Housing Taxation for Stability and Growth

ECFIN Workshop – European Commission

Property taxation and enhanced tax administration in challenging times

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Two relevant OECD studies

1. **Tax and Economic Growth (2008)**
   - How does the tax structure – *i.e.* how taxes are designed and combined – affect GDP per capita?
   - Based on theoretical and econometric analysis, the authors constructed a “tax and growth ranking”.

2. **Housing Markets and Structural Policies in OECD Countries (2011).** [aka: The OECD Housing Study]
   - Collect comparable new cross-country indicators of housing market policies.
   - Analyse how these policies affect housing and broader economic performance and whether they achieve their desired objectives in an efficient and equitable way.

   Both studies contain important lessons for policy-makers concerned about property taxation and implications for growth.
An aggregate study that considered the impact on GDP of four broad tax categories:

1. Personal income taxes
2. Corporate income taxes
3. Consumption taxes
4. Property taxes

**Broaden the base, reduce the rate and eliminate exemptions.**

Re-designing taxation along these lines *within* each of the broad tax categories could ensure sizeable efficiency gains.

Given that reduced rates of corporate tax for small firms do not seem to enhance productivity, a better strategy might be to scale-down exemptions based on firm size in order to finance a generalised reduction in the overall statutory corporate tax rate.
Tax Structures and Growth (II)

The distortionary effect of collecting revenue from different sources can vary significantly. Empirical evidence suggests that taxes can be ranked, in terms of their adverse effect on GDP per capita:

1. Corporate income taxes  **Most harmful to growth**
2. Personal income taxes
3. Consumption taxes
4. Recurrent taxes on immovable property  **Least harmful to growth**

- A revenue-neutral reform that shifts the tax revenue base away from corporate and personal income taxes and towards a greater reliance on recurrent taxes on immovable property and consumption taxes has the potential to be growth-enhancing.

- **Memo:** Taxes on capital transactions are highly distortionary since they discouraging transactions that would allocate these assets more efficiently.
Recurrent Taxes on Immovable Property…

- Do not distort the decisions of economic agents to supply labour, to invest in human capital, to produce, invest and innovate to the same extent as some other taxes (*i.e.* relatively more efficient).

- Are desirable for other reasons, including:
  - Since real estate is highly visible and immobile, these taxes are more difficult to evade and the immovable nature of the tax base may be particularly appealing at a time when the bases of other taxes become increasingly internationally mobile.
  - Recurrent property taxes, with regular updating of valuation, can also increase the progressivity of the tax system (*e.g.* by the exemption of low value properties), provided there are special arrangements are made for the groups of people with low incomes and illiquid assets.
  - Linking the assessment value to market value may increase incentives for developing land as market prices also reflect the development potential of land. This is important given the key role of housing supply rigidities in explaining developments in OECD housing markets.
But taxes on immovable property are under-utilised compared to other revenue sources…

Source: OECD 2008
Tax Structures and Growth (III)

While the conclusions from ‘Tax and Economic Growth’ seemed reasonable, the study was very broad and for certain categories of taxes – particularly property taxation – it lacked detailed empirical evidence on their economic effects.

Thus, for the “evidence-based” policy-maker, some important policy-relevant questions remained…

➢ What are the economic effects and distributional consequences of housing tax expenditures, such as mortgage interest deductibility?

➢ Are transaction taxes in one’s country relatively high compared to other countries? What are the consequences??
The OECD Housing Study

This study strengthens previous OECD housing-related research by:

1. Providing new cross-country comparable policy indicators;
2. Analysing the links between these indicators and housing market and economic performance.

The study analysed many aspects of housing policy, including:

1. Housing finance markets and banking supervision
2. Rental market regulations (e.g. rent controls, tenant protection) and social housing provision
3. Supply-side factors, such as land-use regulations.
4. Housing taxation policy
   - Favourable tax treatment of housing relative to other investments.
   - Transaction taxes in housing markets.
Housing is tax favoured in many OECD countries

- For most investments: the income streams (benefits) are taxed while the expenses (costs) are tax deductible.

- But in many countries owner-occupied housing is taxed favourably:
  - **imputed rental income** stream of owner-occupied housing (i.e. benefits) are generally not taxed (exceptions: CHE, ISL, LUX, NLD, SVN) and **capital gains** on the primary residence are tax exempt (albeit after some holding period in some countries)...
  - at the same time, many countries allow **tax deductibility of mortgage interest payments** (i.e. expenses) ...
    - … and the value of mortgage interest subsidy tends to be much higher than the taxation (if any) on the income stream from owner-occupied housing.

- Most countries use **recurrent property taxes** (a possible substitute for tax on imputed rents) but:
  - These taxes are often not large enough to offset the mortgage subsidy.
  - The property value for tax purposes lags well behind the market value.
    - e.g. the administrative value dates back to 1991 in the UK, 1970 in France and 1973 in Austria.
Tax relief on mortgage debt financing, 2009

Estimated wedge between the market interest rate and the after-tax debt financing cost of housing; increasing in the degree of tax relief

This indicator takes into account if interest payments on mortgage debt are deductible from taxable income and if there are any limits on the allowed period of deduction or the deductible amount, and if tax credits for loans are available. For countries that have no tax relief on debt financing costs, this indicator takes the value of zero. See Johansson (2011) for details.

Source: Calculations based on the OECD Housing market questionnaire.
Rationale for subsiding homeownership (HO)

- Often justified on the basis that HO gives rise to positive spillovers for society – better child outcomes, more community engagement, HO as a pre-commitment device for saving.
  - But these studies are plagued by endogeneity problems (i.e. cannot control for the influence of an unobserved third factor).
  - and some economists worry that HO may unduly constrain labour mobility.
  - … so the jury is out as to whether a tax subsidy to HO can be justified.

- But, more broadly, some argue that HO may provide the most stable tenure arrangement to satisfy basic household needs…
  - a plausible hypothesis that does not necessarily lend itself to econometric verification.

- … and HO may interact with the retirement income systems and be an important device to maintain living standards in old age.
Rationale for subsiding homeownership

- Reasonable people can differ on this issue so let’s assume for the moment that there is some basis for subsidising owner-occupation.

- The question then becomes do current policy settings achieve this goal according to some criteria?

- Criteria in OECD housing study: efficiency and equity.
Consequences of favourable tax treatment of housing

1. Lead to excessive housing investment and crowd out more productive investments adversely affecting growth.
   - Especially the case when the return on owner-occupied property (imputed rent and capital gains) attracts little tax but mortgage interest is tax deductible.

2. Encourage excessive borrowing and speculative behaviour by lowering the cost of mortgage finance and raise house price volatility adversely affecting macroeconomic stability.

3. Tax reliefs for mortgage debt tend to be regressive.
Favourable tax treatment of housing gets capitalised into house prices and amplifies volatility

Panel econometric analysis suggests that, all else equal:

1. Housing demand shocks tend to get capitalised into house prices more in countries with generous tax relief on mortgage debt financing.
   - Financial deregulation was associated with a 30% rise in real house prices in the typical OECD countries, but this rose to 45% in environments with very generous tax relief on mortgage debt financing.

2. Real house prices tend to be more volatile in countries with generous tax relief on mortgage debt financing.
   - A modest increase in the generosity of tax relief – roughly equivalent to moving from Spain to the United States – is associated with a 4% increase in annual real house price volatility.

Generous housing tax policies can encourage households to hold more debt than otherwise and encourages speculative behaviour to the extent that the mortgage subsidy raises the expected net profits from speculative investments.
Favourable tax treatment of housing is regressive!

Tax reliefs for mortgage debt are regressive…

- Favour the better off: higher income households are more likely to be homeowners and tax reliefs usually take the form of a deduction against earned income as opposed to a tax credit.

… and not to mention costly from a fiscal perspective!
Who Benefits from the Home Mortgage Interest Deduction?
United States, 2003

Memo: Annual fiscal cost of MID in USA is approximately 0.7% of GDP (OMB 2011)

1. The columns show the share of tax filers in each income bracket while the line shows the share of the value of mortgage interest deductions claimed by each income bracket. For instance, while 39% of all filed tax returns in 2003 pertained to adjusted gross incomes of less than $20,000, this income bracket accounted for only 4% of the value of mortgage interest deductions. As noted in Prante (2008), while adjustable gross income differs somewhat from other measures of personal income, this distinction does not affect the distributional analysis shown above.

Favourable tax treatment of housing is regressive!

Tax reliefs for mortgage debt are regressive:

- Favour the better off: higher income households are more likely to be homeowners and tax reliefs usually take the form of a deduction against earned income as opposed to a tax credit.

- Generous tax relief gets capitalised into house prices which squeezes financially-constrained households out of homeownership at the margin.

  - Empirical studies based on US data show that tax-favouring of housing tends to encourage excessive leverage and be capitalised into house prices (Capozza et al. 1996), without necessarily expanding housing opportunities for households (Harris, 2010).

  - Across OECD countries, favourable tax treatment diluted the benefits that financial deregulation bought in terms of expanded access to finance.
Homeownership, financial deregulation and housing tax relief

Impact of a 10 percentage increase in the maximum LTV ratio on the homeownership rate of households in the second income quartile

Notes: The Figure shows the impact of a 10 percentage point – or one standard deviation – rise in the maximum LTV on the homeownership rate of each group. The impact on homeownership is expressed in percentage terms, relative to the sample median homeownership rate for each group, to control for differences in median level of homeownership between each group. The dot shows the estimated impact of an increase in the LTV on the group-specific homeownership rate when tax relief on mortgage debt financing is set equal to the sample median level. The upper (lower) bound shows the estimated impact when tax relief is set at 0.5 standard deviations below (above) the sample median level.

Transaction costs in OECD housing markets

These costs include a number of different types of costs and fees:

- **transfer taxes** levied at the sale or purchase of property (e.g. stamp duties, acquisition taxes etc.)

- fees incurred when registering the property in the land registry (e.g. registration of property title and details of owner of property).

- notary or other legal fees: use of a notary is mandatory in some countries to witness and verify the signatories.

- real estate agency fees
Transaction costs refer to average costs. The estimates do not take into account the various tax breaks that exist in countries for certain dwellings implying that the estimated cost may overestimate the actual cost in some countries (for example in Italy) where such tax breaks are frequent. In addition, VAT when applied to certain costs is not included due to data limitations.
Buyer: Taxes account for a large share of transaction costs

Transaction costs refer to average costs. See Johansson (2010) for details. The estimates do not take into account the various tax breaks that exist in countries for certain dwellings implying that the estimated cost may overestimate the actual cost in some countries, in particular in Italy, where such tax breaks are frequent.

Source: Calculations based on OECD Housing Market questionnaire.
Residential Mobility varies across OECD countries
Per cent of households which changed residence in one year period, 2007

Transaction taxes undermine mobility

Controlling for a range of household characteristics, OECD estimates show that higher costs in property purchase are associated with lower residential mobility.

1. Reducing transaction costs from the high level observed in Greece (14%) to the average level among the countries included in the study (~8%) would increase the annual probability of moving by around ½ percentage point.

2. Transaction taxes disproportionately undermine the mobility of younger households, who are more likely to be financially constrained.

From this perspective, transaction taxes are harmful from an efficiency and equity perspective.
Housing Tax Policy for Stability and Growth (I)

The design of housing taxation policy in OECD is far from perfect

- The favourable tax treatment of housing gets capitalised into house prices and amplifies volatility in housing markets, which can potentially undermine long-run macroeconomic performance and stability.
  - It is also highly regressive and costly from a fiscal perspective.
- Transfer taxes on real estate transactions carry non-trivial efficiency costs and reduce labour market mobility.
  - This will inevitably make recovery for the current crisis more difficult.

These outcomes seem particularly unacceptable at the current juncture, where growth is required to reduce unemployment and aid fiscal consolidation.
Housing Tax Policy for Stability and Growth (II)

Tax housing and alternative investments in the same way

- Ideally done by properly taxing imputed rent, allowing mortgage interest deductibility (MID) and taxing capital gains (CGT). But:
  - CGT levied on a realisation basis may undermine labour mobility since any move would trigger a tax and GCT levied on an accruals basis (i.e. yearly) may be practically difficult (e.g. financial constraints for some HHs).
  - Practical issues: by definition, imputed rent is unobservable!
  - Over time, there is a risk that the system will regress to one that subsidizes homeownership (via MID) and is costly from a fiscal perspective.

- A “second best” approach is to either:
  - Remove MID: provided the interest subsidy is phased-out over a number of years, this will not involve a significant efficiency-equity trade-off.
  - Scale-up recurrent property taxes (a possible substitute for tax on imputed rents) by levying them on cadastral values (administrative tax values) that are aligned with market values.
Housing Tax Policy for Stability and Growth (III)

Scale-up recurrent taxes on immovable property.

- Raises new revenue in a fashion that is least harmful to growth.
  - For counties with relatively low yields from taxes on immovable property, annual static revenue gains of at least ½ percentage point of GDP are possible from a shift to the OECD average.
Recurrent taxes on immovable property
Share of GDP (2008)

Source: OECD Revenue Statistics
Housing Tax Policy for Stability and Growth (III)

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  - For counties with relatively low yields from taxes on immovable property, annual static revenue gains of at least ½ percentage point of GDP are possible from a shift to the OECD average.

- Governments can then reduce more distortionary types of taxes – including transaction taxes – in a revenue neutral way.

- Regular updating of administrative values increase housing supply responsiveness, which reduces the price sensitivity of housing markets to demand shocks and aids labour mobility.

- Some practical issues:
  - Updating the tax base is costly but the majority costs may be incurred up-front with subsequent ongoing costs more modest
  - In many countries, these taxes are set at the local level which presents challenges to intergovernmental fiscal frameworks.
Further reading

- Full OECD Reports:

- Shorter OECD pieces:

- All the working papers and data from the OECD Housing Study:
  http://www.oecd.org/document/50/0,3746,en_2649_37443_47333810_1_1_1_37443,00.html