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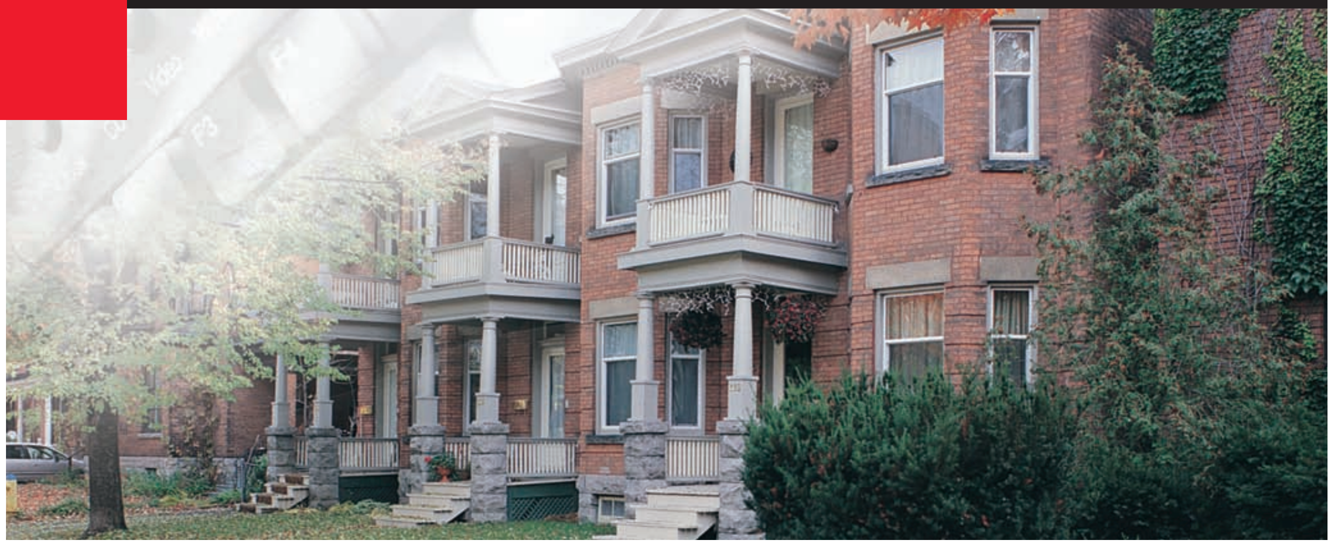

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ALTERNATIVES TO THE WHITE PAPER PROPOSALS

by

J.A. Johnson

A Study Undertaken for

Canadian Mortgage and Housing Corporation

November 30, 1988

EXECUTIVE SUMMARY

The major purpose of this study was to analyze the 1987 White Paper proposals and alternative methods of taxing housing under a value added tax (VAT), employing generally accepted tax criteria. The first step was to identify alternative measures by examining the levies used by European countries and New Zealand as well as the economics literature. The next step was to analyse the shortcomings of these measures and to select one or more preferred options for further investigation, along with the White Paper proposals and a plan for completely excluding housing from the tax base. The third step was to analyze these measures in terms of criteria such as equity and administrative simplicity. The last step was to form conclusions. A secondary purpose of the study was to assess the extent to which housing has contributed to the problems in the Manufacturers' Sales Tax and to compare the White Paper proposals and MST, using the tax criteria noted above.

Investigation of 24 OECD countries indicates that 17 have adopted a consumption form of VAT as a replacement for other sales taxes. All 17 countries utilize the invoice or tax credit method of computing the levy. The standard rate ranges from 10 to 25 percent but nearly all of the countries tax some items at a lower rate. Sales of used dwellings between individuals are not taxed and residential rents are effectively taxed only in Austria. There is great disparity in the taxation of new housing sales. Ten of the 17 countries tax the sales of new housing, but there are differences in the definition of a new dwelling, the costs included and the rate applied. For example, dwellings may be considered as new for up to 5 years in France, some countries exempt all or a portion of land costs and Spain and Ireland tax sales of new dwellings at less than the standard rate. The other 7 countries exempt the sale of new housing but, except for the U.K., subject various components to the levy without allowing a credit for taxes paid on them. All of the six countries tax construction materials but the proportion of land value included in the tax base varies. In the U.K., there are essentially no taxes on new dwellings. Expenditures on land, materials and purchased services are are effectively eliminated through zero-rating, whereby the contractor receives a credit for all of the VAT paid on purchased inputs. In addition, no VAT is levied on direct labour and contractor services are free from tax because an exemption is given to sales of new dwellings. All countries tax materials and most purchased services used in making repairs and renovations but there is variation in the taxation of expenditures for services such as insurance, utilities and financing.

Proposals for tax reform presented in the economics literature were also examined. These proposals included taxing both actual and imputed rents, all housing sales and a one-time tax on dwellings. Under this last plan, properties would be taxed the first time they are sold after the introduction of a VAT but second and subsequent sales of the properties would normally be exempted.

Nine measures for taxing housing under a VAT were examined briefly and 6 were selected for a more thorough analysis: the three reform measures noted above and three methods which are broadly representative of the policies employed in OECD countries. These methods included a zero-rating and exemption plan which virtually excludes land and construction costs, a measure which taxes only construction material and purchased services and a levy on new housing sales (the White Paper proposals). These six measures were analyzed in relation to generally accepted tax criteria; horizontal and vertical equity, economic efficiency, ease of administration and compliance and revenue proceeds. The effect on the development of new housing was also investigated.

No single measure was judged as superior to the other five plans on all tax criteria. In general, measures which ranked high on the horizontal equity, economic efficiency and revenue criteria received a low rating in terms of vertical equity, minimum costs for administration and compliance, and positive impact on new housing development. The reverse is also true and thus, analysts and policymakers could reasonably disagree as which is the best measure if they applied different weights to the criteria. For example, a bureaucrat interested in administrative simplicity would tend to select one of the measures used in OECD countries, whereas a policymaker who wants maximum revenue would prefer one of the reform plans.

The number of feasible plans can be reduced to 4, however, once political acceptability is brought into the analysis. Taxpayers would be strongly opposed to the taxation of all rents or all housing sales. The administrative and compliance costs would be very high because both plans would require that all homeowners be registered as taxpayers and that they keep extensive records.

The choice among the other four plans depends largely on the emphasis placed on each criterion and especially on the short-run revenue and tax-expenditure effects. At one extreme is the zero-rating and exemption of sales plan which would virtually exclude housing from the tax base. It would give the greatest impetus to the construction of new housing but would have the largest negative impact on revenue. At the other extreme are the one-time sale plan and the White Paper proposals. The one-time sale plan would raise 6 or 7 times the amount of revenue secured from the White Paper proposals in the period immediately following the adoption of a VAT, and the White Paper proposals would raise approximately twice as much revenue from new housing as would the plan which exempts land, direct labour and all housing sales. The greatest negative impact on the development of housing would result from the adoption of the White Paper proposals. This effect would be relatively small and short-lived in an expanding market such as Southern Ontario but be more severe and have a longer duration in areas where the demand for housing is stagnant. Over time the one-time sale and White Paper measures converge as a greater proportion of housing is taxed. The measure which exempts all sales, land and direct labour ranks between the complete exclusion and White Paper proposals on almost every criterion and is close to the status quo, as defined by the MST.

In terms of the MST, it was concluded that the shortcomings of the MST were not due to particular problems in taxing housing. In addition if taxation of housing was the only consideration in choosing a MST or VAT, there is not a clearcut case for either levy.

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ABSTRACT

This study examines the 1987 White Paper proposals and other plans for taxing housing under a value added tax (VAT). The first section outlines the major issues in levying a VAT on housing and describes the White Paper proposals.

In the second section, a brief summary of VAT use in OECD countries is given, along with a more thorough discussion of the treatment given housing. Reform measures for taxing housing are also described and six plans are selected for further analysis: a levy on paid and imputed rents, almost complete exclusion of housing capital costs through zero-rating of inputs and exemption of all sales, partial exclusion of these costs by exempting land, direct labour and all sales, the White Paper proposals which include the sales of new housing in the tax base, a one-time tax which would be levied the first-time each property is sold after the adoption of a VAT, a tax on all housing sales but allowing credit for VAT paid on the purchase of the property and on improvements.

Section three is devoted to comparing the six measures in relation to commonly accepted tax criteria: horizontal and vertical equity, economic efficiency, revenue secured and minimum administrative and compliance costs. The impact on the development of new housing is also examined. The chief

conclusion drawn from this analysis is that no one measure is superior to the other five on all criteria and that the selection of the "best" plan depends on the relative importance placed on each criterion.

In the fourth section, a brief history of the Manufacturers' Sales Tax is provided with emphasis placed on changes which affect housing. The deficiencies of the MST are also reviewed and the relationship between these problems and the treatment of housing is also discussed. Last, a comparison between the White Paper proposals and MST with respect to housing is undertaken, employing the tax criteria listed earlier.

The final section summarizes the major conclusions developed in the study. Some observations are also offered to help shorten the list of acceptable plans and emphasize the tradeoffs involved in selecting each of the remaining measures.

Two appendices are also provided which describe housing related taxes in each of the 17 OECD countries levying a VAT. The first appendix describes the treatment accorded housing and immovable property under the respective value added taxes and the second focuses on other property related levies.

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SECTION 1: INTRODUCTION AND OVERVIEW

The fastest growing major source of revenue for central governments is the value added tax (VAT). France introduced a limited form of VAT in 1948 and altered it in 1954, but the first complete levy was adopted by Denmark in 1967. An impetus for the levy was given by the formation of the European Economic Community and the utilization of the tax spread to other countries over the next two decades. At present, the VAT provides a substantial amount of revenue for approximately 50 countries, including 16 in Europe, 12 in Latin America, Israel and New Zealand. Seventeen of the 24 OECD countries employ a conventional form of the levy, Finland levies a limited hybrid form of VAT (Cnossen 1987), and it has been given serious consideration in nearly all of the other six. In many OECD countries the VAT was primarily a substitute for a turnover tax but it replaced a wholesale tax in Denmark, Ireland, Portugal, United Kingdom and New Zealand, a manufacturers' levy in Greece and Turkey and a retail tax in Norway and Sweden (for surveys of the VAT, See Aaron 1982, Cnossen 1987, McLure 1987 and Thirsk 1987).

The percentage of tax revenue raised through the VAT for the 17 OECD countries ranged from 12 to 21 in 1984, with the median at about 16 percent (Cnossen 1987). The standard tax rate ranged from 10 percent in Turkey and New Zealand to 25 percent in Ireland, and the median rate was roughly 18 percent. Except for New Zealand and Denmark, all of the OECD countries tax some items at a lower rate and 9 of these 17 countries levy a higher rate on specific purchases; the higher rate generally ranges from 25 to 38 percent (Cnossen 1987).

There are several reasons for the popularity of the value added tax. As compared to most levies, a VAT facilitates trade agreements because it provides a reliable guide to border tax adjustments and this virtue was important to the countries forming the European Economic Community. A second reason for the widespread adoption of the VAT is that substantial amounts of revenue can be raised by low tax rates because of the broad base of the levy. There is also growing emphasis on expenditure based taxes, in comparison to income levies, and a VAT is generally viewed as superior to turnover, wholesale and manufacturers' sales taxes with respect to economic efficiency. This evaluation is due to its broad coverage, equal treatment of exports and imports in relation to domestic goods and avoidance of "double taxation" for purchased goods and services used as inputs in production. In addition, a VAT is judged as easier to administer than a retail sales tax (Cnossen 1987).

Even though several countries utilize a VAT and some nations have had 20 years of experience with the levy, there are several issues and administrative problems which have not been resolved. Many of these problems are related to the taxation of particular areas of economic activity. The real estate, financial services, agricultural, government, private nonprofit and foreign travel sectors all provide unique and serious problems in the implementation of a VAT. If the value added in these sectors is not taxed, the base is reduced and nonneutralities result. Full taxation, however, often involves complex and unpopular administrative measures. To partly tax the value added in these areas reduces some of the administrative complexity but erodes part of the base and causes some nonneutralities within each sector, as well as across all goods and services.

1.0 ISSUES IN TAXING HOUSING UNDER A VALUE ADDED TAX

There are many issues surrounding the taxation of housing. First, there is the basic question of whether, in principle, housing should be treated in the same manner as most other commodities. It could be argued, for example, that the consumption of housing should be encouraged because it is a merit good in that the value of housing to users, as seen from the perspective of society, is higher than the value placed on it by the users themselves. A case can also be made for treating housing more favourably than other commodities because expenditure on housing forms a higher proportion of income for the poor than for the rich and because good housing benefits individuals other than direct users through reducing medical, fire and other government costs and through encouraging better citizenship. Second, there is the question of whether the taxation of housing should be analyzed in the context of all taxes including income, property and all commodity levies or whether it is sufficient to examine only the impact of the VAT on housing, implicitly assuming that subsidies and other taxes are part of the basic environment in the same manner as factors such as the skills of the labour force, industry structures and government monetary and trade policies.

Even in the latter case, where only the VAT is considered, and merit good, income distribution and externality issues are ignored, there are many economic, political and administrative problems. Many of the problems arise because housing differs from most other commodities in some important respects. First, housing forms a large proportion of expenditure for most households and, hence, the taxation of it causes a large political response. Second, expenditure on housing by owner-occupiers involves both consumption and investment motives. Taxing the return on investment (e.g. capital gains) would introduce a distortion in investment behaviour because capital gains on other investments such as shares of a corporation would not be taxed under a VAT. Third, the value of housing consumption to owner-occupiers must be imputed if consumption is taxed annually, because there is no market transaction as there is with rental expenditure. Fourth, buildings and land can be used both for housing and as an input in the production of goods and services. Fifth, land forms a significant portion of housing costs and it is often difficult to separate land and building costs.

Due to these varied issues there are several proposals for taxing housing under a VAT. One method is to tax the flows of all housing, which would require estimating the imputed consumption value of owner-occupied housing. This method would ensure economic efficiency by taxing all consumption expenditures in a neutral manner but would be extremely difficult to administer and would generate a tremendous amount of taxpayer opposition. A second method is to tax only actual rents and exclude the value of owner-occupied housing. This service would be administratively feasible but would introduce distortions in expenditure between rented and owner-occupied housing and would likely benefit high income consumers more than those with low income. A third measure would be to exclude all housing from the VAT base. This method would provide for neutrality within the housing sector but would cause distortions between consumer purchases of housing and other commodities as well as distortions in the use of real estate between housing and as a business input. In addition, the size of the tax base would be significantly reduced and there would be some administrative difficulties when real estate is shifted between housing and business. A fourth method of taxation is to tax the value of housing each time the property is sold, giving credit for the tax paid on renovations and on previous sales (Gillis 1986). This plan would eliminate the problems associated with taxing imputed and actual rents but would require a large number of individuals to be registered as taxpayers and would necessitate extensive record keeping on the part of the individuals to ensure that expenditures on improvements were not taxed twice. Another difficulty is that the value of consumption may be "undertaxed" for properties sold infrequently and the value of labour involved in improvements undertaken by owners would not enter the tax base until the property is sold. A variant of this taxation method is to restrict the tax to the first sale of the property after the VAT is introduced (Conrad and Gillis 1985). This fifth method would reduce the extensive record keeping involved in taxing each sale but the magnitude of some other problems would be larger, especially because the labour of owners in improvements would never be taxed. In addition, if land (later used for housing) had been taxed in an earlier period, it may be difficult to determine the value of the building when the property is first sold as housing. A sixth measure is to subject only the value of new housing to the tax. This plan would further reduce the number of taxpayers but in addition to the problems associated with taxing properties only once, this measure would reduce the tax base substantially and would likely introduce distortions in the housing market as well as between housing and other goods. To the extent the price of "old" housing rose along with the price of "new" housing, owners would realize windfall capital gains when the tax is introduced, and if the prices of new housing rose relative to old housing, consumers would choose more old housing and less new housing and less of other taxable commodities. In this latter case, the amount of newly constructed housing would also likely fall.

This subsection has indicated some of the issues involved in the taxation of housing and has provided a short description of basic methods which can be employed in taxing housing under a VAT. All of these measures have some shortcomings and it is not obvious that one scheme is superior to all others. The 1987 White Paper on Taxation (Wilson 1987) advocates a particular method of taxing housing and this proposal is described in the next section.

1.1 DESCRIPTION OF WHITE PAPER PROPOSALS

The Manufacturers' Sales Tax was adopted in its present form during 1923 and almost from its inception has been criticized by businesses, citizen groups, academics and government commissions. The levy has a narrow base which causes distortions in production and consumption and results in a low yield for a given rate of tax. In addition, the Manufacturers' levy favours imports and penalizes exports, favours some distribution channels over others and is difficult to administer because of the limited base, multiple rates and large number of transactions where goods are sold to retailers or final users as opposed to wholesalers.

The government has made efforts to reform the tax, including an attempt to replace it with a wholesale levy. These efforts have been largely unsuccessful and as part of the 1987 tax reform package, the government indicated its intention to introduce a VAT (Wilson 1987). The proposed VAT would not only replace the Manufacturers' Sales Tax but would also change the tax mix by placing greater emphasis on consumption taxes and less on income taxes.

The proposed VAT is a multi-stage tax levied on a comprehensive base and is designed to avoid the problems associated with the Manufacturers' tax. It would treat exports and imports in the same manner as domestic goods, place a uniform rate of tax on almost all goods and services, avoid double taxation of goods used as inputs by businesses, not differentiate among channels of distribution and eliminate the need for making arbitrary assessments of value for some transactions.

The proposals include three variants of VAT. The first and most preferred form of VAT is a combined National Sales Tax which would replace provincial retail sales taxes as well as the Manufacturers' levy. The National Sales Tax would be levied on a comprehensive base and the federal rate would be uniform on all goods and services. Each provincial rate would also be the same for all goods and services in the tax base but the rate could vary by province.

In the event that the federal and provincial governments cannot agree on a combined levy two other forms of VAT are proposed, both of which would be exclusively federal taxes. One is a Federal Goods and Services Tax. This levy would be similar to the National Sales Tax in that it would have a comprehensive base and a uniform tax rate. It differs from the National Tax in that it does not place the same dependence on tax calculations for each invoice. Under the National levy, a firm's tax liability is determined through multiplying the firm's sales by the tax rate and subtracting the tax paid on inputs. The VAT is calculated and shown on each invoice and invoices provide proof that tax was paid on inputs. Under the Goods and Services Tax, the VAT is computed for each firm by subtracting the value of purchases from sales and multiplying this difference by the tax rate. There is no need to identify the sales tax separately when making sales to other firms and it is the tax included price of inputs which is important.

A second form of a federal levy is labelled a federal Value-Added Tax. It differs from the National Sales Tax and the federal Goods and Services Tax in that it would allow for the possibility of exempting specific categories of goods and services such as housing or financial services; although not mentioned in the proposals, this type of VAT could also allow for a variation in rates for different categories of goods and services. The Federal Value-Added Tax would be similar to the National Sales Tax in terms of the method of computing tax and reliance on tax information provided by invoices.

1.11 Proposals For Taxing Housing

The treatment accorded housing would be the same under all three forms of VAT. The sale and rental of real estate, both land and buildings, used in business and the sale of new residential property would be taxable but residential rents and sale of used residential dwellings would normally be exempt.

Real estate used as a business input would be treated in the same manner as other goods and services. Firms would pay tax on the sales of land and buildings and deduct taxes paid on inputs. Likewise, owners of commercially rented property would pay tax on rent paid by tenants and receive a credit for the tax paid on land and construction costs as well as for the tax paid on electricity, office furniture and other goods and services. The tax component of rent would be used as a credit when the business tenants compute their tax.

In general, all residential rents would be exempt from taxation and owners would not receive credits for tax paid on inputs, including the tax paid on repairs and renovations. One exception to this rule includes hotels, motels and similar dwellings, where accommodation is usually for periods of less than 60 days. Owners of these properties would be liable for taxes on the rents received and would be able to claim credit for taxes paid on purchases including construction and repair expenses. If an owner of a rental property has both short and long term tenants (more than 30 days), a portion of the rents received would be taxable and the remainder exempt. In this situation costs would be prorated and the tax paid on the costs allocated to short-term rentals would be set against the tax on the rents received from short-term tenants.

For owner-occupied housing there would be no tax on the flow of housing services so no calculation of imputed rent would be required. Purchases of goods and services for repairs and improvements would be taxable.

Sales of used residential property, both owner-occupied and rental, would be exempt from VAT but sales of new dwellings would be subject to the levy. No credit would be allowed for the tax paid unless a substantial proportion of owner-occupied property is used for business purposes or the rental property has short-term tenants. In cases where an input credit has been claimed, a portion of the resale proceeds would be taxable. The rules for personal-use assets such as cottages and hobby farms are the same as for owner-occupied housing, unless the property is sub-divided for the purpose of sale.

Sales and rentals of property owned by charities, non-profit organizations and governments would also be exempt and input credits would not be claimed.

The White Paper proposal, if implemented, would avoid the administrative and political problems associated with taxing imputed rents and sales of used residential property. The scheme would, however, create some nonneutralities with respect to sales of new and used housing, use of property which could be employed for housing or offices and purchased repair services as opposed to the repairs undertaken by the owner. These nonneutralities can be illustrated through examples. In these illustrations it is assumed that there are no other commodity taxes or costs and the tax is shifted forward in the form of higher prices. The calculation of the tax is likely to be identical under the National Sales Tax and Federal Value Added Tax variants and where only one dwelling is involved, the illustrations apply to the Federal Goods and Services Tax as well.

Illustration 1.1

Comparison of a New Dwelling With and Without a VAT

	Without VAT		With VAT (10%)			
	Price	Price Net of Tax	Tax on Sales	Credit for Input	Net Tax	Price including Tax
Land owner						
	$20,000	$20,000	$ 2,000	$ --	$2,000	$22,000
Building Contractor						
	70,000	70,000	7,000	2,000	5,000	77,000
Real Estate Firm						
	100,000	100,000	10,000	7,000	3,000	110,000
Final Purchaser						

In this case a property owner sells land to a building contractor who, in turn, sells a completed dwelling to a real estate firm. The real estate firm then makes a sale to a final purchaser who may live in the dwelling or let it to tenants. If in the no-tax case a final purchaser is relatively indifferent between a used property costing $100,000, and a new dwelling, the introduction of a VAT would cause him/her to select the old dwelling since it remains at $100,000 and the price of a new one rises by $10,000 to $110,000. This illustration also shows that individuals who own dwellings would be less likely to sell and purchase new properties if a VAT is adopted.

Illustration 1.2
Comparison of existing property which could be used for Rental Housing or Rental offices, with and without a VAT

Rent Without a VAT		Rent With a VAT			
Housing	Offices	Housing	Offices		
			Net of Tax	Tax (10%)	Including Tax
$10,000	$10,000	$10,000	$10,000	$1,000	$11,000

This illustration indicates that the introduction of a VAT would increase the rental price for offices or other business use but would not alter residential rents. Although most business users could secure a credit for the tax paid on rent there would be some reduction in the demand for offices.

Thus the adoption of a VAT would result in a smaller proportion of existing rental property being used by businesses and a greater proportion utilized in housing.

Illustration 1.3
Comparison of Housing improved by
Purchases as opposed to Efforts of Owner

	Selling price without a VAT		Selling Price with a VAT			
				Purchased Services		
	Owner Efforts	Purchased Services	Owner Efforts	Net of Tax	Tax (10%)	Including Tax
Original Price	$60,000	$60,000	$60,000	$60,000	$ --	$60,000
Value of Improvements	40,000	40,000	40,000	40,000	4,000	44.000
Selling Price	100,000	100,000	100,000	100,000	4,000	104,000

In this example the price of a dwelling improved through the purchase of services would rise by more than property improved by the efforts of the owner. An individual who is indifferent between the properties would choose the owner improved dwelling after the VAT generated price increase. The other owner would face a longer period before selling his property and as a consequence a VAT would encourage more "do it yourself" work and discourage purchases of services when repairs, renovations and improvements are undertaken.

These illustrations indicate that the White Paper proposals with respect to the taxation of housing under a VAT, if adopted, would alter economic behaviour of consumers and/or producers in what appears to be an undesirable manner. Although it seems clear that nonneutralities would be created under the proposal it is not certain that this measure is inferior to other options, some of which were briefly described in the previous section. Once the deficiencies of other methods of taxing housing under a VAT are examined and all methods are analyzed in relation to a wide spectrum of desirable tax criteria, it may be judged that the White Paper proposals are superior or at least not clearly inferior to other methods of taxing housing. It is the purpose of this study to aid in the evaluation of the White Paper proposals by comparing them with a variety of measures. Some of these measures are used in other countries and others are at the proposal stage. In the next section an outline of the remainder of the study is provided.

1.2 OUTLINE OF THE STUDY

The chief objective in Section 2 is to provide a summary of the treatment accorded housing under the value added taxes levied by European countries and New Zealand. Some attention is also directed to other taxes and to subsidies which pertain to housing in these countries. These summaries are supplemented by appendices which describe the tax treatment of housing in more detail, including giving exceptions to general rules for each country. In addition to describing taxes employed by various countries, three proposed measures for taxing housing are discussed. The final subsection is devoted to a brief evaluation of the various methods for taxing housing.

The major focus in the third section is to compare six schemes for taxing housing under a value added tax. The tax measures include the White Paper proposal, and five other methods selected in Section 2 for more study. The tax criteria include: social justice; consistency with economic objectives, with emphasis on neutrality; ease of administration and compliance including taxpayer acceptance; revenue effects and where relevant, tax-expenditure efficiency. The first subsection discusses the likely incidence of a value added tax on housing, employing the results of previously conducted research. The results of this exercise are not conclusive, but identify the most important factors in the determination of tax shifting and provide a "most likely scenario".

The next subsection compares the selected tax measures with respect to social justice -- horizontal and vertical equity. The discussion of horizontal equity involves a comparison among owners of old housing, owners of newly constructed homes, renters and owners of rental property, all of whom have equal incomes and levels of consumption. The impact on vertical equity or progressivity is determined by using the conclusions derived from subsection of tax incidence, along with data which describe expenditure on housing by income class.

The subsection on economic objectives emphasizes economic efficiency and the distortions caused by the six tax measures. Although the welfare losses associated with each measure cannot be quantified, some indication of the likely qualitative differences among the methods with respect to deadweight losses is provided. The impact of the measures on other economic objectives such as employment and low rates of inflation are also discussed briefly.

The fourth subsection discusses the administrative and compliance problems associated with the tax schemes. A description of some of the difficulties under each measure is provided, and the methods are ranked with respect to overall costs.

The last subsection deals with the revenue effects of each measure, assuming the tax rate is constant and ignoring output and multiplier effects. Comments on the tax-expenditure efficiency of the measures are also given.

In the fourth section a brief history of the Manufacturers' Sales Tax is presented, with emphasis placed on changes in the tax rate and base with respect to housing. The major shortcomings of the levy are also described and the contribution of the tax treatment accorded housing to these shortcomings is analyzed. Last, comparisons are made between the MST and White Paper proposed VAT, in relation to the tax criteria employed in Section 3.

The final section summarizes the major findings of the study and draws some conclusions about the taxation of housing under a VAT.

SECTION 2: TREATMENT ACCORDED HOUSING UNDER VALUE ADDED TAXES IN OTHER COUNTRIES AND PROPOSALS FOR TAX REFORM

A value added tax is generally viewed as a consumption levy but, for administrative reasons, the tax is usually collected at the time purchases are made. This distinction between consumption and purchases is of little importance for most goods because the period between the two is relatively short. The consumption of many durable goods occurs over a period of years, however, and housing consumption takes place over many decades in most instances. The durability of housing not only causes an ongoing difficulty under a value added tax because the tax and consumption flows are not matched, but is the source of a transition problem when a VAT is introduced. This transition problem occurs because consumers of existing owner-occupied housing would not be taxed if the levy is paid at time of purchase. As a consequence, a mix of inequities and distortions would result.

One solution to these problems is to tax individuals on the flow of housing services consumed. This method of taxing housing is easily administered in the case of rental housing, although it would result in a substantial number of taxpayers, but is much more difficult for owner-occupied housing, where an imputed rental value must be determined because there is no market transaction. The registration of all owner-occupiers would be required, thereby adding approximately five times as many taxpayers to the roles as would otherwise exist. In addition, artificial or notional gross rents must be determined from which must be subtracted interest, repairs, property taxes and other expenses or VAT on these items must be deducted from the tax on gross rents. Due to these large compliance costs and the likelihood of strong taxpayer opposition which would accompany them, no country has attempted to tax the flow of owner-occupied housing consumption services under a VAT. To avoid discrimination against tenants, taxes also have not been levied on rents, except in Austria and for long-term leases in Ireland. Rather, countries have attempted to tax housing through various levies on purchases. In the next subsection the practices of OECD countries are described, followed by a discussion of some reform measures. Last, all of these measures are evaluated briefly with the goal of selecting five for further investigation.

2.0 EUROPE AND NEW ZEALAND

Most European countries levy value added taxes according to the guidelines of the Sixth Directive of the European Economic Community (1977). The objective of the Directive was to harmonize taxes within the EEC through setting general rules. In most cases, however, these general regulations provided for exemptions and "grandfathered" practices in force at the time of the 1977 report.

The Directive stated that housing and other forms of immovable property may be subject to VAT as a "supply of goods" or "supply of services". A supply of goods includes transfers of "old" buildings, "new" buildings and building land. According to the regulations a VAT is to be levied on new buildings (including the land on which it stands) and building land (unimproved land as defined by individual member countries). The Directive also includes provisions that allow countries to exempt items which are deemed taxable but were exempt prior to the implementation of the Directive, thus allowing countries to continue to exempt new buildings and land. The Directive exempts other forms of real estate, such as old housing and farm land, and property used for an exempt activity. In addition, there are rules which allow for the waiving of exemptions if the parties to the transaction agree; the waiver would then allow the seller to claim an input credit for his purchases and the buyer to claim a credit upon resale.

Under the supply of services regulations the general rule is that the leasing and letting of immovable property is exempt, with stated exceptions for hotel accommodations, parking spaces, installed equipment and hire of safes. However, an option is provided whereby member countries may include other transactions as "exceptions" to the general exempt status of leasing and letting, which allows for the taxing of rents. The Directive also allows leasing when taxed, to be treated as a supply of goods or supply of services. Under a supply of goods, the VAT is paid in full at the beginning of the contract whereas under a supply of services, the tax is paid over the life of the lease. As is the case for the supply of goods, the Directive allows taxation for otherwise exempt leasing and letting activities if the property is leased to a taxable person.

As shown above, the EEC regulations allow for a variety of practices and of course, the other four OECD members from Europe as well as New Zealand are not bound by EEC rules. Nonetheless, the treatment accorded rental housing is similar in nearly all 18 countries. Except for Austria and leases of 10 years or more in Ireland, long-term rental housing (e.g. more than 30 days or 60 days) is exempt from VAT. Most countries do levy VAT on hotels and other short-term rental agreements, as well as on parking spaces, rental of safes and permanently installed equipment. Roughly one-half of the countries also tax rents for campsites. Thus, except for Austria, and it taxes rentals at 10 percent rather than the standard rate of 20 percent, residential rents are essentially free from value added taxes in OECD countries.

The treatment of sale of goods is much more diverse. All OECD countries essentially exempt the sale of old housing between non-registered individuals and most nations exempt all sales of used housing. Some countries such as France, however, require that property be of at least a certain age, i.e. 5 years, to be exempt. Building land is also only taxable in a minority of countries. The chief rationale for the exemption of building land is that land is not consumed in a normal sense. Land is part of the VAT base in France, Greece, Italy and Spain. France, however, bases its tax on only 70 percent of the value of the land.

There is more variety in the taxing of new buildings. More than 50 percent of the countries include new housing in the tax base but there are differences in the rate applied and in the definition of new buildings. For example, Ireland and Spain tax new housing at less than the standard rate. Most countries define new housing in terms of the value at the time the property is transferred and before the first occupancy but France and the Netherlands consider dwellings as new if they were built in the past 5 and 2 years, respectively. Turkey only taxes dwellings above a given size at present but intends to tax all new housing starting in 1992. In general, new buildings are taxable in Austria, Belgium, France, Greece, Ireland, Italy, Netherlands, New Zealand, Spain and Turkey.

Sales of new buildings used for housing are exempt from VAT in 7 countries but in most cases purchases of construction materials and other items are taxed. An exemption generally implies that there is no tax on the services of the contractor but it also means that no input tax credits can be used by the contractor. Sweden and Belgium reduce this burden by taxing services or supplies used in construction at less than the standard rate. Sales of new buildings are largely exempt from VAT in Denmark, Germany, Luxembourg, Norway, Portugal and Sweden. Only in the U.K. are new buildings completely free from tax. The method employed to free new buildings is to "zero rate" them, which allows contractors to receive a credit for all of the value added tax paid on purchased inputs, including construction materials and land. No VAT is levied on the value added of the contractor and thus, sales of new and old building are treated equally. Purchases of services and materials for repairs and improvements are taxed however, as is the case in other countries. A summary of the treatment accorded rental housing and sales of old housing, building land and new housing is provided in Table 2.0. A more detailed description is given in Appendix A.

Table 2.0

VAT TREATMENT ACCORDED HOUSING IN OECD COUNTRIES

Country	Residential Rents	Old Buildings	Building Land	New Buildings
Austria	taxable	exempt	exempt	taxable
Belgium	exempt	exempt	exempt	taxable
Denmark	exempt	exempt	exempt	exempt
France	exempt	exempt	taxable	taxable
Germany	exempt	exempt	exempt	exempt
Greece	exempt	exempt	taxable	taxable
Ireland	exempt	exempt	exempt	taxable
Italy	exempt	exempt	taxable	taxable
Luxembourg	exempt	exempt	exempt	exempt
Netherlands	exempt	exempt	exempt	taxable
New Zealand	exempt	exempt	exempt	taxable
Norway	exempt	exempt	exempt	exempt
Portugal	exempt	exempt	exempt	exempt
Spain	exempt	exempt	taxable	taxable
Sweden	exempt	exempt	exempt	exempt
Turkey	exempt	exempt	exempt	taxable
United Kingdom	exempt	exempt	exempt	zero-rated

Note: For exemptions and more details on these general conclusions see Appendix A. It should also be noted that special taxes apply to property in some countries and may offset VAT exemptions. These levies are described in Appendix B.

It should be noted that many countries have subsidy programs which encourage the consumption of housing and thus offset the burden of value added taxes. Countries also levy special taxes on housing, some of which offset VAT exemptions and others place a general tax on all housing. Norway and New Zealand, for example, have subsidy programs for the purchase of new housing and subsidized rents are not uncommon. With respect to other taxes, property based levies are nearly universal, although residential property is often favoured in relation to other property. In addition, several countries levy stamp and transfer taxes, some of which do not apply if the sale is subject to VAT. These transfer or turnover taxes are collected each time the property is sold and thus may accumulate to form a larger burden than a VAT if property is sold a number of times. For example, Germany levies an immovable property acquisition tax; France levies a land and building tax, and a local infrastructure tax; Denmark levies, land and service taxes; Austria has an immovable property acquisition tax; Belgium has a registration duty; Greece levies an immovable property tax; Ireland collects a stamp duty; Italy levies a registration duty as does Luxembourg; Netherlands levies a real property transfer tax when VAT does not apply; Spain levies a property transfer tax and Portugal levies a capital transfer tax on real property. Turkey levies several taxes including a real estate capital gains tax and a real estate purchase tax.

In some countries, however, residential housing and particularly low-cost social housing is granted relief through at least partial exemption (Portugal, Spain, Germany) or is taxed at lower rates (France, Belgium, Turkey). These special levies on property are described in fuller detail in Appendix B.

2.1 PROPOSALS FOR REFORM

None of the policies followed by OECD countries in taxing housing under a VAT provides for equal treatment of all types of residential property, as well as between housing and other property and between property and other goods and services. Neutral treatment of all goods and services is often viewed as an important goal of taxation and thus, suggestions for reforming the VAT have been put forward.

The most radical suggestion is to tax the consumption flows of property. As indicated previously, this would ensure neutral treatment of housing consumption in relation to other goods and services but would result in large administrative and compliance costs. Taxes on rental property would require the registration of landlords, many of whom have a small volume of business and would not otherwise be registered. Taxing flows of housing consumed by owner-occupiers would necessitate the registration of all these individuals as well as an annual calculation of notional rent for each residence. However, some countries such as Belgium, and at one time the U.K., include imputed rent in their definitions of taxable income. Thus, even though these calculations of imputed rent may be viewed as arbitrary it does seem to be administratively feasible to determine the value of notional rents for owner-occupied housing and to tax them under a VAT.

Other suggestions for reforming the VAT focus on taxing the stock of housing. One measure, advanced by Conrad and Gillis (1985) and Conrad (1986) is to tax all housing, rental and owner-occupied, the first time the property is sold after a VAT is introduced. They have shown, under some conditions, that a first sale levy on the sale of a dwelling is essentially equivalent to an annual tax on consumption flows, but is much easier to administer. They argue that the chief difference between this one-time levy and an annual tax is that the government receives the present value of the tax at an earlier date under the first-sale VAT. They also conclude that this suggested levy would ensure neutral treatment between rental and owner-occupied housing as well as between owners of old and new housing and suggest that business property could be taxed in a similar manner. While their conclusions are correct within the context of the lifetime model they employ, there are some difficulties with this measure. First, VAT rates may change over time and consequently old and new housing would bear different burdens. Second, the introduction of a VAT may cause a "lock-in" effect (Conrad 1986) in that owners of existing homes would be less likely to change houses because they would be required to pay tax. For example, to move from one $100,000 dwelling to another property of the same value would cost $10,000 (assuming a 10 percent VAT rate). This would distort purchasing patterns and result in some economic inefficiency. Third, improvements generated through the labour of owners would escape tax and therefore, housing improved through the purchase of services would bear more tax than dwellings which are unimproved or repaired by owners. Fourth, owners would be required to become registered when properties are transferred and thus, the number of taxpayers would rise sharply. In addition, complications would occur when the use of a dwelling changes between business and residential use. For example, when a dwelling used for housing is transferred to business use, tax would be collected and a refund would be given to the seller for tax previously paid on the dwelling. Last, even when the present value of the first-sale VAT and an annual levy is the same, consumers are believed to be risk averse and would prefer an annual tax (Conrad 1986). In this situation, purchasing patterns would be distorted because individuals would favour goods and services where the tax and consumption take place in the same time period.

Gillis (1985) has suggested a variant of this tax on the sale of housing, which goes some way towards mitigating most of the problems noted above. Under the Gillis proposal, owners would be treated like sellers of other goods. Property would be taxed each time it was transferred, with the seller receiving a tax credit for the tax paid at the time of purchase. For the first sale after a tax is introduced, there would be no credit. When the property is resold a credit would be allowed for the tax paid on purchases of materials and services used in making improvements as well as on the purchase of the dwelling. This measure would tax improvements undertaken by the owner and eliminate the distortion caused by changes in tax rates over time but the other problems would remain and the administrative and compliance costs would be considerably higher than under the one-time levy on first sales. Owners would be required to keep records which not only indicate the tax paid at the time of purchase but the tax paid on improvements. There would also be some difficulty in differentiating between repairs and improvements, if this was thought to be desirable.

2.2 SELECTION OF MEASURES FOR FURTHER INVESTIGATION

It was demonstrated in subsections 2.0 and 2.1 that there are several ways to treat housing under a VAT. There are many basic plans and a variety of tax provisions to differentiate short-term from long-term rentals, take account of transfers between residential and commercial use of dwellings and to distinguish between a sale of goods and a sale of services. Defining the number of basic plans is arbitrary because differences between some measures appear to be small but are important for some categories of taxpayers. For the purpose of this discussion, however, 9 methods are identified. There are two measures which are based on the consumptions flow of housing services. The first method is to tax residential rents when they are paid and imputed rents for owner-occupied housing on an annual basis. The second method is to exclude imputed rent and tax only paid rents. As noted earlier, no country employs the first method and there are large administrative and compliance costs associated with it. It is generally viewed as the ideal method of taxing housing in terms of economic efficiency, however, and would raise substantial amounts of revenue. In addition, there is a precedent for taxing imputed rent since Belgium and other countries levy an income tax on it. Thus, even though it is less politically acceptable than other options it is worthy of further consideration. At the very least it is a standard with which to rate alternative measures. The second measure of taxing paid rents but excluding imputed rents appears to be widely used only in Austria. And even there, rents are taxed at less than the standard rate. This option also has substantial defects. It distorts decisions between buying and renting a dwelling, penalizes low income individuals in comparison with those with high incomes and would substantially erode the tax base. This measure is not examined further.

The remainder of the measures are based on the transfer of property. Complete exclusion is given to new housing in the U.K. through a system of zero-rating, where no tax is levied on the sale to the final purchaser and the builder is given a credit for tax paid in the construction of the dwelling. In the U.K. there is also no tax on the sale of land or old housing. This program should be examined in more depth because it is used in the U.K. and is both unique and administratively feasible under two of the three options presented in the White Paper.

A fourth method exempts the final sale of a new dwelling, but does tax the materials and purchased services utilized in construction. Land and old housing are exempt. A fifth method differs slightly from this measure in that land sales are subject to VAT. Under the sixth plan, the full value of new housing is taxed except for the cost of land and the seventh scheme includes land in the base. Under both of these two measures sales of old housing are free from VAT. Nearly all of the 17 OECD countries levying a VAT utilize one of these last four measures. The seventh measure is essentially the White Paper proposal and of course, should be examined more fully. Within this group of four measures, method four differs the most from alternative seven because it exempts both land and the value added by the builder. It is selected for further analysis. Although methods five and six are employed in OECD countries, they are similar to four and seven and analysis of the latter two schemes provides information on which an evaluation of five and six could be formed.

The last two measures include old and new housing in the base. Under method eight, the first sale of all dwellings would be taxed after the levy is introduced, but any future resales of the property would be free from tax. Method nine involves taxing all sales of property, with a seller receiving a credit for taxes paid on the purchase of the dwelling and purchases made in improving it. Method eight is superior to nine in that the seller is not required to keep detailed records on the tax paid in improving the property and repairs do not need to be distinguished from improvements. The other chief difference between the methods is that the government collects a tax on any general capital gain (and loses revenue for a capital loss) plus price increases due to owner supplied labour under method nine. Even though gains on individual investments like shares of corporate stock or quantities of rare metals are not normally subject to a VAT levy and neutrality of investments is best ensured by exempting gains on residential property as well, the revenue yield is higher for method nine than for method eight. Thus, because there are relative advantages for measures eight and nine, both are worthy of closer examination.

In this subsection ten basic methods of treating housing under a VAT have been identified and six have been selected for a more thorough analysis in the next section. These six measures are:

(1) a tax on actual residential rents and an annual levy on imputed gross rents for owner-occupied housing

(2) complete exclusion of housing from VAT through zero-rating and exemption of all sales

(3) partial exclusion of housing by exemption of all housing sales and land plus direct labour used in producing new housing

(4) the White Paper proposal, which exempts the sale of old housing but taxes the value of new housing including land

(5) a one-time tax on the first sale of all housing

(6) a tax on all housing sales but allowing a credit for taxes paid on the purchase of the property and on repairs and improvements.

SECTION 3: COMPARISON OF SELECTED MEASURES FOR TAXING HOUSING UNDER A VAT

Tax reform may involve introduction of a new tax, substituting one levy for another, changing the base, rate or administrative features of an existing levy or altering the entire tax system. In all of these situations proposals for change are generally analyzed in terms of how well they meet commonly accepted tax criteria. For example, the White Paper (Wilson, 1987) suggested that a reformed sales tax system should be fair, support the growth and efficiency of the economy and minimize administrative and compliance costs. Although lists of desirable tax criteria have changed over time and differ somewhat among analysts, they share common elements.

In this section, the six methods for taxing housing selected in Section 2 are compared in relation to four criteria:

(1) social justice, which includes both horizontal equity (equal treatment of equals) and vertical equity (progressivity),

(2) consistency with economic objectives, with emphasis on economic efficiency (minimize distortions),

(3) ease of administration and compliance and

(4) revenue adequacy and in some cases, tax-expenditure efficiency [increase (decrease) in housing expenditure in comparison to revenue changes].

Conclusions about equity and economic efficiency depend significantly on the incidence of a value added tax and how gains are distributed from excluding all or part of housing from the tax base. Thus, before examining the six measures against the four tax criteria, the literature on the incidence of a VAT is summarized in the next subsection.

3.0 INCIDENCE OF A VAT

The incidence of a tax relates to the ultimate or final burden of the levy. The individual who has the legal responsibility for paying the tax may not bear the burden of it because the tax may be shifted through the buying and selling of goods and services. For example, the Manufacturers' Sales Tax on automobiles may be shifted forward to consumers through higher prices or backwards to owners of labour or raw materials by lower wages and prices. Although the burden of a tax may differ from the amount of revenue raised, empirical studies of incidence generally assume that the burden and revenue yield are equal.

Individuals can bear the burden of a tax both through their sources of income and through their uses of income. A personal income tax is generally thought to reduce the amount of income available to individuals and excise taxes, such as a levy on liquor, are usually viewed as a burden on purchases or the use of income. When examining the pattern of incidence for a particular levy or the entire tax system, a comparison is usually made with a given standard. The most frequently used standards are a proportional income tax or a lump sum tax. The assumed burden pattern for a lump sum tax may be an equal amount per person (or per family) or the amount that would be paid under another tax.

Studies of consumption based taxes generally conclude that the burden of these levies is distributed across individuals in proportion to their expenditures on taxed items. This conclusion flows from an analysis which employs a simple general equilibrium model. Income is either saved or consumed and a general consumption tax is assumed to replace a general income tax. The substitution does not alter an individual's source of income because the tax between gross and net earnings is replaced by a tax between firms' sale revenues and payments to factors. The replacement of an income tax with a consumption tax does distort the uses of income, however, because the price of consumption goods has risen but the price of capital goods has remained constant. As a consequence, consumers are made worse off than savers.

Most empirical studies which examine the incidence of consumption based taxes accept this line of argument and assume that the burden of sale and excise taxes are borne by individuals in proportion to their purchases of taxed commodities (Dalby 1985) and that the incidence of a personal expenditure tax rests on consumers.

In some studies, however, consumption based levies, and excise taxes especially, are assumed to be borne in relation to factor incomes. The argument underlying this assumption is that factor returns would fall in a taxed industry due to a reduction in output and prices paid for labour and other factors. Factors would then move to untaxed sectors until returns in the untaxed industries and the after-tax returns in taxed industry are equal. In the final equilibrium, prices of goods have risen in the taxed industry and fallen in untaxed industry, while factor returns have been reduced in both industries. On balance individuals do not bear a burden through their uses of income since the price level has not changed but their amount of income received has been reduced.

A single rate general VAT has been shown to be equivalent to a flat-rate personal consumption tax (Conrad 1986) and most of the studies which have investigated the distributional effects of the levy have assumed that the tax is borne in relation to consumption expenditures. For example, this assumption is implicit in the study by Hamilton and Whally (1987), where they attempt to measure the efficiency and distributional effects of the entire set of White Paper proposals, including the stage 1 income tax changes. The assumption of forward shifting is also employed in the very recent investigation of the likely distributional effects of a VAT in the United States (Brashares, Speyrer and Carlson 1988).

The incidence of a VAT has also been examined in the context of a lifetime model and under some assumptions, lifetime consumption is equal to the lifetime returns to labour (Davies 1985). In this situation the burden of a VAT is proportional to labour income as well as to consumption expenditure.

The chief conclusion which can be drawn from this brief survey of the literature on the incidence of consumption based taxes, is that the burden of a VAT is likely to be borne by individuals in proportion to their expenditure on taxed commodities. This conclusion implies that the tax levied on the value added at each stage of production is shifted forward to the final consumer. In the case of housing, the tax paid on land, construction material, construction services and marketing expenses would be borne by the buyers of the dwelling. This line of reasoning also suggests that the benefits from any exclusion given to housing components would accrue to purchasers.

Underlying these judgments are the assumption of a broadly based VAT and the results of an analyses regarding the long-run effects of the levy. Many of the measures for taxing housing exclude a significant portion of expenditures from the tax base and because dwellings are very durable, it takes a considerable length of time for all of the effects of a tax change to be reflected in the housing stock. Thus, the short-run effects of a tax change may be more important for housing than for other commodities. For example, in the situation where new housing is taxed in full but sales of old housing are excluded from the tax base, as is the case under the White Paper proposal, it is likely that the after-tax price of new housing would not rise in the initial post-tax period. In this situation purchasers of new housing would not bear the tax and it would be shared among contractors, land owners and suppliers of construction and marketing services (Fallis and Smith 1987). The reason that the tax would not be shifted forward to buyers of new housing is that the supply of new properties would be small relative to the number of old dwellings offered for sale. Old dwellings are a close substitute for new housing from the point of view of most buyers. If a potential buyer narrowly prefers a new house to an old dwelling in the absence of a VAT, the addition of a tax to the original price of a new house is likely to cause the buyer to purchase the old dwelling. For suppliers of new housing to sell their dwellings, they must absorb at least part of the tax.

Over time, the supply of new dwelling units would fall because of lower after-tax returns from investment in housing. The stock of housing would then become progressively smaller over time and prices would rise. At the end of this adjustment period, dwelling prices would have risen to take account of the tax increase and the burden of a VAT would be borne by purchasers. It is likely that rents would increase along with housing prices, although perhaps constrained by rent controls, and therefore the tax would then be borne by all consumers of housing.

In summary, there appears to be a consensus that the long-run incidence of a VAT on housing rests on consumers of housing. The short-run burden of a VAT may be borne by suppliers, however, because of the long life of most dwellings. The likelihood that the short-run burden rests on suppliers increases if old housing is exempt from the tax base. In the examination of the six measures with respect to social justice and economic efficiency, primary emphasis is placed on the long-run incidence of the tax. However, where conclusions about long-run and short-run incidence differ, the implications of short-run incidence are noted as well.

3.1 SOCIAL JUSTICE

Equity or fairness has been viewed as very important in the design of taxes. It is one of the four canons of taxation provided by Adam Smith (1776) and contemporary analysts always include equity as a goal when investigating a particular levy or the entire tax system. The Royal Commission on Taxation (1966) placed a great deal of emphasis on equity, and particularly horizontal equity, in proposing changes in the federal tax system. In recent analyses of the tax system by the Economic Council of Canada (1987) and Wilson (1987) economic efficiency appears to have displaced equity as the most important criterion, but fairness did receive a significant amount of attention.

3.11 Horizontal Equity

One aspect of fairness or social justice is horizontal equity, which is often labelled "equal treatment of equals". This concept means that two individuals who are in similar economic circumstances should bear roughly equal taxes. Various definitions of similar economic circumstances have been put forward and often include factors such as income (current, permanent or lifetime), wealth, total expenditure, expenditure on necessities, size and composition of the family unit and benefits from government expenditure. In nearly all empirical studies, however, it is only income that is used as a basis for making judgments about horizontal equity and in the vast majority of these investigations, current income is the accepted measure.

Current income is frequently measured by family or individual money income, but some studies also include imputed elements, all taxes on sources of income and earnings retained by businesses (Dahlby 1986). For a discussion of the six methods for taxing housing under a VAT, most of these distinctions are of little importance. However, because some of the plans involve the taxation of imputed rent (either implicitly or explicitly), consistency demands that net imputed elements of income be included in the income base when comparing ratios of tax to income for different individuals.

A VAT does not meet the horizontal equity criterion when defined in terms of current income, because the division between saving and consumption varies among individuals who have equal incomes. Thus, it is difficult to rank the six methods for taxing housing in relation to horizontal equity because a special provision which exempts housing may offset an inequity caused by a higher consumption/income ratio. For example, one individual with a $20,000 income may spend $15,000 in total, $3,000 on housing and save $5,000 (less VAT). Another individual with the same income may spend $18,000 in total, $6,000 on housing and save $2,000. Under a VAT which includes housing, the second individual would pay more tax but if housing expenditures were exempt, the two individuals would both pay the same amount of VAT on consumption expenditures of $12,000. Once total taxes are taken into account it is even more difficult to make conclusions about horizontal equity. In the illustration above one individual may pay more income tax because of fewer deductions and credits and the second individual probably pays more property tax.

Due to these complications, judgments about how methods of taxing housing rank with respect to horizontal equity are restricted to a situation where both income and consumption expenditures (net of VAT) are equal and other taxes are ignored.

Under these assumptions a tax on the flow of consumption expenditure would best meet the horizontal equity test. Two individuals would pay the same tax regardless of the distribution of expenditure between housing and other goods and on the assumption that the tax is shifted forward, renters and owner-occupiers would bear equal burdens. For example, one individual with a $25,000 income may spend $4,000 on housing and $18,000 on other taxable goods and a second individual with the same income may spend $10,000 on housing and $12,000 on other goods. In this situation both would pay tax on $22,000 of consumption expenses. Owner-occupiers would pay tax on net imputed rent as well as on operating costs and renters would pay tax on gross rents. Purchasers of all properties would pay VAT but receive a credit which could be set against taxes on rents or against the tax generated by a resale of property.

The other five methods are related to the sale of properties rather than the monthly or annual consumption of it. All of these measures give equal treatment to owner-occupied and rental residential properties. The inequities caused by these schemes result from different treatment of old and new housing, purchased and owner provided services and consumption of housing and other commodities.

The zero-rating plan would cause horizontal inequities among individuals who spend differing amounts on housing. Under this scheme, the purchases of all housing would be excluded from the tax base. Therefore, two individuals with similar levels of income and consumption would pay different amounts of VAT if one spent a higher proportion on housing than the other. Within the housing sector, however, renters and owner-occupiers would bear equal taxes if they spent equal amounts on housing (where imputed rent is included as an expenditure).[1] Some inequities may arise for new as opposed to improved property. If repair services are taxable it may be difficult to distinguish between repairs and improvements so that a rental or sale of a dwelling which has been improved would include some VAT in the price (assuming tax is shifted forward), whereas a new property would be free from the tax. As a consequence, users of improved property would bear some tax while users of new property or unimproved old housing would bear none.

As compared to the zero-rating plan, the White Paper proposal would tax the full value of new housing but exclude old housing. This program would eliminate inequities between consumers of new housing and other commodities but generate inequities between purchasers of old and new housing. Like the zero-rating plan, inequities would also be created among old properties of equal value but with differing amounts of taxable improvements having been undertaken in the past.

The fourth measure excludes sales of old housing and both land and direct labour costs included in new housing, but does include construction materials and services purchased from other firms. It would rank between the zero-rating plan and the White Paper proposal both with respect to housing and other expenditures and in relation to old and new housing, but would result in some new inequities within the new housing category. Properties utilizing a large amount of land and direct labour would be burdened with less VAT than dwelling where a high proportion of costs result from the purchase of materials and purchased services.

The fifth plan, which imposes a one-time tax on the first sale of all housing, like the White Paper proposal, would treat first time purchases of housing and other commodities in a similar fashion. In addition, this plan ensures equal treatment of new housing and old housing sold for the first time. The resale of old housing would be subject to less tax than the sale of new housing, however, if the old dwellings had been improved through the labour of owners. As is the case for most of the other measures, inequities among buyers of old housing sold more than once would also result if differing amounts of taxable improvements had been undertaken since the first sale.

The last method, of taxing all housing sales would eliminate these inequities (resulting from improvements undertaken by owners) when the dwellings are sold. In between sales inequities could occur because one individual might improve his property through purchasing construction services, whereas another individual owner may undertake the work. In the first case, the owner would pay VAT on both materials and labour costs while the other pays tax only on material. Inequities would not arise under this plan in terms of purchases of old and new housing and housing as compared to other commodities.

Taxation on flows of consumption is the best measure in relation to horizontal equity, followed by method six, which would tax all housing sales. The one-time sale of all properties would rank next. The ranking of the other three measures depends on which inequity is of the most concern: (1) complete exclusion of all housing sales and equal treatment of old and new housing, (2) equal treatment of new housing and other commodities but favouring old housing over new housing sales. This decision might be based on both the size of the respective inequities and the number of individuals involved. Certainly, difference in tax burdens of $5,000 are more serious than differences of $1,000 for similarly situated individuals, and for a given sized inequity, there is more concern if one million individuals are affected than if the issue involves 100,000 people. The difference in tax burdens is likely to be highest for the second inequity, where old and new housing are treated differently. In this situation individuals consuming new housing would pay tax on all expenditure and consumers of old housing would pay tax only on other commodities, whereas all individuals would have a tax reduction if both old and new housing are excluded.[2] The number of individuals affected would be larger for the first inequity because all individuals with similar levels of income and consumption who differ in the amount spent on housing would be treated unequally. In the second case, however, VAT would be the same for all consumers of new housing, regardless of the division between expenditure on housing and other commodities. On net balance the inequity caused by differences in tax burdens is probably more significant than the unfairness resulting from a large number of individuals affected. Thus, the zero-rating plan ranks fourth, the plan which taxes only purchased services and materials next and the White Paper proposal last. The ranking of these three measures is based on short-run effects. In the long-run the ranking would be reversed as all housing would be taxed under the White Paper proposals.

3.12 Vertical Equity

Vertical equity is concerned with the taxation of individuals who are in unequal economic circumstances. One view of vertical equity is that individuals should be taxed in relation to the benefits they receive from government expenditure. This benefits received principle can only be easily implemented for some government expenditures, such as roads, and is not generally used to justify a general levy, (with the possible exception of the property tax). For most taxes it is argued that vertical equity can best be met by following the ability to pay principle. Measures of ability to pay include income, expenditure and wealth but income is the generally accepted standard even when the levy under consideration is based on wealth or expenditure. In empirical work, current income has been the most frequently used measure, but there is increasing emphasis being placed on lifetime income which, as indicated earlier, is equal to lifetime consumption in some models (Dahlby, 1985). When current income is used as the base and forward shifting is assumed, empirical investigations demonstrate that expenditure based taxes are very regressive, in that the ratio of tax to income falls as income rises. The reason for this finding is that saving forms a larger proportion of income for high income individuals than for individuals with lower incomes. Exempting commodities which are relatively more important in the expenditure budgets of the poor reduce but do not eliminate, the regressively of general sales taxes Vaillancourt and Pouluent, 1985). The regressivity at the low end of the income distribution can be eliminated through the use of credits, especially if they are refundable (paid to individuals with no income tax liability) and vanishing (the value of the credit gradually falls to zero as the income of the taxpayer rises).

When lifetime rather than current income is employed in empirical investigations, flat-rate expenditure based taxes are shown to be less regressive. The importance of the income concept is demonstrated in the study undertaken by Davies and St-Hilaire (1987) which focuses on a comparison of the existing income tax, a uniform income tax and a personal expenditure tax. According to their calculations for current income, the ratio of consumption to income (broadly defined) falls steadily from 1.2 in the lowest income class to .5 in the tenth and highest income category, and for an expenditure tax with a $5,000 personal exemption, the proportions of income paid in tax would decline from 12 percent in the lowest class to a little less than 7 percent in the highest group. When lifetime income is the base, consumption divided by income ranges from 87 per cent for the lowest class to 72 percent for high income individuals.

Studies using the assumption that consumption based taxes are borne by income receivers rather than consumers also indicates less regressivity. If is further assumed that "permanent", or lifetime income is the proper base and low income individuals are insulated from the effects of commodity taxes through government transfer payments, the burden pattern for sales taxes is slightly progressive with respect to income (Whalley 1984).

The incidence for a broadly based VAT would be similar to the burden pattern for a flat-rate personal expenditure tax with no exemptions. Thus, studies which assume that the tax is borne by consumers and use current income as a base, indicate that a VAT is regressive (Davies 1985, McClure 1987). This regressivity could be reduced through the use of exemptions and eliminated in the lowest income class by a refundable, vanishing income tax credit (Brashares, Speyrer and Carlson 1988).

Progressivity is usually viewed as a desirable characteristic of a tax system but the impact of a particular tax on the income distribution is of less importance because the regressivity of a single levy can be offset by making another tax more progressive. For example, the effects on low income families of introducing a VAT could be offset by an increase in the sales tax credit under the income tax. If, however, it is judged that the impact of a given tax change is likely to be too small to "trigger" a change in other taxes, the income distribution effects of a proposed change assume greater importance. Whether different treatments of housing under a VAT would affect the structure of other taxes is an open question but for the purpose of this analysis it is assumed that there would be no offsetting changes in other levies.

The distribution effects of a sales tax on consumption flows of housing parallels the pattern of a VAT on all consumption. Cross-section data supplied by Canada Mortgage and Housing show that the values of "rents paid" and house values for owner-occupied housing both fall as a proportion of income. A VAT borne in proportion to consumption flows of housing would be regressive throughout the income scale if current income is used as the base, but would be especially regressive at low incomes where values of rent paid and owner-occupied housing decline in absolute terms between the 0-$4,999 income class and the $5,000-$10,000 category. In comparing rentpayers with owner-occupiers, the tax on owned housing would be more regressive except for the highest income categories.

This conclusion about the regressivity of a tax on housing is consistent with investigations of housing demand, also based on current income. Studies reviewed by Miron (1988) indicate that the elasticity of family formation and elasticity of demand for number of dwellings, both with respect to income, are very low (i.e. less than .5). Although the elasticity of demand for housing quality is closer to unity the conclusion is that the overall elasticity of demand for primary housing is income inelastic, suggesting that the ratio of housing expenditure to income falls as income rises, and consequently, that a proportional tax on housing would be regressive.

There is no doubt, however, that a study which utilized permanent income or examines lifetime housing consumption and lifetime income would yield results that are less regressive because there are many low income individuals including retirees, whose permanent or average lifetime income greatly exceeds their current annual income. Employing the assumption of backward shifting to income receivers would show a further reduction in regressivity. If transfer payments are increased to offset the VAT on housing for low income families, a progressive burden pattern over some income ranges for a VAT on housing would result.

In comparing the various method of taxing housing under a VAT, it is recognized that the revenue yields would differ among the six measures. As a consequence, some plans would potentially have a larger impact on the distribution of income than other methods. For example, if under one plan the average increase in tax was $200, there would be less concern about the redistributive impact of the levy than if the average increase was $2000. In the analysis of the six measures, some attention is given to the size of the tax yield but primary emphasis is placed on comparing the average ratio of increased taxes to income for the various income classes.

As a starting point, it is assumed that there is no levy on housing initially and that taxes are compared to current income on an annual basis. It is also assumed that taxes are shifted forward. Some of the rankings are speculative because of a lack of data on items such as the size and distribution of owner provided services across income classes.

It was noted earlier that the value of owner-occupied housing and rents decline as a proportion of income as income rises. Thus, a VAT on housing would tend to be regressive. Under zero-rating, rents and purchases of dwellings are exempt and only purchased materials and services for repairs plus improvements are taxed. This measure is ranked first in terms of progressivity partly because the impact of the tax would be small. In addition the distribution of the burden would be less regressive than a tax on housing values because owner-supplied services would be exempt and the ratio of value of these services to income likely falls as income rises.

Among the other four measures based on purchases of housing, the two restricted to new housing would almost certainly be the least regressive. Owner supplied services for improvements and repairs would be exempt and it is likely that the ratio of new property purchases to total acquisitions of dwellings rises with income. High income individuals have a greater tendency to purchase new homes and new second properties than individuals with lower incomes. It is difficult however, to compare the progressivity of the plan which only includes construction materials and purchased services in the base with the White Paper proposals. Although the revenue yield would be higher under the White Paper proposals, thereby introducing a larger regressive element into the tax system, the burden pattern would be less regressive for this levy. The ratio of construction materials and purchased services to total dwelling costs (including land) is likely to be higher for multiple dwellings (CMHC 1988), which are utilized relatively more by low income individuals, than for single family properties. It is likely that the difference in burden pattern is more important than difference in revenue yield between the two measures. Thus the White Paper plan is less regressive than the scheme which exempts land, direct labour and contractor services.

The third ranked measure among the four levies based on the sale of properties (fifth overall) is the tax on the one-time sale of dwellings. It differs from the White Paper proposals in that the revenue raised would be larger, although the difference would shrink over time. In addition, the burden of taxation would be more regressive because the base includes the first sale of old housing and lower income individuals are likely to purchase relatively more old dwellings than new properties. The last plan taxes all housing purchases and ranks below the one time sale measure because it would levy a tax on owner-supplied services, which, as noted earlier, fall as the income of the owner rises. In addition, the revenue raised by this measure would be larger than under any of the other methods.

The measure which taxes income flows is difficult to rank in comparison with the four methods based on purchases of dwellings. It is more regressive than two of the measures because it has a larger yield and a more regressive pattern because it taxes owner provided services. In principle it also has a larger yield than the first-time sale plan and the point about taxing owner provided services is also relevant. On the other hand, when taxes and incomes are examined on an annual basis, taxes on dwelling purchases are likely to be even more regressive than a tax related to the value of owner-occupied housing because of the pattern of home ownership. Many individuals purchase property when they are young and have low incomes. They often continue to live in these dwellings over a number of years even though their incomes rise. Thus, the ratio of tax to income would be distributed in a more regressive fashion than if an annual tax was placed on owner-occupied housing. The same relationship is likely to be weaker but hold for rental housing as well. Consequently, an annual tax would show a less regressive pattern if average income rises. In addition, the yield may be lower than the one-time sale if rents rise more slowly than prices and/or notional rents are conservatively defined. Thus, this plan is ranked fourth overall.

It should be noted that these rankings could well change if a different incidence assumption and income base were used in the analysis. Some of these levies could change in classification from more regressive in relation to total VAT to more progressive. In this situation, measures with large yields would rank above those with low yields with respect to progressivity, assuming the burden patterns were similar. As noted earlier, the short-run incidence of a tax on housing might rest on incomes while in the long-run, the burden is borne by consumers. Thus, the rankings of the levies could also vary, depending on the period of analysis.

3.2 CONSISTENCY WITH ECONOMIC OBJECTIVES

The tax system should also aid, or at least interfere as little as possible, with the achievement of economic objectives such as economic efficiency, full employment, price stability, balanced economic growth, viable balance of payments and protection of the environment. All of these objectives are important but special attention has been focused on economic efficiency in the White Paper (1987) and by the Economic Council (1987).

The general rule for economic efficiency requires that the marginal social value of the last unit for every commodity be equal to the marginal social cost of producing it. If this rule is fulfilled in the absence of government revenue measures, the introduction of all taxes, with the exception of a lump-sum levy, would cause distortions and result in a deadweight loss or burden in excess of the revenue raised in most circumstances. For example, it can be shown in a partial equilibrium model that expenditure based taxes cause a deadweight loss because they form a wedge between the price paid by consumers and the amount received by producers. (Boadway and Wildasin 1984) Expenditure taxes also alter consumption/savings decisions and income levies affect work/leisure choices.

In the event that the economic efficiency rule is not met by private market actions, such as in the case of externalities, taxation is one government instrument which can be employed to help reduce the deadweight loss and achieve greater efficiency. For example, if housing is a merit good in that individuals do not consume enough of it from the perspective of government, because of ignorance of its benefits, or if housing generates positive externalities to others in the form of lower welfare and crime related costs, the tax system could be employed to encourage individuals to purchase more and higher quality housing.

The merit good and externality arguments are largely associated with housing for low income recipients, however, as opposed to providing support for a uniform increase in housing consumption. Therefore, to alter market decisions to take account of externalities and special merit associated with housing, public policies should be introduced which provide a much greater stimulus to purchasers of low priced housing than to consumers of expensive dwellings. Broad based tax measures which lower the price of housing for all individuals are costly and economically inefficient methods of encouraging low income individuals to purchase more and better housing. If general tax programs are designed to provide enough encouragement for low income families to purchase the socially desired level of housing, total housing expenditure would be large and high income families are likely to consume more housing than is socially optimal. Thus, although all housing assisted programs have flaws, it may be less costly and more efficient to employ programs such as public housing, rent subsidies, limited home-owner grants and refundable, vanishing tax credits than to free housing expenditures from a general sales tax.

If the merit good and externality problems can be solved through selective expenditure, revenue and regulatory programs, a tax measure which aids all housing would tend to improve economic efficiency if the difference between the value of the last unit and the cost of producing it is greater for dwellings than for other commodities. If however, the divergence between value and costs for the marginal unit is less than for many other items the case for favouring housing is much less clear.

In the case where the marginal efficiency rule is fulfilled in the absence of taxes, as noted earlier, expenditure based taxes would introduce distortions and result in a deadweight loss. Under some assumptions, the deadweight loss can be minimized by varying the tax rate in accordance with the inverse elasticity rule. Under this rule tax rates are set so that they are inversely proportional to the corresponding price elasticities of demand (Boadway and Wildasin 1984). Thus, commodities with relatively large price elasticities of demand are taxed at a lower rate than goods which have less elastic demands. As demonstrated by Miron (1988) and others, the demand for housing is price inelastic and thus, should be taxed at a higher than average rate if the inverse elasticity rule is followed. Baudot (1986), however, has reviewed work which indicates, in some circumstances, that tax rates should be higher on goods complementary to leisure and lower on goods viewed as substitutes for leisure. She goes on to argue that relationships among commodities is likely to be stronger than between commodities and leisure and that the information required to implement the inverse elasticity rule is large. As a consequence, Baudot concludes that deadweight losses would be minimized by taxing all commodities at the same rate.

The conclusion that housing should be taxed at the same rate as other commodities does not necessarily imply, however, that the standard VAT rate should be levied to housing. Income and property taxes exist at present and they have a differential impact on housing as compared to other commodities. Adding a multi-rate VAT to the tax mix could reduce these differences.

No study has been identified which describes the relative total tax burden on various commodities but Daly and Jung (1987) have computed average and marginal effective tax rates for eight Canadian industries including construction and three asset categories, one of which is buildings. Their results suggest that the total marginal tax rates on construction is one of the two highest among the eight industries studied and that the rate for buildings is higher than for machinery and inventories. They also present results from three models for the major levies and when federal and provincial sales taxes are excluded (the situation if existing sales taxes are removed), construction is always shown to bear an above average tax rate and the burden on buildings is consistently higher than on the other two assets. The experiments undertaken by Daly and Jung to include a business transfer tax, 1985 discussion paper proposals and the 1986 budget package do not significantly alter these conclusions. Economic Council estimates (1987) based on individual and corporate taxes yield similar conclusions for the construction industry but because property taxes are excluded, inventories are shown to be taxed at a greater rate than buildings.

It is recognized that individual and corporate tax reform measures adopted in 1988 favour construction in relation to most other industries (Hamilton and Whalley 1987) and thus narrow the difference between the marginal tax rate for construction and the average rate for all industries. In addition the Daly and Jung results are not directly applicable to housing because the construction and building categories include nonresidential dwellings and their analysis is based on corporate investments. As noted earlier, some housing construction is undertaken by other forms of business and property owners.

There are other studies which cover fewer taxes but bear on the question of whether total taxes, excluding the federal sales tax which would be replaced if a VAT is introduced, place a greater burden on housing in comparison with other commodities or investments. Davies and St. Hilaire (1987) argue that the advantage accruing to housing due to the exclusion of imputed rent from the individual income tax-base is largely offset by the property tax. Damus, Hobson and Thirsk (1987), however, present some simulation results from an open economy general equilibrium model which show that there would be a welfare gain if property taxes on residential property were increased and taxes on nonresidential property were decreased. In studies dealing with commodity taxation Baudot (1987) provides taxes which indicate that tariff rates on materials used in construction, renovations and improvements are slightly higher than average for the 35 commodity categories examined and Kuo, McGirr and Paddor (1988) show that provincial sales taxes place a less than average burden on residential construction and imputed rent on owner-occupied development (this latter finding is irrelevant, of course, if the National Sales Tax option is implemented and provincial taxes are abolished).

It is difficult to arrive at an unambiguous conclusion as to whether housing bears a larger tax burden than other commodities in the absence of a federal sales tax, partly because views differ about the incidence of corporate income, property and sales taxes and tariffs. Empirical results also depend on the data, models and estimation techniques employed in analyses as well as on the levies included. For example, the property revenue is sometimes viewed as a payment for government services rather than a tax on property and hence is excluded from investigation of tax burden. It does not appear, however, that total taxes on housing are significantly larger than the average burden borne by other commodities.

When the discussion of tax burden is limited to a general commodity tax, there appears to be near-unaminity among researchers and political leaders in their view that economic efficiency would be furthered by implementing a levy with a broad base and uniform rate. If some items are excluded from the tax base or taxed at different rates, it is argued that the difference between marginal values and marginal costs will vary by commodity and consequently, that the deadweight loss would be higher than with a uniform tax. As noted earlier, it is particularly important that commodities which are closely related (have large cross price elasticities) be taxed at the same rate. Thus, since different categories of residential housing expenditures are very close substitutes, it seems reasonable to conclude that all of these expenditures should be taxed at the same rate. In comparing the relative merits of the six measures for treating housing under a VAT it is assumed that a desirable target is to levy an equal rate on purchases of old and new dwellings, improvements and repairs. It is assumed as well that the tax on rented and owner occupied housing should be the same.

An annual tax on gross rents, both actual and imputed, would ensure neutral treatment of all types of housing. Owners of rented property would be allowed a credit for taxes paid on repairs, improvements and the purchase of the dwelling. Housing occupied by owners would be taxed in a similar manner and taxes paid on purchases would be credited against the levy on gross rents. The tax on gross rents would also place housing on a par with other commodities taxed under a VAT.

The second ranked scheme is the tax on all dwelling purchases as well as on purchased repairs and improvements. This levy is inferior to the annual tax on rents because the labour provided by owners in housing construction, improvements and repairs is not taxed until dwellings are sold. As a consequence, this measure provides an incentive for an owner to substitute his own labour for purchased services and some deadweight loss occurs. The delay in taxing increases in value, whether caused by owner-supplied services or general economic conditions, also causes some economic inefficiency because of a "lock in" effect whereby individuals are reluctant to sell or exchange properties. When they sell their property, a tax on the gain must be paid and the proceeds may not be sufficient to purchase another property which is viewed as more desirable and priced at a level below the original dwelling. In other respects, however, this measure is similar to the annual tax on rents. Except for owner supplied services which escape tax until the dwelling is sold, various types of housing expenditure are treated equally and housing is treated in the same manner as other goods.

The third ranked measure on economic efficiency grounds is the one-time sale of both old and new property. It ranks behind the method which taxes all dwelling sales because the labour supplied by owners after the first sale is never taxed. Therefore, dwellings improved through the purchase of services bear a larger tax as compared to housing improved through owner-supplied labour. For example, assume two houses have been sold once at a price of $100,000 plus $10,000 VAT. If one dwelling is improved through owner-supplied labour of $50,000 and the second by purchased services of the same amount, the price of the first would be $150,000 plus $10,000 tax whereas the price of the second dwelling would be $150,000 plus $15,000 tax. The tax wedge is larger for the second property and buyers would prefer the first property because of the tax induced price difference. In the event that market pressures caused both dwellings to be offered at the same price, the seller of the first house would receive a larger after-tax return.

The three remaining methods, like the first three, treat residential and owner-occupied housing in a neutral manner but they impose differential burdens on various housing elements and between housing and most other goods. The zero-rating plan, which grants credits to contractors for taxes paid on construction materials and services used in new housing and exempts sales of old or new housing, but taxes materials and labour purchased for improvements or repairs, ranks fourth with respect to economic efficiency. It is neutral between sales of new housing and old housing which is unimproved or improved through owner-supplied labour, but discriminates against old housing improved by purchasing materials or services.

This zero-rating measure is judged to be inferior to the one-time first sale for two reasons. First, it favours most housing expenditures in relation to nearly all other commodities and therefore distorts consumer purchasing patterns more than under the first-sale option, which includes most housing expenditures in the tax base. Second, the differences in the amount of the tax wedges are likely to be larger between a house constructed by a contractor and one built by the owner, under the zero-rating scheme. This point can be demonstrated by an example. Assume that a dwelling constructed by contractor consists of \$60,000 material and \$40,000 labour and an individual owner also uses \$60,000 of material and supplies \$40,000 of labour services when constructing a similar dwelling. Under the zero-rating scheme no tax is levied on the first dwelling but the \$60,000 of materials purchased by the individual home builder would likely be taxed since she would not normally be a registered taxpayer. Under the first-sale method, the full value of the property (\$100,000) would be taxed in the first case but only the \$60,000 of materials would be taxed in the second situation. In this illustration the tax wedges at a 10 percent rate, would be zero and $6,000, respectively for the zero-rating plan and the values would be $10,000 and $6,000 under the first-sale measures. The differences in tax wedges are $6,000 and $4,000 in this illustration but the discrepancy between the two values would typically be larger because labour generally forms less than 40 per cent of the total cost of a dwelling, which includes land as well as materials and labour. A similar example could be constructed for a comparison between a new dwelling and an old property of equal value, when the old property is improved through the purchase of taxable items.

The fifth ranked measure is the plan which exempts land and direct labour in the construction of new housing as well as sales of old housing. Material and purchased services employed in making improvements are taxable. This plan is superior to the zero-rating plan when housing is compared to other taxable commodities because construction materials included in new housing would be taxed. Thus the tax wedges between new housing and other commodities would be less unequal than under the zero-rating plan. This measure which taxes materials and purchased services used in new housing, however, discriminates against new housing in relation to old housing: an old property valued at $100,000 would bear no tax when sold whereas a new dwelling of similar value would be burdened by a tax equal to the cost of construction materials multiplied by the VAT rate. Since old and new housing are viewed as closer substitutes than housing and other commodities, the nonneutrality caused by tax differences on sales of old and new housing is judged to create a larger deadweight loss than would occur under the zero-rating plan where housing sales tend to be treated equally. The difference between the two plans is larger, the greater the ratio of material costs to total costs for new housing. It should also be noted that the taxation of materials and purchased services measure is not neutral between the use of direct labour which is free from tax and purchased services which are taxable. As a consequence "make" or "buy" decisions are distorted and some deadweight loss results.

The lowest ranked alternative encompasses the White Paper proposals, where old housing sales are exempt but sales of new dwellings are taxed in full. Materials and purchased services used in repairs and improvements would be taxed. This ranking results from extending the arguments employed in comparing the zero-rating and taxation of construction materials methods. The White Paper proposals are superior to both when comparing expenditure on new housing with expenditure on other taxable commodities but are worse than both when examining sales of old and new housing. Taxing land and labour as well as materials increases the tax wedge for new housing. A sale of an old dwelling valued at $100,000 bears no tax but the sale of a new property of equal value would be subject to a tax of $10,000, assuming a 10 percent VAT rate. This difference is larger than would occur under the plan which only taxes construction materials and accounts for ranking the White Paper proposal last. It should be noted, however, that the ranking of the three last methods is based primarily on the situation shortly after a VAT is introduced. Over time prices of old housing would rise as the stock of housing falls and tax is paid on a larger proportion of dwellings. At some point the deadweight loss associated with the White Paper proposals would be less than under the other two methods. This point would be reached more quickly in a dynamic housing market where the construction of new housing is large relative to the existing stock and substantial improvements are being made in old housing.

3.21 Impact on Employment and Price Level

The introduction of all taxes tend to reduce the level of economic activity and employment if the revenue is not spent. A more relevant comparison is between the employment effects of equal yield taxes. A VAT is almost certain to have a more detrimental effect on employment than either a proportional income levy or lump sum tax because it falls more heavily on consumption. In comparing a VAT which includes housing and a VAT which excludes housing but is levied at a higher rate to keep revenue constant, it is likely that the second would have a larger negative impact on employment because land and material, relative to direct labour, form a large component of housing and land generates little indirect use of labour.

Evidence regarding the impact of a VAT on overall price levels is scarce but evidence from European experience, where the VAT replaced other sales taxes but also raised greater revenues, indicates that a one per cent increase in a VAT causes the price level to rise by about .7 per cent (Aaron 1982). In comparing the impact of a VAT with taxes it replaced, price levels rose approximately 2 per cent. It also appears that the total price effect took place in first two years after the introduction of the tax and price increases then returned to their pre-VAT growth rate (McLure 1987). The same pattern occurred in New Zealand, where prices rose sharply immediately after the tax was introduced but then fell back to the "normal" rate in succeeding periods (Due 1988). The effect of a VAT on housing would be small, and would be unlikely to follow this pattern, especially for the levies on housing sales. Initial effects on housing prices would be small, although rents may increase more quickly, because of the large housing stock. It is only after housing stocks adjusted to the impact of the tax that the price of housing would rise substantially. The period of time between the introduction of the tax and a significant rise in housing prices would be longer for the White Paper proposals than for most of the other five measures. The effect for an annual tax on rents would take place quickly and the total impact would be one of the largest. The overall impact of the zero-rating plan would be the smallest of the six measures and the White Paper proposals would rank third.

3.3 EASE OF ADMINISTRATION AND COMPLIANCE

Ideally, a tax should be simple to compute and levied on a base which is easily determined. In addition, the liability should be certain and the tax convenient to pay (Smith 1776). A tax fulfilling these criteria would be economical to administer and result in low compliance costs.

The introduction of any major tax on expenditure, income or wealth, however, tends to cause extensive administrative costs for a government and large compliance cases for taxpayers. The adoption of a new levy requires the formulation of conceptual base, the development of legislation which takes account of business practices, organization of an administrative structure, including appeal procedures, and a large public relations effort to convince taxpayers of the rationale for the new levy as well as to inform them of the procedures for remitting the tax. When a new tax is introduced a large amount of consultation with taxpayers is also needed to sort out anomalies, special cases and administrative issues. Businesses and other groups may put forward a great deal of effort in consulting with government officials and often must develop new accounting procedures, provide an educational program for employees and alter decisions about pricing, investments and other policies. Individual taxpayers are required to keep a different set of records and become familiar with new tax forms in many cases.

The introduction of a broad-based VAT is a major undertaking. The number of taxpayers who must be registered is larger than for other sales taxes and several times the number subject to the Manufacturers' Sales Tax. There are many small businesses, especially in the service sector, who are not subject to federal and provincial sales taxes but would become registered taxpayers under a VAT and there are numerous areas of activity which have not been taxed previously. In these areas, such as agriculture, financial services and real estate, definitions of the tax base must be determined and administrative procedures formulated.

In the United States, which does not have a federal sales tax, the U.S. Treasury (1984) did not provide an estimate of the initial implementation costs but suggested that when phased in, the administration costs would be $700 million per year and require 20,000 additional employees. It was also estimated that there would be 20 million taxpayers (not including farmers) as compared to less than 6 million under a standard retail sales tax levied by the state governments. The administrative costs of $700 million are sizeable and do not include taxpayer compliance costs but are small in comparison to the estimated yield of $240 billion (10% rate on $2,400 billion base).

The White Paper (1987) does not provide any administration or compliance cost estimates and they would vary depending on which option is selected. The marginal cost of introducing a VAT would be lower if a National Sales Tax is introduced as opposed to either the Federal Goods and Services Tax or Federal Value Added Tax where federal administration would be added to the existing provincial staffs. The Federal Value Added Tax would be more costly to administer than the goods and services levy, both because it would require more documentation, which must be examined, and because a larger number of exemptions (and perhaps more than one tax rate) would increase the complexity of a VAT. The White Paper also does not give an estimate of the number of taxpayers who would be registered taxpayers under a VAT. The number would depend on both the coverage of the tax and the minimum level of annual sales which requires registration. Taking both the U.S. estimate and the number of taxpayers under the provincial sales taxes into account, however, it appears that the number of taxpayers under a broad-based tax would exceed 1.25 million.

Both the U.S. Treasury estimates and the experience of other countries indicate that the ratio of administrative cost to revenue is low and that the tax can be administered effectively (Aaron 1982, McLure 1987). Due (1988) argued that New Zealand has shown that a broad-based VAT can be implemented in a manner which meets taxpayer approval. In general, governments and taxpayers view the VAT as superior on administrative grounds to the taxes it replaced (McLure 1987).

As noted earlier, real estate along with financial services, agriculture and the nonprofit sector are among the most difficult areas to tax under a VAT. In most countries the administrative difficulties have been so great that at least a partial exemption has been given to transactions in these areas. For example, actual rents are generally exempt from taxation at least partly because of the difficulties of taxing owner-occupied housing, and sales of old housing between individuals are not taxed because of the complexities involved in record-keeping and the registration of sellers.

All of the six methods for taxing housing analyzed in this study add to the complexity of the levy but the administrative and compliance costs vary greatly among the measures. The taxation of actual and imputed rents would create, by far, the highest compliance and administrative costs. The taxation of actual rents would not be difficult, although it would require the registrations of individuals who own only one or two dwellings, including landlords who let part of their residences. Taxing imputed rents, however, would require the registration of all homeowners, which would add more than 6 million taxpayers to the roughly 1.5 million who would otherwise be subject to the tax. This number could be reduced by setting the annual minimum sales value, over which registration is required, at a level which would exclude most homeowners but this would also exclude much of the housing expenditure from the tax base and create inequities and nonneutralities between homeowners and renters, and among homeowners. This measure would also require individual taxpayers to keep extensive records so that they could claim credits for taxes paid on operating and capital expenditures.

These expenditures not only would include the amounts paid for the purchase of the property and the materials and services used for improvements but also insurance, utilities, interest and perhaps, property taxes.

The next most complex method of taxing housing is the scheme which would tax all housing sales but give a credit for tax paid on the purchase of the dwelling and on materials and services used for repairs and improvements. This plan would again greatly increase the number of taxpayers because all sellers would require registration in order to receive credit for taxes paid. As opposed to the taxation of rents, however, tax returns would only be filed when ownership of the property is transferred and records on operating costs such as utilities would not generally be required.

The third ranked measure with respect to complexity is the one-time sale of all dwellings. This plan would involve the taxation of all first sales but individuals who are not taxpayers would not require registration and would not have a need to file a return (Conrad 1986). What would be required when a property changes hands is to establish whether a tax has ever been paid and this would be determined by a title search. If tax has not been paid it is then collected, regardless of the position of the buyer or seller. If tax has been paid and the seller is a registered taxpayer, the government also collects a tax and a buyer who is a registered taxpayer receives a credit. If tax has been paid and the seller is not registered, no tax is collected when the buyer is also not a taxpayer. If the buyer is registered the tax is "collected" and refunded to the seller (Conrad 1986). Although this plan would result in lower administrative and compliance costs than the measure which subjects all housing sales to tax, some problems would arise (Gillis 1985). First, if a land sale was taxed as a first sale in one period and then sold as a part of a dwelling in a second period, the value of the building must be determined to avoid double taxation. Se ond, when uses of a property change, complications arise. For example, when an owner-occupied property is sold to a registered taxpayer who uses it in commercial activity, the government would be required to give a tax refund to the owner-occupier in compensation for the tax paid when the property was first purchased. The refund could be the tax paid by the commercial buyer (Conrad 1986) or the original tax plus interest (Gillis). The second scheme is more complex, especially if the property had been transferred several times among nonregistered individuals.

The measure which ranks fourth in terms of complexity is the plan which exempts all housing sales and zero-rates purchases made by contractors in constructing new housing units. Fewer transactions are taxed under this measure in comparison to the first-sale measure but other problems arise. One difficulty is in distinguishing between improvements and new dwellings. For example, when a building is torn down and a new structure is erected on the same site, a judgment must be made as to whether VAT should be levied against the new dwelling. A second problem is that individuals who construct their homes or rental buildings may seek registered status to obtain a refund for taxes paid on materials and purchased services. If this practice is allowed the number of taxpayers would increase significantly. It should also be noted that it would be very difficult to implement th s plan under the Federal Goods and Services Tax option.

The measure embodied in the White Paper proposals is next in decreasing order of administrative and compliance problems. This measure, which subjects both new housing and improvements to VAT is not subject to the problems noted with respect to the zero-rating scheme but does require a distinction to be made between old and new housing (e.g. a dwelling is considered new housing until it is two years old). Notional prices must also be determined if buildings are constructed by owners. The major administrative problem associated with this measure, however, is in the proration of expenditures when both housing and commercial activity is involved. For construction firms, taxes on land and materials used in the building of commercial structures can be credited against taxes on sales whereas no credit is given for taxes paid on items used in housing. As a consequence, there will be an incentive for construction firms to attribute as many expenditures as possible to nonresidential dwellings and to repairs and renovations. The same attribution problem arises with respect to rentals when some rents are taxable (e.g. short-term or commercial) and the issue also affects the portion of a property which is taxed upon resale.

The top-rated plan in terms of ease of administration and compliance is the measure which exempts land and all housing sales and only taxes the purchase of materials and services. One reason for this high ranking is that the tax base would be similar to the base under the Manufacturers' Sales Tax and thus businesses would be familiar with it. As a consequence there would be fewer transitional problems. In addition, registration of fewer taxpayers would be required because building contractors who deal only in housing would have no need to be registered. They would neither pay the tax or receive credit for VAT paid on land, material and services. There are nearly 100,000 of unincorporated businesses engaged in construction and approximately 15,000 corporations in the industry with annual sales below $50,000 (correspondance with

Dept. of Finance). Some portion of these firms may only be involved in the development of housing.

3.4 REVENUE EFFECTS

A broad-based value added tax can raise a substantial amount of revenue with a low tax rate and concerns have been expressed about a VAT being a "money machine" which can be used by governments to finance higher levels of expenditure (McLure 1987). Although value added taxes have raised larger amounts of revenue than the levies they replaced, the differences are not substantial in the periods immediately after the introduction of the new taxes. The U.S. Treasury (1984) and McLure (1987) also cite evidence indicating that the ratio of total tax to G.N.P. in various countries is largely unaffected by whether a VAT is levied.

The White Paper (1987) did not present a numerical estimate of the revenue that would be raised under a VAT but suggested that the yield would be little more than the current proceeds of the Manufacturers' Sales Tax plus the revenue raised by the surtaxes on individual and corporate incomes. During the recent political campaign it has been charged that the Government intends to raise more revenue from the proposed VAT than indicated in the White Paper and that these extra proceeds would be used to finance a larger level of expenditures and to reduce the budget deficit. The Government has responded by maintaining that the introduction of a VAT would be revenue neutral, at least in the initial period after the levy is adjusted.

When the tax base is broad, the granting of an exemption or zero-rating can be largely offset by levying a higher single tax rate or a system of several rates, but there is some economic or political limit to the tax rate because of inequities, inefficiencies and taxpayer opposition. In addition, granting exemptions or zero-rating in one area of economic activity encourages other sectors to press for more favourable tax treatment. Thus, narrowing the tax base in a significant manner would not only reduce the amount of revenue that can be raised by a VAT in a given year but also curb the growth in revenue over a number of years. Following this line of argument, the treatment of housing under a VAT is even more important from a revenue standpoint now that the government has suggested that food and much of the nonprofit sector would be exempt from a VAT.

The White Paper (1987) did not provide a breakdown of the proposed tax base by type of expenditure and thus it is difficult to determine the proportion of the base that would be accounted for by housing. McLure (1987) and the U.S.

Treasury (1984), however, give estimates of various VAT bases along with the fraction of the base contributed by major components. The U.S. Treasury estimated that total 1988 consumption expenditures would total $3,100 billion. Under its estimated VAT base (which is broadly comparable to the White Paper base) of $2,400 billion, rental value of owner and tenant occupied housing (including farms) of $460 billion would be exempt but new housing sales would be taxed. New housing plus repairs and improvements would equal $170 billion or approximately 7 percent of the estimated tax base. McLure's U.S. estimates are based on 1984 and under his "limited exclusion " option, new housing plus renovations would form 8 percent of the tax base ($150 billion divided by a base of $1,857 billion) and under his "liberal exclusions" alternative, all housing expenditures except for some repairs would be exempt. The base falls to $1,077 billion and less than 50 percent of consumption with this alternative.

It was noted in the discussion of equity and economic efficiency that there are large differences in the amount of revenue that would be raised under each of the six measures for taxing housing. The plan which taxes all housing purchases, as well as materials and purchased services used in repairs and improvements, would raise the largest amount of revenue, assuming that the choice of method does not affect the tax rate. The tax base would include the sales of old and new housing and for first-sales of old housing there would be no credit given. Thus, a large amount of revenue would be secured in the first few years after the introduction of the tax and then would taper off as credits would be given for second and subsequent sales of dwellings. Even in later years, however, the revenue would be larger than under the other plans. New properties are taxed in full and the value of owner provided labour and general capital gains on old housing are captured in the tax base when resales take place.

In principle the second ranked plan with respect to revenue is the annual tax on all rents. It is not likely to fully capture capital gains in the base because rents are generally related to original cost and do not include a speculative element. Thus the yield would be less than under the measure which taxes all housing sales. Practices followed in implementing the levy could strongly influence the yield of the levy, however. On the one hand, if no credit is allowed for property tax payments, interest costs and other operating costs, the tax base and revenue would be larger than if net imputed rent was defined as the proper base. On the other hand, generous notional tax credits may be given for these items and taxpayers may also be able to classify some expenditures such as recreational equipment or lawn ornaments as operating costs of the property. In addition, the notional gross rents for owner-occupied housing may be set at levels which are below market rents to minimize complaints and appeals and increases may lag behind the growth in paid rents. Rent control measures may also keep paid rents below the rental values which would exist in an unconstrained market. In terms of the flow of tax receipts, increases in value due to the services provided by owners would be reflected in revenue increases earlier under the annual rent measure, as compared to the taxation of all housing sales plan.

The first-time sale of all housing measure would rank next with respect to the amount of revenue raised under a VAT. This measure has a smaller base than the plan which utilizes annual rents because it does not include the value of labour supplied by owners after the first sale. Rental values may also include the value of some unrealized capital gains. In practice, however, the yield from a tax on first-time sales may exceed the amount raised from a levy on rental values if nominal rents on owner-occupied housing are defined in a manner such that they are below market values. In comparison with the measure which taxes all housing sales, the yields would be equal initially but a difference in receipts would occur and grow over time as capital gains are realized on second and subsequent sales of dwellings. Thus, under the first-time sale plan revenue would be large in the initial period after the VAT is adopted but would decline by a greater percentage over time in comparison with the measure which taxes all housing sales. It is difficult to estimate the difference in the proceeds between the two measures but in a situation where all old housing has been subjected to a first-sale levy, the proceeds from this measure might, on average, be a little less than two-thirds of the revenue raised by a tax on all housing sales.[3] The average annual combined value of real capital gains and labour supplied by owners may be approximately equal to 2 percent of the housing stock and several studies indicate that new dwellings add roughly 2 percent to the value of the housing stock (Miron 1988, Smith, Rosen and Fallis 1988, CMHC 1988). Both increases would be taxed under the all sales option and only the value of new housing would be included in the first-sale base. In addition, purchased services and materials used in repairs and renovations are taxed under both tax measures and these expenditures appear to be roughly equal to two-thirds of the expenditures on new housing (CMHC 1987, CMHC 1988).

The White Paper proposals rank fourth in terms of the revenue raised by a VAT. Estimates provided for the United States suggest that a tax on new housing plus repairs and improvements would account for 7-8 percent of the revenue obtained from a broad-based VAT, and these numbers are likely to be approximately correct for Canada. The first-time sales option would raise several times this amount in the first year after the levy is adopted (e.g., 6 to 7 times if expenditure on new housing equals 2 percent of the housing stock value, old houses are sold every 5 years on average and expenditures on new housing are roughly equal to 150 percent of the expenditures on repairs and improvements). The revenue difference between the two measures would shrink over time and the two yields would be equal once all old housing is sold at least once.

The plan which taxes expenditures on repairs and improvements but only purchases of services and materials for new housing would raise less revenue than the White Paper proposals. From a breakdown of housing components (supplied by CMHC) it appears that materials accounts for a little more than one-third of the total cost, with the remainder taken up with labour, land and builders' margin. If purchased services are small or included in the materials category and if it can be assumed that two-thirds of the builders' margin are subject to VAT, the yield from the levy which exempts land, direct labour and the profit margin for the builder would be roughly one-half the amount raised by the White Paper proposals on new housing. If expenditures on items utilized in repairs and improvements are equal to two-thirds of the expenditures on new housing, the proceeds from employing this more restricted measure would be approximately 70 percent of the revenue secured by the White Paper plan.

The least amount of revenue would be obtained from the scheme which exempts all housing sales, zero-rates materials, land and purchased services utilized in the providing new housing but taxes materials and purchased services for repairs and improvements. Some of the items included in builders' margins, such as insurance, interest, legal, and office expenses are also likely to be taxed in this program. Thus, the yield from this levy would be a little less than three-fifths of the funds secured from the measure which includes materials and purchased services embodied in new housing.

3.41 Tax-Expenditure Efficiency and Impact on Development of New Housing

Tax receipts are often reduced by exemptions, deductions and credits in order to accomplish social objectives. For example, food and other "necessities" are generally exempt from sales taxes in an effort to reduce the tax burden on low income individuals and credits or deductions of charitable donations are allowed under income taxes to encourage charitable giving by individuals and firms. Accelerated depreciation for tax purposes is also allowed to stimulate purchases of capital inputs and tax credits have been utilized to aid specific industries or firms located in depressed areas. These deductions, exemptions and credits are called tax-expenditures and tax-expenditure efficiency measures compare the change in the variable under consideration with the loss in revenue due to the expenditure. For example, in comparing the measures which are designed to encourage charitable donations, one might be judged as more efficient than the other if the increase in donations divided by the revenue loss is larger.

It is more difficult to evaluate tax-expenditures which favour housing than measures to encourage charitable donations because housing programs generally have more than one objective, e.g. aid low income families and increase the supply of housing. If, however, it can be assumed that the chief purpose of providing some relief to housing under a VAT is to increase the amount of housing consumed and/or increase the volume of activity in the construction industry, some speculative judgments can be made about the tax-expenditure efficiency of the six measures analyzed in this study. In this discussion, as opposed to the perspectives adopted in some other subsections of the study, it is assumed that the starting point is one where the flow of total consumption including housing, is fully taxed. In this context, a VAT on imputed and actual rents is taken as the standard comparison. It is also assumed that the price elasticity of demand for all housing is equal to unity and that the demand for old or new housing, taken separately, is price elastic.

The greatest reduction in revenue would occur under the measure which zero-rates land and construction expenditures for new housing, exempts contractor services and all housing sales, but taxes purchases of materials and services for repairs and improvements. This plan would also have the highest tax-expenditure efficiency rating in the long-run and give the greatest stimulus to the construction industry. The elimination of a 10 percent tax would result in a 10 percent reduction in price if supply is perfectly elastic and the quantity of housing consumed would also increase by approximately 10 percent. This levy would also encourage the purchase of new dwellings instead of undertaking repairs and improvements, thereby both stimulating the demand for new housing and causing the housing stock to depreciate more quickly. It would also, however, give an incentive for owners to substitute their own labour for purchased materials and labour in making repairs, thereby reducing the volume of business for commercial firms. It should also be noted that in the short run, where supply is inelastic, the tax-expenditure efficiency would be low in that the tax reduction would tend to lead to higher prices on sales rather than an increase in the housing stock.

Less revenue would be lost by adopting the measure which taxes purchases of materials and services for new housing as well as repairs and improvements but exempts land, direct labour and housing sales. As a consequence, this plan may have a higher tax-expenditure efficiency rating than the zero-rating scheme in the period immediately following the adoption of a VAT. In later periods, however, the plan which taxes material and service purchases is likely to have a lower rating because it provides a smaller subsidy to housing in total and places a relative burden on new housing. Thus, individuals are less likely to substitute new housing for old housing. This measure would also encourage contractors to use direct labour rather than to purchase services and therefore, subcontractors may suffer a loss in business activity.

The first-time sale measure is similar, in principle, to the annual tax on rents in the long-run, except that the yield would be less because owner-occupied services and capital gains beyond the first-sale would not enter the tax base. In the initial periods following the adoption of a VAT, however, the tax-expenditure efficiency would be much higher because the revenue yield would be much larger than under the rental measure and the impact on the development of housing and renovations would be little different.

The tax-expenditure efficiency of the plan which taxes all sales would be similar to the first-sale measure in the initial period after the introduction of a VAT. In subsequent periods, the yield from the all sales plan would be larger as all capital gains, including increases due to labour supplied by owners, would be included in the base. This levy would also continue to place a burden on purchasers of old housing as resales take place, assuming prices increase, whereas price increases would not be taxed under the first-sale plan. As a result, individuals would be more likely to purchase services in making renovations and would tend to purchase new as opposed to old properties under the all sales measure. Thus, the all sales measure receives a higher tax-expenditure efficiency rating.

In the long-run, after all units of the existing housing stock have been taxed, the tax-expenditure efficiency would be almost identical for the White Paper proposals and the first-sale measure. In the period following the introduction of a VAT, however, the effects would be very different. The White Paper proposals would exempt sales of old housing so the yield would be much less. In addition, placing a tax on new housing and exempting old housing sales places a relative burden on new housing. Given that new housing forms such a small proportion of the total housing stock and the two forms of housing are close substitutes, contractors would be required to absorb the tax. Profit margins would fall, and consequently, the number of new housing units would be reduced. In comparison to the taxation of all rents measure, the White Paper proposals would yield almost the same revenue if the level of new housing was unaffected by the proposals (a usual assumption in tax-expenditure calculations) but the amount of new housing and revenue yield are both likely to fall because of the tax placed on new housing. Thus, the White Paper proposals are given a very poor rating w -h respect to short-run tax-expenditure efficiency.

The overall rankings of the six measures with respect to tax-expenditure efficiency depends partly on the weight given to the amount of new housing developed and the time period analyzed. In the period following the introduction of a VAT the first-time and all sales measures would receive the highest ratings because of the large increase in revenue but the greatest impetus to housing development would be given by the zero-rating scheme. Given that any special treatment accorded housing under a VAT would be "justified" by the importance of increasing housing consumption, it seems reasonable to rank the six measures in the following order: (1) zero-rating plan, (2) exemption of land, direct labour for new housing and all housing sales, (3) first-time sale of all housing, (4) all housing sales, (5) all rents and (6) White Paper proposals.

A summary of the rankings for all of the taxation criteria is provided in the concluding section of this study but the main results are summarized in Table 3:1. The table shows that no one measure dominates any other measure on all of the criteria. The rankings for horizontal equity and economic efficiency agree and the rankings for vertical equity and minimum administrative and compliance costs are similar but the ratings for the two groups are very different. The revenue rankings also have some agreement with the horizontal equity-econom c efficiency ratings and tax-expenditure indexings are close to the vertical equity-administrative ease rankings, except for the White Paper proposals. The White Paper proposals receive a high ranking on the administrative ease criterion and a moderate rating on the vertical equity and revenue criteria but are given the lowest rating for the other three criteria. If only long-run effects are considered, however, the White Paper ratings would improve to 4 for the horizontal equity and economic efficiency criteria and 5 on the tax-expenditure criterion. In the next section, the White Paper proposals and Manufacturers' Sales Tax treatment of housing are compared.

Table 3:0

Ranking of Measures With Respect to

Taxation Criteria

	Horizontal Equity	Vertical Equity	Economic Efficiency	Minimum Administration and Compliance Costs	Revenue	Tax Expenditure efficiency
1. Tax on actual and imputed rents	1	4	1	6	3	5
2. Zero rating plan plus exemption of housing sales	4	1	4	3	6	1
3. Exemption of land, direct labour and housing sales	5	3	5	1	5	2
4. White Paper* Proposals	6	2	6	2	4	6
5. One-time sale of all housing	3	5	3	4	2	3
6. Taxation of all housing sales with credits for taxes paid	2	6	2	5	1	4

* It should be noted that short-run effects contribute to these rankings. If only long-run effects are considered the White Paper proposals would rank 4th on horizontal equity and economic efficiency criteria and 5th with respect to tax-expenditure efficiency.

SECTION 4: MANUFACTURERS' SALES TAX--HISTORY, CRITICISMS AND COMPARISON WITH WHITE PAPER HOUSING PROPOSALS

The Manufacturers' Sales Tax (MST) is levied on the selling price of all goods manufactured or produced in Canada, or imported into Canada, unless exempted due to special provisions. Goods are taxed at the manufacturing stage for Canadian produced goods and at the point of entry for imported commodities.

At present the standard rate is 12 percent but alcoholic beverages and tobacco products are subject to an 18 percent rate, telecommunications are taxed at 10 percent and an 8 percent rate is levied against building materials. Food, services, clothing and utilities are chiefly exempt and only 45 percent of consumer expenditures are taxed, with more than 60 percent of the revenue raised by levies on six commodities (Gillis 1985C).

4.0 HISTORY OF MANUFACTURERS' SALES TAX

A national general sales tax was first introduced in 1920. It took the form of a 1 percent multistage turnover tax, levied on all sales of goods, except for transactions at the retail level. There were some administrative difficulties with the levy and it was sharply criticized for favouring imports and vertically integrated firms. The multistage levy was replaced by the Manufacturers' tax in 1924 (Due 1951).

This single-stage tax was also criticized as placing a burden on the poor as well as on businesses. Between 1924 and 1930 a lower rate was introduced for some goods and the initial standard rate of 6 percent was reduced in steps to 1 percent. It was expected that the tax would be abolished but tax receipts fell by a large amount during the early years of the Great Depression and the Government recognized the revenue raising power of the sales tax (Gillespie 1988). The rate was raised in two stages to again reach 6 percent by 1932 and exemptions were reduced in the 1931-34 period. A further increase to 8 percent was implemented in 1936 but some exemptions were added each year, starting in 1934. In 1938 an exemption was given to building materials for the purpose of aiding housing.

During World War II the sales tax rate was not increased even though income rates were raised sharply, because of a concern that a sales tax increase would add to inflationary pressures, place a greater burden on the poor and create difficulties in maintaining the established price ceilings. The base was broadened, however, by removing several exemptions, including the exemption for building materials (Due 1955). In 1945, the exemption of most building materials, along with several other goods, was restored. In addition, an exemption for machinery used in manufacturing was introduced. With the need for greater revenue during the Korean war, the tax rate was raised to 10 percent in 1951. The rate was further increased to 11 percent in 1959.

Building materials were again added to the base in 1963 and taxed at a rate of 4 percent. The rate on building materials was then increased to 8 percent in 1964 and to the standard rate of 11 percent in 1965. In 1967 the standard rate was raised to 12 percent but the tax rate on building materials remained at 11 percent. During 1974 the rate on building materials was reduced to 5 percent, as part of a package to stimulate investment but was not altered when the general rate was reduced to 9 percent in 1978. In 1984 both rates increased by one percentage point to 6 and 10 percent respectively and in 1986, the two rates were raised in two stages to the present levels of 8 and 12 percent. As described in the paragraphs above and shown in Table 4.0, government policy with respect to the taxation of building materials has varied over time and rate changes have not always followed the pattern of changes in the general rate.

The importance of the sales tax as a source of federal government revenue has also fluctuated over the 68 years the levy has been in existence. The percentage of federal revenue accounted for by the sales tax rose from 9 percent in the first complete year of operation (1921) to 24 percent in 1924

Table 4.0

Manufacturers' Sales Tax Rates

	Standard Rate	Rate on Building Materials
1924	6	6
1937	8	8
1939	8	0
1941	8	8
1946	8	0
1963	11	4
1964	11	8
1965	11	11
1967	12	11
1974	12	5
1978	9	5
1985	10	6
1987	12	8

Sources: John F. Due, The General Manufacturers Sales Tax in Canada, Canadian Tax Foundation, 1951; The National Taxes, Canadian 'ax Foundation, various years.

as rates rose, but then declined to 6 percent in 1931 because of gradual reductions in tax rates. Due to several increases and some removal of exemptions the percentage of total revenue raised from the sales tax rose steadily until it reached an all-time high of 31 percent in 1938 (Due 1951). As the yield from the income taxes and other sources of revenue increased significantly during World War II, the sales tax fell in relative importance to 7 percent in 1946. This downward trend was reversed after the war as the sales tax rate increased and federal income tax rates were lowered and the proportion of revenue from the sales tax rose to more 21 percent by 1965. The percentage then fell slowly as income tax proceeds increased sharply and this trend was accentuated with the reduction of the tax rate in 1978. The percentage reached a level of 12 percent by 1983. With a broadening of the base to include items such as marginal manufacturing, the adoption of the wholesale values for transactions such as those involving the purchase of automobiles, and the increases in tax rates, the percentage of sales tax revenue to total federal revenue rose to 14 percent in 1987. Thus the proportion of sales tax revenue to total federal revenue has varied from 6 percent to 31 percent over the life of the levy, but the percentage has only fluctuated in the 11 to 27 percent range since 1950. The relative importance of the sales tax has depended primarily on the sales tax rate and the yield of other levies, especially the income taxes. Except for the inclusions of building materials in 1963, the treatment of items related to housing under the MST appears to have little impact on the relative importance of the levy.

4.1 ATTEMPTS TO REFORM THE MANUFACTURERS' SALES TAX

The Manufacturers' Sales Tax has been criticized since its inception and various governments commissions, along with other groups, have made proposals for reforming it. As noted in the previous paragraphs the tax was criticized as being regressive and difficult to administer during the 1920's and

1930's. Business groups also claimed that the tax was a burden on trade and the cost of collecting it was high. In response to these charges, exemptions were increased to reduce the burden on low income individuals (including building materials to lower the cost of housing) and improvements were made in the administration of the levy. Nonetheless, criticisms continued and the Rowell-Sirois Commission Report (1940) was critical of the levy because of its regressivity and nonneutral treatment of different industries.

After World War II these criticisms were repeated and it was also charged that the sales tax was inflationary. In addition it was argued that the levy was pyramided at different rates for various goods as commodities moved from manufacturers to final consumers. One of the reasons the tax was reflected in different increases in price at the retail level is that some producer goods were taxed and they formed various proportions of costs for different goods. Although the exemptions for machinery and building materials went some way toward meeting the objection of taxing producer goods, concerns about the tax remained and a Sales Tax Committee was appointed to examine the levy with respect to: exemptions, appeals, a tax base when similar goods are channelled through different distribution routes and tax burdens on imported and domestic goods. The Committee (1956) recommended broadening the exemptions for building materials and machinery, establishing notional prices to value goods sold to customers other than wholesalers, increasing the right to appeal, treating imports and domestically produced goods in a neutral fashion and replacing the Manufacturers' tax with a wholesale levy. Few of these recommendations were acted upon, however.

The Royal Commission on Taxation (1966) reiterated many of the suggestions made by the 1956 Committee and made the general suggestion that the base be broadened to include more items. One exception to this general recommendation, however, was the proposal that more producer goods be given exemption from the tax. The Commission also expressed a preference for exempting all shelter related items and for the removal of taxes on all construction material used in business but was concerned about the loss of revenue. Its overall recommendation was that the Manufacturers' tax be replaced with a retail levy and that housing be given an exemption from this retail tax.

The Royal Commission's recommendations relating to the sales tax were not implemented, although an exemption was granted for construction and transportation equipment. Attempts were made, however, by the government to replace the Manufacturers' tax with a wholesale levy during the 1973-83 period. The proponents of the change suggested that the wholesale levy would improve horizontal equity, due to the inclusion of more items, and administration of the tax because fewer transactions would require the determination of notional prices. The chief advantages claimed for the wholesale measure, however, were that it would be more neutral with respect to imports and domestically produced goods, reduce pyramiding of taxes into price increases which exceed the tax, and provide more neutral treatment of goods sold through different distribution channels. Taxpayer opposition to the proposed change was strong because the gains in neutrality and equity were perceived to be small and transition plus administration costs (more taxpayers) were viewed as large. The Report of the Federal Sales Tax Review Committee (1983) recommended that a wholesale levy be rejected and that consideration be given to replacing the Manufacturers' levy with a retail sales tax or a VAT. The Government accepted this recommendation and the 1987 White Paper proposed the three variants of a VAT described in Section I of this study.

4.2 RELATIONSHIP BETWEEN PROBLEMS WITH MST AND TREATMENT ACCORDED HOUSING

The summary of efforts to reform the Manufacturers' Sales Tax presented above suggests that the levy has many shortcomings and that several of these problems have been identified by various government tax commissions as well as by business representatives and academic researchers (Gillis 1985c). Most of the criticisms focus on the distortions caused by the levy but concerns have also been expressed about related inequities and administrative problems.

One principal shortcoming of the levy is its narrow base. The large number of exclusions results in an excess burden because a wedge is formed between the price and cost of production for taxed goods but not for untaxed commodities. The exclusion of more than half of consumer expenditures also limits the amount of revenue that can be raised by a politically acceptable tax rate and interferes with the attainment of horizontal equity.

A second problem with the tax is that it penalizes exports and aids imports. Even though export sales are exempt from the levy, tax is paid on some producer goods and it becomes embedded in the price of the product. There is no provision for rebating this embedded tax to firms when goods are exported. Thus, exporters of Canadian goods are at some disadvantage when competing in foreign markets. Domestically produced goods are also at some disadvantage in relation to goods imported into Canada. Many domestic manufacturers incur large marketing, assembling and distribution costs, which form part of their tax base, but these costs are generally borne by wholesalers and retailers for imports. Imported goods are taxed under the Manufacturers' Sales Tax at the point of entry so no tax is levied on marketing and distribution expenditures.

A third difficulty arises because manufacturers engage in large advertising efforts to promote the sale of their brand name products in some cases but in situations where retailers place their brand names on goods, they undertake extensive marketing campaigns to stimulate sales. In the first instance the advertising costs enter the tax base, but in the second case, the good is sold to the retailer before marketing costs are incurred and thus these marketing expenditures are not taxed. This same type of problem arises in the construction industry where assembling costs are taxed if undertaken by the manufacturer but do not enter the tax base if assembled on the construction site.

Another difficulty involves the treatment of transportation costs. Cost of shipping materials and equipment to a manufacturer enter the tax base but costs of transporting the manufactured product to wholesalers and other customers are generally excluded. Therefore, the tax affects location decisions in that a manufacturer would be encouraged to locate close to the source of raw materials rather than to chose a site near customers.

A fifth and major defect is that producer goods may account for as much as one-third of the tax base. Taxing producer goods results in greater pyramiding of the levy and introduces noneutralities among goods with varying amounts of taxed goods used as inputs. The taxation of producer goods also encourages the use of more labour and less capital.

The MST is also criticized because the tax burden is distributed in a regressive manner, assuming the tax is shifted forward to consumers and is examined in relation to annual income, chiefly because the ratio of consumption to income falls as income rises. The ratio of taxable expenditure to total expenditure also falls for higher income groups.

There are also administrative problems with the levy, including appeal procedures, allowances for bad debts, treatment of nonpayment of tax, definition of marginal manufacturing and determination of value when transactions do not involve a sale from a manufacturer to a wholesaler.

This brief review of the criticisms levelled against a MST suggests that although the treatment of housing contributes to some of the general problems associated with the levy, it is not a major source of efficiency, equity or administrative difficulties. The concerns expressed about exports, imports, producer costs and location decisions are little affected by tax provisions directed specifically at housing. Levying the tax at the manufacturers' level does cause some distortions in that contractors are encouraged to construct items on building sites rather than purchasing completed units from manufacturers, but the shifting of functions beyond the manufacturing level is a widespread problem. Similarly, the exclusion of land, labour and other services from the tax base and assessing a lower rate on construction materials creates distortions and inequities in comparison to taxed items but the problem of a narrow base is due to a large number of exemptions. It is not clear that economic efficiency and equity would be enhanced by greater taxing of housing if other exemptions remain. In addition the favourable treatment accorded housing may reduce the regressivity of the tax.

4.3 COMPARISON OF WHITE PAPER PROPOSALS AND MST WITH RESPECT TO HOUSING

The substitution of the National Sales Tax version of VAT for the MST would have the greatest impact on housing. Not only would a larger proportion of operating and new housing costs be subject to a federal levy, but the provincial sales tax base would be expanded to include these items as well. The adoption of a National Sales Tax may also encourage Alberta to introduce a sales tax. The other two White Paper proposals would have a smaller impact on housing because provincial sales taxes would be largely unaffected and the Federal VAT variant could provide for an exemption or lower than a standard rate on housing.

The introduction of any of the three proposals would, however, increase the cost of housing. The increased tax on operating costs, such as expenditures on financial, insurance, utility and repair services, would be initially borne by owners of rental property but gradually shifted to tenants as demand increases and supply of rental units falls. Where rents are controlled, this adjustment process would take longer and the supply of units would fall by a greater proportion (Fallis and Smith 1987). The burden on individuals residing in owner-occupied housing would be felt immediately. As noted earlier, the tax on the development of new housing would cause higher prices but the tax would not be fully shifted until a reduction in the housing stock took place. This adjustment period would be longer than in the case where only operating costs are taxed and would be more lengthy in situations where demand is increasing at a low rate and construction falls slowly. In the period before full adjustment takes place, much of the tax burden would rest on suppliers of new property and especially landowners. If the supply of land for housing is not elastic in the long-run, some of the burden would rest on landowners and housing prices would rise by less than the full amount of the tax, even after all adjustments have taken place.

The VAT measure which exempts land, direct labour and contractor services is much like the MST except that the VAT would include services purchased by contractors and some operating costs, such as insurance, financial, utility and repair services. Thus, some guidelines to the relative advantages and disadvantages of replacing the MST with the White Paper proposals can be secured from the analysis provided in Section 3.

In terms of social justice, the substitution of a VAT for the MST would result in an improvement in horizontal equity but the progressivity of the tax system would not be altered significantly. Low income individuals would bear a smaller tax burden, however, if some of the VAT proceeds were used to provide a larger refundable vanishing credit under the individual income tax. When only provisions which affect housing are examined, the MST is superior to the White Paper proposals.

Replacing the MST with a VAT would broaden the tax base and lower the average tax rate. As a consequence, taxes on manufactured goods would fall and taxes on other goods would rise. Individuals in similar economic circumstances are likely to bear more equal sales tax burdens than under the MST where manufactured goods are at a high rate and many other goods are completely exempt from the levy. This tendency toward more equal treatment of individuals in similar circumstances would be enhanced if a National Sales Tax is adopted.

When examining only the provisions which affect housing, however, the case is less clear. Under the MST dwellings are taxed at a 3 to 4 percent rate if construction materials account for between 40 and 50 percent of total cost. This effective rate is below the weighted average rate for all goods. When operating costs are also taken into account the "under taxation" of housing becomes more pronounced because financing, insurance, labour and most utility services are exempt from MST. Thus, individuals who consume a high proportion of their incomes in the form of housing would bear lower sales taxes than individuals who are in similar circumstances but spend less on housing. Horizontal inequities also arise if there is variation in the ratio of construction materials to total cost when new properties are purchased. These inequities would be virtually eliminated under a broad-based VAT because all expenditures would be taxed at the same rate but the gains may not be large because variations in the amount spent by individuals similarly situated is relatively small. A large inequity would be introduced under the White Paper proposals, however, because new housing would be taxed in full and old housing would be exempt. As noted in Section 3, it is judged that the second inequity is of greater importance in the short-run.

A general VAT on all goods would be little more regressive than the MST but the exemption of food would slightly reduce the regressivity of a VAT (Hamilton and Whalley 1987). In addition, the proceeds of a VAT may be sufficient to not only cover the revenue raised by the MST but to also replace the income surtaxes and provide for a vanishing refundable income tax credit. The elimination of the surtaxes would reduce the progressivity of the tax system but the credit would reduce the regressivity of taxes at the lower end of the income distribution. The combined effect would likely increase the relative burden on middle income receivers, however.

The White Paper proposals dealing with housing also generates conflicting effects on progressivity, when compared to the MST. Including a much higher proportion of operating costs in the tax base increases both the overall burden on housing and the regressivity of the tax system. Broadening the tax base for new housing to include land and contractor services is likely to make the tax less regressive because purchasers of new housing are likely to have higher average incomes than buyers of old housing. Over time, however, this latter point would have less significance as increasing amounts of the housing stock would be subject to the tax. The overall impact of the White Paper proposals with respect to housing would be to make the tax system less progressive, in relation to the MST.

A general VAT would be superior to the MST in terms of economic efficiency. As noted earlier in this section, the MST introduces nonneutralities for exports, imports and goods sold through different distribution channels, affects location decisions and results in tax pyramiding due to the taxation of producer goods. A broad-based VAT would eliminate most of these problems as goods and services would be taxed at the same rate. Hamilton and Whalley (1987) estimate, with the use of a general equilibrium model, that the welfare gain would be in the neighbourhood of $900 million or .33 percent of Gross Domestic Product if the MST was replaced by a VAT. They also note that there would be a relative shift toward manufacturing and away from services but that output of services would also increase due to overall increase in economic efficiency. In addition, Hamilton and Whalley suggest that increased exemptions would reduce efficiency gains from replacing the MST with a VAT.

On the assumption that any externalities or merit good attributes associated with housing are taken account of by other policies, the White Paper proposals for housing are superior to those encompassed in the MST. The taxation of many operating costs would reduce noneutralities between expenditures on housing and other items. In the period following the introduction of the White Paper proposals large inefficiencies would result in the market for dwelling purchases, however, because old housing would be exempt and a substantial tax wedge would be formed between the price and production cost for new housing. Old housing would bear the cost of the MST on building materials but the tax on new housing would be more than double this amount (even if the tax rates were equal) because land, direct labour contractor services would be included in the base. Over time, though, more properties would be subject to VAT and this difference in tax wedges would become less significant. Thus, nearly the full cost of housing, operating as well as capital costs, would be included in the tax base and the treatment between housing and other expenditures would be neutral. Under the MST, housing would be taxed at lower than average rate.

The administrative and compliance costs would be much higher for the VAT than for the MST, especially in the initial period after a VAT is introduced. Even after the transition problems have been solved the VAT would involve larger costs because the number of taxpayers and taxable transactions would be greater. In addition, a VAT would involve many small wholesalers and retailers who would not be taxpayers under the MST.

All measures of taxing housing under a VAT involve some complexity but the White Paper proposals are superior to most other methods. Sales of most old housing would be exempt from the levy and individual owners and consumers would not be required to become registered taxpayers. The White Paper proposals would involve greater administrative and compliance costs than does the MST, however. Developers of land and building contractors would become registered taxpayers and both landlords and contractors would be required to allocate expenses between business and residential units. Complications would also result when there are changes between residential and commercial uses of property. Revenue Canada would be required to monitor more taxpayers and transactions.

The revenue yield from a broad-based VAT is a function of the rate and the rate could set at a level where the receipts are equal to the yield of the MST. Concerns are often expressed about high marginal rates because of their impact on evasion, economic efficiency and tax tolerance. Due to its broad base a VAT can raise substantial amounts of revenue before reaching the political limit on tax rates and thus, the potential yield of a VAT is much larger than for a MST.

Given that the rate of tax is set, the adoption of the White Paper proposals would add a substantial amount of revenue from the levy on housing. More operating costs of land, direct labour and contractor services would be brought into the base whereas under the MST only the construction materials used in repairs, improvements, and new housing are taxed. If the total value of housing, including the contribution of services encompassed by operating costs, is now taxed at roughly 3 percent and an 8 percent VAT is introduced, the proceeds from a sales tax on housing would more than double. This increase in revenue may not take place immediately after the introduction of a VAT, however, because the levy may reduce the construction of new housing until the housing stock is reduced.

The tax-expenditure efficiency of the White Paper proposals in relation to the MST in the long-run is not clear but the amount of housing consumed and activity in the construction industry would be lower with the VAT. Under the White Paper proposals, the revenue would be higher but there would be increases in the price of housing. The price increase would be in the neighbourhood of 5 percent for an 8 percent federal levy and 7 to 8 percent under a National Sales Tax of 12 percent. This price increase would reduce the quantity demanded for housing and the amount of housing consumed. The impact on the construction industry would be even more pronounced in the period immediately after a VAT is introduced. Housing starts would fall because it is unlikely that the tax on new housing could be shifted to buyers and the net return would fall to contractors and others involved in developing residential properties. In this period revenue and construction may both fall.

The overall conclusions which can be drawn from this section is that the case is mixed for replacing the MST with the VAT proposed in the White Paper proposals in terms of the treatment of housing. Comparisons between the two levies with respect to specific goals indicate that the differences are often small. In addition, an increase in an income tax credit, financed partly by an increased tax on housing, would make the tax system more rather than less progressive. The horizontal equity effects would also become less significant and would be eventually reversed as a higher proportion of the housing stock is subject to the VAT.

The shift to a VAT would increase the amount of revenue raised from housing except perhaps for the period immediately after the tax was introduced, but much of this increase could be obtained by raising the rate on construction materials from 8 to 12 percent. There would also be an increase in economic efficiency from replacing the MST with a VAT because nearly all consumption expenditures would be taxed at the same rate and land may bear a larger proportion of the sales tax. The levy would cause some distortions, however. Owners of rental property would be encouraged to hire their own managers, repair and servicing personnel and supervise renovations directly, rather than to hire these services from firms. The exemption for self-provided services would tend to favour owners of properties with several rental units. All owners of property would be encouraged to provide their own labour in undertaking repairs and improvements.

Adopting a VAT would increase administrative and compliance costs because more transactions and taxpayers would be involved, including building contractors and land developers who have a small volume of business. In addition the heavier tax burden would curb the consumption of housing over time and reduce construction activity, especially in the period following the adoption of the tax.

SECTION 5: SUMMARY AND CONCLUSIONS

Investigation of 24 OECD countries indicates that 17 have adopted a conventional consumption form of value added tax as a replacement for other sales taxes. All 17 countries utilize the invoice or tax credit method of computing the tax and the standard rate ranges from 10 to 25 percent. Nearly all of the countries tax some items at a lower rate and 9 levy a higher rate on specific purchases.

Rents and sales of used housing are treated in a near uniform manner across countries but there is great disparity in the taxation of new housing sales. All of the countries exclude imputed rent on owner-occupied dwellings and sales of used housing between individuals who are not registered taxpayers. Paid residential rents are also exempt in all countries, except for Austria which taxes rents at one-half the standard rate. Ten of the 17 countries tax the sales of new housing but there are differences in the definition of a new dwelling, the costs included and the rate applied. Most countries define a new house as one that is sold for the first time but Belgium and France consider housing as new for up to 2 and 5 years respectively, under some conditions. Approximately one-half of these countries exempt the full value of land from the tax base and France includes 70% of land values in its base. Spain and Ireland tax sales of new dwellings at less than the standard rate.

The other 7 countries exempt the sale of new housing from the tax base but, except for the U.K., subject various components to the levy without allowing a credit for taxes paid on them. All of the six countries tax construction materials but the proportion of land value included in the tax base varies. Most exempt land but many include the cost of preparing it for building. Sweden, however, includes only 60% of these preparation costs and other services related to construction in the tax base. In the U.K., all taxes on new dwellings, including land, are effectively eliminated through zero-rating, whereby the contractor receives a credit for all of the VAT paid on purchased inputs. In addition, no VAT is levied on direct labour and contractor services are free from tax because sales of new dwellings are exempt.

All countries tax materials and most purchased services used in making repairs and renovations. There is variation in the taxation of expenditures for services such as insurance, utilities and financing, however, depending on whether financial services and sales of electricity, water, etc. are included in the general VAT base.

In addition to various treatments accorded housing in OECD countries, some proposals for reform were examined.

These proposals included taxing actual and gross imputed rents, all housing sales and a one-time tax on dwellings. Under this last plan, properties are taxed the first time they are sold after the introduction of a VAT but second and subsequent sales of the properties would not normally be taxed.

Nine measures for taxing housing under a VAT were examined briefly and 6 were selected for a more thorough analysis: the three reform measures noted above and three methods which are broadly representative of the policies employed in OECD countries. These methods included a zero-rating and exemption plan which virtually excludes land and construction costs, a measure which taxes only construction material and purchased services and a levy on new housing sales (the White Paper proposals). These six measures were analyzed in relation to generally accepted goals of taxation: horizontal and vertical equity, economic efficiency, ease of administration and compliance, revenue effects and tax-expenditure efficiency. The results of this analysis were summarized in Table 3.0 and are reproduced here. The table demonstrates that no single measure is superior to the other five plans on all tax criteria. In general, measures which rank high on the horizontal equity, economic efficiency and revenue criteria receive a low rating in terms of vertical

Table 3:0

Ranking of Measures With Respect to

Taxation Criteria

	Horizontal Equity	Vertical Equity	Economic Efficiency	Minimum Administration and Compliance Costs	Revenue	Tax Expenditure Efficiency
1. Tax on actual and imputed rents	1	4	1	6	3	5
2. Zero rating plan plus exemption of housing sales	4	1	4	3	6	1
3. Exemption of land, direct labour and housing sales	5	3	5	1	5	2
4. White Paper Proposals	6	2	6	2	4	6
5. One-time sale of all housing	3	5	3	4	2	3
6. Taxation of all housing sales with credits for taxes paid	2	6	2	5	1	4

equity, tax-expenditure efficiency and minimum costs for administration and compliance. The reverse is also true and thus, analysts and policymakers could reasonably disagree as to which are the best measures if they applied different weights to the six goals or criteria. For example, a tax administrator may well choose one of the three measures used in OECD countries whereas someone who placed emphasis on maximum revenue or horizontal equity would tend to prefer one of the reform plans.

When political economy considerations are brought into the analysis the number of feasible alternatives can be immediately reduced to 4. Taxpayers would be strongly opposed to the taxation of all rents or all housing sales. The administrative and compliance costs would be very high because both plans would require that all homeowners be registered as taxpayers and that they keep extensive records. In addition, the taxation of imputed rents may require the determination of notional values for items such as property taxes. If input costs were liberally defined, the revenue yield of the levy would also be low.

The choice among the other four plans depends largely on the weights given to the six criteria and especially on the short-run revenue and tax-expenditure effects. Some general observations can be made, however, which may help in choosing among the four plans. First, the one-time sale of all property and White Paper proposals converge over time, although the short-term effects of the two measures are quite different. Second, the short-run differences among the zero-rating, White Paper and the exemption of land, direct labour and housing sales plans are small. In addition, the horizontal equity ranking of the White Paper proposals would change over time from last to a tie for first with the one-time sales plan. Third, although the plans would have different effects on the overall progressivity of the tax system, the impact would not be large and all of these measures are rather clumsy and indirect methods of redistributing income. Fourth, the economic efficiency ranking would change over time so that the zero-rating plan would place last and the White Paper proposals would be top-rated along with the one-time sale measure. It should also be noted that the ranking is based on the assumption that other more direct policies would be implemented to take account of any positive externality or merit good effects associated with housing. If, however, these effects are to be incorporated into the analysis of the tax treatment of housing under a VAT, the zero-rating plan is the preferred measure. Fifth, there are administrative and compliance problems associated with each of the measures but all four plans are feasible. Three are used in other countries and the one-time sale plan appears to be manageable. In addition, the ranking among the four measures is based chiefly on the number of taxpayers who would be involved and it may be that the zero-rating plan involves less complexity per transaction and per taxpayer than the other plans.

There would be substantial differences among the plans with respect to the impact on the tax proceeds and the housing industry, however, especially in the short-run. At one extreme is the zero-rating plan. It would give the greatest impetus to the construction of new housing, although there would tend to be a reduction in repairs and renovations. This plan would also have the largest negative impact on revenue.

At the other extreme, in terms of revenue, is the one-time sale plan. This measure would raise 6 or 7 times the amount of revenue secured from the White Paper proposals in the period immediately following the adoption of a VAT. A case could be made, however, for levying a lower tax on old housing because it was taxed under the MST.

The greatest negative impact on the development of new housing would result from the adoption of the White Paper proposals. In an expanding housing market this effect would be relatively small and short-lived, however.

Given these large differences in the measures, choices can be made. If the emphasis is placed on stimulating the development of new housing, the zero-rating method should be adopted, although it should be noted that this measure could only be implemented under the National Sales Tax and Federal VAT versions of the levy. If there is a desire to raise substantial amounts of revenue in the early years of a VAT, the one-time tax on all housing sales is the logical choice. The yield from this levy would decline over time, however, and a desirable characteristic of a tax is that its yield at least keeps pace with the growth in government expenditure demands. In addition, the one-time sales method would result in a substantial "lock-in" effect and would generate a large amount of taxpayer opposition because of the large tax levied on sales of all housing.

The closest alternative to this reform measure, which might be viewed as "too new" or "radical" is the plan incorporated in the White Paper proposals. This plan has been employed in OECD countries and would generate more revenue than the other two plans. Even though it would tend to reduce development of housing in the short-run, this effect may be of very short duration in a dynamic market, such as exists in Southern Ontario.

If neither the zero-rating or White Paper plan are acceptable, a compromise would be the plan which exempts direct labour, land and sales of all housing. It ranks between the other two measures in terms of revenue and impact on development of new housing and it would be the closest measure to the status quo, as defined by the MST. The revenue yield and consequent burden on housing could be increased under this plan by including direct labour and/or land in the base. Similarly, the yield and burden associated with the White Paper proposals could be decreased by exempting land from the base.

The issue of taxing land has received very little attention elsewhere in this study and there is a divergence in the treatment of land by other countries. One argument for exempting undeveloped land is that it is not consumed or used up as is the case for other goods and services and that a VAT is a consumption based tax. A second reason for exempting land is that most of the capital gains associated with housing is caused by an appreciation of land prices and that capital gains should not enter the tax base. Third, the exemption of land from the base would reduce the shift in property development from housing to commercial activity under plans such as the White Paper proposals. This tendency would result because commercial tenants may be able to shift the VAT burden to customers whereas residential tenants do not have this opportunity. There are also arguments for including land in the tax base. First land accounts for more than 25 percent of new housing costs in most instances and excluding it would reduce tax revenues. Second, consumers gain pleasure or satisfaction from land as well as the building component of housing and the economic efficiency rule implies that the tax on two equally valued units of housing should be the same, regardless of the tax/building mix. Third, it is difficult to determine the value of undeveloped land once it has been developed. If the exemption of developed land is allowed, there are administrative problems in separating land and building costs. Both lines of argument have merit but it is judged that the case for including land in the tax base is strongest. Thus, it should be taxed under either the White Paper proposals or the measure which excludes direct labour and all housing sales.

APPENDIX A: DESCRIPTION OF VAT PROVISIONS REGARDING HOUSING AND OTHER FORMS OF IMMOVABLE PROPERTY IN OECD COUNTRIES

As described in Section 2, the treatment accorded housing under the value added taxes levied by O.E.C.D. countries is far from uniform, even though the actions of most European countries are governed by a common set of rules established by the European Economic Community. The purpose of this appendix is to outline the special provisions employed in each country. Since 12 of the 17 countries described in this appendix are members of the EEC, the rules set forth by the Sixth Directive of the EEC (1977) are first presented. The regulations which apply to each of the countries are then described. Last, to facilitate a comparison among countries, the major features of the tax treatment regarding housing are summarized in two tables.

Most European countries levy value added taxes according to the guidelines of the Sixth Directive of the EEC. The Sixth Directive's objective was to harmonize taxes within the EEC and regulations are provided for the taxation of housing and other forms of immovable property. Under these regulations, housing and real estate may be subject to VAT as a supply of goods, or a supply of services.

Supply of goods includes transfers of "old" buildings, "new" buildings and building land. A VAT is to be levied on new buildings (including the land on which it stands), and building land (i.e. unimproved or improved land as defined by individual member countries). The most important supply of goods provisions of the Sixth Directive concerning housing and real estate are as follows:

1. Taxable persons are defined as those who carry out economic activities. In particular, real estate traders are subject to taxation (Article 4). Furthermore, a provision is made whereby non-taxable persons engaging occasionally in the supply of taxable goods, (i.e. supply before first occupation including land and the supply of building land), may waive exemption. However, it should be noted that the member countries may but are not required to treat as taxable persons those who engage occasionally in the supply of new buildings and building land.

2. According to Article 13-B, supplies of real estate other than new buildings, building land, and transactions made by taxable persons, are exempt from VAT (unless the waiver is enacted).

3. Countries are permitted to exempt items which are deemed taxable by EEC VAT laws, providing these items were exempt in the individual country, prior to the implementation of the Sixth Directive (Article 28-3-a). Hence, new buildings could be exempt in various countries.
4. Real estate supplies are exempt if they are used by the supplier for an exempt activity (Article 13-B-c).
5. Furthermore, taxable persons may opt to pay tax on those supplies of immovable goods which are exempt (i.e. "old" buildings and their land); however; this provision does not apply to building land. (Article 13-C-b and 13-B-h).
6. The supply of land not considered "building land", is free from tax. Consequently, farm land escapes tax .

The letting and leasing of immovable property are generally considered supplies of services in the EEC but the Sixth Directive is not clear whether leasing should be treated as a supply of goods or supply of services. This distinction is important. Taxing the leasing of immovable property as supply of goods requires that the VAT is paid in full at the time of supply. Under a supply of services, VAT is paid in smaller amounts over the duration of the contract and the present value of the tax payments may be different. In practice, countries are permitted to tax leasing under the alternative of their choosing.

A general regulation, article 13-B, states that the leasing and letting of immovable property are exempt; exceptions are the letting of hotel accommodations, parking spaces, permanently installed equipment and machinery, and the hire of safes. However, an option is provided whereby member countries may include other transactions as "exceptions" to the general exempt status of leasing and letting. As a consequence of this option, residential rents could be taxed in all countries but it is only in Austria where rents are generally taxable. In addition, leases for ten years or more are subject to VAT in Ireland. Taxation is permitted for otherwise exempt leasing and letting activities if the property is leased to a taxable person (Article 13-C-a).

Several problems and/or issues arise regarding the VAT treatment of real estate. Although the Sixth Directive was designed to harmonize taxes, its' provisions allow for diverse VAT levies to exist across EEC countries. For instance, most countries tax new housing but it is exempt in Germany and Denmark. In addition, the United Kingdom stands alone as the only EEC member to zero-rate new buildings. Moreover, the distinction between "new" and "old" takes on various meanings by country. In Belgium, a building is "new" until December 31 of the year follow its first occupation. A "new" building in The Netherlands, however, is one which has been transferred within two years of its first occupation.

A problematic area in the administration of VAT concerns the treatment of maintenance and improvements to real estate. Generally, VAT is levied on project engineering, levelling, construction alterations and maintenance of existing buildings. But, in the United Kingdom, new construction is zero-rated while building repair and maintenance is subject to VAT. Disputes have arisen over what constitutes "repair and maintenance", and "new construction". Consequently, the VAT treatment of real estate will not be uniform across EEC countries, and certainly not across all OECD countries. Furthermore, it is interesting to note that land and buildings not subject to VAT, may be liable to registration duties (i.e. turnover taxes - details of these various duties are found in Appendix B).

To facilitate understanding of the differences in treatment of housing across the 17 OECD countries which employ a VAT, a brief description of the regulations in each country is given in the following paragraphs (more detailed information can be obtained from Aaron 1982, Bergivik and

Vanden Broek 1986, Conrad 1986, Due 1988, Gillis 1985B, Timmermans and Joseph 1986). Although Finland is an OECD country, it is excluded from this study due to the hybrid nature of its VAT.

AUSTRIA

The supply of Austrian immovable property is exempt without credit from VAT. However, this does not apply to the supply of new buildings and other supplies by building contractors, which are subject to VAT. Land and buildings not liable to VAT are subject to the immovable property acquisition tax.

Leasing or renting of immovable property is considered to be a taxable supply of services. However, it is subject to a reduced tax rate of 10 percent as compared to the standard rate of 20 percent.

BELGIUM

Supplies of immovable property are generally exempt from VAT. This exemption does not hold in the case of certain new buildings transferred by a person who is a professional building contractor. Such supplies (excluding the land on which the building stands) are liable to a lower VAT rate of 17 percent (standard rate 19 percent), and the transferor will be entitled to a credit for previous VAT paid. Also, the transferee (providing he is a taxpayer), will be permitted to credit the VAT paid on the transfer. Moreover, occasional constructors of buildings or those who sell a new building, may request to waive exempt status. It is interesting to note that although the supply of land (improved or unimproved), and the supply of old buildings are exempt from VAT, they are liable to registration duties. Furthermore, "new" buildings in Belgium are those occupied until December 31 of the year following first occupation of the premises. Improvements, repairs and maintenance are subject to VAT.

Leasing and renting of immovable property are exempt from VAT, but the leasing of immovable property for industrial or commercial purposes by an enterprise which specializes in this field, is taxable. Also, hotel accommodation, the letting of premises for parking vehicles, the letting of permanently installed equipment and machinery, and the hire of safes are subject to VAT.

DENMARK

In Denmark, real property is not considered a good. Hence, sales of immovable property are exempt from VAT. However, the first sale of real property by a building constructor is largely taxable in effect because the services utilized in construction (planning, construction, repairs and maintenance) are subject to VAT. Registered taxpayers who purchase a building are required to own it for ten years in order to claim full VAT credit. Also, taxpayers have the option to waive exempt status.

The letting of immovable property is not taxable. Notable exceptions are:

(1) rooms in establishments which are let out for periods of less than one month

(2) camping, parking and advertising space

(3) services by hotels, restaurants, catering services etc.

Letting of a parking space is taxable only if it is not part of the letting of a residence. A provision is made whereby an enterprise which lets property for industrial use may apply for VAT registration. Providing certain conditions are satisfied, a building contractor who has constructed a building for the purpose of letting it for business use may register as a taxpayer. Thus, he may credit VAT due on the construction against the VAT for which he will be liable on the rent.

FRANCE

A value-tax is levied on the following transactions in France:

(1) division of land into separate lots

(2) sales and incorporations of building sites

(3) sales of buildings

- buildings five years old or older, or which were already sold once within this period to a non-trader, are not liable to VAT.

(4) certain self-deliveries of immovable property

(a) where the goods are used for needs other than those of the company (e.g. personal needs of management)

Self-deliveries of immovable property are normally taxable but, the following transactions regarding immovable property are exempt: certain transactions related to township development and the sale of building sites and the transfer of land for the construction of low-rental apartment blocks. Building land is normally taxable except transfers to:

(1) national or local authorities

(2) certain organizations in connection with social housing purposes

(3) those involved with agricultural, industrial and urban development planning and with re-allotment of

agricultural land

It should be noted that land undergoes a 30 percent reduction to its base before VAT is applied.

In general, the leasing and letting of real estate are not taxable. However, commercial leasing is taxable except: non-improved land, rural property and empty premises. The letting of parking spaces, hotel accommodation, permanently installed equipment, and the hire of safes are taxable. Also, an option for taxation exists where the real estate is let to an entrepreneur.

GERMANY

The supply of immovable property is subject to the immovable property acquisition tax whether it contains new buildings, existing buildings or unimproved land and whether or not the supply is made by an entrepreneur or non-entrepreneur. VAT is not levied on the supply of new buildings by professional building contractors providing there is a contractual connection between the supply of land and building. Entrepreneurs who supply immovable property to other entrepreneurs have the option to waive VAT exemptions. Self-supplied repairs and maintenance are exempt in Germany. However, repairs and maintenance undertaken by a third party are taxable. Also, improvements undertaken by owners are exempt whereas third party improvements are taxable. Although sales of real estate are not subject to VAT, the taxpayer can opt to be taxable (this privilege is not extended to those engaging in transactions on an occasional basis).

Exempt status is given to the leasing and letting of immovable property in Germany. Notable exceptions include parking spaces and camp sites. Providing that the property is not to be used as a dwelling, entrepreneurs may waive the tax exemption.

<u>GREECE</u>

Article 6 of Greece's VAT law lists the property transactions which are taxable at the standard rate. The delivery of immovable property (i.e., the transfer of ownership of buildings and the land on which they stand) will be liable to VAT providing:

(1) the transfer refers to buildings, and not to any other immovable property

(2) the transfer must include the necessary building land for the buildings

(3) the building must be new (i.e. the transfer must take place before first occupation of the building)

(4) the building permit must have been issued as of January 1, 1987

In addition, construction by contractors of works on immovable property (e.g. repairs, construction, excavation) are taxable under article 6 providing that the "works" do not constitute maintenance work; maintenance work is considered a supply of services and is subject to VAT under Article 8. Transactions not liable to VAT, are subject to the transfer of property tax.

Taxable supplies of services include: hotels, furnished rooms and houses, parking areas, safe deposit boxes and the leasing of industrial premises. Exemptions include the leasing of immovable property of any kind apart from those mentioned above, and the delivery of immovables other than those mentioned in Article 6.

IRELAND

The supply of immovable property is taxable only where a person disposes of or creates an interest (an interest is any estate or interest therein for a period of at least ten years but does not include a mortgage), in a property which was:

(1) developed since October 31, 1972 by him or on his behalf; and

(2) property for which he was entitled to claim the input tax credit

Hence "old" buildings sold by non-registered persons escape VAT. Transfers are liable to a stamp duty at rates up to 6 percent. The taxable base on the sale of a building is the open market value of that building. Services related to the construction of buildings are taxed at 5 percent. New housing is given special treatment since it is subject to a VAT rate of 10 percent, which is less than half the standard tax rate of 25 percent. Maintenance, repair and alterations to immovable property are taxed at the special rate of 5 percent.

In general, the letting of land is exempt from VAT unless the leasing of immovable property amounts to the disposal of an interest in such property as mentioned above. Exceptions to this rule include:

(1) letting in the course of carrying on a hotel business

(2) letting of machinery or business installations when let separately from any other immovable goods

(3) provisions of parking facilities

(4) the hire of safes

Rents receivable on leases of less than ten years are considered supply of services and are generally exempt; however, any lessor of land and buildings may waive exemption. For periods of at least ten years, a supply of real estate is said to have taken place. In this case, the supply is subject to VAT.

ITALY

Generally, the supply of immovable property by an entrepreneur within the scope of the activities of a business enterprise is subject to VAT at the standard rate. Exceptions include:

(1) unimproved land which cannot be used for building projects

(2) the allocation of low value dwellings to members of a qualifying building cooperative society

Thus, new housing sales and building land are subject to tax. Repairs, maintenance and improvements undertaken by a third party are also taxable but self supply of these services is not taxable. A registration tax is also imposed on the transfer of immovable property.

The leasing or renting of immovable property is exempt from VAT but financial leasing is an exception. Likewise, the letting of real estate is VAT exempt, except: hotel accommodation, the letting of installed equipment and machinery, and the hire of safes. Parking spaces are not subject to VAT. Moreover, entrepreneurs who lease immovable property to other entrepreneurs can opt to waive the exemption.

LUXEMBOURG

Supplies of immovable property are generally exempt from VAT but new dwellings built by the entrepreneur under a sale or construction agreement are taxed at the standard rate. Entrepreneurs supplying immovable property to other entrepreneurs can also opt to waive exempt status (providing the property is to be used in a taxable event). Supply and transfer of rights in immovable property (except supplies of property pursuant to a building contract) are liable to registration duties. Repairs, maintenance and improvements to buildings undertaken by third parties are taxable; however, self supply of these are exempt.

Leasing immovable property is exempt from VAT. Transactions taking place between registered taxpayers are permitted to be taxed if both parties agree (except for dwellings). As in other countries, hotel accommodation, the letting of permanently installed equipment and machinery, spaces for parking vehicles and the hire of safes are taxable.

NETHERLANDS

In the Netherlands, the supply of immovable property is generally exempt, but the supply of newly built immovable property is taxable (including land) if the supply takes place before, on, or at the latest, two years after it was used for the first time (taxable at the standard rate). Although the property is exempt after two years, an option exists whereby the exemption may be waived. It should be noted that "newly built" immovable property does not mean that a complete new building has been built; rather, major alterations to a building can constitute "newly built" property and thus be taxable. Nonetheless, if a transfer of immovable property is not subject to VAT, a real property transfer tax is levied.

The leasing of immovable property is generally considered a supply of services to which an exemption from VAT applies. An option is available whereby the leasing transaction can be taxable providing the entrepreneur and tenant agree (this does not apply to dwellings). Activities always subject to tax include:

(1) accommodation for tourism and travel business

(2) machinery and business installations

(3) parking spaces

(4) safety deposit boxes

NEW ZEALAND

In October 1986, New Zealand implemented a VAT-type tax called the Goods and Services Tax (GST). The treatment of real estate and housing is as follows. Since land is not "consumed" in the normal sense, the supply of land (excluding buildings), is not be liable to the GST. Concerning the construction of new buildings, the GST is levied (at the standard rate) on the price charged in respect of any alterations and additions to, and maintenance of a building. Registered persons using the building for business purposes are permitted to deduct the GST. VAT applies to the sale price of existing homes; however, sales made by non-registered persons are not taxable and thus, the transfers of most old housing escapes the tax (Due, 1988). The sale of existing buildings used in a taxable activity by registered persons, is treated in the same manner as other taxable supplies made by registered persons. Thus, the purchases of commercial facilities, old or new, are taxed and purchasers receive a credit. However, the purchase of an existing building by a registered person from a non-registered person will be treated according to the rules governing second hand goods. These rules provide for the registered person to obtain an invoice from the seller showing the name, address, purchase price, quantity and description of the goods bought. In this way, the dealer may calculate the GST included in the purchase price and offset it against the liability for the period. If sufficient supporting evidence is not available, the registered person may not claim a deduction. Thus, registered persons who purchase used goods will not need to treat those goods differently from new goods for GST purposes.

Residential rent is not included in the GST tax base. The rental of business accommodation (including parking facilities) is considered a taxable supply. If the tenant is a registered person, the tax is deductible. The supply of services in connections with the provision of short term accommodation (e.g. hotels, motels, guest rooms and camping grounds), is liable to GST. This applies if the stay does not exceed four weeks. In the case where the stay exceeds four weeks, only services other than the provision of accommodation (e.g. laundry and meals) are subject to the tax.

NORWAY

Real estate (comprising land and the buildings on it) is not considered to be "goods". However, services rendered in relation to immovable property, including the construction of such property are taxable. Once a building is finished and it is used by an entrepreneur within a business, VAT paid on the construction may be credited against the VAT due on his turnover of taxable sales. This credit is not available if the building is used for exempt activities. Purchases of repairs and maintenance services, as well as material, are taxable.

The leasing of immovable property (land or buildings) is not subject to taxation. Only the hiring out of goods, machines and equipment associated with real property are taxable. Therefore, the letting of hotel rooms are exempted. This exemption covers the maintenance and upkeep of a building as long as such items are included in the rent.

PORTUGAL

The supply by building contractors of new or restored buildings or parts thereof with the pertinent piece of land is subject to a transfer tax and is exempt from VAT. Construction works however, (including the transforming of undeveloped land into property suitable to be built on, or erecting a new construction or restoring an existing one), attracts VAT. A reduced VAT rate is charged to construction services supplied to domestic cooperatives engaged in construction and housing development. Entrepreneurs are permitted to waive the right to exemption. The sale of old housing is exempt from VAT but the supply of urban and rural immovable property is subject to a transfer tax regardless of whether the property is a building plot, a new or old building, or a piece of undeveloped land and whether or not the supply is made by an entrepreneur or a non-entrepreneur.

The leasing, (including financial leasing) and renting of immovable property is exempt from VAT. Exemptions may be waived if both parties are entrepreneurs. However, the following transactions are subject to VAT:

(1) hotel letting

(2) facilities for camping in tents and caravans and for the collective parking of vehicles

(3) letting of safes

(4) facilities designed for exhibition and advertising

(5) letting of permanently installed machinery and equipment separately from any other immovable goods

(6) the leasing of immovable property resulting in a transfer for consideration of the right to exploit a business or industry

SPAIN

In Spain, VAT applies to the construction of buildings and parts thereof. The supply of building land and the first supply of a building, are taxable transactions (even if this type of transaction is carried out on an occasional basis). Domestic housing is taxed at a lower rate whereas other sales are subject to the standard rate. Supplies of "old" buildings (after the construction or restoration works have been completed) are exempt from VAT. Moreover, transfers of land located within areas of urban expansion to land development boards and the allocation made by such boards of such land, after subdivision, to such owners are exempt. Article 6.2 of Spain's VAT laws provides also for the taxation of the performance of construction work where more than 20 percent of the taxable base of the supply is attributable to materials provided by the entrepreneur for the construction.

The letting of immovable property by entrepreneurs is considered a supp v of services in the case of the following: commercial buildings, business premises or factories. These constitute taxable transactions. The letting or leasing of land and residential dwellings are exempt (except as mentioned above). However the following are considered taxable supplies of services,

(1) the letting of sporting and recreational facilities
(2) the letting of facilities in trade fairs and exhibitions
(3) the provision of facilities in hotels, restaurants and camping
(4) spaces for parking
(5) warehousing and storage facilities

(5) the letting of developed land and land in the process of being developed

The letting of rural or undeveloped land is exempt. Residential dwellings are exempt from VAT.

SWEDEN

In Sweden, sales of immovable property are exempt from VAT but construction services are taxable. These services are taxed at reduced rates (e.g. levelling, soil improvement, blasting and drilling). For services rendered in relation to building construction and other services concerning real property, the taxable value is equal to 60 percent f the consideration received or sales value.

The leasing of immovable property is not normally taxed. But, the letting of temporary furnished accommodation constitutes a taxable service. Moreover, the letting of buildings or premises, or the assignment of a lease to a taxable business could be subject to tax. That is, the property owner may wish to be subject to VAT on the letting of buildings and immovable installations to taxable entrepreneurs for use in their business. Thus, the owner may credit VAT charged previously for construction, maintenance and repair against the VAT charged by him on the lessee. If the lessor has opted to be taxable on the letting of a building, the taxable base is 60 percent of the market value.

TURKEY

In Turkey, building contractors are liable for VAT in accordance with the general rules. The supply of residences less than 150 square metres in area, and deliveries to "house building cooperative societies" are exempt from tax until December 31, 1992. Residences over 150 square metres in area are liable to VAT. Furthermore, the supplies of immovable property for commercial, industrial, agricultural or professional use are taxable. Tax is applied at the standard rate

Leasing of immovable property is taxable only in the case of industrial, agricultural and independent professional activities.

UNITED KINGDOM

For a person constructing a building, or if someone has commissioned another person to construct a building, and he grants a major interest in the building, the dwelling is zero-rated (this includes the land). In addition, the supply of certain services connected with the construction are also zero-rated, as is the supply of building materials connected with the construction. If, however, a real estate transaction is connected with the business of the supplier, it is liable to VAT (except as mentioned, the construction industry). Other land transactions (including the buildings on the land), are exempt. Furthermore, self-supplied repairs, maintenance and improvements are exempt. Repairs and maintenance undertaken by third parties are taxable.

The leasing and letting of real estate is exempt unless it is a hotel, boarding house, parking or camping space. Maintenance and repairs are taxable unless they are included in the rental fee. An indirect tax is levied on the rental value of land and buildings known as "rates". The letting of installed equipment and machinery and the hire of safes are exempt.

TABLE A:1

VAT TREATMENT ACCORDED THE SUPPLY OF IMMOVABLE PROPERTY

COUNTRY	BUILDING LAND	NEW BUILDINGS	OLD BUILDINGS
Austria	exempt	taxable	exempt
Belgium	exempt	taxable	exempt
Denmark	exempt	exempt	exempt
France	taxable	taxable	exempt
Germany	exempt	exempt	exempt
Greece	taxable	taxable	exempt
Ireland	exempt	taxable	exempt
Italy	taxable	taxable	exempt
Luxembourg	exempt	exempt	exempt
Netherlands	exempt	taxable	exempt
New Zealand	exempt	taxable	exempt
Norway	exempt	exempt	exempt
Portugal	exempt	exempt	exempt
Spain	taxable	taxable	exempt
Sweden	exempt	exempt	exempt
Turkey	exempt	taxable	exempt
United Kingdom	exempt	zero-rated	exempt

Note: These rules are general in nature. For details on exceptions to these rules, the descriptions by individual country should be consulted. Also, in some countries, immovable property is exempt from VAT but subject to other forms of taxation. See Appendix B for further descriptions of these various levies.

TABLE A:2

VAT TREATMENT OF RENTS RESULTING FROM LEASING AND LETTING

COUNTRY	LEASING AND LETTING
Austria	taxable
Belgium	exempt
Denmark	exempt
France	exempt
Germany	exempt
Greece	exempt
Ireland	exempt
Italy	exempt
Luxembourg	exempt
Netherlands	exempt
New Zealand	exempt
Norway	exempt
Portugal	exempt
Spain	exempt
Sweden	exempt
Turkey	exempt
United Kingdom	exempt

Note: These rules are general in nature. For details on exceptions to these rules, the descriptions by individual country should be consulted.

APPENDIX B: DESCRIPTION OF SELECTED LEVIES ON HOUSING AND OTHER FORMS OF IMMOVABLE PROPERTY

Appendix A was chiefly devoted to a discussion of VAT provisions which define the tax base for housing and other forms of immovable property in OECD countries. It was noted that many countries give some tax relief to property through full or partial exemptions or tax buildings and/or land at a lower than standard rate. For example, rents are rarely taxed and sales of land and old buildings are generally exempt under value added taxes. Even new buildings, which are included in the VAT base in many countries, are sometimes assessed or taxed at a lower rate than most goods and services. In addition to the U.K.'s system of taxing the entire value of housing at a zero rate, Ireland and Italy levy a lower than standard rate against the sale of new housing. Sweden aids new housing by including only 60 percent of the value of construction services in the base and France subjects building land to VAT after a 30 percent reduction has been applied to the base. In some countries such as Norway and New Zealand, the VAT is also partly offset through the use of subsidy programs for purchases of new housing.

Returns to investments from residential property are also given some tax relief in comparison to other forms of income under personal and corporate income taxes. Capital gains from the sale of owner-occupied housing are generally exempt and imputed rent is rarely taxed by personal income levies. Moreover, mortgage interest is an allowable deduction when calculating taxable income in some countries. The effective rate of tax on investments in rental property is also often reduced by general provisions for buildings such as accelerated capital cost allowance schemes and investment tax credits, and by special provisions such as the deduction based on gross rental income in France.

There are, however, special taxes on property levied in all countries and some nations offset the effect of granting tax relief from value added taxes through transfer taxes levied when property changes hands. Property taxes, typically administered by local governments, are generally employed and even though housing is granted some relief in relation to commercial property, residential property is discriminated against when compared to other expenditures.

Most countries exempting the sale of land and buildings from VAT, collect revenue from these transactions through transfer taxes. In effect, these turnover taxes cascade throughout the system with each subsequent resale of the same piece of property. Generally, however, residential property (particularly low-cost social housing), is given relief through exemption from these duties (Portugal, Spain, Germany) or is taxed at lower rates (France, Belgium, Turkey). More information on these transfer taxes and other selected levies that pertains to property is provided for each country in the following pages. (More detail can be found in OECD 1984, OECD 1985, Canadian Home Builder's Association 1987)

AUSTRIA

An immovable property acquisition tax is levied on transfers of title of immovable property in Austria. The normal rate for this tax is 8 percent; however, a decreased rate of 7 percent is levied on those transfers of immovable property with values not exceeding $9,600.

BELGIUM

A registration duty is charged to title acquisition of immovable property. The standard rate is 12.5 percent but other rates may apply.

DENMARK

Stamp duties are levied on the transfer of immovable property. Moreover, the Land Tax and Service Tax is charged to real estate in Denmark. The Land Tax applies to all privately owned property and is levied at varying rates (0-5.5 percent for municipalities and 1.5 percent for counties).

The Service Tax is applied to publicly owned property and the value of buildings on business property (1 percent on land and business property, public buildings are taxed at a rate of .5 percent by municipalities and .375 percent by counties). Moreover, immovable property may be subject to a land registration duty.

FRANCE

In France, the purchase of land with no intention of developing it within four years, attracts a 16.6 percent registration fee (in place of VAT). Furthermore, other taxes ar levied on property:

(1) Land and Buildings Tax - the tax base is the rental value of the property with a deduction of 50 percent from this amount for residential property (average rate of 18.05 percent in 1980).

(2) Property Tax - is levied on the rental value of dwellings and their dependencies (average rate of 16.13 percent in 1980).

(3) Land Tax - the tax base consists of the rental value less 20 percent.

(4) Local Infrastructure Tax - applies to the construction, reconstruction and enlargement of buildings (1 percent of the value, although rates

of up to 5 percent may be charged).

GERMANY

The supply of immovable property is subject to the immovable property acquisition tax (this applies to new buildings, existing buildings and unimproved land). The rate charged is 2 percent (down from 6 percent since January 1983). Also, a real property tax is levied on agricultural and forestry establishments and on developed and undeveloped real property (.6 percent of the capital value of agriculture and forestry, .26 percent of the capital value of single family houses, .31 percent of the capital value of two-family houses and .35 percent for miscellaneous property).

GREECE

The Transfer of Immovable Property Tax (TPT) is charged in those cases where VAT does not apply.

IRELAND

A stamp duty is levied as follows:

(1) on deeds of conveyance (where the land is unregistered) or deed of transfer are taxed from zero for sales up to $1,800, to 6 percent for property over $89,500.

(2) leases - the stamp duty on the annual rent varies according to the length of the lease and the rent received.

In addition, another tax on immovable property known as Rates, (similar to the Canadian Property tax) is levied.

ITALY

A registration duty is imposed on contracts for the transfer of immovable property at the rate of 10 percent. The rate is 15 percent for transfers of rural land, subject to certain exceptions. Also, the tax due is limited to $44.80 if the transaction is also subject to VAT. Transfer and cadastral taxes are charged to transfers of immovable property at a rate of 2 percent (in cases where the transaction is also subject to VAT, the amount due is fixed at $45.00).

LUXEMBOURG

Registration duties are charged on the transfer of land and buildings. Also, mortgages are subject to duties.

NETHERLANDS

Where a transfer of immovable property is not subject to VAT, the real property transfer tax comes into effect. The base of this tax is the sale price of the transfer or the market value if this figure is higher (rate of 6 percent). Moreover, a Municipal Tax is levied with a tax base of either the real unoccupied capital value or floor space of the building.

NEW ZEALAND

A stamp duty is levied on exempt real estate sales. Also there are two taxes on immovable property [illegible] New Zealand - Rates and the Land Tax. The base for Rates may be:

(1) annual values of properties

(2) capital values of properties

(3) land values of properties

It is up to each local authority to choose a base for its surrounding area (rates of up to no more than 18 percent on annual values and 1.25 percent on capital values). The beneficiary of the Land Tax is the central government. Included in the base are land values and values of all improvements up to ground level. Land values below $134,610 are given zero tax bases, values between $134,610 - $269,220 are given tax bases of $1.53 multiplied by V - $175,000 (where

V is equal to the land value), and properties valued over $269,220 are taxed on bases equal to their land value. As of 1982, a flat rate of 2 percent is charged on the taxable value.

PORTUGAL

The principal tax on immovable property in Portugal is SISA (capital transfer tax) which is levied between 8 and 10 percent. The base is usually the sale value of a transfer; however, if the property is thought to produce a taxable income exceeding 5 percent of the sale value, the base may be set at that income level multiplied by twenty.

SPAIN

The base for the Rural Land Tax is the presumed net income from agricultural property or the real or potential income (rate of 10 percent). The Urban Land Tax is levied on the real or potential income from land and urban buildings (rate of 20 percent). Also, a property transfer tax is charged to: second or subsequent transfers of urban immovable property and rights in rem over such property, excluding guarantees and any transfer of rural and undeveloped land, at a rate of 6 percent.

SWEDEN

Various taxes on immovable property exist in Sweden:

(1) Municipal Guarantee Tax - properties are valued at 75 percent of their market value. Municipalities levy a tax of 1.5 percent to this value.

(2) Standardized Income Tax - is levied on the following groups:

a) owners of detached and semi-detached dwellings - these owners have their taxable incomes raised by a percentage of the assessed value of their property.

b) tenants - owners ; ocieties and their members - taxable income is raised by three percent.

c) public utility housing companies - taxable income is increased by three percent.

(3) Forestry Levy - is levied on agricultural properties provided the properties are not exempt from the Municipal Guarantee Tax and provided their assessed value includes an allowance for forestry (rate is .3 percent).

TURKEY

An Immovable Property Tax is imposed on the capital value of buildings, land or land plots at varying rates.

Furthermore, a Real Estate Capital Gains Tax is charged to the change in capital value of land, land plots and buildings situated thereon (differing rates apply). Also, immovable property is subject to a Real Estate Purchase Law tax.

UNITED KINGDOM

The main tax on immovable property in the United Kingdom is known as Rates. The tax base is a property's Rateable Value (i.e. an estimate of the net annual value at the time of valuation). Also, a Development Land Tax is exacted on the amount of development value realized in the disposal of an interest in land. In addition, general stamp duties apply to transfers of immovable property.

FOOTNOTES

1. Assume the following information:

	Owner Occupier	Renter
Money Income	$18,000	$20,000
Imputed rent	2,000	
	$20,000	$20,000
Rent	-	5,000
Housing expenses (including VAT)	3,000	
Imputed rent payments	2,000	
Expenses on housing	$ 5,000	$ 5,000

This example shows that renters and owner occupiers are treated equitably under the zero-rating plan. If owner-occupiers consume more housing and less of other goods than renters, horizontal inequities would, of course, result.

2. Assume the following information:

Case I - All Housing Excluded

	Individual 1	Individual 2
Total Consumption and income	$20,000	$20,000
Expense on Housing	5,000	10,000
Expense on other commodities	15,000	10,000
VAT (10%)	$ 1,500	$ 1,000

Case II - Old Housing Excluded
New Housing Taxable

	Individual 1	Individual 2
Total consumption and income	$20,000	$20,000
Expense on old housing	10,000	
Expense on new housing		10,000
Expense on other commodities	10,000	10,000
VAT (10%)	$ 1,000	$ 2,000

In this illustration the difference in tax burdens is largest in Case II, where old housing is excluded but new dwellings are taxable. In the short-run, the incidence of the tax may rest on producers of new housing rather than consumers. In this situation the inequity occurs on the sources of income rather than with the uses of income.

3. The reader should be aware that the relative magnitudes presented in the following paragraphs are very speculative. They are "back of the envelope guesstimates" designed to give the reader some perspective on the likely differences between the measures rather than providing reliable estimates of revenue yields.

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