TAXING RESIDENTIAL HOUSING

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Outline

• Key Tax Instruments
• Price Effects
• Concluding
KEY TAX INSTRUMENTS
Personal Income Tax

In a comprehensive income tax, fully neutral taxation of owner-occupation (compared to renting and investing instead) requires:

a. Full Taxation of Imputed Rents ...
b. ... and of Capital Gains on Housing
c. Deductibility of Mortgage Interest Payments

But we rarely observe a or (for primary residences) b, though we still quite often observe c!
This Has Two Big Consequences:

• General Bias to Investing in Housing as Opposed to Other Productive Assets—a Real Output Loss
  – Which can be large: in the U.S., an estimated tax subsidy of around 19 percent of the user cost

Justified by social benefits from ‘homeownership’?
  – In any case, evidence is that tax incentives have led to bigger houses, not more owner-occupation
• ‘Debt Bias’ at Household Level:

  – Better to acquire housing by debt than by equity if alternative is investing own funds in fully taxed assets
    • ... which is rarely the case

  – Incentive to borrow against housing if other interest is not deductible
    • ... which is often the case
Favorable Taxation of Housing is Associated with More Household Debt

and in the U.K. and U.S., mortgages fell significantly relative to home value after reductions in the value of mortgage interest relief
In Terms of Fairness:

• Richer benefit more as:
  – More likely to be able to borrow
  – Deduct against higher marginal rate
    • ... which can redress that by delivering as a credit instead

• But perhaps less distorting for them as may hit cap on tax-free savings
Transaction (or ‘Transfer’) Taxes

(Differing legal forms (stamp duties, registration fees)... but similar economics)

These Have Two Main Attractions:

• **Low Administration and Compliance Cost**, since
  – Often collected as part and parcel of the property titling or registration process
  – Incentive to comply when failure to do so jeopardizes legal claim

• ‘An Old Tax Is a Good Tax’
But also have severe weaknesses:

- **May Undermine Creation of a Formal Property Market and Other Revenues**
  - Incentive to undervalue may undermine property tax base
  - Incentive to conceal may perpetuate (informal) land tenure

- **Lock-in Effect**: Can prevent mutually beneficial transactions
  - Impact on labor mobility a particular concern

- **What purpose if other instruments are available?**
Value-Added Tax

Housing is a large part of consumption: 15% in some countries

• **Ideally: Include Rents and Rental Values in VAT**
  – (Is that double taxation with ‘ideal’ PIT treatment? No more than having to buy VAT-ed goods out of after-tax income)

• **But (as with PIT) Impractical**
  – ? Impute from property tax values, if accurate enough
So ‘Best Practice’ (At Least, in the EU and Others) Is To:

• **Tax First Sales of New Residential Property**
  – House price is present value of future housing services, so this is just prepayment—the same method as for other durables

• **Exempt Rental Values and Rents**
  – With option to tax for businesses
Three Issues with This:

• **Fairness:**
  – Windfall gain to existing owner-occupiers
    • Could tax first sale of all houses, but then lock in effect
    • Measures to protect first-time buyers, as Australia?

• **Excludes Changes in Value**
  – Tax increase in price at sale (with refund if negative)

• **Doesn’t Handle (Unexpected) Changes in VAT Rate**
Property Tax

Many attractions, especially as a local tax:

• Relatively Immobile Base, so Relatively Non-distorting
  – But shouldn’t overstate this: All that can be taxed without distorting is any location-specific rent
  – Evidence, nonetheless, that a relatively growth-friendly tax—at least at current levels
• **An Implicit Benefit Tax for Public Services**

• **Relatively Progressive**
  - But not if it really is a benefit tax!

• **Relatively Stable Over Cycle**
  - But by same token, a poor automatic stabilizer:

Source. LoanPerformance; Census Bureau, Quarterly Summary of State and Local Tax Revenue.
But also Some Cons:

• Administration Can Be Costly, and Setup Expensive and Time-Consuming
  – Data-intensive (property discovery, assessment), though simplifying devices exist

• Political Costs Can Be High
  – Highly visible
  – Link with spending benefits may be unclear
  – Pressures for exemptions

• Case for Taxing Business Property is Weak
  – Aside from location-specific rents and benefit motive
There is wide variation in use...
... Which Tends to Increase with Income Level...

... suggesting scope for greater use in many countries
Key Elements of Reform

• **Political Will**—including adequate resourcing

• **Appropriate Tax Policy Design**
  – Base rate—and exemptions
  – Coordination issues

• **Detailed Planning of Administrative Reform:**
  – Broad coverage of tax rolls and cadastre
  – Strong valuation and record keeping
  – Clear allocation of responsibilities between (and proper incentives for) central and local governments

• **Reduce/Replace Transaction Taxes**
Overall

• Important to consider combined effect of all taxes

For which: Define Effective Average Tax Rate (EATR) as PV of all taxes in percent of housing services and capital gains over holding period

– Varies with length of holding period, leverage, house inflation...
Effective Average Tax Rates on Owner Occupation
(in percent)

Note: Assumptions maintained throughout are: mortgage interest rate 6 percent; discount rate 5 percent; imputed rent 4 percent of house price; investor unmarried and in the top-income tax bracket, purchasing an owner-occupied house; no repayment of principal; proceeds of home sales used entirely to purchase another property.
So, EATRs:

• **Can Be Very High** when holding period short and transaction taxes large

• **Can Be Negative**
  – e.g., for large mortgages in countries with mortgage interest deductions but no tax on imputed rents

• **Vary with Decisions of Investor**—so distort

  ... and look very haphazard
PRICE EFFECTS
• Expected Taxes Should Be Reflected—‘Capitalized’—in **Level** of House Prices
  — But will also come to be reflected in housing supply...
  — And no impact if taxes finance benefit of equal value

• This Often Makes Reform Difficult
  — A case for gradualism: e.g., U.K. phased out mortgage interest relief over a decade
• Capitalization Effects Can Be Complex...
  – e.g., impact of transfer taxes will depend on how often houses are traded

• ... Including in Their Interaction with Tax Provisions
  – e.g., rising prices encourage removing equity through increased borrowing, and the expectation of price increases raises the expected return on borrowing to acquire housing assets
• It Is Less Clear How Taxes Affect Either Rate of Increase of or Volatility in House Prices:
In terms of the Rate of Increase:

• Viewed as a financial asset, housing must yield same post-tax return as other assets...

... so higher tax on marginal return to investing in housing must lead to a higher pre–tax return...

... and part of that return comes as capital gains
And indeed, no strong evidence house prices increase less rapidly where taxes are high:

- Wide variation in house inflation in U.S., far beyond differences in state taxes
- No systematic difference across countries:

<table>
<thead>
<tr>
<th>High-Tax Countries</th>
<th>Medium-Tax Countries</th>
<th>Low-Tax Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain 110.9</td>
<td>Brazil ...</td>
<td>U.S. 45.3</td>
</tr>
<tr>
<td>France 105.9</td>
<td>Canada 65.2</td>
<td>Ireland 108.5</td>
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<tr>
<td>Denmark 75.7</td>
<td>Germany -18.0</td>
<td>Italy 56.4</td>
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<tr>
<td></td>
<td>U.K. 124.1</td>
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</tbody>
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Source: Staff calculation based on data from OECD Economic Outlook, Vol. 83.
In Terms of Volatility

• **Theory Unclear**: e.g., transaction tax
  – Might be expected to discourage ‘speculative’ transactions, and so reduce volatility
  – But also thins the market, which can increase volatility

• **Evidence Weak**: some signs that:
  – More favorable treatment housing associated with more volatility (in OECD)
Should Taxes Be Used to Affect House Prices?

...or asset prices more generally?

- Have Been Quite Widely Used:
  - Both to soften the market
    - e.g., Korea, pre-crisis Ireland
  - And to strengthen it
    - e.g., post-crisis Ireland, U.S.
Issues:

• **What Do We Care About—Level, Increase, Volatility?**
  – If e.g., rate of price increases, then may need to pre-announce a *decrease* in taxes

• **A Plus: Capitalization Effects Mean Implementation Lag Less of a Concern Than Usual** with discretionary fiscal instruments...
  ... but they remain an issue: e.g., in U.K., anticipation of transfer tax cut had the perverse effect of reducing transactions
• Risk of Worsening Policy; but also Chances to Improve
  – e.g., support price not by extending hard-to-remove tax preferences but by cutting transaction taxes
  – Underlying distortions worsened/improved as measures increase/reduce differentiation between asset/income categories

• Better Instruments?
  – Loan-to-value rules, etc.

• Who Should Control Macroprudential Taxation?
CONCLUDING
• An important, sensitive, and difficult area

• Very few countries have solved all the difficulties

• Areas for progress relatively clear in many:
  – Removing housing tax preferences
  – Strengthening property tax
• Reform can take time and requires unusual commitment

• Use as macroprudential tool needs more experience sharing and analysis

• Good luck!