ELSEVIER

Economic Modelling 20 (2003) 895–921

Economic Modelling

www.elsevier.com/locate/econbase

The welfare effects of housing taxation in a distorted economy: a general equilibrium analysis

Brita Bye*, Turid Åvitsland

Research Department, Statistics Norway, Pb 8131 Dep., N-0033 Oslo, Norway

Accepted 12 June 2002

Abstract

Efficient capital taxation has been one of the most important objectives for large tax reforms implemented in several countries during the last decades. The Norwegian Tax reform of 1992 took a large step towards tax neutrality between the different capital types and uses. However, housing capital is still an exception. In this paper the welfare effects of imposing a neutral system of housing taxation are analyzed by using an intertemporal CGE model for the Norwegian economy. The tax reform implies a substantial increase in the tax revenue from housing taxation, and the welfare effects of different rebating alternatives are considered.

Keywords: Capital taxation; Housing tax reform; Dynamic equilibrium analysis

1. Introduction

Efficient capital taxation has been one of the most important objectives for large tax reforms implemented in several countries during the last decades.[1] The Norwegian Tax reform of 1992 took a large step towards tax neutrality between different capital types and uses. However, housing capital is still an exception. The marginal effective tax rate on housing is substantially lower than the marginal effective tax rates on other capital types and uses. The current system of housing taxation is characterized by a low imputed value of the house for taxation purposes combined

Abbreviations: D58; H21

*Corresponding author. Tel.: +47-21-090000; fax: +47-21-090040.

E-mail address: brita.bye@ssb.no (B. Bye).

[1] Examples are the US Tax Reform Act of 1986, Slemrod (1990b), The Swedish Tax reform of 1991, Agell et al. (1998) and The Norwegian Tax reform of 1992, Holmøy and Vennemo (1995).

0264-9993/03/$ - see front matter
PII: S0264-9993(02)00039-1

with a low imputed rate of return. Together, this generates a low marginal effective tax rate on housing capital.[2]

The lenient taxation of housing capital has been criticized from an efficiency point of view.[3] Too much capital is allocated to housing compared with other types and uses of capital, giving an efficiency loss for the economy. Therefore, increased housing taxation may have a positive welfare effect. From a public finance perspective there may exist welfare improving tax reforms which include increased taxation of housing and where some or all of the additional tax revenue is used for reducing other distortionary taxes. The last years focus on internationalization and mobile tax bases, introduces another argument for increased taxation of housing capital: Housing capital is not very mobile between countries or other tax jurisdictions. Increasing the tax burden on housing may be an additional source of financing public spending if other tax objects more easily are moved to low tax countries, and traditional tax bases are eroded.[4]

As pointed out by Goulder and Thalmann (1993) it is possible to have efficient capital allocation along different dimensions. Efficiency along one dimension may imply a lower degree of efficiency along another one. Two dimensions of efficient capital allocation are respectively intratemporal and intertemporal efficient capital allocation. When effective tax rates are equal across types and end uses of capital, net marginal products of capital tend to be equal, and total output and welfare are larger than when net marginal products differ. This is static or *intratemporal efficiency* in capital taxation.

The gain from intratemporal efficiency must be compared to efficiency along the intertemporal dimension. To obtain the 'modified Golden rule' allocation of consumption and total savings, the optimal marginal effective tax rate on all savings is zero, see e.g. Atkinson and Sandmo (1980) and Judd (1999).[5] This is *intertemporal tax neutrality* for a closed economy. In a small open economy with interest rate given in the world financial market, capital income taxation will also in this case drive a wedge between private return to capital and social return to capital, and savings are too low. The tax reforms of the last decades may have put too much attention to static neutrality in capital taxation and too little attention to

[2] While working with this analysis the Ministry of Finance was preparing a housing taxation reform. The motivation for this reform was the fact that the valuation of housing for taxation purposes was too arbitrary and thereby unfair. The result, however, was that the existing rules were carried on. In addition, a rule stating that the valuation of the house for taxation purposes should not exceed a certain percentage of the market value was introduced.

[3] However, there may be efficiency arguments in favour of subsidising owner-occupied housing, Rosen (1985). People may take more care of their houses or become more involved in the local community when they are owners. But such externalities do not seem to be quantitatively important. In addition, subsidising housing through lenient taxation of owner-occupied housing tends to support the middle- and upper income classes and not the poor. In this paper we disregard distributional aspects and the mentioned externalities associated with home ownership.

[4] For an overview of the rapidly increasing literature on tax competition see Wilson (1999) and Schjelderup (2000).

[5] Judd (1999) shows that the optimal long run tax rate on capital is zero in a dynamic model with a revenue constraint.