

## Special Feature D: Residential real estate taxation and macroprudential policy<sup>35</sup>

**Residential real estate-related (RRE-related) taxes and changes to them may have a significant impact on RRE prices as well as on incentives for mortgage-related household debt.** RRE-related taxes rarely account for a substantial portion of fiscal revenue but they can have a considerable influence on financial stability outcomes through the asset (house) price and household debt channels.<sup>36</sup> Taxation acts mainly through demand-side incentives for households to own, rent, invest in RRE or take on mortgage debt. Taxes also affect the supply of residences, but such taxes<sup>37</sup> are more relevant for RRE developers than households.

**RRE-related taxes affect the cost of buying, financing, owning, renting, selling, gifting or inheriting property.** Taxes that are of particular relevance for financial stability comprise RRE-related transaction tax, recurrent property ownership and income taxes. The latter group includes capital gains tax, rental income taxes, and provisions for mortgage interest deductibility. While tax changes, especially material ones, are likely to be more or less capitalised into house prices immediately, certain RRE-related taxation provisions may also have powerful structural incentives with important long-term macroprudential ramifications for house prices and household indebtedness. This special feature highlights the macroprudential impact of selected RRE-related taxes and describes their interlinkages with macroprudential instruments.

### D.1 Residential real estate-related taxation

**RRE taxation can be seen as a tax on the consumption of housing services or as a payment for local public services, but in most cases it is closely related to capital taxation rules.**<sup>38</sup>

Given the prevailing use of RRE taxation as an investment asset, an ideal (first-best) and neutral tax treatment with respect to other investments is to tax the net return from a property, including capital gains, after the deduction of depreciation, maintenance costs and interest payments. In the case of owner-occupied housing, this implies taxing an imputed rent<sup>39</sup>, but most countries choose to substitute imputed rent taxation with a blend of transaction and recurrent property taxes. However, the combination of mortgage interest tax relief and a recurrent property tax, the latter often at low rates and based on outdated property values, leads to a bias towards home ownership and debt financing. Therefore, the second-best solution is to abolish the deductibility of mortgage interest payments and the transaction tax, and to levy a recurrent property tax based on up-to-date market valuations instead.

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<sup>36</sup> See also "**Report on residential real estate and financial stability in the EU**", ESRB, December 2015.

<sup>37</sup> For example, value added tax for the sale of new buildings or vacancy tax.

<sup>38</sup> See Johannesson Lindén, Å. and Gayer, C., "**Possible reforms of real estate taxation: Criteria for successful policies**", *Occasional Paper Series*, No 119, European Commission, Directorate-General for Economic and Financial Affairs, October 2012.

<sup>39</sup> An imputed rent is the rental value of owner-occupied housing (i.e. rental income saved by a homeowner).



## Recurrent property tax

**The property tax imposes a direct and recurrent cost on homeowners.** Despite the fact that RRE usually represents the largest share of household assets, it is still the majority's favourite investment asset. Without a disincentive in the form of a recurrent property tax or other types of tax, most people are therefore likely to prefer RRE to other investments. In the absence of a total wealth tax, the recurrent property tax also serves as a partial wealth tax. In addition, inheritance tax could also be viewed as a postponed recurrent property tax, but the latter is annual, much smaller and thus perhaps easier to stomach over time than the former. Moreover, a large one-off inheritance tax creates strong incentives to avoid it altogether.

**The recurrent tax on property may be designed in a multitude of ways, but certain features may have positive financial stability implications by dampening house price volatility.** As a general rule, the more punitive and progressive the design, the less attractive RRE becomes for investment purposes. In this regard, three possible features stand out: heavier taxation of non-primary residences, non-deduction of the associated mortgage debt from the tax base, and the use of up-to-date market valuations for the tax base.

**First, a higher property tax on secondary and subsequent residences lowers incentives for buy-to-let activity, which is also often debt-financed.** Although an optimal supply of RRE for renting is dynamic and market-specific, an excessive increase in debt-financed buy-to-let activity could put pressure on house prices and burden banks with riskier exposures.

**Second, using gross rather than net-of-debt property values for the tax base reduces incentives for debt accumulation by households.** Allowing the deduction of associated mortgage debt from the property tax base introduces a bias in favour of leveraged investment in RRE, even when it could be achieved without debt financing. Furthermore, it also encourages mortgage equity withdrawal, not least because for households it is usually more difficult to leverage other types of assets. It is also noteworthy that in Norway, for example, the net wealth tax allows for a full deduction of mortgage debt from the wealth tax base, but only a certain portion of debt used to fund other types of assets, thereby creating an additional advantage for RRE investments.

**Third, a closer alignment of the tax base with up-to-date market valuations could strengthen the dampening impact on house price volatility.** A full and frequent revaluation of cadastral (taxable) values could introduce too much volatility into payable tax liabilities, making it especially burdensome for asset-rich (in the form of housing), low-income households. Some limited smoothing and lagging mechanisms of taxable values could therefore be adopted to alleviate such volatility, but at the same time they should not present much distortion to the allocation of capital among the various types of investments.

## Transaction tax

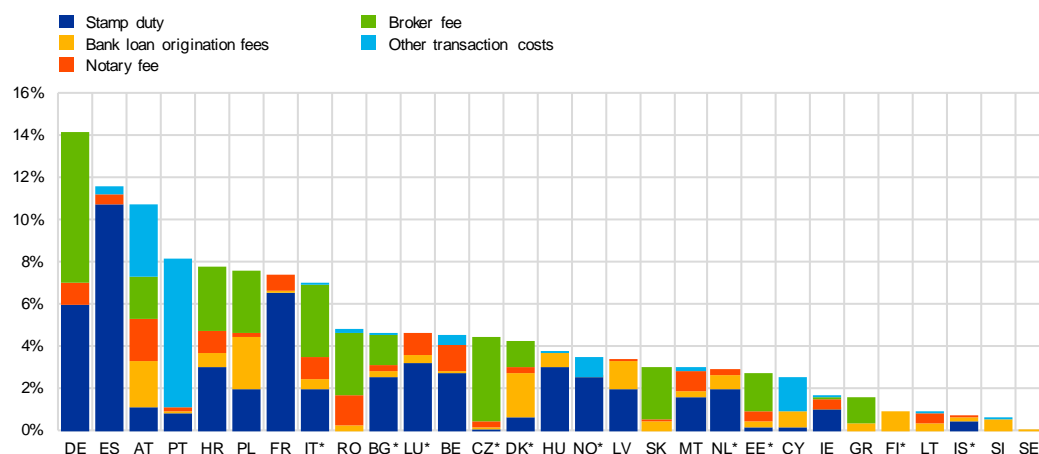
**The transaction tax on the transfer of residential property represents a one-off cost of home ownership.** Just like other RRE-related taxes, the transaction tax (stamp duty) discourages home ownership and also makes other untaxed assets more attractive when it applies to RRE transactions only. However, it also distorts the reallocation of residential properties, as well as the efficient allocation of capital among different investments in general. Moreover, it reduces market liquidity, creates welfare loss, and also hampers labour mobility and home exchange. The stamp duty is usually charged as a certain percentage of the transaction price, which makes its distorting effects even more significant.



**While the property transaction tax is a procyclical source of fiscal revenue, it might have a countercyclical impact on house prices.** The stamp duty is not the only, but often by far the largest, part of transaction costs faced by a homebuyer (see Chart D.1). Taken together, these transaction costs represent a significant barrier to entering the housing market. Moreover, most of them are also proportional to the transaction value. As a result, with higher house prices, a larger amount of money is needed to pay the stamp duty and other transaction fees, thereby forcing some potential buyers to postpone purchases and easing pressure on house prices. The evidence on whether a higher transaction tax rate or its increase could, ceteris paribus, deter speculation is not clear-cut. In any case, the EU tax authorities have not been using stamp duty as a tool to moderate house price volatility. Outside the EU - in Canada and New Zealand for example - special transaction taxes have been introduced for acquisitions by non-residents to discourage an influx of foreign RRE investors.

**Chart D.1**  
**Estimated cost of entry into the housing market: stamp duty and other transaction costs paid by the buyer**

(percentage of average price of a standard apartment bought by a hypothetical family)



Sources: IWG/AWG membership survey and Bank of Lithuania calculations.

Notes: (1) A hypothetical family with two children; both parents earn an average salary and decide to buy their first home (i.e. first-time buyers), namely, a 70 m<sup>2</sup> three-bedroom apartment in a new building located in one of the residential neighbourhoods of the capital city; (2) in some cases, bank fees can also include mortgage registration and notary fees; (3) other transaction costs include property transfer taxes, property and mortgage registration fees, and other administrative costs; (4) in countries that are marked with an asterisk (\*), mortgage interest deductibility could be applied based on the family situation; (5) in Norway, the described hypothetical family would not be able to obtain a mortgage for the specified apartment as it would not fulfil existing borrower-based requirements.

## Rental income, capital gains taxes and mortgage interest deductibility

**Although most EU countries do not tax imputed rents on owner-occupied housing, it is nevertheless important to tax other rental income in the same way as other capital income.**

Otherwise, RRE investments would have an advantage over other types of capital income, e.g. interest income on bonds or dividends from equity investments.

**In the same vein, capital gains from RRE transactions should be taxed as capital gains on the transfer of other assets.** However, more often than not various reductions, deferrals or full exemptions apply for capital gains made on a primary residence, properties held for a certain period or when the gain is reinvested in another property (i.e. home exchange or upgrade); this results in another bias in favour of RRE investments. There are also strong doubts as to whether capital



gains tax can meaningfully restrain speculative activity. In contrast to the transaction tax, where tax liability arises when a purchase transaction is made, the capital gains tax liability materialises only when a divestment is made and can be satisfied from the sale proceeds.

**Mortgage interest relief is intended to lower costs for homebuyers.** However, given that usually neither imputed rents nor capital gains are taxed to the same extent as other investment returns, it leads to a bias towards leveraged RRE investments. The deductibility of interest payments lowers the after-tax cost of debt and thereby creates incentives to use debt financing. Moreover, it specifically promotes mortgage debt, as the deductibility of interest payments on other forms of debt is rarely available to households.

**The deductibility of mortgage interest encourages debt-financed homeownership and may lead to adverse macroprudential outcomes.** The combination of lower after-tax mortgage interest costs and various other tax benefits of homeownership results in a strong structural bias in favour of debt-financed RRE investments. This is likely to be capitalised in house prices and might contribute to housing bubbles as well as excessive household debt accumulation. In other words, favourable RRE-related taxation represents an important structural vulnerability that poses financial stability risks and increases the probability of a real estate-related banking crisis.<sup>40</sup> Mortgage interest deductibility is still allowed in 11 EEA countries<sup>41</sup>. It is worth mentioning that eight of these countries were included in the list of 11 countries<sup>42</sup> that received ESRB country-specific warnings and recommendations on medium-term vulnerabilities in the RRE sector in September 2019.<sup>43</sup>

## D.2 Interaction of macroprudential and RRE-related taxation instruments

**Taxation is first and foremost used to meet various fiscal policy objectives, but in so doing can also contribute to financial stability.** Individual RRE-related taxes, combinations thereof or specific design features may produce spillovers with macroprudential consequences. Spillovers in the opposite direction are much less direct, but nonetheless material, given that macroprudential policy helps to ensure RRE market stability and macro-financial stability more generally.

**The extent to which taxation and macroprudential instruments can be substituted for or complement each other depends on their impact, transmission channels and mutual reinforcement.**<sup>44</sup> For instruments to be substitutes, both of them should be able to achieve the same effect through the same transmission channel. If this is the case, then the use of one may call for a deactivation of the other, whereas the choice of an instrument should be based on relative effectiveness. By contrast, instruments would be complements if the use of one enhances the effectiveness of the other or because they operate through different transmission channels. In practice, however, the line between substitutes and complements is often blurred, as even substitutes could be calibrated for joint additional use to achieve a desired effect. Since taxation and macroprudential instruments are activated by different authorities, the coordination needs are greater for instruments that are complementary rather than substitutable, assuming that the conflicting uses of the latter are less likely to happen.

<sup>40</sup> “**Report on residential real estate and financial stability in the EU**”, ESRB, December 2015.

<sup>41</sup> BG, CZ, DK, EE, FI, IS, IT, LU, NL, NO, SE.

<sup>42</sup> BE, CZ, DE, DK, FI, FR, IS, LU, NL, NO, SE, of which only BE, DE and FR do not allow mortgage interest deductibility.

<sup>43</sup> “**ESRB issues five warnings and six recommendations on medium-term residential real estate sector vulnerabilities**”, ESRB, press release, 23 September 2019.

<sup>44</sup> See Fell, J., “**Real estate-related taxation and macroprudential policy: substitutes or complements?**”, presentation at the Macroprudential Policy Conference 2019 organised by the Bank of Lithuania in Vilnius, 1-2 July 2019.



**The transaction tax and the loan-to-value (LTV) requirement could complement each other.**

Both instruments require a certain amount of savings from a buyer/borrower and thus their joint use (change) could strengthen the effect on house prices and related credit demand. However, the transaction tax would operate mainly through the house price channel, whereas the LTV requirement would operate largely through the credit channel and would also affect household and bank resilience. In the case of special transaction taxes for RRE acquisitions by foreigners, an additional transmission channel would be opened for non-resident investors.

**There are many other examples of the interaction between macroprudential and RRE-related taxation instruments, but it all boils down to their impact on house prices and mortgage debt.**

For example, a stricter debt-to-income (DTI) requirement and lower mortgage interest relief would both reduce credit demand and lower house prices. A higher recurrent property tax and stricter LTV requirement for non-primary residences would both reduce incentives for buy-to-let activity, thereby easing pressure on house prices and reducing demand for related riskier mortgages. However, only capital- and borrower-based macroprudential tools can directly ensure bank and household debt-related resilience, whereas both taxation and macroprudential instruments could be used to moderate house prices and mortgage debt cycles.

**It is also important to note that RRE-related taxation has a much more all-encompassing effect on the housing market than macroprudential policy, since the latter operates largely through the credit market.**

First, RRE-related taxation applies to the entire housing stock, including all properties that are not mortgaged. Second, it also affects all RRE transactions, including speculative investment flows and buy-to-let activity, even if transactions are not financed with debt. Third, RRE-related taxation covers mortgages provided by unregulated entities. Fourth, taxation may also be more successful in capturing cross-border RRE-related activities.

## D.3 Conclusions

**The shortest summary of how RRE-related taxation could contribute to financial stability would also be the best advice on this matter: RRE-related taxation should not promote debt-financed homeownership.** RRE-related taxation features that skew incentives in favour of RRE investments or mortgage debt financing may pose risks to financial stability by putting pressure on house prices and increasing household indebtedness. In this regard, it is critical to phase out the preferential treatment of RRE investments, particularly the deductibility of mortgage interest payments.

**The interaction between macroprudential policy and taxation deserves more attention and cooperation between fiscal and macroprudential policymakers.** Taxation is a very powerful policy tool, but tax authorities more often than not tend to disregard the macroprudential dimension of various taxes and prioritise other objectives. Moreover, macroprudential and taxation instruments can be both substituted for and complement each other, but their interaction in addressing risks to financial stability remains relatively unexplored, either theoretically or empirically.<sup>45</sup> The relative effectiveness, flexibility and implementation lags of instruments may also differ. Given the importance of taxation, macroprudential authorities must develop expertise and proactively inform fiscal policymakers about the macroprudential aspects of RRE-related taxation.

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<sup>45</sup> To strengthen the assessment of the financial stability implications of various RRE-related tax measures, macroprudential policy databases should also include taxation changes, not least because available research points to a quite significant impact of some RRE-related taxation changes on house price and credit dynamics.

