The effects of the abolition of property tax on housing prices and inflation

The Government has proposed that the state property tax on housing be abolished. The view of the Riksbank is that the change in property tax may lead to a one-off rise in house prices of around 5 per cent on average, which may also lead to a slight rise in household consumption. This will in turn have a small temporary impact on inflation. However, the impact on both house prices and household consumption is very difficult to assess.

The Government has proposed that the state property tax on housing be abolished with effect from 1 January 2008. The finer details of the proposal are still being discussed. Preliminarily, the tax cut will be financed by a municipal property charge of no more than SEK 4,500 for a detached house and SEK 900 for an apartment in an apartment block and by raising the capital gains tax from 20 to 30 per cent.[26] The abolition of property tax on houses and apartments is expected to cost the state SEK 16 billion according to the Government's own calculations. The new municipal property charge is estimated at the same time to generate income of around SEK 10 billion and the increased capital gains tax SEK 6 billion. The Government thus considers the abolition of property tax to be fully financed. These assessments are, of course, uncertain. If the Government's calculations prove correct, the reform will not have any direct effect on the total disposable income of households. However, the reform may affect demand in the economy and inflation through other channels. Firstly, there will be a direct effect on CPI since property tax affects housing costs for detached houses and also rents in apartment blocks, both of which are included in CPI. The effect on rent also has an impact on UND1X. A change in the taxation of detached houses will, however, not have this effect. Secondly, an indirect effect on demand and inflation will arise if the reform affects housing prices and thus household wealth. Here only the effects on demand and inflation which may arise through changes in housing prices are discussed. The direct effects on CPI are taken up in Chapter 1 of this report. This article only takes into consideration the most recently notified change in property tax. The recent price rise of housing is probably partly explained by the sharp reduction in property tax introduced by the Government last year as an initial step when a ceiling on property tax on land was also introduced. The standard income taxation on tenant-owned properties was also abolished at the same time.

The effects of tax changes on housing prices.

What impact might the abolition of the state property tax conceivably have on housing prices and thus on households' property assets? Since the abolished tax is to be financed by increasing other taxes in the housing sector, net taxation will not be affected.

On the one hand, these facts might lead one to draw the conclusion that the reform should not have any effect on housing

26 The higher tax will also apply to those capital gains in respect of which households have been able to defer tax liability under the deferment rules. Accumulated deferments totalled around SEK 150 billion for the 2005 income year. Approximately SEK 6.5 billion was subject to taxation in the 2005 income year, while new deferments amounted to SEK 38 billion according to details from the Ministry of Finance.

prices.[27] On the other hand, part of the financing – the higher capital gains tax – is a tax that the average homebuyer will only face when selling their house at some point in the future. Given average periods of possession of between 20 and 30 years, it may be difficult for a homebuyer to have a reasonable idea of how large this capital gain and the ensuing tax on it will be. The deferment system also means that many homeowners in practice postpone the payment of capital gains tax for most of their lives. Since neither death, inheritance nor gifts lead to tax having to be paid, taxation can in practice be postponed for even longer. It is therefore reasonable to assume that the average homebuyer is more interested in how large their cost of housing will be in the short term and how this will be affected by changes in the more visible current taxation of housing.

If the annual tax on housing decreases, a household intending to purchase a house may increase its mortgage burden to a corresponding extent without an increase in the annual cost of housing. The household can therefore afford to pay more for a house than before the tax cut. If, after a tax cut, homebuyers are prepared to borrow more money to such an extent that the higher loan cost corresponds exactly to the tax cut, the percentage price increase on a house can theoretically be calculated using

$$(1) \qquad \frac{\Delta P}{P_0} = -\frac{\Delta\tau}{i(1-t)}$$

where $\Delta\tau$ is the change in the effective tax burden expressed as a proportion of the house price (the effective tax rate) and $i(1-t)$ is the nominal interest rate after tax (tax reduction).[28] It is then assumed that the entire change in tax is fully "capitalised" in house prices. This assumes, among other things, that one disregards the fact that prices in the long tern may be dampened by new build becoming more profitable in the event of price rises in the second-hand market.

When property tax is abolished, the tax expenditure of homeowners will be reduced by a total of around SEK 13 billion. Instead, they must pay around SEK 8 billion in a municipal charge. Disregarding what homeowners have to pay in increased capital gains tax, this change in tax produces a reduced total current taxation of SEK 5 billion. This corresponds to a decrease of 0.16 percentage points in the average effective tax rate.[29] If this tax relief is fully capitalised, it would, with an assumed nominal interest rate of 3.5 per cent after tax,[30] lead to house prices rising by an average of 5 per cent [=(0.0016/(0.035)=0.05].[31] Prices of tenant-owned housing should

27 We have disregarded the fact that a small proportion of financing consists of increased tax on those capital gains in respect of which households have been granted a deferment.

28 In a strict theoretical model with rational individuals, the anticipated increase in value should also be taken into consideration. See, for example, Boije (2000), "The capitalisation effects of changes in taxes and subsidies", in Lindh, T. (ed), *The pricing and valuation of properties,* Research Paper 2000:4, the Institute for Housing Research, Uppsala University.

29 In the fourth quarter of 2006, the estimated market value of housing stock amounted to SEK 3,057 billion, while the tax relief amounts to SEK 5 billion. This corresponds to a decrease in the effective tax rate of 0.16 percentage points (5/3057=0.0016).

30 Assuming a capital income tax rate of 30 per cent, this corresponds to a nominal pre-tax rate of 5 per cent. The five-year mortgage rates are currently around that level.

31 The calculation refers to the average price effect for Sweden as a whole. In the Financial Stability Report 2007:1, the Riksbank gives some examples of the magnitude of the price effects in different regions.

rise slightly less since the tax relief is not as great for them. This calculation should be interpreted with some caution, however. The impact that the change in taxation has on house prices may, for instance, be dampened if households believe that property tax will be increased again after the next election. This calculation is moreover very sensitive to the interest rate level selected. A lower (higher) interest rate would lead to higher (lower) price rises, ceteris paribus. The calculation also disregards the effects of increased capital gains tax. However, it is not entirely easy to know what effect this will have on house prices in the future. One difficulty in this context is the deferment system. Viewed solely from the demand side, it would be reasonable for a higher capital gains tax to have some price-dampening effect even if most homebuyers are probably more concerned about the more visible current taxation. However, the deferment system means that the present-day value of the increased capital gains tax is in practice very low. This indicates that house prices will not be substantially affected by an increase in capital gains tax. At the same time, the increased capital gains tax can affect the supply of housing. Without a system of deferment, an increase in capital gains tax would make it less advantageous for a homeowner to sell their home. In other words, it would reduce the supply of housing and have a price-raising effect. However, those households that had planned to sell their home in the near future and decided not to replace it with an owned property (in particular older households) can choose to do so before the turn of the year in order to avoid the increased capital gains tax on both the new capital gain and previous deferment. This will increase the supply of housing and in doing so, may in the short term dampen house prices to some extent. The effect on prices of the increased capital gains tax is very difficult to assess due to the deferment system. Its effects on demand and supply of housing are difficult to penetrate. The view of the Riksbank is none the less that the combined effect of the announced tax changes can be expected to lead to a rise of approximately 5 per cent in house prices for Sweden as a whole.

Effects on private consumption and inflation

The question then is the extent to which higher housing prices may affect demand and accordingly inflation. Simple consumption models which do not capture "all" parts of the economy usually indicate a reasonably strong correlation between changed house prices and private consumption. However, there is considerable lack of clarity in research literature on what this correlation actually measures. With this proviso, calculations made using a model of this kind indicate that a one-off rise in house prices of 5 per cent will have increased the level of consumption by 1 per cent in three years' time. If the import content of consumption is assumed to amount to 50 per cent on the margin, an increase in consumption of this amount would lead to an increase in total demand of 0.25 per cent [1x0.5x0.5].[32] This would have a small and temporary effect on inflation. It should, however, be stressed that very simple model calculations of this kind must be interpreted with considerable caution.

32 Household consumption corresponds to almost 50 per cent of GDP.