China can decrease leverage by levying real estate tax

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In recent years, the high nongovernmental debts in China, i.e., high debts of enterprises and residents with an increasing leverage, have received extensive attention at home and abroad. High debts are very risky for every single company and household and for the country. High debts may trigger a financial crisis when the expenditures for the loans come to surpass the returns. Moritz Schularick of the Free University Berlin and Alan Taylor of the University of California Davis found that “credit growth is a powerful predictor of financial crises” from a database of 14 high-income countries in 2010. How to solve the problems of high debts and decrease leverage is a pressing matter now.

Elementary arithmetic teaches us that external debts can be benign for the country when (i) the involved companies are expanding and can make productive use of the loans, and (ii) when the earnings of the application of the loaned capital surpasses the costs of the loan, i.e., when the interest rate of the loan is below the rate of return of the chosen applications — and remains so at least as long as the redemption will take. It is indisputable that leverage can work in two directions. It can increase earnings and make better running companies and better private life, and it can work in the opposite direction, ruin companies and make private life miserable.

The high debt ratio of Chinese households and real estate companies is related to real estate bubbles. If a real estate bubble is not eliminated, it is difficult to reduce the high debt ratio and eliminate the financial risk. Real estate and bank credit are naturally linked. Banks provide funds for both the supply and demand sides of real estate. That has created a high leverage in the real estate industry. Without adjustment in housing prices, deleveraging is difficult to sustain.

What measures are conducive to reducing housing prices? We recommend the implementation of real estate tax. It is actually helpful to reduce the pro-cyclicality of the financial cycle, i.e., to reduce the amplitude of financial variables’ fluctuations during the credit cycle of the expansion and contraction of access to credit over time: If we have a real estate tax and no land-transfer fees, in fact, we rely less on fiscal and more on finance, which is conductive to reducing the pro-cyclicality of finance. Lowering the actual housing prices (i.e., to pay once, namely when acquiring a flat) by introducing a new permanent but affordable burden (by an annually continuing real estate tax) is the key to deleveraging.
First, we need to deal with the relationship between real estate tax and land-transfer fees. Land in China is divided into collective land and State-owned land. State-owned land is owned by the State. Land auctions do not grant land ownership, but land use rights for a certain number of years (mostly 70 years). The important motivation for the Chinese Government, especially local governments, to develop real estate comes from China's tax system.

Second, in the total value of real estate, the value of the house itself is small. The actual building cost in China is quite low. By 2014, China's Engineering Cost Network showed that the cost of multi-story housing per square meter was 1,362 yuan, and that of high-rise housing was 1,817 yuan per square meter, or US $19 to US$26 per square foot, which is surprisingly low compared with the U.S. standard. The key to implementing real estate tax is separating the value (and price and ownership) of the land and of the "bricks."

Third, a good real estate tax system should balance the interests of all parties, including government, banks, developers and residents. A good tax policy design is the key to continuous operation of real estate tax. This tax rate must ensure that the government receives the same amount of revenue as the previous land auctions so as to have the initiative to levy. In order to stabilize housing prices, the government must impose a relatively high real estate tax. If the real estate tax is set too low, it will not play a role in regulating housing prices.

Good real estate tax measures are conducive to supply-side reform of the real estate market and the establishment of a long-term mechanism for price control in the real estate market. The role of real estate tax on the market should be long-term and sustainable. It can adjust the housing needs of different income groups quantitatively, so as to adjust supply and demand rationally. At the same time, it increases the revenue of local governments, which makes local governments more active in levying taxes. When there is no land to sell, local governments also have tax revenue to provide better public goods and services.

Fourth, as an important substantive element of real estate tax, the system of reduction and exemption is the key to the sustainable and sound operation of real estate tax. Real estate tax should be levied on the valuation of real estate. We should differentiate on whether the land-transfer fees have been paid or not. The real estate with the land-transfer fee already paid should be exempt from the real estate tax within 70 years. A value-added tax should be considered, that is, the added value from the sale of real estate should be taxed.

If the price paid by the residents to purchase the house already includes the land-transfer fee, it is obviously unfair to use this price as the basis for the annual payment of real estate tax. Therefore, a reasonable choice could be converting the land-transfer fee that has been paid into annual payments and then assessing the real estate value, or deducting it from the real estate appraisal value in a certain proportion.

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