ECONOMIC SURVEY OF SWEDEN 2007:

FISCAL ISSUES RELATED TO THE HOUSING MARKET

This is an excerpt of the OECD Economic Survey of Sweden 2007,
from the section on the housing market in chapter 4.

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investors. This would at the same time allow them more differentiation within their stock of dwellings.

Fiscal issues

In previous decades, fiscal support for housing consumption was abundant. Including interest subsidies for rental housing, housing allowances and favourable tax treatment of owner-occupied housing, etc., expenditures increased from around 1.7% of GDP in 1970 to close to 4% of GDP in 1990 (Englund *et al.*, 1995). These direct and indirect subsidies were drastically reduced with the 1990/91 tax reform, which cut interest subsidies, increased the real estate tax rate to 1.5% and reduced the tax value of interest deductibility to 30% from previously up to 50% for persons in the highest income tax brackets. Finally, value added tax rates for building material, heating and other housing services were almost doubled to match the standard VAT rate. Since the 1990/91 tax reform, the real estate tax rate has been altered quite frequently: it was raised to 1.7% in 1996, between 1997 and 2000 the assessment values were frozen, and when un-frozen in 2001, the rate was lowered to 1.0% for owner-occupied houses and 0.5% for apartments.

Housing taxation as of 2006 is below neutrality

As of 2006, housing taxation is based on a wide set of instruments: a real estate tax, imputed rent taxation, interest deductibility as well as capital gains and wealth taxes (Table 4.2). The effective taxes, however, are weakened by several factors. First, the

Table 4.2. **Housing taxation in Sweden, 2006**

	Owner-occupied houses	Tenant-owned cooperative apartments	Rental housing
Real estate tax *(fastighetsskat)*	1% of assessment value[1]	0.5% of assessment value[1, 2]	0.5% of assessment value[1]
Imputed rent tax *(schablonintäkt)*	none	The corporate tax rate of 28% is paid exclusively on imputed rent income being 3% of assessment value (this corresponds to a 0.84% tax of assessment value)[2]	none
Interest deductibility	Interest expenditures of any kind are deductible at a rate of 30%. If this leads to net capital income being negative and exceeding SEK 100 000 annually (SEK 200 000 for couples), then a lower rate of 21% is applied for the part of negative net capital income exceeding this ceiling.[3]	Interest expenditures paid within the cooperative are deductible against imputed rent income. Interest expenditures paid individually for debt taken up to finance purchase of a share in a tenant-owned cooperative are deductible as described for owner-occupied housing.	For rental apartments owned by a corporation: As for other expenditure, interest can be deducted from rental income before paying corporate taxes of 28%.
Capital gains tax *(kapitalvinstskat)*	⅔ of capital gains are counted as capital income and taxed at 30%, but this can be deferred[4]		
Wealth tax *(förmögenhetsskat)*	1.5% of wealth above SEK 1.5 million (3 million for couples)[2]		

1. New housing is exempted for 5 years, afterwards only half of it is paid for another 5 years. Full tax is paid after 10 years. For owner-occupied housing, a limitation rule prevents real estate tax payments to amount to more than 4% of disposable household income.
2. For tenant-owned cooperatives, the property assessment value is based on the comparable market value of the apartment block if used for private rentals. Due to rent regulation, this may be only a small fraction of the sum of individual apartments' market value. This lowers effective real estate tax, imputed rent tax and wealth tax.
3. If net capital income is negative, tax deductibility of interest expenses only matters if the person has sufficient earned income against which to deduct. As all pensions, sickness and unemployment benefits etc. are taxed as earned income, this is usually the case. Only social assistance, child benefits and housing benefits are not taxed as earned income.
4. For housing capital gains, taxation can be deferred indefinitely as long as the gain is re-invested in another owner-occupied house or tenant-owned apartment. Deferral can even extend across generations when a person dies and a house is transferred to the heirs.
Source: Taxes in Sweden, *www.skatteverket.se.*

property value assessment set by the tax authorities is required to be 75% of the actual market value. Second, no tax is paid for the first 5 years after a new house is build, and only half is paid for the next five years. Third, a limitation rule prevents real estate taxes from rising above 4% of disposable household income.[16] Around 200 000 individuals are affected by this rule. Consequently, the effective real estate tax rate for owner-occupier homes amounts to around 0.94%, or 0.71% when taking the below-market value assessment into account.

For tenant-owned apartments, the combination of real estate tax and imputed rent taxation is comparable to a 1.34% real estate tax rate, and at first glance, it could therefore seem as if tenant-owned apartments were taxed more than owner-occupied houses. However, tenant-owned apartments benefit from a somewhat artificial value assessment. As the real estate tax and imputed rent tax is paid by the cooperative rather than the tenant-owners, the property value assessment used as tax base is derived from the market value of the apartment block if used for private rentals. In the metropolitan areas where the negotiated rents are well below what tenants would be willing to pay, the sum of market values of the shares in a tenant-owned cooperative may be several times higher than the market value of the apartment block sold as a whole. On a national average, probably the effective real estate and imputed rent taxes of tenant-owned cooperatives are comparable to that of owner-occupied housing.[17] Consequently, the arguments made for owner-occupied housing below could be made with similar conclusions for tenant-owned apartments.

The ideal housing tax system would be to give deductibility for interest expenses while mirroring it by imputed rent taxation, thereby taxing the benefit associated with living in the house. Such imputed rent taxation would come in addition to VAT paid on building materials etc. when constructing the house. In principle, the VAT ought not be paid before housing services are consumed, but charging it up-front at the time of construction is a reasonable practical arrangement which does not disadvantage the average home owner (Box 4.5). In principle, the imputed rent could vary with the interest level in capital markets, thereby mirroring the fact that a higher (lower) interest rate leads to higher (lower) tax reductions when borrowing costs are deducted. However, if abstracting from this by applying a constant imputed rent factor to the assessed house value, then an imputed rent tax becomes mathematically identical to a real estate tax as they are applied to the same tax base.

To assess whether the system of housing taxation is appropriate, the first question is, therefore, whether the real estate tax as of 2006 is neutral *vis-à-vis* the taxation of other assets. It appears that the real estate taxes applied to owner-occupied as well as tenant-owned housing are too low, but the answer is complicated by two factors. First, it depends on the level of interest rates. Second, it depends on what is the relevant alternative when the person considers investing in owner-occupied housing or financial assets. Someone who owns a debt-free house with a SEK 1 million market value, would under 2006 rules pay real estate tax equal to 1% of the property assessment value of SEK 750 000, *i.e.* SEK 7 500 a year. If the person sold the house, moved into rental housing and invested the money in bonds with a 5% nominal yield, she/he would pay capital income tax equal to 30% of 5% of SEK 1 million, *i.e.* SEK 15 000 a year. For the investment return that remains after tax, *i.e.* SEK 35 000 a year, the person would not be able to rent a house similar to the one sold. In fact, the real estate tax rate should be twice as high as in 2006 in order to avoid that different tax treatment skews the choice between owner-occupied and rental housing. A

Box 4.5. **The relation between value-added taxation and imputed-rent/real-estate taxation**

When an owner-occupied house is constructed, valued-added tax (VAT) is paid on building materials as well as construction services, etc. With consumption taxes paid up front in this way, it could be asked whether imputed rent (or alternatively real estate) taxation implies unwarranted double taxation. This is not the case, though, because imputed rent is not supposed to mimic consumption taxes, but rather capital income taxes. When living in her house, the owner-occupier both receives a return on investment and consumes this return. It is instructive to draw a parallel to what happens if, instead of buying a home, the capital is invested in bonds with the interest income being spent on consumption. In that case, the person would first pay capital income tax on the interest receipts and then VAT when the money is spent. For neutrality, housing taxation must therefore include both imputed rent and value added taxation.

Another issue relates to the timing of the VAT payment. Considering an owner-occupied house as an investment good, it could be argued that VAT on construction materials and services should be refunded when the house is being built. Thereafter VAT should be charged when the consumption of housing services takes place. In a system with imputed rent taxation, the net present value of tax payments would then be as follows, where A is the initial house price, π is annual house price inflation, i is the imputation factor, $t_{capital}$ is the capital income tax rate, t_{VAT} is the valued added tax rate and δ is the discount rate:

$$NPV \ tax \ payments = \sum_{t=1}^{\infty} \frac{1}{(1+\delta)^t} \Big[A(1+\pi)^t i \, t_{capital} + A(1+\pi)^t i (1-t_{capital}) t_{VAT} \Big] \tag{1}$$

In practice, however, VAT is charged on the physical transactions occurring when the house is constructed, implying an initial house price $B = (1 + t_{VAT})A$. The net present value of tax payments is as follows:

$$NPV \ tax \ payments = \frac{B}{1+t_{VAT}} t_{VAT} + \sum_{t=1}^{\infty} \frac{1}{(1+\delta)^t} B(1+\pi)^t i \, t_{capital} \tag{2}$$

One difference between the two regimes is that a larger investment is needed when constructing a house when VAT has to be paid up front. In equilibrium, however, house prices will be higher, so VAT related to the remaining value of a house is recuperated when selling. An intuitive argument then goes as follows: If keeping the house fully maintained, so that it can be sold for the same price as it was constructed, the VAT on construction will in some sense not be paid by the owner, because it will forever remain as a constant markup on the house price. Effectively, VAT is only paid on the maintenance work, and thereby the time profile of the owner's VAT payments is not much different between the two regimes (1) and (2).

Nevertheless, paying VAT up front entails a financing cost which tends to make the net present value of tax payments larger in (2). On the other hand, if house prices increase substantially, then up-front VAT is advantageous for the owner. If, for example, urban development makes the location of an existing house more attractive, then only imputed rent taxation would rise, while no VAT would be paid on the additional consumption associated with the rising location value. The opposite applies if the value of a particular house falls. For assets that can be reproduced (buildings), prices should be expected to grow in line with general inflation, albeit slow productivity growth in the construction sector would imply that the real price of newly constructed housing (with given characteristics) should trend upwards. For assets that cannot be reproduced (land), prices should grow faster than general inflation – at the rate of the nominal interest rate in a

Box 4.5. **The relation between value-added taxation and imputed-rent/real-estate taxation** (cont.)

world with a constant population and Cobb-Douglas preferences. In dynamic general equilibrium, prices are in each period determined by an adjustment of the housing stock to the point where marginal utility equals the resource cost (shadow price) of newly constructed housing. Rational agents foresee this price development, and via the user-cost of housing capital, it will have a level effect on the housing stock, but no effect on the house price trend. Considering 1976-2005, for which data are available, national average house price inflation exceeded CPI inflation by 1.5%. Looking ahead, with this real house price increase coming on top of CPI targeted at 2%, nominal house price increases could be $\pi = 3.5\%$. Assuming a (nominal) discount rate equal to the net-of-tax (nominal) interest rate, $\delta = interest\ rate\ (1\text{-}t_{capital})$, and applying a benchmark interest rate of 5% together with the Swedish $t_{capital} = 30\%$, it appears that $\pi = \delta$. Thereby the discount and price increase terms cancel each other out, making (1) and (2) identical. So for the average house there is no difference between the two tax regimes if indeed nominal house price increases continue at a 3.5% long-run average.

Strictly speaking, the relevant price trend would not be the one for a house having given characteristics, because repair is needed to maintain the house's characteristics. The equations could therefore be solved under the alternative assumption that house prices – net of repair – remain flat $\pi = 0\%$. If full imputed rent taxes (with i equal to the capital markets' nominal interest rate) had been applied in Sweden, then the up-front application of VAT would entail over-taxation with net present value of 8.6% of the price of the house, given $t_{VAT} = 25\%$. In conclusion, the up-front application of VAT may in practice imply a bit of over-taxation of net present value, somewhere in the range of 0-8% of the price of the house. However, this is offset by the discount implied by value assessments being set at only 75% of the market value.

similar non-neutrality is created for a first-time buyer borrowing all the money needed to buy the house. She/he would save SEK 15 000 a year in income tax payments when deducting mortgage interest expenses. Effectively, the difference of SEK 7 500 *vis-à-vis* the real estate tax is an indirect tax subsidy. It has a fiscal cost, and it encourages people to buy bigger houses than they would have preferred to do in the absence of the indirect tax subsidy. Consequently, with a benchmark nominal interest rate of 5% (2% inflation and 3% real interest rate), a neutral real estate tax rate for owner-occupied housing would be 1.5% of the market value, or in fact 2.0% to compensate for the property assessment values being systematically below market values (Table 4.3). A parallel argument can be made for tenant-owned apartments.

Some caveats apply for first-time buyers in very expensive areas and those contributing to voluntary pension savings plans. For people with very large interest expenditure and negative net capital income (typically first-time buyers), the value of interest rate deductibility decreases to 21%, implying that the neutral real estate tax rate would be lower. But at a mortgage interest rate around 5%, this applies only to the part of household debt exceeding SEK 2 million (4 million for a couple) and thus concerns only a small minority of urban households.[18] More importantly, it should be noted that if the alternative to buying a house is to invest via a pension saving scheme, then the current 1% real estate tax rate is exactly neutral, as investment returns are taxed by only 15% while they accrue inside pension saving schemes.[19] About 40% of the 25-64 year olds make

Table 4.3. **The real estate tax rate for owner-occupied housing that would be neutral *vis-à-vis* alternative financial investment**

Per cent

Capital tax considered for neutrality	Nominal tax rate	Real tax rate[1]	Nominal interest rate[2]					
			1990-99 average 9.2		Benchmark 5.0		2000-06 average 4.6	
Tax on positive capital income from investment held outside pension funds Tax deductibility of interest expenses	30	50	2.8	(3.7)	1.5	(2.0)	1.4	(1.8)
Tax deductibility of interest expenses if negative net capital income exceeds SEK 100 000	21	35	1.9	(2.6)	1.1	(1.4)	1.0	(1.3)
Pension saving schemes	15	25	1.4	(1.8)	0.8	(1.0)	0.7	(0.9)
Average across all current home owners								
Marginal capital tax rate[3]	25.1	41.9			1.3	(1.7)		
Average capital tax rate[4]	26.2	43.6			1.3	(1.7)		

Note: Numbers in brackets indicate what the real estate tax rate needs to be in order to imply full neutrality when taking into account that property assessment values are systematically 25% below market values.

1. Because part of the return on an investment is simply compensation for inflation, a capital tax applied to the nominal return implies heavier taxation than what appears at first glance. The real tax rate is what can meaningfully be compared to tax rates for earned income. It measures the effective tax on real investment returns as (1+nominal return)/(1+inflation), here using the benchmark nominal interest rate being 5% and inflation being 2%.
2. Based on quarterly averages of 5-year mortgage bonds.
3. Based on the following stylised characteristics and assumptions: For the 40% 25-64 year olds contributing to private pension saving schemes, this is, at the margin, the relevant alternative investment for three quarters, while debt repayment or assets held outside pension schemes is the relevant alternative for the remaining quarter. When moving into retirement, the speed of pension payments from private schemes can be adjusted thereby giving the recipient roughly the same flexibility to choose net saving flows on the favourable tax conditions as for those in working age contributing. Presumably, one in twenty has interest expenditure exceeding the SEK 100 000 threshold. Consequently, 30% face a *marginal* capital tax rate of 15%, 4% face a marginal rate of 21% and 66% face a marginal rate of 30%.
4. Based on the following stylised characteristics and assumptions: Half of the housing stock value is financed by debt. Presumably only a fiftieth of this debt mass is subject to the lower 21% interest deductibility. Had savings not been placed in mortgage equity, those contributing to private pension saving schemes might have placed half of the mortgage equity in their pension scheme. All other mortgage equity would have been placed in assets outside pension schemes. Consequently, the relevant *average* capital tax rate is 30% with a weight of 0.49, 21% with a weight of 0.01, 15% with a weight of 0.25 and 30% with a weight of 0.25.

Source: OECD calculations.

contributions to voluntary private pension schemes. The maximum annual contribution is SEK 20 000 for most, but rising to SEK 39 700 for high-income individuals. On average the 25-64 year olds contribute SEK 6 000 a year, meaning that most have remaining flexibility to increase their contributions if they wish.[20]

Under the current personal capital tax system, the real estate tax rate for owner-occupied housing would need to be raised to 1.3% to be neutral *vis-à-vis* how other capital assets are taxed (Table 4.3). This holds if considering the marginal capital tax rate, which is relevant when individuals and families decide where to place savings surpluses: building up mortgage equity by repaying debt, or placing it in financial assets. It also holds for the average capital tax rate which matters for assessing whether there is an implicit housing subsidy via the tax system.If adjusting for low assessment values, in fact, the neutral real estate tax rate would be 1.7%.

Independent of the level of real estate taxes, a tension is evolving between tax-favoured pension savings and interest deductibility. It is closely entangled with the issue of housing taxation, because of the still-easier access to flexible mortgage equity withdrawal and deferred amortisation, whereby the house is used as collateral to obtain cheap borrowing. The gap between the low 15% tax on investment returns in voluntary pension savings and the 30% tax value of interest deductibility invites tax planning by giving

incentives for homeowners to shift to interest-only loans while increasing pension savings. With house prices now being far above what anybody had imagined when the 1990/91 tax reform was made, the net-present value of the tax revenue loss from such an arrangement may easily exceed SEK 100 000 in a typical example, part of which accrues to financial intermediaries (Box 4.6). Financial market development and flexible mortgage are beneficial, but may require renewed attention to skewed tax incentives. The only effective way to address this is to raise the very low tax rate on investment returns in voluntary pension savings or reduce the tax value of interest deductibility.

Box 4.6. **Low taxes on pension investments invite tax planning to benefit from interest deductibility**

Consider a couple aged 45 buying a house worth SEK 2½ million. They use their liquid savings and need mortgage finance for the remaining SEK 1½ million. One option is to take a loan with linear repayment over 30 years, meaning SEK 50 000 annually. Their income is sufficient to pay such a mortgage, and following common practice, the mortgage credit institute is therefore willing to offer them an interest-only loan as an alternative. Using this loan, they can channel the SEK 50 000 into their individual pension schemes. If (for simplicity of illustration) they buy the very same bond in the pension scheme as is issued for their mortgage loans, they will earn the same interest rate as they pay, say 5%. With interest expenditure of 5% * 50 000 = 2 500, their income tax payments will be reduced by 30% * 2 500 = 750, whereas the pension savings tax on the interest income is only 15% * 2 500 = 375. The net result is a tax subsidy of SEK 375 in the first year, and with another SEK 50 000 being moved into pension savings every year, the tax subsidy grows above SEK 15 000 in the year they are 65. From thereon it gradually declines when they retire and start repaying the mortgage with the extra pension income. In net-present-value terms, the couple saves tax payments in the order of magnitude of SEK 100 000-200 000, depending *inter alia* on how they liquidate the pension savings and the mortgage in old age. It is close to the equivalent of one year's earnings net of social contributions, income and consumption taxes for one average worker. Fees from financial institutions will absorb some but not all of the taxes saved: if additional mortgage borrowing costs are 0.5% of the increase in outstanding debt, then it is about half of the taxes saved at nominal interest rates of 5%; holding the bond in the pension savings plan is not expensive. For simplicity, this calculation abstracts from the fact that pension contributions are deductible from income taxes when made while pension receipts are taxed as income, since this is neutral as long as the person faces the same marginal tax rate when working and when on pension. In practice, many face a lower marginal rate when retired, in which case the reduction in tax payments from the described arrangement is larger.

Capital gains on housing are generally liable for taxation in Sweden unlike in most other countries where gains on an individual's principal residence are exempt in order to avoid lock-in effects and thus potential obstacles to mobility it could create (OECD, 2006d).[21] However, in the Swedish framework both owner-occupied housing and tenant-owned cooperative housing have preferential treatment via a discount on the tax base. When such a dwelling (which has been the owner's primary residence) is sold, two-thirds of the capital gain is counted as taxable income and taxed at the standard capital income tax rate of 30% (thus, the effective tax rate is 20% of the nominal gain). Moreover, taxation can be deferred for the part of the sale proceeds that is reinvested in another house or

apartment and deferred taxes can be transferred at death to heirs who inherit a house.[22] Deferral of capital gains taxes amounts to a quite sizeable interest-free credit granted and the total stock of deferrals outstanding in 2005 was equal to 4.7% of GDP. Deferral reduces lock-in effects and thereby facilitates mobility, but by allowing a deferral of capital gains taxes only when buying another house or an apartment, people who sell their house to move into a rental flat have to pay the tax. Thereby, the incentives given by deferral favour tenant-owned and owner-occupied housing and distort the choice of tenure (Finansdepartement, 2003) – notably so when real estate prices have risen significantly as in the recent past. A general disadvantage of a capital gains tax is that it may increase house price volatility (Fuest *et al.*, 2004). The argument goes as follows: when house prices are above their equilibrium value, home buyers are less cautious, because the tax deductibility for capital losses softens the consequence if having to sell some day at a lower price. *Vice versa*, prices may go further below equilibrium because potential buyers will value houses less when knowing that they would be taxed of any capital gain. Consequently, prices may become more volatile, but how large a role this has played in Sweden is hard to quantify.

For the wealth tax there is no explicit preferential treatment of housing assets, but effectively there is, as the property assessment value is below market value, thereby implying lighter taxation than for financial assets. For those in tenant-owned housing, this is magnified by the fact that their share of cooperative equity, which is the basis for personal wealth taxation, is calculated based on the property assessment value of the apartment block if used for private rental housing, as described above.

In sum, there are good arguments for increasing housing taxation, for example by increasing the real estate tax. In addition to the concern for neutrality underlying the discussion above, it should be noted that globalisation will make it increasingly important to focus taxation on less mobile factors such as land and housing. Consequently, the optimal real estate tax rate would be higher than indicated in Table 4.3.

Housing taxation initiatives in the 2007 Budget and the new government's programme

In the 2007 Budget, the government declares that it will abolish the real estate tax in two steps.[23] In 2007, the property value assessments would be frozen at the level applied for taxation in 2006. This would apply to all housing categories, including one-family houses and holiday homes as well as multi-family houses (apartment buildings). For one-family houses and holiday-homes, the real estate tax associated with the land value would be capped at SEK 2 per square metre or SEK 5 000 per property if that is lower. For multi-dwelling houses, the real estate tax rate would be reduced from 0.5% to 0.4% and imputed rent taxation would be abolished. The wealth tax, which is paid by many homeowners following the strong house price increases of recent years, would be halved in 2007, as a prelude to later abolition, but the halving in 2007 will only apply to financial wealth, not to housing wealth.[24] In a second step, a commission would be established to prepare the abolition of the state real estate tax from 2008 and the introduction of a municipal real estate fee that would not be based on the property value assessment. This might be coupled with adjustments of the municipal financial equalisation scheme and other measures to address distributional effects across income groups as well as regions. The key concern stated as the reason for these changes is that the dependence on current property value assessments makes the real estate tax go up in ways that are unpredictable and felt as unfair by households. Another argument made is that the automatic adjustment of the

property value assessments makes real estate taxes go up without an active political decision being made. Changes made in the second step will be fully financed within the housing sector. But currently there is no commitment to finance the cuts made with the 2007 Budget. In one step, Swedish housing taxation is being reduced by almost ¼ per cent of GDP – close to what the nominal tax freeze in neighbouring Denmark has produced over five years.

Implementing such a strong reduction of housing taxation is most unfortunate seen from a macroeconomic perspective. It would worsen the non-neutrality described above with housing taxation already being below what would be neutral *vis-à-vis* other parts of personal capital taxation and would also risk overheating the housing market and construction sector (Chapter 1). It is a legitimate concern that movements in real estate taxes resulting from rising house prices can create liquidity problems notably for older persons, but this can be solved in other ways than by abolishing the real estate tax (Box 4.7).

It is true that a number of vehicles are used for taxing immovable property in Sweden: stamp duties, real estate tax, wealth tax and capital gains tax. But the combined revenue from these taxes is not large compared to other countries (Figure 4.8) – even if capital gains taxes from housing are included (which in 2003 amounted to an additional 0.3% of GDP).[25]

The preferred policy option

The first-best solution would be to replace the 2006 housing taxes with an imputed rent tax at a rate that ensures neutrality *vis-à-vis* interest deductibility. A second-best would be to maintain the mix of real estate and imputed rent taxes applying in 2006 while raising the tax rates to neutral levels, thereby mimicking a pure imputed rent tax system. It should also be recommended to let the taxation of tenant-owned housing be based on property value assessments that reflect the value of each individual apartment.

Alternative policy options

If, nevertheless, abolition of the state imputed rent and real estate taxes is pursued, a number of measures should be recommended:

● Introducing a local land or real estate fee, as announced by the government would have a number of positive effects including encouraging municipalities to issue more land for construction, thereby helping to meet the rising demand for housing. To fully reap these benefits, however, it is important that such a fee reflects actual valuations and that municipalities decide to set the fee at a level that is not too low. Development of mortgage instruments as described in Box 4.7 should handle any liquidity problems for home owners.

● Strengthen the taxation of housing capital gains. The effective tax rate could be increased by simply applying the standard 30% tax rate on the full housing capital gain rather than on merely two thirds of the gain as is the case currently. Adjustments to diminish the effective tax rebate associated with deferral should also be pursued, but without creating lock-in effects. One option is not to grant deferral when the owner dies and the house or apartment is transferred to the heirs. It would even have the appeal of reducing lock-in effects, as older persons would then not disadvantage their heirs if selling their house or apartment to move into a rented special living facility adapted to the functional limitations older persons may have. To reduce possibilities to circumvent

> ### Box 4.7. **New mortgage products could relieve homeowners of tax-generated liquidity problems**
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> When house prices go up in an area, all homeowners become richer. Some realise the gain by selling the house. But also those remaining where they are become richer as the difference between the market value of their house and their remaining mortgage debt, *i.e.* their so-called mortgage equity, grows. Under the current system where real estate taxes follow updated property value assessments, they therefore get to pay more taxes. The tax increase is small, however, compared to the growth of mortgage equity: the average homeowner in Stockholm has experienced a price increase of 15% in the last year, worth around SEK 375 000 of mortgage equity.* At the same time, his real estate tax dues have increased by around SEK 2 800 and some households may find it difficult or simply inconvenient to find the money for paying this – in particular pensioners arguing that "my pension is small, and you cannot eat bricks and mortar".
>
> If the problem with real estate taxes in an environment of rising prices is actually more about financing and liquidity, instead of wealth, cutting real estate taxes is not the best solution. Instead, the stream of yearly tax payments can simply be transformed for cash-constrained tax payers by mortgage financing of the tax liability. When house prices increase 15%, mortgage credit institutions would have no worry lending an additional 0.1%. A natural solution would therefore be that payment of the real estate tax becomes part of the standard financial package offered by the mortgage credit institution or bank financing the purchase of the house. It can be made in a way so the person or family buying a home will know exactly how much they will have to pay each month. If house prices then grow, a bit of the rise in house value will be matched by additional debt to finance the increasing real estate tax, leaving the homeowner with a slightly lower increase in mortgage equity than otherwise. Conversely, if house prices fall, mortgage debt will be reduced more rapidly, as the lower real estate tax is matched by more debt repayment. In any case, the homeowner's monthly payment is completely foreseeable. And for the lending institution the risk of loss associated with default would be smaller than today, as falling house prices are slightly less likely to lead to negative mortgage equity and thereby an inability to recover debt when repossessing the house as collateral. Both parties gain and should see an interest in developing such instruments. The current limitation rule implying that no one can pay more than 4% of their disposable income for real estate tax, could be maintained, but there would be less need for it, were the financial products describe above to develop.
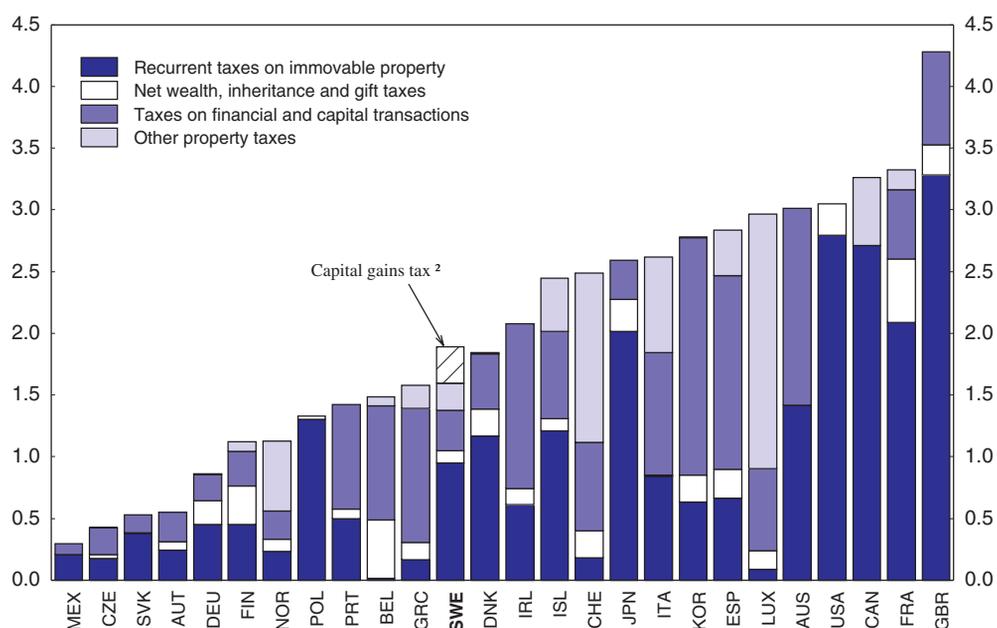>
> Regulations may need to be adjusted to allow credit institutions to offer taking over the administrative task of automatically paying the home owner's real estate tax bill, and to allow mortgage institutions to increase lending slightly without initiating special procedures such as re-assessment of the house value.
>
> * This calculation is based on the average house price of around 2.5 million SEK in Stockholm county and the price increase from 2005Q2 to 2006Q2.

the tax payment, deferral should not be granted if the property is donated as a gift. Another option is to charge interest when capital gains taxation is deferred while moving to a system based on accrual rather than realised housing capital gains. If designed appropriately, such a system would generate substantial revenue without increasing lock-in effects (Box 4.8).

- Reduce the tax deductibility of interest expenses. One option is to move the threshold for the 21% rate, so that it applies for all negative net capital income. The 30% rate for

Figure 4.8. **Property tax revenue**

As percentage of GDP, 2004[1]

Recurrent taxes on immovable property
Net wealth, inheritance and gift taxes
Taxes on financial and capital transactions
Other property taxes

Capital gains tax [2]

MEX CZE SVK AUT DEU FIN NOR POL PRT BEL GRC **SWE** DNK IRL ISL CHE JPN ITA KOR ESP LUX AUS USA CAN FRA GBR

1. 2003 for Australia, Belgium, Greece, Mexico, Poland and Portugal.
2. Only available for Sweden.

Source: OECD, *Revenue Statistics*, 1965-2004, 2005 edition.

positive capital income should be maintained in order to avoid increasing tension with respect to the already complicated rules about how entrepreneurial income should be divided up as capital income and income from work. Although reduced interest deductibility would thereby introduce an asymmetry between positive and negative net capital income, this does not invite tax planning as such, but rather reduces the scope for such tax planning via pension savings (Box 4.6).

When assessing these policy options it should be stressed that by far the best would be to maintain the system as it applied in 2006. Imputed rent or real estate taxes based on updated value assessments are unpopular in all OECD countries, but neither a capped local land fee as envisaged by the government, nor a higher capital gains tax or lower interest deductibility would deliver results that match the 2006 system. The experience of other countries shows that, in practice, taxation of housing capital gains can be difficult to maintain in a way that generates significant revenue. And reducing interest deductibility can only re-establish tax neutrality for those (young generations) financing the house with debt, but not for those (mid-aged and older generations) with large housing equity. By far the best solution would therefore be to maintain housing taxation as of 2006 – possibly shifting some of the revenue to municipalities – while letting mortgage products be developed to relieve home-owners of the liquidity problem, as discussed above (Box 4.7). If, however, reforms are undertaken, they should at a minimum be fully financed, including the 2007 cut in housing taxes.

Box 4.8. **How can capital gains tax deferral be adjusted without lock-in effects?**

Taxation of housing capital gains needs careful design to avoid lock-in effects that would hamper labour mobility and thereby economic growth, but also distort housing consumption by hindering adjustment in size, location, tenure etc. when needs and preferences change. Lock-in effects can arise if, following a house price increase, the associated capital gain is taxed more lightly if the owner remains in the house compared to moving. By deferring the taxation of housing capital gains that are re-invested in another home, the current Swedish system avoids such lock-in. However, interest-free deferral – typically lasting for several decades – weakens the effective taxation. A key question is therefore whether effective housing capital gains taxation could be strengthened by charging interest on deferral.

In the current system where capital gains are taxed when realised (*i.e.* when a house is sold), it would not work, because it would bring back lock-in effects: If moving following a house price increase, interests would start to accrue on the capital gain, but not so if remaining in the same house.

This problem is solved, however, if personal capital gains would be taxed on an accrual basis (*i.e.* when they are generated, even if not realised). In a pure form, accrual capital gains taxation would imply that housing capital gains are calculated each year based on assessed values while allowing the home owner to defer payment to when the property is sold – or even later. Capital losses would entail a tax refund. In such a system there would be no lock-in, as capital gains are taxed continuously whether moving or staying.

In practice, the most interesting might be hybrid models relying on the prices at which each property has actually been traded, thereby reducing the uncertainties associated with relying on assessed values. One possible hybrid would be as follows: When a house is sold, an implicit path is generated between the price at which it was originally bought and the final sales price, while mirroring the average price trend of the geographical area. Based on this price path, annual capital gains and cumulated interest can be calculated. Alternative price interpolations could also be used, and in some sense such hybrid models could be thought of as variation of realised capital gains taxation where the tax rate grows with the length of home ownership. The popular tractability of such arrangements would be that home owners only face a tax bill when realising their housing capital gain, thus having a cash flow to pay with.

Housing allowances and direct subsidies

Apart from different forms of real estate taxation housing allowances and direct subsidies have an influence on the tenure decisions of households. They need to be seen in the context of what changes may happen with regard to housing taxation, so as to ensure neutrality between owner-occupied, tenant-owned and rental housing. At the current juncture, although the size of the subsidies has been reduced by over two-thirds since the early 1990s (Figure 4.9), the design of the schemes is continuing to give incentives for more housing consumption, thereby distorting the household's choice.

Housing allowances are given as a consumption support for families with children and low incomes as well as to pensioners. Those benefits are open to households in all tenure types and are determined by the level of housing expenditures (up to a certain cap) and the size of the household (including the number of children). The actual amount paid takes the

Figure 4.9. **Direct housing subsidies**
as percentage of GDP
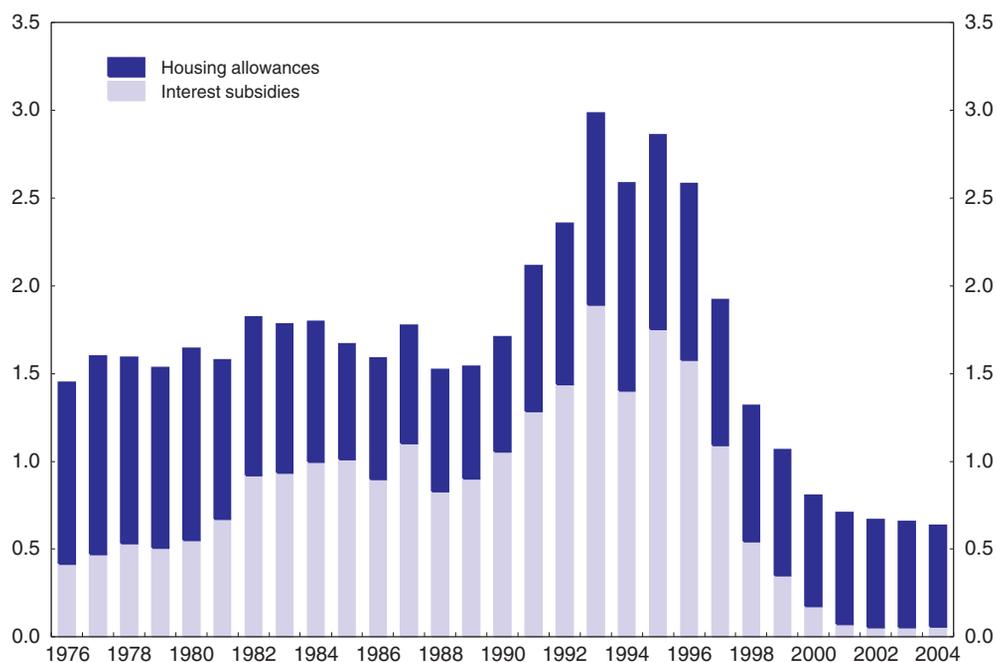
Source: Statistics Sweden and OECD Analytical database.

household's income level into account by subtracting a certain share of the income from the calculated benefit.[26]

The share of the rent (or the cost of housing for owner-occupiers) paid by the housing allowance for families varies between 20% and 33% and around a fifth of total households receive them (Åhrén, 2004).[27] It is mostly directed towards the rental sector: 31% of all households who rent a dwelling receive housing allowances, compared with 10% of households in the tenant-owner sector and 7% in owner-occupied homes. This generous scheme benefits a large share of poorer households (82% of lone parent households and 23% of pensioner households), but arguably sets questionable incentives as it increases with the level of housing expenditures up to a cap of SEK 63 600 for a family with one child (a four-room apartment of 80 square metres in Stockholm has an annual rent of about SEK 100 000). In addition, granting housing allowances also risks creating poverty traps in so far as individuals might have low incentives to move from unemployment to full-time work or to extend the numbers of hours worked when the income-tested benefits are taken away and tax payments increase (Chapter 3).

On a very general level, it may be asked what purpose a housing benefit serves at all in a system which provides for income support – which people are free to spend on housing or other goods as they wish to. Arguments for a more paternalistic approach would run along the lines that people tend to spend less on housing than would be optimal and that the state therefore needs to act in a corrective manner. Even if one subscribes to this view, however, the design of the Swedish system does even more than to ensure that a sufficient share of income is spent on housing: by linking it proportionately to housing expenditures

it encourages more expensive housing. Ideally, an allowance should depend on the income, not the housing situation of the individual and give the freedom of choice regarding the level of housing expenditures. A flat-rate system as has been introduced in the UK recently ("Local Housing Allowance") would be one alternative. This pays out a certain amount depending on the region the person lives in and the tenant has the choice whether to spend it all on housing or to pay less and retain the difference.

Similar to the housing allowance scheme, interest subsidies are given proportionately to the actual or implied interest cost for building new rental dwellings as well as tenant-ownership dwellings.[28] The benefit is calculated on standard costs and is independent of whether loans have actually been taken up or not (Box 4.9).[29] Since this right is not limited in time, interest subsidies, once granted, will be paid out for ever, or at least as long as the buildings are still there (unlike interest deductibility). Thus, interest expenditure grants grow every year for every new vintage of dwellings that are granted interest subsidies. The Spring Fiscal Bill 2006 declared that, with the approval of the Swedish parliament, housing finance would be reformed and a new system introduced from 1 July 2008. At the same time, interest grants will be abolished: no new interest subsidies will be given from this date, and interest subsidies decided on before this date will be phased out over a period of time. However, as proposed by the new government, the Riksdag has decided that all production subsidies will be abolished already from 1 January 2007 and that already granted subsidies be phased out during a five-year period. No new production subsidies are envisaged. The focus has been shifted towards the situation of the households rather than support to "brick and mortars".

Box 4.9. **Calculation of interest subsidies**

Interest subsidies are granted only for a dwelling area below 120 square metres (no subsidies for exceeding areas) according to the following formula:

Grant base * subsidy interest rate * 30% = Interest grant.

The grant base depends on the number of dwellings (for multi-dwelling buildings) as well as the size of the dwellings. The grant per square metre is decreasing with the size of the dwelling. The maximum amount per dwelling is SEK 963 000 for a 120 square metre dwelling. For a 70 square metre dwelling the grant base is SEK 684 250. The subsidy interest rate is determined by the National Board for Housing, Building and Planning on a weekly basis, depending on the interest level in general (the prevailing rate in 2006Q3 is around 4%). For each project that has been granted interest subsidies, the rate is fixed for five years, after which time the subsidy interest is changed according to the prevailing rate at that time. The last part in the formula reflects the fact that 30% of the interest on loans is tax deductible.

For a 70 square metre dwelling the interest grant thus amounts to:

SEK 684 250 * 4% * 30 % = SEK 8 211.

An increase in interest rates and apartment building activity leads to increased government expenditures. Sensitivity analysis on the budget effects show that an increase in the long term interest rate (5-year mortgage bonds) of 1 percentage point compared to the present interest rate forecast for 2006-08 will lead to higher cumulative government expenditures of around SEK 700 million (0.03% of GDP) until 2008. And with the current rate of construction of dwellings at around 30 000 per year, the level of expenses due to interest subsidies will rise by approximately SEK 225 million (0.01% of GDP) each year.

Housing credit guarantees play only a small role today. The system was introduced in 1992, as the state moved from a regulated state lending system involving subsidized loans to a guarantee system administered by the National Housing Credit Guarantee Board (BKN). Now, government credit guarantees can be provided for loans advanced by financial institutions in Sweden against a fee (0.25-0.6% of the guaranteed amount).[30] While the government is fully responsible for BKN's debt, guarantees issued after 1997 must be fully financed by fee income. Only guarantees from 1992-96 are still financed by the government budget and amounted to SEK 160 million (0.006% of GDP) in 2005.

The existence of the state-operated credit guarantee scheme has to be seen in relation to the transition from a system of state loans for housing production that existed prior to 1993 to a system with no state loans. However, from today's point of view maintaining such a scheme is questionable. It is true that asymmetric information problems can lead to market failure in financial markets.[31] In this regard, a credit guarantee system can help to make the market function again. However, in practice other approaches are more common, such as taking collateral – a mortgage on the financed house for example. A guarantee system provided by the state, in contrast, runs the risk that it encourages risky lending by banks, even more so as the pricing for these guarantees is probably perceived as being below what private insurance markets would charge. It is difficult to see a reason why the Swedish mortgage loan market should not function well without this scheme and hence consideration should be given to abolishing it.

Planning and construction

A key factor in dealing with changes in demand for housing is to ensure a swift and targeted supply response in regions where it is most needed. In this regard it is remarkable to see that the average Q ratio (of house prices to construction costs) for the country as a whole has been below one for the past two decades, *i.e.* construction has just not been profitable (Figure 4.10). At the end of 2005, the Q ratio had been above one only in a quarter of municipalities, including Stockholm.[32] One reason is the exceptionally high level of construction costs relative to other countries which has damped residential investment for the most part of the last decade (see Box 4.1).

Lack of competition in the construction sector

Lack of competition in the construction sector – in contrast to many other highly liberalised parts of the economy – has been repeatedly pointed out in previous *Surveys* (OECD, 1999, 2004). The high housing subsidies of the past have apparently led to market structures with informal cartels and little incentive for cost-containment. In a recent survey of 600 managers in the construction sector, 50% of respondents stated that cartels exist, with half of them saying they were quite frequent. And a recent study found that 30% of construction costs are due to a lack of efficiency.[33] The four largest developers, which account for a large share of the market, do not normally purchase construction services in the market as 75% of apartments are built in-house. This results in higher building costs than for smaller developers, who procure projects to a much greater extent (Konkurrensverket, 2006). The large construction companies are vertically integrated in terms of access to the requisite building material and the three biggest construction companies together have a share of two thirds of the Swedish market.[34] Barriers to entry for new enterprises are high and smaller companies already operating usually cannot compete on major construction projects. Also, growth in companies is inhibited by the fact

Notes

16. The limitation rule was introduced in 2001 with the background that house prices in attractive coastal areas have been rising fast and thus causing an increasing tax burden for permanent residents in those areas (whose average income is below that of second-home owners). Originally the limit was 5% of disposable income, but from 2006 it was reduced to 4%.

17. In principle, the separation of the cooperative's interest deductibility, imputed rent taxation and real estate taxes on the one side, and the tenant-owner's interest deductibility on the other side, could be a disadvantage if cooperative interest expenses exceed imputed rent, as there would then only be partial interest deductibility. But as shares in tenant-owned cooperatives can be used as collateral for mortgage finance, this tax disadvantage can be circumvented by shifting debt to the tenant-owners. This is effectively what happens when over time cooperative debt is being repaid.

18. The average purchase price of houses in 2005 was SEK 1 066 428 for the country as a whole. Only in 12% of municipalities the average purchase price was above SEK 2 000 000 (SEK 3 218 000 for Stockholm, SEK 2 689 000 for Gothenburg and SEK 2 611 000 for Malmö).

19. Unlike most OECD-countries, but like Denmark and Italy, Sweden allows for income-tax deductibility of voluntary contributions to pension savings schemes. Subsequently, when pensions are paid out from the scheme, they are taxed as income (Yoo and de Serres, 2004). Aside from any differences in the marginal income tax rate faced by the person while contributing versus receiving pensions, this means that capital income is taxed at 15%, being only half of the tax rate for capital income earned outside a pension scheme. In practice, the tax on pension fund earnings is paid by insurance companies as 15% of an estimated yield of the fund capital calculated by multiplying the fund capital by the so-called state lending rate.

20. See "Privat pensionssparande 2004" at www.scb.se.

21. Most countries exempt capital gains on a primary residence if it has been owned for a certain minimum period (mostly 2 years) and if it is not used for business purposes. In Spain, an exemption exists for persons above 65 years of age. Hungary provides tax exemption if the proceeds from selling the property are reinvested within a certain period and Portugal (like Sweden) grants a rollover in case of reinvestment. Only Japan and the United States tax capital gains on principal residence. However, tax rates in Japan decrease with the holding period and the US system grants exempt amounts (USD 250 000/USD 500 000 for couples) as well as lower tax rates than for other capital gains (OECD, 2006d).

22. Previously, capital gains tax had to be paid if the proceeds where reinvested outside of the country. But this regulation has been abolished as it was out of line with the non-discrimination principle in the EU.

23. See 2007 Autumn Budget Bill: "Putting Sweden to work – a good deal for all", Ministry of Finance, 16 October 2006.

24. It is positive that the exemption of housing wealth from the reduction in wealth tax will limit the overall housing tax reduction, but it is symptomatic that this move will open up further for tax planning, as persons shifting out equity from housing by increasing mortgage debt and investing in financial assets will benefit from the halved wealth tax, thereby reinforcing the incentive discussed in Box 4.6.

25.   It should be noted that in Sweden the relationship between the tax base and the actual market value and its development have been rather close compared to the situation in most other countries where real estate taxes sometimes are levied on bases determined far back in history. Any effect of this is, however, captured by Figure 4.8 which compares revenues rather than statutory tax rates.

26.   The formula for calculating allowances is (Åhrén, 2004):
        Housing allowance = a*housing expenditure - b*income with 0.5<a<0.75 for families depending on their level of housing expenditure (0.91 for pensioners) and 0.2<b<0.33 (0.5<b<0.62 for pensioners) for income   in   excess   of   SEK 117 000   for   lone   parents   and SEK 58 000 per person for parents. In addition, families with children receive a flat rate supplement. The benefit amount is capped and does not increase further for yearly expenditures over SEK 63 600 (for a family with one child).

27.   Housing allowances were reduced significantly from 1996 on by raising the eligibility qualifications (childless households older than 29 years were excluded and a limit to the qualifying floor space was introduced) (Chen and Enström, 2004).

28.   The present system has been in force since 1993 and when it was introduced one argument was that the system should be seen as a parallel to the right to interest deductions of owner-occupiers and tenant-owners (a view that has since been largely abandoned). Subsidies to owner-occupied homes were completely phased out in 2000.

29.   Before 1993 there was a "real" interest grant that took into account actual productions costs and actual interest rates, a system that step by step had been adapted to the high inflation during the 1970's and 1980's, and thus tended to make way for continuing cost increases. The present system, based on standard costs that have been unchanged since 1993, has been intended to make builders more cost conscious. Another difference is that the previous interest grant system (before 1993) was a time limited support for the receiver. The subsidy interest rate that the property owners had to pay was increased every year until it met the market interest rate, then the grant ceased (*i.e.* it was the difference between the subsidy interest rate and the market interest rate that was subsidised to a decreasing degree).

30.   The guarantee covers any losses the bank incurs. When the borrower defaults, the bank sells the property and will be reimbursed by BKN for any remaining credit amount. In this case, BKN takes over the right to demand repayment of the losses from the borrower.

31.   In case of a loan contract that allows for bankruptcy, the lender takes the risk that the borrower does not pay back his money. If he raises interest rates to compensate for this risk, more risk averse borrowers would chose not to take up the loan. As the downside is limited by the debt contract, the remaining borrowers simply chose to take up even more risk if the interest rate is higher. In this situation, the lender will react by rationing credit rather than increasing interest rates, leaving a share of willing borrowers without access to funds (Stiglitz and Weiss, 1981).

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