INTERPRETING CHINA'S PILOT REAL ESTATE TAX REFORM

China's National People's Congress (NPC) declared a significant revision to the country's taxation code at its October 2021 session, with the announcement that it had authorized the State Council to enact pilot real estate tax reforms in selected areas nationwide.

The move can be seen in the wider context of the government's continuing push towards the goal of "common prosperity," and has three stated objectives: to advance the legislation and reform of property tax, guide rational housing consumption and economical use of land resources, and promote healthy development of the real estate market.

In this summary report we introduce the pilot tax reform plan, explain what's new, and examine the implications for the real estate market.

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Pilot Real Estate Tax Reform: Key Points

Catchment:

All forms of residential and non-residential real estate and land use rights in the designated pilot areas, excepting legally-owned rural homesteads and homes.

Mechanism:

The State Council is to finalize the tax reform measures and nominate the pilot sites, while regional authorities will draw up the specific implementation rules.

Timeline:

The pilot reform program will run for five years, with an application for continued authorization due to be presented to the NPC six months before expiry.

The NPC Announcement

The NPC is China's most senior legislative body, with responsibility for establishing the country's taxation system. However, the process to revise existing laws or to introduce and implement a new law can take from three to five years, or even longer. That would mean slow progress towards the goal of advancing real estate tax reform. In contrast, authorizing the State Council to implement a pilot reform scheme, rather than enacting nationwide legislation, allows for a more effective administrative operation and more rapid execution of the goal.

Three Pillars of the Reform Plan

Upholding the principle that housing is for living in and not for speculation

The central government's Economic Work Conference first put forward the doctrine that "We must insist that homes are used for living in, not for speculation" in 2016. In the five years since, China's real estate market has been somewhat stabilized via extensive regulatory interventions. However, a still-narrow range of available investment channels means that real estate remains a favored asset option for residents and for "hot money" alike. Levying the new real estate tax will raise the cost of property ownership, potentially dissuading further speculative capital from entering the market and promoting more "rational" housing consumption. By weakening the investment attributes of real estate, the government hopes to guide the housing market back to its primary, residential, virtues.

Narrowing the wealth gap in pursuit of common prosperity

Despite the sustained advocacy of the "Homes are for living in" guiding principle, real estate continues to dominate individual asset allocation within China. In fact, data released by the China Securities Regulatory Commission shows that property accounts for up to 70% of total assets of urban households nationwide. The central government identifies this imbalance as an obstacle to wider social equality and the promotion of common prosperity. Imposing a real estate tax will likely curtail investment yields and introduce housing price downside potential to the market. In turn, some people may find more housing more affordable, helping to narrow the wealth gap between rich and poor, promote social equality, and expediate the realization of common prosperity.

Creating an alternative long-term revenue source to stabilize local government finances

Data from the National Bureau of Statistics shows that China's national fiscal revenues were at RMB18.29 trillion in 2020. Land transfer fees accounted for RMB8.4 trillion, or nearly 46% of the total. This figure is indicative of local governments' long-held dependence on land-related revenues, a habit developed during the rapid expansion of the real estate sector over the past 20 years. However, the situation is now changing. As the urbanization rate plateaus and urban expansion enters a stage of maturity, the stock of available land resources is diminishing. That means land-derived revenues alone will be insufficient to keep local governments afloat. IMF data shows that China's local government implicit debt was at RMB37 trillion in 2018 and RMB42 trillion in 2019, accounting for 40% and 43% of their GDP, respectively. Consequently, local governments have a pressing need to find a new, long-term, sustainable source of fiscal revenue to replace land transfer fees. Real estate taxes levied on existing properties have been employed for many years in other countries, and should prove a valuable reference point for China.

Current Real Estate Taxation Structure

China's existing real estate tax structure was promulgated in the *Interim Regulations of the People's Republic of China on Real Estate Tax* of 1986, and revised in 2011. The regulations stipulate that tax may be levied on all forms of property. However, individually owned real estate for non-business use is exempt. Real estate in other specific categories is also exempt, comprising real estate owned by defined state agencies or organizations; for self-use as allocated by the Ministry of Finance; for use at defined temples, parks and historical sites; or otherwise exempted by the Ministry of Finance. The tax net is aimed at owners of property rights, including land rights, and is based on the taxable value of the property or the rental income obtained from renting it out. The current regulations have three tax rates as follows:

1.

The annual payable tax rate applied to self-use properties is 1.2%, based on the value of the commercial property

2.

The tax rate applied for leasing properties is 12%, based on the rental income from renting the commercial property

3.

Property tax is levied at a rate of 4% on residential housing rented out by individuals at market rental prices, regardless of their use

However, in 2011 a first pilot reform exercise was launched, with municipal governments in Shanghai and Chongqing trialing expanded real estate tax measures. Shanghai introduced a levy on new residential property purchases, while Chongqing taxed high-end or luxury residences. Ten years on, authorities in both cities have gained valuable experience, but the limited scope of the trials has resulted in very moderate fiscal returns. In Shanghai, the expanded measures have seen total real estate taxation contribute an annual average of just 2.6% to the city's coffers over the past ten years. The contribution of real estate tax derived from individual housing ownership has been less than 1%.

Shanghai real estate tax，land transfer fees and fiscal revenues from 2011 to 2020

Source: Shanghai Municipal Bureau of Statistics, CREIS

What's Different About the New Pilot Plan?

Simply put, the new reform will introduce a much broader scope of taxation across all commercial and residential property in the designated pilot cities. Legally owned households in rural areas will continue to be exempt. The pilot locations are still to be specified. We are also awaiting critical details such as when the program will commence, whether the tax net will include all existing properties or just new acquisitions, and if first-time home buyers will be exempt, as well as the range of taxation rates. However, we believe that the new pilot will introduce a comprehensive real estate tax structure significantly wider than the Shanghai and Chongqing housing tax measures of 2011. Such a structure may encompass all taxation measures directly related to real estate, including but not limited to stamp tax, land value-added tax, deed tax, and farmland occupation tax.

Implications for the Real Estate Market

The real estate tax reform measures are designed to guide "rational consumption" in the real estate market and to help establish a long-term sustainable market mechanism. Increased costs of holding real estate assets should curtail speculation in the market. When investment incomes fail to cover the cost of holding an asset, idle properties may also return to the sales market, thus increasing supply and helping to stabilize prices.

In the event that housing prices start to decline, developers will become less willing to acquire land at premium pricing, thus softening land pricing. In turn, the market will accommodate greater potential pricing downside. As housing becomes more affordable to some people, the purely investment attributes of property will be diminished, supporting a gradual move to the goal of common prosperity.

Previously vacant properties will also be encouraged onto the market due to the greater costs of holding assets. Increased supply will provide prospective tenants with more choices, thereby stabilizing overall rental levels in the residential market.

If the pilot real estate tax reform program produces the expected results, we can expect it to become a normalized mechanism for guiding the direction of China's real estate market.

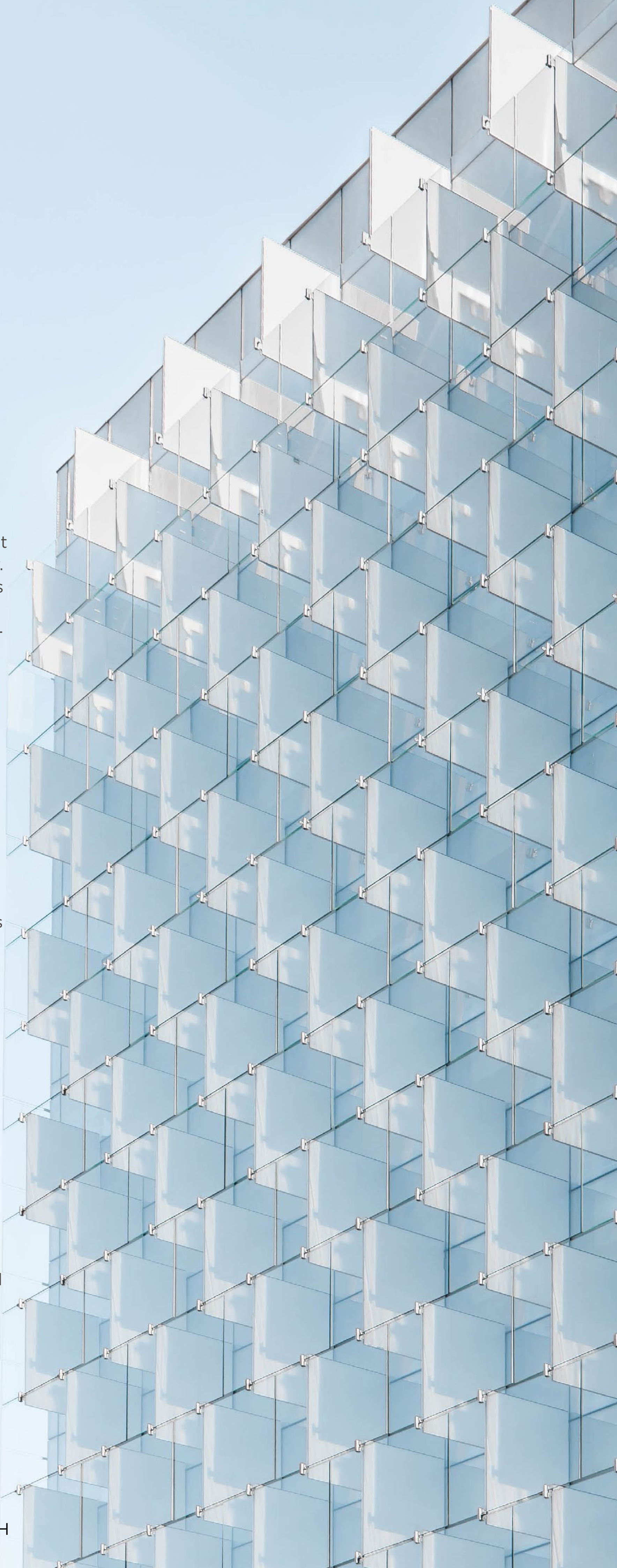
Conclusion

The pilot real estate tax reform measures announced by the NPC in October have the potential to effect profound change in China's economic model, real estate policies, investment environment, and how its people view property. If existing residences including first-time homes are brought into a nationwide tax catchment the financial impact on homeowners and lower-income classes could be significant, depending on how tax rates are set.

As well, real estate developers could see a business curtailment and consolidation as the industry reshapes. While any potentially significant downside in real estate pricing caused by implementing such a taxation policy could have knock-on effects elsewhere in the economy. Such factors will require close observation and careful management.

However, we should remember that the reforms will essentially bring China into line with real estate taxation policies in many economies internationally. It is imperative for China's local governments to build a long-term sustainable revenue stream as an alternative to land sales, if they are to stave off a future debt crisis. And the central government is determined to deter excessive property speculation, return rational buying behavior to the market, and pursue the overarching ambition of achieving common prosperity across the country.

In conclusion, the real estate tax reform measures support the needs of China's local governments and the goals of the central government. We expect to see a controlled and careful implementation of the pilot measures over the next five years, all working towards the objective of stable and healthy long-term development of China's real estate market.



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