ECFIN Workshop

Property taxation and enhanced tax administration in challenging times

Distortions from Housing Taxation Provisions

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Outline

1. Tax Treatment of Housing
2. Impact on prices and leverage
3. Possible policy responses
4. Several selected issues

1. Tax Treatment of Housing

A. Within a comprehensive income tax, fully neutral taxation of owner-occupation would require full taxation of imputed rents and capital gains on housing, and deductibility of mortgage interest payments.

- that is, housing is treated similarly to any other asset yielding a flow of returns.

1.

B. In practice, imputed rents and capital gains on primary residences are rarely taxed, creating a general bias towards housing that mortgage interest relief is likely to reinforce.

- Mortgage interest relief would not tax-favor mortgage finance if the alternative to borrowing were investing less in fully-taxed assets – but that is typically not the case.

1.

C. The distributional impact of mortgage interest relief can be complex, but deductibility likely favors the better off (but not the richest).

-

1.

- Note, in this regard, the fact that some buyers already face an after-tax return leads some to argue on fairness grounds for some tax relief to ensure that the less well-off also pay an after-tax rate. Against this, deductions are worth more to the better-off (that can be eliminated by use of refundable credits instead).

- Externalities arising from home ownership could also support an argument for some tax preference to encourage ownership.

1.

D. Property- and property transactions taxes also play an important role.

- Property taxes have potential appeal both in serving as user charges reflecting the value of local public services – hence they are often allocated to lower-level governments – and can be less vulnerable to tax competition than other taxes;
- Housing transactions are often subject to tax, sometimes at significant rates.

2. Impact on prices and leverage.

Tax policy can affect two key aspects of housing markets: house prices and households' leverage.

- These are interrelated, as rising prices encourage removing equity through increased borrowing, the availability of cheap loans drives up prices, and the expectation of price increases raises the expected return on borrowing to acquire housing assets.

2.

A. Favorable tax treatment is likely to be capitalized in prices, may be reflected in the rate of house price inflation, and can also increase housing price volatility.

- For housing, capitalization is the important concept for tax (and benefit) incidence analysis.
- Even in the long run, supply is unlikely to be perfectly elastic.

2.

B. Tax effects can substantially reduce the user cost of – and hence increase the demand for – owner-occupied housing.

- eg, for the US, deductibility and other tax features on average provided an estimated tax subsidy equivalent to around 19 percent of the user cost. That is, a reduction of 235 bps for a taxpayer facing a user cost of 10 percent.

2.

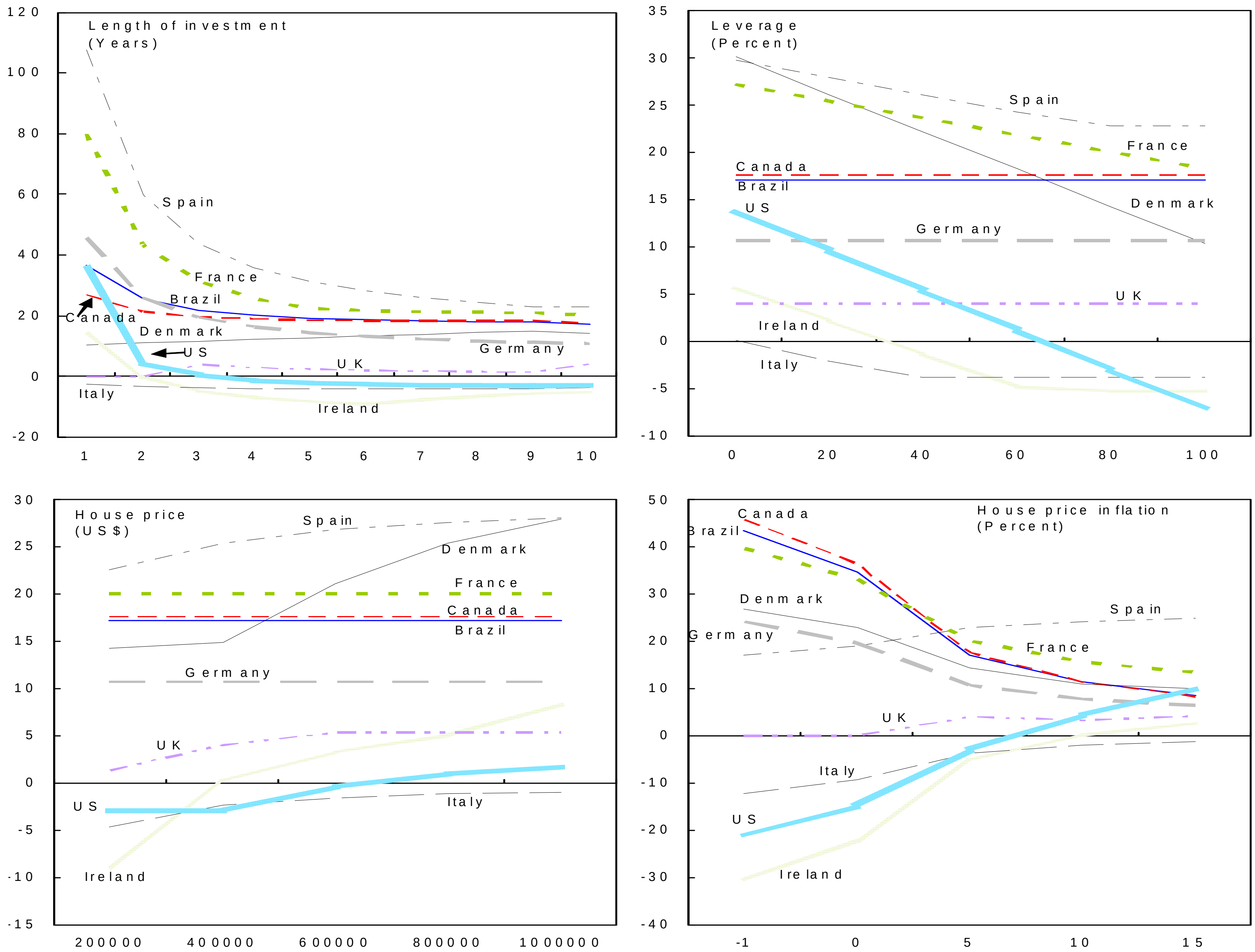
C. Effective tax rates on housing (reflecting also transactions taxes) vary enormously across countries, and with the circumstances of the investor and investment.

- An effective average tax rate (EATR) can be calculated as the ratio of the PV of total taxes over an expected holding period to the sum of the PV of imputed rent and capital gains.

2.

- EATRs can be high – sometimes over 100 percent – when the holding period is short and housing is subject to high transactions taxes. They can also be negative, for example for investors with large mortgages in countries that allow mortgage interest deductions but do not tax imputed rents and alternative assets.
- Countries can be broadly grouped into those with high-, low- or medium EATRs……

Figure 1. Effective Average Tax Rates on Owner Occupation
(In percent)



Source: IMF staff calculation.

2.

- To sum up, rankings change as important parameters vary, but: Spain, France, and to a lesser extent Denmark, have relatively high tax rates across a range of assumptions; Italy (which stands out as having almost consistently negative EATRs), Ireland, and the US have low EATRs.

2.

D. Taxation does not appear, however, to have been the main driver of house price developments over the last decade.

- Strong price increases occurred in all countries, including in the high tax group …

Real Cumulative House Price Inflation between 1998 and end-2002

(In percent)

High Tax Countries			Medium Tax Countries				Low Tax Countries		
Spain	France	Denmark	Brazil	Canada	Germany	U.K.	U.S.	Ireland	Italy
110.9	105.9	75.7	...	65.2	-18.0	124.1	45.3	108.5	56.4

Source: Staff calculation based on data from OECD *Economic Outlook*, Vol. 83.

2.

- This conclusion also flows from the diverse experiences in local markets: in the US for example, booming property markets in coastal cities went with more stagnant developments inland, despite relatively small interstate variation in tax rates.
- Nor are there changes in tax rules that clearly account for housing price movements over the period.

2.

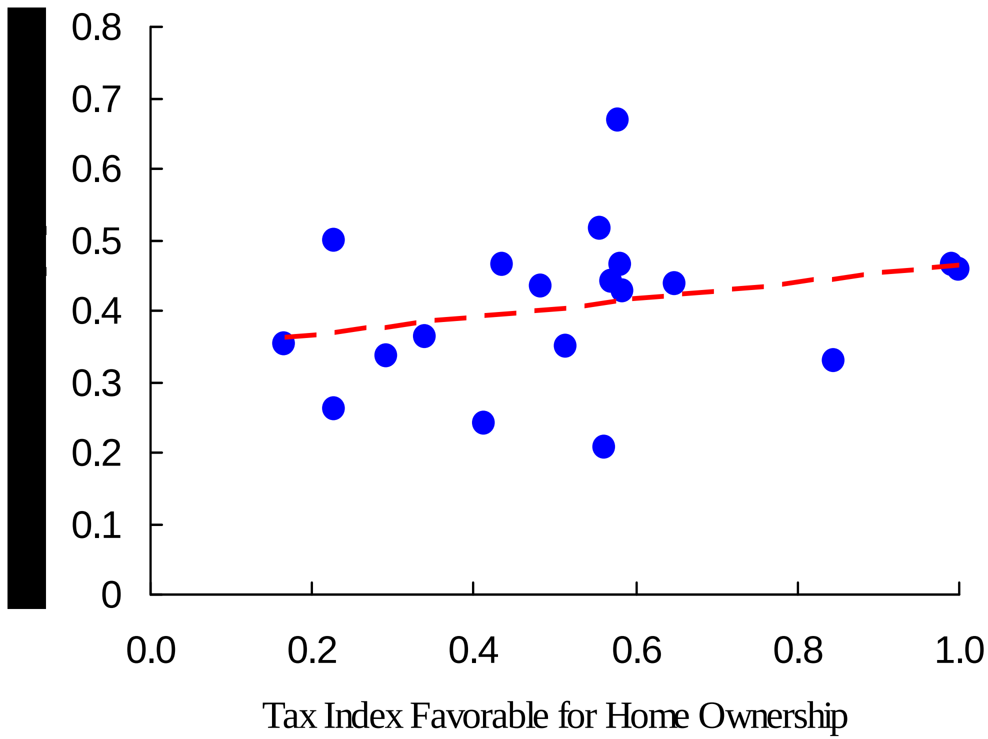
E. Mortgage interest tax relief encourages the build up of (gross) housing debt if alternative investments are less than fully taxed.

- This is often the case, as noted above, because the after-tax return on other investments then exceeds the cost of mortgage-backed borrowing.
- As seen above, EATRs fall markedly – in many cases changing from positive to negative – as leverage increases.

2.

- There is evidence that countries offering more favorable tax treatment for home ownership have higher ratios of mortgage debt ….

Figure 2. Debt Ratios and the Tax Treatment of Owner-Occupation



Source: Cardarelli, Igan, and Rebucci "The Changing Housing Cycle and the Implications for Monetary Policy," Chapter 3, World Economic Outlook, IMF, April 2008.

2.

- Other econometric evidence for the UK and US confirm that mortgages fell significantly relative to home value after reforms reducing the value of mortgage interest relief.

3. Possible Policy Responses

A. Alleviating tax distortions to housing markets would improve efficiency and help avoid macroeconomic imbalances – but timing is important.

- The desirability of many of these reforms has long been recognized.
- The social objectives underlying these distortions can be achieved through better-targeted measures (such as outright grants).

3.

- And, to the extent that they are capitalized in house prices, existing tax subsidies do not even help first-time buyers.
- Some reforms toward greater tax neutrality, however, would likely reduce house prices and/or construction activity, and so be procyclical at present.

3.

B. For the short-term, creating more tax breaks for housing should be avoided, but there may be scope for reducing transactions taxes.

- In this regard, recent time-limited tax credit for housing purchase in US probably just shifted timing of purchase, rather than increasing total demand.
- Scaling back transactions taxes would remove an impediment to efficient trading, increase prices, and speed up clearance of any excess stock of unsold houses. It could also improve labour mobility.

3.

C. When housing markets regain robustness, other distortions could be addressed. Possibilities include:

- taxing imputed rents and capital gains
- If imputed rents remain untaxed, phasing out mortgage interest relief.
- Fully taxing first sales of residences under VAT (and perhaps taxing gains on subsequent transactions).

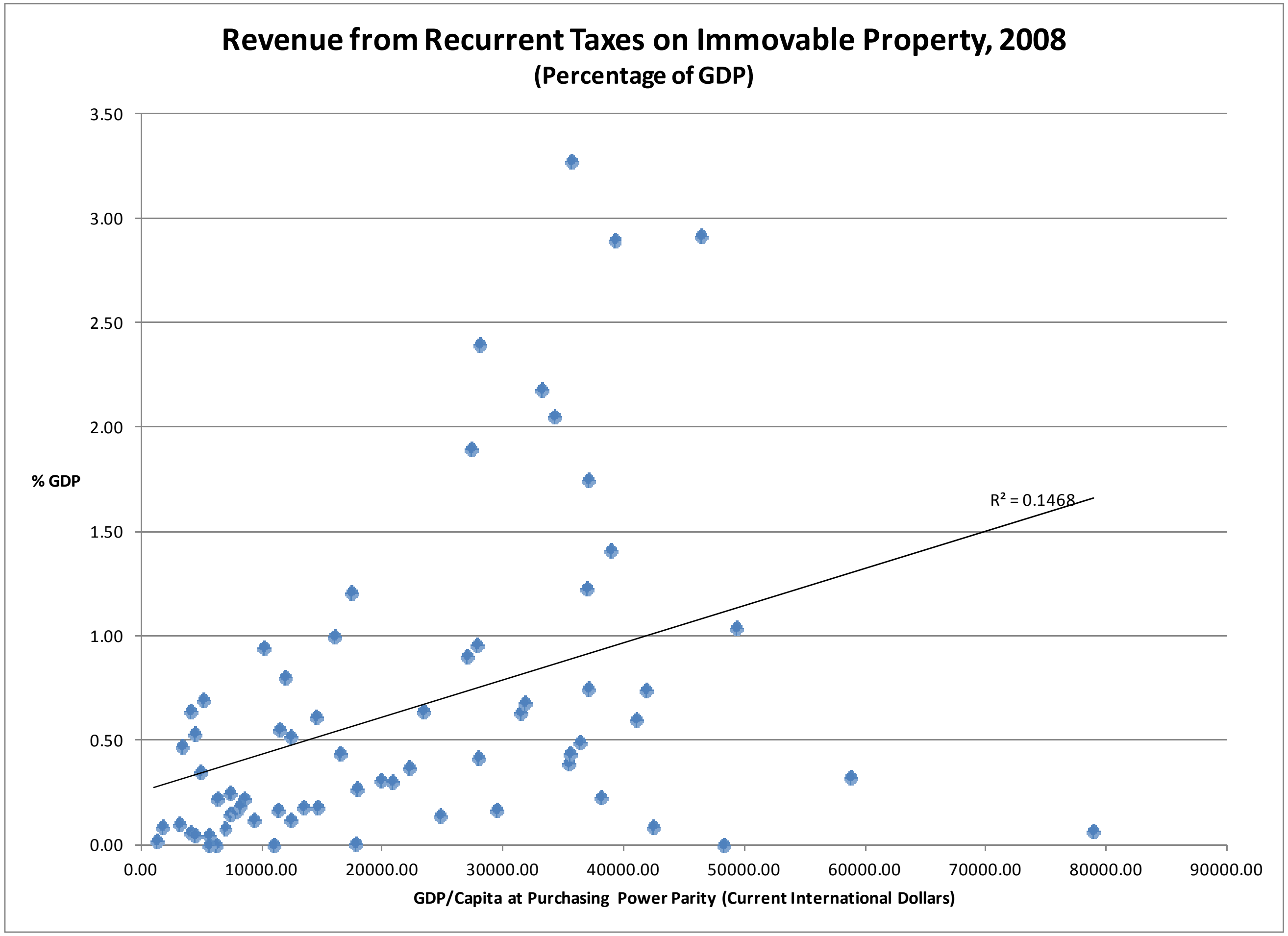
4. Several selected issues

A. Property taxes and Revenue mobilization

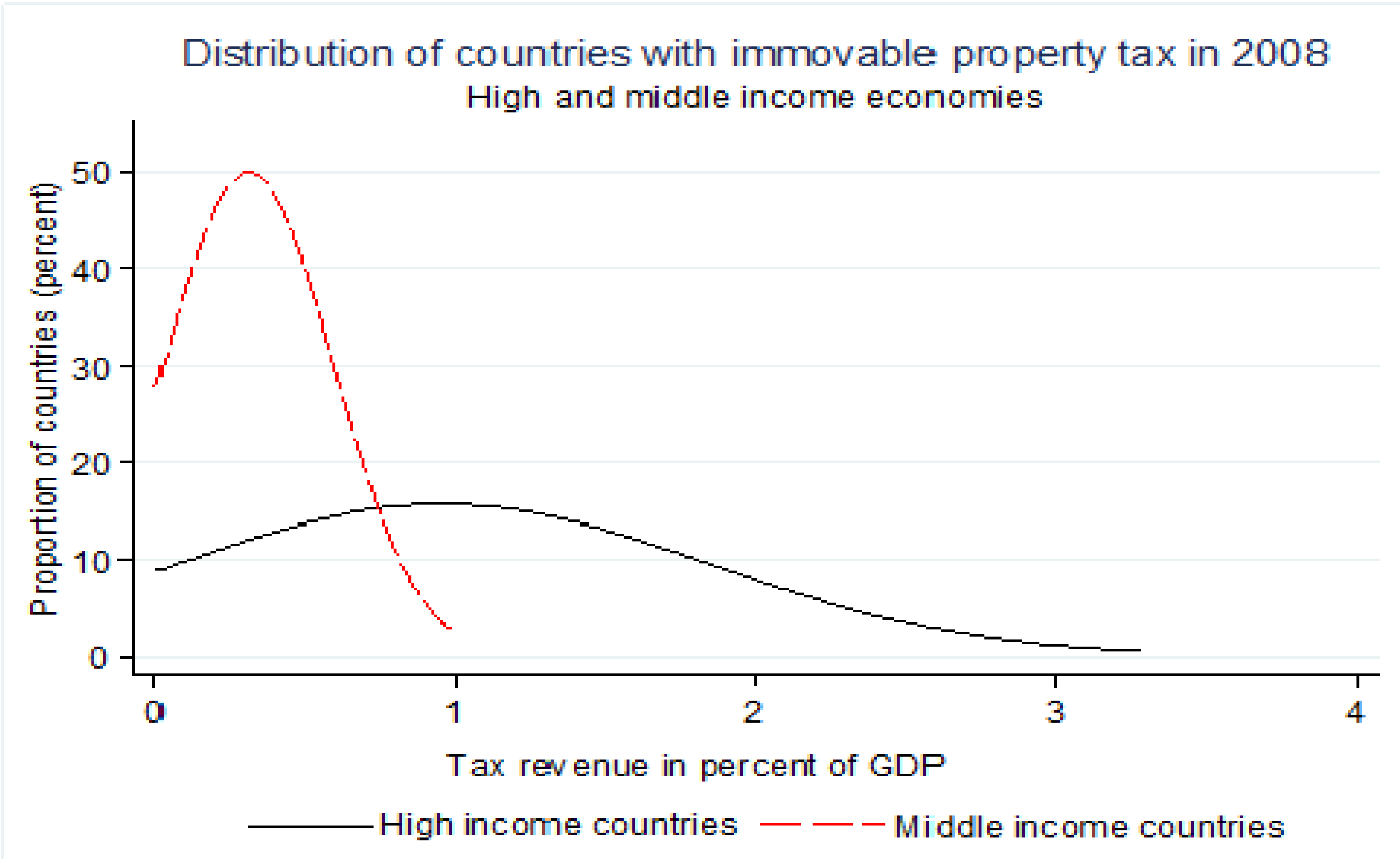
- Revenue yields vary significantly, suggesting that if low-yield countries emulated high-yield countries, this could be an important source of revenue.
- They currently yield around three percent of GDP in Canada, UK and US, but below 1 percent in other G20 countries, and significantly below 1 percent in developing countries.

Recurrent Property Tax Collections Across Income Levels

OECD and selected non-OECD countries, 2008)



Distribution of Yields from Property Taxes, 2008



4.

- Simple-minded benchmark: the average revenue ratios of the best performers in each income group. Thus, for high income countries, that would yield a collection potential of about 2.7 percent of GDP when based on the five best performers; while the similar target in middle income countries would be a much lower 0.8 percent of GDP.
- Implies the average revenue increase among this group of 31 high income countries would be 2.1 percent of GDP; and an additional 0.6 percent of GDP in the 27 middle income countries.

4.

B. Is (recurrent) real property taxation a close substitute for taxing imputed rents? (That is, is the property tax a distortion that can offset other distortions?)

Against this:

- Benefit view of property taxation, and Tiebout effects.
- Local-level property taxation involves many budget constraints, so additional revenue may require a system of interjurisdictional transfers/equalization payments from the center.

4.

- Political economy: property taxes currently vary according to the expenditure responsibilities assigned to local governments:

  • For those countries in which local governments have a significant responsibility for redistributive services such as social protection and health (Austria, Denmark, Finland and Germany), dependence on the property tax is relatively low, and income taxes are more heavily used. …

4.

- This suggests that governments may choose to use the property tax to pay for “property-related” services and not “people-related” services; it may be difficult and undesirable to turn the property tax into “general revenue.”

4.

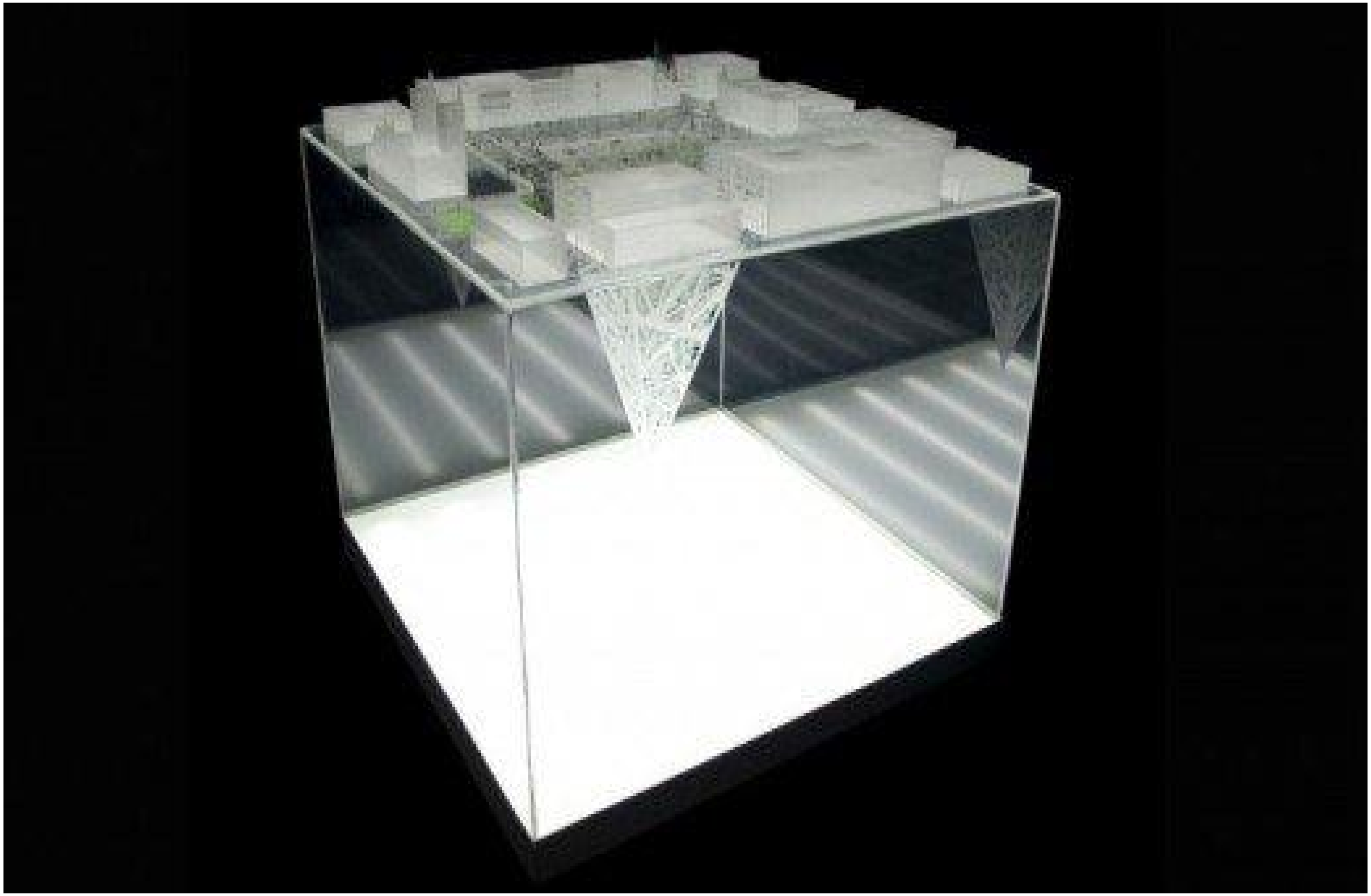
C. Is the property tax base "relatively immobile?"

Plausible, but against this:

- Clearly land is immobile, but unimproved land (that is, land without added capital) has little or no value.
- An increase in the tax would raise revenue from old investments; but this is true for many types of tax increases (eg, increase in VAT falls inter alia on accumulated wealth).
- The base could be immobile only to the extent that the tax burden is related to benefits, so the base would become mobile when increased tax is not tied to increased benefits (so that it is not a possible source of significant general revenue).

4.

D.



- The point is, property is subject to significant non price controls and regulations; tax effects cannot be analyzed in isolation, because they govern to some extent allowable economic responses to tax changes. So some caution is warranted in analyzing tax effects, to account for unintended consequences.
- Or, from another perspective, the optimal policy may be a package that combines tax changes with changes in regulations.

Thank you