Implications of the Proposed Consumption Tax Rate Increase on Housing—Lessons from the EU

By Fumio Shinohara
Social Development Research Group
fshino@nli-research.co.jp

Fiscal restructuring is a key issue in the post-Koizumi era. The consensus view sees a consumption tax rate hike as inevitable. Drawing on the experience of European Union countries, we argue that Japan should consider adopting a reduced tax rate for housing.

1. Introduction

On the critical issue of fiscal restructuring, the Ministry of Finance, Tax Commission, and government are agreed that a consumption tax rate increase is unavoidable. Proponents also include top leaders of the business community. At present, the consensus scenario calls for a swift interim hike to 8% and final goal of 10%.

In a recent consumer survey by *Nikkei Shimbun*, over half of respondents accepted a consumption tax rate hike as necessary—35% regarded it as "necessary if used to fund the public pension system," and another 19% as "necessary if used for fiscal restructuring."[1]

Prime Minister Shintaro Abe has stated that "spending cuts and a tax overhaul should take priority over a consumption tax hike." But most consumers apparently remain skeptical of the government's fiscal management capability, and resigned to shouldering the growing burden of the public pension and long-term care insurance.

Once implemented, tax hikes are difficult to undo. Consumers thus need to vocalize their skepticism, and challenge the government on this issue by all means available.[2]

The Tax Commission, claiming to preserve the integrity of the consumption tax, calls for an across-the-board tax rate increase. What they fail to mention is that taxing food and other necessities at the higher standard tax rate makes the consumption tax increasingly regressive for low-income consumers. This is something that consumers must recognize more clearly.[3]

Not all necessities are low in price. For the average family seeking to live in a comfortable residence, life's biggest expenditure (or investment) is often the purchase of a home. Boosting the tax rate on that home purchase can have dire consequences. For example, if the tax rate is raised to 10%, the tax burden on the

[1] *Nikkei Shimbun*, morning edition, August 22, 2006.

[2] In the general account budget, spending cuts and the economic recovery are boosting tax revenue beyond expectations, bringing a primary balance almost within reach. Meanwhile, funds for the so-called second budget or Fiscal Loan and Investment Program are diminishing. But many fiscal issues still need to be addressed ahead of the tax increase, including ways to clean up special account budgets.

[3] Taxation is progressive when the tax rate increases with income, and regressive when the tax rate decreases with income. The consumption tax tends to be more stable as a revenue source than the income tax, which is directly affected by economic conditions. But being regressive, it puts a greater burden on low-income families.

purchase of a 25-million yen residential building doubles from the present 1.25 million yen to 2.5 million yen.[4] This is a substantial increase that will probably need to be financed with the home loan.

Despite the large transaction size, a home purchase is by no means a luxury for ordinary working households. Moreover, policymakers need to consider the many vital functions performed by housing—not only in securing a comfortable residence, but accommodating the aging society, as well as providing a base for long-term care.[5]

In the European Union, many countries have adopted special measures for the value added tax (VAT) on housing (the equivalent of Japan's consumption tax), and levy a reduced or zero-tax rate instead of the standard tax rate.

However, the Tax Commission argues that reduced tax rates exist in EU countries simply because standard rates are high and in the double-digit range. As long as Japan's tax rate is under 10%, the argument goes, a reduced tax rate is unnecessary.

This 10% criterion is an arbitrary and convenient rationalization to stabilize tax revenue collection. By disregarding the special considerations made in EU tax policies, the commission reveals its true intention—to avoid the reduced tax rate so that more tax revenue can be collected.

Since the consumption tax is paid by consumers, companies are not allied with consumer interests on the tax rate hike. The consumption tax is levied on value added, and as long as companies can deduct input taxes, the consumption tax rate hike has little impact on corporate profits.

In fact, large companies enjoy significant tax profits due to the so-called "95% rule." To simplify the calculation of tax exemptions, this rule stipulates that 95% (not 100%) of sales revenue is taxable.[6] Thus large companies—who would vigorously oppose a corporate tax rate hike—have little reason to oppose the consumption tax rate hike.

Only one business segment has come out in opposition to the consumption tax rate hike—companies that build and sell homes, who stand to be directly affected by the consumption tax rate hike.

Of the myriad issues surrounding the consumption tax rate hike, this paper examines reduced tax rates and other special tax measures countries have adopted for housing. We then argue for the reduced tax rate—which the Tax Commission has dismissed based on an arbitrary 10% tax rate criterion—in the hope of stimulating serious debate on this critical issue.

2. Past and Current Issues

Since its introduction in 1989, the consumption tax has become the main vehicle for increasing the tax system's reliance on indirect tax revenue relative to direct (income) tax revenue. In 1997, the 3% consumption tax rate was raised to 5%.

With regard to residential investment (households' purchases of new homes), the initial effect of the consumption tax was minor. However, the 1997 tax rate hike had a pronounced effect—demand surged before the hike in 1996, and recoiled sharply afterwards in 1998. The tax rate hike also triggered a prolonged economic recession and asset deflation, during which residential investment dwindled until edging up in 2004 and 2005 (Exhibit 1).

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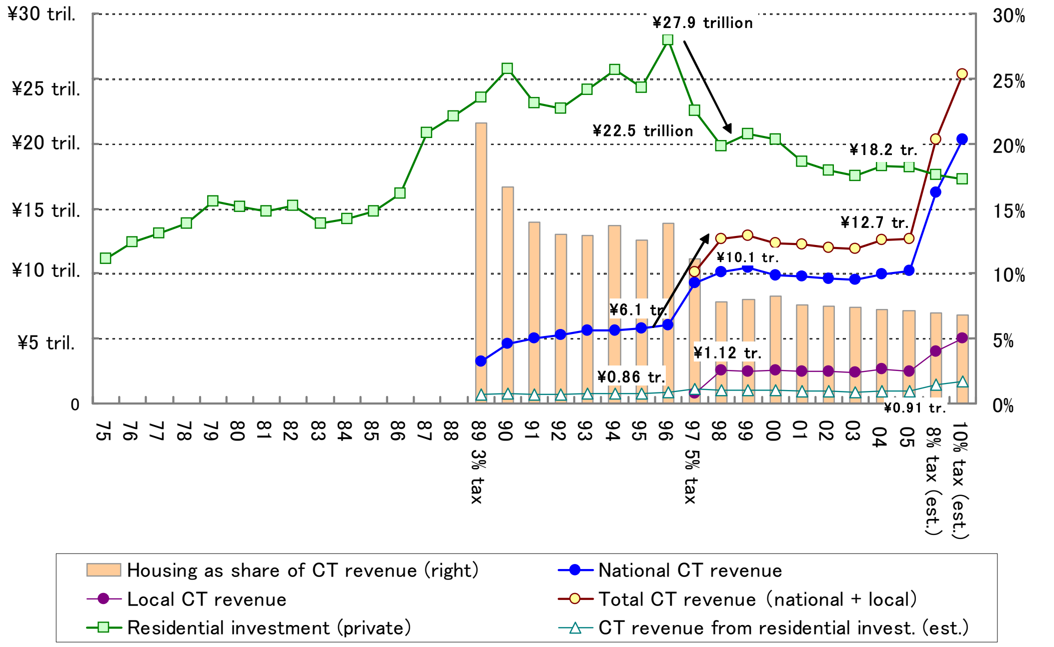
[4] The author is currently constructing a quantitative model that assesses the impact of a consumption tax rate hike on the housing market and economy. The model is expected to be ready by the end of this year.

[5] Since rental housing construction will also be taxed, the issue encompasses more than owner-occupied housing.

[6] Large companies benefit most from the 95% rule because the sheer size of sales revenue generates more tax profit.

Exhibit 1　Consumption Tax (CT) Revenue and Residential Investment Trends



Note: Consumption tax revenue for 8% and 10% tax rates are estimated from the fiscal 2005 tax base, and are not forecasts.
Source: Ministry of Land, Infrastructure and Transport; Ministry of Finance

Moreover, the estimated consumption tax revenue from residential investment dropped from 1.1 trillion yen in 1997 to 0.9 trillion yen in 2005. In the same period, total consumption tax revenue actually rose from 10.1 trillion yen to 12.6 trillion yen. Thus as far as residential investment is concerned, the tax rate hike actually reduced tax revenue.

This happened because unlike ordinary necessities, housing is better characterized as an investment rather than consumption good. Thus depending on economic conditions, a tax hike on housing can decrease the tax revenue yield relative to ordinary goods.

Besides the consumption tax, housing transactions are subject to a registration and license tax and property transfer tax, which are based on asset value. After the purchase, homeowners must also periodically pay a property tax and urban planning tax.

Theoretically, since housing provides a service over the long term—making it different from ordinary consumer goods and services—the consumption tax should be levied on a periodic and continuing basis, similar to the property tax.

To tax housing in the same way as ordinary consumer goods and services is the equivalent of collecting taxes on a future tax liability. At minimum, today's tax burden needs to be alleviated by the amount corresponding to future taxes because this amount represents an excessive tax burden at the time of purchase.

Moreover, a consumption tax hike boosts the transaction cost, thereby discouraging transactions and hampering tax revenue growth. It also leads to more dire economic consequences from the downturn of spending associated with home purchases. In addition, a rate hike can also have repercussions for housing and urban planning policy management. All of these considerations make it necessary to approach housing taxes and tax increases with great care. As explained below, EU countries have done just that in the way they levy the VAT on housing.

In the interest of avoiding regressive taxation and distortions in asset taxation, Japan has in the past levied a low consumption tax rate based on the tenet of spreading the tax burden broadly and thinly. If the tax rate must be raised in the future, its impact on the housing market needs to be accurately assessed so that both objectives—policy effects on housing and tax revenue growth—can be realized.

3. International Comparison of Housing Taxes

Before examining the housing tax situation in the EU (and U.S. for reference), we first review the situation in Japan:

(1) Residential buildings are taxable, while land is not taxable by custom.

(2) New and existing homes are taxable. However, transactions by individuals are not taxable. If a business (taxable entity) buys an individual's home to make improvements and resell to a third party, that business incurs a consumption tax liability.
Thus the consumption tax is levied not only on a new home purchase, but every time that a home is resold in the existing home market. This contradicts the tax theory tenet stating that the same item should not be taxed more than once.

(3) At present, there is no reduced tax rate or tax exemption on a home purchase, remodeling, or substantial renovation.

(4) Besides the consumption tax, home purchases are subject to transaction taxes (registration and license tax, property transfer tax, etc.).

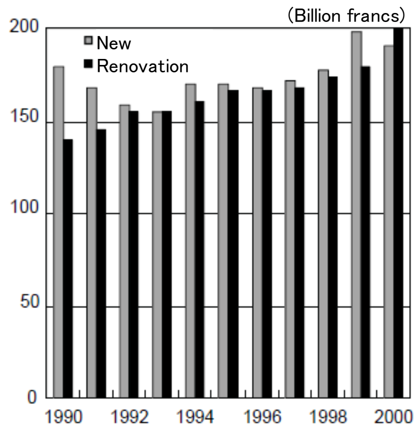
(1) France

France has a poor collection rate for the personal income tax, and the value-added tax (TVA) is the largest source of tax revenue. The standard tax rate is 19.6%, while the reduced tax rate is 5.5%, and the special reduced tax rate is 2.5%. With regard to housing, the standard TVA rate is levied on the building and land. However, vacant lots purchased by individuals for the purpose of home construction are exempt.

Unlike Japan, the TVA is levied only on new homes. Existing homes are levied a separate 4.89% transfer tax.[7] To avoid double taxation, the TVA and transfer tax are seldom levied together on a new home purchase.

In the past, substantial renovation was taxable at the standard tax rate. But to promote renovation of the existing housing stock, a 5.5% reduced tax rate was introduce in 1999. As a result, annual investment in home renovation has grown larger than new residential investment. In agreement with the EU, the government has decided to continue the reduced tax rate by designating home renovation as a labor-intensive industry.

Exhibit 2 New Residential Investment and Renovation Investment (France)



Source: INSEE, *Comptes de la construction*.

(2) Germany

The standard tax rate is 16%, and the reduced tax rate is 7%. The standard tax rate will be increased to 19% in 2007.

[7] For businesses that transact existing properties, the standard tax rate is levied on the margin or commission, along with a transfer tax rate of 0.6% instead of 4.89%.

Exhibit 3　International Comparison of VAT (General)

	Japan	France	Germany	U.K.	U.S.
Year implemented	1989	1968	1968	1973	—
Taxable person	Anyone who carries out the transfer of assets, etc.	Anyone who independently supplies goods or services for the purpose of obtaining income	Anyone who independently carries out business or professional activities	Anyone who independently supplies goods or services and is required to register	(Sales tax, not VAT) Retailers and service providers (depending on state and category, taxable person may be consumer or retailer). Real estate transactions are exempt.
Standard tax rate	5% Includes local consumption tax	19.6% National tax	16% Federal, state & local tax → 19% in 2007	17.5% National tax	8.625% New York state & local tax
Taxable amount	Purchase price	Purchase price	Purchase price	Purchase price	Purchase price
Non-taxable transactions	Finance, insurance, health care, education, welfare, etc.	Finance, insurance, health care, education, postal services, etc.	Finance, insurance, health care, education, postal services, etc.	Finance, insurance, health care, education, postal services, welfare, etc.	Health care, perishables, newspapers and periodicals, sales to NPOs, manufacturing equipment, fertilizers, janitorial services, real estate transactions, construction, manufacturing equipment installation, etc.
Zero-tax rate	None. However, tax exemption and input tax deduction exist for exports	None. However, tax exemption and input tax deduction exist for processing, repair, maintenance and storage of goods for international trade, and export insurance and credit	None. However, tax exemption and input tax deduction exist for exports	New home construction & transaction, food, water utility, newspapers, periodicals, books, domestic passenger transport	No such concept. Tax exemption exists for exports.
Reduced tax rate	None	5.5% reduced rate: food, books, transportation, home improvement & renovation. 2.5% special reduced rate: newspapers & periodicals, drugs, etc.	7% reduced rate: food, water, periodicals, domestic passenger transport, etc.	5% reduced rate: household fuel & electric power, maintenance and repair of unoccupied housing, and housing on the Isle of Man.	Limited tax breaks at state or local level
Increased tax rate	None	None	None	None	None

Exhibit 4　International Comparison of VAT（Housing）

	Japan	France	Germany	U.K.	U.S.
Construction of new building					
New residence New non-residence New second house	Taxable	Taxable	Taxable	Zero tax rate Taxable Zero tax rate	Non-taxable (*1)
Transaction of new building					
New residence New non-residence New second house	Taxable	Taxable	—	Zero tax rate Taxable Zero tax rate	—
Transaction of new building & land					
New residence & land New non-residence & land New second house & land	Structure is taxable	Taxable	—	Zero tax rate Taxable Zero tax rate	—
Transaction of existing building					
Residence Non-residence Second house	Taxable (except b/w individuals) Taxable Taxable (except b/w individuals)	—	—	—	—
Transaction of existing building & land					
Residence & land Non-residence & land Second house & land	Structure is taxable (except b/w individuals) Structure is taxable Structure is taxable (except b/w individuals)	—	—	—	—
Leasing & letting					
Residence	—	—	—	—	Non-taxable (except hotels & short-term stays)
Non-residence	Taxable	Taxable in principle	Non-taxable (often option to tax)	Non-taxable (often option to tax)	Non-taxable (*2)
Second house	—	—	—	—	Non-taxable (except hotels & short-term stays)
Renovation & addition					
Residence	Taxable	5.5% reduced tax rate for renovation, but not	Taxable	Zero tax rate (*3)	Varies (*5)
Non-residence	Taxable	Taxable	Taxable	Taxable	Varies (*5)
Second house	Taxable	Taxable	Taxable	Zero tax rate	Varies (*5)
Maintenance & repair					
	Taxable	5.5% reduced tax rate	Taxable	Taxable (*6)	Taxable except for capital goods

Notes: (*1) Tax laws vary by state. The sales tax is usually exempted for construction work including building, rebuilding, renovation, and remodeling. On the other hand, maintenance & repair services are usually taxable. (*2) New York City levies a commercial rent tax on tenants who pay at least $250,000 in annual rent. (*3) Conversion of non-residence to residence is also zero-rated. (*4) Even for a secondary residence, substantial renovation is zero-rated. (*5) For construction, labor and materials are often fully tax exempt. For example, roof retiling is treated as a capital expenditure, and labor is generally tax exempt. However, maintenance & repair are generally fully taxable including labor. (*6) A reduced tax rate of 5% is applied on maintenance and repair of unoccupied housing and housing on the Isle of Man, and rebuilding of a residence into another type of residence.
Sources: MLIT; NLI Research Institute

New home construction is taxable. However, property transactions are not subject to the VAT, regardless of whether the housing is new or existing. Instead, transactions are levied a property transfer tax of 3.5%. People thus prefer to buy built-for-sale housing rather than build a new home. The two taxes are never levied at the same time. Renovation is subject to the VAT.

(3) U.K.

The standard VAT tax rate is 17.5%, and the reduced tax rate is 5%. The sales tax that preceded the VAT was not levied on housing transactions. As a result, new home transactions remain untaxed under the VAT. Technically, however, these transactions are zero-rated rather than tax exempt. This is beneficial to the end-point vendor who sells to consumers because the vendor can deduct input taxes.

For new homes, the zero-rate is applied regardless of whether the housing is a primary or secondary residence, with no limit on the number of residences. The zero-rate is also levied on housing construction. As for renovation, a reduced tax rate had been considered as a way to encourage the improvement of existing housing stock. However, it has been applied only in limited cases.

The VAT is not levied on existing home transactions. The only tax that consumers pay on these transactions is a separate stamp duty land tax (SDLT).

Despite urgings by the EU to discontinue the zero-rate, the U.K. has shown no intention of complying.

(4) U.S.

Instead of an EU-type VAT with input tax deductions, a state and local sales tax is levied. Real estate transactions and construction are generally not subject to the sales tax.

Since home purchases are regarded as an investment, mortgage interest payments and local taxes (property tax) are deductible from the federal income tax. The effective property tax rate, which ranges from 0.5% to 1.8%, is generally higher than in Japan. However, the property transfer tax, which ranges from 0.3% to 1% depending on the city and state, is lower than in Japan. Since no sales tax is levied, taxes do not significantly hamper real estate transactions.

The existing home market is very brisk, with 6.78 million transactions reported in 2004. This volume outnumbered new home construction (including rental units) of 2.07 million units.

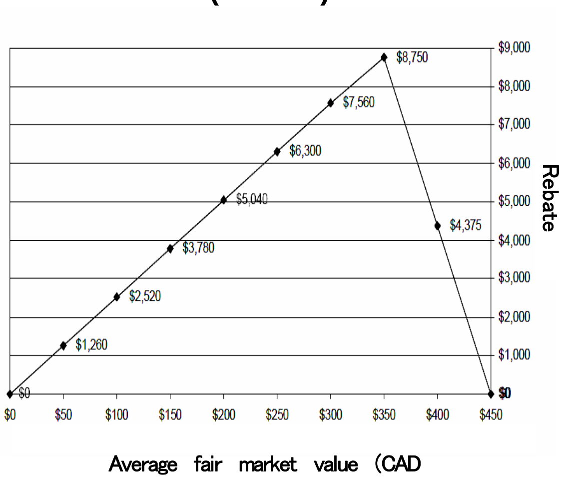
(5) Canada

Canada levies a 7% goods & services tax (GST) along with a separate provincial sales tax (PST), which is 7.5% in Quebec province and 8.0% in Ontario province. Three provinces including Nova Scotia have a 15% harmonized sales tax (HST) of 15% instead. Due to favorable fiscal conditions, both the GST and HST were reduced by 1% in July 2006.

Tax-exempt categories include finance, health care, education, and rent payment of at least one month. Exports, food, agricultural and fishery goods, and pharmaceuticals are zero-rated. While new housing construction is taxable at the standard tax rate, first home owners can receive a partial tax rebate. Existing-home transactions are not taxable.

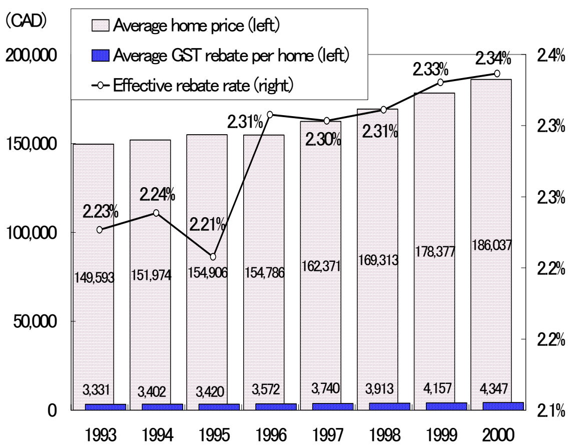
The tax rebate on new home purchases applies to purchase prices of up to CAD 450,000. However, the rebate amount peaks at a purchase price of CAD 350,000, and decreases for purchase prices that are either greater or smaller. The maximum rebate amount is CAD 8,750 (CAD 7,560 from July 1, 2006), for an effective rebate rate of 2.21% to 2.34%. At the present tax rate of 14%, the post-rebate tax rate thus comes to 11% to 12% (Exhibits 5 and 6).

Exhibit 5　Tax Rebate and Home Price (Canada)



Source: Canada Revenue Agency

Exhibit 6　Average Home Price and Effective Rebate Rate (Canada)



Source: Canada Revenue Agency

(6)　Australia

Australia introduced a 10% GST on July 1, 2000 that applies to all transactions in principle. However, tax exemption exists for food, pharmaceuticals, health management, child raising, tourism by foreigners, lifesaving, senior services, and transfer of farmland.

New homes are taxable, while existing homes are tax exempt. To reduce the tax burden on new home purchases, a subsidy of AUD 7,000 is available called the first home owner grant (FHOG). Being a fixed amount, this subsidy is more favorable for low-priced homes (and low-income households). Until recently, an additional subsidy of AUD 3,000 was also available for new homes built by June 30, 2004. The subsidization policy is based on the government's estimate that the 10% GST reduces consumer demand by 2.3%.

(7)　Other EU Countries

Italy levies a standard VAT (IVA) rate of 20%. However, both new and existing housing transactions are subject to a reduced rate of 4%. In the Netherlands, the standard VAT rate is 19%, which is applied to new home transactions. However, a reduced rate of 6% is levied in some cases such as house painting of existing homes.

In Spain, the standard VAT rate is 16%, with two reduced rates—7% for new homes, and 4% for social housing. Existing home transactions are tax exempt. In Sweden, Switzerland, and Denmark, transactions of new and existing homes are tax exempt. In Belgium, new homes are taxable, while existing homes are tax exempt.

(8)　EU Directive on the Taxation of Real Estate

The value-added tax in the European Union is based on the Sixth Council Directive 77/388/EEC of May 17, 1977, as amended in Council Directive 2001/41/EC of June 19, 2001. EU member states are expected to gradually modify their VAT systems in accordance with the following principles.

(1) The standard VAT rate may be no less than 15%

(2) Member states may apply up to two reduced rates of no less than 5%.

(3) Since the transfer of immovable property constitutes a supply of goods, and leasing or letting of immovable property constitutes a supply of services, anyone who carries out a transaction even on an occasional basis may

be treated as a taxable person (thus the VAT applies to all real estate transactions).

(4) The supply before first occupation of buildings and the land on which they stand is a taxable activity (existing buildings are omitted; Japan's taxation of existing buildings contradicts tax theory tenets).

(5) Leasing or letting of real estate is tax exempt.

(6) A reduced VAT rate may be applied on labor-intensive services (including home renovation and repair).

(7) Input VAT attributable to tax-exempt transactions shall not be deductible (tax exemption negates the right to deduct the VAT paid at an earlier stage).

4. Conclusion

While EU countries differ in how they apply the VAT to housing transactions, all countries have adopted some form of tax relief, including a reduced rate tax, zero-rate tax, tax exemption, tax rebate and subsidy program.

Meanwhile, Japan's Tax Commission has opposed the adoption of a reduced tax rate. They claim that adoption entails shifting from the present sales ledger method to an invoice-based method, something that would unnecessarily burden small and medium enterprises (SMEs) and complicate tax collection procedures. They also claim that the broad-based scope of the consumption tax would be compromised. Finally, they claim that a reduced rate is unnecessary as long as the consumption tax rate is under 10%.

As for the present sales ledger method, taxpayers are already required to prepare supporting documents for input tax deduction. Moreover, in the countries we studied, taxpayers including SMEs have no apparent problems under the invoice rules. Thus the commission's concerns aside, Japan could stand to benefit from the early adoption of invoice rules.

The 10% tax rate criterion is not only arbitrary, but circumvents key issues. It would be wise to learn from the extensive experience of EU countries, where amid varying economic and social conditions, many have adopted reduced tax rates of around 5% for housing transactions, in line with the EU directive—5.5% in France, 7% in Germany, 4% in Italy, and 4% and 7% in Spain. These cases strongly suggest that if Japan intends to raise the consumption tax rate, adoption of a reduced rate for housing must be seriously contemplated.

Essentially, the consumption tax is a lump-sum tax on housing—an asset that provides housing services over an extended period—that includes tax payments on future housing services. In view of this critical difference from ordinary goods, the rational approach suggested by tax theory is to apply a reduced tax rate on housing transactions.

In terms of housing policy, a consumption tax rate hike from 5% to 8% also threatens to offset the stimulative effect of tax breaks for transaction taxes (registration and license tax and real estate purchase tax).

However, at an even broader policy level, the proposed consumption tax hike could cause major policy conflicts. For example, although earmarked for aging policies, the tax hike could impede the goal of building a housing environment necessary to deliver long-term care. In addition, the regressive nature of the consumption tax could overburden households trying to raise a family, aggravating the declining birthrate.

In light of these factors—the special status of housing, regressive nature of the consumption tax, and potential problems of policy conflict—we believe that the proposed consumption tax hike must include alternative measures such as a reduced tax rate to sustain the balance and effectiveness of all relevant policies. The Tax Commission's preoccupation with efficient tax collection must not be the overriding concern.