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Assessing the sustainable nature of housing-related taxation receipts: The case of Ireland[1]

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INTRODUCTION

The impact of the financial crisis of 2008/09 on the Irish public finances was arguably greater than for any other country in the OECD. The Irish economy had exhibited particularly strong budgetary performances vis-à-vis other European countries in the lead up to the crisis; over the period 2005 - 2007 the Irish Government recorded a General Government (GG) budget surplus in each year of 1.3, 2.8 and 0.3 per cent of GDP respectively, while the GG debt to GDP ratio had, in 2006, fallen to less than 24 per cent. To put these numbers in an international context, over the 2005-2007 period the GG budget balance in Germany averaged -1.5 per cent of GDP, with the debt to GDP ratio averaging 66 per cent. However, the crisis precipitated an alarming deterioration in the Irish public finances with an average annual deficit of 8.9 per cent of GDP being recorded over the period 2008-2013 with the debt to GDP ratio quickly escalating to a peak of 123 per cent in 2013.

One of the main sources for this rapid, adverse transformation in the public finances was the over-reliance of Irish budgetary receipts on the booming housing market. In the decade preceding the financial crisis, Irish house price growth was larger than that in any other western economy. This significant period of house price growth was also accompanied by a sustained increase in housing supply. For instance, Irish housing supply over the period 2005 - 2007 averaged approximately 84,000 units per annum. This compares with an average at the same time in the UK of 210,000 units - just over a twofold difference, despite a fourteen fold differential in population levels.

The impact of property market developments was compounded by the nature of the Irish taxation system at this point; stamp duty and VAT receipts, in particular, were collected as a fixed percentage of the house price. Therefore, as prices and volumes sold increased substantially so too did the taxation receipts. However, much of this increase was subsequently proven to have been

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unsustainable. House prices by 2007 were commonly acknowledged to have been overvalued by between 30 to 35 per cent. The onset of the international financial crisis triggered one of the largest corrections in house prices observed across the OECD; between 2007 and 2012 Irish house prices fell by 50 per cent in nominal terms.

In this paper, we attempt to quantify the extent of housing related tax windfall gains and losses accruing to the Irish Exchequer over a thirty year period as a result of disequilibrium in the housing market. This involves a three-step modelling approach where we relate property dependent taxes to the housing market while estimating equilibrium in the latter before solving for the tax take consistent with that equilibrium. In so doing, we find that the fiscal position compatible with equilibrium in the housing market has at times diverged greatly from actual outturns. This has important implications for both budgetary policy (tax and expenditure planning) and fiscal governance.

Our estimates suggest that over the period 2003 to 2008 positive windfalls ranged from 30 to 54 per cent of the actual amount, while, between 2010 and 2013, the negative windfall ranged from 11 to 21 per cent of the relevant taxation aggregate. For stamp duty, it is clear that over the recent period, the negative windfalls were considerably larger than the actual amount collected. In total, our estimates point to an average annual positive tax windfall of 44 per cent (of the housing related tax take) between 2006 and 2008 and a negative windfall of 27 per cent between 2010 and 2013.

From a broader fiscal perspective, these results mean that headline fiscal ratios (such as the GG balance as well as cyclically adjusted variants) are likely to have been distorted with the level of distortion linked to the degree of disequilibrium in the housing market. Over the housing bubble period (2003-07), our estimates suggest that the GG balance in Ireland was inflated by 0.5 per cent of GDP per annum - a very significant sum given that the GG surplus averaged 1.3 per cent of GDP during this period. Conversely, the estimates also suggest that the deficit (between 2008 and 2013) was overstated by 0.1 per cent of GDP per annum on account of the abnormally low levels of activity within the housing market.

The results confirm the significant role played by the housing market in influencing both the tax-take and the overall fiscal position in Ireland. With the on-going adjustments in the housing market, it would appear that prices and volumes have overcorrected in recent years. This means that housing related taxes have been artificially low and have acted as a drag on key fiscal ratios. Such a finding indicates that housing related taxes can be expected to recover quite significantly over the medium-term. This, in turn, has implications for the formulation of budgetary policy and, in particular, the manner in which the structural budget balance is estimated. The results here (all else equal) would indicate that current estimates of the structural deficit may be overstated (due to the failure to adequately capture housing market developments). Much

greater emphasis should be given to modelling key taxation aggregates in framing fiscal policy decisions.

Understanding the link between tax aggregates and the economic activity associated with them is also important from a forecasting perspective. At times, tax forecasting errors in Ireland have been high partly relating to housing market developments. Incorporating likely future developments in the housing market should improve the accuracy of fiscal planning over the medium-term.