

Housing Taxation Policy

1. Introduction

- 1.1 The main purpose of any tax is to raise revenue for the Exchequer. However, the tax system is also used to promote various economic or social objectives. This can be done by way of tax exemptions, low tax rates, differential tax rates or special reliefs and incentives. 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.
- 1.2 It is widely recognised that specific interventions in the taxation area targeted at certain sectors of the housing market, for example, tax changes directed at owner occupiers generally or perhaps a subset of owner occupiers, such as first time buyers or residential investors need careful consideration of their implications for the wider housing market. Interventions intended to benefit one area can sometimes trigger unexpected and unplanned consequences in other sectors. Given that the construction sector accounts for about 20% of Ireland's economic output at present, and given the major risks to the economy of any volatility in this sector, caution should be exercised before launching any new interventions which might tend to aggravate the risks.
- 1.3 In addition to supporting a large level of employment and economic activity the construction/housing sector is also an important source of revenue for Government which can be used to finance the implementation of other priorities. Therefore, any proposed changes should be approached with caution from both an overall economic view point and a Government finance point of view.
- 1.4 Under current conditions (all other things being equal) tax take from the sector (particularly the rental sector) can be expected to rise going forward as the abolition of the property and area based schemes and the new horizontal measures (limiting the availability of tax reliefs in any one year) begin to impact. Likewise (all things being equal) if the volume of construction output and/or the volume of second hand sales increase then tax revenue can be expected to rise and vice versa and if the value of construction output and/or second hand sales increases, tax revenue can be expected to rise and vice versa. According to recent research by Davy Stockbrokers tax revenue from the property market (VAT, Stamp Duty and Capital Gains Tax) has tripled since 2002 and is estimated to reach €7.5 billion (or c.5% of GNP) in 2006 or almost 17% of expected total tax-take for the year, up from 5% eight years ago. While the future level and value of output from the construction sector and the associated level of value and turnover in the second hand market is uncertain, any unexpected volatility in the sector could have an adverse impact on the stability of expected Government receipts. Davy estimated that each 1% change in the volume of property built or traded could cost as much as €105 million in tax foregone with each 1% change in price worth about €75 million.

2. Taxation measures directly affecting the housing market

2.1 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;
- VAT where a reduced rate of 13.5% applies rather than the standard rate of 21%.

2.2 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 that there is considerable market sensitivity to changes in taxation. 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.

2.3 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 reliefs; the urban renewal, town renewal and rural renewal schemes, and the special reliefs for hotels, holiday cottages, student accommodation, multi-storey car parks, third-level educational buildings, sports injuries clinics, developments associated with park and ride facilities and the general rental refurbishment scheme. Some of these schemes have residential elements, either for owner-occupiers or rental dwellings. 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. Housing Market Trends

Housing Sector and the Economy

3.1 Housing construction (including home improvements) accounted for 15% of GNP last year, a figure that has risen significantly in recent years. The sustained growth of housing output in recent years has been associated with a significant increase in employment in the construction sector, from 126,000 in the second quarter of 1998 to 263,000 in the second

quarter of this year, an increase of 109%. In the second quarter this year (the latest period for which data are available), employment in construction accounted for 13% of total employment, up from 8½% in 1998. 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 €945 million in 2005. In addition, the VAT yield from the sale of new housing in 2006 is estimated at approximately €1,910m with an estimated additional €418m being raised from VAT on the maintenance and repair of all housing.

- 3.2 In the recent *Pre-Budget Outlook*, the Department of Finance noted that, while the outlook for the Irish economy is broadly favourable, there are significant downside risks which could alter this picture. One of the key risks is the exposure of the Irish economy to the construction sector which raises the economy's vulnerability to adverse developments in this sector such as rising interest rates.

Housing supply

- 3.3 Recent Government initiatives in this area whether through the tax code or the planning system have predominantly been aimed at increasing supply. In recent years housing output has risen to record levels showing an impressive supply response to demand pressures. For instance, new home completions increased from 38,482 in 1997 to 86,000 last year, an increase of 123% (appendix 1 details the annual statistics in relation to housing completions from 1997 to 2005). This year, the rate of house building remains strong. Unpublished data from the Department of Environment, Heritage and Local Government (DoE) show that new house completions rose by nearly 7% year-on-year in the first half of this year (note that the unpublished data take account of the fact that some of the output this year has been attributed to last year due to a backlog of completions at the beginning of this year). The number of completed homes this year is now likely to be around 89,000. In *per capita* terms, the level of house building in the State, at around 20 homes per 1,000 of population, is about four times the average level achieved in the remainder of Western Europe. However, the large number of completions in Ireland should be seen in the context of the housing stock in Ireland (relative to the size of the population) being below the EU average.
- 3.4 Home ownership rates are high in Ireland, with up to 80% of private dwellings in the State being owner-occupied in 2003. In the majority of other EU States the rates of owner occupancy are in the 50% to 70% range¹.

House Prices

- 3.5 The latest figures house price statistics from DoE show that the average nationwide price for a new house was €308,302 in the second quarter of this year. The equivalent for a second-hand house was €379,011. Prices were higher in Dublin, with an average new house price of €397,337 and second hand house price of €516,589.
- 3.6 Nationally, prices for new houses rose by 10.8% last year; for second-hand houses prices rose by 12.1% (appendix 2 sets out details of price levels on new and second hand houses for the period 1997 to 2005). In the first half of this year, new house rose by 11.7% year-

¹ Housing markets, wealth and the Business cycle in OECD countries, OECD April 2004.

on-year while second hand house prices rose by 14.3%. While these are strong growth rates, there is some evidence – some of it anecdotal – that house price inflation may be beginning to moderate. For instance, *ESRI/ptsb* data show that the monthly rate of increase has eased over the summer. Anecdotal evidence mainly relates to the possibility that houses are taking longer to sell and that, at the upper end of the market, there has been an increase in the number of houses withdrawn from auction. Moreover, wholesale interest rates have risen by 125 basis points over the last year, and it would seem unlikely that this is not having at least some impact on price developments. Finally, the large increase in supply in recent years may be having a positive impact on price developments.

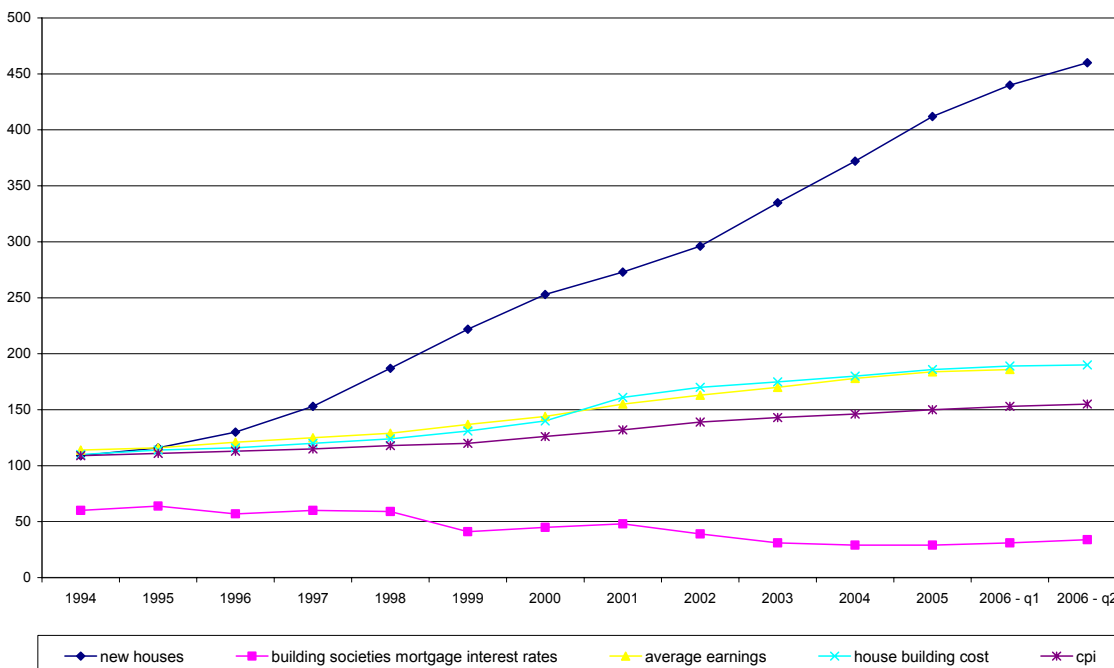
First-time Buyers

3.7 According to *ESRI/ptsb* data, the average price paid by a first-time buyer in August of this year was €275,637, 16% higher than in the same period of last year. Nationally, 37% of all houses sold in 2005 were purchased by first-time buyers. Not unsurprisingly, this proportion was higher for new houses, with first-time buyers purchasing 45% of new houses sold compared to 30% of second hand houses sold.

Link between Price, Affordability and Supply

3.8 The following graph provided by DoE shows the changes in new house prices, house building costs, average adult earnings, consumer prices and mortgage interest rates since 1994. The data indicate that since 1996/97, 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.

Trends in house prices, building societies mortgage interest rates, earnings, cost indices (1991Q1=100)



source : Department of Environment

- 3.9 Affordability is defined as the portion of a representative household's income used to service mortgage debt. An affordability index is produced by *EBS/DKM*. The data show that for a first-time buyer working couple, affordability has been relatively stable over the period since 2001, with rising prices being offset by higher incomes and lower interest rates. This year, however, the increase in interest rates has led to a slight deterioration in affordability.

Rental Market

- 3.10 Private rents declined consistently between mid-2002 and mid-2005 according to the rent sub-component of the Consumer Price Index. Since then, however, the private rental market has picked up, and, indeed, has been reasonably strong this year. For example, private rents in the first eight months of the year were 4.5% higher than in the same period of last year. One possible explanation for the recent strength of the rental market is the additional boost to demand stemming from the inflow of migrant workers, especially since the accession of the New Member States.

Latest Perspectives on the Housing Market

- 3.11 While the annual rate of increase in the first half of the year was fairly robust, there is growing evidence of a slowing in the rate of house price inflation. Thus, while most commentators expect double-digit growth this year, this mainly reflects developments in the first half. In terms of next year, most commentators are expecting a slowdown in house price inflation relative to this year. In terms of housing output, the consensus is for output of 89,000 units this year with a slight fall to 88,000 in 2007.
- 3.12 Data from the Central Bank show that the outstanding level of mortgage credit in July of this year was €105.3 billion, 25.3% higher than in the same period of last year. While still very strong, this was the slowest rate of growth since October 2003. However, on an adjusted basis, the rate of mortgage credit growth remains very strong by historical standards. Moreover, 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. The Bank has warned that this indebtedness raises the vulnerability of households to economic 'shocks'.
- 3.13 As regards the medium-term outlook for the housing sector, there is a general consensus that a falling-off in the current high levels of activity is likely in the years ahead. The medium term demand for housing is estimated to be in the region of 60-70,000 units per annum. Ultimately, therefore, housing output must fall from the current relatively high levels to more sustainable levels. Given that the production of housing is relatively labour intensive, this will inevitably involve a decline in construction employment. The main risk is that this occurs rapidly; given the loss in competitiveness in the exposed sector of the economy, a rapid decline in employment in construction would involve a pickup in unemployment.

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. Maintaining the delivery of housing at affordable prices, improving the quality of houses and neighbourhoods and providing tailored housing solutions will require sustained investment going forward.

- 4.2 €7 billion has already been provided in the Department of the Environment, Heritage and Local Government's capital envelope over the period 2006-2010 to provide for housing – the second highest sectoral allocation after transport.
- 4.3 The strength of the local authorities housing programme can be gauged by the fact that almost 8,500 houses were under construction at the end of 2005. When the units in progress by the voluntary and co-operative housing sector are taken into account, over 10,000 social homes are in the process of construction.
- 4.4 The most recent tri-annual Housing Needs Assessment showed a 10% reduction in the Housing Waiting List from 48,413 in 2002 to 43,684 in 2005. *40% (17,667) of households in need are now on the waiting list for less than one year.* The number of people on the waiting list in Dublin fell by 20% from 15,674 in 2002 to 12,608 in 2005. 56 (of 90) local authorities saw drops in their housing waiting list.
- 4.5 The Government has substantially increased expenditure on housing support for people on low incomes in recent years. In 2005, public social expenditure on housing was more than 1½ % of national income (GNP) – around 4 times the OECD average.
- 4.6 The 5-year local authority action plans for housing provide a strategic reference for investment. The Department of the Environment, Heritage and Local Government's policy framework '*Building Sustainable Communities*' provides structure and sets investment priorities in a broader, sustainable housing context.
- 4.7 '*Towards 2016*' endorses the principles set out in '*Building Sustainable Communities*' and sets out a longer 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.
- 4.8 A report examining means of increasing the supply of Affordable housing is currently being undertaken by consultants, "Three Dragons" & "Strategic Solutions", on behalf of the Affordable Housing Partnership. It is examining a range of possible options to increase and expedite the supply of affordable homes. However, the final report is not due for publication until mid December (after the Budget) and no firm proposals have emerged as of yet.

5. Possible Tax Interventions in the housing market

- 5.1 As pointed out above, the Minister in Budget 2006 suggested that he might consider reintroducing revised versions of the Living Over the Shop Scheme (LOTS) and the Park and Ride relief but no firm proposals have as yet been received.

5.2 *Stamp Duty Options*

The position in relation to Stamp Duty has been outlined in a previous TSG paper and is not addressed here.

- 5.3 It is believed by many economic commentators that the housing market is approaching a degree of equilibrium in that supply is beginning to match the demand for housing. In an interview with the Financial Times on 18 October, 2006 the Governor of the Central Bank, Mr. John Hurley, said that his "central scenario" for the Irish housing market was for a "soft landing" next year and beyond and pointed out that Ireland remained "under-housed" compared with other European countries, with fewer houses per head of population. Nevertheless he expected house building activity to slow but believed that its role in driving economic growth would be taken up by infrastructure projects. Given the current state of the market the impact of any proposed measures on confidence in the property market given current prices, levels of consumer debt etc. would need to be carefully borne in mind. In addition it may be opportune to let the changes introduced last year – i.e. the termination of a number of property based schemes and the introduction of the general horizontal measure bed down before any major new initiatives are proposed.

6. **Preliminary Conclusions**

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

- The Irish economy remains significantly exposed to fluctuations in the construction sector; the pace at which the housing market eases to sustainable levels is identified as a key downside risk to the outlook for future economic growth.
- The full impacts of measures taken in last year's budget abolishing certain property-based reliefs and introducing a general horizontal measure have yet to come into effect.
- Output is unlikely to continue at its present level (regardless of the level of immigration, "under-housing", level of household formation, strong underlying economic factors etc.). In addition, prices are unlikely to continue to rise at previous rates as the impact of recent (and expected future) interest rate increases and more moderate wage increases begin to be felt.
- Caution should be exercised before adopting any policy measures which could tend to exacerbate house price inflation. While there have been some preliminary signs of a moderation in house price inflation the danger remains that any measure that acted as a stimulus to house price inflation at this time could aggravate the economic impact of any future downturn in the sector.
- Data indicate that first-time buyers are competing effectively in the housing market. The higher stamp duty threshold for second-hand houses, introduced in Budget 2005, has undoubtedly assisted in this regard; although another way of looking at this is that the value of the stamp duty relief has simply been capitalised into higher house prices paid by first-time buyers and by buyers generally.

- 6.2 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

Data from Department of the Environment, Heritage and Local Government, Annual Housing Statistics Bulletin 2002, 2003 and 2004

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	86,000

APPENDIX 2

Data from Department of the Environment, Heritage and Local Government, Annual Housing Statistics Bulletin 2002, 2003 and 2004

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
<i>2004</i>	<i>249,191</i>	<i>322,628</i>	<i>294,667</i>	<i>389,791</i>
2005	308,302	397,337	379,011	516,589