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Christian Hilber, 19 May 2019

Why banning the construction of second homes in St. Ives and elsewhere has been a bad idea and what to do instead

In May 2016 the local residents of St. Ives approved a referendum that stops newly built houses in town from being used as a second home. A few other Cornish towns have followed suit. And tourist destinations in other parts of the country are contemplating similar policies. The Economist, the Times and the BBC recently pointed to unintended consequences of these policies: higher prices for existing homes, less construction of newly built homes and an adverse effect on the local economy—mainly tourist and construction businesses.

In recent research (here and here for the academic piece) we explored the economic impacts of banning the construction of new second homes in the touristy parts of Switzerland. The Swiss Second Home Initiative was approved in March 2012 and banned the construction of new second homes in municipalities with more than 20% of such homes.

There is one crucial difference between the Swiss Alps and St. Ives. In the Swiss Alps, primary and second homes are very different; think of wooden chalets near ski lifts as second homes and stone or brick buildings near schools and stores as primary homes. In St. Ives and other towns in Cornwall, primary and second homes tend to be rather similar—they are close 'substitutes'. This has important implications.

When the ban was introduced in Switzerland, demand of second home investors shifted elsewhere, perhaps to the French or Austrian Alps. Unemployment rates started rising and the price of primary homes started falling relative to the unaffected areas. And because already built second homes became dearer (no new construction allowed!), the price of these rose with the unintended consequence of financially benefiting the owners.

In St. Ives, where the typical primary and second home tend to be rather similar, demand of investors shifted from newly built to existing homes, increasing the price of existing homes and reducing the price of newly built ones. The emerging gap between the two prices is the so called 'conversion option' of existing homes—the monetary value of the option to convert a primary into a second home. Newly built homes no longer possess such an option.

So it seems the bans in Switzerland and Cornwall backfired. In the case of St. Ives, existing housing has become even less affordable for young would-be buyers who want to get their feet on the owner-occupied housing ladder, and, there is less new construction of affordable housing. But also local firms, particularly construction and tourism businesses and, importantly, their workforce, lose out. If the ban intended to help young local residents who struggle to find decent jobs and affordable homes, then it backfired spectacularly.

The ban in St. Ives will likely not even succeed in improving the local community 'character'. One particular concern in tourist destinations like St. Ives is that they are seasonal and thus, for much of the year, resemble ghost towns. The trouble with the ban is that it does encourage second home investors to buy up existing homes from local residents. Over time, St. Ives is thus set to become more—not less—like a ghost town. Exactly what the ban intended to avoid.

The only potential beneficiaries of the ban are already existing owners of housing in St. Ives—owners of existing primary and second homes. They financially benefit because their assets are higher in demand and thus become more valuable.

So what can and should be done to address the legitimate concerns of local residents in touristy places?

First and foremost, local policy makers and local residents have to ask themselves whether they are really willing to accept and bear the long-run adverse consequences associated with keeping second home investors out, namely, an adverse effect on the local construction and tourism businesses. If (big if) the answer is 'yes', then local authorities should consider alternative policies to a ban.

A much better policy would be a sizeable *annual local* tax on the current value of second homes. Compared to a ban on the construction of second homes, such a tax has important advantages. First, it generates revenue for the local authority and this may be used to provide or improve local public services for permanent residents—think of local schools, libraries or social services. A ban, in contrast, generates zero revenue and moreover limits the potential of local authorities to benefit from Section 106 agreements—private agreements between local authorities and developers attached to a planning permission to make development, that would otherwise be unacceptable, palatable to local authorities. Second, since the proposed tax has to be paid every year, it discourages buying property for investment purposes. It makes the investment less attractive financially. This will help with the affordability of existing homes. A sizeable local annual tax will most effectively repel those investors who consider second homes as pure investment and not as consumption. The second home investors who still buy, mainly for consumption motives, can be expected to be around more often. Seasonal tourist locations will look and feel less like 'ghost towns'.

But why not just a tax on the transfer of properties? The trouble is that the Stamp Duty does not encourage second home investors to use the property more intensively. In fact, the longer the investor holds the property, the less important, is the Stamp Duty relative to the capital gain at point of sale. The same argument applies to potential new second home investors. A rise in Stamp Duty will lead to a small one-time downward adjustment in the price (reflecting the increased anticipated tax burden). Once prices adjust, new second home investors may still mainly consider expected capital gains and not the presumed consumption value of the property. And it is important that the tax is *local* because otherwise it does not generate local tax revenue, benefiting local residents.

Allowing local authorities to charge a multiple of the Council Tax to second home investors may be a sensible 'second best policy' that is clearly preferable to a ban. The trouble is, that the Council Tax is highly regressive. It thus won't much discourage wealthy investors from buying large underutilised properties.

How could the proposed policy work in practice? One could just take the last sale price of a house (from the Land Registry) and the corresponding local house price index to adjust the price to the current market price. The local authority could set a tax rate on the so assessed current price. A high (low) tax would reduce house prices significantly (moderately) but also strongly (only weakly) adversely affect the local economy.

The political backlash against second home investors is not confined to Cornwall or Switzerland. It is a worldwide phenomenon. There has been a staggering amount of wealth accumulation among a growing cohort of high earners that has led to a dramatic increase in second home investments in the more desirable seasonal tourist areas worldwide (and in 'superstar cities' such as London). The ensuing political backlash has been spreading quickly around the world.

Second home investors are a popular scapegoat—In Britain mainly for the ongoing housing affordability crisis. However, the nation-wide crisis has little to do with second home investors. The underlying causes are mainly a dysfunctional planning system and a lack of fiscal incentives for local authorities to permit residential development (see here or here). If national policy makers are serious about addressing the national housing crisis, they should focus on the underlying causes, otherwise, like the ban in St. Ives, their policies are likely to backfire as well.