IPTI Xtracts

Property Tax and Assessment News from Around the World

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New Zealand's new housing policy is really just a new tax package — and it's a shambles

Economists like to talk about "optimal policy instruments" — essentially, policies that achieve their objectives more effectively or efficiently than the alternatives, and have minimal unintended consequences.

Judged by those criteria, the New Zealand government's recently announced package of housing policy instruments is a long way from optimal. You might even call it a shambles.

How so? To the uninformed, the package's main elements may seem to address the housing affordability crisis by doing several things:

- removing tax deductibility of interest on loans for residential property investments
- extending the bright-line test — the period after which the property sale attracts a capital gains tax (CGT) liability — from five to ten years
- favouring new builds in these tax changes
- introducing a "changes of use" rule that effectively makes family homes liable to CGT if sold within ten years and rented out for more than one year
- and raising income and house price caps for the government's First Home Grant scheme.

If we examine the package in light of the three optimal policy requirements, however, we can see the problems.

Achieving the policy's objective

Economists have a policy "rule" that to achieve various policy objectives, you need at least as many policy instruments. The housing package is a hodgepodge of inter-related measures, but it has several explicit objectives:

- stabilising house prices
- facilitating home ownership
- discouraging (ill-defined) speculative investment
- increasing the housing stock with mainly (undefined) "affordable homes"
- closing what the government claims is a housing "tax loophole".

To these, add implicit objectives of tackling perceived income and wealth inequalities between tenants, landlords and homeowners.

Overall, this is quite a task, and it would be remarkable if any set of housing policies could achieve such wide-ranging objectives.

Arguably, the primary target of this policy package is stopping the inexorable upward march of (mainly Auckland) house prices. Failing to achieve that would simply put it among a long line of attempts by previous governments (National and Labour) over the past 20 years at least.

In all cases, the biggest problem has been insufficient political commitment to boosting housing supply.

Unintended consequences

All taxes cause "distortions", mostly unintended, which need to be mitigated. Furthermore, policies that have conflicting objectives are "incoherent" and typically among the most distorting. This applies to the housing package's removal of interest deductibility.

Previously, in New Zealand and almost every other country, interest on business loans is treated as a legitimate expense and therefore tax deductible, regardless of the nature of that business.

With that coherent principle now not applying to housing, then, what about other types of business loans the government thinks it should favour or disfavour? No doubt arguments could be made for such policies, but the result is an ad hoc tax system that generates multiple undesirable distortions and perverse incentives.

It could be argued the "new build" aspect of the housing package gets some incentives right by directing rental housing investment toward increasing the housing stock.

But with already existing constraints on new house building — such as planning regulations and availability of suitable land — the policy is likely to have little impact. It will simply shift housing investors from competing with first-time buyers for existing properties to competing with them for new properties.

Over time the rental housing stock becomes a patchwork of homes that do or don't qualify for tax exemptions. Exploiting these new loopholes and assorted distortions to property prices will likely provide plenty of employment for tax accountants.

A back door capital gains tax

It would be rare to find a liability based on transactions and timing among the principles of a good tax policy. But the bright-line test manages both — it incentivises delaying property sales to avoid the tax even when selling would otherwise be in the taxpayer's best interest.

It was originally introduced in 2010 with a two year threshold, without supporting evidence, supposedly to stop so-called speculators from flipping properties for quick profits. A ten year threshold cannot be branded an anti-speculation policy, it is simply a back-door CGT.

As with most back-door policies, this CGT is inevitably less transparent and coherent than a policy designed to tackle the problem head-on would be.

Consider the hypothetical case of an Auckland homeowner relocating to Sydney to work for two years. It wouldn't be sensible to sell the Auckland house due to high transaction costs and the risk of slipping on the property ladder when trying to buy back later. Much better to rent in Sydney while also renting out the Auckland home.

But this would now generate a potentially substantial tax bill on the family home. Indeed, one calculation showed just such a plausible scenario could generate a CGT liability of almost a year's salary — simply to move to a similarly priced house.

Alternative policy instruments

If there are better alternatives, they do not lie in even more ad hoc fiddling with a coherent tax regime.

Instead, like the famous real estate mantra of "location, location, location", the mantra for New Zealand housing policy should be "supply, supply, supply". Specifically, supply in Auckland.

Successive governments have aimed policies nationwide when rapid house price inflation is almost exclusively urban and essentially an Auckland phenomenon.

Without policies that reform construction sector regulations and open up more land for urban housing, there is little prospect of Auckland house prices stabilising while current demand-driven trends persist. To make matters worse, the government's first-home buyer schemes will merely raise demand without incentivising supply.

With too many objectives and the probability of numerous unintended consequences, the government's housing policies risk being seriously incoherent.

Even 'dungers' are too pricey in NZ property market

New Zealand was a world leader at containing Covid-19, but it now leads the world in something less desirable.

It has the most unaffordable housing market among the 36 Organisation for Economic Co-operation and Development (OECD) nations.

Even "dungers" - a local term for run-down houses - are selling for over NZD$1m (£510,000) in Auckland's most expensive neighbourhoods.

Median house prices surged nearly 23% over the last 12 months to NZ$780,000.

Although New Zealand faced its worst recession in a generation due to the Covid pandemic, its swift lockdown measures worked, and it was one of the first developed economies to start showing signs of economic recovery.

The country also plans to open a travel bubble with neighbouring Australia on 19 April, one of the first glimmers of a return to normal for its important tourism sector.

Like many countries, New Zealand enacted a number of stimulus measures last year, pouring billions into the economy.

Coupled with historically low interest rates, the stimulus stoked an already-strong housing market in New Zealand.

"Housing affordability continues to be one of the 'big' issues for New Zealanders looking to get onto the housing market," said Wendy Alexander, the acting chief executive at the Real Estate Institute of New Zealand (REINZ).

REINZ figures show the median price in Auckland, the country's biggest city, is now NZ$1.1m, up 24% over the last year.

'Dungers' for millionaires

Even "dungers" are not immune to high prices. One sold in the suburb of Avondale for NZ$1.81m in January.

“Common sense would suggest that run-down or derelict properties could sell for a bargain."

"However, as we’ve seen time and time again, this isn’t always the case in the current market," Ms Alexander told the BBC.

Currently, houses under NZ$500,000 account for just 17.6% of the market, while houses over NZ$1m made up over 30% of the market, according to REINZ.

A year ago, those numbers were reversed, with nearly a third of houses in the lowest bracket.

Houses typically took around 30 days to sell, which is the fastest sales rate in 17 years.

Investors are now the biggest property buyers in the country of five million, with 40% of sales in the final quarter of 2020 made to owners of multiple properties.

Cooling measures

Last month, New Zealand’s Prime Minister Jacinda Ardern introduced cooling measures for the property market.

The measures doubled to ten years the amount of time that investors need to hold onto a property in order to avoid paying a tax on selling it.

The changes will also stop investors from claiming mortgage payments as an expense against their rental income.

The government also pledged to speed up the pace and scale of house building with a new government fund.

Treasury's warnings on Auckland light rail: Diluted accountability, risk of further delay

Treasury is cautioning the Government that its chosen way forward for Auckland light rail could "dilute accountability" and further delay a project that is already years behind schedule.

That is also the view of the Infrastructure Commission, which noted that Transport Minister Michael Wood's attempt at an inclusive approach was not international best practice.

The concerns are revealed in Wood's Cabinet committee paper, which also considers how to find the billions of dollars that will be needed to build it, including possibly raising petrol taxes.

Last week Wood announced the next step forward for light rail - an establishment unit between central and local government to come up with the mode, route, costings and financing options for Cabinet to consider later this year.

The unit will be overseen by a board which includes an independent chair, chief executives of the Ministry of Transport, Auckland Council, Auckland Transport and Waka Kotahi, Treaty of Waitangi partners, a local board representative, and observers from Treasury and the Infrastructure Commission.

But Treasury said the board was too broad, and mixing stakeholders and advisers with those responsible for setting up a new business case was fraught.

"We are concerned ... [it] will dilute accountability and could result in delays due to a lack of clarity around decision-making," Treasury said in the paper.

"It is critical for the future of the project that there is as broad agreement as possible on key choices such as mode and route alignment. However, the Treasury's recommendation, aligned with international best practice, is that this is most effectively achieved through a separate stakeholder and/or expert advisory group."

The advisory group would ensure stakeholders' views were taken into account, Treasury said.

"These views are also held by the NZ Infrastructure Commission."

Act Party transport spokesman Simon Court, formerly a civil and environmental engineer, agreed it was a mistake to include stakeholders on the board.

"Each stakeholder will have separate agenda and, having delivered infrastructure projects in Auckland myself, I know it's just not possible to please everyone all of the time."

Wood said that Auckland Council had also raised concerns about the board's ability to make critical decisions in a timely way.

But he said these were outweighed by the need for "inclusivity, building consensus and social licence", given the current absence of a plan.

"The role of the independent chair will be critical in bringing together the diverse composition of the board," Wood said in the paper.

Woods is hoping for shovels in the ground by the next election for a project that has already been pushed back by years; Jacinda Ardern promised as Labour leader in the 2017 election campaign that the first leg of the project - from the CBD to Mt Roskill - would be completed within four years.

The establishment unit will investigate costs, but Wood said they will inevitably be high.

Funding should be a combined approach "across Crown, NLTF (National Land Transport Fund), farebox, local government tools (to capture local/regional community benefit), private funding sources (to capture commercial/private business benefit) and new value capture mechanisms".

Value capture could see property owners bearing the costs of projects that increase the value of their land.

"Agreements with property owners, public and private sector partnering for development, and targeted rates may all play a role in this funding toolkit," Wood said in the paper.

Seed funding of $1.8 billion is committed from the NLTF, but if more is needed from the NLTF, it would see either other transport projects losing out or an increase in petrol taxes and road user charges.

Similarly, a Crown grant would come at the expense of "wider government priorities", or it would require more debt.

Ardern has said it's too early to consider how much it will cost and where that money will come from, but she has previously ruled out any more regional fuel taxes for as long as she is PM.

Once the establishment unit came up with a plan and business case, Cabinet will make the key decisions on the route, mode and who will deliver the project.

The Herald understands it will be six to eight years before light rail is up and running in Auckland.

Why is the New Zealand government telling its central bank to focus on rising house prices?

New Zealand is a small economy, but it is a trend setter of sorts in central banking. The nation was among the first to adopt an explicit inflation target. The Reserve Bank of New Zealand's mandate from the government is "to keep future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent midpoint" and to "support maximum sustainable employment." In February 2021, the government formally added a clause to the RBNZ's mandate, instructing it to consider housing prices in making monetary policy decisions. The change has drawn attention – and some raised eyebrows – from the world's central bankers. Here's what it's all about.

WHAT HAS CHANGED?

Like the U.S. Federal Reserve, the Reserve Bank of New Zealand (RBNZ) is charged with maintaining stable prices and pursuing full employment. On February 25, 2021, Finance Minister Grant Robertson announced that "the Bank will have to take into account the Government's objective to support more sustainable house prices, including by dampening investor demand for existing housing stock to help improve affordability for first-home buyers." With this announcement, the scope of the central bank's mandate was extended to housing prices for the first time. (To read the formal remit to the RBNZ, click here.)

WHAT LED TO THIS MOVE?

The government of New Zealand faced pressure to calm the housing market as the median house price increased 22.8% from February 2020 to February 2021. Prime Minister Jacinda Ardern rolled out a program to build 8,000 new houses as part of the 2020 budget. After her Labour Party won a landslide victory in October 2020, Ardern renewed her commitment to increase the housing supply. Critics said that was inadequate. On March 22, the Labour Party announced new policy initiatives, targeting first-time home buyers. Ardern increased the income thresholds for existing programs that provide grants and loans to first-time home buyers and adjusted policies aimed at taming demand for investment properties. All this contributed to the government's decision to enlist the central bank in its efforts to make houses more affordable.

WHAT DOES THE CHANGE MEAN FOR THE CENTRAL BANK?

RBNZ Governor Adrian Orr unsuccessfully tried to head off the move. In December 2020, he said, "Adding house prices to the monetary policy objective would be unique internationally, which could make monetary policy less effective and impact financial market efficiency."

On March 4, 2021, Orr downplayed the implications of the changed mandate for future monetary policy decisions. "Importantly, the Monetary Policy Committee's remit targets remain unchanged. We remain focused on maintaining low and stable consumer price inflation and contributing to maximum sustainable employment.” Orr signaled that the RBNZ is likely to pursue housing goals with macroprudential policies rather than rate hikes. “We will be considering our financial stability policy settings via our prudential tools – like loan-to-value ratios, bank stress testing, and capital requirements – against particular types of mortgage lending. This is done with a view to moderating housing demand, particularly from investors, to best ensure house price sustainability.”

In its November 2020 Financial Stability Report, the RBNZ had expressed concern about the booming housing market. On March 1, 2021, it reinstated loan-to-value restrictions on mortgage lending – seeking to protect borrowers and overall financial stability from the potential risk of a price correction in the medium term.

WHAT DOES THE CHANGE MEAN FOR CENTRAL BANK INDEPENDENCE?
The announcement of the change to the RBNZ remit drove up 10-year government bond yields in New Zealand, perhaps signaling that the added consideration of housing prices will force the bank to raise rates sooner than expected. This concern is perhaps overblown, given Orr’s commitment to the use of macroprudential tools rather than interest rate adjustments to address housing. However, economists have also raised concerns over the wording of the change to the remit. Cameron Bagrie, founder of Bagrie Economics, told the Financial Times: “The use of the phrases ‘government policy’ and ‘government objectives’ in relation to house prices risk encroaching on the independence of the RBNZ. They should have just said house prices should be a consideration, an explicit mention of what already happens. I think linking it to government policy/objectives goes too far.”

SHOULD CENTRAL BANKS CONSIDER ASSET PRICES IN MONETARY POLICYMAKING?
In making monetary policy, central banks generally focus on the prices of goods and services, but there are occasional calls for them to pay more attention to prices of assets, such as houses or the stock market. This debate is not new; as early as 2000, it was a topic of global discussion – the second Geneva Report on the World Economy was titled “Asset Prices and Central Bank Policy.”

There long have been calls to use interest rates as a tool to pop asset bubbles. However, in his first speech as a Federal Reserve Governor in 2002, future Fed Chair Ben Bernanke argued that it was crucial to use the right tool for the job when making policy. “As a general rule, the Fed will do best by focusing its monetary policy instruments on achieving its macro goal – price stability and maximum sustainable employment – while using its regulatory, supervisory, and lender-of-last resort powers to help ensure financial stability.”

In the same 2002 speech, Bernanke directly addressed the idea that the Fed should meddle directly with asset prices: “I think for the Fed to be an ‘arbiter of security speculation or values’ is neither desirable nor feasible.” However, asset prices can have implications for the Fed’s mandated goals of full employment and price stability – as well as for its responsibility for avoiding financial crisis – so a central bank cannot ignore developments in these markets. Bernanke favored the use of macroprudential tools to deal with financial market excess, rather than preemptive interest rate hikes. Identifying asset price bubbles is difficult, and taming them with the conventional tools of monetary policy has implications for the macroeconomy.

This is especially clear when considering the extent of monetary policy tightening that would be required to reliably control asset prices. Research from the San Francisco Fed has found that it would have taken 8 percentage points of monetary tightening between 2002 and 2006 to completely avoid the housing bubble that preceded the 2007-2009 global financial crisis. For context, the federal funds rate has not been 8 percentage points above its April 2021 level since October 1990. A monetary policy that contractionary would surely have slowed the recovery from the recession of 2001 and likely driven the economy back into recession.

WHY MIGHT HOUSING PRICE BUBBLES BE COSTLY?

The costs of preemptive rate hikes still must be weighed against the costs of financial instability associated with asset price bubbles. Historically, costly bubbles have been associated with credit booms, while other bubbles are less damaging. Housing price booms can be especially dangerous because they are heavily financed by extension of credit by the mortgage market. These factors – along with other threats to financial stability – have to be considered by central bankers as they analyze the balance of risks in the economy.

However, the mandate given to the RBNZ from the Finance Minister appears to have a different priority. Rather than describing house prices as a potential threat to financial stability, the government mandate asks the RBNZ to consider the impacts of its policy decisions on housing affordability. Governor Orr has said that the RBNZ should consider housing prices as they pertain to financial stability with its macroprudential toolkit as opposed to trying to reduce housing prices for first-time buyers, a goal better met by increasing the supply of houses and targeted fiscal policy.

WHAT DOES THE CURRENT FED LEADERSHIP SAY ABOUT ASSET PRICE CONSIDERATIONS FOR MONETARY POLICY?

Like his predecessors, Federal Reserve Chair Jay Powell is skeptical of the use of interest rates to deal with asset price bubbles and prefers to turn to macroprudential tools for that purpose. In a January 2021 press conference, Powell said, “We don’t actually understand the tradeoff between if you raise interest rates and thereby tighten financial conditions and reduce economic activity now in order to address asset bubbles and things like that—will that even help? Will it actually cause more damage, or will it help? So I think that’s unresolved. And I think it’s something we look at as not theoretically ruled out, but not something we’ve ever done and not something we would plan to do. We would rely on macroprudential and other tools to deal with financial stability issues.”

In its updated statement of its monetary policy strategy, the Fed said it views financial stability as part of its assessment of risks, not as one of its primary mandated objectives: “[S]ustainably achieving maximum employment and price stability depends on a stable financial system. Therefore, the Committee’s policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee’s goals.”