

Addiction to real estate investment – when side-effects begin to dominate

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Since independence, Malta has come a long way in growing its economy. GDP per capita in pps has increased from merely 65% of the EU average in the 1990s to 110% by 2025. Nevertheless, despite the significant progress in living standards and prosperity, in recent years discussions on quality of life or well-being have risen high on the national agenda.

Such debate is essentially driven by an underlying sentiment of over-crowding or congestion, be it on the roads; pedestrian streets; in public places of relaxation and recreation; in health services; in the infrastructure, like electric power and sewage services; and noise and dust levels, especially from construction activity, which are all viewed as impinging on citizen's quality of life.

In recent years, this sentiment has led to debates on how economic growth should focus on quality, rather than quantity, and driven by productivity gains, with Government's Vision 2050 shaped in this direction. These are objectives that can be hardly disputed. But would achieving such objectives be sufficient to address over-crowding or congestion?

Would replacing demand for low-skilled workers with higher skilled ones, or welcoming 4.5 million or more better quality tourists than those visiting today, result in less congestion or less over-crowding? This would most likely result in stronger GDP growth and higher income levels, and given the nature of human beings, it would probably create a desire for even more of both to further enhance wealth, but it would not nonetheless make over-crowding or congestion, and their side-effects, fade away!

While shifting focus towards upskilling workers to better equip them in engaging in higher value-added activities and enhance their productivity is necessary, by itself it is not a sufficient condition to address over-crowding or congestion as it does not tackle the root cause which citizens feel is impacting their quality of life and well-being.

The root cause of congestion and over-crowding stems from the addiction to investment in various forms of residential real estate. By residential real estate, it is meant all immovable property used for shelter by persons to work, retire, or holiday in Malta.

The addiction to investment in residential real estate, however, has not been limited to “developers” or “speculators”, but is more widespread, including households pulling down their own dwelling to profit from developing it in apartment blocks, either directly themselves or by selling it to a developer, and those households holding a small portfolio of properties for investment purposes, be it to earn rent, for capital appreciation, or for both. Indeed, the 2023 HFCS report of the Central Bank of Malta shows that 36.5% of the surveyed Maltese-born households in 2023 owned additional property apart from their residence.

Such addiction is not irrational. It is a logical response to incentives that affect the rate of return on such assets relative to other assets (financial or other real assets) that operators in the field,

including households, observe. After the curtailment of significant public provisioning of housing in the late 1980s, the rise of the private market in residential real estate since then provided an attractive rate of return as property prices climbed steadily, with annual property price inflation over the past two decades averaging at 5.75% each year.

While in the past, investment in residential real estate mostly generated returns in terms of capital appreciation, over the past decade, residential real estate generated also strong income flows with the rise of the rental market to accommodate the inflow of migrant workers and tourists, making the overall rate of return much higher. Indeed, in the years 2016 to 2025, building permits of dwellings swelled by 77%, or almost 42,000 units over the previous decade, while building permits for hotels increased almost nine-fold from 125 to 1,118.

The incentives that fuelled the addiction to residential real estate investment are several. While addictions of various kinds initially usually generate high satisfaction, eventually when their side-effects begin to dominate, negative consequences begin to creep in. *(end of part 1)*

Investment in residential real estate critically hinges on the expectation that such dwellings are occupied by people, and therefore such kind of investment inevitably presupposes a desire for further growth in inflows of people, be it for work, pleasure, or any other reason. If this is the driver of the sentiment of loss in quality of life or well-being, then what is needed is a review of the incentive structure that sustains such addiction.

The incentives for investment in residential real estate are many and varied. From a fiscal perspective, advantages range from a lower tax rate of 15% on rental income relative to a maximum 35% on corporate or personal income, to annual zero taxation on single and even multiple holdings of residential real estate, irrespective of their utilisation. The latter ensures that in periods of downturn, declines in property prices can be very limited as owners, especially those without outstanding debt obligations, may hold on rather than sell as they would not be exposed to negative cashflows on their investment.

Besides, various universal fiscal schemes providing grants and tax benefits, to a growing broader definition of first-time buyers, help support demand and hence sustain property price inflation. Electoral pledges to exempt residential real estate not for own use from inheritance tax would also provide a further incentive to such kind of investment.

Subsidies to airlines and water and electricity consumption to collective accommodation establishments as well as rented apartments help support tourist inflows. At the same time, weak enforcement on unregistered residential real estate used for tourism purposes increase further the after-tax rate of return on such kind of investment. In 2019, Central Bank of Malta staff had conducted a web-scraping exercise which identified 8,761 distinct properties advertised for short-term letting, while the number of officially registered holiday furnished premises back then were around less than half of this figure despite a favourable low tax rate that was aimed to disincentivise tax evasion on rental income.

The banking sector also provides incentives for this addiction with a very low mortgage interest rate, currently at around 2.7%, with bank lending portfolios increasingly concentrated in real estate, as savers earn virtually a zero rate of return on their bank deposits, thus effectively

subsidising borrowers and at the same time enabling banks to record healthy profits and increasingly diversifying their risk across a larger pool of borrowers. Although since 2019 macroprudential policy by the Central Bank of Malta has been increasingly restrictive to address such sectoral concentration in bank lending, the rising share of bank lending for this activity remains relentless.

Even the local capital market has in recent years been infected by such addiction. Some issuers have been borrowing funds even to acquire property owned by related companies of the same UBO and use such cash to invest in other residential real estate.

Low labour taxes also provide incentives to employers in preferring adding labour resources to capital, which sustains demand for labour and hence inward migration given the demographic trends in the indigenous Maltese population. Both employers and trade unions have strongly resisted the introduction of a mandatory second pillar pension to improve pension adequacy because this would effectively raise taxation on labour, where according to European Commission data, Malta has among the lowest labour taxes at about 70% of the EU average.

As with any other addiction, withdrawal cannot be sudden but requires a period of transition since it often involves unpopular choices that usually generate short-term pain for longer-term benefit. However, such kind of timeline often presents challenges to policy makers operating in a democracy as the time horizon is usually determined by the date of the next election.

As long as the incentive mechanism remains untouched, the addiction to investment in residential real estate will remain, together with the need for people to fill such properties, irrespective of their skill levels, productivity, or the quality of tourists, though steering the economy to “quality” together with more productivity-led growth, would undoubtedly help ease transition pains.

Ultimately, households need to reconcile their addiction to residential real estate investment, and the population growth it presupposes, to earn them an attractive rate of return, with their desire for a better quality of life and higher well-being from less over-crowding and congestion. The island state of Singapore has shown that a higher population density and level of quality of life than Malta’s can co-exist. However, this needs to be accompanied by a robust planning and management culture, together with strong political will, in the absence of which, trade-offs become inevitable when side-effects begin to dominate.