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Considerations on the introduction of residential property tax

There have been various opinions formulated on the introduction of property tax and the expected revenues. It is this debate we wish to contribute to in several respects. A critical point of the introduction and operation of property tax is determining the base of the tax, i.e. the value of dwellings. The main advantage of our concept is that it would make it possible to levy property tax with little input, based on real market prices and, at the same time, it would make it easy to filter out the most glaring irregularities. The volume of revenues to be expected of the various property tax concepts is a similarly complex question. In this study, we present the estimated volume of these revenues using property market data, highlighting on tax exemptions depending on the value of property and the owner of property respectively. In addition to the well-known tax concepts, we also outline a property tax combined with personal income tax. What is meant by the latter is an opportunity for taxpayers to deduct property tax from their PIT. This would make it possible, within the framework of social justice, not to increase burden on citizens with a declared income proportionate with their property wealth but to increase burden on those who own valuable property despite a low declared income. Accumulating considerable wealth from undeclared income may be typical in the latter group.

The introduction of property tax, ways to determine the value of properties, a "bearable" property tax rate and the expected volume of revenues have been the focus of several forums and professional debates in recent times. Beyond domestic political and economic players, international institutions, too, have joined the examination of the introduction of property tax in Hungary. It is this debate we wish to hereby contribute to in several respects. It is important to note, at the same time, that it is not our goal to formulate an economic political proposal; this study is strictly restricted to the numerical presentation of facts and the expected effects of various decisions.

In the following part of this study, the main characteristics of the Hungarian housing market, the volume of housing assets and housing wealth, and the forms of property taxation in the international practice are to be presented. In chapter three, property tax is to be placed into the Hungarian taxation system and the most important question that arises related to property tax is to be discussed, which is how to determine the value of properties, i.e. the base of the tax, in a way considering the values of individual properties and at the same time preventing considerable misuse that could be made possible by the information asymmetry between property owners and the tax authority.

In other words, how should property owners determine prices close to real market prices. Chapter four presents the volume of the aggregated housing wealth that could serve as a tax base in the case of various tax exemptions. Chapter five numeralises the expected volume of property tax revenues based on the above housing wealth estimations. Finally, chapter six draws attention to some further questions to be made clear, while the appendix at the end of the study summarises the revenues expected of the introduction of property tax.

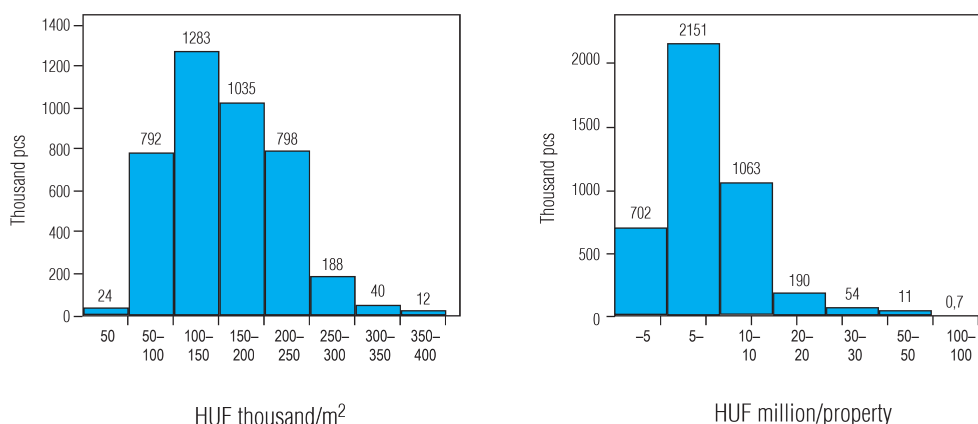
INTERNATIONAL AND DOMESTIC HOUSING MARKETS

Just like in developed economies, housing wealth constitutes a determinative part of household wealth in Hungary, too, ahead of the value of financial savings and personalty. In an international comparison it can be established that, in Hungary, the ratio of housing wealth within household wealth is very high; there are some 4.2 million dwellings in the country. Under *Vadas*' estimation (2007), housing wealth is in the range of twice the GDP, with a value of some HUF 42 thousand billion in 2005[1]. Since the average square metre price of residential property did not rise in 2006, there were no significant changes in housing wealth in 2006, either. The distribution of housing prices and housing wealth is rather unbalanced, i.e. there are much more properties of a lower value and few properties of a high value in Hungary *(see. Chart 1)*.

The Hungarian property market significantly differs from the practice of other countries in two respects. On the one hand, the housing wealth of Hungarian households is high in an international comparison. Among G7 countries, it is only in Italy and the United Kingdom where the ratio of property wealth to income is higher. On the other hand, the ratio of owner-occupied dwellings is extraordinarily high. Over 90 per cent of dwellings in Hungary are occupied by the owners (and their family); under official data, market tenement property is of negligible weight. Despite the dynamic rise in mortgage loans in the past years, mortgage burden does not amount to more than 10 per cent of housing wealth at an aggregated level.

Chart 1

THE DISTRIBUTION OF HOUSING PRICES AND – ASSETS IN HUNGARY IN 2005



Source: Vadas (2007)

Table 1

PROPERTY TAXES IN THE WORLD

Country	Size of tax	Country	Size of tax
Austria	0.2–1.0%	Bulgaria	0.0015
United Kingdom	established annually	Czech Republic	1–10 CZK/m^2
France	rental fee 0.55–1.8%	Estonia	0.1–2.5%
Ireland	0.3–1.2%	Croatia	–
Japan	1.4–2.1%	Poland	0.54 PLN/m^2
Canada	3%	Latvia	0.15%
Germany	0.6–3.0%	Lithuania	1–1.5%
Italy	0.4–0.7%	Romania	4,000–5,900 RL
Portugal	0.8–1.0%	Slovakia	1–4.5 SKK/m^2
USA	changing	Slovenia	no uniform rate

Source: collected by index.hu

Since housing wealth is a significant unit of wealth in every country, levying tax on it is a frequent practice *(see Table 1)*. This is especially efficient in countries where there is large-scale concealment of income and income may thus be observed in consumption and units of wealth.

THE PLACE AND OPERATION OF PROPERTY TAX IN THE TAXATION SYSTEM

On the basis of the above it can be established that the introduction of property taxation may be justified in Hungary, which was also the conclusion of a study by *Kiss* and *Krekó* (2007). On the one hand, the current taxation system relies too heavily on direct income taxes. On the other hand, the significant housing wealth makes it possible to introduce a new tax category that allocates burden along a wider social scale; instead of work incomes, often invisible for the taxation system, it focuses on duly registered property.[2]

Property tax can be introduced either simply as an additional budget revenue or combined with the current personal income taxation system. What is meant by property tax combined with PIT is an opportunity for taxpayers to deduct the amount of property tax from their PIT. This would make it possible, within the framework of social justice, not to increase burden on citizens with a declared income proportionate with their property wealth but to increase burden on those who own valuable property despite a low declared income. Accumulating considerable wealth from undeclared income may be typical in the latter group.

A critical point of the introduction and operation of property tax is determining the base of the tax, i.e. the value of dwellings. Two properties in the same street of the same district may significantly differ in value, which calls for the introduction of a tax base determination method that makes evaluation on an individual basis possible, thereby avoiding unfair taxation, while granting sufficient control to the tax authority. A method meeting these criteria is to be outlined as follows.

The central element of our concept is that taxpayers should be allowed to establish the value of their property themselves. The Hungarian Inland Revenue Office (APEH) could provide guidance on square metre prices, on the basis of the property data store of the

Central Statistical Office (CSO/KSH). The property data store of CSO is an annual publication of property values on a street basis, based on the purchase agreements submitted to the Stamp Office. Through the self-assessment, the problem that could arise from subjectivity, i.e. the determination of the exact value of complex assets – millions of dwellings – by a state authority on the basis of some necessarily insufficient and, in the opinion of most taxpayers, unfair parameters, could be avoided. At the same time, the Revenue Office guidance on square metre prices could be an anchor.

Self-assessment could operate as follows: on the basis of a guide price set by the Revenue Office for a certain district or county, owners would decide whether or not to accept this guide price as a tax base. If they did not accept it, they could enter any other square metre price in their tax return, but in this case they should be aware that the Revenue Office would be entitled to send out a property value estimator.[3] If the price determined by the taxpayer differed from that established by the property value estimator by over a certain percentage, e.g. by over 20 per cent, the difference, just like in the case of other tax differences, would have to be settled increased with a penalty. Since property owners are practically unable to cooperate when making their tax return, the Revenue Office, when checking tax returns, could filter those that differ from the average price of the street or area concerned and the property prices of CSO to an extreme extent. From the years following the year of introduction, it would be an opportunity for further control that taxpayers should be consistent also in time: it would be difficult to justify to the tax authority if there was a significant decease in the declared value of a dwelling from one year to another, detached from market processes.

The declaration of the property value determined by taxpayer could be made, similar to other incomes and tax credits, through the PIT declaration. If the PIT declaration is made by the employer, a statement on property wealth should be attached, similar to other statements on further incomes and credits (voluntary pension fund payments, etc.). Taxpayers who make their PIT declaration themselves, should simply enter the value of property and the calculated amount of property tax in the correct lines of the PIT declaration.

If the amount of property tax does not exceed the PIT obligation, taxpayer does not have any extra tax obligation. If, on the other hand, the amount of property tax exceeds the PIT obligation, taxpayer is to balance the difference between the already paid PIT and the property tax.

From the administrative point of view, the main advantage of our concept is, on the one hand, that it would make it possible to levy property tax with little input, based on real market prices and, at the same time, it would make it easy to filter out the most glaring irregularities. On the other hand, the procedure necessary for the introduction of a new tax category could be avoided because it would be sufficient to add “a new line” to the PIT declaration. It is important to add furthermore that, if the property tax was introduced, the tax payment obligation would extend to all property owners (including natural and legal entities as well as Hungarian and foreign owners).

THE VALUE OF RESIDENTIAL PROPERTIES – THE PROPERTY TAX BASE

So as to estimate the volume of tax revenues expected of the introduction of the property tax, it is necessary to determine the volume of taxable property wealth. Several versions of various tax exemptions have been published. In order to keep these ramifying exemption issues manageable, the possible exemptions are cate-

gorised along two major dimensions: the value of the property and the person of the taxpayer.

As regards the volume of property wealth, three options are examined here:

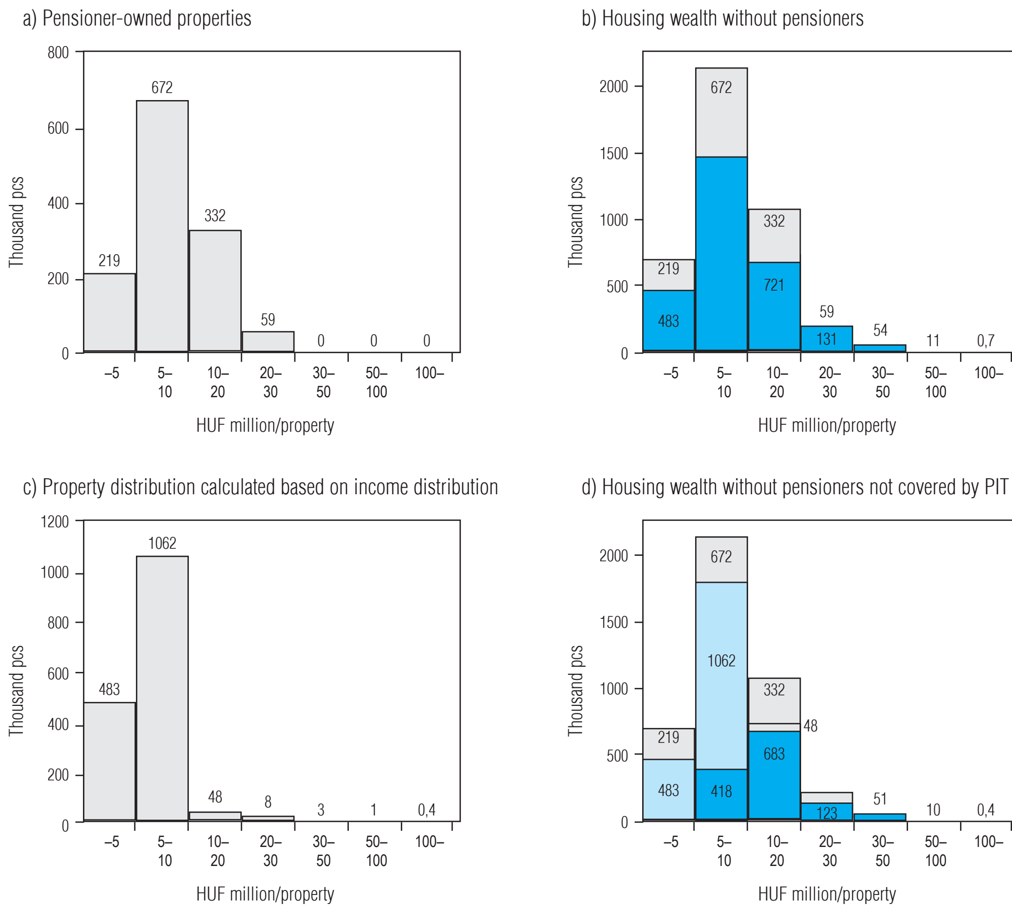
- all property is taxable irrespective of their value;
- only property worth over HUF 10 million is taxable, and
- only property worth over HUF 20 million is taxable.

There are three alternatives regarding the person of the taxpayer, too: there is no regular exemption; pensioners are exempt from the tax and, finally, pensioners are exempt from the property tax plus the tax is deductible from PIT, as outlined above. The exemption granted to pensioners could, in theory, lead to tax avoidance. However, the currently valid property transfer duty lessens the chance of tax avoidance on the one hand and, on the other hand, there is also an opportunity to introduce a differentiated duty. If property is bestowed on a person who is exempt from property tax, for example, a higher duty rate could be applied.

The effects of these exemptions on the tax base, i.e. the volume of taxable property wealth, have been calculated the following way. From the detailed property data base at our disposal, selection on the basis of property value can be easily polled *(see Table 2, column 2)*. Calculations on taxpayer-related exemptions require assumptions, however. In order to sep-

Chart 2

THE EFFECTS OF TAX EXEMPTIONS ON THE DISTRIBUTION OF HOUSING WEALTH (2005)



arate pensioner-owned property assets from the total property assets we have assumed that pensioners' properties belong to the category of under HUF 30 million, within which their distribution corresponds to the general distribution of properties, i.e. we have divided up pensioner-owned properties according to the general distribution of properties of under HUF 30 million, *[see Chart 2, panel (a)]*, afterwards dividing this from the total housing assets *[Chart 2, panel (b)]*. The volume of housing wealth attained as a result is presented in *column 3* of Table 2.

The distribution of property wealth attained as a result of pensioners' exemption is the basis for determining the property wealth liable to the property tax alternative of pensioners' exemption combined with PIT. Unfortunately there are no detailed cross section income-wealth data at our disposal on the basis of which the volume of property wealth that is not "burdened" with PIT-obligation could be precisely calculated. If there was no tax concealment, the distribution of incomes and property wealth would be closely related and the property tax deductible from PIT would not generate any extra tax revenues. Lacking cross section data, two approaches are to be applied.

In the first approach it is assumed that the likelihood of income concealment is the same in every income category and, accordingly, every single part of the property distribution is proportionally reduced by the housing wealth of those who do submit a PIT declaration. Clearly, in this case the estimation is distorted downwards because in the case of higher incomes, the likelihood and rate of tax concealment is higher *(see the lower values in the last column of Table 2)*.

In the second approach we assume that, ideally, the income- and property distribution of PIT payers are closely related, i.e. those who conceal their income live in properties of a low value on the basis of their declared income. In reality, however, they own property of a much higher value compared to their declared income. Therefore, if the "property distribution" calculated on the basis of income distribution is deducted from the actual property wealth distribution, we attain a property distribution in disaccordance with the income distribution. If a person whose declared income is the minimum salary lives in a property worth HUF 200 million, for example, he should be living in a dwelling worth some HUF 5 million on the basis of his income. This property worth HUF 5 million is deducted from the housing wealth because this is covered with income/PIT. The remaining property wealth worth HUF 195 million, which is not covered by PIT, remains part of the property wealth distribution, i.e. it appears as extra revenues. So as to determine the property wealth in accordance with the PIT declaration, the minimum/maximum income scale is divided up according to the steps of the minimum/maximum property wealth. The bands of the

Table 2

PROPERTY WEALTH, 2005

(HUF billion)

Base of property tax	Exemption of taxpayers		
	None	Pensioners	Pension + PIT
Total housing wealth	42 148	29 957	13 319–18 871
Property wealth worth over HUF 10 million	22 831	16 670	7 412–15 530
Property wealth worth over HUF 20 million	7 944	6 429	2 859–5 961

income categories attained thereby correspond to the bands of property wealth. On the basis of this, the number of PIT payers in the respective income categories is determined. Finally, the housing wealth of the taxpayers who belong to these income bands *[Chart 2, panel (c)]* is deducted from the property wealth in the corresponding bands of property wealth *[Chart 2, panel (d)]*. Clearly, the volume of property wealth attained is higher than in the case of the even tax concealment assumed above *(see the higher values in the last column of Table 2)*.

It is important to underline once again that, in the combined PIT-property tax system it is only those whose income and therefore whose PIT obligation are not in accordance with their property wealth that will have extra tax obligation.

THE SIZE OF THE TAX AND THE EXPECTED TAX REVENUES

The 6 tax exemption categories presented and the rate of the property tax involve a high number of variation opportunities. Before discussing the estimated volume of the tax revenues expected of these variations, it is worth considering the size of the property tax rate. Due to the *no-arbitrage* condition applied in economic theory, the yields of a unit of financial means and a unit of real means are equal, i.e. the interests on financial investments equal the yields of property, which latter are made up of the change in the price of property plus the rental fee (for the basis for these models see Poterba, 1984). If we want to tax the yields of these means without distorting the structures of the various forms of investment /savings, it is impossible to determine the sizes of tax on these means independently of one another. Since in Hungary financial savings are burdened by interest tax, determining the "neutral" size of the property tax rate is no longer a "free parameter" because the property tax rate has to equal the product of the interest multiplied by the interest tax. On the basis of the 20 per cent interest tax and the bank of issue base rate, the neutral value of the property tax is 1.6 per cent.

The volume of the expected tax revenues generated by the above tax exemption variation is most easily estimable compared to the vol-

Chart 3

PROPERTY TAX REVENUES

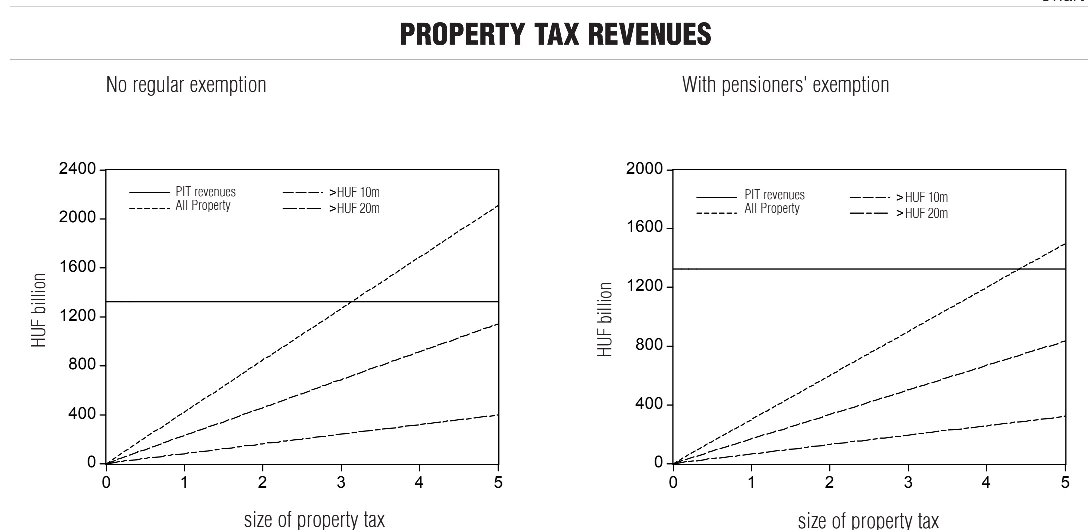
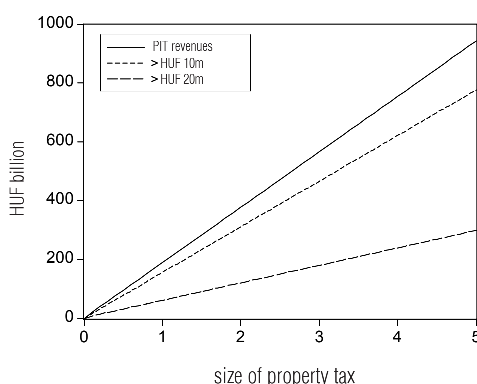


Chart 4

EXTRA REVENUES FROM PROPERTY TAX COMBINED WITH PIT



ume of personal income tax. The most descriptive index number is the property tax rate in the case of which the revenues from the property tax just equal the personal income tax revenues.

The expected property tax revenues in the case of various tax rates can be calculated on the basis of the table (the detailed results of the calculation are also presented in *Table 3* at the end of the study).

Considering the left chart of Chart 2, two important conclusions can be made. On the one hand, taxing the total property wealth would produce revenues equal to those of the personal income tax in the case of a property tax rate of approximately 3 per cent. On the other hand, any value limit on properties significantly reduces the expected tax revenues. If pensioners and properties worth under HUF 20 million are granted tax exemption, the expected tax revenues, in the case of the 0.25 per cent tax rate in common knowledge, is extremely low already (for detailed numerical data see Table 3 in the Appendix).

In the following we shall present the volume of extra tax revenues in case the property tax is deductible from PIT. As earlier mentioned, in this case taxpayers without a "visible" income or with an income in disaccordance with their wealth would also have a share of public burden. The extra tax revenues compared to PIT are presented in *Chart 3.*

SOME CLOSING THOUGHTS

In this analysis, we have approached the issue of property tax emphatically from an economic direction. It is important to point out at the same time that its practical introduction requires the clarification of several further details. Among these, we can emphasise the cooperation between land registries and the Revenue Office to guarantee the up-to-date connection of the two data bases as well as provide a suitable capacity for checking declarations. From the legal point of view, it is an important question how to define the circle of pensioners (e.g. the status of disability pensioners) and how to manage the tax liability of co-owners (e.g. should the incomes of husband and wife be added up in the case of jointly owned property). In the case of the property tax combined with personal income tax, taxing property owned by the unemployed emerges as a marked issue. Similar to taxes on other assets, like the vehicle tax, it is possible to ignore the

unemployed status. It is also an alternative to grant exemption from the tax for the period of registered unemployment. In the latter case, similar to the exemption of pensioners, it is advisable to establish incentives that prevent mass-scale property transfer to unemployed family members. A further question is how to manage the issue of non-residential property (like holiday homes) in the system of property taxation.

Appendix

Table 3

PROPERTY TAX REVENUES

(HUF billion)

Property tax rate	Property tax revenues						Super-tax revenues		
	No regular exemption available			Exemption to pensioners			Pensioners+PIT		
%	Total	>10 million HUF	>20 millin HUF	Total	>10 million HUF	>20 million HUF	Total	>10 million HUF	>20 million HUF
0.2	84	46	16	60	33	13	27–38	15–31	6–12
0.4	169	91	32	120	67	26	53–75	30–62	11–24
0.6	253	137	48	180	100	39	80–113	44–93	17–36
0.8	337	183	64	240	133	51	107–151	59–124	23–48
1.0	421	228	79	300	167	64	133–189	74–155	29–60
1.2	506	274	95	359	200	77	160–226	89–186	34–72
1.4	590	320	111	419	233	90	186–264	104–217	40–83
1.6	674	365	127	479	267	103	213–302	119–248	46–95
1.8	759	411	143	539	300	116	240–340	133–280	51–107
2.0	843	457	159	599	333	129	266–377	148–311	57–119
2.2	927	502	175	659	367	141	293–415	163–342	63–131
2.4	1012	548	191	719	400	154	320–453	178–373	69–143
2.6	1096	594	207	779	433	167	346–491	193–404	74–155
2.8	1180	639	222	839	467	180	373–528	208–435	80–167
3.0	1264	685	238	899	500	193	400–566	222–466	86–179
3.2	1349	731	254	959	533	206	426–604	237–497	91–191
3.4	1433	776	270	1019	567	219	453–642	252–528	97–203
3.6	1517	822	286	1078	600	231	479–679	267–559	103–215
3.8	1602	868	302	1138	633	244	506–717	282–590	109–227
4.0	1686	913	318	1198	667	257	533–755	296–621	114–238
4.2	1770	959	334	1258	700	270	559–793	311–652	120–250
4.4	1855	1005	350	1318	733	283	586–830	326–683	126–262
4.6	1939	1050	365	1378	767	296	613–868	341–714	132–274
4.8	2023	1096	381	1438	800	309	639–906	356–745	137–286
5.0	2107	1142	397	1498	834	321	666–944	371–777	143–298

Notes

[1] Although a publication by the Central Statistical Office (KSH) entitled The National Accounts of Hungary, 2004-2005, does include some estimations on housing wealth, the aggregation level thereof is not suitable for making the calculations related to property tax.

[2] Economic literature has a vast coverage on the comparison of income and wealth taxes (see e.g. Atkinson and Stiglitz,1980; Cremer et al, 2001; Gordon, 2000, 2003; Makoto, 2007), the presentation of which is out of the scope of this study, however. To say that in countries where a significant part of incomes is invisible, it is rational from the point of view of economics to increase the rate of better controllable categories like taxes on consumption and wealth, is a robust statement, however.

[3] There is a similar system in operation when setting property purchase taxes, too. The Stamp Office is entitled to question the price included in the purchase agreement and levy the purchase tax based on its own expert estimation.

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