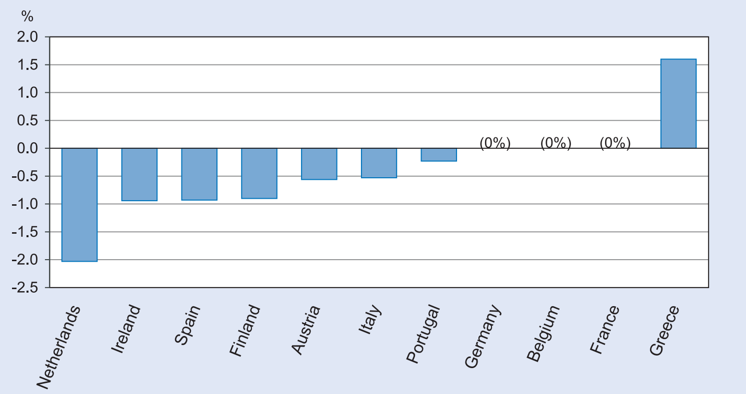
Tax Preferences for Housing

Prices of assets and durable goods, like houses, are more volatile than prices of non-durable goods. The reason is that demand fluctuations in durable goods markets meet an inelastic supply which reacts only slowly to demand and price incentives. Market price responses to fluctuations of demand are the more pronounced the lower is the price elasticity of demand. Preferential tax treatment for buying a durable good, like a house, reduces the after-tax cost of the good as well as the price elasticity of demand for it and, thus, increases the price volatility in the market above the level that would prevail if there were no tax preferences.

A recent OECD study (van den Noord, 2003) shows that tax preferences for owner-occupied housing in the countries of the euro area differ quite substantially. The amount of tax preferences is measured by the tax wedge, which here is the difference between the after-tax and pre-tax real interest rate on mortgage loans. In 7 out of 11 euro area countries, the tax wedge is negative, which means that there is a tax subsidy for housing (Figure 1). This subsidy is highest in the Netherlands, where it reduces the real costs of home financing (real after-tax interest rate) to about half a percent (not shown). In most other countries with a negative tax wedge, the real costs of financing are a little higher than in the Netherlands – between 1.5 and 2.5 percent – but also clearly below the usual real market interest rates. The exception is Greece, where housing is not tax-subsidised but, instead, heavily taxed. (Taxing real estate, which is relatively easy to assess and to administer, might serve in Greece to offset loopholes and tax evasion in the system of public revenues.)

Figure 1

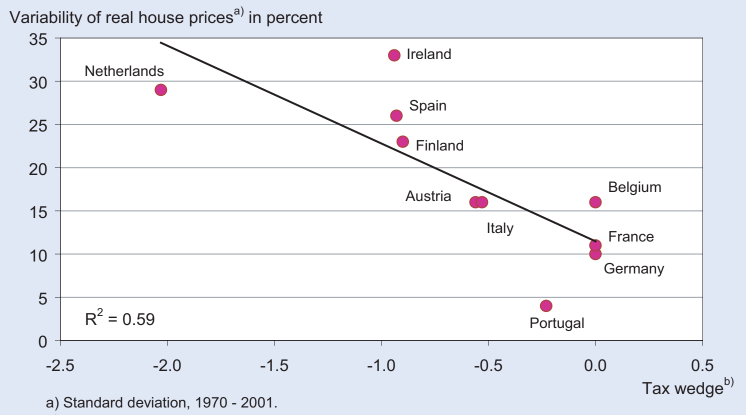
Tax Wedge in the Owner-Occupied Housing Market



Note: Tax wedge is here the difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation.
Source: van den Noord (2003).

Figure 2

Tax Wedge and Variability of House Prices



a) Standard deviation, 1970 - 2001.
b) As in Figure 1.
Sources: van den Noord (2003).

The relation between preferential tax treatment of a durable good and the price volatility in its market is clear on theoretical grounds. But it can also be established empirically for the market of owner-occupied dwellings in the countries of the euro area. Figure 2 depicts the correlation between the tax wedge for housing and the variability of real house prices (1970–2001, standard deviation; Greece has been excluded from the correlation analysis). Generally one can say: the higher the tax preferences for housing, the higher the volatility of house market prices.

There is an important implication of this analysis for macroeconomic policy making. Asset price fluctuations cause wealth effects for the asset owner in the same direction and may thus lead to a further reinforcement of an inflationary (or deflationary) tendency in the economy. The more the tax preferences for housing differ across countries, the more pronounced might be the inflation differentials. Such an "asymmetry" could be an additional burden for monetary policy in a monetary union.

R.O.

Reference

van den Noord, P. (2003),"Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", OECD, *Economics Department Working Paper* no. 356.