INCREASE IN NORWEGIAN PROPERTY TAX WOULD LIKELY REDUCE SUPPLY AND RAISE HOUSING COSTS, INCLUDING FOR FIRST-TIME BUYERS

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Economists have long proposed an increase in Norwegian property taxes. We agree that property tax is an efficient way of creating tax revenues, but do not concur that an increase would necessarily benefit first-time buyers, as has been suggested. Nordic Credit Rating (NCR) is also concerned by the likely effect of higher property taxes on economic growth, credit risk for banks and the impact on credit ratings and funding costs.

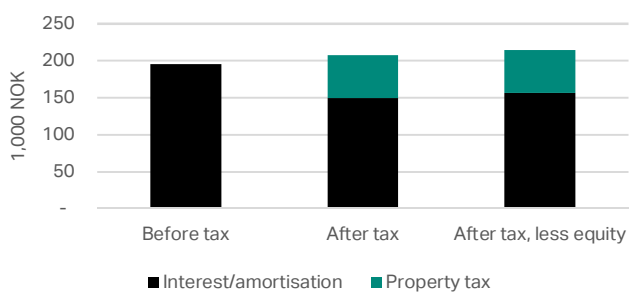
PROPERTY TAX - A REALITY CHECK

In an article in Dagens Næringsliv (DN) newspaper on 26 Jun. 2019, Statistics Norway researcher Erlend Eide Bø claimed that increased property tax would, among other things, benefit first-time buyers as property prices would fall by 20%. The article was based on an earlier discussion paper "Taxation of housing: Killing several birds with one stone", also by Mr. Bø, published by Statistics Norway's Research Department in November 2015. In this note, we look at the likely effects of the property tax increase suggested by Mr. Bø on housing costs (currently, property is taxed through the wealth tax, with significant value discount). The relationships described here are complex and could prove difficult to model. However, in our view, they should be taken into account in any discussion of property tax.

WHO WOULD BENEFIT FROM HIGHER PROPERTY TAX?

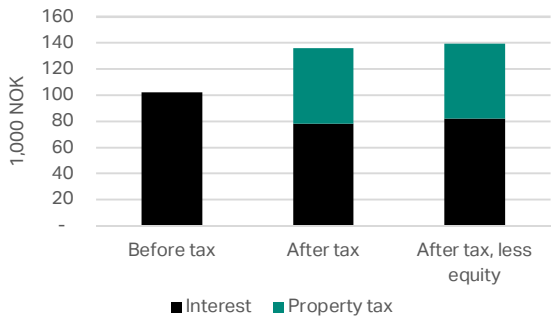
Economists view property tax as efficient since property cannot be moved abroad. In addition, property tax does not reduce incentives to work and prevents overinvestment in housing. However, given the current tax regime in Norway, any increase in property tax would entail a huge transfer of value from homeowners to the government, which might or might not choose to transfer the value back to taxpayers by cutting other taxes. Another argument for increased property tax is that it would reduce housing prices and lower the need for mortgage loans. However, in our view, new entrants to the housing market would not be better off, except perhaps for a small number with high incomes and low equity.

Figure 1. Annual costs: Amortisation, interest and property tax



Based on NCR data

Figure 2. Annual costs: Interest and property tax



Based on NCR data

Mr. Bø argues that a property tax equivalent to 11% of total tax revenue would lead to an 18% fall in housing prices (a 20% decline is assumed in the DN article). An 11% increase in tax revenue would amount to about NOK 150bn, which represents 1.8% of the total value of Norwegian dwellings (source: Eiendom Norge). Accordingly, we assume that property tax is equal to 1.8% of market value in the example below (Mr. Bø cites an example implying a 1.7% property tax level).

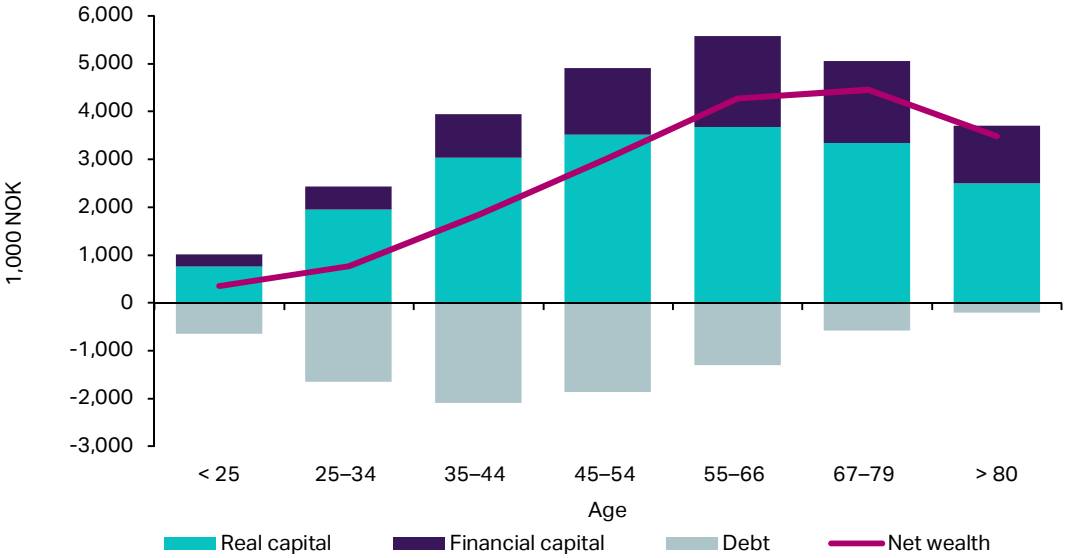
Figures 1 and 2 illustrate a slightly simplified example of total costs for homeowners buying a property at NOK 4m before property tax is introduced and an equivalent property at NOK 3.2m after tax is introduced. In both the "before tax" and "after tax" cases the buyer has equity of NOK 0.6m and takes out an annuity loan to finance the remainder at 3% interest over 25 years. In the "after tax, less equity case", the buyer has equity of NOK 0.48m (15% of the property value). Amortisation is included in Figure 1, but not Figure 2.

The charts show that the property buyer has higher annual costs after tax is introduced even if the property price were to fall by 20%. This is obviously dependent on the relationship between property tax and price level; if a 20% price fall could be achieved with 1.4% property tax, the annual cost would be the same as before property tax was introduced. This would also be the case if the price fell by 36% given 1.8% property tax. It should be noted that the actual taxation method would probably be different. Mr. Bø suggests taxing imputed rental income and a modified wealth taxation schedule.

SECOND ORDER EFFECTS – LOWER BUILDING ACIVITY AND CONSUMPTION

Norwegian households have most of their savings invested in housing (real capital in Figure 3 is mostly property), a consequence not only of benign taxation rules but also of the fact that all Norwegian wage earners are covered by public and collective pension schemes.

Figure 3. Household wealth and debt, 2017, by age of main provider



Source: Statistics Norway, FSA

If housing prices were to fall by 20%, homeowners looking for more space would have problems affording it, since a large part of their equity would be wiped out. This would have a particularly negative impact on young families. We believe that such a fall would stall turnover in the housing market, making it more difficult for first-time buyers and young families. It would also mean that fewer new homes would be built due to reduced demand. Moreover, building costs would not be impacted by a property tax and so lower housing prices would make it less attractive to build new homes.

In his paper, Mr. Bø suggests that the government should cut other taxes by the same amount as the increased property tax. Since most Norwegian wage earners are homeowners, this would mean that on average, the net effect on disposable income would be close to neutral. However, there would still be a significant effect on net wealth, which most likely would have a negative impact on consumption. Empirical studies indicate that a housing price fall of 10% leads to a reduction in consumption of 0%-6%. Studies on Norwegian data suggest an effect of around 1% (source: Norges Bank Staff Memo nr. 11/2017).

In his paper, Mr. Bø suggests that the government should increase property taxes over a protracted period. This would reduce the negative effects described here, but we believe that it would still have a significant negative impact on homebuilding activity.

NEGATIVE EFFECT ON BANK CREDIT RATINGS

A price drop of 20% would mean that the average loan-to-value (LTV) for Norwegian instalment mortgage loans would increase from 64% (2018) to 80%, as illustrated in figure 4. Moreover, 57% of loans extended in 2018 would have an LTV ratio above the 85% threshold set by the Norwegian Financial Supervisory Authority (FSA), see figures 5 and 6. This would obviously have a negative impact on Norwegian banks' credit risk and would also impact our current 'a' assessment of the Norwegian bank environment. We assess the other Nordic markets at 'a-'. We expect that bank credit ratings would be negatively affected by a significant increase in property taxes, and that this would increase funding costs for banks and consequently also mortgage rates.

Figure 4. Average LTV ratio of Norwegian mortgage installment loans

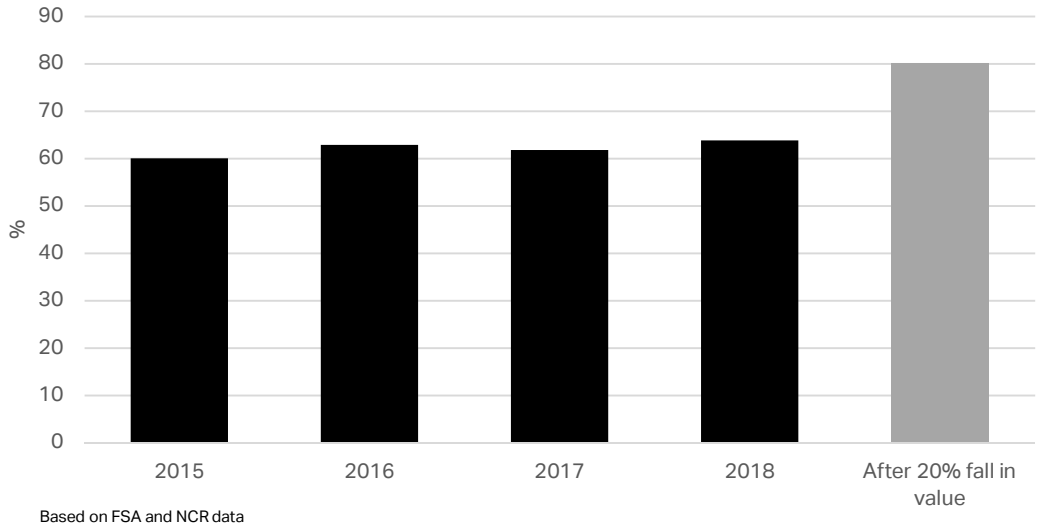
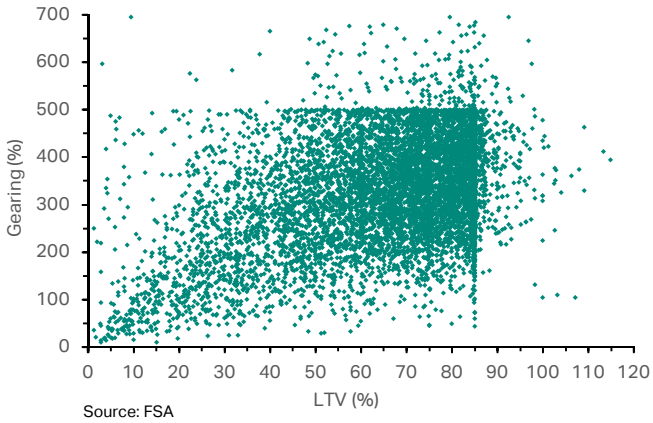
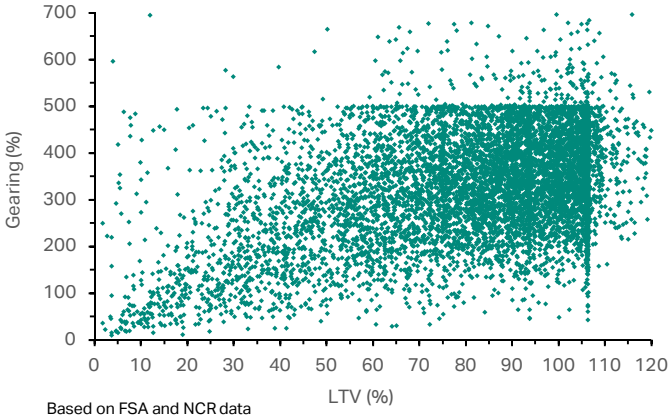


Figure 5. LTV and gearing of new installment loans, 2018



Source: FSA

Figure 6. LTV and gearing of new installment loans after 20% price drop



Based on FSA and NCR data

We are also concerned that the likely negative effects on consumption and GDP would increase loan losses. This is especially a concern if any rise in property tax were to coincide with an economic recession, which we believe was one of several factors behind the domestic banking crisis in the late 1980s and early 1990s.

We doubt that the long-term benefits of higher property taxes would outweigh the short- and medium-term costs. At the very least we would expect a broader analysis of the costs and benefits than we have seen so far. In any event, we do not expect politicians to adopt meaningful changes in taxation of housing anytime soon as the political costs of removing tax incentives to homeownership would be too great.

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