Vitas Vasiliauskas: Real estate taxation and macroprudential policy

Welcome remarks by Mr Vitas Vasiliauskas, Chairman of the Board of the Bank of Lithuania, at the Macroprudential Policy Conference "Real estate taxation and macroprudential policy", Vilnius, 2 July 2019.

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Good morning, Ladies and Gentlemen:

It is my pleasure to join you today at this already-traditional conference, and to thank you all – speakers, panellists and participants – for gathering to discuss this very timely topic. I would also like to express special thanks to our keynote speakers – Professor Klaas Knot, president of De Nederlandsche Bank, and Henrik Braconier, chief economist at Sweden's Finansinspektionen, who delivered the keynote speech yesterday.

Regretfully, I was not able to be here when you began discussing the interlinkages between real estate taxation and macroprudential policy instruments, and shared country experiences in residential real estate taxation. Still, today's agenda promises us another intensive day with engaging discussions and, hopefully, some helpful answers.

Dear Colleagues:

In welcoming you all today, I hardly need to list the benefits of macroprudential policy and its instruments. I am sure that macroprudential policy works – especially as a preventive tool. Let's take current Lithuania as an example. The economy is growing, but we do not observe economic agents – creditors and borrowers – acting irresponsibly (what we had prior to the financial crisis). I believe that other countries experiences, the ESRB framework and the policy instruments prove, if not the effectiveness, than at least their potential.

It is worth noting that we still lack clear evidence on the interactions of various macroprudential measures with other policy areas.

This is true, despite the fact that macroprudential policies have been gaining recognition and use among policymakers in many countries. In fact, data shows that the usage of macroprudential measures increased persistently in the immediate post-crisis years. This trend is evident in both advanced and emerging market economies, albeit to a different extent.

In my opinion, measures directed at affecting crediting in the economy are effective tools with an impact on the economic cycle – especially in the low interest rate environment.

We consider current timing to be appropriate to deepen our understanding of the links between macroprudential and other policies, as policy makers need to think in the frame of a well-balanced policy mix. I believe that policy makers' cooperation is a desirable outcome, but it may be hard to implement. Ideally it would be beneficial, but in reality it is quite difficult to achieve, primarily due to different goals and horizons, as far as policy is concerned.

Unlike before the crisis, today, the mandate of the Bank of Lithuania includes both micro and macroprudential responsibilities. In practice, this means that, with respect to decision-making, we act as an autonomous entity and do not require separate approval from other national institutions. Yet, as tax policy is obviously beyond our mandate, we need broader discussions that often involve delicate political issues.

Although most taxes affect individual behaviour, property taxation is generally perceived as less distortionary than labour or capital taxation. Furthermore, property tax can produce a positive externality: it may contribute to ensuring financial stability. It is widely believed that demand shocks tend to amplify when property taxes are low, inducing excessive price volatility. This notion has some empirical support; for instance, many researchers argue that property taxes can reduce house price volatility.

But here too, I believe that it is important to analyse the possible implications for the economic cycles of different policies. The intermediate objectives of macroprudential and fiscal policies might differ. Nevertheless, the underlying goal of all policies is to achieve a stable and sustainable rate of economic growth. As such, it is crucial that policy makers make time to listen to each other.

One of the main areas where fiscal and macroprudential policies intersect is the housing market. In many countries – and in both advanced and emerging economies – governments intervene in the housing market. Such policy decisions can indeed contribute to financial stability – or instability, for that matter.

Additionally, there is some evidence that government housing-related interventions (e.g., mortgage interest deduction and state-supported mortgage insurance schemes) can lead to larger house price volatility. This is especially the case when policymakers target policy goals other than financial stability, such as increasing home ownership rates.

In the period leading to the financial crisis, here in Lithuania we also had some fiscal incentives. First, before the crisis (from 2002 until 2008), there were income tax incentives for individuals taking housing loans. As a result, mortgage interest rates were effectively reduced by a third. Looking back, now we can say that those incentives were probably one of the factors, which escalated irresponsible borrowers' behavior before the crisis, especially since it was not stopped early enough. Second, there was a housing loan insurance scheme, which shifted the risks of the riskiest borrowers from banks to the state-owned mortgage insurance company. Naturally, this created grounds for moral hazard concerns.

In other words, such government policy stance, together with other economic factors (such as EU membership, plans to introduce euro in 2007, the enthusiasm regarding economic expansion etc.) clearly fostered credit and house price growth. Looking back, it is evident that policymakers failed to acknowledge the excessive boom in the economy. Subsequently, they did not make effective use of fiscal stabilization tools.

The introduction of a universal property tax (or at least a credible plan to do so) and the abolishment of the tax incentive could have had a suppressing impact on property prices. Indeed, according to OECD research, reduction of tax deductions related to mortgage financing costs can reduce house price volatility. That would probably not have prevented the bubble from emerging, but it might have limited the damage.

Returning to today, we see that Lithuania still does not have a universal residential real estate tax. Last year, the Bank of Lithuania released suggestions concerning the tax system. One of those suggestions was primarily related to the residential real estate tax – we suggested broadening the base of residential real estate taxation. Our proposals have not yet found their way forward politically.

What we have today in Lithuania is a situation in which real estate taxation exists – but more in theory than in practice. For example, last year, residential real estate taxation generated only 1.7 m euro as budgetary income, which is only a tiny fraction – 0.02 % – of the total state budget income.

OECD also reports that, in total, real estate taxation in Lithuania constitutes around 0.4% of GDP. Is that enough? To compare, total real estate taxation in Latvia constitutes around 0.9% of GDP, while in Poland – around 1.2% of GDP. The OECD average is around 1%. So due to the current tax design real estate taxation in Lithuania has little real effect. This is clearly not a suitable outcome.

The current discussion is relevant not only internationally, but also for Lithuania in particular – especially given our past experiences. We – I mean many of us – still need to do our homework on the taxation design side. My understanding is that countries experience different problems and come up with different “recipes” for solving them. So, today’s policy discussion on whether real estate taxation and macroprudential policies are complements or substitutes is highly relevant.

We will also continue looking into country-specific experiences – successful and less so – with residential real estate related tax systems. In this respect, the experience of other countries can play a crucial role. Thus, I look forward to hearing from our keynote speaker about the policy recipes chosen and implemented in the Netherlands.

To wrap up, this is the third macroprudential conference organized here in Vilnius, and I am glad to see that the agenda is filled with interesting presentations by people from many different institutions.

I’m excited to open the floor to the discussions. I believe that we have a good mix of policymakers, researchers and representatives of international institutions for this to happen. I wish us an interesting day and a fruitful exchange of views, hopefully leading to positive policy outcomes.

And now, I gladly pass the microphone to our keynote speaker – Professor Klaas Knot. I look forward to hearing your thoughts on the possible effects of the taxation of residential real estate, and the possible interlinkages with macroprudential policy.

Please, Klaas, the floor is yours.