Housing Taxation Policy

1 Introduction

1.1 This paper assesses the current state of the housing market in terms of output, prices, credit availability and growth, it outlines the existing tax treatment for residential property and it sets out the position in relation to a number of recent initiatives in this area. The paper also describes the current situation in relation to social and affordable housing and examines issues that may arise in the future in the area of housing taxation policy.

1.2 While the main purpose of any tax is to raise revenue for the Exchequer, the tax system is also used to promote various economic or social objectives. In the housing sector, there are various special tax arrangements which depart from tax neutrality and are aimed at promoting special housing policy objectives such as increasing the supply of new houses, helping owner-occupiers, and increasing the supply of rented accommodation.

1.3 Ireland is not unique in this respect as most other European Countries provide for similar measures. (a summary of these measures is attached as Appendix 3). However, Ireland is the only OECD country that allows households a tax deduction for mortgage interest payments at the same time as *not* taxing property values, capital gains or imputed rent. This fact is often overlooked when housing taxation measures such as stamp duty for example, come up for debate.

2 Housing Market Trends

Housing Sector and the Economy

2.1 New housing construction has been one of the main driving forces behind overall output growth in recent years, and its share of overall activity has risen accordingly. Last year, for instance, housing construction (including home improvements) amounted to 16% of GNP, compared to 9% as recently as 2000. Reflecting the employment intensity of output in this sector, employment in construction more generally has risen from 170,000 (10% of total) to 270,000 (13% of total) over the same period.[1] In terms of the public finances, significant revenue for the Exchequer is gained from housing market activity. For instance, the Stamp Duty yield from residential transactions totalled €1.31 billion in 2006. In addition, the VAT yield from the sale of new housing (private and social) in 2007 was estimated at approximately €2.95 billion at Budget time with an estimated additional €0.55 billion being raised from VAT on the maintenance and repair of all housing.

2.2 The concentration of activity in one sector is not ideal. Given the weight of this component in overall GNP, lower levels of output (see below) will exert a negative drag on overall growth rates over the short-term at the very least.

[1] It is not possible to break employment in construction into its housing and non-housing components.

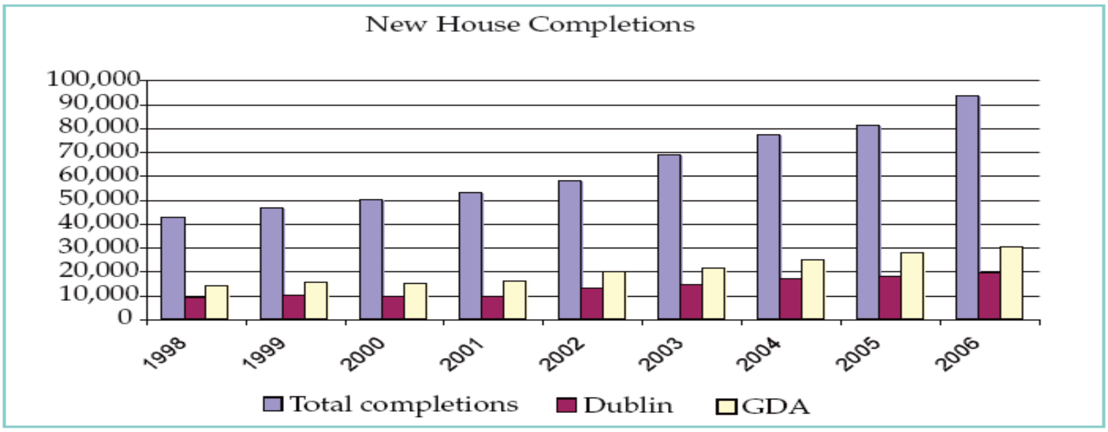
Housing supply

2.3 The Government's response to rising house prices has primarily been aimed at boosting supply. Over the period 1997 – 2006, the stock of housing increased by 40% (available information suggests that some of these are unoccupied houses). However, the annual rate of completions has now reached levels which are in excess of the medium term demand for housing, so that a lower level of output is in prospect going forward.

2.4 In the opening months of this year, leading indicators of future new housing output – such as new house registrations and new housing starts – pointed to a sharp decline in output in the second half of this year. The flow of information over the summer confirms this picture; actual completions in July, for instance, were 36% below their level a year earlier. It now appears likely that actual completions this year will be of the order 70,000 – 75,000 units, compared to just over 88,000 last year (on a national accounts basis); this would amount to an annual decline of around 20%. A further decline in completions appears to be in prospect for next year. While the medium term demand for housing is tentatively estimated as being in the region 60,000 – 70,000 units per annum, a key risk is that completions may be less than this and some commentators are in fact forecasting output of 55,000 units next year.

Housing Stock

2.5 Ireland has seen a significant increase in the delivery of new houses over the last number of years. This need arises as a result of the demographic conditions as well as the major immigration over recent years. The chart[2] below shows the number of new house completions analysed by Total Completions, Dublin Completions and Greater Dublin Area Completions:



There are estimated to be about 1.8 million units of housing stock in 2006. This estimate is based on the number of dwellings surveyed for the Census of Population 2006, including both vacant and occupied dwellings. This represents about 420 units for every 1,000 persons, which closely compares with the EU norms where the average is approximately 450 per 1,000 persons[3].

House Prices

2.6 House prices have been on a modest declining trend this year, with the price level in July being 3.2% below the peak recorded in January. New houses declined by 2.1% over this period while the price of existing houses declined by 2.9%.

[2] Annual Housing Statistics Bulletin 2006, Dept of the Environment, Heritage and Local Government
[3] Annual Housing Statistics Bulletin 2006, Department of the Environment, Heritage and Local Government

2.7 A number of factors appear to be weighing on recent house price dynamics. The most important factor would appear to be rising interest rates, with policy rates having doubled in less than two years. Secondly, the very large increase in new housing supply has helped ensure a greater balance between supply and demand. Speculation in the media in the context of the election regarding stamp duty changes may also have had a role in price trends earlier in the year.

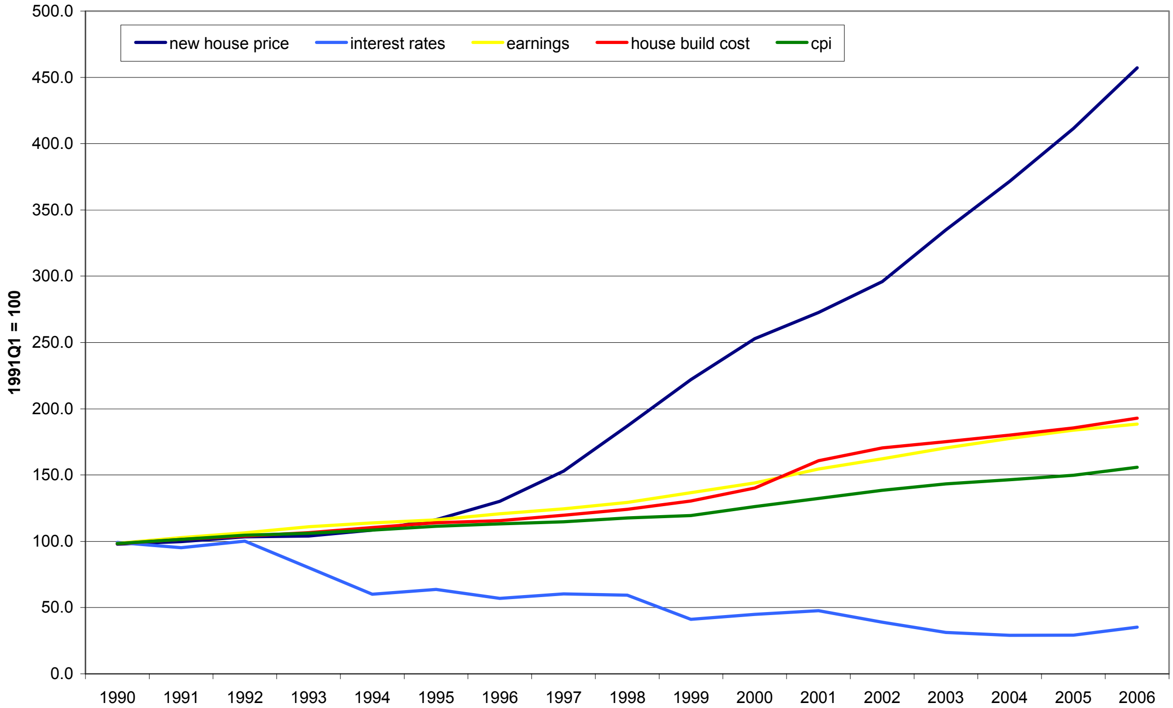
First-time Buyers

2.8 According to *ESRI/ptsb* data, the average price paid by a first-time buyer in July of this year was €268,904, 1.2% lower higher than in the same period of last year. Nationally, 38% of all houses sold in 2006 were purchased by first-time buyers. Not unsurprisingly, this proportion was higher for new houses, with first-time buyers purchasing 47% of new houses sold compared to 30% of second hand houses sold.

Link between Price, Affordability and Supply

2.9 The graph below shows developments in new house prices, house building costs, average adult earnings, consumer prices and mortgage interest rates since 1990. The data indicate that since the mid-1990s, the increase in house prices has greatly outpaced the increase in house building costs. This would appear to indicate a substantial increase in profitability in the new house building sector.

Figure 1: house prices, mortgage interest rates, earnings, house building costs (1991Q1=100)



source : Department of Environment.

2.10 The affordability index produced by *EBS/DKM* defines affordability as the portion of a representative household's income used to service mortgage debt. The data show that for a first-time buyer working couple, affordability has been relatively stable over the period since 2001 – 2005, with rising prices being offset by higher incomes and lower interest rates. There was a slight deterioration in affordability last year, mainly reflecting the impact of rising mortgage interest rates. This year, however, rising interest rates have been offset by an easing of house prices, changes to mortgage interest relief and continued strong income growth, so that affordability has been broadly unchanged.

Rental Market

2.11 Demand for private rental accommodation remains strong, with rental prices rising at an annual average rate of 10% in the first eight months of the year. Continued inward net migration appears to be one of the main factors impacting on demand; it is also possible that rising interest rates and declining prices are causing prospective buyers to postpone home purchase with spill-over effects into the rental market.

Latest Perspectives on the Housing Market

2.12 While there is a market consensus that housing output will decline this year and next, the scale of decline is open to debate (see section 2.4). Generally speaking, forecasts published prior to the summer tend to be more optimistic, while more recent forecasts – which incorporate the somewhat more negative data which became available over the summer – have been more pessimistic.

2.13 Data from the Central Bank show that the rate of growth of mortgage credit – while still relatively strong – has been on a declining trend this year. In July (latest data), mortgage lending was 17.9% higher than in the same period a year earlier, the slowest rate of growth since early-2002. Notwithstanding this moderation, the sustained nature of credit growth in recent years means that the level of household indebtedness relative to income levels is high in both historical and international terms.

2.14 The general expectation at the current juncture is that some modest decline in house prices is in prospect for this year, with prices stabilising thereafter. However, some commentators are suggesting further or larger declines.

3 Taxation measures directly affecting the housing market

3.1 Taxation measures that directly affect the housing market include:

- Mortgage interest relief for owner-occupiers with larger relief for first-time buyers;
- Rent relief for tenants;
- Mortgage interest relief for investors in residential accommodation;
- Capital Gains Tax exemption for a person's principal private residence;
- Stamp duty exemption and relief for new houses bought by owner-occupiers;
- Stamp duty relief for second-hand houses bought and occupied by first-time buyers;
- Dwelling house exemption for Capital Acquisitions Tax purposes;
- Special tax regime for rented accommodation;
- Special tax incentives for housing under the urban, town and rural renewal schemes and for student accommodation;
- Higher rate of corporation tax for dealing in development land;
- Rent a Room Scheme;
- A reduced rate of VAT of 13.5% applies rather than the standard rate of 21%.

Property Tax Incentives Schemes – Residential Elements

3.2 In addition, to the specific measures to assist home owners such as the first time buyers stamp duty relief and the mortgage interest relief for first time buyers there are reliefs for residential properties under the main area based tax incentive schemes and the student accommodation scheme.

3.3 The area based tax incentive schemes such as the Park and Ride, Urban Renewal, Rural Renewal and Town Renewal Schemes, the Living Over the Shop Scheme and the student accommodation scheme have had an impact on both the supply of housing accommodation and Exchequer returns. The first five of these schemes provide relief for both owner occupiers and lessors of residential property while the student accommodation scheme is confined to lessors.

3.4 The annual cost in terms of tax foregone of all of these schemes has expanded significantly in recent years and based on Revenue statistics the combined amount of relief claimed in respect the residential elements of the aforementioned schemes in 2005 was €472m with a tax foregone cost of approximately €191m, 95 per cent of this tax foregone cost accrued to residential lessors. As this type of relief for lessors can only be set off against rental income these reliefs act as strong inducements for individuals to purchase rental property and may have ameliorated the effects of low rates of returns from rental properties which have been a feature of the residential property market in recent years.

3.5 The tax cost is significant but it could be argued that the additional housing output from the schemes is modest by reference to the record output in new housing in recent years. The 4 area based schemes were reviewed by Goodbody Economic Consultants and they estimated that the 4 area based schemes provided 28,479 additional housing units during the period 1998 to 2006. Indecon conducted a similar review of the remaining property tax incentives in 2005 and they estimated that over 15,000 additional bed-spaces were developed under the Student Accommodation Scheme between 1999 and 2006.

3.6 In Budget 2006, following a major review of tax reliefs including the special property based schemes the Minister for Finance announced the termination, subject to certain transitional provisions, of the following tax incentive schemes:

- Urban Renewal;
- Town Renewal;
- Rural Renewal;
- Accelerated Capital Allowances for Hotels;
- Capital Allowances for Holiday Cottages;
- Student Accommodation;
- Multi-Storey Car Parks;
- Third-level Educational Buildings;
- Sports Injuries Clinics;
- Developments associated with Park and Ride Facilities;
- General Rental Refurbishment Scheme.

3.7 At the time he pointed out that he was introducing the transitional measures to take cognisance of the fact that there were over 250,000 jobs in the construction sector and the building industry accounted for around 20 per cent of the economy and said that one should "not do anything that disrupts unnecessarily an industry that is such an important driver of jobs".

3.8 The primary policy rationale of the area based schemes was to promote the rejuvenation of inner city and town areas and in the case of the Rural Renewal Scheme to promote regional development and in many areas the schemes have been successful in achieving these policy objectives. However, the high ongoing Exchequer cost gave rise to a relatively modest output of housing units and this should be given due consideration if similar tax incentives are proposed in the future.

Changes in Housing Taxation since 2006.

Mortgage Interest Relief

3.9 In Budget 2007, the ceiling for mortgage interest relief for first-time buyers was doubled from €4,000 single/€8,000 married to €8,000 single/€16,000 married. The cost of this measure is estimated at €60m in a full year.

3.10 The ceiling for mortgage interest relief for non first-time buyers was increased from €2,540 single/€5,080 married to €3,000 single/€6,000 married for 7 years. The cost of this measure is estimated at €10m in a full year.

3.11 The measure for first time buyers was put in place in recognition of the pressures on those starting out to buy their first home. The increase for non first time buyers was implemented in recognition of the fact that the ceiling on interest relief for such buyers has not been increased since 2000. The seven year period in which preferential levels of tax relief on first time buyers mortgage interest are available allows sufficient time for mortgage interest payments to become more manageable by becoming a smaller proportion of disposable income.

3.12 This overall measure was designed to help with affordability of owner-occupier mortgages and to support rather than inflate the market.

3.13 The most recent estimate from the Revenue Commissioners is that for 2007 mortgage interest relief will cost about €480 million in total of which approximately €310 million (about 65%) relates to first-time buyers.

3.14 While this move was broadly welcomed some commentators criticised this measure as having a potential inflationary effect on house prices. It should be pointed out that the increased allowances are available to all first-time buyers who are still in the first seven years of their mortgage and not just to those who will purchase this year. Therefore those who have already bought their homes will potentially benefit and only a portion of the total cost of this measure for first-time buyers would go to those purchasing homes this year.

3.15 The Government Programme includes a commitment to further increase in Budget 2008 the mortgage interest relief for first-time buyers to €10,000 single/€20,000 married. The cost of the measure is estimated at about €10 million in a full year.

3.16 The Programme also includes a commitment that "as income taxes are reduced", the rate of mortgage interest relief will be kept at 20% for all home owners. (The cost of this will form part of the overall cost of the commitment to reduce the standard rate of tax which is to be achieved over the lifetime of the Government, if economic resources allow).

Removal of the VAT waiver of exemption for residential properties.

3.17 The Finance Act 2007 removed the facility which allowed landlords to waive the normal VAT exemption and charge VAT on short-term residential lettings. This removed the landlords entitlement to a VAT refund on the purchase of a property for residential letting purposes.

3.18 The lump sum VAT refund amounted to approximately 12% of the gross purchase price of a new residential property, i.e. equivalent to the VAT included in the gross price at the 13.5% rate. The landlord must in turn charge VAT on the rent. The VAT refund was effectively an interest free loan to the landlord which is repaid to the Exchequer over a period of 20 to 30 years.

3.19 The VAT waiver facility was never intended for use in respect of residential lettings. The waiver option had been marketed to private investors as a way of getting Exchequer funding to subsidise property purchases. This was not the intention of the option to waive the VAT exemption.The change was applied to properties acquired or developed after the passing of the Finance Act. Waiver arrangements in respect of existing lettings, or new lettings of properties which the landlord has acquired before the date of passing of the Finance Bill were not affected. This ensured no disruption to existing arrangements but stopped the expansion of the practice in respect of new acquisitions.

Stamp Duty

3.20 The position in relation to Stamp Duty has been outlined in TSG paper 07/04. The Finance (No 2) Act 2007, which was recently enacted, introduced a complete stamp duty exemption for first-time owner-occupiers of residential property. The cost of this measure is estimated to be in the region of €70m in a full year.

3.21 There is clear evidence that a slowdown in the property market is having an impact on yield. The downward trend evident in recent months accelerated in August with the total stamp duty Exchequer receipts now some €267m below target compared to just €173m in July. The stamp duty yield from property for August is not available, however, Revenue Net receipts show that the yield from property up to the end of July was running €205m below target.

3.22 There are also short and longer term risks to the prospective take from stamp duty. In the short term, a sustained reduction in property market activity and house prices will have a direct affect on future stamp duty. Similarly, the exemption of first-time buyers from stamp duty on residential property has also affected the yield. The cost of this exemption is estimated at around €70 in a full year, i.e. 2008.

Possible Options for Consideration in the Future

3.23 Specific and targeted changes were made to certain taxation measures that affect the housing market in response to the Bacon reports on housing which were produced for the Department of the Environment, Heritage and Local Government in the period 1998 to 2000. The outcome of these interventions demonstrates <u>that there is considerable market sensitivity to changes in taxation.</u> Specifically, tax changes such as the abolition of mortgage interest relief on investment properties and the increase to 9% in Stamp Duty on investment properties in an effort to improve the position of first-time buyers were seen to have a negative effect on the rental market and industry indications subsequently suggested that supply was threatened due to a lack of confidence in the market. XXXXXXXXXXXXXXXXXXXXXXXXXXXX

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3.24 The Táinaiste in Budget 2006 suggested that he might consider reintroducing the Living Over the Shop Scheme (LOTS) in a more focused way. The Department of Environment Heritage and Local Government are currently engaging consultants to undertake a review of the benefits of introducing a new LOTS scheme. No firm proposals have been received yet.

4 Social and Affordable Housing

4.1 A stable and affordable housing market contributes positively to economic stability, social well being and national competitiveness. The private housing sector cannot, however, address the housing needs of all sections of the population. A significant number of households will continue to be unable to achieve home ownership on the open market or will face affordability problems in the private rental market over the coming years.

4.2 The overall objective of the Department of Environment, Heritage and Local Government's housing policy is 'to enable every household to have available an affordable dwelling of good quality, suited to its needs, in a good environment and, as far as possible, at the tenure of its choice'.

4.3 The National Development Plan 2007-2013 provides over €18 billion, of which €12 billion is exchequer funding, for housing. This equates to an annual average provision of €2.6 billion.

4.4 *Towards 2016* endorses the principles set out in the Department of Environment, Heritage and Local Government key policy strategy: *Building Sustainable Communities* and sets out a long term vision for policy development. It includes a €350 million housing package. It commits to the provision of 27,000 new social housing units over the period 2007-2009. In addition, affordable housing measures will contribute an additional 17,000 units over the same period.

4.5 The Rental Accommodation Scheme will be rolled out to expand the choice available to people at different points in their lifecycle and to help to provide the necessary spring board to accessing employment, training or education opportunities which may lead to broader accommodation options for the individual in the future.

4.6 The Department of the Environment, Heritage and Local Government's policy framework '*Delivering Homes Sustaining Communities'* provides greater detail on the implementation of the goals of the *Building Sustainable Communities* Framework document which set the investment priorities in a broader, sustainable housing context.

5 Preliminary Conclusions

5.1 In light of the above analysis, the following preliminary conclusions appear warranted:-

- The Irish economy is clearly exposed to fluctuations in the new housing construction sector, and the pace at which the new housing output reverts to more sustainable levels will have a key impact on short- to medium-term economic trends.
- Based on all the available evidence, a sharp decline in prices is unlikely, although a further softening is possible.

- Caution should be exercised before adopting any policy measures which could tend to destabilise the house market. The influence of taxation policy and changes on house prices over the course of housing price cycle should be neutral.
- Data indicates that first-time buyers are competing effectively in the housing market. The changes introduced by the Finance Act (No 2) 2007 by abolishing stamp duty on the purchase of second hand houses for first time buyers and the increase in mortgage interest relief introduced in Budget 2007 has undoubtedly assisted in this regard.

It may be useful for the Group to have a discussion on the current position in light of the analysis and preliminary conclusions presented.

APPENDIX 1

Year	*Number of House Completions*
1997	*38,842*
1998	*42,349*
1999	*46,512*
2000	*49,812*
2001	*52,602*
2002	*57,695*
2003	*68,819*
2004	*76,954*
2005	*80,957 **
2006	*93,419 **

Source: Department of Environment
* note that the distribution of completions between 2005 and 2006 is affected by technical factors.

APPENDIX 2

Year	New House Prices (€)		Second Hand House Prices (€)	
	Nationally	Dublin	Nationally	Dublin
1997	102,222	122,036	102,712	131,258
1998	125,302	160,699	134,529	176,420
1999	148,521	193,526	163,316	210,610
2000	169,191	221,724	190,550	247,039
2001	182,863	243,095	206,117	267,939
2002	198,087	256,109	227,799	297,424
2003	224,567	291,646	264,898	355,451
2004	249,191	322,628	294,667	389,791
2005	276,221	350,891	330,399	438,790
2006	305,637	405,957	371,447	512,461

Source: Department of Environment.

APPENDIX 3

Representative Sample of Taxation of Residential property in a number of OECD States

	Imputed rental income taxed	Tax relief on mortgages		Capital gains on housing assets taxable	Inheritance tax
		Interest	Principal repayments		
Austria	N	Y (up to ceiling)	N	Y	Y
Belgium	Y (with fixed deduction)	Y (within limit)	Y (within limit)	Y (if sold < 5 years) POOD are exempt	Y
Canada	N	N	N	Y (on 50% of gains) POOD are exempt	N (but subject to capital gains tax)
Denmark	N	Y	n.a.	Y POOD are exempt	Y
Germany	N	N	N	Y (if sold <10 years) POOD are exempt	Y (lower than for financial assets)
Finland	N	Y (up to a ceiling)	n.a.	Y POOD exempt if sold > 2 years	Y
France	N	N	N	Y POOD are exempt	Y
Ireland	N	Y	N	Y POOD are exempt	Y
Italy	N (for POOD)	Y (for POOD)	N	Y (50% for POOD)	Y (until 2001)
Netherlands	Y	Y	N	N	Y (above tax free threshold)
Norway	Y	Partly (as other interest expenses)	N	Y	Y
Spain	N (for POOD)	Y	Y	Y (exempt if reinvested)	Y
Sweden	Y	Y	N	Y (exempt if reinvested)	N
United Kingdom	N	N	N	Y POOD are exempt	Y
United States	N	Y (up to ceiling)	N	Y (until 2002) (deduction for POOD if held > 2 years)	Y (to be phased out)

Note: POOD = principal owner-occupied dwelling.

Source: Catte, P. *et al.* (2004), "Housing Markets, Wealth and the Business Cycle", *OECD Economics Department Working Papers*, No. 394; Baunkjoer, C.F. (2004), "Housing Taxation", *Housing and Housing Policy in Nordic Countries*, M. Lujanen (ed.), Nordic Council of Ministers