in the value of the land as does new transport links and other infrastructure. Capturing this large increase is often referred to as “planning gain”.

The question of who captures the benefit from rising land values, and how this is used, has been at the centre of land reform debate for centuries. In many countries, the planning system or compulsory purchase laws enable the uplift generated by planning and collective development to be captured by the state. This was also historically the case in the UK.

However, the 1959 Town and Country Planning (Scotland) Act reinstated the principle that landowners are entitled to ‘hope value’ on any land compulsorily purchased. In practice, this means that where public authorities wish to purchase land for development, landowners are compensated not on the basis of what the land is actually worth at the time, but on the basis of what it one day might be worth if it ever got residential planning permission. Because the difference between existing use value and hope value is usually dramatic, these changes significantly increased the cost of land for development, and ended the ability of public authorities to deliver cheap land for new housing. In other words, the changes meant that the benefits from rising land values would flow to landowners rather than the general public.

Planning authorities are able to capture a small amount of the uplift through negotiated legal agreements called Section 75 (S75) agreements. S75 agreements place obligations on developers to ensure that part of the planning gain goes towards benefiting local communities, for example through affordable housing or leisure facilities. However, the value of Section 75 contributions tends to be relatively small compared with the total land value uplift. For example, the Centre for Progressive Capitalism estimates that S75 contributions in the Edinburgh City Region amounted to £32 million in 2015-16, while the total land value uplift amounted to £350 million (Centre for Progressive Capitalism, 2017).

2.3 Mortgage credit market

In addition to supply-side factors, the housing land market is also shaped by the demand for housing. Multiple factors meant that demand for housing in Scotland, particularly since the mid-1990s, has grown far faster than supply. These include growing incomes, a growing population and changes in household formation (e.g. more people choosing to live alone – see Scottish Government, 2010).

But demand for housing is not limited only by people's incomes or savings. The majority of land and property in Scotland is bought using credit, usually in the form of a mortgage. Thus, the demand for housing is to a great extent determined by the ability and willingness of financial institutions to create and extend credit. As a result, regulatory constraints on the practice of lending against property assets have a key impact on the land market and the macroeconomy more generally (Aron et al., 2012). In Scotland, as in the rest of the UK, these regulations have changed significantly in recent decades.

For the majority of the twentieth century, mortgage lending was limited to building societies which operated a conservative lending model. However, beginning in the early 1970s a steady stream of financial deregulation eased credit supply conditions and incentivised banks to become active players in the mortgage lending market[1]. This was further assisted by a gradual lowering of interest rates from the early 1990s, which reduced the cost of credit. The result was a major shift in the role that retail banks play in the economy, from mainly lending to businesses for productive investment, to primarily lending to households for home purchase, taking land as collateral (Jorda et al, 2016).

As a result of these changes, the amount of credit flowing into the housing market increased considerably. In the UK, the stock of mortgage lending increased from 20% of GDP in the early 1980s to over 70% before the financial crisis (Ryan-Collins et al, 2017). Figure 4 *(page 9)* shows the value of new mortgage loans made each year in Scotland between 1974 and 2016.

[1]For a full account of the deregulation of the banking sector see Ryan-Collins et al. (2012, pp. 48–52)

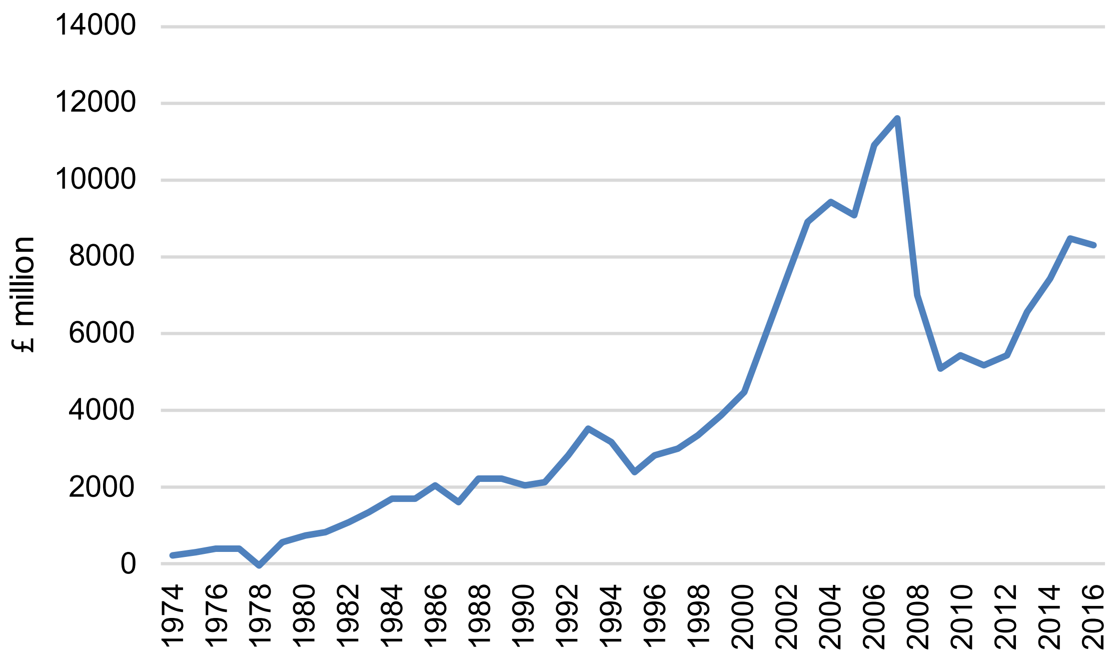

Figure 4. New mortgage loans in Scotland
(first time buyers and home movers)
Source: UK Finance (n.d)

A major driving force in house price increases in the last thirty years has thus been a relatively elastic supply of credit meeting a fixed supply of land. As former Chair of the Financial Services Authority Adair Turner (2015, p. 71) has argued: “Lending against real estate generates self-reinforcing cycles of credit supply, credit demand and asset prices.” Similarly, Muellbauer and Williams (2011) describe credit supply conditions in the mortgage market as the “elephant in the room” when it comes to understanding the behaviour of house prices and land prices in countries that have experienced high house price growth since the 1970s.

The normalisation of double digit house price growth, combined with the expectation that house prices will continually increase, helped to transform housing and land into a desirable financial asset. This demand has been further supported by government policies which have sought to subsidise the cost of home purchase such as mortgage interest relief at source (MIRAS), until it was abolished in 2000, and then subsequently via various ‘help-to-buy schemes’.

2.4 Taxation

Historically land was the primary source of taxation in Scotland, but over time there has been a shift away from the taxation of land towards flows of income and of expenditure (Mirrlees and Adam, 2011). While taxes based on land and property continue to form an important part of the tax base, a number of changes over the past half-century have led to housing being treated favourably relative to other goods and services.

In thinking about the taxation of housing, it is important to recognise that housing has two attributes that are relevant for tax design (Bell and Eiser, 2015):

1. Housing is a consumption good that provides a flow of services to occupants; and
2. Housing provides an asset for homeowners, the value of which can go up or down.

On both of these attributes, housing is treated favourably relative to other goods and services. Historically, housing consumption was taxed via the 'Schedule A' income tax – a tax on imputed rental income[2] – however this was abolished in 1963. While imputed rent from owner-occupancy is no longer subject to taxation, landlords' rental income is still subject to income tax. The tax-exempt status of imputed rental income makes it more attractive to receive income in this form than in other forms, which has the effect of distorting investment decisions, attracting more capital into the housing market (Callan, 1992).

Today the council tax operates as a recurring tax on property, however it is a highly ineffective property tax since the tax is based on what the estimated value of the property was on 1 April 1991 and therefore bears little resemblance to current market values.

When capital gains tax was introduced in 1965 an exemption was made for primary residencies. This tax exemption means that, relative to people who choose to invest in other assets, those who treat their home as an investment will benefit when selling that home. This is particularly relevant in Scotland where real house prices have risen considerably, with owners enjoying windfall gains that have gone untaxed.

Recently changes to inheritance tax have further enhanced the tax treatment of housing compared with other assets. In the 2015 summer budget the Chancellor of the Exchequer announced a new transferable main residence allowance that effectively raises the tax-free allowance from £325,000 to £500,000 per person for estates that include a house, and to £1 million for married couples.

[2]Imputed rent is the 'in kind' income that homeowners receive from their property, and is calculated as the rent that would be paid for a similar property in the private rented sector. The concept of imputed rent rests on the idea that owner-occupiers benefit from housing services they would otherwise have to pay for by renting a property.

Significantly, under the current taxation system in Scotland there are no taxes which discourage passive land owners from retaining vacant or derelict land. This has meant that, in an environment of rapidly rising land values, it can be profitable to acquire land and hold onto it rather than develop it.

There is evidence that the UK's favourable tax treatment of homeownership is linked to its comparatively high house price volatility, and creates significant distributional advantages to homeowners who benefit from rising real values compared with those who rent (Oxley and Haffner, 2010).

2.5 Market transparency

To date the land reform process in Scotland has put emphasis on improving the transparency of land ownership in Scotland. Scottish Ministers have announced the target to complete the Land Register of Scotland within 10 years, and within 5 for public sector land.

However, to understand the dynamics of the land market it is also important to have information on the value of land across Scotland. To date there remains a near total absence of publicly available data on land values, both in aggregate and at a granular level across different locations in Scotland. Despite a plethora of generalised indices of house prices, the only official index of land prices compiled and maintained by the Valuation Office Agency was discontinued in 2011[3]. This paucity of market information on land values creates significant inefficiencies and restricts the ability of policymakers, market participants and researches to undertake informed analysis about the land market and its wider economic significance.

3. THE NEED FOR REFORM

In summary, the market for housing land in Scotland can be characterised by the following key features:

- a reliance on the private sector operating on a speculative model to deliver new house building;
- a legal framework that allocates the uplift in the value of land resulting from planning permission to landowners, rather than public authorities;
- a liberalised mortgage credit market;
- a taxation system that is highly favourable to land and property; and
- a paucity of publicly available information on land values and ownership.

This system, which has led to rapid house price inflation, has contributed to a number of socio-economic problems.

[3]Estimated land values were included in the Valuation Office Agency's 'Property Market Report' which was discontinued in 2011.

3.1 Housing affordability

Between 1995 and 2015 the share of income spent on housing costs in Scotland increased by 50%, from 12% to 18%. This was the second sharpest increase of any UK region outside London. The effect of this on disposable incomes has been equivalent to a 13p increase in the basic rate of income tax (Resolution Foundation, 2016). High housing costs have therefore acted as a constraint on living standards, reducing the amount of money that people have to spend on other goods and services. The UK Government currently spends nearly £2 billion a year on housing benefit to help people afford their rent, and there are currently 143,100 applicants on the waiting lists for social housing (Scottish Government, n.d.).

The gap between poverty measures before and after housing costs has also widened in recent years, reflecting the cumulative impact of increases in housing costs. In 2015-16, housing costs were responsible for pushing an extra 160,000 people into absolute poverty (Scottish Government, 2017b). The impact of housing on child poverty is particularly significant. As Figure 5 *(below)* shows, child poverty was largely unaffected by housing costs in the late 1990s, but since then there has been a growing divergence between the two measures, indicating that housing costs have become a growing burden.

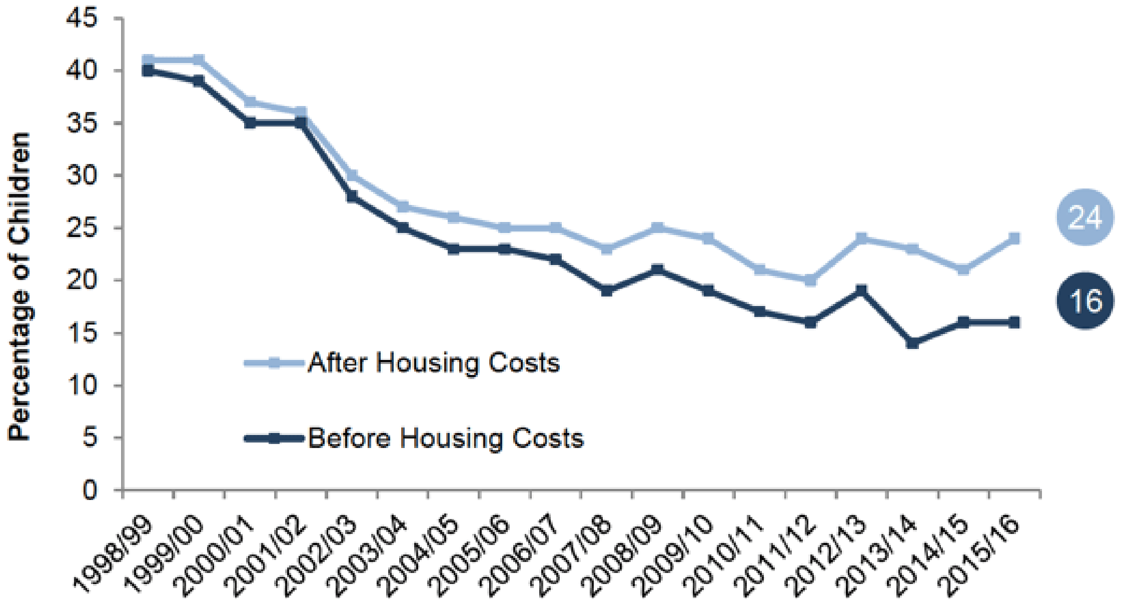

Figure 5. Percentage of children in Scotland in absolute poverty.
Source: Scottish Government (2017b)

3.2 Tenure patterns

Rising housing costs have had a significant impact on patterns of housing tenure. Following the surge in homeownership in the second half of the twentieth century, the number of people who own their homes has been declining for the past decade.

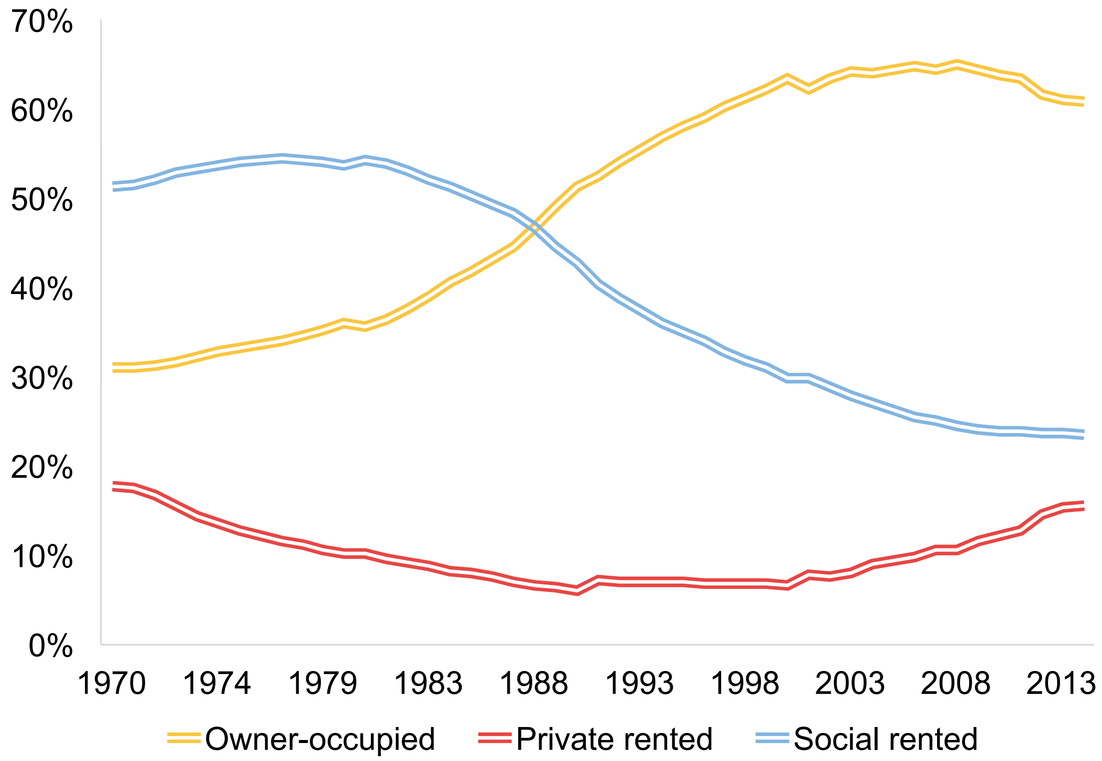

Figure 6. Tenure.
Source: Scottish Government (2017a)

As house prices have continued to increase and the gap between house prices and earnings has grown larger, the cost of homeownership has become increasingly prohibitive. Although easier access to mortgage credit and Right to Buy discounts covered this widening gap for a while, eventually the stoking of demand started to have a negative effect as rising house prices rendered homeownership increasingly unaffordable for much of the population.

Despite new subsidy schemes aimed at aspiring homebuyers, both middle earning and poorer households have increasingly found themselves with little choice but to rent privately, producing a dramatic shift in the tenure pattern. These dynamics have been particularly pronounced among those in the 16–34 age group, where between 1999 and 2016 levels of homeownership fell from 53% to 36%, and private renting increased from 13% to 40% (Scottish Government, 2017c).

A shift away from homeownership towards private renting is not necessarily a bad thing. The examples of Germany and Switzerland, which both have homeownership levels well below 50%, demonstrate that high levels of homeownership are not a prerequisite for a prosperous society. However, both Germany and Switzerland have well regulated, secure private rental and significant cooperative housing sectors. But in Scotland, there remains a significant gap between the private rented market and homeownership in terms of both price and quality. In 2014-15, housing costs amounted to 25% of household income for private renters, compared to 9% for mortgaged homeowners (Scottish Government household income, 2017d). In the absence of a wider policy to level the playing field between tenures and create a more affordable and secure private rental market, the rapid increase in private renting can be seen as a symptom of a dysfunctional market.

3.3 Vacant and derelict land

In 2016 there was over 2,000 hectares of vacant urban land, and over 10,000 hectares of derelict land in Scotland. Much of this land has remained in the same state for decades.

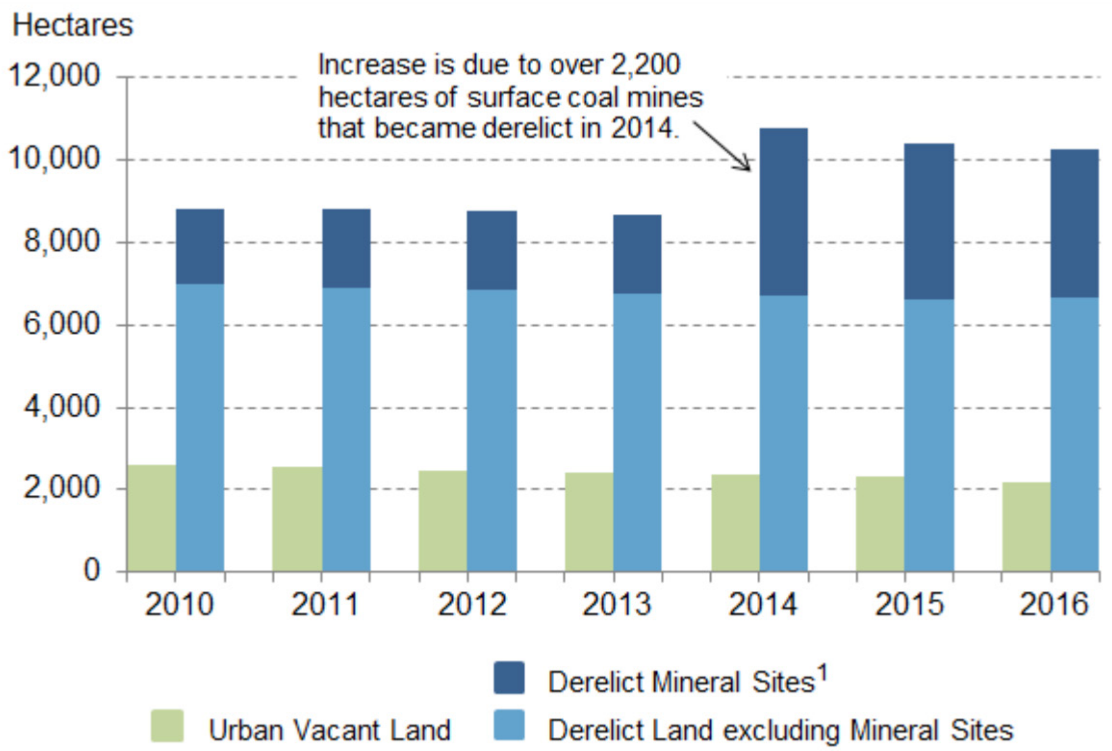

Figure 7. Total Derelict and Urban Vacant Land, 2010-2016
Source: Scottish Government (2016)

Urban vacancy and dereliction in Scotland is now primarily a matter of private not public land ownership, with more than twice as much vacant and derelict land held by known single private-sector owners than known single public-sector owners (Adams, 2015a). This is clearly not in the public interest. There is little justification for having large amounts of land lying vacant or derelict in urban areas, particularly when land for housing is in short supply. The prevalence of vacant and derelict land is a clear symptom that the land market is not working efficiently. As Adams (2015b) writes:

"Since keeping land vacant incurs no taxation and relatively few holding costs, many landowners are under no pressure to sell, and are quite prepared to wait until that tempting offer finally arrives, even if it never does."

3.4 Inequality

In 2012/14 total property wealth in Scotland was £238 billion (Scottish Government, 2017e). This has increased dramatically in recent decades as a result of significant house price inflation, driven by rising land values. But this property wealth is distributed very unevenly across the population. Figure 8 *(below)* shows the distribution of total net property wealth across all households by decile. Those in the first three deciles of households have zero or negative wealth, whereas the property wealth of the top 10% of households is nearly eight times greater than the wealth of the bottom half of all households combined (Scottish Government, 2017e).

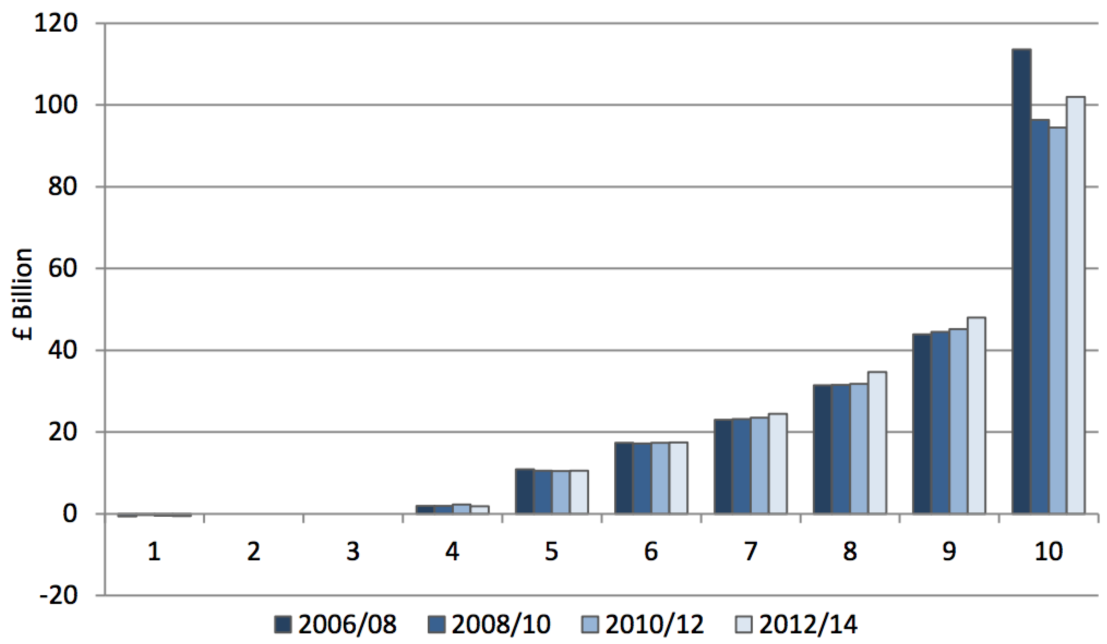

Figure 8. Value of household net property wealth by decile 2006/08 – 2012/14
Source: Scottish Government (2017e)

For those who own property, rising land values have generated an untaxed windfall which has increased net wealth. This has provided significant benefits, not just to the wealthiest households but also to a growing middle class who managed to get a foot on the property ladder. For example, some homeowners used housing equity to leverage up further and buy a second property, or enter the Buy to Let market. Others have converted housing equity into cash via home equity release. In the third quarter of 2017, over 55s across the UK withdrew a total of £824m of property wealth from their homes – the highest amount since records began (FT Advisor, 2017).

However, windfalls from rising land values also have a cost. When the value of land rises, the total productive capacity of the economy is unchanged or diminished because nothing new has been produced: it merely constitutes an increase in the price of the asset. While this makes individual owners wealthier, in aggregate society is no better off because those who do not own property will face higher rents in the rental market and have to save more for a deposit for a mortgage. As a result, much of the property wealth accumulated in recent decades has come at the expense of current and future generations who do not own property, and who will see more of their incomes eaten up by higher housing costs (Ryan-Collins et al, 2017, pp. 172–178).

Thus, a dysfunctional land market is contributing to a growing divide in society between those who own property, and those who do not. This division is now being further reinforced by the ‘Bank of Mum and Dad’ and the process of inheritance, as some of this wealth is passed on to parts of the next generation.

3.5 Economic growth and macroeconomic stability

Not only is Scotland’s current land market not particularly fair, it is also not particularly efficient. There is evidence that the availability of high returns from investing in existing land and property assets diverts investment from more productive areas, harming productivity growth and output. This applies to both the banking sector, which mainly channels credit into property markets rather than productive investments, as well as non-bank investors who invest in property to capitalise on rising land values (Chakraborty et al, 2016).

Economic performance has become closely intertwined with the land market. Most major boom bust cycles in the UK and abroad over the past 30 years have been associated with instability in the housing market. There is evidence that household consumption – the main contributor to economic growth – is increasingly linked to the interaction between housing wealth and credit (Muellbauer and Murphy, 2008). Consumers spend more when house prices rise, and spend less when house prices fall, meaning that volatility in house prices is transmitted into volatility in the wider economy (Aron et al., 2012, p. 410). However, an economic model based upon increasing asset-based wealth as a means of stimulating consumption is highly inefficient. Large increases in house prices are required to generate small increases in consumption. Such a model also inevitably leads to rising levels of household debt (the corollary of mortgage lending), which eventually weighs down on consumption and can lead to increased financial fragility (Kumhof et al., 2015; Perugini et al., 2015; Stockhammer, 2004).

There is also evidence that high house prices constrain people's ability to move for work. This reduced labour market mobility can impact negatively on wider economic performance and productivity (Barker, 2004).

4. OPTIONS FOR PUBLIC POLICY

The land market is of critical importance to Scotland's economy. However, it is clear that the current 'rules of the game' are fuelling a housing crisis, impairing living standards, exacerbating inequalities and stifling economic growth. How then to deal with these challenges?

Because land is intimately bound up with legal frameworks, any analysis of the land problem that starts from the premise of minimising state involvement cannot succeed. There can never be a 'free market' in land. The unique features of land mean that there is no self-correcting equilibrium in the land market, as standard economic theory would suggest.

On the other hand, there is no 'big bang' policy solution that can solve these issues, and no panacea to emulate. In this section, a number of policy options are discussed which could help to increase the supply of land for housing and overcome some of the challenges outlined in this paper. There are likely many different means of addressing the problems identified in this paper, and the proposals that follow are not intended to be a comprehensive set of policy solutions but rather some initial areas that merit further exploration.

4.1 Land value capture

As discussed in section 2.2, the question of who captures the benefit from rising land values, and how this is used, has been at the centre of land reform debate for centuries. The early classical economists such as Adam Smith and John Stuart Mill objected to the ability of landowners to make windfall gains at the expense of wider society. They considered returns earned from the ownership of land to be unjust and inefficient – referring to these windfalls as 'economic rent'.

But whatever one thinks of these moral arguments, there is strong evidence from around the world that capturing land values can be an efficient way of meeting the demand for housing and infrastructure.

In Germany, the planning law freezes the value of the land when the local municipality decides to specify an area for residential construction. The uplift in land values from the sale of housing plots then pays for the infrastructure required for the development (Centre for Progressive Capitalism, 2016). In Hong Kong, the Mass Transit Railway (MTR) has become one of the world's leading railway operators by operating what is known as the 'Railway + Property model' (R+P model). Under this model, the Mass Transit Railway Corporation (MTRC) buys land at existing use value, builds rail infrastructure and accompanying developments, and then leases the surrounding land to businesses at greatly increased values due to the presence of the railway and adjacent developments. Today it is one of the most profitable railway systems in the world, while ticket prices are low by world standards. Rather than requiring public subsidy, as is common with many railway systems, the MTR contributes significantly to the public purse (Purves, 2015).

Similar models have been used historically in the UK, which was perhaps best embodied in the New Towns programme. For each New Town, a public development corporation was established which purchased land compulsorily at agricultural prices, drew up a comprehensive masterplan for the town, and then built the necessary infrastructure using money borrowed from the Treasury. They granted planning permission on the sites they owned and sold them to private house builders, using the uplift in the value of the land to repay the loans (DCLG, 2006).

However, under the current legal framework, public authorities in Scotland are prevented from purchasing land at existing use value, meaning that the uplift in the value of land accrues to landowners. This system keeps land prices high and supply low, and is therefore a significant obstacle to achieving a step change in house building.

Reinstating the ability of public authorities to acquire land at near use value could potentially have a transformative effect on the land market. This would mean that public authorities, rather than the landowner, would capture the uplift in the value of land, unlocking significant funds for infrastructure development.

One way of doing this could be to make relatively small amendments to the 1963 Land Compensation Act so that, going forward, no account is taken of prospective planning permissions with regards to compensation for land designated for housing and infrastructure (Centre for Progressive Capitalism, 2016). Although this relates to compulsory purchase orders (CPOs), in reality it is likely that few CPOs would ever need to be issued. Evidence from the UK's own past, and from equivalent countries, shows that the very existence of strong compulsory purchase powers can be enough to shift the balance of incentives in the operation of the land market. In the knowledge that the land could be purchased by the state at near use value, landowners would be incentivised to part with land at a low but fair price. This could have the powerful dual effect of increasing the supply of land and lowering the market price by eliminating landowners' ability to profit from 'hope value'.

The Centre for Progressive Capitalism estimates these changes could unlock an additional £8.6bn to finance infrastructure in Edinburgh alone over the next 20 years (Centre for Progressive Capitalism, 2017).

4.2 Compulsory sale order

Keeping urban land vacant and derelict for long periods of time does not appear to be in the public interest, therefore using public policy to bring these sites back into use would seem justified. While CPO powers could be applied to bring vacant and derelict land into use, compulsory sale orders (CSOs) may offer a more efficient means of doing so (Adams, 2015b).

Introducing CSOs would give local authorities the authority to sell land which has been vacant or derelict for a defined period via public auction. As with CPOs, it is likely that few CSOs would ever need to be issued – their mere existence would act as a powerful way to shift the balance of incentives among owners of vacant and derelict land who would face a 'use it or lose it' dilemma. However, unlike CPOs, CSOs would not require up-front public investment – the public authorities would manage the auction process but would not take ownership of the land. Thus, CSOs could offer a low cost and efficient way to release vacant and derelict land back into the market.

New CSO powers were recommended by the Land Reform Review Group in its final report, however the Scottish Government has yet to bring forward legislation to act on this recommendation (Land Reform Review Group, 2014).

4.3 Housing land development agency

Even with measures to lower the price and increase the supply of land for housing, it is unlikely that the private sector alone can deliver the new homes that Scotland needs. Evidence from around the world, including from the UK's own history, indicates that success in housing requires a more proactive role for the state in the land market.

This could take different forms, but one option would be to create a new public body tasked with making sure that enough land is available for new housing. A new 'housing land development agency' could be given the power to purchase, develop and sell land, and potentially also to develop new towns. When combined with reforms to compulsory purchase laws outline in section 4.1, a new body of this type could, if implemented effectively, be a powerful way to make the market work more efficiently. With the ability to purchase land at low cost, it could also offer a more efficient and transparent way to capture value uplift than relying on S75 agreements. It could also play a strategic role ensuring that land is owned and used in the public interest. Similar institutions play important roles in other countries. In South Korea, around half of all residential land development and almost all industrial land development is carried out by the Korean Land Corporation (KLC). Since being formed in 1975, the KLC has played a key role in transforming the economy of South Korea by efficiently managing land and promoting economic development (Kaganova, 2011).

This has helped ensure that land and housing have remained affordable in South Korea – between 1995 and 2013 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 the UK's shot up from 100 to 167.7 (Muellbauer, 2014). In the UK, the New Towns Development Corporations played a similar role in the past, as noted in section 4.1.

In recent years, the idea to establish a new public body of this type been recommended by the Land Reform Review Group, the RICS Scotland Housing Commission and the independent Commission on Housing and Wellbeing.

The function could be taken on by an existing institution, or be allocated to a new body. Any new entity would likely need borrowing powers, and would also need to be sufficiently well resourced. An area for further exploration is whether such a function could be taken on by an arm of the soon to be established Scottish National Investment Bank, announced by the First Minister in the 2017-18 Programme for Government (Scottish Government, 2017f).

4.4 Taxation

The options discussed so far have focused on the market for the supply of new houses. However, what happens in the second-hand housing market is also important for development, because the price of land for development is based on the ultimate sales value of the homes that can be built on it (see the residual valuation methodology outlined in section 2.1). This means that, unlike other markets, the price of new housing is largely determined by prices in the second-hand market. Where there is significant house price inflation in the second-hand market, this feeds back into higher development costs for the supply of new houses (in the form of higher land costs). Similarly, any new measures which help to stabilise or reduce prices in the second-hand market will feed back into lower development costs.

As outlined in section 2.4, the current taxation system is skewed in favour of land and housing, which has contributed towards house price volatility and growing demand for housing as a financial asset. It also means that landowners are not incentivised to put their land to productive use. Taxation can therefore be a powerful tool to help stabilise house prices and incentivise the efficient use of land. Here, a range of options can be considered.

One approach would be to retain the existing suite of taxes but remove the various exemptions that place housing and land at an advantage relative to other goods and services. In practice, this would mean revaluating the council tax bands, bringing vacant and derelict land into the non-domestic rates regime, abolishing the capital gains relief on primary residences and unwinding the transferable main residence allowance for inheritance tax. Taken together, these measures would likely help to stabilise house prices and incentivise the efficient use of land.

Another option would be to undertake more fundamental reform of the tax system by shifting some of the tax base onto land. Economists have long recognised that a tax on the market value of unimproved land is the most economically efficient way of raising taxes (Mirrlees and Adam, 2011, p. 371). Being fixed in supply, taxing land does not distort economic activity in the same way that taxing other goods and services does. By attaching a cost to owning land, a land value tax (LVT) would diminish the incentive to buy land and property for speculative purposes rather than productive purposes, and a good part of any increase in land values would be shared with the public purse. LVT also has a strong moral basis: capturing the unearned windfalls from collective development for the state and wider community. Additionally, since land cannot be hidden or moved to a tax haven, land value taxation is difficult to avoid or evade.

But despite the compelling economic case for land value taxation, the policy has struggled to gain political traction in the UK and many other advanced economies. Among OECD countries, only three countries feature a pure land tax: Australia, Denmark and Estonia.

This is partly due to perceived challenges around practical implementation: LVT requires land values to be assessed fairly and accurately on a regular basis; property taxes generally tend to be politically unpopular because of their visibility or 'salience'; land-rich but cash-poor people may struggle to afford the tax; and introducing the tax overnight could create significant winners and losers and pose risks to financial stability.

However, there are steps that could be taken to alleviate some of these concerns. For example, LVT could be introduced as a replacement for other taxes such as council tax and non-domestic rates, thereby offsetting the burden on households, and phasing it in gradually over an extended period of time would minimise the risk of creating overnight winners and losers. Cash poor owners of valuable land could be allowed to delay payment until they die or at the point of sale, or they could give up a percentage of their equity in the property each year, enabling the community to gain from any capital appreciation (Mayhew and Smith, 2016).

A variant of LVT is a system of split rate taxation where separate taxes are levied on the value of the land and the value of the physical property, and are usually taxed at different rates. The idea behind split rate taxation is that by enabling taxes on land to be higher than on buildings, new development is encouraged while speculation and hoarding of land is penalised. Split rate taxation can be seen as a compromise between pure land value taxation and an ordinary property tax falling on land value plus buildings.

4.5 Data and transparency

The land market is one of the most important and consequential markets in Scotland's economy. As well as playing a key macroeconomic role, understanding the land market is crucial for assessing important policy questions, from the efficiency of tax reform to the economics of housing development. However, there is currently no reliable public dataset on land values in Scotland.

There would therefore appear to be a strong case for assessing, collecting and publishing granular data on land values and land market activity in Scotland on a regular basis. This would provide market participants, researchers, academics and policy makers with greater transparency and information, which in turn would facilitate more informed decisions.

5. CONCLUSION

This paper has identified a dysfunctional land market as lying at the root of Scotland's housing crisis, which in turn has undermined living standards, exacerbated economic inequality and stifled productivity growth and output. As well has helping to meet Scotland's housing needs, addressing the issues outlined in this paper would also generate a number of long-term benefits for Scotland's economy:

- A more productive and dynamic economy: Reducing the ability to make windfall gains from rising land prices would shift investment patterns away from existing property and towards productive assets – stimulating growth and productivity. It will also help to dampen boom bust cycles in the property market.
- A fairer and more inclusive society: Escalating land prices have driven a wedge through society between those who own property and those who do not. Capturing more of the uplift in the value of land for public benefit will reduce the polarising effect of the land market and lessen the extent to which some people can make windfall gains at the expense of others. Housing conditions and the cost of housing are also closely linked to health and wellbeing. A more proactive public role in house building should improve the quality of the housing stock, enhance placemaking and reduce the incidence of homelessness – helping to build a fairer and more inclusive society.
- Improved living standards: Increasing the supply of housing and reforming the tax system should over time help to lower the cost of housing relative to incomes, therefore freeing up money be spent on other goods and services and improving living standards.
- Healthier public finances: Lower housing costs would reduce public expenditure on housing benefit. Additionally, enabling public bodies to capture the uplift in land value would unlock funds that could be used for infrastructure investment, freeing up government revenues to be deployed elsewhere.

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