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How do services of owner-occupied housing affect income inequality and redistribution? ☆

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ABSTRACT

This paper aims at analyzing the redistributive impact that the inclusion of the imputed rental market value of owner-occupied housing would have if used for quantifying the ability to pay rather than imputation based on cadastral values. We consider the Spanish personal income tax as reference, due to the differential treatment that it provides for imputed income from owner-occupied housing, together with the exceptionally high percentages of home ownership in Spain. By means of micro-simulation we explore the consequences of alternative possibilities for dealing with implicit income from owner-occupied housing.

1. Introduction

Both cash and non-cash income determine the economic well-being of households (Smeeding et al., 1993). Nevertheless, inclusion of non-monetary income in economic analyses or for government tax and transfer program purposes entails substantial measurement difficulties, which probably explains why incomes from services of consumer durables are often omitted in the studies on income distribution, in the production of consumer price indexes and in the calculation of macroeconomic indicators (Katz, 1983).[1]

The treatment of in-kind income in the definition of ability to pay for personal income tax purposes is a classic topic in Public Finance theory. The personal income tax programs of most countries tax income differently depending on the source,[2] which is a violation of the classic principle of horizontal equity.[3] A clear example of this difference is found in the differing intensities with which monetary and non-monetary income are taxed. Arguments about whether

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[1] Some exceptions are Lerman and Lerman (1986), Yates (1994), Buckley and Gurenko (1997), and Smeeding et al. (1993).

[2] Goode (1975) provides an attractive formulation on the global concept of income, extending the classical definition of Haig-Simons.

[3] See Shoup (1969) and Musgrave (1990).

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and how non-monetary income should be taxed are often raised in income tax reforms.[4] Debate has focused especially on the tax treatment of non-monetary real estate income accruing to those living in homes they own.

The differential treatment which the Spanish personal income tax (PIT) provides for this type of income, together with the exceptionally high incidence of primary residence ownership in Spain make it especially interesting to consider the consequences for Spain of alternative possible ways of treating the imputed income of owner occupiers derive from their homes.

Real estate income receives specific treatment in the Spanish personal income tax (PIT) via the criteria for measuring taxable income, including income exemption criteria, and through different tax rates and tax credits.[5] In the special case of owner-occupied housing, Act 18/1991 – which regulated the PIT from 1992 to 1998 – requires the imputation of an in-kind return on owner-occupied housing via the application of a stated rate to the cadastral value of a home.[6] The debate on the limitations of this procedure for properly reflecting ability to pay is the main motivation for this paper.[7] In particular, this paper analyzes the redistributive impact resulting from the inclusion in the taxable income of the imputed rental market value of owner-occupied housing based on cadastral values versus alternative valuation methods.

The analysis makes use of the results of micro-simulations for three different scenarios. In the first scenario, the actual Spanish PIT regulations regarding owner-occupied housing are modelled whereas alternative methods of determining the taxes for non-monetary income enjoyed by those living in owned homes are used for the second and third simulation scenarios. More specifically, the second scenario includes a new imputation at market value, although this change is made maintaining the initial tax liability, whereas in the third scenario the tax liability is recalculated by adding the new returns at market value to the tax base. Using the simulation results for these three scenarios, the authors assess the extent to which the treatment of owner-occupied housing in the PIT affects measures of income inequality and changes overtime in income inequality. The period covered in this study is from 1992 to 1998, which are the years of the enforcement of Act 18/1991.[8]

The structure of the paper is as follows. Following this introduction, the second section considers the concept of personal ability to pay and taxable income, with special attention to non-monetary income. The third section introduces alternative means of income imputation for owner-occupied housing, while the fourth section includes the empirical analysis and a discussion of the results. Concluding remarks are presented in the final section.

2. Non-cash income and ability to pay in personal income tax

In most OECD countries, the personal income tax is the most important component of the tax system, not only in terms of total revenues but also in sociopolitical relevance. To a great extent, this position results from the suitability of the object of taxation – income – as a gage of taxpayer ability to pay and as an instrument for achieving government redistributive goals. The measurement of taxpayer ability to pay by the income earned in a year requires defining, clearly and precisely, the different types of taxable income. This is also essential for the design of a personal income tax program. Regulations in different countries usually set forth categories of income that will be taxed at higher or lower rates. The variety of income sources and taxpayer strategic behaviour will tend to artificially modify the outcomes for a PIT program, violating the desirable principle of horizontal equity. From an academic perspective, the most frequent method of assessing the extent to which an income tax program appropriately considers ability to pay is to compare the definition of income for the PIT to the most widely accepted measure of what income is considered to be in economic terms.

For this purpose, the concept of economic income traditionally chosen in public finance theory is the one identified in the definitions given by von Schanz (1896), Haig (1921) and Simons (1938) (from now on SHS).[9] This concept was initially introduced by von Schanz (1896) and was then further developed in the American public finance literature by Robert M. Haig, for whom economic income is the monetary expression of the net increase in an individual's economic ability between two moments in time. Later, this notion was completed with the concept of "full income" proposed by Henry Simons.

A first consideration regarding the SHS definition is that the inclusion of some type of income does not require monetary materialization. More specifically, in-kind income, such as employers' contributions to pension plans, insurance subscriptions paid by employers for employees, workers' use of company houses or cars, free or low price utilization of staff canteens, vouchers for various types of consumption, and subsidies of financial expenditures or acquisitions of goods or services can all be counted as income. However, including these items in the legal definition of taxable income is complex, especially for types of income in-kind where there is no predefined monetary value. Indeed, the high administrative costs of quantifying these types of income tends to lead either to their exclusion from the tax base or to estimation of these sorts of income through indexation methods. Social transfers provided by different levels of government – such as public pensions, unemployment benefits and other social benefits

[4] See OECD (2006).

[5] Ayala et al. (2006) provide a detailed analysis of the differential treatment of income by source in the Spanish PIT.

[6] The cadastral value is the housing price recorded for fiscal purposes.

[7] The United Nations System of National Accounts (1968) recommends including housing service in the statistics of household income.

[8] This period selection is due to the availability of information in PIT records of cadastral value of all (nonrented) owner-occupied housing. From 1999 on, there is no longer any imputation of income for owner occupied primary residences.

[9] Sunley (1977) provides an interesting discussion on the concept of economic income given by Haig-Simons and their notion of the legal definition for the tax base of a personal income tax.