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The Impact of Tax-Sharing Reform on Housing Market in China

Bo Pang[1,a,*]

[1]RCF Experimental School, Chaoyang District, Beijing, China
a. pangbo@rdfzcygj.cn
**corresponding author*

Abstract: The impact of Tax-Sharing Reform on the housing market in China and its effectiveness in curbing speculative practices are subjects of critical importance. The Chinese government's principle of "Housing is for living, not for speculation" underscores the challenges posed by the persistent housing bubble, fueled by speculative behavior. This study delves into the historical context of the 1994 tax-sharing reform, which initially stimulated the growth of the housing market by increasing government revenue and providing local governments with greater financial autonomy. Drawing on a comprehensive analysis, this paper explores the underlying causes of the current issues in the housing market and evaluates the effectiveness of the tax-sharing reform in regulating speculative practices. While the reform exhibited positive outcomes in the past, this study argues that its applicability in the present scenario warrants scrutiny. The evolving market dynamics and contextual factors necessitate a reevaluation of the policy's effectiveness. Taking a balanced approach, the paper critically examines the benefits and drawbacks of the tax-sharing reform in the context of the current housing market challenges. Additionally, the study presents the author's perspective on the reform's limitations and proposes alternative policy suggestions to address the persisting issues more effectively. By offering insights into the reform's impact on the housing market's development trajectory, this research aims to contribute to a more nuanced understanding of the relationship between fiscal policies and the Chinese housing market. The paper uses qualitative method and case study to illustrate the topic.

Keywords: housing bubble, tax-sharing reform, fiscal policy, land finance

1. Introduction

On March 5th, 2023, the Premier of the China State Council, in the government work report, emphasized the principle that "Housing is for living, not for speculation" [1]. The ongoing challenges in China's real estate market primarily revolve around the existence of a housing bubble, largely fueled by speculative practices. Interestingly, looking back at the 1994 tax-sharing reform, it becomes evident that this fiscal policy did play a pivotal role in stimulating the growth of the housing market. In July 1993, the vice-premier of The State Council, Rong Ji Zhu, first proposed the idea of reform tax system, aiming for increasing government revenue. By generating additional revenue for local governments and allowing them greater financial autonomy, the reform created an environment conducive to increased investment and improved infrastructure, nurturing a thriving housing market.

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Price-rent ratio acts as strong evidence to support the existence of housing bubble in the real estate market [2].

This paper aims to explore the underlying causes and contributing factors to the problems in China's housing market. Subsequently, it will critically analyze and discuss the effectiveness of the tax-sharing reform in regulating the speculative bubble in the housing market. By presenting a balanced assessment of its benefits and drawbacks, the study will shed light on the reform's impact on the housing market's development trajectory.

However, while the tax-sharing reform demonstrated positive outcomes in the past, this paper argues that it may not be ideally suited to the current model of China. Various contextual factors and shifting market dynamics demand a reevaluation of the policy's effectiveness in the present scenario. As such, the paper will present the author's perspective on the limitations of the tax-sharing reform and propose alternative policy suggestions to address the persisting issues in the housing market more effectively.

2. The Underlying Causes of the Housing Bubble

2.1. Lack of Property Tax

Over the past decade, housing prices in China have skyrocketed by approximately 110%, making it the second-highest increase globally, according to data from the Global Property Guide. One of the key contributing factors to this surge can be attributed to the absence of a property tax in China. In countries like the US and the UK, property taxes act as a financial burden, discouraging excessive investment and preventing housing bubbles.

2.2. Speculative Bubble

Another significant issue adding to the housing craze is excessive credit leverage. An incident that exemplifies this is the "Shen Fang Li" case in Shenzhen in 2021. A popular blogger with millions of followers on Weibo was exposed for illegal real estate speculation, including real estate crowdfunding and recruiting shareholders for property agents.

This housing frenzy can be attributed to a combination of cultural, economic, and social factors. Owning property, especially a home, holds deep cultural significance in Chinese society, symbolizing stability, success, and social status. Many Chinese people view homeownership as a way to secure their family's future and prosperity. In Chinese culture, home is what they considered as the shelter, it is the most safe and comfortable place in the world. People get a house; they get a home. Chinese people are good at saving with an average saving rate of 44.9% as stated in 2019, and buying a house is the method for them to save money. This is a consuming habit rooted as they were born. The middle class, constituting more than 30% of the total population (more than 204 million), plays a significant role in driving up demand by purchasing multiple properties, with school-district houses being a preferred choice. Middle classes in China buying houses also to preserve the value of money and with a solid basis of funds, they are relatively keener on the pursuing of life quality, therefore they are constantly improving their living conditions like buying a bigger house or school-district houses, especially when the two-child policy implemented in China.

Additionally, the Chinese financial market historically offered limited investment options, leading people to turn to real estate as a safer and more tangible investment choice due to the generally appreciating property prices. Stock A in Shanghai consists of great fluctuations and the growth rate is quite transient. Stock A isn't an ideal investment opportunity for investors to consider for long-term investing. If a house is sold from 5,000 yuan per meter square to 20,000, the investors will be profitable and get excited. This is the investment psychological anticipation for investors.

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2.3. “School Districting Area” Policy

Research has shown that there is a clear positive-correlated connection between the quality of school and the nearby housing prices [3]. As is known to all, Chinese lay a great emphasis on the cultivation for the next generation. They will try to ensure their offspring for a higher education and a better future. Thus, many households choose to live near their children’s schools, elevating the asset price in the region. Whether in tier 1, tier 2, or tier 3, the housing price surged in a rate approximately around 10% [4].

2.4. Land Finance

Scholars in China have noticed and investigated the relationship between the housing price level and land finance [5]. The root cause of the property catastrophe since 2008 can be linked to over-reliance on land finance from the tax-sharing reform system [6]. While this reform strengthened the bond between local and central governments, stimulating investment and economic growth, it also led to local governments overly depending on land sales for revenue [7]. This over-reliance left them vulnerable to market fluctuations, impacting public services and infrastructure projects.

Property developer bids land from local governments. Local governments then transfer 70-Year land usage rights to property developers. Land sales become an important revenue stream for local governments. Local authorities, incentivized by financial gains, encouraged property development and sales to boost revenue, attracting both genuine buyers and speculative investors [8]. This surge in demand, fueled by speculation, artificially inflated property prices, resulting in a housing bubble. Specifically, speculators bought properties solely for investment purposes, rather than for housing, further driving up prices beyond their intrinsic values. When the bubble burst, it caused market instability and potential financial risks.

The tax-sharing reform led to varying financial capacities among regions, with cities experiencing strong economies and high demand witnessing rapid growth in housing supply and higher property prices [9,10]. On the contrary, less-developed areas struggled to attract investments, leading to inadequate housing supply and limited affordability, creating a divide between urban centers and rural areas.

2.5. Disparities and “Ghost Cities”

Some local governments approved excessive housing construction to meet revenue targets, resulting in the creation of “ghost cities” -- urban areas with a surplus of vacant properties. However, in China, different tiers have different problems in the real estate market. It’s never about a sole problem that exists as a whole in China’s real estate market. The first sign of soaring price in the housing market arises most apparently in Tier 1 cities and coastal cities, like Shanghai and Shenzhen [11]. In Tier 1, there is housing shortage due to the well-developed economy and population. Otherwise, cities in tier 2 and tier 3, the problem of surplus is so severe that many cities have become ‘ghost cities.’ Most famously, the Ordos New Town, also known as Kangbashi, as a ghost city in China. The city was intended to host about 300,000 people in the early 2000s, but in reality, there were solely a third people lived there in 2016 with numerous skyscrapers but virtually no sign of human living. However, the ghost cities are not abandoned by people, but more unoccupied, which is the product of surplus. People naturally choose to go and stay in big cities for a better job and a higher living standard. These cities lacked the necessary population and economic activity to support the large number of newly built houses, indicating a mismatch between supply and actual demand, leading to wasted resources and high property market risks. One of the most renowned examples of a ghost city in China is Ordos New Town, also known as Kangbashi. Originally designed to accommodate approximately 300,000 residents in the early 2000s, the stark reality revealed a mere third of that population actually residing

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there by 2016. Despite its impressive array of skyscrapers, the city appeared devoid of any significant signs of human life [12].

They have implemented a number of policies to add discounts to the housing price, including lowering the price by tax refund or by coupons, adopting easy mortgage and low down payment, qualifying more people to fulfill the residency policy, requiring no social security and making no limitation of owned properties. For example, in Hangzhou, the local government has carried out preferential policy, property-buying perks for families with three children. Foshan, Guangdong Province, the local government remove restrictions of which limiting the quantity of houses that residents can buy.

3. Remedies to Solve the Problem

3.1. Past and Current Practices

The central government has played a significant role in the dramatic escalation of housing prices over the past decade. This phenomenon was notably influenced by the injection of 4 trillion RMB into the market, intended for low-income housing, infrastructure, and social welfare. This intervention aimed to mitigate the repercussions of the 2008 sub-prime crisis and steer China away from its financial impact. Often termed as quantitative easing, this measure was crucial to prevent capital from overwhelmingly flooding into the real estate sector, which had become a veritable reservoir of economic activity.

The 2008 sub-prime crisis serves as a critical subtext here. The crisis, largely precipitated by the extreme inflation of the housing bubble and the cataclysmic aftermath when the bubble inevitably burst, cast a long shadow over the global financial landscape. The aftermath of 2008 saw a gradual but steady increase in housing prices, except for a brief market slowdown from 2010 to 2013. Impressively, the annual growth rate remained around 33%, underscoring the remarkable resilience of the market.

The government’s role in this trajectory, marked by financial interventions and strategic measures, underscores the intricate interplay between policy decisions and market dynamics, as well as the broader context of global financial crises. The expansive fiscal policy implemented is often blamed as one of the triggers to push up the price in the property market [13].

3.2. Policy Suggestion

The government’s “Three Red Line Policy” aims to regulate the property market, control house prices, and encourage real estate enterprises to transition manufacturing and service industries. Though seen as a significant effort, the policy’s short-term impact has resulted in a loss of investor confidence and increased financing costs for housing enterprises. The recent Evergrande default exemplifies the high risks associated with this measure. Nevertheless, the policy effectively curbs excessive land acquisition and unchecked expansion by property enterprises.

With the releasing of property tax, many people with more than a dozen houses afraid of tax burden, so they will sell out the houses, thus increasing the supply of houses. Property tax influences the housing market by shaping the cost of purchasing, renting or investing and increasing the local government tax revenue. There had already been property taxes implementing in Hong Kong, which charges 4% of the rent annually.

Nonetheless, since China has a huge population, this makes it especially difficult to set the criteria on how to collect the tax. Specifically, if collected by the size of the houses, it will be extremely varied and difficult to collect, which involves the statistics of residential housing about how many houses hold per capita. If collected by the population living together in the house, the government cannot collect many taxes. Moreover, there will be the resistance from those vested interests.

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However, if the government and the property developer publicize the real-estate information, eliminate the asymmetry of information, the government can use the evaluating market price to set the property tax rate.

For example, Chongqing made a plot scheme in 2011. However, problems existed in the pilot reform of property tax. Critics have argued that neither the legislative process nor the tax basis is reasonable. Further, the tax rate is too low to be truly effective. The effect of implementation of property tax rate was not obvious. Problems still need to be solved and require long-term discussion.

On February 8th, 2021, Shenzhen took the lead in guiding prices for second-hand homes nationwide, with a total of 3,595 residential complexes in the city issuing detailed price guidelines. The actual impact of the policy obviously exceeded market expectations. In the first half of 2021 alone, the transfer of second-hand housing in Shenzhen dropped by 45% from the previous month and 35% from the previous year, and the transfer volume was the lowest in nearly three years.

Nevertheless, there are only 15 cities implemented the policy until present. Local government financing needs to be solved. This action will require local government to find new source of revenue, whether it be of transfer payment from central government, or be of developing sectors with local advantage, encouraging local government to create things that truly can raise the value of products, which required the local government to lend money, larger scale of debt burden. Moreover, the development pattern varies from city to city. For some cities like Hangzhou and Foshan, heavily rely on land finance. They will run out budget if they don't sell land. But for cities like Beijing and Shanghai, they have intrinsic financial attribute themselves, so they won't worry much. It is quite sophisticated.

To address the housing needs of the floating population in central cities, the government must develop a classified urban housing regulation system. This system should focus on matching housing demand with population inflow and outflow. Efforts to develop a standardized housing rental market and expand public rental housing coverage can contribute to a balanced housing market. However, this policy requires long-term implementation and may face limited effectiveness in cities where housing bubbles have already burst.

4. Conclusions

The Chinese property market's significant growth and challenges have been closely tied to the tax-sharing system and the over-reliance of local governments on land finance. The absence of a property tax in China has fueled a craze for real estate investment, leading to soaring housing prices and speculative behavior. The '3 red line policy' and other regulatory measures have been introduced as efforts to manage the market, but their short-term impacts on investor confidence and financing costs have raised concerns.

The over-reliance of local governments on land finance, stemming from the tax-sharing reform system, has further exacerbated the property market's instability. By depending heavily on property taxes for revenue, local authorities have neglected diversifying their income sources and have become highly vulnerable to fluctuations in the property market. This has led to excessive housing construction, regional disparities, and the creation of ghost cities, resulting in wasted resources and market risks.

Addressing these challenges necessitates a comprehensive approach, including the implementation of a well-structured property tax system. By encouraging transparency in real estate information and promoting fair tax rates based on market evaluations, the property tax can act as an effective tool to manage housing demand and prevent speculative behavior. Additionally, efforts to develop alternative revenue sources for local governments and prudent investment in infrastructure and public services can help mitigate the risks associated with over-reliance on land finance.

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Furthermore, research and empirical analysis are essential in understanding the implications of various policy measures and guiding their long-term effectiveness. By continuously evaluating and refining these policies, China can foster a balanced and sustainable housing market that caters to the needs of its population while promoting economic stability and growth.

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