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Thesis Prospectus: "Residential Property Tax Trials in Shanghai and Chongching: What will be their effect on housing prices?"

Objective:

On January 28, 2011, Shanghai and Chongching began levying a property tax on individual residential properties in an attempt to curb speculative investment and cool local residential property markets. The tax is currently being levied on a trial basis with varying differences in policy between the two cities. The Chinese central government has indicated plans to implement similar property taxes throughout China in the future, leading many to closely watch the implementation of the tax in Shanghai and Chongching and analyze its consequent effects on the local property markets.[1] The aim of this thesis will be to examine the property tax on trial in Shanghai and Chongching and evaluate the effects, if any, on the local housing prices a year after its implementation.

Background:

After the foundation of the People's Republic of China in 1949, China relied on a Soviet-style system of "welfare housing." Under this system, state-owned enterprises (SOEs) allocated housing units to employees at heavily subsidized rates and little regard to supply-and-demand conditions. This system continued relatively unchanged until Deng Xiaoping began his economic reforms in the late 1970s that gradually transformed it into

[1]KPMG. Shanghai and Chongching Pioneering Property Tax on Trial Basis. Issue brief no. 6. China Alert. 2011.

an open real estate market. Hung-Gay Fung, Jau-lian Jeng and Qingfeng “Wilson” Liu break down the development of China’s real estate market into five phases.[2]

The first phase of development started after the founding of the People’s Republic of China and lasted until 1978. During this phase, China relied on the aforementioned Soviet-style system of “welfare housing.” In the second phase, from 1978 to early 1987, China began its experiment of the “One-third Housing Sale Model.” This model was used in a few selected cities and required the government, SOEs, and individuals to each cover one-third of construction and maintenance costs for new units. During the third phase, from 1987 to 1991, an amendment to the constitution allowing transfer of land-use rights was passed, and marked the formal initiation of China’s real estate marketization process. The housing Public Accumulation Fund (PAF) was also gradually launched throughout the country.[3]

The development of the real estate industry began to accelerate during the fourth phase, which lasted from 1992 to 1997. Relaxed regulations on land-use rights began to be offered in designated economic development zones, and by 1994, the Urban Real Estate Law, which provided the main legal framework for real estate markets at the national level, was adopted. From 1998 to the present, China’s real estate market has been in its fifth phase of development. During this time, it has seen the removal of all remaining parts of the old housing system and a further acceleration of its marketization. In 1998, the State Council issued a directive essentially ending the “welfare housing” system and making employers convert real housing distribution to financial housing assistance. Thereafter,

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[2] Fung, Hung-Gay, Jau-Lian Jeng, and Qingfeng "Wilson" Liu. "Development of China's Real Estate Market." Chinese Economy 43 (2010): 71-92. P72
[3] Fung, p72

urban residents began to rely on personal salaries, the PAF, personal mortgage loans, and financial housing subsidies provided by employers to purchase housing.[4]

Since these reforms, China has seen major growth in its real estate industry. Real estate investment grew at an average annual rate of 22.1 percent between 1998 and 2007, and by 2005 real estate capital accounted for 42.6 percent of GDP.[5] Real estate is now a major concern for the Chinese government as it is now one of the largest sectors of the economy, and numerous other sectors are directly tied to its growth. [6]

After the financial crisis began in 2007, China's real estate market began to stumble and many investors suffered major losses. [7] The $665 billion dollar economic stimulus package unveiled by the central government in 2008 and accompanied cuts in interests rates led to a rebound in the property market. Property sales soared 60 percent in the first seven months of 2009 and housing prices rose to unprecedented levels.[8] This led many to fear that much of the stimulus money had been funneled into the asset market and was creating a worrisome bubble in the real estate market. In 2010, the central government began unveiling several measures to curb the rise in housing prices. These measures ranged from changes in lending practices to raises in the minimum down payments for first-time homebuyers. These measures had some success in slowing the rise in housing prices, but in a move to further reign in the rise in property prices, the central government

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[4] Fung, p73
[5] Fung, p82
[6] Roberts, Dexter. "Mania on the Mainland." Business Week 1 Nov. 2010: 30-34.
[7] Fung, p86
[8] "Bubble Fear as China Spends Big." Northern Territory News 21 Sept. 2009: 14.

announced the implementation of a trial tax on residential properties in Shanghai and Chongching at the beginning of 2011. [9]

The tax differs slightly in policy from Shanghai to Chongching. Both make residential properties purchased by non-local residents a common target of the property tax, but differences remain in tax rates and local targets of taxation. Shanghai's property tax only affects newly purchased residential properties, and does not differentiate high-end properties from the rest. Chongching's tax takes a very different approach in by clearly targeting high-end residential properties and retrospectively and prospectively taxing detached residential properties. Shanghai has adopted a rate of 0.6 percent, and Chongching has adopted differing rates of 0.5 to 1.2 percent for different targets.[10]

These two property taxes are the first of their kind in China, and went into effect on January 28, 2011. They are an integral part of the central government's plan to stem speculation in the real estate market, and, thus, should be carefully examined. These taxes will be the main focus of my thesis as I attempt to analyze their affect on housing prices in Shanghai and Chongching.

Preliminary Research and Hypothesis:

Extensive research has already been done on the effect of property tax on housing prices. The majority of the literature investigates the impact of property tax on housing prices in relation to the quality in the local services provided. These studies have largely used markets in the United States and Canada to conduct their research. However, Zhang Qing and Xujian Guo point out in their paper "The Modernization of Real Estate Taxation in

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[9] "Building Excitement." Economist 3 May 2011: 13-14.
[10] KPMG

China," that the taxation system in China differs from those commonly found in the Western World. They note that owners of Chinese real estate hold incomplete property rights. Thus, those owners who are liable for taxation imposed by both central and local governments are defined as "stakeholders in the process of development, transfer, holding, and tenancy of real estate instead of as the beneficiaries of local public services." [11]This and other major differences in allocation and use of tax revenue in Chinese cities has prompted me to focus mainly on previous studies where research on property taxes that are not accompanied by an increase in the output of local services is included.

In a study conducted by Wallace E. Oates's, it was found that when taxes are not accompanied by an increase in output by local services, the majority of the rise in taxes is capitalized in a form of reduced property values.[12] Another study by Krantz, Weaver, and Alter found that property tax changes are approximately 60 percent capitalized into property values.[13] Cebula found in another study that property tax would cause housing prices to decline as a whole due to the negative correlation between housing prices and property taxes.[14] However, a more recent study done by Weida Kuang and Hua Zhou on property tax and supply and demand elasticity's effect on housing prices in China, found that property tax had a more trivial effect on housing prices, decreasing only .02% for every one percent increase in property tax based on their theoretical model. They also

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[11] Qing, Zhang, and Xujian Guo. "The Modernization of Real Estate Taxation in China."Journal of Property Tax Assessment & Administration 3 (2006): 5-12.
[12] Oates, Wallace E. "The Effects of Property Taxes and Local Public Spending on Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis." Journal of Political Economy 77 (1969): 957.
[13] Krantz, D. P., R. D. Weaver, and T. R. Alter. "Residential Property tax capitalization: consistant estimates using micro-level data." Land Economics 58 (1982): 88-96.
[14] Cebula, R. J. "Are property taxes capitalized into housing prices in Savannah, Georgia An investigation of Market Mechanism." Journal of Housing Research 18 (2009): 63-75.

found that demand elasticity had a much larger impact on housing prices than did property tax.

I will continue to read and look at past scholarship as it relates to my thesis topic. However, based on the past studies that I have viewed, I can now hypothesize that the newly implemented tax in both Shanghai and Chongching will have a negative effect on housing prices.

Methodology and Data:

As of now, I have not yet developed the theoretical and/or mathematical model that I will use in this thesis to determine the impact of the property taxes on housing prices in Shanghai and Chongching. I plan on gathering data on past and future housing prices from the National Bureau of Statistics of China (NBSC) a year after the property tax's implementation. The NBSC currently reports two official house price indices that are regularly updated: the "Average Selling Price of Newly-built Residential Buildings" and the "Price Indices for Real Estate in 35/70 Large and Medium-sized Cities." When using this data, I will also take into consideration biases in the indices observed in Jing Wu, Yongheng Deng and Hongyu Liu's paper "Measuring House Prices in China's Emerging Residential Housing Market." [15]

[15] Wu, Jing, Deng, Yongheng, Liu, Hongyu "Measuring House Prices in China's Emerging Residential Housing Market." *IRES Working Paper Series.* June 2011.

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