2020 Research report summary

A New Taxation of Housing

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SNS

Summary

FOR CENTURIES, housing and other forms of real estate have in most countries been important objects of taxation. In Sweden, 3 percent of total tax revenues today come from housing. Taxes on owner-occupied homes – one-family houses and shares in housing co-op associations (*bostadsrätter*) – are among the most controversial aspects of the tax system. An individual's residence is central to his or her well-being, and the way it is taxed affects house prices and housing costs, thereby also the distribution of income and wealth as well as the size and composition of the housing stock. The tax system should follow broadly accepted principles. Favoring certain groups of households, regions, or types of housing should be the result of an explicit political decision.

This report adopts a broad approach to housing taxation. The primary focus is on owner-occupied homes; however, the relationship to taxes on rental housing plays a central role. Taxation should aim for neutrality with respect to the choice of housing and form of housing tenure. Tenure preferences vary across households and across stages of the lifecycle, and it is not up to the tax system to govern this choice. After-tax housing costs should be the same for equivalent dwellings, be they rental, owner-occupied, or owned cooperatively.

The returns from housing come in two forms: housing services and capital gains (or losses). These returns, like other forms of capital income, should be subject to taxation. A complication is that the value of housing services cannot be observed directly, while capital gains are observable only when the gain is realized, often after many years of increasing prices. It naturally follows that housing is subject to more than one type of tax. The owner of a one-family house pays a property tax (*fastighetsavgift*) related to its value, a capital gains tax imposed at the time of sale, with the right to get a deferment, and a stamp duty at the purchase of a new house.

The owner of a share in a co-op pays a capital gains tax and, indirectly, his or her part of the property tax imposed on the co-op association. The owner of a rental apartment building pays several taxes: tax on the operating surplus, property tax, stamp duty, and tax on dividends from the property. Taxes are levied on both ownership, returns, and transactions, and understanding how these taxes interact is crucial.

Furthermore, interest payments are deductible from taxable income. This is a natural consequence of the taxation of capital income. A fully mortgaged investment should basically have no effect on tax payments, be it in financial assets or a home. The total taxation of owner-occupied homes should thus follow the value of interest deductions for a fully mortgaged property.

The current housing taxes are the result of a long historical development. In the 1980s, the tax basis was an imputed income computed according to a progressive rate on assessed value. The imputed income was taxed on top of other forms of income following a progressive scale. With the 1991 tax reform, this double progressivity was replaced by a proportional property tax, separate from the tax on labor income. The property tax came under growing criticism as house prices skyrocketed around the turn of the millennium. In 2008, the property tax was reformed and capped in kronor so that the tax is the same on all houses at above-median values. In relation to the house value, the tax has gone from progressive in the 1980s to currently being regressive. During the same period, the tax on capital gains has undergone several changes. Currently, the capital gains tax and the property tax are roughly equally important sources of government revenue.

Today, housing taxation deviates from neutrality in primarily two respects. First, expensive houses are taxed lightly compared to cheaper houses. Second, shares in housing associations are taxed lightly compared to one-family houses and rental apartments. The relationship between one-family houses and rental apartments is approximately neutral at today's low interest rates: the sum of property tax and capital gains tax is currently at the same level as the value of interest deductions.

A problem with the property tax is that the tax rate is independent of the interest rate. On average and over time, the system is at best neutral relative to interest deductions. It so happens that the general housing tax level is well-aligned with the present interest level, but this will no longer be the case once interest rates revert back to more normal levels. According to calculations in the report, tax payments in kronor tend to be stabilized over time if the property tax rate follows the interest level.

Neutrality is not a technical or »aesthetic« issue concerning the inner logic of the tax system. It is about efficiency and distribution. The current deviations from neutrality create incentives to build large and expensive houses in exclusive locations and attractive regions rather than cheaper and more modest houses in ordinary locations. They create incentives to sell rental apartment buildings to co-op associations, thereby reducing the supply of rental apartments, the natural form of tenure for many young households. The lack of neutrality reduces housing costs for homes that attract high-income households in expanding metropolitan areas.

By imposing the tax only at the date of realization, a capital gains tax tends to reduce mobility in the housing market, as the homeowner can reduce the present value of tax payments by abstaining from moving. Calculations in the report estimate that this reduction may correspond to 3–6 percent of the value of the house. Only taxing gains above the normal rate of price increases (e.g., 2 percent annually) would enable limiting this lock-in effect.

The critique against the previous property tax focused primarily on the lack of predictability, which was an increasing problem in the period of rapidly increasing house prices in the early 2000s. As illustrated in the report, there has been considerable uncertainty regarding how prices will develop from year to year. In some years, average house prices have gone up or down by as much as 20 percent, and the market values of individual houses have fluctuated much more. In light of this, it is urgent to find a way to reduce the immediate impact of current market prices on the property tax.

The report concludes with a concrete reform proposal for future housing taxation.

- Rental apartment buildings are, like today, taxed according to the general principles for business incomes. The property tax for rental apartment buildings is abolished.
- Shares in co-op associations are taxed based on an assessed market value, following the same principles as one-family houses. The property tax on co-op associations is abolished.
- An imputed income from one-family houses and shares in co-ops is taxed as income from capital.
    - The imputed income is calculated as a standard interest rate multiplied by a moving average of assessed values over a number of previous years.
    - The standard interest rate follows a moving average of the government borrowing rate with an addition of, for example, 2 percent.
- »Excessive« capital gains on one-family houses and shares in co-ops are taxed upon realization as income from capital.
    - Taxable gains are calculated as the difference between the realized gain and a »normal« price increase (e.g., 2 percent annually) with deficits being fully deductible.
    - In case of inheritance, the estate pays tax on the difference in assessed value from the time of purchase.

- The stamp duty is replaced with a fee covering administrative costs.
- The deductibility of interest payments is maintained. The current reduced tax rate for large deficits is also maintained.

A reform along these lines would yield a stable and neutral system of housing taxation within a nominal taxation of capital income. In the current low-interest environment, such a reform would not increase the average taxation of one-family houses, whereas the tax on shares in co-ops would increase. However, the structure of taxation would change with reductions at low values and increases for more expensive houses. The tax on capital gains would be radically lowered. Transition problems could be reduced by, for example, allowing current homeowners to continue paying taxes according to the current rules until a future sale.

This tax reform would improve the neutrality between forms of tenure, between cheap and expensive homes, and between regions. It would increase mobility by limiting the capital gains tax that is due at the time of sale. It would improve predictability by letting the tax rate follow the market interest rate and by letting the tax base follow moving averages of past interest rates and assessed values.

About the author

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