II.2. Taxation of housing

There are several reasons for macroeconomists to monitor developments in the taxation of housing. There is evidence of property taxes ([37]) being the least distortive tax source, making a case for property taxes to play a greater role in tax systems than today. Taxation of housing furthermore influences investment and consumption decisions, and can thereby have implications for macroeconomic stability and labour mobility.

This section describes the current state of taxation of housing in the euro area and looks at some design principles for taxation of housing. It also points to the favourable tax treatment of housing in the euro area, which encourages debt-building and over-investment in housing, and argues that there is a potential for shifting taxes towards recurrent taxes on property. ([38])

The contribution of recurrent property tax to overall revenue is low

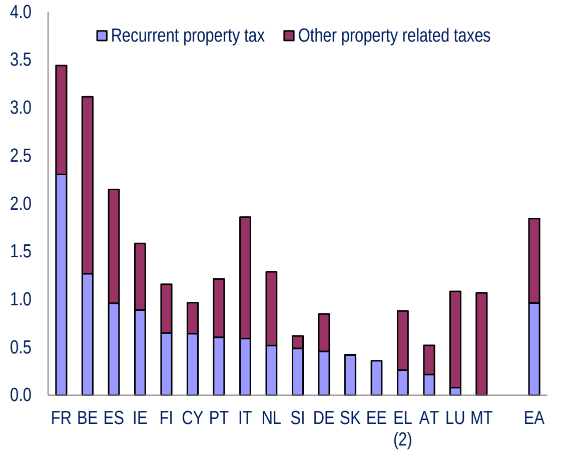
Property taxes generally play a relatively small role in the euro area in terms of revenue collected. While the average tax burden in the euro area in 2010 was 38.9 %, the revenue from recurrent property taxes was on average 0.96 % of GDP. Adding other property-related taxes (including transaction taxes) the revenue amounted to 1.84 % of GDP. ([39])

The reliance on recurrent property taxes varies considerably between countries (Graph II.2.1). Recurrent taxes on property range from 2.3 % of GDP in France to nil in Malta. Belgium has the second highest income from recurrent property taxes, with 1.27 % of GDP. Revenues are below the euro area average in all but three euro area Member States. ([40])

([37]) In this text property taxes only refers to taxes on immovable property.
([38]) The work draws, to a large extent, on the paper by Johannesson Linden, Å. and C. Gayer (2012), 'Possible reforms of real estate taxation: Criteria for successful policies', European Economy, Occasional Papers No 119 (October); and Chapter 5 of the report: European Commission (2012a), 'Tax reforms in EU Member States 2012', *European Economy*, No 6 (written jointly by DG ECFIN and DG TAXUD).
([39]) Data come from the report European Commission (2012b), 'Taxation trends in the European Union'.
([40]) The data do not cover taxation of imputed rents, which falls under personal income taxation. This underestimates revenues from taxation of housing in Luxembourg and the Netherlands.

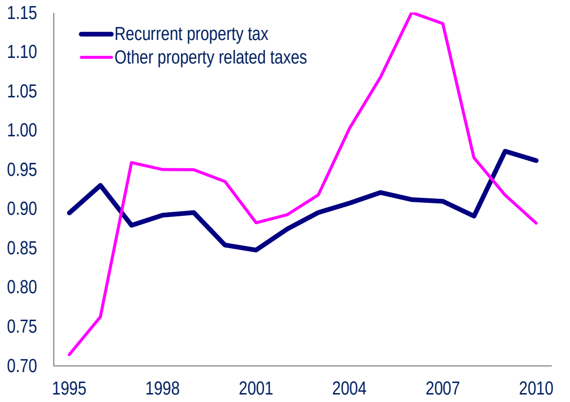
Recurrent tax revenue tends to be fairly stable over time. Revenues from recurrent property taxes as a share of GDP have amounted to between 0.85 % and 0.97 % of GDP over the last 15 years for the euro area as a whole (Graph II.2.2).

Graph II.2.1: **Revenues from property taxes (in % of GDP, 2010) (1)**



(1) Ordered by revenues from recurrent property taxes. Other property-related taxes include taxes on net wealth, inheritance, gifts and other property items and on financial and capital transactions. Data do not include personal income tax on imputed rents.
(2) Data for Greece are provisional.
Source: Commission services.

Graph II.2.2: **Revenue from property taxes (in % of GDP, 1995-2010) (1)**



(1) Averages are weighted. Other property-related taxes include taxes on net wealth, inheritance, gifts and other property items and on financial and capital transactions. Data do not include personal income tax on imputed rents.
Source: Commission services.

Tax revenue can be increased by broadening tax bases and/or by increasing tax rates. The relative stability of revenue observed in Graph II.2.2 partly reflects the fact that the tax base, i.e. the cadastral value ([41]), has often not been revised over the last two decades, drifting sometimes far away from property market values.

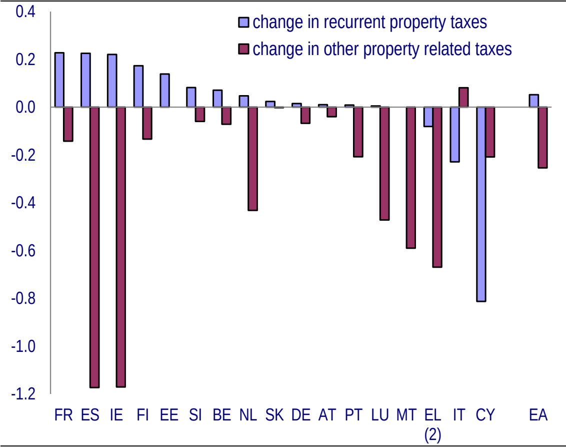
Many euro area countries have not updated property values for many years. Examples include Austria, which applies cadastral values from 1973, and Cyprus, with values from 1980. Belgium (1975) and Germany (mainly 1964) adjust cadastral values with inflation or a corrective factor not linked to house-price developments. According to the information available, at least ten euro area countries (BE, DE, EE, EL, ES, FR, IT, CY, LU and AT) apply outdated property values. The Netherlands undertakes annual updates and some countries are currently reassessing their cadastral values. ([42])

The share of transaction taxes in property taxes is high despite their more distortive and volatile nature

Other property-related taxes generated in 2010 on average about as much revenue as the recurrent tax on property. One of the main items in this category is transaction taxes on property. As indicated in Graph II.2.1, there are significant variations between countries in the ratio of the revenue from other property-related taxes to GDP. The revenue also fluctuated quite a lot over the period 1995-2010, from approximately 0.71 % of GDP in 1995 to 1.15 % of GDP in 2006 in the euro area (Graph II.2.2).

Graph II.2.3 presents the changes in revenue from property taxes in euro area countries between 2007 and 2010, a period of severe economic downturn. It shows that revenues from other property-related taxes (transaction taxes) were adversely affected, especially in Spain and Ireland, but also in Greece, Malta, Luxembourg and the Netherlands. In Spain and Ireland revenue fell by approximately 1.2 % of GDP. By contrast, revenues from recurrent taxes proved to be much less sensitive to the recent crisis, even increasing slightly over the period in a number of countries (ES, IE, FR, FI and EE). ([43])

Graph II.2.3: **Changes in revenue from property taxes (in % of GDP, 2007-2010) (1)**



(1) Other property-related taxes include taxes on net wealth, inheritance, gifts and other property items and on financial and capital transactions. Data do not include personal income tax on imputed rents.
(2) Data for Greece are provisional.
Source: Commission services.

The ranges of tax rates applied to property transactions in the euro area are presented in Table II.2.1. All but two countries apply transaction taxes on property. Belgium, Italy and Greece even apply tax on property transactions at rates of more than 10 %. ([44]) A second group of countries (FR, ES, LU, CY and PT) apply relatively high rates, in the range of 5-8 %.

A drawback with transaction taxes is that they tend to discourage transactions that would allocate properties more efficiently, thereby making the market thinner. These taxes also have a negative impact on labour mobility given the high transaction costs incurred by changing property. The higher the rate, the more distortions will be created. Recurrent taxes are therefore preferable to transaction taxes on property.

As indicated above, transaction taxes also tend to be more volatile than a recurrent tax. This volatile nature of transaction taxes is due to the fact that both the volume and the price of transactions tend to follow the business cycle. Significant revenue from transaction taxes in boom phases tends to lead policy makers to assess the budgetary situation too optimistically. Conversely, major revenue falls in downturns can produce an extra and unanticipated challenge for budgetary consolidation, aggravating the effect of business cycles. Thus, the volatility of transaction taxes contrasts with the more stable nature of recurrent

([41]) The cadastral value refers to the valuation of a property in a public register used for taxation purposes.
([42]) Johannesson Linden, Å. and C. Gayer (2012), op. cit.
([43]) Figures for Cyprus must be interpreted with caution as there might be some errors in the data.
([44]) Some of these structures are progressive, thus the rates do not reflect average tax levels.

taxes on property. Low predictability of tax revenue complicates budgetary planning, which is especially important for indebted countries. (45)

Table II.2.1: **Tax rates on property transactions in the euro area (2012) (1)**

Tax level	Member State
≥10%	BE, EL*, IT*
5-8%	FR, ES, LU, CY*, PT*
<5%	AT, DE, IE, MT, NL, SI, FI
None	EE, SK

(1) * indicates a progressive or multiple rate structure. In Italy some rates are levied on cadastral values rather than transaction values.
Source: Commission services.

A tax on real property transactions could potentially deter speculation and thus help reduce the risk of housing market bubbles. However, this relationship remains empirically ambiguous. It could also prove to be politically difficult to use the transaction tax as a timely policy response to mitigate price increases in the housing market. Moreover, other policies are available that can deal more effectively with housing market bubbles, such as capital requirements and loan-to-value limits. (46)

Some design principles for optimal taxation of housing

Several approaches to designing taxes on residential property have been discussed in the literature. (47) A distinction should be made between business property, owner-occupied housing and rental housing. A company's building assets are an input into the production process. Therefore the taxation of those business assets could severely distort resource allocation. In any event business building assets should not be taxed more than other inputs into production. Taxation of residential housing could be considered as part of the taxation of both consumption and the return from investment/savings. (48) There are also good arguments for taxing land values, in the case of both business and residential properties.

As housing is an asset, a natural starting point is that housing should be treated in the same way as other capital investments in the tax system. A house that is rented out will generate rental income that can be seen as capital income and taxed at the same rates as other capital income. If the owner alternatively chooses to live in the house, he or she will benefit from the return on the investment, in the form of an imputed rent, which should be taken into account and measured. When imputed rent payments are taxed, deductibility for depreciation allowances and mortgage interest payments should apply so that the net capital investment is taxed. Consistent with the treatment of other financial assets, capital gains from housing transactions should also be taxed in order to achieve neutrality vis-à-vis investment in other assets. A tax on imputed rental income could be approximated through an annual recurrent tax on the property. This assumes that imputed rents are proportional to property values. Property values should then be set as close as possible to actual market values.

At the same time, housing provides a service. It provides accommodation and a place to store goods, eat and socialise, which is a set of consumable services. Like other consumption goods and services, it could be covered by value added tax. The tax would then be regarded as a levy on the present value of the stream of services that the house will generate in the future. It means that VAT should be applied when the house is sold the first time. This would be in line with the treatment of other durable goods, e.g. cars or refrigerators. Another alternative is to apply a tax on the flow of services from housing over time. That translates into taxing the rent or the imputed rent for owner-occupied housing, preferably at the standard VAT rate. Estimating the imputed rent for owner-occupied housing properly and fairly involves some practical difficulties and most countries do not apply this approach. To achieve equal treatment between owner-occupied and rental housing they do not levy VAT on rental payments either.

(45) See European Commission (2012b), op. cit. Revenues from transaction taxes are more cyclical than recurrent taxes as revenue depends not only on market prices, but also on the number of transactions. Moreover, a recurrent tax will still be more stable than taxation of real-time transactions, especially if cadastral values are updated periodically, e.g. after a few years instead of every year.

(46) See Crowe C., G. Dell'Ariccia, D. Igan and P. Rababal (2011), 'How to deal with real estate booms: Lessons from country experiences', *IMF Working Papers*, No 11/91.

(47) See for instance Mirrlees, J., S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Portaba (2011) 'Tax by design, the Mirrlees review', *Oxford University Press for Institute for Fiscal Studies* or OECD (2010), 'Tax policy reform and economic growth', *OECD Publishing*.

(48) In the Mirrlees review recommendations build on both an asset approach and a consumption approach. OECD (2010) (op. cit.) note that return on investments other than housing is normally taxed first at corporate and personal level and then taxed with VAT when the return is consumed. For housing, applying VAT and the asset approach would mean that such taxation takes place in the reverse order.

Land is an especially attractive tax base. The supply of land is fixed (i.e. price-inelastic) and will not be affected by a tax. A tax on land will therefore reduce the selling price by the same amount and only reduce earnings to landowners. Land buyers will face the same (tax-augmented) prices of land after the introduction of the land tax. There is therefore no distortion arising from this tax, which makes it especially attractive for revenue purposes. Taxing landownership translates simply into taxing an economic rent and involves a transfer of earnings from landowners to local or central governments. It is, however, hard to distinguish land values from properties (buildings and other structures) built on it. The markets for land without any buildings will tend to be narrow, at least in some areas, and prices could be difficult to observe. As market prices for properties will normally include land values and as there are other good reasons for taxing residential property, property taxes could act as a proxy for taxing land values and thereby avoid the additional complexity of valuing land separately.

Globalisation has implications for policy design. Capital and labour have become increasingly mobile and less efficient to tax. This might imply that countries need to rethink their tax structures. Taxation of property is regarded as the tax least affected by globalisation and should therefore gain momentum in a country's tax structure. Another advantage of immovable property as a tax base is that property ownership is generally easy to establish and identify, and thus the tax is difficult to evade.

Favourable tax treatment of housing in the euro area: debt-bias and over-investment risk

In most countries owner-occupied housing receives favourable tax treatment compared to taxation of other forms of investment.

Firstly, capital gains on residences are often exempted from capital gains tax, in particular when gains are on primary residences. In some countries the exemption is made dependent on how long the owner has lived in the house before sale.

Secondly, there are only a few countries that apply taxation to imputed rental income on main residences in the euro area. These are the Netherlands and Luxembourg. In Belgium, Spain and Italy, taxes on imputed rents apply to residences other than the main dwelling. Even if recurrent property taxes are regarded as a proxy for a tax on imputed rents, the rates and the tax bases are normally too low in comparison with the tax treatment of other capital assets. Valuation of properties is, as indicated earlier, often outdated and can be far below market prices.

Thirdly, ten euro area countries apply some form of mortgage interest deductibility for owner-occupied properties. ([49]) In the presence of mortgage interest deductibility, a tax on imputed rents and/or a recurrent property tax are essential to balance the tax subsidy provided by the deductibility. The tax is needed to achieve neutral tax treatment of various investment possibilities. If interest deductibility is provided to house-owners while imputed rental income is either (i) not taxed (or taxed too low) or (ii) approximated with a recurrent property tax which is generally low, an implicit tax subsidy is provided which favours investments in owner-occupied housing and household indebtedness through mortgage loans. Hence there is a risk that households will be encouraged to invest too much in housing in relation to other assets, which could contribute to higher private-sector debt and an over-allocation of capital to the housing sector, which is normally not considered to be the most productive economic sector.

Empirical studies also indicate that reduced interest costs due to interest deductibility are capitalised into higher house prices. ([50]) Tax subsidies for mortgage interest payments have also been found to be correlated with price volatility on the housing market. ([51])

In this context, a first-best solution is either to tax imputed rents, but these rents are difficult to measure in practice. An alternative is to increase

([49]) A detailed overview of the current treatment of mortgage interest deductibility in Europe is given in European Commission (2012a), op. cit.

([50]) See for instance Capozza, D.R., R.K. Green and P.H. Hendershott (1996), 'Taxes, mortgage borrowing, and residential land prices', In 'Economic effects of fundamental tax reform', ed. Aaron, H. and W. Gale, *Brookings Institution*, pp. 171-198; Harris, B. (2010), 'The effect of proposed tax reforms on metropolitan housing prices', Tax Policy Center, Urban Institute and Brookings Institution. Other results indicate that demand shocks (e.g. through financial deregulation) have a greater likelihood of being capitalised into real house prices when the country provides interest deductibility. Andrews, D. (2010) 'Real house prices in OECD countries: The role of demand shocks and structural and policy factors', *OECD Economics Department Working Papers*, No 831, OECD Publishing.

([51]) Van den Noord, P. (2003), 'Tax incentives and house price volatility in the euro area: Theory and evidence', *OECD Economics Department Working Papers*, No 356, OECD Publishing; Andrews, D. (2010), op. cit.

the recurrent tax on property, which can be seen as an approximation of a tax on imputed rents. A second-best design of the taxation of owner-occupied housing could be: (i) not to allow mortgage interest deductibility and (ii) to levy a (lower) recurrent tax on property. In this way, housing investments would still be taxed and the tax system would not favour debt.

The application of VAT on housing also varies across euro area countries, which means that consumption of housing services in the euro area is only partly exposed to VAT. ([52]) More than half of these countries apply VAT on the sale of new dwellings, but many countries apply lower rates than the standard rate. Different practices apply to the VAT treatment of construction, alteration and maintenance of property. The rental of residential properties is normally exempt or zero-rated. Overall, only part of the consumption of housing services is taxed.

Shifting the tax burden towards recurrent property tax

Empirical studies by the OECD rank the type of taxes according to their effect on economic growth and find recurrent property taxes to be the least harmful type. ([53]) This suggests that a rise in property taxes should play an important role when considering an increase in revenue or a shift in the tax burden.

A reform shifting the tax burden from more distortive taxes (e.g. labour taxes) towards property taxes could then enhance growth. The same is true for tax shifts within property taxes, moving the tax burden from high transaction taxes to recurrent taxes on property. Table II.2.2 identifies the countries in the euro area where such shifts appear particularly attractive. ([54])

Many euro area countries (DE, EE, EL, IT, CY, MT, AT, PT, SI, SK and FI) have low recurrent taxes on property and might have potential for increases. Of these countries, Germany, Italy, Austria and Finland also have a high tax burden on labour, which might indicate both a need and room for shifting taxes from labour to recurrent property taxes. The Netherlands, which applies taxation of imputed rents in addition to recurrent taxes on property, might also have potential for shifting tax from labour to housing. ([55])

Table II.2.2: **Potential for tax shifts (1)**

Country	Potential for tax shift from labour to property			Potential for tax shift within property taxes
	High tax burden on labour	Low recurrent taxes on property	Potential for tax shift	High transaction taxes
BE	X			X
DE	(X)	X	(X)	
EE		X		
IE				
EL		X		X
ES				X
FR	X			X
IT	X	X	X	X
CY		X		X
LU				X
MT		X		
NL	(X)			
AT	(X)	X	(X)	
PT		X		X
SI		X		
SK		X		
FI	(X)	X	(X)	

(1) A euro area country displaying both a fairly high tax burden on labour and low recurrent taxes on property may consider a tax shift from labour to property. (X) depicts borderline cases reflecting relatively high employment rates in some countries.
Source: Commission services.

Raising revenues from recurrent property taxes to the euro area average of 0.96 % of GDP would for instance correspond to an increase of around 0.5 % of GDP in the case of Slovenia, Germany and Slovakia.

Tax shifts within property taxes would also be particularly relevant for countries with high transaction rates. A gradual shift from a tax on property transactions to a recurrent tax on property could potentially improve the functioning of the housing market in several countries (particularly BE, EL and IT but also ES, FR, LU, CY and PT). ([56])

([52]) Information has mainly been collected from OECD (2011), 'The taxation of residential property: Background note for the November Roundtable at Working Party No 2, (3 November).
([53]) See for instance OECD (2010), op. cit.; Johannesson Linden, Å. and C. Gayer. (2012), op. cit., also gives an overview of empirical results on tax shifting and its impacts on GDP.
([54]) A country is considered to face a challenge related to a high tax burden on labour and is evaluated to have low recurrent taxation of housing if the respective indicator is significantly worse than the weighted EU27 average. For more information see chapter 5 in European Commission (2012a, ibid).
([55]) This analysis does not take into account the application of VAT or a capital income or capital gains tax to housing, which preferably also should be considered.
([56]) A country is considered to have a particularly high transaction tax if the country has a tax rate equal to or above 5 %.

Conclusion

The low ratio of property taxes to GDP in most of the euro area indicates that there is room to shift taxation towards property taxes. Many euro area countries could consider shifting from personal and corporate income taxes to consumption and property taxes in order to increase GDP per capita in the long run. A shift could result in stronger growth in the short-to-medium run.

A transaction tax reduces the number of transactions and thereby makes the market thinner. It can adversely affect labour mobility, and discourages transactions that would allocate the housing stock more efficiently. A recurrent tax on residential property is less distortive and forms a more stable revenue base. Thus, many euro area countries should consider shifting away from (high) taxes on residential property transfers to a recurrent tax on residential property. A way to do that would be to reduce transaction taxes and update cadastral values according to market values.

The tax systems in the euro area generally allow mortgage interest deductibility without taxing imputed rents sufficiently, which often provides tax incentives for households to over-invest in housing and to take on debt. Euro area countries should consider measures to ensure that such an implicit subsidy to housing investment does not take place.