

COMMENTS ON VAT AND HOUSING

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I would like to expand on Option A as developed in this paper, which might amount to standard VAT treatment of housing with one exception. Let me first note that anyone who believes a VAT is easier to administer than a true accrual-based income tax should read this paper. The need for complex definitions is apparent, given the different facts and circumstances related to real property.

My proposal is based on an idea I developed almost 20 years ago (Conrad 1990) called the First Sale VAT,¹ variants of which appear to have been adopted in some countries. This proposal was modified by Conrad and Grozav (2008) and is quite similar to Mr. Poddar's proposal, with one exception and with added administrative details. I believe my proposal, or alternatively Option A, can be implemented in the United States if a decision is made to implement a VAT. The steps include:²

1. Tax all transactions of real property, preexisting or new. There should be no difference in the VAT taxation of real property and fresh green beans or new shirts.
2. The administration of the VAT on real property would be similar to the administration of the VAT on imports (VAT on imports is administered by the customs department).
 - a. In like fashion, VAT would be imposed on real property at the time of supply, defined as the date of closing in the United States.
 - b. If the seller is a VAT taxpayer, nothing happens because that person would have received a credit at the time of purchase.
 - c. If the seller is not a VAT taxpayer, then the seller receives a credit on the closing documents for the inflation-adjusted VAT paid at the time of purchase, with any positive balance accruing to the government.

Given the current title system in the US, I believe the proposed system can be administered. The VAT paid on the date of closing can be recorded in the closing documents and on any deed of trust and, thus, there should be a record of the VAT paid even years later. Inflation

¹ Only the first sale of real property would be taxed under the First Sale VAT. This proposal was based on the full tax prepayment approach and has some theoretical appeal. The first purchaser of an asset would prepay the full VAT for that and all subsequent purchases. Mr. Poddar's concern about changes in relative prices (capital gains) should not be an issue (except perhaps on distributional grounds) because the capital gain would be treated like a capital gain of any asset (such as a marketable security). That is, if the seller consumes the capital gain, then VAT would be paid; if the seller purchases another type of asset, defined as saving, then VAT would be deferred.

² See Conrad and Grozav (2008) for a more complete discussion.

indexation is not a problem. If a mortgage can be amortized in the closing documents, then a published list of the values of the GDP deflator can be used to compute the price adjustment.

The essential difference between the Poddar proposal and the Conrad-Grozav (2008) proposal is the practice of indexing the initial purchase for inflation. I believe inflation indexing is necessary in order to preserve the neutrality of the VAT on real property. For instance, if a real estate agent purchases and resells property in 2009, that person should be a VAT taxpayer and should receive a full credit for the VAT on the purchase in 2009. In similar fashion, a taxable person who purchases a machine used to produce output should receive a credit in 2009 for the full value of the VAT paid, even though the machine may last for a number of years. Such treatment is necessary in order to preserve the consumption basis of the VAT. A nonregistered person who purchases a residence and then sells that residence some years later should be afforded the same treatment in real terms. In effect, the VAT credit is tied to a specific taxable activity (the purchase and sale of a specific asset) and deferred until the sale of that asset, which may be years after the time of purchase.³

Unlike full tax prepayment, with either Mr. Poddar's Option A or Conrad-Grozav's 2008 proposal, the VAT on real property becomes a type of capital gains tax on a realization basis. For instance, if the relative price of housing does not change between the purchase and sale dates, then the net VAT to the government will be zero with the tax-inclusive adjusted basis of the property transferred to the new owner. Thus, the VAT on housing maybe a step in the right direction toward developing a "new," perhaps even "modern," income tax.⁴

This proposal and Mr. Poddar's Option A are really based on four practical aspects of the VAT that may make either proposal preferable to a theoretically pure First Sale VAT.

1. First, the VAT as applied is not really a tax on consumption in any economic sense. In fact, I believe the VAT is not even a tax on consumption expenditures. Consumption for economic purposes is defined as a flow. Housing, cars, light bulbs, and even canned green beans are stocks, not flows, and thus any such purchase is really an investment decision. The decision to buy housing, relative to the S&P 500, cars, light bulbs, or canned green beans is based on the computation of the net present value of the consumption benefits that will accrue from making the purchase. This means that the theoretical concept of consumption and saving (or investing) is really an issue about whether to purchase stocks relative to flows. Whether it is more productive for a consumer to allocate part of her portfolio of stocks to investing in housing, or plant and equipment relative to the S&P 500 or a lawn mower is really not a call an economist, at least this economist, can make. That decision depends on relative returns (measured in terms of future consumption) and risks. The bottom line of this point is that all the

³ Note the similarity between this type of transaction and a cash basis VAT. In general, a VAT must be administered on an accrual basis in order to be effective. The treatment of real property for non-VAT taxpayers would be one, and I believe the only, exception to this rule.

⁴ The fact that the VAT is legally paid by the purchaser is immaterial. Under a capital gains tax on a realization basis, the seller is liable for the tax and will simply try to shift the tax forward.

neutrality results about consumption taxes, in general, and the VAT, in particular, do not generally apply to the VAT in practice.⁵

2. Second, housing is a mixed-use stock. That is, owner-occupied housing is used for both consumption and investment. Like a miser who buys equities and bonds and then follows them every minute of every day, there is both investment and consumption value to the purchase of stocks. How the consumer values the consumption relative to the investment benefits is the consumer's problem. The applied economist or the tax administrator, however, cannot make such distinctions because they must rely on observable data. If the real relative price of housing has changed during the holding period, then there has been a real gain or loss. Thus, Mr. Poddar's proposal about not giving a refund in cases where the real relative price falls is incorrect in my view. The proposal is equivalent to taxing net gains while not allowing losses.
3. Third, one common concern about imposing a VAT on pre-existing assets that a lock-in effect will be created. I note two things about this problem. First, the problem arises because the tax is imposed on a realization, not an accrual basis. I've been giving thought about how to impose an approximation of a true income tax on an accrual basis and believe it is practical for the most part. Owner-occupied housing is an exception under any income tax that can be administered and there will always be a lock-in effect. Second, the lock-in effect is really a special case of a general problem, if you want to call it a problem, with the VAT: the way a nonregistered person avoids paying the VAT is to not purchase taxable goods and services.⁶ Under a VAT, nonregistered persons will have an incentive to eat at home rather than in restaurants, watch TV instead of going to the movies, make their own clothes rather than buy, and even mow their own grass. That is, consumers are given an incentive to "save," with saving as a practical matter defined as any non-taxable activity including own consumption of household production.
4. Fourth, housing in the United States is tax favored because much or all of the capital gain is exempt. Housing is favored because it is the only non-investment interest expense that is deductible. This deductibility provides an incentive to leverage housing: witness the development of the second mortgage market after the 1986 Tax Act.⁷ If the United States does not change this policy and a VAT is implemented, then imposing a

⁵ Even the tax prepayment approach may have different effects depending on changes in relative prices. For instance, consider the choice of purchasing relative to leasing housing (or a light bulb). In theory, the present value of the VAT on the lease would be equal to the present value of the purchase. Relative prices change, however, and thus the present value of the flow ex post will not in general equal the present value of the prepayment. This is really an issue of risk bearing and whether the potential user prefers to bear the risk on a purchase price or on a flow basis.

⁶ This fact may be one difficulty in getting a VAT imposed in the US during the next few years. There is an effort to provide incentives to increase consumption given the economic situation. A VAT would create an offsetting incentive.

⁷ Interest should be deductible from an income tax. Thus, housing is tax favored because interest on credit cards, auto loans, and other noninvestment related credit is not deductibility.

VAT as proposed under either Mr. Poddar's Option A or the Conrad-Grozav (2008) proposal would provide one method to offset this distortion in the income tax.

I close with two general points. The current United States income tax system has several consumption taxation elements, including qualified retirement accounts. In addition, it is not clear whether the US corporate tax or the taxation of capital income, however defined, in general, offsets the net consumption tax basis for some, if not most, Americans. These elements combined with interest deductibility for housing may create negative marginal effective tax rates not just for housing, but for all stock purchases. This raises the issue of whether it is better to fix the income tax system to make it closer to a consumption base (if that is the policy decision), rather than imposing a completely separate tax on effectively the same base. Adjusting for any progressivity concerns, it may be the case that the only economic justification for imposing two taxes on the same base is to increase the probability of collecting the single tax once. Running a second transaction-based tax, however, creates additional administrative costs and thus it may be better to simply move the current US tax system to a full consumption basis, again, if that is the policy decision. There might be fewer adjustment costs because US taxpayers are already familiar with the current regime.

Finally, I have reservations about the need for a VAT in the US on either administrative or efficiency grounds. I have worked on implementing VATs in a number of countries and have viewed the VAT as a long-term transition to an income tax. The VAT is not a modern tax in any sense of the term. It was developed at a time when there were no computers, record keeping was less sophisticated, and tax administration was underdeveloped. Thus, I have viewed and continue to propose the VAT as a way to develop a tax administration capable of administering an income tax on a more or less accrual basis. In addition, one familiar justification for imposing a VAT in developing countries is that the VAT, while it can be elastic, is not as elastic as, for instance, a flat-rate income tax with an exemption. Thus, the proportion of VAT revenues to total revenues should fall with economic growth and increases in real incomes. According to this view, the fact that Canada and Australia have adopted a VAT means (abstracting from federalism issues) that they have joined the ranks of the relatively incapable, either politically by reducing taxation of income on a residence basis or administratively.⁸ The US might have to admit defeat, but it should do so only after looking seriously at alternatives to taxing income on an accrual basis that can be administered. Or alternatively, moving to an accrual based income tax as part of a VAT – Income tax reform. I believe stocks and flows in the housing sector are indicators of a more general issue about any second-best analysis of neutrality. That is, it is difficult to shift a tax base further toward one stock, the stock of human capital, as is the policy intent of the VAT, and make any claim about neutrality or of increasing economic efficiency.

⁸ The fact that the VAT's share of total revenue may not have fallen could result from changes in both the structure and the rates of the income tax.

Sources

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