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Tax Treatment Encourages Residential Investment

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The economic survey on Ireland by the OECD (issue 5 2008) proposed phasing out policies that distort the housing market, which in turn could help to dampen future housing cycles and maintain competitiveness in the economy. Specifically it suggests that tax breaks favouring owner occupation contributes to making housing expensive and that these effects could be reduced either by “limiting mortgage tax relief... or by implementing a property tax”.

The OECD is an economic think-tank committed to the market economy and tends to provide policy prescriptions based on economic principles. Their policy prescription for the Irish housing market can be linked to the work of Nobel Prize winning economist James Tobin. To explain Tobin’s theory and to keep matters simple, let’s assume that there are two types of investments. Business fixed investment in plant and machinery, computers, fixtures and fittings etc and residential investment in new housing that families buy to live in and that investors buy to rent out to others.

Tobin postulated that firms base their investment decisions on what he called the ‘q’ ratio. Complicated stuff this but the intuition behind this is relatively straight forward. The q theory of investment relates the performance of the stock market to business investment. ‘q’ is an estimate of the value the stock market places on the operating assets of a company relative to the replacement costs of installed assets. It is the ratio of the market value of assets to the replacement cost of those operating assets. If the q ratio is greater than one it means that the market value of capital is greater than its replacement cost. When this is the case, firms will want to invest in more fixed capital.

The value of any asset is the extent to which assets generate cash both now and in the future. Tobin’s hypothesis goes that if these cashflows are positive after adjusting for the cost of capital, then the company’s market value will rise. This gives a high q ratio. It follows that any form of government policy that will lower costs and improve profitability (i.e cuts in taxation) will increase the q value and provides an incentive for business to invest. Therefore, according to Tobin’s theory, business fixed investment depends on the market price of capital *relative* to its replacement cost. Similarly, residential investment depends on the market price of houses *relative* to the costs of construction.

It is the supply and demand for the existing stock of housing that determines the market price of housing, and this in turn determines new residential investment or, more precisely, the flow of residential investment. Because the supply of housing is fixed at any one point in time the demand for housing will determine the market price of houses. But the demand depends on the *net* return on owning a house. The gross return is the rent received if the house is rented or the implicit rent that the homeowner receives from living at home plus any capital gains from the increasing inflated value of the house. The costs include, inter alia, the interest to be paid on the mortgage. After adjusting for taxes, these costs are deducted from gross return to give

a net return. So, for example, a reduction in interest rates or policies designed to reduce the costs of borrowing such as mortgage interest tax relief will increase the net return and therefore increase the demand for houses. This incentive will increase demand and lead, *ceteris paribus*, to higher house prices.

However, the tax treatment of housing makes business fixed investment different to residential investment. Under Irish tax laws nominal interest payments are tax-deductible, while nominal capital gains are tax free.

Corporate income tax reduces future profitability and cashflows, (lowers the 'q' value), and discourages business fixed investment. It makes the market value of assets fall relative to their replacement value. But, while corporate income tax discourages business fixed investment, the treatment of personal income tax liabilities works in the opposite direction and encourages investment in housing. Irish tax laws do not require a home owner to pay tax on the rent that she pays to herself (the 'imputed' rent), but it does allow her to deduct mortgage interest. Part of the cost of owning a home can be deducted but the benefits of owning a home are not added to the gross return. So, while nominal interest payments are deductible, nominal capital gains due to house inflation remain untaxed.

Because of this type of tax treatment, Ireland invests too much in housing compared to other forms of investment. If tax laws are designed that provide incentives to invest in residential investment (housing) and dampen investment in business capital, the proportion of output devoted to business investment will be lower due to this tax penalty. The tax system warps the choice the economy makes between the levels of business output and the level of housing.

Perhaps it is time to eliminate mortgage interest tax relief and, most importantly, pass the benefits back to the consumer by lowering personal taxes and, by doing so, help make the economy more competitive.

But my view, for what its worth, is that householders needn't worry about the possibility of any looming property tax. The OECD report reminds us that Ireland has over 80% private home ownership and even though we would all like lower personal taxes we will not give up any subsidy to owning our home. This is a very large special interest group and in this case at least, the ballot box is more powerful than the market.