Recently adopted lower VAT rate on newly-built homes to ignite the property market

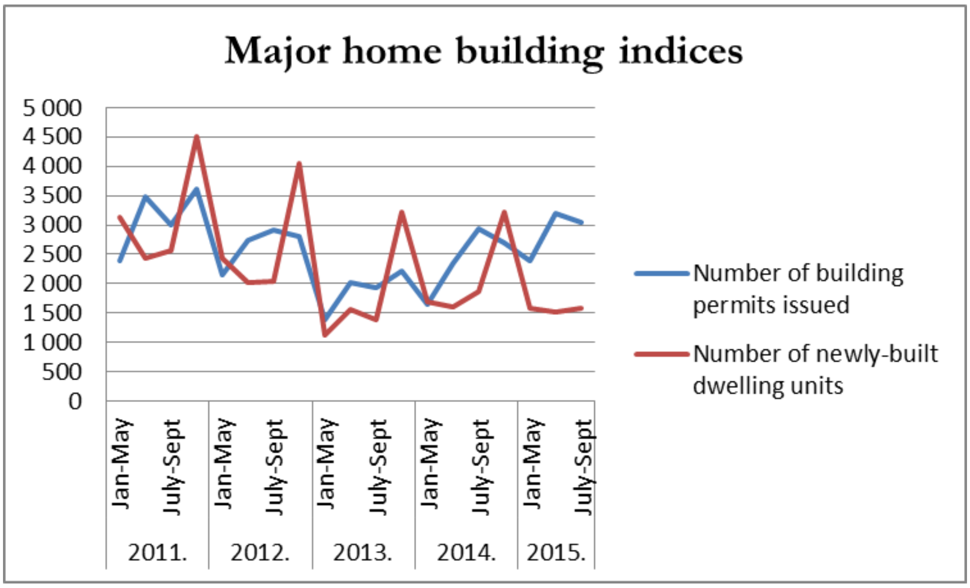
Currently, one of the major challenges the real estate market is facing lies in the fact that the stock of old residential properties is not being replaced by a new one in a timely manner. Through a proposed amendment, which was adopted by the National Assembly on 15 December 2015, the Government aims to facilitate a change in this aspect. According to the new provision, the rate of VAT payable for new dwelling units is reduced from the prior 27 percent to 5 percent for the period 2016-2019. In addition, the bill contained a number of significant measures to cut related red tape and thus improve the sluggish performance of the construction sector. These measures are expected to lead in the aforementioned period to a sharp rise in the number of new residential properties.

Building of residential properties

It has to be noted that there is actually no shortage of residential properties. However, the number of new units is only a fraction of the total stock and with the pace of growth prevalent in the past years it would take too long until the entire stock could be replaced.

According to data by the Hungarian Central Statistical Office (KSH), the number of new dwelling units completed in Q1-Q3 2015 was 4657, 9.5 percent below the figure of last year (5144). Although it is higher than the record low reached in 2013, it is still a meagre figure. The 24 percent growth in the number of building permits (to 8616) signals that real estate developers are already laying the groundwork for future projects as they have realized that demand has been picking up. The total number of sales transactions on the property market has also increased, albeit 98 percent of them were completed in the used residential property segment and for the time being the sector's recovery has been limited only to this category[1]: the market of new homes has not shown signs of a turnaround yet.

[1] In 2014, the number of transactions on the domestic market for used residential property grew by 28 percent, while – in light of data from the initial three quarters of the year -- for this year the sector is expected to expand by probably as much as 40 percent. Including fourth quarter estimates, the number of transactions may total 155 000 in this segment, which would be on a par with the turnover in 2009.



Source: Hungarian Central Statistical Office (KSH)

Housing policy and regulation

Several measures were introduced in 2015 that are having a positive effect on the residential property market. As of 1 July 2015, the Family Housing Allowance (CSOK) has become available. According to real estate agency Otthon Centrum, due to special conditions the scheme is more popular in the countryside than in Budapest, but even there it has not added more than 10 percent to overall growth. Personal bankruptcy as a legal term was introduced in September 2015, and this may also limit the number of units put on the market under forced sale.

The popularity of state-subsidized housing loans has also waned, as a consequence of low interest rates and fixed-rate mortgages. The gradual lowering of the base rate by the National Bank of Hungary has resulted in lower rates for home mortgages, thus fixed-rate loans with a tenor of 5-10 years have become more attractive and more predictable alternatives which are underpinning further expansion of the real estate market and the launching of development projects in the short and the medium term.

The Government has found that low project profitability has been behind the failure of the residential property developers to take advantage from market upturn. This has prompted the reduction of the 27 percent VAT rate for the period 2016-2019. Besides lowering the VAT rate, the bill also proposed a number of measures aimed at cutting red tape for the construction sector:

- The former process for obtaining a construction permit is replaced by a simple obligation to report of building activity in case of the construction of a new residential property up to a floor space of 300sqm;

- The building of new residential property is exempt of paying home building duty and administrative duty;

- Administration related to public utility services is to become faster and less complicated. The law stipulates a deadline for the issuance of statements by public utility service providers;

- Issuance of the certificate on the completion of building works becomes free of charge in case the construction is completed within three years after building activity was reported. In order to prevent unfinished or delayed construction works, a duty will be payable depending on the length of works and the building will have to be demolished in case in remains uncompleted ten years after building activity was reported.

- The environmental impact assessment procedure will be abolished.

As an additional incentive, the Government eases requirements also for private home builders: in the next four years they can reclaim the difference between the 27 percent and 5 percent VAT, up to HUF 5 million, by submitting construction bills.

The Government is expecting these measures to boost the residential property market and economic growth; and improve employment and housing conditions. According to Minister for National Economy Mihály Varga, VAT reduction may add 3000-5000 per year to the number of newly-built dwelling units from the current 8000-9000; and in case at least the 3000-unit threshold is reached, tax revenues to the state budget will not be lower.

With these steps, the Government has followed some international examples. The VAT rate on flats and houses up to a floor space of 150 sqm and 300sqm, respectively, is 7 percent in Poland. In France and Romania the VAT rate on non-luxury flats is 5.5 percent.

Analysts welcome the steps

In the opinion of real estate agency Otthon Centrum, dwelling units built for sale are set to drive the number of newly-built properties higher, and the number of units built for sale may more than double in 2016 from the current 3000-4000 estimated for this year. It is anticipated that due to the lower VAT rate several real estate developers will put new units up for sale before they obtain building permits; therefore the number of residential property transactions is seen higher – more than 10 thousand -- than that of newly completed units.

Analysing the impact of measures on private households, economic research tank Századvég stresses that the Government's expectations are well-founded. In their study, analysts conclude that the current supply-side impediments jeopardize the growth of the market of newly-built units and the approved package of measures may significantly improve this situation. According to their calculations based on input-output table models, the fiscal impact of reducing the VAT rate to 5 percent is to turn positive provided growth reaches at least 3000 extra units per year. In this case, the VAT revenue shortfall would total HUF 7.2bn, while expenditures would rise by HUF 5.7bn from personal income tax and wage contributions, HUF 1bn from capital gains tax, HUF 0.6bn from excise taxes and by HUF 0.3bn from sectoral taxes. Estimates by the Hungarian Association for Homebuilding are similarly favourable, as they are expecting personal income tax and duty revenues to rise and the number of public work employees to drop as a consequence of these steps.

Although experts are anticipating that prices will edge lower on the market, the altogether 17 percent nominal reduction (in terms of the property's gross price) will not fully translate into end-prices. In the opinion of Viktor Zsiday, manager of Citadella investment fund, and Otthon Centrum analysts, VAT reduction will have the following four impacts:

- Lower prices for new and used residential properties (as planned projects are launched and provide larger supply on the market);
- Higher plot prices due to larger demand for new dwelling units;
- Higher building costs due to the "already visible" labour shortage in the construction sector;
- Higher developer profit margins.

The recovery of the home building sector may add extra impetus to total construction sector output and overall economic growth. Higher capacity utilization within the construction sector will accordingly lead to higher wages for skilled workers and create thousands of new jobs.

As the market has long anticipated a VAT cut for the construction sector and developers on the sidelines have eagerly waited for better conditions, the new situation is likely to cause a prompt and massive turnaround.

Medium-term outlook is hard to predict

As the 5 percent VAT rate is set to remain in place until 2019, the coming period will be a busy one for the market of newly-built dwelling units. As the VAT rate is to rise again to 27 percent in 2020, both developers and buyers will in the next four years concentrate on bringing forward investment projects and purchasing transactions.

It is too early to predict whether the supply or the demand side is to see a larger impact, but the number of new home transactions is certain to soar in the next four years and the Government will achieve the intended positive U-turn on the market.