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TITLE PAGE

Homeownership taxation in Flanders: moving towards 'optimal taxation'?

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Homeownership taxation in Flanders: moving towards 'optimal tax'?

Abstract Belgium devolved administrative and budgetary responsibility for the favourable income tax treatment of owner-occupied dwellings to its administrative regions in July 2014. This change allowed the regions to redesign their housing-related tax instruments. This paper examines a tax policy reorientation of the Flemish Region according to the principles of the optimal tax theory based on the proposals of the British Mirrlees Review. These principles are used as a benchmark to determine whether owner-occupied housing is treated favourably via the tax system in Belgium. A brief comparison is also carried out with four other countries (Denmark, Germany, the Netherlands and the United Kingdom) in order to test for the use of these theoretical principles in other tax systems. Since none of the countries come close to optimal taxation and the Mirrlees Review is not uncontested, practice-based recommendations of international organisations are also taken into consideration. It has been determined that, recently, the Belgian tax system and more specifically Flemish homeownership taxation moved closer to what optimal taxation could be, but that this did not come about by explicitly considering the mechanisms of the tax system.

Keywords Homeownership, Income tax, Mirrlees Review, Optimal Tax Theory, Neutrality

Introduction

It is well-known that countries have favoured and often still favour homeownership in their income tax system (Bourassa & Grigsby, 2000; Hendershott & White, 2000; Ter Rele & Van Steen, 2003). This has also been the case in Belgium (De Decker & Geurts, 2003). Up to and including June 2014, the federal government mainly subsidised homeownership via personal income tax while the administrative regions of Flanders, Brussels and Wallonia (regions hereafter) had and still have authority for real estate transaction tax and immovable property tax (Haffner et al., 2014). They are, however, entirely responsible for their own housing policies. In Flanders, the region on which this contribution focuses, this mix in policies and taxation levels was one of the drivers behind the size of the owner-occupied sector, accounting for 70%, as figure 1 shows. The tenure distribution between the five countries studied in this article and Flanders indicates that the market share of homeownership in Flanders and Belgium, together with the United Kingdom (UK), is relatively high compared to the Netherlands, Denmark and Germany.

[FIGURE 1 TO BE INSERTED]

Homeownership policies in Flanders and Belgium receive broad-based support among the public and politicians,¹ even though it is also well-known that tenants face poorer housing outcomes than homeowners (Winters et al., 2015). The Flemish Housing Council, which is the official advisory board of the Flemish government in the matter and which consists of housing experts and representatives of the most important stakeholders, endorses the line of reasoning that housing policies should be more effectively targeted at tenants and vulnerable households (Vlaamse Woonraad, 2011, 2013). One of the main obstacles for the Flemish government in attempting to change the situation in the past has been that its total budget available for housing policy is far less than the federal budget for tax benefits to homeowners. However, since July 2014, further to the Sixth State Reform of Belgium, the regions have been allowed to design their own tax policies for owner-occupied housing.

This contribution analyses the direction of potential reforms if the conceptualisation of optimal taxation is adopted. To be able to draw a conclusion in this respect, the next section provides background information on Belgian taxation of owner-occupiers within the context of housing taxation. This is followed by the principles recommended by the prestigious British Mirrlees Review on optimal taxation. After this, taxation of owner-occupied housing in Flanders is compared to the recommendations as they would apply to owner-occupied housing. The recommendations are also compared to taxation approaches in the countries referred to in this study (figure 1) in order to be able to state whether these principles are applied more widely. As the Mirrlees Review is not uncontested, especially as regards its conclusion pertaining to zero tax on normal income from wealth, in our analysis we cover other recommendations as well. Aiming to promote economic growth, the European Commission (EC) and the OECD recommend a shift from the taxation of labour to the taxation of capital and consumption (European Commission, 2012; OECD, 2010, 2015). These recommendations were integrated when formulating our alternatives for tax design in Belgium and

¹ Background information can be found in Winters (2013). In contrast to that publication, which presents a history of Flemish housing policy, the present contribution focuses on the favourable treatment of homeownership by the tax system. Both publications take as their point of departure the recent transfer of responsibilities from the national level to the regional governments.

Flanders. In the last section, we briefly describe the political process in Belgium and Flanders that led to certain recent adjustments of the tax treatment for owner-occupied housing.

Taxation of homeownership in Belgium

The European Commission (2012) distinguishes four types of taxation on housing levied in many countries. These four types are briefly discussed and then linked with policy in Flanders. The term housing implies that the tax is not just relevant for owner-occupied housing.

Transaction taxes are a type of tax that may be levied on an ‘investment’ activity. It is usually levied only once on the transaction for a property and exists in many member states of the European Union (European Commission, 2012). According to Cnossen (2010, p. 83), “the rationale for these taxes, which have not been harmonised [in the European Union], is weak.” Such a tax levied on a transaction can be considered easy prey.

This statement also applies to Flanders as it levies ‘registration duties’ on any purchase of an existing dwelling (table 1). Compared internationally, the standard tax rate in Flanders (10%) is high. However, as a consequence of lower rates for affordable dwellings (5%) and social dwellings (1.5%), as well as a number of exemptions and the ‘portability’ of taxes when moving house, the average tax rate is lower.

Value Added Tax (VAT) is levied on added value for consumption. This tax has been harmonised in the European Union further to the Common VAT Directive of 2006. It specifies the uniform basis for the application of VAT and determines the goods and services on which VAT should be levied. In the case of housing, it should be levied on the housing services that the occupant is consuming, as these are new and so imply added value during a certain period. VAT should be levied on the price for this added value, the rent or the imputed rent. The latter is fictitious income that the owner pays to himself as occupant. As levying a monthly VAT amount on housing consumption would involve a huge amount of administration, countries do not levy VAT on housing services but rather on the purchase of the new dwelling:

since the purchase price of a dwelling may be taken to represent the present discounted value of its future services, by extension the VAT on the purchase price may be considered a good proxy for the discounted value of the VAT that should have been levied on the flow of housing services. (Cnossen, 2010, p. 74; see also McDaniel & Surrey, 1985)

This is the usual way forward for housing: a once-only VAT levy at the time of acquisition of a new dwelling (or on materials or renovation or repair works). It can be regarded as an approximation of the periodic (monthly) tax on consumption (rent or imputed rent). Cnossen (2010, p. 77) calls it no more than a “second-best substitute”, as revenues will be missed out with regard to future changes in house values.

Nevertheless, Belgium also levies the standard VAT rate of 21% on the purchase of a new dwelling (table 1). It allows for lower rates for social housing (6% or 12%), as well as for repairs and renovations on dwellings (6%) over a certain age.

Taxation of capital income through income tax is based on an investment good approach (Poterba, 1984). It implies that the dwelling, as an investment, creates income by delivering housing services that can be consumed by the owner-occupier, who is considered to be receiving income in kind (imputed rent), or by a tenant who pays for the services in cash. From this investment point of view, the owner of the dwelling will have to pay income tax on the profits that the dwelling generates. These profits consist of net income from renting the dwelling. Income from renting takes the form of rent paid by the tenant or of an imputed rent. For landlords, income may be determined based on actual profits (rent income minus costs) or imputed profits. For owner-occupiers the income must be determined as imputed income (imputed rent), while costs can either be determined based on actual costs (which require administration and control) or again based on imputed costs (which allow for simplicity in administration). Apart from rent and imputed rent, from an investment point of view, capital gains (or losses) can also generate taxable income from dwellings. Contrary to the investment approach and for practical reasons, the so-called consumption good option is sometimes chosen: in this case, neither owner-occupied housing income nor housing costs are taken into account when taxing income (OECD, 2010).

In Belgium, income from dwellings is taxed in a rather complex way which differs according to tenure. For owner-occupiers the rules changed in 2005. Before that year, a partial investment approach engrained in national income tax had been followed. The tax was levied on the 'cadastral income', a measure for imputed rent on income from the property. Interest costs from mortgage loans could be deducted, but capital repayments (not to be considered as costs) were also deductible. This cadastral income was determined in 1975 and, except for a yearly indexation since 1991, was not updated thereafter. As a result, it underestimates the market value of a dwelling while also failing to reflect price evolutions and price differences between regions. Since 2005, the imputed rent for owner-occupiers is no longer taxed through income tax, while the deductions that were available before 2005 (e.g. for mortgage interest and mortgage repayments) have been remodelled into a new lump sum deduction called 'woonbonus'. This change in the tax relief system of 2005 nearly doubled the average subsidy per household (Damen, Vastmans & Buyst, 2014; Heylen & Winters, 2012). Capital gains in Belgium are not taxed, except in case the dwelling is sold within five years of the purchase date, a rule which was introduced to counter speculative sales.

Last but not least, another popular tax on housing in the European Union is the periodic **property tax** connected to the location of the dwelling. It can be described as a user charge or benefit charge (European Commission, 2012, Wood & Ong, 2012). The idea here is that consumers are able to choose the level of local services that they prefer and that municipalities compete for consumers with varying levels of tax and associated municipal services. An alternative view is that property tax functions as a levy on capital or the consumption of the capital embodied in the dwelling.

A property tax is in place in Belgium. Since it is levied only at the regional and local level, one can regard it as a tax for the use of land and regional and local services. The tax base for property tax is once again cadastral income (which in this case is also used for rental housing).

Optimal taxation

The previous section summarises the taxation of homeownership in Belgium. The central question in

this section is whether this taxation can be called optimal in the sense that no reforms can increase societal welfare, regardless of how this is defined (Heady, 1993; Jacobs, 2013). Mirrlees et al. (2011b, p. 332-333) describe such a “good tax system” as follows:

a tax system that can raise the revenue that government needs to achieve its spending and distributional ambitions whilst minimizing economic and administrative inefficiency, keeping the system as simple and transparent as possible, and avoiding arbitrary tax differentiation across people and forms of economic activity.

This definition implies that such a tax system will have to serve different masters at the same time (Mirrlees et al., 2011b, p. 332), because if a system satisfies the criterion of neutrality (avoidance of arbitrary tax differentiation across taxpayers or activities) it may not, for example, achieve its distributional ambitions (Heady, 1993). The underlying assumption about the impact of taxation is that all taxes always distort behaviour and that outcomes of taxation therefore may not be efficient and/or effective for society (Feldstein, 1976; Heady, 1993).² Therefore, the challenge in designing an optimal tax system is to minimise inefficiency and maximise welfare.

This challenge was taken up by the Mirrlees Review for the UK. The underlying research papers were published in 2010, and the review itself with the recommendations in 2011 (Mirrlees et al., 2010; Mirrlees et al., 2011a). The aim of the study was to realise “a progressive, neutral tax system”, implying that the tax system should be considered to operate as an all-encompassing system in which not all taxes need to address all objectives. A well-known example here is that a desired progressivity of the system (better-off households paying relatively more tax) need not imply that each tax has to be progressive. Furthermore, the tax system should seek neutrality between types of activities and groups of people in order to avoid undesired behaviour which would result in welfare losses. Last but not least, it should successfully apply a progressive taxation approach as efficiently as possible (Mirrlees et al., 2011b, p. 334):

This means having a rate schedule that reflects knowledge of the shape of the income distribution and the responsiveness of people to taxes and benefits at different income levels. It also implies taking decisions over both whether to work (including when to retire) and how much work into account in addition to other responses such as tax avoidance and migration.

An obvious conclusion at this point is that there will not be one design of tax policy that can be called optimal. The optimum solution will depend on the existing income distribution in a society, the preferences of people, etc.

² One of the few exceptions to this statement is a lump sum tax for which the tax amount is not linked to ability to pay and can, therefore, not be changed by the taxpayer by changing behaviour. The literature regards it as first-best alternative (Feldstein, 1976; Jacobs, 2013; Mirrlees et al., 2011a, p. 31). Any other taxation, including optimal taxation, is regarded as a second-best alternative because of the resulting difference in price between the demand for and supply of goods or services. These distortions come about as incomes and consumption are taxed instead of the earning ability of individuals, which is unobservable.

The choice to use the British Mirrlees Review for our exploration had different reasons. First of all, in Belgium a comprehensive and actual review is not available. Furthermore, among economists there is a broad consensus that the Mirrlees review is currently the most authoritative framework for considering optimal taxation. It entails the latest knowledge about economic theory and empirical analyses and thus formulated its recommendations for reform based on the state of the art in the field. This links in with other literature which promotes the same concepts, which are elaborated on in the next section. Decoster (2013) also argues that a strong point of the Mirrlees Review is that it is academically driven.

The choice for the Mirrlees Review as a benchmark for optimal taxation, however, does not imply that the Mirrlees Review is uncontested. One of its controversial recommendations relates to whether or not income from wealth should be taxed. This discussion is presented in the next section.

Taxation of owner-occupied housing benchmarked against the Mirrlees Review for five countries

What does the Mirrlees Review say about optimal taxation of owner-occupied housing? We will link in with other literature and compare those recommendations with taxation in five countries. This ‘triangulation’ allows us to provide a theoretical and empirical framework to evaluate the tax system in place in Belgium/Flanders. We will discuss the first three types of taxation (transactions tax, value added tax and personal income tax). As the Mirrlees Review does not formulate recommendations for property tax, this type of taxation is not included in the discussion in this section. The fact that property tax is not listed implies that it will introduce welfare costs that outweigh its welfare benefits, presuming all other taxes are implemented according to the recommendations (as discussed in the remainder of this section).

Transaction taxes

The Mirrlees Review is clear about transaction taxes: there should be none, since taxes that are levied without the possibility to deduct costs, in the case of generating income, or input costs, in the case of VAT, are regarded as inefficient (Mirrlees et al., 2011b, p. 337). The Mirrlees Review does not stand alone in this recommendation. A well-known economic argument is that high transaction taxes discourage the mobility of households on the labour market (OECD, 2010; Van Ewijk and Van Leuvensteijn (eds.) 2009). Immobility prevents people from choosing housing according to their preferences and so results in a lower level of welfare than would otherwise be the case.

As can be observed from table 1, however, none of the countries have chosen to forego some kind of transaction tax. Presumably, tax revenues are very welcome. Belgium is the only country that allows for lower rates, and Flanders applies them as explained above.

[TABLE 1 TO BE INSERTED]

Value Added Tax

The Mirrlees Review (Mirrlees et al., 2011a, p. 478) recommends that VAT should be a relatively broad-based tax with few exceptions. Agreement is widely present in the literature regarding the non-suitability of VAT for realising the redistribution of income of households via their final consumption expenditure. As Cnossen (2010, p. 36) formulates it:

VAT can not be used to achieve vertical equity goals. Its main objective is to raise revenue as neutrally as possible. This requires the broadest possible base and a single rate.

However, table 1 shows that not all countries follow this recommendation. VAT taxation is mixed: Belgium, Denmark and the Netherlands follow suit by levying the standard rate on added value in connection to new housing construction. Germany exempts certain transactions, while Belgium allows for a lower tax rate for social housing ownership and the UK allows for a zero rate for all new construction. On repairs, only Denmark and Germany do not allow lower rates, while they are applicable in Belgium and in the other countries under study.

For the UK specifically, the Mirrlees Review recommends that the 0% VAT rate for new construction, the transaction tax, as well as the annual property tax, be traded in for an annual levy on housing which would be proportional to the value of the dwelling. Mirrlees et al. (2011b, p. 344) describe this tax “as a substitute for VAT”. This VAT looks very much like a VAT levy on the consumption of housing services, as described above. We suppose that the introduction of a broad-based VAT levy, the recommendation of the Mirrlees Review, must have been considered a step too far for the Mirrlees Review, considering the widely-used zero rate for housing-related added value in the UK. As can be observed from table 1, the special recommendation of the Mirrlees Review for the UK has not been followed up.

Personal income tax

With regard to income tax, the Mirrlees Review proposes that:

Income from all sources should be taxed ... our approach would allow all costs of generating that income to be deducted... Saving and investment are [also] costs associated with generating future income... A deduction could be given each year for the opportunity cost of capital previously saved/invested. This is the rate-of-return allowance (RRA) treatment of saving... For assets where only the risk-free ('normal') rate of return is likely to be earned, this approach can be simplified, and returns on such assets can just be tax free. (Mirrlees et al., 2011b, p. 335-336).

This definition contains a number of ideas that beckon further discussion. First, the approach that income from all sources should be taxed the same way can be described using the concept of tax neutrality (O'Sullivan, 1986). If it is applied to a subcategory of all sources, e.g. income from capital taxed for owners of rental and owner-occupied housing, one speaks of tenure neutrality. The investment good approach is the concept used when any income from wealth/capital is taxed and costs that have to be made to generate that income are deductible from taxable income. As indicated above, in the case of homeownership this approach would imply that imputed rent and capital gains would be taxed (and capital losses would be deductible from taxable income). Mortgage costs, mortgage interest and other costs for maintenance, depreciation and insurance would be deductible, for example.

However, the Mirrlees Review does not recommend the investment good approach as outlined here so far, but recommends to also include foregone earnings on own equity as a deductible cost. This is called the 'rate-of-return allowance' for the use of savings (own equity) instead of a mortgage loan when paying for the purchase of a dwelling. Interest on own equity is tax

deductible as well as the interest on loans. In a risk-free situation costs will then offset income, resulting in a zero tax on income from property. The result is equivalent to the situation where a consumption good approach is applied. Mirrlees Review states that this type of taxation is close to a tax on expenditure, as income from equity in a risk-free situation remains untaxed.

Originally, the argument of zero capital taxation was a broadly accepted outcome of the theory of optimal taxation. The idea was that income from wealth/capital should not be taxed, as taxation of income from wealth would drive a wedge between present and future consumption. However, economic literature does not unanimously applaud zero capital taxation. Leaving aside implementation difficulties (such as how to determine the abnormal return over the lifecycle of a dwelling), the fact that income from wealth/capital is practically exempted from income taxation is quite likely the most controversial recommendation of the Mirrlees Review. Jacobs (2013: 25) calls it “a mystery” of the Mirrlees Review when even one of the underlying research papers by Banks and Diamond (2010) advised to tax normal returns on capital to some extent. Ample support for this argument can be found in the literature.

Piketty and Saez (2012) explain that this zero capital taxation outcome of the modelling exercise on the effects of optimal taxation was based on assumptions which cannot be considered plausible. App & Rees (2012) argue that a reform towards zero capital taxation is based on a model of household behaviour over the lifecycle that ignores important aspects of reality. Jacobs (2013) argues that houses (besides pension wealth) are one of the most important assets of households and that, by not treating housing as an asset, individuals will get very strong incentives to accumulate wealth. Returns on housing investment would remain out of reach of the tax authorities, thereby shifting the tax burden to another, much more distortionary tax base, Jacobs argues. Furthermore, Decoster (2013) argues that property can be seen as a measure of the individual ability to earn money and that it is therefore an appropriate instrument for redistribution. Abelson (2012, p. 401) concludes: “On the whole, the arguments for taxation of income from capital seem to be stronger than the arguments against it”.

Returning to owner-occupied housing and the taxable income it generates, all countries have made their own choices, but none of the countries implements a rate-of-return allowance. As table 2 shows, when the imputed rent of the owner-occupied dwelling is taxed, a mortgage interest deduction generally applies (Denmark, Netherlands). To simplify the argument, other costs are not taken into account. Imputed rent taxation seems to have suffered a downfall as many European countries, including Belgium, have abolished this instrument (Haffner, 2002; Haffner et al., 2014). Based on the argument that taxpayers would not understand the concept of imputed rent, in Denmark the taxation, but not the interest deduction, was replaced by a local property tax in 2000. Germany consciously opted for the consumption good approach for owner-occupied dwellings (no taxation of imputed income, no deduction of costs, and no capital gains taxation) in 1996. The UK was not able to estimate imputed rents and therefore abolished their taxation in 1963. Over a period of about ten years, the mortgage interest deduction was faded out by 2000 as well. The exception is Belgium, with the deductible *woonbonus*, while imputed rent is not taxed through income tax. On the taxation of capital gains, table 2 shows unity, i.e. all countries generally do not tax capital gains.

[TABLE 2 TO BE INSERTED]

It must be concluded based on the 'special' tax treatment for owner-occupiers in income tax that taxation is generally not, or no longer, based on an investment good approach. Furthermore, neutral taxation of net income from housing for owners of dwellings is not achieved in any of the countries, as a relatively 'normal' investment good approach to income taxation is applied to private-person landlords (Haffner et al., 2014). It includes rent income taxation with deduction of certain costs. Capital gains are mostly taxed as well, at minimum when tax authorities aim to counter price speculation. It does not include the rate-of-return allowance, and this is therefore not the item where personal income taxation differs for homeowners and private-person landlords.

As for Germany and the UK earlier on, Belgium, for the period from 2005 to 2014, can be regarded as a case in point for the move away from neutral capital income taxation. When income taxation of homeownership in Belgium changed to the *woonbonus* in 2005 (see above), the tax treatment for rented dwellings and second homes did not change. The tax base in income tax in the latter cases was and remained the (undervalued) cadastral income, which for dwellings other than owner-occupied dwellings was increased by 40%. A cost deduction (for paid interest) applies up to a certain level, and an additional deduction for capital repayments ('long-term savings') is also available, but smaller than the *woonbonus*. The result is an unequal treatment of owner-occupation and renting in income tax.

In the Netherlands as well, where imputed rent is still taxed, neutral taxation of owners of dwellings seems to have become an unlikely perspective. The Netherlands no longer levy income tax on imputed rent when the amount of mortgage interest is lower than the amount of imputed rent. This implies that when the mortgage loan has been repaid, tax on imputed rent is no longer levied. The owner-occupied dwelling in fact changes tax status from investment good when the mortgage loan is being repaid to consumption good once the mortgage loan has been repaid.

Recommendations by the OECD and the European Commission

In this paper we show that what the Mirrlees Review calls optimal is often not applied in the different countries for various reasons. Sometimes, as in the case of the rate-of-return allowance, even experts differ in opinion, as we discussed previously. And in many cases there may be other reasons for a favourable tax treatment of owner-occupation, such as the desire to stimulate homeownership. On the other hand, governments welcome the tax revenues, as is often the case for transaction taxes. Reducing these revenues would require a higher tax burden on other items, e.g. employment and/or income (Haffner et al., 2014).

However, higher labour costs are not desirable from the point of view of economic growth. This is an argument that was tested with data by Johanssen et al. (2008; see also the overview of results in European Commission, 2012) from the OECD and it was taken on board by the OECD (2010) and the European Commission (2012). Aiming to promote economic growth, recommendations include a shift from taxes on labour income to the generally lower taxes on consumption and immovable property (real estate). Like the Mirrlees Review, the OECD (2010) promotes the use of broad bases for VAT, possibly combined with lowering the tax rate or other compensating measures.

The European Commission (2012) recommends a shift from transaction taxes on immovable property, which can be considered to be in line with the general economic literature (including the Mirrlees Review; see above), to the periodic taxation of immovable property.

Neutral taxation of income on immovable property is also recommended by the Mirrlees Review, but this is in fact minimised by exempting normal returns (see above). This is not the first choice of the OECD and the EC. Their first choice would be applying the investment good approach, which entails taxation of net imputed rent (imputed rent minus costs) and capital gains. Moreover, both emphasise that imputed rent should be based on the market value of the property (OECD, 2010; European Commission, 2012).

The outstanding difference with the Mirrlees Review (next to the rate-of-return allowance) is the recommended tax options. The OECD (2010) recommends that, if imputed rent is exempted from taxation along with capital gains, no mortgage interest deduction be allowed through income tax and that a property tax be levied. The European Commission (2012) more generally recommends in that case to levy a recurrent tax on immovable property. These recommendations imply that recurrent taxes on immovable property could be realised either by a property tax or an income tax. In both cases, the tax will be calculated as a percentage of value, but based on different arguments, as indicated above. The Mirrlees Review does not recommend either tax approach (in the case of normal returns).

Options for Flanders

Suggestions can now be formulated as regards the main question of this study: what should Flanders consider when re-examining its taxation of owner-occupied housing when a move towards 'optimal' taxation is desired? The focus is on the following recommendations: 1) reduction of transaction taxes; 2) application of broad-based VAT; 3) neutral income taxation between renting and homeownership; 4) application of property tax.

Transaction taxes in Belgium are among the highest in Europe, even if tax breaks are taken into account (OECD, 2015). For this reason, the abolition, or at least a reduction (EC, 2012), of transaction taxes is recommended. This measure is expected to increase mobility on the housing market and on the labour market, as concluded by Isebaert (2013), and to contribute to employment and economic growth (Hoi, 2009; see also Andrews et al., 2011, p. 72).

According to the OECD (2015), the yield of **VAT** in Belgium is relatively low and authorities should suppress reduced VAT rates. In line with an OECD (2010) recommendation, more effectively targeted reductions than the present ones can also be considered. For example, reductions for energy-saving investments might be justified since these are expected to generate externalities for society.

For **income tax** the recommendation is to apply the same taxation approach for income from all sources. Applied to housing, for Belgium it would imply including owner-occupied dwellings in income taxation. Moreover, the tax base (the cadastral income) should reflect the real market value of the dwellings (OECD, 2015). The principle of levying tax on imputed rent after the deduction of costs would mean a reintroduction of the system used before 2005, which is still in place for rented dwellings. It would also imply a gradual abolition of the *woonbonus* for owner-occupation and of the deduction for 'long-term savings' for rented dwellings and second homes (OECD, 2015). According to Hoi (2009), such a reform could generate additional revenues in the order of 0.2% of GDP, while it would still leave Belgium less reliant on immovable property taxes than other countries.

Concerning the use of **property tax**, if the (re-)introduction of the investment good approach in income tax is deemed unrealistic, Flanders actually could compensate the favourable tax

treatment of homeownership in income tax on the local level by levying a supplementary property tax on owner-occupation, or by lowering property tax on rental accommodations.

Small steps towards 'optimal taxation'

In Flanders, the transfer of tax competence for the *woonbonus* offered a policy window to evaluate, rethink and adapt the tax treatment of dwellings. In this article we analysed how the Belgian tax system, and more specifically Flemish taxation, could have moved closer to an optimal situation. If Flanders had used the policy window with the aim of transitioning towards optimal tax design, what steps could have been taken? Recently, Flanders made the first decisions in reducing the main tax advantage for homeowners (the *woonbonus*). However, this was not the result of deliberate choices, but rather coincidence.

On 25 May 2014, elections were held in Belgium for the European, federal and regional parliaments. During the political campaigns in the pre-election period, the reform of housing taxation was not a main issue as in Flanders most political parties agreed upon the continuation of the *woonbonus*. Asked for their opinion during debates, politicians were very careful in expressing their position, fully aware that for the electorate it was a sensitive issue.

More than a year earlier (in January 2013), and in response to the announcement of the transfer of the income tax competence for owner-occupied housing from the federal to the regional authorities, the Flemish Housing Council (2012) had issued a recommendation for a rather radical reorientation of the *woonbonus*. The advice was based on evidence from former and recent research (De Decker, 2000; Doms et al., 2001; Heylen & Winters, 2012) and on predictions for a rise in budgetary costs associated with the *woonbonus*. When the advice became public, it provoked immediate and extreme reactions from the public at large and politicians, stating that the proposed changes were out of scope. The reactions implied a very limited willingness on the part of the population to pay more taxes in general, and on their houses in particular. According to Peeters (2014), the legitimacy of the tax system in Belgium is under pressure and taxpayers are less and less prepared to comply with the rules and accept new taxes. This might apply even more so to the owner-occupied dwelling, since homeownership is widespread in Flanders and is of great significance to most people (Meeus et al., 2013). Also prior to the elections, and referring to the path dependency of housing policy and a lack of planning culture in Flanders, De Decker (2014) concluded that the window of opportunity offered by the state reform would probably be missed.

Another reason for the resistance of the general public and politicians against reform was a lack of knowledge about the effects of these tax benefits. A study on the effects of the *woonbonus* published on 24 June 2014 might have contributed to counterbalancing some opinions. Goeyvaerts et al. (2014) argued that the benefit of the *woonbonus* was mostly capitalised in house prices and for this reason did not contribute much to making homeownership more affordable. Furthermore, the study showed that 72% of the benefits of the *woonbonus* accrued to the top 40% of income earners and increased income inequality. Moreover, budgetary prognoses predicted a strong rise of the cost for the Flemish government in the years ahead. At the time of publication of the study, for several days discussions concerning the *woonbonus* were omnipresent in the media. Strong negative reactions, as in January 2013, however, were not voiced. This happened at a time when negotiations for a new Flemish government were in the last phase and the programming of budgetary savings was inevitable. On 23 July 2014, the coalition agreement for a Flemish Government for 2014-2019 was

concluded and a cut-back of the *woonbonus* was announced. From 1 January 2015 on, for new loan contracts the deductible lump sum has been reduced by one third and the tax benefit is now calculated at a flat rate of 40% instead of the marginal tax rate (up to 50%), while for current contracts the deductible lump sum is no longer indexed. The savings will not be used for redirecting Flemish housing policy, as was suggested by the Flemish Housing Council and Goeyvaerts et al. (2014), but only to balance the Flemish budget.

A coalition agreement was reached at the federal level in October 2014. For the new government, a reform of the tax system is one of the priorities. The coalition agreement includes several principles of optimal tax theory and puts forward a tax shift aiming to reduce the tax burden on labour, the goal being to increase employment. As regards alternative tax revenues on capital or consumption, the agreement remains vague. The announcement of other policy measures, such as skipping the next indexation of wages, increasing pensionable age and cuts in social expenses, provoked strong social protest and four days of general strike in December 2014. Social movements argued for a tax shift towards taxes on capital and put two measures forward: a capital tax targeted at very large capital owners (a 'wealth tax') and a tax on capital gains. In this discussion, there seems to be a broad consensus that tax on capital in the form of owner-occupied dwellings should be excluded, except for the very rich.

Nowadays, very little public and political support can be observed for a further change towards a tax on dwellings designed along the lines of what the OECD and EC recommend. Apart from the Flemish decision to reduce the *woonbonus*, the only small step in this direction has been the restriction of the conditions for a reduction of VAT for renovation as included in the federal coalition agreement.³

If considerations about stimulating further economic growth gain more ground, in the long run a very gradual increase of property tax might become acceptable. A requirement for this is that the cadastral income is re-estimated to reflect the market value of dwellings. An institutional difficulty needs to be solved in this perspective since determining the cadastral income is a competence of the federal state, while income from it would accrue to the regions (and provinces and municipalities; OECD, 2015). As the costs would fall on the federal government, it has no incentive to take this highly unpopular measure. Nevertheless, negotiations about cost distribution may bring a solution in the future. Alternatively, the regions could design their own tax base for property taxes in a more market-conforming way. As budgetary pressures have not disappeared and economic growth will be desirable, both push and pull factors are at work.

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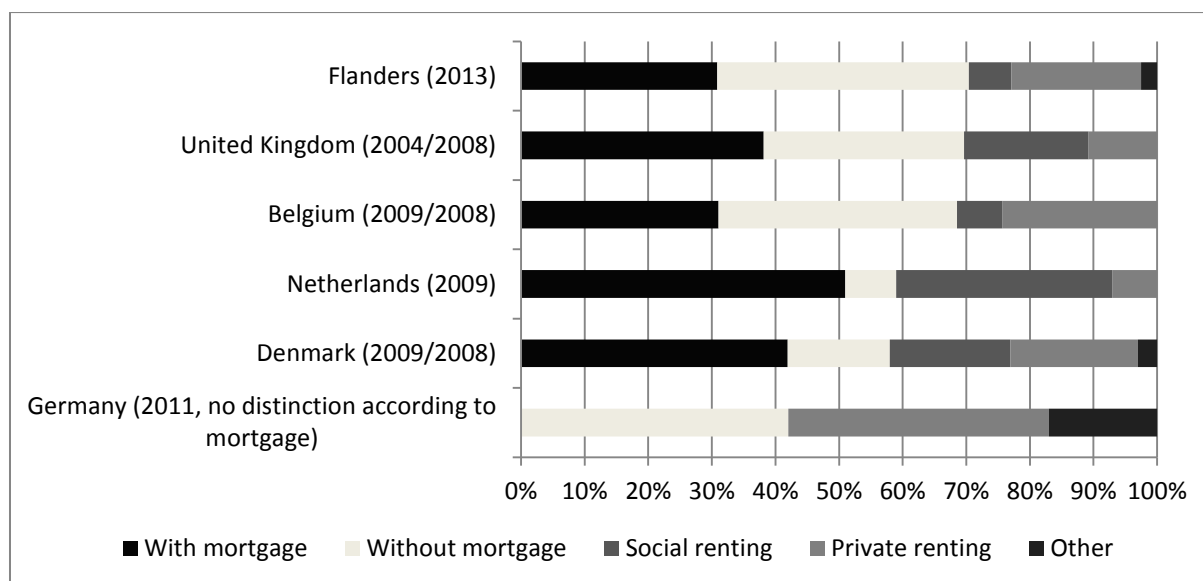
³ The condition for the reduced VAT rate of 6% on the renovation of dwellings will in the future only be available for dwellings older than ten years (instead of five years).

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Figure 1 Housing market tenures in Flanders, Belgium, Denmark, Germany, the Netherlands and the UK; different years



Sources: Housing Statistics 2010 for tenures in Belgium, Denmark and UK and EU-SILC for share of mortgagees; Grote Woononderzoek 2013 for Flanders (Winters et al., 2015), WoON 2009 for the Netherlands (authors' calculations) and for Germany the 2011 Zensus (Kofner (2014) interpretation which classifies public and cooperative ownership of rental dwellings as other).

Table 1 Transaction tax and VAT on housing in Belgium/Flanders (2015), Denmark, Germany, the Netherlands (2009) and the UK and according to the Mirrlees Review

	Transaction tax levied on the acquisition of a dwelling (new and/or existing)	VAT levied on the acquisition of a new dwelling and repair/maintenance/renovation
Mirrlees Review - general	No	Broad-based, largely uniform VAT with equivalent taxes on housing
Actual taxation		
Belgium/Flanders	For existing dwelling, but lower rate for affordable and social dwelling, several exemptions and portability	Lower rate for social housing, social ownership and for repairs and renovations on dwellings 10 years or older
Denmark	No	All added value
Germany	For all transactions	All added value; exemption for land and newly-built dwellings possible
Netherlands	For existing dwelling	Lower tax rate for labour costs for repairs
UK		
- Mirrlees Review	Replace the 0% VAT rate for new construction, the stamp duty land tax (transaction tax), as well as the council (property) tax, with an annual levy on housing which would be proportional to the value of the dwelling	
- Actual taxation	For all transactions	Lower tax rates than standard: 0% for new construction; 5% for repairs

Source: Haffner et al. (2014); Cossen (2010); OECD (2015)

Table 2 Owner-occupiers' income taxation in Belgium/Flanders, Denmark, Germany, the Netherlands and the UK and according to the Mirrlees Review (latest year available)

	Imputed rent income taxed	Debt interest deductible (for sake of simplicity no other costs considered)	Capital gains tax
Mirrlees Review	Yes	Yes	Yes, if capital gains amounts to excess returns in the short term
Actual taxation			
Belgium/Flanders	No, in federal income tax	Yes, included in 'woonbonus'*	No
Denmark	Yes, in property tax	Yes	No, size limit applied
Germany	No	No	No
Netherlands	Yes, but not economic value	Yes	No
UK	No	No	No

*) 'Woonbonus' is a lump sum deduction which includes interest and capital repayments for a mortgage loan, as well as premiums for life insurance

Source: Haffner et al. (2014)