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INTRODUCTION: OVERVIEW OF TAXES ON PROPERTY

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BETTER POLICIES FOR BETTER LIVES

Overview

I. Characteristics of the Housing Market
II. Income from residential property
III. VAT and the taxation of housing services
IV. Other taxes on immovable property
V. Tax capitalisation and incidence
VI. Property taxes and their impact on economic growth

I. Characteristics of the housing market

A number of features of the housing market will affect the impact of taxation on economic efficiency, administrative and compliance costs, fairness, etc.

- The heterogeneity of property (location, size, public services, state of repair, etc.) has an impact on the valuation and amount of **housing services**.
- Heterogeneity results in search costs. Transaction taxes and, to some extent, taxes on capital gains could further reduce the efficient allocation of the housing stock.
- There may be large economic and psychic costs of moving.
- Property is “lumpy” and has a long economic life.
- Residential property is an asset (investment good) which yields a return; this return is a stream of housing services (consumption good). A tenant will pay rent to a landlord in order to enjoy these services. In the case of owner-occupiers, no market transaction takes place, but there is the opportunity cost of the rent that would otherwise have had to be paid to enjoy these housing services – often referred to as the imputed rent from owner-occupation.

I. Characteristics of the housing market

- Owner-occupiers may consume large amounts of housing services without having other income (owners may be liquidity constraint when they have to pay taxes on property).
- Housing services are either consumed by the owner-occupier or the renter. The choice of whether to rent or to buy will be an important lifestyle choice; the relationship between the tax regimes for renting and buying may have a significant influence on this choice (amongst other things, including the functioning of the mortgage market and the tax treatment mortgage interest payments, etc.).
  - Possibly absence of a well developed rental market / need to buy property for access to public services like schools.
- Residential property is often only partly financed with own funds; excessive borrowing – possibly stimulated by a favourable tax treatment of mortgage interest payments – may contribute to the creation of housing bubbles.
- The existing stock of residential property is large in relation to the flow of new dwellings. Prices in the short term depend primarily on the demand for the existing stock; significant cycles and trends in prices can occur.
- Public goods that are otherwise not priced and public provision of services such as education may get reflected in property prices, perhaps indicating how important they are in practice, providing a basis for taxes that can act as a form of benefit to user charge.

II. Income from residential property

Income from residential property consists of the return that a taxpayer has in the property, i.e. the gross return from rent plus any capital gain, less the costs of earning that income – i.e. maintenance and repairs, mortgage interest, etc.

On income side:

- Property let to tenants: the return can be measured easily.
- In case of owner-occupier, there is no market rent but the owner benefits from living in the property and saves the cost of renting a similar property. But how to determine accurately the 'imputed rent' for tax purposes?

On cost side:

How to distinguish between maintenance and improvement costs? How to measure maintenance and repair costs accurately as some of these costs can be done by owner him/her self?

II. Income from residential property

Capital gains on residential property can arise for a variety of reasons, including :

- General inflation of the price level,
- An upward trend in real property prices over time (e.g. reflecting income elastic demand as living standards rise and families want to occupy more space, or sub-divide into separate households, and price inelastic supply due to planning and zoning restrictions),
- Increase in size of population
- Improvements made,
- Externalities (e.g. improvements in transport and social infrastructure may generate capital gains while deteriorations could lead to capital losses).

A tax on capital gains would provide a way of taxing the windfall gains that a property owner might receive without any effort on their own part, but the tax authorities would also need to consider whether it is appropriate to adjust the base for general inflation and how to allow for improvements made by the owner

If maintenance costs would not be deductible for tax purposes, wouldn't this have to be considered when taxing the capital gains?

II. Income from residential property

Taxation of income from residential property in practice:

- Countries do not tax imputed rent from owner occupation in the income tax (but possibly under a recurrent tax on immovable property), and/ or do so on the basis of outdated (and low) valuations that mean that the effective tax rate is well below the statutory rates of income tax.
- Countries do not tax capital gains on residential property, or provide exemptions and reliefs such as reduced or zero rates if property is held more than a certain number of years, roll-over relief when the proceeds of a property sale are reinvested in another residence or exempt owner-occupied property altogether.

Such exemptions and reliefs may give rise to a number of distortions, including favouring:

- Owner occupation compared to residential property that is owned and let to tenants by a landlord
- Residential property compared with other saving and investment, including investment in business. This is especially so if the return on owner occupied property (i.e. imputed rent, capitals gains) is largely untaxed but the owner benefits from mortgage interest relief.

III. VAT and the taxation of housing services

In order to buy goods and services an individual generally has to pay income tax on his/ her income (whether from earnings or capital) and then indirect taxes on the goods and services themselves. Applying the same principle to residential property an individual (owner and/or tenant) would pay income tax on the return on the asset and indirect taxes on the consumption of housing services.

Residential property is a capital good that can, if properly maintained, yield a stream of housing (i.e. consumption) services over many years. In broad terms this consumption can be taken to be the rent that a tenant pays, or the imputed rent that an owner occupier would have had to pay if s/he were renting the property.

About half of EU member states levy VAT at the standard rate on the first sale of residential properties by a builder-developer (price = present value of future housing services – but is this fully accurate, especially if price is determined in short term by existing housing stock?) (VAT will be capitalized in rent that will be asked in the future), as well as maintenance and improvement work on existing properties. Other members charge a lower rate of VAT or apply an exemption.

(China had its Business Tax!)

IV. Other taxes on residential property

- Recurrent taxes on immovable property
- Transaction taxes
- (net) wealth tax
- Estate, inheritance and gift taxes

V. Tax capitalisation and tax incidence A simple example

Price apartment net of tax = 200; a transaction tax has to be paid by buyer of 10%; total (after-tax) price paid buy buyer =220 & seller receives 200.

Buyer has paid the tax; but did he also 'bear' the tax? Answer depends on the price in the absence of the 10% tax.

Case A: in the absence of the tax, the seller would be able to ask 220 to the buyer. Hence, the introduction of the tax does not change the total (after-tax) price, but it has reduced the price the seller receives (i.e. the tax is fully capitalized into the price)!

→ in this case, the old owner/ the seller bears the 10% tax (although he does not actually pay it)!

Case B: in the absence of the tax, the seller would still sell at price 200 & the buyer would now have to pay only 200. Hence, the introduction of the tax has increased the after-tax price of the apartment (i.e. the tax is NOT capitalized in the price of the apartment).

→ in this case, the buyer not only pays but also bears the 10% tax.

V. Tax capitalisation and tax incidence Introducing the concepts

Tax Incidence:

- Taxpayers who have to "pay" the tax can shift its burden to other agents!
- They can (only) do so by changing their behaviour. This may take time.
- Economic incidence therefore depends on demand and supply elasticities, which measure the responsiveness to a change in (after-tax) price.
- Those taxpayers who are the least responsive (i.e. who are the least able to alter behaviour) bear the bulk of the burden.
- Short-term elasticities may differ from long-term elasticities. Long-term incidence may differ from short-term incidence.

Standard textbook example: the incidence of the corporate income tax:

legal incidence is on the business, the economic incidence lies on capital owners (especially in a closed economy) but also on, and especially in an open economy where capital is mobile, workers (lower wages) and consumers (higher prices).

V. Tax capitalisation and tax incidence Introducing the concepts

Tax capitalization:

- Future tax liabilities on the return to an asset can have consequences in the present, as the future tax liability becomes incorporated (capitalized) into the price of the asset (i.e. taxes may reduce the price of the property).
- Full capitalization occurs when, after controlling for all housing characteristics (structure, neighbourhood and public services), differences in housing prices exactly equal the present value of variations in expected tax liabilities.
- Announcement effect: merely announcing a tax will reduce the price immediately!

There is a large literature that evaluates to which extent taxes are capitalized into property values. This is a complex issue, especially because higher taxes may imply better public services, which have an opposite effect on property values.

The capitalization literature provides insights about the incidence of property taxation. Full capitalization implies that current owners bear the entire burden of the tax change; partial capitalization suggests that current owners are able to partly shift the burden to new/ future owners.

V. Tax capitalisation and tax incidence

The agent who actually pays the tax is not necessarily the agent who bears the tax.

Taxes might be capitalized in the pre-tax price of immovable property, implying that a tax decrease will not lower the after-tax price that the buyer will have to pay but will lead to an increase in the pre-tax price the buyer can ask.

So: if the after-tax price does not change (but the pre-tax price does change) in response to a tax change, the seller bears the tax!

But: if the pre-tax price remains fixed and the after-tax price increases as a result of a tax increase, the buyer bears the tax!

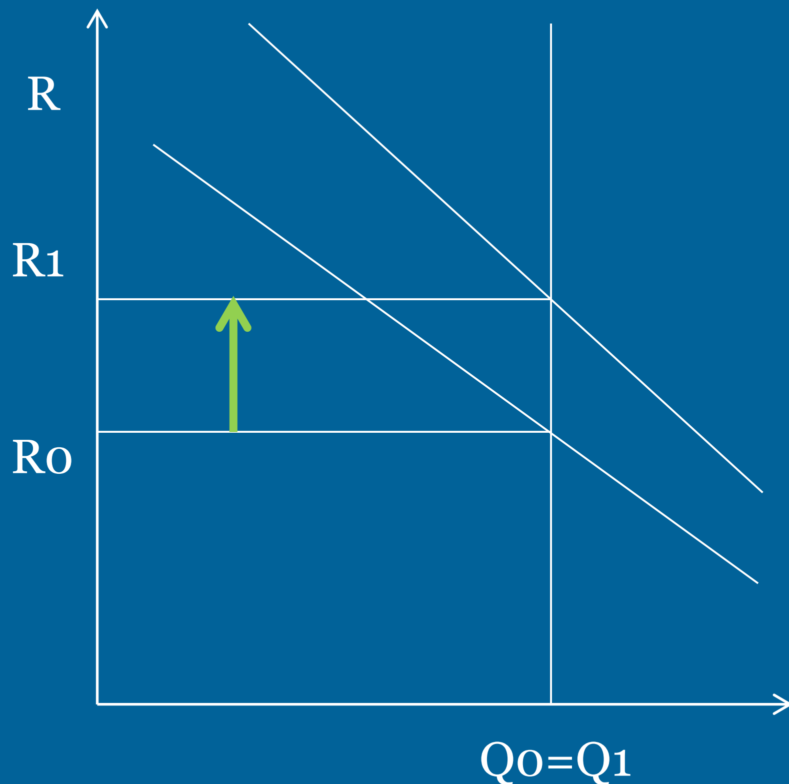
The more inelastic is the supply and the more elastic is the demand for immovable property, the larger will be the extent that property taxes are capitalized in prices and that the seller will bear the tax (irrespective of whether the seller or the buyer actually pays the tax).

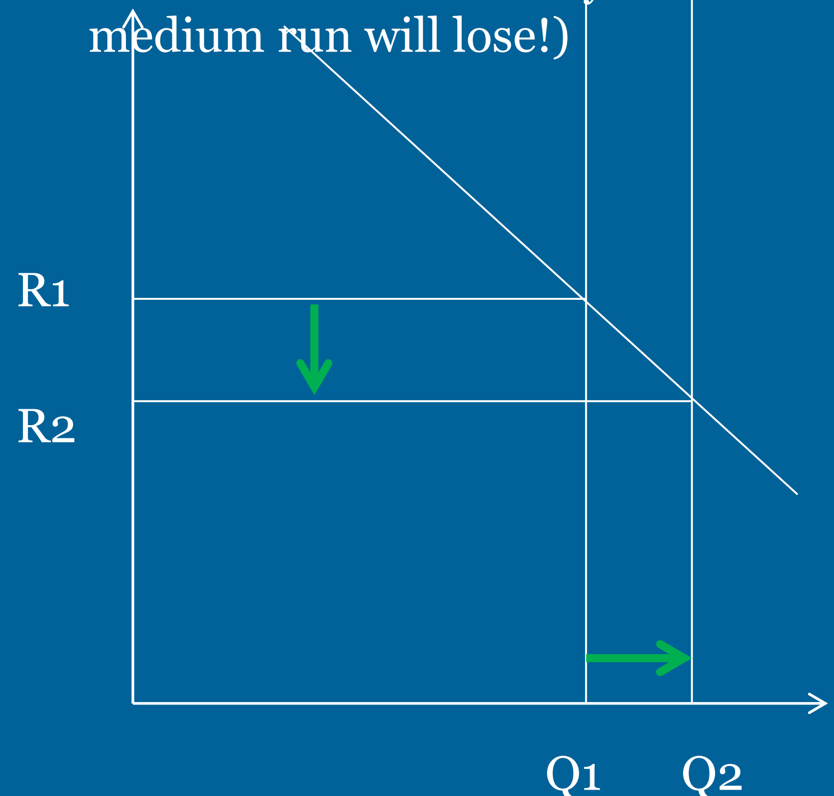
The incidence of a property tax will fall more on the buyers and less on the sellers the more elastic is the supply and the more inelastic is the demand for immovable property.

Case study: impact of increased property tax relief

SHORT RUN: property prices increase (as taxes are capitalized into prices) leading to windfall gains for current owners of increased tax relief

LONG RUN: supply increases (more houses are built, so prices decrease) – in longer run, also new buyers (at that moment)will benefit. But households who buy in the medium run will lose!)





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VI. Property taxes and their impact on economic growth

Recurrent taxes on <u>residential</u> immovable property (land and buildings) are part of a pro-growth tax mix, because they are:

- Efficient as they do not affect decisions to supply labour, invest in human capital, to produce, invest and innovate to the same extent as other taxes.
- Inelastic supply implies low Dead Weight Losses (so efficient).
- Highly visible taxes + immobile tax base: more difficult to evade.
- Provide an incentive to efficiently use land and housing capital.
- Preferential tax treatment of housing may distort capital flows (e.g. leading to over-investment in housing / under-investment in other saving vehicles): restoring balance may increase growth.

FOCUS ON OVERALL TAX BURDEN ON RESIDENTIAL PROPERTY

- FIRST BEST: tax actual and imputed rents (and capital gains on a realization basis) as other capital income at the personal level and allow for mortgage interest deductibility as well as deductibility of maintenance costs.
- SECOND BEST: no taxation of imputed rents in income tax, no mortgage interest deductibility but levy recurrent taxes on immovable property.

VI. Property taxes and their impact on economic growth

Recurrent taxes on immovable business property

- Taxes on businesses are amongst the most distortive type of taxes/ most negative impact on economic growth. This holds not only for the corporate income tax but also for recurrent taxes on business immovable property (except if there is a strong link with service delivery)
- Do not tax business immovable property at higher rates than residential property!
- Although capital is locked-in (so inelastic) and could therefore be taxed at high rates, investors will anticipate the increase in tax burden and will not invest!
- Tax burden will be shifted to workers (lower wages), consumers (higher prices, thereby reducing competitiveness) and will be borne only partly by capital owners.

Recurrent taxes on net wealth

- Discourage savings and may encourage people to move their wealth offshore
- In practice, net wealth taxes often exempt certain assets, such as pension fund assets and residential property, thus distorting the portfolio choice and proving a method of tax avoidance (e.g. borrowing money which reduces net wealth to purchase tax exempt assets)

VI. Property taxes and their impact on economic growth

Financial and capital transaction taxes are highly distortive

- It is always less distortionary to tax the income and services provided by assets than the transaction involved in acquiring or disposing of them.
- Transaction taxes and taxes on income/ consumption discourage the ownership of the assets, but the transaction taxes have the added distortionary cost of discouraging transactions that would allocate these assets more efficiently.
- For example, transaction taxes discourage people from buying and selling houses and so discourage them from moving to areas where their labour is in greater demand.

Estate, inheritance and gift taxes

- Inheritance taxes are like net wealth taxes but levied only at the end of a person's life, so less distortionary (as most of it is unplanned)
- They may be seen as a way of taxing income or capital gains that were not taxed while the person was alive.
- Gift tax as anti-avoidance measure, but may reduce growth by delaying the transfer of assets between generations.
- Problem with succession of businesses (possible growth implications).

VI. OECD Tax and Growth Recommendations

Because of the under-taxation of residential immovable property in many OECD countries

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Because of the nice efficiency characteristics of property taxes,

the OECD "Tax and Growth" empirical study has concluded that shifting the tax mix, on average across the OECD, to more income and/ or recurrent taxes on immovable property would be a pro-growth tax strategy in many countries.

Thank you for your attention

Are there any questions?

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