Journal of Economic Behavior & Organization 116 (2015) 439–450

Contents lists available at ScienceDirect

Journal of Economic Behavior & Organization

journal homepage: www.elsevier.com/locate/jebo

Relative consumption of housing: Marginal saving subsidies and income taxes as a second-best policy?☆

Thomas Aronsson[a,*], Andrea Mannberg[a,b]

[a] Department of Economics, Umeå School of Business and Economics, Umeå University, SE-90187, Sweden
[b] Tromsø University Business School, 9037 Tromsø, Norway

ARTICLE INFO

Article history:
Received 8 August 2014
Received in revised form 13 May 2015
Accepted 19 May 2015
Available online 29 May 2015

JEL classification:
D62
H21
H23

Keywords:
Relative consumption
Housing
Taxation
Behavioral economics

ABSTRACT

This paper analyzes whether marginal taxation of labor and capital income are useful second best instruments for internalizing the externalities caused by conspicuous housing consumption, when the government is unable to implement a first best corrective tax on housing wealth. The rationale for studying income taxation in this particular context is that first best taxes on housing wealth may be infeasible (at least in a shorter time perspective), while income taxes indirectly affect both the level and composition of accumulated wealth. We show that a suboptimally low tax on housing wealth provides an incentive for the government to subsidize financial saving and tax labor income at the margin.

1. Introduction

This paper examines whether marginal labor and capital income taxation/subsidization might be useful means of externality correction when consumers have positional preferences for a durable good, in which case the individual's consumption of this good imposes externalities on other people. Housing constitutes an obvious example by giving the owner a direct consumption benefit and at the same time being an asset through which to fund future consumption. Although our analysis is applicable to any durable good having these properties, we will refer to it as housing in what follows. This will be further explained and motivated below.

There is a growing body of evidence showing that people are concerned with their relative consumption. A typical finding in this literature is that individual well-being increases if the individual's own consumption or income increases relative to the consumption or income of referent others (e.g., Easterlin, 2001; Johansson-Stenman et al., 2002; Blanchflower and Oswald, 2004; Luttmer, 2005; Solnick and Hemenway, 1998, 2005; Clark and Senik, 2010).[1] If concerns for relative consumption are

☆ The authors would like to thank an associate editor, two anonymous referees, David Granlund, and Magnus Wikström for helpful comments and suggestions. Research grants from the Swedish Research Council (ref 421-2010-1420) and from the Wallander-Hedelius Research Foundation (W2010-0368:1) are also gratefully acknowledged.
* Corresponding author. Tel.: +46 90 786 50 17.
E-mail addresses: thomas.aronsson@umu.se (T. Aronsson), andrea.mannberg@umu.se (A. Mannberg).
[1] Academic work on conspicuous consumption dates back at least to Veblen (1899), although the associated policy implications were briefly touched upon already by Mill (1848). An economic theory of relative consumption was first presented in Duesenberry (1949).

http://dx.doi.org/10.1016/j.jebo.2015.05.011

driven by the desire to signal status or wealth, one would expect that clearly visible goods are more positional than less visible goods, i.e., that the utility of consuming visible goods to a larger extent is driven by preferences for relative consumption. Evidence from survey–experimental studies suggests that this is also the case, since visible goods such as houses and cars have been found to be more positional than other, less visible goods (Alpizar et al., 2005; Solnick and Hemenway, 2005; Carlsson et al., 2007). Calculations presented in Alpizar et al. (2005) show that the degree of positionality (the extent to which relative consumption matters compared to absolute consumption) for housing is substantial: on average, about 50 per cent of the utility gain of additional expenditures on housing may be due to increased relative consumption.[2] Therefore, individuals' choices of housing seem to impose substantial externalities on other people.

If housing, at least in part, represents conspicuous consumption, a first best policy would be to tax housing wealth such that the externality that each individual imposes on other people becomes fully internalized. Yet, although taxes on housing wealth are used in many countries, the tax rates are often quite low; at least by comparison with the magnitude of the positional externality mentioned above. This argument will be substantiated below, where we show that our model combined with empirical evidence of relative consumption concerns would imply an annual tax on housing wealth of between 2 and 3 per cent of the market value under reasonable assumptions. However, in many countries (Denmark being a notable exception) property taxes are substantially below this rate.[3] In addition, taxes on owner-occupied housing are in practice often lower than official tax rates imply. This is so since mortgage interest is often deductible from taxable income and since imputed rents go untaxed. This implies that capital in terms of housing is preferentially treated in comparison to other types of capital (e.g., Gervais, 2002). One reason for setting such low tax rates might be that property taxes are politically controversial, and homeowners constitute an influential group in society. In Sweden, for instance, the Homeowners' Association was formed partly for the purpose of collective action against taxation of housing wealth and most likely contributed to the significant reduction in effective tax rates during the latest decade. Also, since taxes on housing wealth (or property in general) are often local or regional, the policy incentives implicit in such taxes may not correctly reflect positional externalities; at least not if the consumption comparisons go beyond the local or regional jurisdiction.[4]

Therefore, if an optimal corrective tax on housing wealth is not feasible, it is important to consider other instruments to correct for the externalities caused by conspicuous consumption of housing. In this paper, we focus on an optimal mix of labor and capital income taxation, which is defined conditional on the existing tax on housing wealth. A key role of real estate is to fund future consumption, suggesting that a marginal saving subsidy (negative marginal capital income tax) provides an incentive for individuals to save more in financial assets and spend less on housing. In turn, this policy counteracts the positional consumption externality that housing gives rise to. One may thus conjecture that marginal saving subsidies/taxes are key second best instruments for internalizing externalities associated with durable goods consumption. Yet, since such subsidies/taxes are still only indirect instruments for correction, there is room for other instruments as well, and we consider an optimal labor income tax alongside the savings-oriented policy described above. The idea here is that positional concerns may lead individuals to increase their labor supply, and a marginal labor income tax policy can be designed to counteract this incentive.[5] Therefore, the mixture of labor and capital income taxes constitutes an interesting combination, since it will affect both the level and composition of accumulated wealth.

Our study contributes to a large literature on tax and other policy responses to consumption positionality and to some extent to the ample literature on taxation of owner-occupied housing. The latter has shown that preferential tax treatment of owner-occupied housing causes over consumption of housing services (see, e.g., Skinner, 1996; Gervais, 2002). However, to the best of our knowledge, this literature disregards externalities caused by positional preferences. The literature dealing with optimal policy responses to positional externalities focuses almost exclusively on (a) positional concerns for non-durable goods, and (b) typically also on model economies with one single private consumption good (in addition to leisure).[6] In other

[2] See also Zahirovic-Herbert and Chatterjee (2011), who find that people are willing to pay more for homes with a name attached to it, and Patacchini and Venanzoni (2014), who find significant peer-effects on the demand for housing quality in USA.

[3] In Sweden, for instance, the tax on housing property is 0.75 per cent of the value of the property up to a maximum limit (where the value attached to each property by the tax authority is typically lower than the market value). The corresponding rate is between 0.2 and 0.7 per cent in Norway, where the municipalities freely decide on the implementation (about 30 per cent of the municipalities did not implement such a tax in 2009). Denmark applies a system with two rates: 1 per cent if the market value of the property is less than 3 million DKK and 3 per cent otherwise. The corresponding tax in Finland is 0.32–0.75 per cent of the market value. In Germany, the tax rate varies between 0.26 and 0.35 per cent. Great Britain also applies a zero rate except for homes with very high market values. Property taxes in the U.S. are based on the market value and the rates vary between states (although the tax is formally collected at the local level); in California, the maximum rate is 1 per cent (The Swedish Homeowners' Association, http://www.villaagarna.se/; Wikipedia, https://wikipedia.org; Germany Trade and Invest, http://www.gtai.de/GTAI/Navigation/EN/Invest/Investment-guide/The-tax-system/taxation-of-property.html; International living, http://internationalliving.com/real-estate/countries/france/taxes/; http://internationalliving.com/real-estate/countries/spain/taxes/; Properties in Europe, http://www.properties-in-europe.com/info_italy_tax.htm; http://soumi.fi).

[4] Recent evidence suggests that social reference groups are not formed solely based on the local environment; possibly due to technological developments of social media and the Internet. For instance, Becchetti et al. (2010) found that the importance of social comparisons between countries has increased over time, and Clark and Senik (2010) found that that Internet access is positively correlated with relative consumption concerns.

[5] Goerke and Hellesheim (2013) show in a theoretical model that individuals under certain conditions supply more labor if they are concerned with their relative consumption than they would in an undistorted economy without relative concerns. Empirical evidence pointing in this direction is presented by Bowles and Park (2005). They consider a model where individuals derive utility from their own consumption relative to the consumption of a reference group with higher income, and show empirically that increased inequality is associated with a larger number of work hours.

[6] See, e.g., Boskin and Sheshinski (1978), Ng (1987), Tuomala (1990), Ljungqvist and Uhlig (2000), Dupor and Liu (2003), Aronsson and Johansson-Stenman (2008, 2010, 2014), Wendner and Goulder (2008), Knell (2010), and Bilancini and D'Antoni (2012).