



# How Should Property Prices be Moderated?

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**F**rench property prices increased between 1998 and 2007 and between 2009 and 2012. The first part of the increase owes to a series of factors common to the Euro zone as a whole (relaxing of financing conditions) and also, in part, to various factors specific to France (policies designed to support demand, insufficient supply of property, increase in construction costs, etc.). The latter increase can more directly be linked to the financial crisis, which led to a decline in sectors which had previously been considered safe bets, one of these being property, the appeal of which was further enhanced by a series of policies designed to support demand.

Housing represents the largest expenditure item for French households, far ahead of groceries. Indeed, access to decent housing, or even any form of housing, has become a major problem, particularly in areas where there is insufficient supply to meet demand, such as the Parisian region. There are various arguments in favour of a public policy aimed at controlling the increase in property prices or even reversing the property price curve, particularly since part of the increase in prices is the result of poorly-adapted public policies; indeed, the increase in prices highlights inequalities (notably to the detriment of young generations from modest backgrounds) and leads to economic inefficiencies, such as increased distance between home and work, investment (in the event of a bubble) in overvalued assets or even loss of competitiveness in the French economy when the cost of housing has repercussions on wages and the business real estate sector. The risks associated with a turnaround in the property mar-

ket appear less significant to us in France than in other countries. With this in mind, we would suggest combining measures designed to stimulate supply, correct certain imbalances in demand and ease congestion in the market.

With regards to stimulating supply, we would suggest that property management be improved by systematically transferring its responsibility at inter-communal level. We also emphasize the need of increased productivity gains and competition in the construction industry.

As for easing congestion in the market and making property taxation fairer, we would suggest gradually eliminating duty on transfers for valuable consideration in stages and reforming the system governing property tax on built-on property. The latter would then be based on the net sale value of the asset (market value minus any outstanding loans). This reform, which would have no impact on the budget, would be accompanied by the taxation of unrealised capital gains on undeveloped land, encouraging the sale of land once it reaches the point at which it can be built upon. Such reforms would mean having to quickly enforce the obligation for notaries to record information in notarial databases.

At the same time, we would recommend gradually withdrawing all building subsidies, those costly measures (over 4 billion euros in 2012) that tend to maintain prices but produce limited positive results in terms of increasing home ownership levels.

Housing policies and, in particular, policies designed to increase home ownership hold great potential for improvement in terms of not only efficacy but also equity and financial savings.

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## Introduction<sup>1</sup>

Housing represents the largest expenditure item for French households, accounting for an average of 22% of disposable income, double the amount spent on groceries<sup>2</sup>. Indeed, access to decent housing, or even any form of housing, has become a major problem in France, particularly in areas where there is insufficient supply to meet demand, such as the Parisian region. Nevertheless, the State spends 40 billion euros a year on making home-buying more accessible, including support for tenants and aid designed to increase home ownership levels. We might, then, wonder how relevant public housing policies actually are. The present Note suggests avenues for reform, focusing primarily on housing purchase prices<sup>3</sup>.

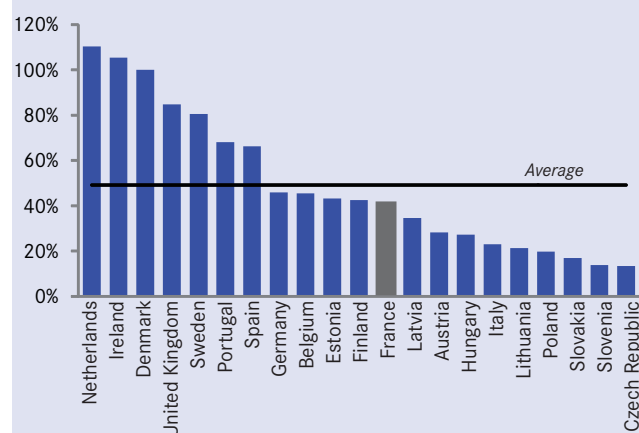
Housing prices are initially seen to be the result of the difference between the demand (on the part of those looking to buy) and the supply (on the part of housing owners and owners of land that can be built upon). If prices increase, it is because demand is growing faster than supply. Increasing prices is detrimental in terms of both redistribution and economic efficiency:

- Increasing prices is anti-redistributive insofar as the division of land is anything but egalitarian. Firstly, increased prices, which affect certain regions in particular (notably the Île-de-France region), serve to highlight regional differences and reinforce incidences of exclusion. They are also transferred from younger generations to older generations who are already home-owners, with modest young households finding themselves heavily penalised when it comes to buying a property;
- Increasing prices results in economic inefficiencies, by forcing certain workers to live away from the area in which they work, for example, meaning they have further to travel between their home and their workplace and making it difficult to fill certain job vacancies; insofar as it is brought about by a speculative bubble, it also drives households and businesses to make investments that will prove to be loss-making (as is currently the case in Ireland and Spain). There may also be consequences in terms of competitiveness if the repercussions of increasing housing prices are felt on wages, in which case labour costs increase for companies, particularly since the cost of property is itself one of the items on the operating statement.

There are therefore various arguments in favour of a public policy aimed at controlling the increase in property prices

or even reversing the property price curve, particularly since part of the increase in prices is the result of poorly adapted public policies. It is, however, important to be wary of two phenomena in particular. On the one hand, those countries that have experienced financial crises followed by a reduction in the cost of property assets (as is the case of Japan) have taken years to fully rectify the situation and return to a position of harmonious growth. On the other, those households in debt will be the first to be affected by a turnaround in the property market insofar as they will have paid a heavy price for a property that will suffer a significant decrease in value in the event of it being resold very shortly thereafter, as a result of divorce or loss of employment, for example. Both of these risks would, however, appear to be more limited in France than in certain other countries. With regards to the former, it is important, first and foremost, to note that France, and the Île-de-France region in particular, has already experienced a price adjustment of some 20%, with no noticeable macro-economic impact, in the first half of the 1990s. The latter risk would also appear to be less significant in France than in other European countries since the average household debt is lower (chart 1). Furthermore, the Bank of France over-indebtedness commission makes it easier than in other countries to manage cases of insolvency by negotiating or requiring creditors to restructure the debt after examining the case.

**1. Real estate debt of households in various European countries in 2010**  
Property debt/disposable income in %



Sources: European Mortgage Association and Eurostat.

<sup>1</sup> An extended version of the present Note entitled “*Le prix de l’immobilier et les politiques inflationnistes*” is available at [www.cae-eco.fr](http://www.cae-eco.fr). The authors would like to sincerely thank Pierre-Henri Bono (IDEP), Agnès Bénassy-Quéré (CAE), Meradj Mortezapouraghdam (Sciences-Po), Hélène Blanche-Naegele and Cyriac Guillaumin (CAE) for their assistance. They would also like to thank Patrick Artus, Mahdi Ben Jelloul, Dominique Bureau, Pierre-Philippe Combes, Gabrielle Fack, Robert Gary-Bobo, Pierre-Olivier Gourinchas and Stéphane Grégoir for their situational perspectives.

<sup>2</sup> The proportion was only 18% in 2004. Source: *Comptes du Logement* 2012.

<sup>3</sup> The issues of rent and social housing will be dealt with in a later Note.

<sup>4</sup> In this case we have limited the comparison to countries in the Euro zone that have not been affected by banking crises and sovereign debt since 2009.

We might therefore consider that the benefits of a drop in French property prices (in terms of access to housing and purchasing power) would greatly exceed the drawbacks, particularly if the drop were the result of a reorientation of public policies which should refrain from maintaining prices as they have done in the past through a series of demand subsidy policies, without worrying about supply. We would suggest a series of measures designed to encourage a return to a position of neutrality between property rental and ownership, ease congestion in the property market and stimulate the supply of both housing and land.

## Why has there been a significant increase in prices over the past fifteen years?

French property prices increased by an average of 6% per year between 1996 and 2012, far more significantly than either consumer prices (1.7%) or rent (2.5%). In the long run, there are three key phenomena that can be observed (chart 2):

- In France, prices significantly increased between 1996 and 2007 (+9% per year); following an adjustment of 10-15% in 2009, prices began to rise again in 2010-2011. The Benelux countries experienced similar increases between 1996 and 2007, with only the Netherlands seeing a noticeable drop in prices following the 2009<sup>4</sup> crisis;
- Prices in Germany, on the other hand, have remained remarkably stable since 1996<sup>5</sup>;

The situation in the Île-de-France region was similar to that of the rest of France until 2007, when the increase became more significant. Prices there increased by 19% between 2008 and 2012, as opposed to 'only' 2% across the country as a whole.

The similarities observed in the evolution of property prices in France and in the Benelux countries between 1996 and 2007 suggest that these increases are due to fundamental factors (such as demographics, which are relatively dynamic in these countries) and favourable credit conditions in the Euro zone rather than to any regulations specific to France as such. In order to ascertain the reasons behind the evolution of prices, it is important to consider each of the multiple factors that might have influenced supply and demand, taking into account the three main motivations that drive buyers, namely finding somewhere to live, making an investment that will provide a steady stream of income, or even putting some of your savings away in the hope of maintaining their value (safe haven) or to achieve capital appreciation (speculation).

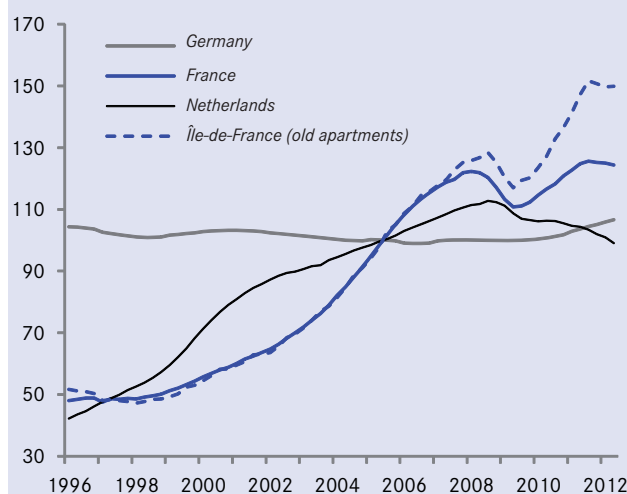
<sup>5</sup> Prices have very recently increased in this country.

<sup>6</sup> A cross-sectional study on the price of building land in France (private homes) shows that the differences in price between different employment areas can be largely explained by differences in demographic growth. See Combes, P-P., Duranton, G. and Gobillon, L. (2012): "The Cost of Agglomeration: Land Prices in French Cities", *IZA Working Paper*, no 7027, November.

<sup>7</sup> See Piketty, T. and Zucman, G. (2012): *Capital is Back: Wealth-Income Ratios in Rich Countries, 1870-2010*, Mimeo PSE.

## 2. Evolution of house prices

Base 100: 2005



Sources: Federal Reserve of Dallas and notaries' database-INSEE.

## Nine factors affecting property price increases prior to the 2009 crisis

There are nine different mechanisms, six relating to demand and three to supply, that can be used to explain the increase in property prices over the 1996-2008 period (Table 1). The first of these demand-related factors is demographic growth and an increase in the number of households; since 1990, the number of households has increased by 1% per year; the average size of a household is decreasing, although this decrease is not uniform across all travel-to-work areas<sup>6</sup>. The second factor in the price increase is the accumulation of private wealth, which accounted for almost six times the GDP in 2010 as opposed to only three times the GDP in 1970<sup>7</sup>. The revaluation of real estate has, of course, contributed to this two-fold increase, but the strong preference for property investment (around two-thirds of household assets) has discouraged savers from achieving capital appreciation on property to invest in other assets, which has helped maintain prices. The third factor is the evolution of earned income; hourly wages (excluding general government sectors) increased by 39% in France between 1998 and 2008, whereas cumulative inflation was only 21% over the same period (source: Eurostat). These initial three factors that would be conducive to dynamic demand, namely demographics, the

increase in private wealth and the increase in earned income, are, strikingly, virtually non-existent in Germany, where property prices remained rather stable over this same period<sup>8</sup>.

### 1. Factors affecting the increase in house prices In France, 1998-2008

Demand	Supply
Demographic growth and increase in the number of households (division of households)	Severe shortage of supply in the Île-de-France region
Increase in private wealth	Poor management of supply
Increase in earned income	Increase in the cost of construction
Relaxing of financing conditions	
Dynamic foreign demand	
Policies designed to support demand	

Source: Authors.

The fourth demand-related factor, this one applicable to the entire Euro zone, is the relaxing of financing conditions, involving a drop in interest rates and the extension of loan terms. The proportion of property loans in France lasting 20 years or more increased from 16% of all credit in 2001 to 57% in 2009, with the average term increasing by over 20% over this same period<sup>9</sup>. According to the Centre d'analyse stratégique<sup>10</sup> ('French Centre for Strategic Analysis'), relaxing financing conditions would explain more than half of the increase in the prices of existing properties. Whilst they may be somewhat fragile, these assessments do nevertheless reflect those carried out on other countries<sup>11</sup>. Financing conditions were all the more significant in France since households were not yet very heavily indebted at the time when prices started to increase<sup>12</sup>.

A fifth demand-related factor is that of the dynamism of foreign demand for both second homes and investment in securities, even with a speculative goal in Paris –one of the world's most popular tourist destinations<sup>13</sup>. The final demand-related factor, this time specific to France, is the series of tax exemption and incentive plans designed to encourage home ownership (Table 2). Over the period in question, the German Federal Government, on the contrary, greatly reduced building subsidies.

### 2. Full-year budgetary cost of property-related fiscal instruments In millions of euros

System	(validity)	Scope	2011	2012	2013
Périssol	(1996-1999)	New or old housing properties	60	60	60
Classic Robien	(2003-2006)	Renovated new or old housing properties	455	455	455
'New' popular Borloo	(2006-2009)	Renovated new or old housing properties	60	60	60
TEPA	(2007-2012)	Purchase or construction of a main residence	1,863	2,100	1,465
Scellier	(2008-2012)	Renovated new or old housing properties	240	450	620
Intermediate Scellier	(2008-2012)	Renovated new or old housing properties	120	225	310
PTZ and PTZ+	(2005-...)	First-time buyers purchasing their main residence	1,100	1,340	1,370
			3,898	4,690	4,340

Reading: Building subsidies in France date back to 1984 (Quilès and Quilès-Méhaignerie schemes). Certain schemes, such as the Périssol Law and the Robien Law, are no longer accessible but still have a gradually decreasing cost. For a detailed description of building subsidies in France see CAE Report no 82 (2007) and the report produced by the ministère du Logement et de la Ville ('French Ministry for Housing and Towns') in February 2008.

Note: (\*) Extended to 2009.

Source: PLF (2013).

<sup>8</sup> According to the same sources, private wealth in Germany increased from 350% of the GDP in 1998 to 400% in 2008; hourly wages excluding government sectors increased by only 19% between 1997 and 2007, with a cumulative inflation in consumer prices of 16% over the same period. The link between the wage situation and property prices is reinforced by the observation of developments in Ireland and Spain prior to the crisis.

<sup>9</sup> Source: CGEDD according to housing surveys.

<sup>10</sup> Ben Jelloul, M., Collombet, C., Cusset, P.-Y. and Schaff, C. (2011): «L'évolution des prix du logement en France depuis 25 ans», *Note d'Analyse du CAS*, no 221. See also Antipa, P. and Lecat, R. (2009): «The Housing Bubble and Financial Factors: Insights from a Structural Model of the French and Spanish Housing Markets», Document de Travail de la Banque de France, n° 267.

<sup>11</sup> See Glaeser, E.L., Gottlieb, J.D. and Gyourko, J. (2010), "Can Cheap Credit Explain the Housing Boom?", *NBER Working Paper*, no 16230, July

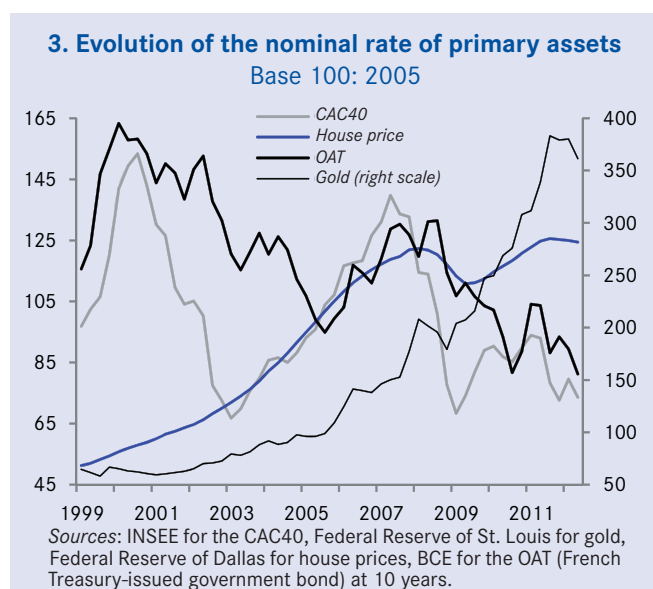
<sup>12</sup> The throughput ratio of property debt to GDP accounted for only 21% in 2000 (as opposed to 53% in Germany). Source: European Mortgage Association.

<sup>13</sup> In 2010, according to the *Chambre des Notaires* (French 'Society of Notaries'), non-residents accounted for 6.4% of transactions in Paris in terms of value, a rise due notably to the increase in the wealth of growing and recently liberated countries such as Brazil, Russia, etc. The same phenomenon can be observed on the Côte d'Azur.

In addition to these six factors that stimulated demand there were three factors that were simultaneously detrimental to supply, namely the insufficient freeing-up of land in the Parisian region, which resulted in a chronic shortage of housing<sup>14</sup>, poor supply management as a result of the number of different town councils managing property and land policy, and a very marked increase in the cost of construction (+4% per year over the period in question). The reasons for this increase are yet to be established but might be linked to a lack of competition due to the structure of the sector, resulting in the benefits of construction-related productivity gains not being passed on to buyers.

### The 2010-2012 increase

The price hike observed after 2009 not only in France (primarily the Île-de-France region) but in other countries in the Euro zone as well (Belgium, Luxembourg, Germany and Austria) is partially due to the drop in interest rates. Having said that, property was undoubtedly also considered to be a safe bet, its progression mirroring that of gold (Chart 3)<sup>15</sup>. Although the increase certainly incorporated an element of speculation, the 2010-2012 period was remarkable with regards to perceived risk (with the temptation to fall back on investments considered to be safe), as were the financing conditions. With this in mind, it is not so much a matter of knowing whether there is a speculative property bubble in France (Box 1) but rather of acknowledging that certain exceptional factors that support demand might disappear over the coming years. These aspects are, however, common to all of the countries in the Euro zone. One way of at least partially bridging the price gap between France and Germany (Box 2) would be to eliminate the fiscal instruments that artificially support demand in France, as Germany has already done over the course of the past decade.



## 1. A speculative bubble?

We talk about a speculative bubble when the price of an asset –in this case a property– becomes disconnected from its supposedly fundamental determining factors; what then motivates buyers is primarily the hope of making a capital gain when they sell the asset on and not a need for somewhere to live, or even to protect part of their wealth from potential depreciation. The property market tends to compare the evolution of property prices with that of rental costs in its bid to understand this issue. If prices increase faster than rental costs, the return on housing investment –the rental cost/property price ratio– decreases, the profitability of rental investment sags and households are encouraged to become tenants rather than owners. In such a situation, the continuing increase in prices can only be explained by other factors –speculation or falling back onto something that is considered to be a safer bet.

Despite the fact that the rental market is very strained in certain areas (and Paris in particular), the increase in rental charges has generally been controlled since 1998, increasing by an average of 2.6% per year. As a result, the price/rent ratio doubled between 1998 and 2008 (table). So unique was the context of 2010, however, that it would be incorrect to conclude that there was a speculative bubble (in the sense of purchasing with the aim of making a capital gain), with a financial crisis encouraging households to stick to the apparent safety of bricks and mortar and a decrease in interest rates supporting demand. Given the inherent temporary nature of such factors, however, we can expect a fall in demand once the crisis situation has passed.

### Price-rent ratio Relative long-term average figure

	1998	2008	2011
Germany	90	77	81
France	73	143	141
Italy	76	119	103
Belgium	90	155	161
The Netherlands	95	149	130

Source: *Perspectives économiques de l'OCDE*, vol. 92 (average since 1980, or earliest date available, equal to 100).

<sup>14</sup> According to the 1999 and 2009 censuses, the number of homes increased by 0.6% per year in the Parisian region whilst demographic growth alone amounted to 0.7% per year. The increased availability of vacant homes helped restore the balance up until 2009. Indeed, the number of vacant homes dropped by 83,000 in the Île-de-France region whilst it increased by 318,000 in the rest of France.

<sup>15</sup> In 2011, according to SAFER ('French Land Development and Rural Establishment Societies'), the price of agricultural land increased by 6% whilst agricultural revenue decreased by 3.6%, a sign that such land was also considered a safe bet rather than a productive investment.

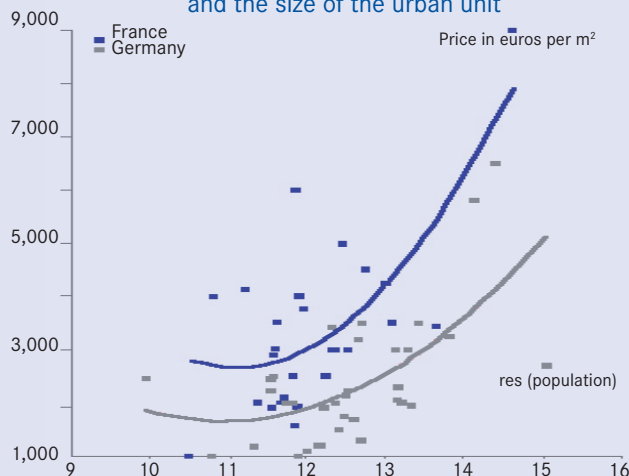
## 2. A comparison of the French and German situations

Between 1996 and 2012, property prices in France doubled, despite remaining stable in Germany. In 2012, the average purchase price per square meter was 60% higher in France than in Germany, whilst the average rental cost was only 10-20% higher. The rent/price ratio, which gauges the rental return on investment, is far lower in France than in Germany.

The high prices in France are strongly concentrated in the Île-de-France region, which, with some 10 million inhabitants, is home to 15% of the French population. In order to refine the diagnosis, it is important to compare towns and urban areas of equivalent size. In Germany's third-largest city, Munich (1.2 million inhabitants and 2.03 million within the urban area), for example, rental costs have recently increased and now reflect those observed in Lyon, a city of similar size. Outside of Paris, France has only two cities with over 1.2 million inhabitants whereas Germany has eight, including Berlin, where prices are half of those observed in the two quasi-capital cities in the north (Hamburg) and south (Munich) of the country. Paradoxically, despite being the largest country in Europe in terms of area, France has all of its policy centres concentrated in the smallest area, with all the congestion costs this brings with it.

The chart shows that the purchase price per square meter in France exceeds the purchase price in Germany by 66% with regards to town centre properties of an equivalent size.

**Relationship between the purchase price of a residence in the town centre and the population of the town**  
Quadratic relationship between price and the size of the urban unit



Sources: Authors' calculations based on data provided at [www.num-beo.com](http://www.num-beo.com) and confirmed by the notaries' database and Kholodilin K.A. and Mense, A. (2012): «German Cities To See Further Rises in Housing Prices and Rents in 2013», *DIW Economic Bulletin*, no 12.

## Improving property supply management

### The supply and development of land

As we have already seen, one of the main reasons for the increase in property prices is the scarcity and the poor management of supply. The first aspect to be rectified is the fragmentation of land-related decision-making, for which town councils have been responsible since the decentralisation law of 1982 (issuance of building permits, drawing up of the local development plan (PLU), etc.). For inter-communes with expertise in the fields of development and town planning, the PLU is established at inter-communal level, although this only concerns around 180 communities, that is only 7% of the 2,600 existing communities<sup>16</sup>. Since the introduction of the so-called Grenelle II Law, the State has encouraged communities to really harness this expertise, a move that needs to be adopted on a widespread scale, both for the purposes of establishing the PLU and for the issuance of building permits, since inter-communality really is the way forward when it comes to housing. Indeed, there are significant economies of scale to be expected as a result in terms of administrative management, as well as, moreover, optimisation with regards to development, transport and public facilities.

**Proposal 1.** Transferring responsibility for the PLU at inter-communal level and trialling the transfer in pilot areas, starting with areas where there is insufficient supply (zone A) and gradually expanding to incorporate other areas.

**Proposal 2.** Making towns and inter-communes both outside of the capital and in the départements of the outer suburbs of the Parisian region jointly responsible for issuing building permits.

There is a severe shortage of supply in the Île-de-France region where communal division is very high, with the average town occupying a small area and residential areas bordering towns with high concentrations of office jobs. The business taxes collected by the latter are insufficient to finance the housing policy of the former and competition between business real estate, which generates tax revenue for the town, and residential real estate, which tends to increase expenditure (collective facilities, even though new residents also generate tax revenue), is far from conducive to ambitious housing policies.

<sup>16</sup> The classification of cities by areas (Abis, A, B1, B2 and C) is determined by ministerial decree.

The case of central Paris is itself unique, with a severe rationing of supply under the guise of protecting a remarkable historical heritage<sup>17</sup>. Furthermore, the growth of the existing housing stock has been entirely absorbed since 1968 by an increase in the number of second homes and vacant residences, which accounted for 14.3% of housing in 2009 as opposed to 5.6% in 1968. According to financial calculations, with no accounting for price adjustment, a return to the 1968 rate today would be equivalent to releasing a further 120,000 residences, that is 36% of the residences built in the Parisian region between 1999 and 2009. In the majority of cities, second homes and vacant residences account for a maximum of 10% of the existing housing stock.

Despite the existence of a region-wide urban development document drawn up by the region itself with the support of the State (the *schéma directeur de la Région d'Île-de-France* ('Île-de-France Regional Masterplan'), SDRIF), its local variations and in particular its implementation are proving particularly problematic. In addition to the phenomenon of communal division, there is also a lack of desire for inter-communality on the part of towns in the centre and to the west of the Parisian urban area, with the ring-road creating a clear barrier which only serves to accentuate the pressure already exerted on the Parisian market by the demand for second homes. The current project involving the covering over of the ring-road is an opportunity to eliminate this physical barrier, provided that part of the space freed up by the initiative is set aside for the construction of housing.

Finally, the PLU, drawn up in 2001 and adopted in June 2006 by the Conseil de Paris ('Council of Paris'), specifies the maximum heights for building façades in accordance with the width of the street in question, with an additional limit imposed in certain neighbourhoods, essentially 25m in the neighbourhoods of central Paris and 31-37m elsewhere. This 37m limit should be increased in certain parts of the capital and along the ring-road in order to accommodate high-rise buildings of a reasonable standard which could house members of the middle classes who are currently relegated to the inner or outer suburbs.

**Proposal 3. Introducing a special regime in the inner suburbs of the Parisian region whereby full jurisdiction over development and town planning matters is granted to an entity comprising Paris and the three départements that make up its inner suburbs (alternatively, if Paris Métropole were to become an urban municipal authority, this could be the relevant entity).**

**Proposal 4. Continuing to cover over the ring-road with the aim of reducing the psychological barrier between Paris and its adjoining towns and to encourage the creation of park areas and the construction of buildings. Increasing building density by various means, such as permitting the construction of taller buildings in the outer arrondissements of Paris, for example, without affecting the current regulations that apply to more central neighbourhoods.**

According to architects involved in the Grand Paris initiative, free land and land that could be freed up in the Parisian urban area represents an area equivalent to that of Paris<sup>18</sup>. Developing these areas is therefore a major issue. In this case, development is still hindered by the departmental authority for mixed-investment companies (MICs), which is responsible for such matters. In addition to the measures proposed above, each of the existing MICs in the Parisian region could find themselves granted jurisdiction over the entire Île-de-France region with the aim of optimising the use of its productive capacities and balancing out its load plan. It would, of course, be preferable to increase competition in this sector. Towns currently have greater faith in their local MIC because it involves their elected representatives. As soon as larger structures (communities, regions, the Grand Paris initiative, etc.), with their increased monitoring power and reliable expertise, are given ownership of a project, the opening up of the town planning market will start to make sense.

**Proposal 5. Opening up development organisations in the Île-de-France region by giving them regional jurisdiction and increasing competition.**

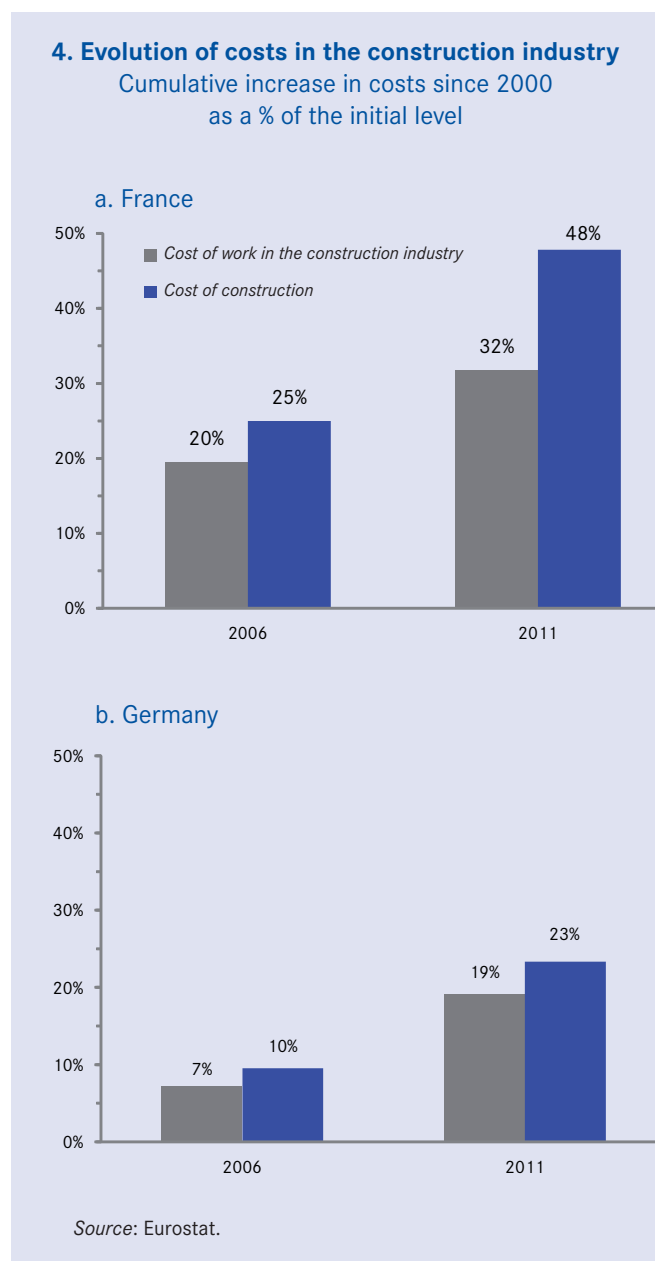
### Construction costs

All of these measures relating to the freeing up of construction space in terms of both floor area and height must be supported by a turnaround in the evolution of construction costs, which is drifting somewhat in France in relation to the Benelux countries and Germany. Since 2005, for example, the cumulative difference between the evolution of construction prices and that of consumer prices has been 14%, as opposed to only 5% just across the Rhine. The increase in construction costs since 2007 can be explained not by increasing wage bills in the construction sector (+10% in France between 2006 and 2011; +11% in Germany over the same period) but

<sup>17</sup> We cannot miss this opportunity to quote Edward Glaeser: 'The modern desire to preserve Baron Haussman's Paris has helped turn the affordable Paris of the past –with its history of impecunious but ultimately celebrated artists– into a boutique city that today can be enjoyed only by the wealthy. But what penniless artist can still afford to live in the centre of Paris nowadays? When space excessively limits construction, there is a risk that prices might stagnate or rise incessantly', Glaeser E.L. (2011): *Triumph of the City*, The Penguin Press, p. 136, authors' trans.

<sup>18</sup> See, for example, <http://www.ateliergrandparis.com/construire/utiliserlefoncier.pdf>

rather by other factors which might be linked to productivity, the proliferation of standards or competition-related issues (Chart 4). Certain technical innovations in the construction sector represent an ideal opportunity to reduce such costs, provided, however, that the productivity gains achieved are reflected in prices and not absorbed by the profession as a result of a lack of competition. It would be most beneficial to entrust a technical working group with the task of carefully monitoring the evolution of prices in the construction sector, making the appropriate international comparisons and identifying any excessive margins that might be applied.



Under benefit of inventory, the actions to be taken include, on the one hand, trimming back all of the different types of standards that apply to town planning and, on the other, looking at the best way to ensure optimal synchronisation, with regards to large projects, between all of the stakeholders involved, including architectural firms, design offices and construction companies. Common practice when it comes to public project management involves launching a call for tenders among architects and then signing a contract with the chosen architect for the completion of the work. A single simultaneous call for tenders for the design and implementation of the project<sup>19</sup> where a series of teams, each comprising an architectural firm and various construction companies, compete against each other would help save both time and money, around 15% of the total cost of the project according to certain industry specialists<sup>20</sup>.

**Proposal 6.** Creating an inter-ministerial working group comprising experts in the field to understand the drift in construction prices, identify any potential lack of competition and potential avenues for boosting productivity and suggest measures designed to both improve synchronisation between project designers and developers and facilitate the entry of new players into the construction market (by simplifying the standards system, if necessary).

### Reforming the property tax system

The property tax system can be broadly divided into three areas, namely tax on transactions, tax on ownership and tax exemption measures.

We would suggest reducing or even gradually eliminating tax exemption measures and duty on transfers for valuable consideration, reforming the property tax on buildings system and modifying the capital gains tax system. The general idea is to tax ownership rather than transactions in order to ease congestion in the property market and make the taxation of capital gains on property more appealing with a view to discouraging a 'sitting-on-the-fence' attitude. Towns and municipal associations must benefit from a more favourable capital gains tax system in order for them not to have any reason to postpone the classification of land reserved for other purposes as building land when faced with a demand for housing.

<sup>19</sup> For further information on this procedure and examples thereof please see Conception-réalisation: recommandations pour un bon usage du processus, produced by the *Mission Interministérielle pour la qualité des constructions publiques* ('French Interministerial Mission for the Quality of Public Construction', August 2010).

<sup>20</sup> It is important to seek real gains in terms of efficiency and not just cost. It is not a matter, in this case, of challenging the actions of public authorities to ensure that employment law in the construction sector is enforced.



## Gradually phasing out building subsidiaries

A number of studies have highlighted the inflationary effect of building subsidies and of policies designed to support the demand for housing in general<sup>21</sup>. The reasoning behind this is based on a conventional impact analysis, showing that any aid mechanism aimed at potential buyers can be partially captured by suppliers in the form of price increases<sup>22</sup>. In extreme cases, prices per square meter can even increase by the exact amount of the aid received. The Scellier scheme involving building land may therefore have brought about a price increase of an average of €7/m<sup>2</sup> on the boundary of Zone B2<sup>23</sup>, which corresponds to a 7% increase in those areas located on the fringes of the scheme. In geographical terms, however, the effects vary, with the greatest price repercussions of the scheme being felt in those areas where there is insufficient supply to meet demand (greater Parisian region and Mediterranean region)<sup>24</sup>. Likewise, the interest-free loan (PTZ) is estimated to have resulted in only 75,000 new instances of home ownership between 1996 and 1999 out of a total of 533,000 beneficiary households over the same period<sup>25</sup>. 458,000 citizens are therefore believed to have become home-owners even without the PTZ, which would consequently appear to have had a mass windfall effect. Furthermore, the PTZ introduces a questionable skew in favour of home ownership and to the detriment of the rental market<sup>26</sup>. Developing the PTZ at a time when unemployment levels are high and there is a risk of the property bubble bursting might also backfire on new buyers. Encouraging modest households to invest in an asset that brings with it a risk of depreciation over the coming years is without doubt not a highly advisable move; they should, however, be encouraged to diversify their portfolios<sup>27</sup>. Given the current situation, it would undoubtedly be wiser to offer a series of 'rent-to-buy'-type schemes<sup>28</sup> where the household in question has the option of buying the property after renting it for ten years and where the rent paid to date is deducted from the final purchase price. It would then be up to the lessor to bear the risk of loss in value by taking out the appropriate financial market insurances. This solution would appear to be more reasonable than placing this risk at the door of modest households that are already faced with the uninsurable risk of job insecurity.

Generally speaking, the cost of tax exemption mechanisms far outweighs the results they appear to produce.

**Proposal 7.** Preparing for the complete elimination of exemption practices designed to promote construction over the course of several years (to take into account the non-retroactivity of certain mechanisms).

**Proposal 8.** Ensuring tax neutrality between the private rented sector and the home-ownership sector. This would mean gradually eliminating loan interest exemption practices such as the PTZ+ and instead exploring the possibilities of rent-to-buy schemes for modest households which would prevent the risk of loss of asset value in the event of a turnaround in the local property market.

## Taxing ownership rather than transactions

### Gradually eliminating duty on transfers for valuable consideration

Sales of land and housing are subject to different taxes depending on the intended use of the asset in question (agricultural land, building or non-building land, etc.), the time that has passed since the completion of the works (5 years prior to or after completion of the works) and the type of seller or buyer (and whether or not they are subject to VAT).

Duty on transfers for valuable consideration (DMTO) is the primary tax applicable to transactions involving existing properties (that is properties that were completed at least 5 years previously) and accounts for 5.09% of the total amount of a property transaction. As is true of any transaction cost, it can certainly prove a hindrance to exchange and therefore mobility, since an owner losing his job in an area of economic decline will hesitate to sell and move to a region with a more dynamic job market.

<sup>21</sup> See Fack, G. (2005): «Pourquoi les ménages à bas revenus paient-ils des loyers de plus en plus élevés? L'incidence des aides au logement en France (1973-2002)», *Économie et Statistique*, no 381-382 and Lafferère, A. and Le Blanc, D. (2002): «Comment les aides au logement affectent-elles les loyers?», *Économie et Statistique*, no 351.

<sup>22</sup> See *Note du CAE* n° 1, February 2013.

<sup>23</sup> Zone B2 is one of the five zones (Abis, A, B1, B2 and C) introduced by the 2009 Scellier Law as a way of setting upper limits for rental costs and the resources available to tenants (these zones cover several urban areas).

<sup>24</sup> Bono, P-H. and Trannoy, A. (2013): «Évaluation de l'impact du dispositif Scellier sur les prix fonciers», *Document de Travail AMSE*, n° 2013-04. Surprisingly, no other rental investment support systems have been evaluated to the best of our knowledge.

<sup>25</sup> Gobillon, L. and Le Blanc, D. (2005): «Quelques effets du prêt à taux zéro», *Économie et Statistique*, no 381-382.

<sup>26</sup> See Schaff, C. and Ben Jelloul, M. (2010): «Favoriser la mobilité résidentielle en modifiant la fiscalité du logement», *Note d'Analyse du CAS*, n° 196.

<sup>27</sup> It should also be noted that since the rental-housing sector consists primarily of apartment blocks, encouraging ownership of the main residence might contradict the environmental objectives of housing densification.

<sup>28</sup> For reasons that remain unclear, the rent-to-buy scheme introduced in 1984, by means of the *prêt social location-accession* ('social rent-to-buy loan', PSLA), for example, has had limited success.

New homes, meanwhile, are subject to VAT (20% as of 1<sup>st</sup> January 2014). There is, however, no economic justification for applying VAT to a new building in its entirety, including the 'straight' value of the land (the VAT should be applied only to the value added to the land, that is the value of the construction works). Furthermore, VAT does not apply to the exchange of non-building land<sup>29</sup>.

The elimination of duty on transfers for valuable consideration would result in the loss of around 9 billion euros in tax revenue among the various public authorities (figures of 2011). We would suggest compensating for this loss by means of a property tax reform.

### Basing property tax on net sale value

Local property tax as a tool is perfectly suited to the funding of local expenditure, including public facilities such as roads, schools, park areas, cultural facilities, etc. which create additional income for owners which can then legitimately be taxed to fund them<sup>30</sup>. The problem with this taxation system, however, is being able to review the price scales as building values evolve. The general review that took place in 1990 was not reflected in tax assessment bases since Parliament opposed this move. Taking advantage of the Amending French Finance Act (PLFR) for 2012, the government has proposed that a review of the rental values of premises used for housing be undertaken. The new revision undertaken this year will not, however, come into force until 2018, meaning that there is still time to reflect upon a new means of calculating the assessment.

It would be possible to base property tax (buildings) in France on the sale value of the property, that is on its market value, as of 2013, although the tax authorities consider it impossible to know the sale value of all existing properties since the latter come onto the market once every nineteen years on average. Data gathered by notaries, however, makes it possible to accurately estimate the actual value between two transactions<sup>31</sup> (Box 3).

One unfair aspect of the current system is that it taxes the gross property asset value, without deducting the value of any debts incurred in order to fund the purchase of the property. As a result, new home-owners pay property tax as soon as they come into possession of the property, despite the fact that for the first year of ownership their net wealth is limited to the amount of their personal investment, that is an average 20% of the total value of the property purchased. We would consequently suggest basing property tax on the net value of

the property. With regards to the current situation, transferring the burden in this way would benefit new home-owners who have not finished repaying their mortgages (18 years on average) to the detriment of those who own major assets, who are older and belong to the highest deciles<sup>32</sup>. The reform would also rectify certain horizontal inequalities such as the difference in taxation between the owner of an old home in the town centre (lowly taxed) and the owner of a new home on the outskirts of town (more heavily taxed), for example.

### Budget neutrality

The proposed property tax reform would help compensate for the loss of revenue resulting from the elimination of duty on transfers for valuable consideration. The net property wealth of associated debts in 2011 was around 6,300 billion euros at market value<sup>33</sup>. A rate of 0.5% would recover at least 30 billion euros, that is 12 billion more than property tax on buildings and therefore more than the shortfall on duty on transfers for valuable consideration (9 billion). There would then be a margin of 3 billion to offset any VAT-related initiatives involving building or developed land. It is, of course, perfectly possible to implement this reform and maintain the current distribution of proceeds from duty on transfers for valuable consideration among the various authorities (1.20% for the town, 3.80% for the département and 0.09% for the State) euro for euro. Finally, the withdrawal of assistance for the purchase of new homes would result in a budgetary saving of over 4 billion euros.

**Proposal 9.** Gradually eliminating duty on transfers for valuable consideration, basing property tax on the net sale value of the building and gradually increasing the scale applicable to the latter in accordance with decreasing levels of duty on transfers for valuable consideration. These changes would be implemented over the course of a decade.

### Reforming increment value duty

When an asset is taxed at its sale value, the unrealised capital gain is taxed de facto. Implementing the above-mentioned property tax reform would result in the unrealised capital gain being taxed at 0.05% per year. Since a property comes

<sup>29</sup> Likewise, the end of the property VAT payable by individuals selling their property less than five years after completion of construction works as of 1<sup>st</sup> January 2013 is also something to be celebrated.

<sup>30</sup> The so-called 'Henry George' Theorem, see Arnott, R.J. and Stiglitz, J.E. (1979): "Aggregate Land Rents, Expenditure on Public Goods, and Optimal City Size", *Quarterly Journal of Economics*, vol. 93, no 4.

<sup>31</sup> A property tax based on sale value rather than rental value is still preferable when there is a bubble since by taxing the sale value you are also taxing the bubble and thus helping to suppress it.

<sup>32</sup> The debt would then be dealt with in the same way as the solidarity tax on wealth (ISF) for which the debt is deductible, the idea being to tax assets and not household accounts.

<sup>33</sup> See Note INSEE of 22 January 2013.

### 3. Estimating the sale value of a property based on notarial databases

Property transaction data is recorded by notaries in two databases, the BIEN database for Paris and the Île-de-France region, which currently contains details of some 2 million transactions, and the PERVAL database covering the rest of France, with over 7 million. Using what is known as the hedonic method, this information makes it possible to calculate the sale value of any asset, even if it has not been involved in a sale transaction for some time.

The hedonic method consists of breaking an asset (in this case a property) down into a series of different characteristics, such as surface area, number of rooms, balcony, lift, parking etc. The prices recorded for transactions involving the property are then used to attribute a default value to each of these components, which in turn gives the hedonic price of an asset that has not been priced in the market. This method also takes into account local differences in terms of amenities (including transport, schools, park areas, proximity to the town centre, etc.).

Work carried out in various countries over the past forty or so years has shown that this method makes it possible to closely align property values. With regards to central Paris, almost 90% of the variance in apartment prices can be explained, as opposed to around 80% outside of Paris. Where houses are concerned, the adjustment is generally a little less, at around 75%, but is nevertheless an acceptable basis on which to calculate sale values whilst waiting for the property to sell, in which case the market value replaces the hedonic value of the asset.

onto the market every 19 years on average, this tax would be equivalent to a capital appreciation on property tax of  $19 \times 0.5\% = 9.5\%$ . The advantage of this system is that it makes the taxation of unrealised capital gains almost pain-free and reduces the likelihood of trying to retain the asset or under-estimate its value when it comes to registering it with a notary<sup>34</sup>.

This argument is, of course, only valid provided that the assets are subject to property tax on buildings. Agricultural land, however, is not subject to this, and the tax on the sale of such land once it has been made suitable for building, which was introduced in 2010, is very limited. When non-building land becomes building land, its value suddenly increases. As a result, it is preferable to tax the owner immediately (and not, as is currently the case, at the time of sale) in order to encourage them to make the capital gain as soon as possible (by selling the asset), rather than waiting for prices to increase. Towns would then have the means to anticipate future needs in terms of the collective facilities required to accommodate new inhabitants. The tax would be calculated annually based on the unrealised capital gain and the taxes paid would be deducted from the taxes due at the time of sale<sup>35</sup>.

**Proposal 10.** Taxing unrealised capital gains on property in the event of a change of development plan (agricultural land becoming building land, for example) and allocating revenue to the authorities responsible for issuing building permits.

If the present proposals regarding property tax and capital gains are to be implemented it is essential that notarial databases be completed as exhaustively as possible. In this res-

pect, the law of 28 March 2011 relating to the modernisation of legal and judicial professions and certain regulated professions extends the field of jurisdiction of notaries and combines the duty to register the land with an actual act resulting in units of value. In basic terms, notaries are now obliged to complete the PERVAL and BIEN databases according to their location and in return for payment. Rural areas in particular are still poorly covered. Nearly two years after the law was passed, the implementation orders are yet to be published, yet it is essential that it be implemented as a matter of urgency. In the event of any failure to fulfil obligations being observed, it would then be necessary to look at introducing sanctions.

**Proposal 11.** Publishing the implementation orders of the law of 28 March 2011 relating to the obligation on the part of notaries to complete notarial databases with regards to registering land.

## Conclusion

Housing policies and policies designed to increase home ownership in particular hold great potential for development in terms of not only efficacy but also equity and financial savings. The reforms put forward in the present Note relate to the administrative organisation of both the market and the tax system. They are designed to stimulate supply, correct imbalances in demand and ease congestion in the market to encourage mobility. The issues at stake are important not only in terms of the well-being of the populations concerned but also in terms of the competitiveness of the French economy. ●

<sup>34</sup> It is logical to maintain the current tax regime governing capital appreciation on property during the transition period.

<sup>35</sup> The amount of building land transactions intended for the construction of houses is around 6 billion euros (source: EPTB ('basin territorial public establishment') survey. A tax of 30% would therefore recover 2 billion euros.

# How Should Property Prices be Moderated?

## The 11th propositions

**Proposal 1.** Transferring responsibility for the PLU at inter-communal level and trialling the transfer in pilot areas, starting with areas where there is insufficient supply (zone A) and gradually expanding to incorporate other areas.

**Proposal 2.** Making towns and inter-communes both outside of the capital and in the départements of the outer suburbs of the Parisian region jointly responsible for issuing building permits.

**Proposal 3.** Introducing a special regime in the inner suburbs of the Parisian region whereby full jurisdiction over development and town planning matters is granted to an entity comprising Paris and the three départements that make up its inner suburbs (alternatively, if Paris Métropole were to become an urban municipal authority, this could be the relevant entity).

**Proposal 4.** Continuing to cover over the ring-road with the aim of reducing the psychological barrier between Paris and its adjoining towns and to encourage the creation of park areas and the construction of buildings. Increasing building density by various means, such as permitting the construction of taller buildings in the outer arrondissements of Paris, for example, without affecting the current regulations that apply to more central neighbourhoods.

**Proposal 5.** Opening up development organisations in the Île-de-France region by giving them regional jurisdiction and increasing competition.

**Proposal 6.** Creating an inter-ministerial working group comprising experts in the field to understand the drift in construction prices, identify any potential lack of competition and potential avenues for boosting productivity and suggest measures designed to both improve synchronisation between project designers and developers and facilitate the entry of new players into the construction market (by simplifying the standards system, if necessary).

**Proposal 7.** Preparing for the complete elimination of exemption practices designed to promote construction over the course of several years (to take into account the non-retroactivity of certain mechanisms).

**Proposal 8.** Ensuring tax neutrality between the private rented sector and the home-ownership sector. This would mean gradually eliminating loan interest exemption practices such as the PTZ+ and instead exploring the possibilities of rent-to-buy schemes for modest households which would prevent the risk of loss of asset value in the event of a turnaround in the local property market.

**Proposal 9.** Gradually eliminating duty on transfers for valuable consideration, basing property tax on the net sale value of the building and gradually increasing the scale applicable to the latter in accordance with decreasing levels of duty on transfers for valuable consideration. These changes would be implemented over the course of a decade.

**Proposal 10.** Taxing unrealised capital gains on property in the event of a change of development plan (agricultural land becoming building land, for example) and allocating revenue to the authorities responsible for issuing building permits.

**Proposal 11.** Publishing the implementation orders of the law of 28 March 2011 relating to the obligation on the part of notaries to complete notarial databases with regards to registering land.



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