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“Mortgage Interest Tax Deduction in the Netherlands: A Welcome Relief”

Speech by Klaas Knot at the Macroprudential Policy Conference “Real estate taxation and macroprudential policy”,
Vilnius, 2 July 2019

Klaas Knot delivered the keynote speech at the 2019 Macroprudential Policy Conference on 2 July in Vilnius, with the theme ‘Real estate taxation and macroprudential policy’. He shared Dutch experiences with real estate taxation and macroprudential policy application, and called for countries to bring taxation and macroprudential policies into line in order to reduce the volatility of housing market cycles and their impact.

I'm glad I have the opportunity to exchange views here with you about this important topic. But to be honest, I'm also a little bit surprised that it's me who has been invited as a Keynote speaker. When it comes to macroprudential policy and real estate taxation, it seems the Lithuanians do a far better job than we do now in the Netherlands, and certainly than we did in the past. While our Loan-to-value-limit still stands at 100% and mortgage interest deduction (MID) is the most generous in Europe, the Lithuanian LTV-limit stands currently at 85%. And mortgage interest deduction was abolished already in 2009.

I can imagine that for the next edition of this conference it would therefore be more appropriate to invite Vitas to Amsterdam, so I can make notes on what he has to say. Nevertheless, let me be so free to share some of my thoughts and experiences with every one of you. Let's together build on a collective set of lessons learned. Previous crises and downturns have shown us that residential real estate markets are an important concern for both financial and macroeconomic stability. This not only holds for my country, where the drop in house prices starting in 2009 severely prolonged the economic downturn. It is probably also true for a country like Lithuania, where 90% of all households are owner-occupiers.

In past decades the total value of residential real estate as a percentage of Gross Domestic Product (GDP) has increased substantially in almost all developed countries. Often this surge in house prices was accompanied by a surge in household debt, which has made economies even more prone to housing shocks. You can see this in figure 1.

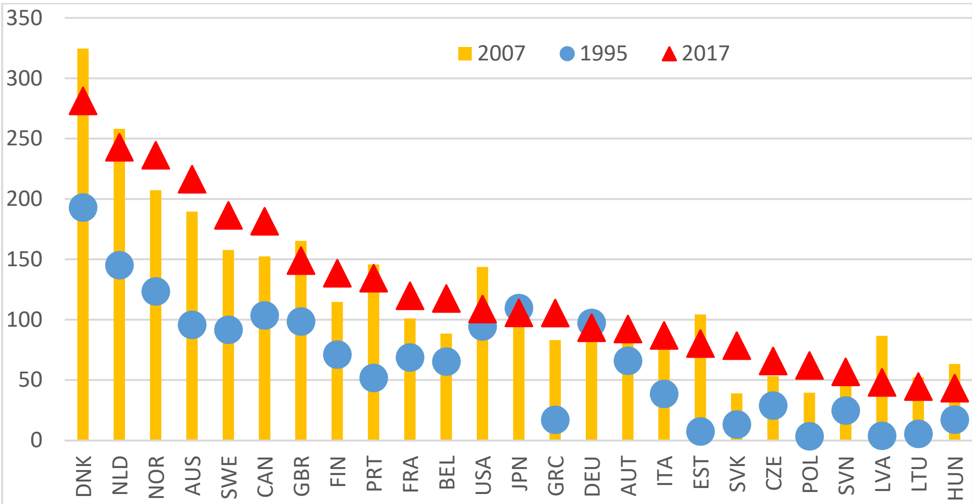

Figure 1: *Household debt as a percentage of net annual disposable income. OECD data*

From World War II onwards, housing policy in many countries became very much geared towards promoting homeownership. This worked via both favorable tax treatment of housing, and the deepening of mortgage markets. Homeownership rates have in almost all countries been steadily on the rise.

The Dutch case is by no means an exception. In this Keynote I would like to share the long experience that my country has with tax relief on mortgage interest. Or, as I will refer to it today: Mortgage Interest Deduction. But also our experience with the new macroprudential tools that were introduced after the global financial crisis. I believe the Dutch case is an interesting example of the distortive power of mortgage interest deduction. And it clearly illustrates why macroprudential policy is especially needed in such an environment.

First, I would like to look back at over a century of mortgage interest deduction in the Netherlands, up until the global financial crisis. Second, I will take some time to discuss what measures were introduced in the wake of that crisis. Third, I will discuss in a broader context how I believe macroprudential policy and real estate taxation should ideally work together in stabilizing housing markets. It is in this third part especially that I hope we can combine all insights, thoughts and experiences.

The Dutch experience up until the global financial crisis

In the Netherlands mortgage interest deduction was introduced already in 1893, by our Minister of Finance at that time: Nicolaas Pierson. He overhauled the tax system and shifted the tax base from mostly indirect taxation towards sources of income. In this new system, a house was seen as a source of income. Rents or imputed rents were therefore taxed, and costs like interest payments could be deducted. Already back then, on a net basis most homeowners and landlords with a mortgage loan received a subsidy, since the rental income was taxed relatively lightly.

However, the effects of mortgage interest deduction in the early decades were still relatively contained. Because homeownership rates were very low, namely less than 20% by 1920. Moreover, getting a mortgage loan was nearly impossible for most households since a substantial down payment was required.

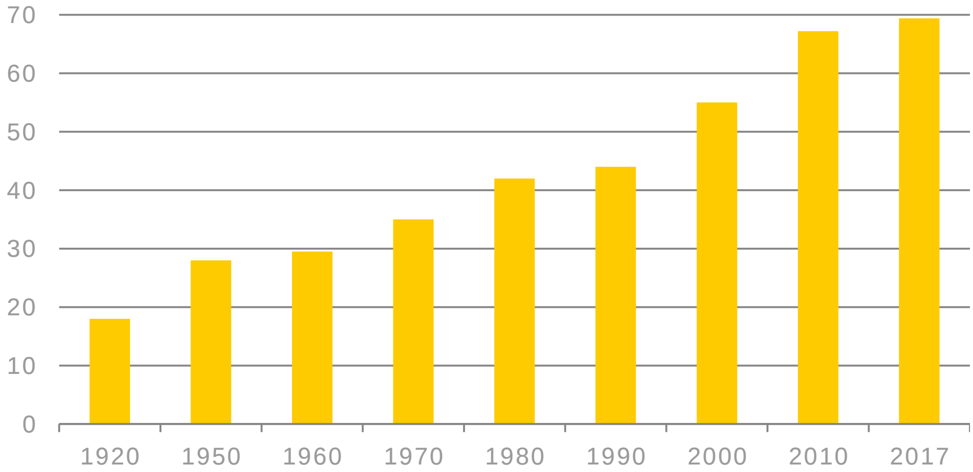

Figure 2: *Homeownership rates the Netherlands.*
Taken from van de Zeeuw & Kraan (2001) and Eurostat.

After World War II in many countries – including the Netherlands – the idea slowly emerged that more homeownership would contribute to welfare, and should therefore be further promoted. In general, the housing shortage at that time meant that governments were willing to take drastic action to stimulate access to housing. The introduction of a mortgage guarantee scheme in 1956 meant that more and more households could access the mortgage market. Since the government guaranteed that the loan would be paid off, lenders were willing to take on additional risk, and were able to loosen their down-payment constraints. Additionally, households that wanted to buy a newly constructed home were eligible for additional subsidies that were introduced to stimulate building - in Dutch called “premiewoningen”.

Meanwhile homeownership and mortgage debt were steadily on the rise. By the 1970’s 35% of all households were owner-occupiers. And by the early 90’s this number stood at 45%. Currently the homeownership rate in the Netherlands is almost 70%.

From the 1990’s onwards the Netherlands experienced a spectacular surge in mortgage debt and house prices. From 1995 to 2008 house prices more than doubled in real terms. Mortgage debt increased in the same period. from around 50% of GDP to over 100% of GDP, as you can see in Figure 3.

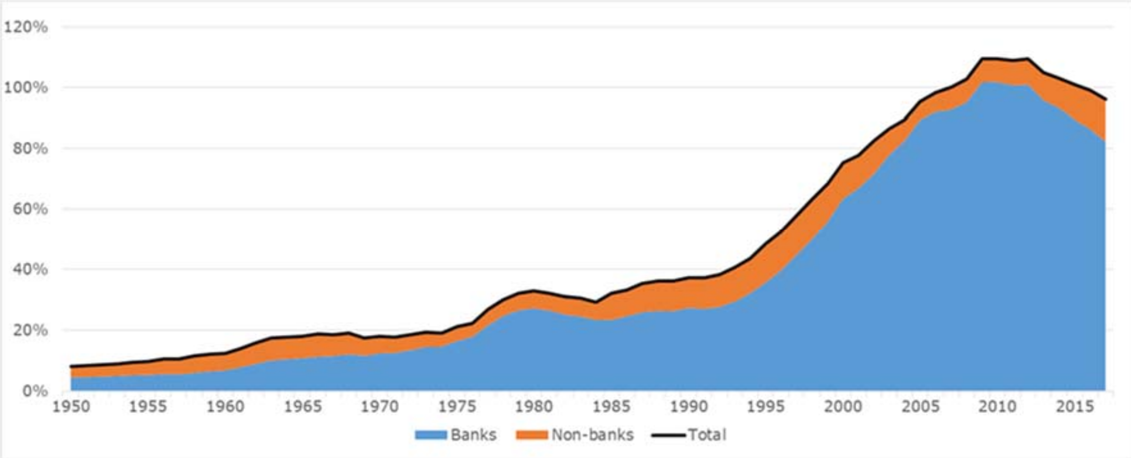

Figure 3: *Mortgage debt as a percentage of GDP in the Netherlands (1950 - 2018)*

It is in this period that households and mortgage suppliers discovered “innovative” ways to fully exploit the tax advantages of mortgage interest deduction. New mortgage products were introduced that combined interest-only mortgages - and hence, maximum deduction - with saving or investment accounts that allow for deferred amortization. At that time mortgage suppliers also gradually started to loosen their credit standards. First, by allowing households to increase borrowing by including partner income for determining the maximum mortgage. Secondly, by an ongoing increase in the loan-to-value of new mortgages. Borrowing at 110% LTV was not an exception anymore by the early 2000’s. Additionally, households started to withdraw home equity by taking out an additional mortgage loan.

Although I would be the first to admit that these practices in hindsight seem outrageous, we must remember this: In part the high levels of borrowing by Dutch households are the flipside of high mandatory pension savings in the Netherlands, where contribution rates of around 20% of gross income are not exceptional.

Liquid savings of Dutch households – for instance to use for a downpayment – are therefore quite limited. With homeownership being subsidized to this extent, the only viable option for many households to fulfill their housing needs, was to therefore to take out very high mortgage loans.

The global financial crisis and policy response
As I mentioned before, the global financial crisis followed by the Eurocrisis, hit the Dutch economy relatively hard. One can imagine that the high LTV-ratios of Dutch household and a fall in house prices resulted in many households facing negative home equity. At its peak 35% of Dutch homeowners were “underwater”.

It will come as a surprise to most of you, but foreclosures and arrears remained at very low levels during this entire period. Dutch households always keep meeting their mortgage payments. Some believe it is deeply rooted in our Calvinist culture. I believe that our strict personal bankruptcy procedures play a large role as well.

The position of mortgage creditors in the Netherlands is very strong. Banks and other creditors may even evict residents from their homes without judicial interference. But while households kept making their monthly payments, they had to drastically cut consumption.

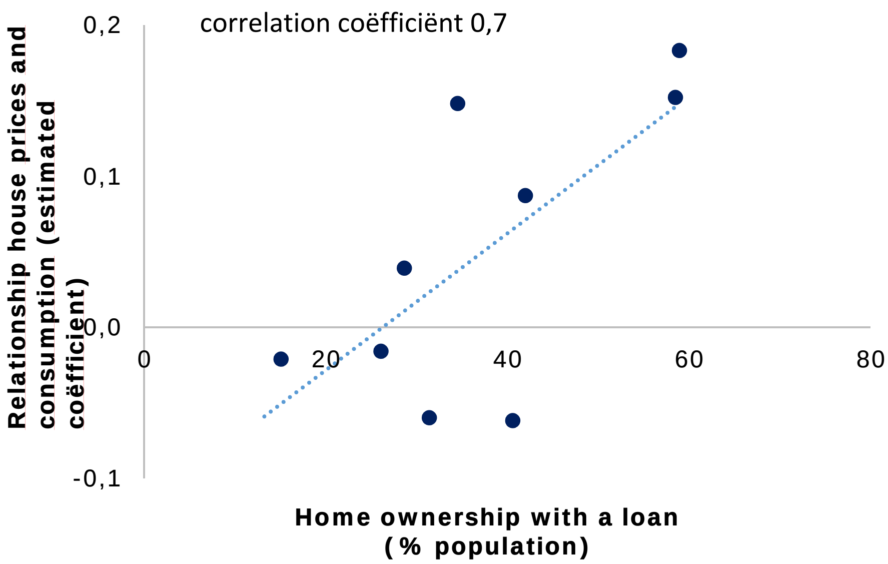

Figure 4: *Correlation of houseprices and consumption for selected countries. DNB Bulletin (2018) link.*

A recent study at DNB showed how, internationally, the response of consumption to changes in house prices is positively related to the share of households with a mortgage loan. The dot in the top right corner of Figure 4 represents the Netherlands. So while the direct losses for financial institutions were relatively low, the macroeconomic consequences were severe.

The recession following the financial crisis made it clear to policymakers and politicians that mortgage debt had risen far beyond optimal levels in the Netherlands and led to excessive macroeconomic volatility. Finally the time seemed right for a discussion on the effects of mortgage interest deduction. The Dutch Central Bank – together with other economic advisors - had already recommended scaling back mortgage interest deduction for some years. However, the M-word had up until then been a political taboo. But now, also in light of the fiscal deficit at that time, cutting foregone tax on earnings due to mortgage interest deduction was finally on the table. In 2011 the total tax advantage due to mortgage interest deduction amounted to 14 billion euros, roughly 2.5% of GDP.

Eventually, the cabinet took various measures to reform the housing market. I would like to highlight three of them. Firstly, for new mortgages it was decided that they would only qualify for mortgage interest deduction when the loan was fully amortized over a 30 year period. Figure 5 shows the result of that policy measure becoming effective in 2013.

Figure 5: *Outstanding debt (in billions of euro) by year of origination. Taken from DNB Financial stability report (2017) link.*

While annuity mortgages were almost non-existent in 2012, in 2013 the new flow contained a large volume of them. [The fact that there are still interest-only mortgages and savings mortgages in the flow, is mainly due to existing mortgages being rolled over.]

Secondly, an LTV-cap was introduced in 2012 at 106%. From 2012 the LTV-cap was lowered yearly by 1 percentage point and it remains at 100% today. Most international guests will probably raise their eyebrows: can you even call that a cap? But for many Dutch households this cap was actually binding. Households had gotten used to being able to finance transaction taxes, broker fees and solicitor fees using their mortgage loan.

Thirdly, DSTI-limits that appeared to have not been applied consistently before the financial crisis, were written in law. They now apply to all mortgage suppliers – banks and non-banks. Although I welcome the steps that have been taken, including recent steps to seriously start scaling back the maximum rate at which mortgage interest can be deducted, the situation in the Netherlands is still far from ideal. Mortgage interest deduction is still among the most generous in the world.

And although the Netherlands is one of the few countries where both DSTI -and LTV-limits apply, both of them are very high by international standards. As president of the Dutch Central Bank I will therefore keep stressing that additional reforms are needed.

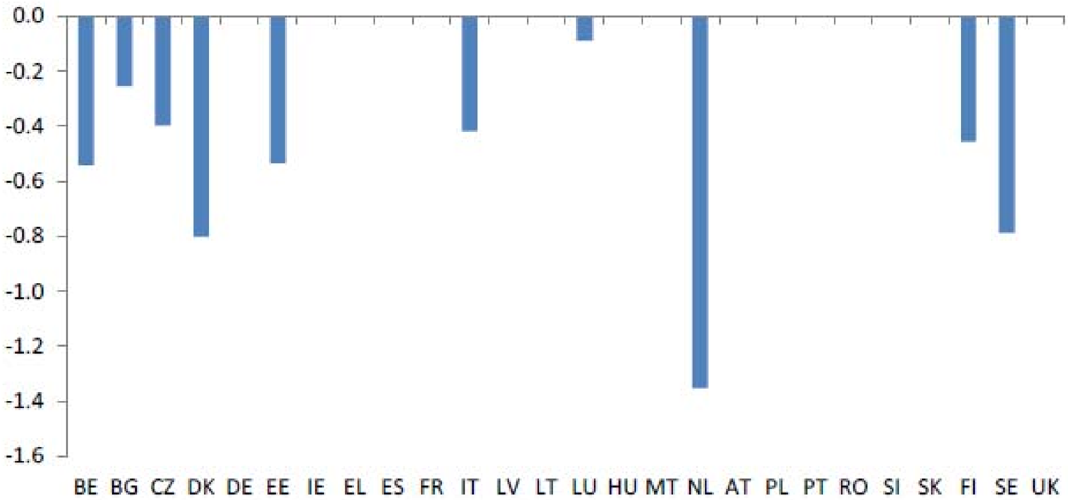

***Figure 6**: Contribution of MID to marginal costs of housing investment.*
Graph taken from EC (2014) Tax reforms in the EU 2014 link.

Why macroprudential policy and taxation are both substitutes and complements
Taxation in most countries favors owner occupied housing. In some cases very explicitly so, via mortgage interest relief, as you can see in Figure 6. In other cases, because housing wealth is taxed much less than other sources of wealth. Tax systems therefore generally contribute to cyclicality instead of containing it.

Macroprudential policy is therefore often partly in place to offset the negative elements of the tax-system. This is the most clear when the tax system induces a debt-bias, as it does in various countries that still offer mortgage interest deduction. However, in fact it also holds when the tax system favors investment in housing over other sources of wealth.

In most countries, the idea that homeownership is the preferred tenure for all households, is still deeply embedded in society. From an economic perspective the case for homeownership over renting is much less clear. The often mentioned pros, like better maintenance of properties, and cons, like less labor mobility and more debt - are at best in balance. From a fiscal perspective I therefore believe that countries should strive to move to a tax system that is more or less neutral towards homeownership.

Not only does this benefit financial and macroeconomic stability via structurally lower debt and real estate prices. It also creates a level playing field for private rental housing. Currently, the supply of housing in this segment of the market is often suboptimal. In my country this segment still dominated the housing market in the post-war years, but now only makes up a small fraction of the total housing stock.

So yes, I believe that proper real estate taxation and macroprudential policy are to some extent substitutes. But fiscal incentives are not the only source that can amplify residential real estate cycles. The feedback loop of adaptive expectations of house price growth remains another source of risk. Exuberance leads to more exuberance, panic to more panic, also when taxation does a better job than it does today. Macroprudential tools such as DSTI -and LTV-limits can structurally limit this mechanism and at the same time protect households from over indebtedness.

I realize that I formulated the typical nuanced answer you can expect from an economist: “real estate taxation and macroprudential policy are both substitutes and complements”. I hope for everyone here in the room that the panelists in the next session – where this question will be discussed more extensively – will be a bit less nuanced so we can have a lively debate.

Concluding remarks
Before we move to this next session, I would like to say a few more words and conclude. As I stated at the start of this Keynote: the impact of volatile housing markets on financial stability and macro-economic stability and performance is significant. To me, the Dutch case clearly illustrates that too much household debt severely exacerbates this mechanism.

In my view, current tax systems often contribute to cyclicality, by either incentivizing debt financing or stimulating investments in housing over other investments. In such an environment macroprudential instruments are partly in place to offset these features of the tax system.

Ideally however, I would like to see tax systems and macroprudential instruments working in tandem, to structurally limit the risks of excessive house price growth and leverage. Therefore I believe that for us, as policymakers, there are still important steps to be taken the coming years. In various countries there is still room for improvement to extend the macroprudential toolbox or fine-tune the current instruments. Moreover, in most countries the tax system can be improved a lot to reduce cyclicality. Residential real estate taxation should therefore gradually transition to a level much more comparable with other sources of wealth.

I want to emphasize here that when it comes to macroprudential tools and real estate taxation, I believe in a structural approach. Using these tools to “lean against the wind”, by making discretionary changes to them through the cycle, is a far more difficult and risky exercise for us policymakers.

That all said, I would like to thank everybody here for coming and giving me this stage. I really hope this conference will push this essential issue higher up the policy agenda.