Fair Economic Return
Restoring equity to the social fabric of New Zealand¹

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Abstract
This paper addresses the demand side tax distortion that, along with loose monetary policy has underpinned the emergence of a dangerous speculative bubble in the New Zealand housing market. Several demand-side tools have already been employed, such as, Loan to Value ratios (LVRs), Brightline tests, and removal of interest deductibility for landlords. But low interest rates and the tax subsidisation of housing income remain as potent incentives for over-investment in owner-occupied and rental/investor housing.

We suggest an approach we call the Fair Economic return (FER). The intent is to build on the broad base low-rate approach taken since the late 1980s that is now embedded in the NZ tax system. FER is derived from the Risk-Free Rate Method (RFRM) that was first discussed in the McLeod Tax Review Issues paper 2001 and is now the basis of the Foreign Investment Fund regime (FIF). Under a FER approach, currently untaxed housing income is included in the tax base.

By treating all personal income the same for tax purposes, regardless of source, the playing field is levelled. Moreover, such an approach overcomes the disadvantages of introducing a Capital Gains Tax (CGT) which, in any case, has proven to be not politically acceptable at this time in New Zealand. FER does not upset well-functioning rental markets; it encourages better use of the housing stock and makes a significant and stable revenue stream possible for government. It is targeted using a realistic per person net equity exemption so that it affects the top deciles of residential housing owners only. Its progressive impact could significantly reduce housing wealth inequality over time.

Keywords: taxation, housing, capital gains, speculation, RFRM, Fair Economic Return, FER.
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1. Introduction
By early 2021, a seriously out of kilter housing market was wreaking havoc on the social fabric of New Zealand, creating fortunes for some lucky real estate owners, and considerable misery for many others, including young families trying to provide a first home; older people shut out of the property market and young adults and Māori & Pacifica whanau, many of whom subsist in unstable and unaffordable rentals and motels.

Encouraged by low interest rates, readily available loans and tax-free capital gains, investment in housing has become the prime vehicle for wealth accumulation. Housing is viewed as a tradeable commodity and store of wealth, rather than a human right or a basic human necessity. Accumulated fortunes in real estate enable and entrench a landed gentry whose incentives to work and contribute in a meaningful way are blunted. A growing class of property-owners can command the labour of others from their unearned income without having to make a social contribution themselves. Price signals no longer, if they ever did, direct resources where they will produce the most social good. With no inheritance tax or death duties this advantage flows through to the children of the wealthy with implications for further class stratification, lowered productivity and for gross intergenerational unfairness.

The Labour government has believed that neither a capital gains tax, nor a land tax, nor stamp duty, nor a wealth tax is the answer to the housing crisis. Yet the widespread unease that the growing wealth divide in housing is socially damaging makes doing nothing untenable. Other tools such as bright-line tests, loan to value ratios (LVRs), and non-deductibility of interest for some landlords can be helpful, but they are by no means sufficient on their own: it is argued here that they should be used as complementary tools to support a fundamental change in the way housing is taxed.

While this paper does not directly engage with the supply issues of the housing market, if the price signals are corrected, fewer houses would be built for private investors relying on capital gains and there would be less over-investment in top-end owner-occupied housing and second homes. Potentially this could allow more real resources to be diverted to the building of state and social houses for the desperate New Zealand families and whanau living in motels, garages, transitional housing and private rental slums.

We first describe the economic context, then outline the case for extending the income tax base to capture currently untaxed housing income. The Fair Economic Return (FER) described next is in line with the fundamental approach, long supported in New Zealand, of broad-base, low-rate tax. Bringing an accounting lens, we address the perceived objections to a FER and how they can be overcome. The FER is designed to be simple to understand, relatively easily implemented with low compliance costs, politically saleable and effective in meeting agreed reform objectives.

2. Identifying the problem
Step one is knowing what problem we are trying to address. The immediate symptom of the current housing bubble raises fears of a sharp contraction with much widespread pain but also reflects deeper problems. An economics perspective suggests New Zealand has a serious resource mis-allocation problem, a serious social problem, and a serious inequality problem.

The Speculative bubble
Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. (Keynes, 1936, p. 159)

Regardless of how housing unaffordability is measured, New Zealand is a world leader, as shown by the real price index (log scale) in Figure 1. New Zealand house prices have continued to rise
faster than elsewhere. The Economist found that while in the year to January 2021, international real house prices rose by an historic high of 5% on average, in New Zealand they rose by 22%.

**Figure 1 The real house price index Q1 2000- Q2 2020**

If house prices climb faster than either earnings or rent payments for a long period of time, a housing bubble may be forming. On this basis, house prices appear to be on an unsustainable path in Australia, Canada and New Zealand. Ten years ago, they reached similarly dizzying heights against rents and incomes in Spain, Ireland and some American cities, only to endure a brutal collapse.

The bubble in New Zealand and elsewhere has been inflated by the increased use of housing as an investment asset, encouraged by historically low interest rates, fiscal stimuli and the favourable tax environment especially for capital gains and imputed rentals.

On 23rd March 2021, changes were announced to limit interest deductibility and extend the bright-line tests for investors to help rebalance the market in favour of first home buyers. Despite the policy changes the upward pressure on prices continued into 2021. By May 2021, there was some evidence the market may have been cooling, but not by much. The Real Estate Institute of New Zealand (REINZ) data show that price escalation is not just an Auckland problem: for the 12 months to May 2021 housing prices increased an astonishing 30% nationwide (Figure 2).

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2 [House prices are going ballistic | The Economist](https://www.economist.com/), 10th April 2021.
3 This interactive graphic is taken from the Global house price index [Global house prices | The Economist](https://www.economist.com/). As at Quarter 2 2020, the NZ real price index was 180% higher in NZ than in 2000. The next highest Canada was 168% higher, while Australia was 122% higher and 40% in Ireland. Using house prices versus income and house prices versus rents, NZ market was still in top position: 72% overvalued against rent and 50% overvalued against incomes, overtaking Canada on all three measures.
4 [Global house prices | The Economist](https://www.economist.com/) April 16th 2021
5 [The next steps in Labour’s housing plan - NZ Labour Party](https://www.labour.org.nz/)
6 [Property market momentum remains but pace of growth slowed in May (corelogic.co.nz)](https://www.corelogic.co.nz/)
Figure 2 New Zealand house price indices (REINZ, 2021)

Figure 3 shows that Mum and Dad investors and professional landlords were responsible for over 40% of all purchases and 37% of new builds in early 2021. The recent policies are less onerous (or do not apply) for ‘new builds’ so the percentage of investors in the ‘new build’ market may increase. However, overall investor activity was expected to slow as tighter LVRs and removal of interest deductibility are factored in.

Figure 3 Share of purchases Q1 2021 by buyer and property type

Two Auckland academics researched rentals in Auckland bought between 2002-2016 and modelled the landlord’s expected returns (Rehm & Yang, 2020). They found that “the vast majority whether leveraged or bought with cash failed to show they would generate a fair rate of return. The purchase only makes sense if capital gains are expected. For rentals bought in 2016, they found 86% were negatively geared and would generate losses, while almost all of

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7 Property Data & Analytics | CoreLogic
the rest were generating well under an economic return from rents alone. Their findings include this indictment:

*The authors find that housing speculation in Auckland is endemic and its housing market is a politically condoned, finance-fuelled casino with investors broadly betting on tax-free capital gains.* (Rehm & Yang 2020, p 72)

There is a dearth of data on New Zealand’s rental stock and who owns it. The 2018 census shows a 16.5 percent increase in the number of households renting since 2013. In 2018, around one third of New Zealand households (527,853) were renting compared to less than a quarter (22.9 percent) in 1991 (Statistics NZ, 2020, p. 36). Some of these rentals are in the state housing sector.

An Inland Revenue OIA8 shows for the tax year ended March 2019, of 290,000 taxpayers with residential rental property, 108,000 had losses with an average $8,935 loss and 182,000 had profits with an average of $14,061. The net effect is $1.09 billion of taxable profit on an estimated $300 billion rental stock (see Tax Working Group 2019, p 109).

From 1 April 2019, at an extra cost to landlords of $190m per annum, rental losses were ringfenced and made non-deductible against other income.9 But these losses can be carried forward and deducted against future rental income. Recent changes in 2021, discussed below, phase out interest deductibility over the next four years. Thus, future tax losses should fall, and taxable profits should rise, but the actual additional extra tax revenue will depend on how the accumulated tax losses are carried forward.

**Real resource allocation problem**

An economics perspective illuminates a woeful misallocation of resources and lost opportunities. Land, labour, architects, wood, steel, concrete, infrastructure are the scarce housing resources that market signals are supposed to allocate to their highest use.

Faulty market signals have resulted in an over-investment in family and second homes: many have become mansions well beyond the need for modest shelter and the source of fortunes for those in these markets.10 In spite of declines in average household size, by 2018 almost a third of occupied private dwellings had four or more bedrooms compared with less than a fifth in 1991(Statistics NZ 2020, p 20). Some of these mansions are empty or under-rented, often with overseas owners.11 When scarce materials are diverted to over-investment in renovations, oversized houses and unaffordable new builds, they are not available to build, repair and maintain the kind of houses appropriate for low-income families.

As Bernard Hickey (June, 2021) said:

*Most houses are built by smaller builders or franchisees who don’t have the engineering and earthworks skills or equipment to do this type of building. These types of projects are also more complex from a consenting and planning point of view, which further delays housing supply. Their entire business models are based on buying lumps of land, building spec houses on them and making profits from land price appreciation and a margin from building a large house.* 12

In the meantime, the numbers in severe housing need mushrooms with thousands of families living in unsafe motels with few desperately needed state and social houses available as discussed below. The New Zealand economy is much the poorer for the waste implied by the

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9 [Ring-fencing of residential rental property losses | BDO NZ](https://www.bdoadvisory.com/cybersecurity/)
10 A recent NZ Herald supplement demonstrates how multi-million dollar properties are very common with the most expensive house in NZ worth over $38m. See [The 0.004%: New Zealand's most expensive houses revealed - NZ Herald](https://www.nzherald.co.nz.property/news/article.cfm?c_id=263&objectid=12852704)
11 See for example [Sir John Key's former Parnell mega mansion sits empty and neglected - NZ Herald](https://www.nzherald.co.nz/nz/news/article.cfm?c_id=263&objectid=12846502)
12 [The week that was for the long weekend - The Kākā by Bernard Hickey (substack.com)](https://substack.com)
current situation. A further widespread complication is that, along with supply chain hold-ups of building materials in a COVID-constrained world, the widespread remediation of leaky buildings is putting the building sector under further pressure.

**Unacceptable social stress**

As the bubble has inflated, the explosion in the social disaster of families squeezed out of rentals into unsafe motels or living in cars and garages or overcrowding is daily frontline news. Extreme housing need is indicated by the official housing register and Figure 4 shows the way in which the number of families on this register has continued to grow. There were 23,687 on this register as at March 2021, a growth of 45% since March 2020. Ninety percent of households on this list are classified as Priority A and “have a severe and persistent housing need that must be addressed immediately.” The remainder Priority B (10%) have a “serious housing need”.

**Figure 4. The number of households seeking public housing through MSD**

For those on the register: 42% are families with children, comprising 33% sole parents and 9% couples; 19% are aged over 55; 62% are Māori & Pacifica. These are households who are ill-suited to private developer new builds.

One of the major contributors to the intractable problem of child poverty in New Zealand is the lack of suitable, affordable and stable housing for low-income families. Poor housing is implicated in all the negative indicators such as third world diseases, transience, truancy underachievement, and lowered life prospects. In turn, these factors contribute to lower productivity of their parents and to the ability of the future workforce to produce the goods and services an ageing population will need.

The latest statistics (2019/20 pre-COVID) show that approximately 319,000 children (27.9%), 210,500 children (18.4%) and 160,000 children (14.0%) were under the 60%, 50%, 40% after-housing costs poverty lines respectively.14 In the year to March 2021, the impact of COVID on this already disadvantaged group is expected to show a produce a sharp deterioration in these figures as discussed in depth by McAllister et al (2021).

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14 Latest child poverty figures • Child Poverty Action Group (cpaq.org.nz)
Wealth inequality

There is a dearth of reliable, accurate data as to the distribution of net wealth in New Zealand, especially at the top end. In a report dated June 2016 released under the Official Information Act, Inland Revenue (IR) reviewed 18 High Wealth Individuals (HWI) in the context of the HWI community and found there was no evidence that “wealth is simply a store of tax paid income ... with the great majority of wealth being generated by realised and unrealised gains on capital assets”. While some HWIs were paying significant tax, a large proportion (over 33%) of the core wealth held by HWIs was untaxed. Among the reasons were: untaxed business gains; long-term property investment; and long-term investment in shares.

The three-yearly household economic survey (HES) data, used to estimate the distribution of net wealth in New Zealand have a well-recognised underestimation problem for wealth held by high wealth individuals (HWI). In the 2021 budget, the Minister of Revenue, the Hon David Parker allocated $5m to Inland Revenue to gather better information on the distribution of wealth and income in New Zealand:

... the Household Economic Survey, currently used, doesn’t provide good enough data on the distribution of income and wealth. ... the highest net wealth of anyone surveyed most recently was only $20 million.16

To begin to address this problem, Treasury has used updated methodology to augment HES data.17 Figure 5 shows the wealth distribution, including the top one percentile, using estimates based on capitalisation of income generated from capital. With owner-occupied housing excluded, the top decile of individuals owns 82% of total net wealth and the top 1 percentile owns 33%. The inclusion of owner-occupied housing improves the relative position markedly for deciles 7, 8 and 9 and makes that of deciles 1-6 marginally less negative. But despite this equalising effect, the top decile still has 70% of total wealth and the top 1 percentile has 25%.

While owner-occupied housing appears to play a modest equalising role, the bulk of housing wealth is held in decile 9 and 10. And, in terms of asset classes, residential real estate is by far the largest. The value of residential property and land, including rentals, across the country as at December 2020 was $1.386 trillion (Reserve Bank of New Zealand, 2021). In June 2021 the Reserve Bank reported a rising equity share for both owner-occupied and rental housing.

The proportion of equity in owner occupier housing and land is at an all-time high of 79.1% in the December quarter, surpassing the most recent peak in September 2016. The proportion of equity in rental properties is at a record high of 76.1% and appears it will keep rising. When LVR restrictions were introduced in 2013, the proportion of equity in rental properties was around 68%. LVR restrictions were removed on 1st May 2020 in response to the COVID-19 pandemic. LVR restrictions have since been re-introduced from the 1st March 2021. 20

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15 Treasury 2016 High Net Wealth Review, OIA Andrea Black, 2018
17 In experimental estimates, survey data is augmented with media rich list, and the capitalisation of taxable income. Treasury Advice (scribd.com)
18 Data for owner-occupied housing is a HES estimate based on self-declared principal dwellings held by owner or family trust.
19 Household balance sheet - March 2021 quarter (rbnz.govt.nz)
20 https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Statistics/tables/c21/household-balance-sheet.pdf?revision=515a4a5b-a512-4959-8a5c-0fd9d159c96d
Shares ($197 billion), and private superannuation funds and KiwiSaver ($70.5 billion) are much smaller asset classes and do not carry the same resource misallocation issues. Clearly housing is a large asset class with net equity disproportionately held in the highest two wealth deciles.

Treasury, as noted, uses the capitalisation applied to taxable interest income to determine net equity held in bank deposits. By analogy, applying a deemed rate of return to net equity held in housing gives a measure of the untaxed income that can be imputed to housing.

3. How did the playing field get tilted?

The reforms of the late 1980s were based on a comprehensive income tax concept that included income from all sources and treated all income the same. The bank model was adopted for retirement saving so that it was treated the same as savings invested in the bank.

Thus, between 1988s and 1990s tax exemptions for superannuation schemes were ended as part of switch to “tax, tax, exempt” (TTE) system (in contrast to the previous “exempt, exempt, tax (EET)” approach generally adopted worldwide. New Zealand has been an outlier in adopting TTE (St John, 2007a; St John & Ashton, 1993). To be logical, the tax reforms required that all income from capital be included in the base. Thus, the reforms were to be completed with a comprehensive capital gains tax as set out in 1990 (see below). The failure to implement this leg of the tax changes meant that housing became the tax preferred way to save as it entailed a regime of TEE that was highly favourable to housing when other saving was taxed TTE.

Investing in housing was further enhanced by several changes in the early 1990s. The $10,000 cap on offsetting rental losses against other income was removed (1991); the Loss Attributing Qualifying Company (LAQC) regime was introduced (1992) to permit rental losses deductibility against private income for taxation purposes. Depreciation allowances also became more generous (1993).

As Figure 6 shows, between 1991 and 2002 number of individual taxpayers reporting rental income rose by 150% but net income actually fell (Russell & Baucher, 2017, p. 73).
The trend begun in 1991 of housing as a tax-favoured asset was exacerbated by increase in top tax rate to 39% in 2000. The number of companies (including LAQCs) returning residential property income rose twelvefold between 2000 and 2011 (from 2,400 to 29,800). Over five years ended 31st March 2007 to 2011 inclusive, companies reported property losses totalling $1.24 billion, nearly $250 million per year. This represents a significant undermining of the tax base and is implicated in the growth of inequality.21

4. Why not a Capital Gains Tax?
The realised capital gains on house sales shown in Figure 7, rose to a record-high $6.7b in the 2020 December quarter and totalled $16.3b since the first lockdown started in March 2020.

Figure 7 Realised capital gains from NZ homes sales (Quarterly $b)22

Total tax-free gains since the 2017 election of Labour to Dec 2020, were $60.8b suggesting foregone tax revenue of around $20b+. But little of that capital gain would be taxable had New

21 For more detail see Russell & Baucher (2017,Chapter 4).
22 Corelogic 2021
Zealand had a CGT as Labour promised in 2017. This is because the calculation of the gain takes the selling price less the purchase price and that purchase may have been many years ago. Much of the capital gain also would be on the family home ruled out as part of a CGT when the government commissioned the 2019 TWG.

A Capital Gains tax (CGT) *may* achieve *horizontal equity* in theory but only if capital gains are measured on an accruals basis. Under the more practical, realisation basis, capital gains are captured only when there is a sale: only those capital gains made since the date of valuation associated with introduction of the CGT are counted. Thus, a realistic CGT is just a transactions tax rather than one based on sound tax principles. But, even then, the implementation of such a tax is far from straightforward. It requires decisions as to how to value, when to value, how to treat the family home, how to define the family home, how to treat short term v long term gains, whether and how to allow for inflation, to name a few. The 2019 Tax Working Group wrestled with these problems in the extensive report on how to implement a comprehensive capital gains tax for New Zealand (Tax Working Group, 2019). Even if a workable CGT could be devised, it might come in just as capital losses are experienced that, coupled with the ability to pass capital losses forward it may limit the generation of significant revenue for many years if not decades.

The critical message for this paper is that any feasible future CGT has no impact on the accumulated untaxed capital gains in housing that have compounded over years of neglect to date, and is thus limited, if not impotent, to address the root harm of housing inequality.

**5. Background to Capital Gains Tax debate**

New Zealand is one of only two OECD countries to lack a broad CGT regime. Box 1 lists the large number of reports and tax working groups that have looked at taxation in NZ since the late 1960s including whether there should be a capital gains tax.

**Box 1 Déjà vu: the graveyard of CGT in NZ**

| • 1967 Ross Committee  
| • 1982 McCaw Committee  
| • 1987 Brash Consultative Committee Accrual Tax  
| • 1988 Valabh Consultative Committee International Tax Reform  
| • 1989 Report of the Consultative Committee on Income from Capital. 1989 comprehensive CGT  
| • included gains on family home  
| • DavidCavgillabandons CGT 20th March 1990  
| • 1988 Royal Commission Social Policy  
| • 1988 Brash CommitteeSuperannuation and Life Insurance V1 and V11  
| • 2001 McLeod TaxReview, issues and final report  
| • 2010 TaxWorking Group Report  
| • 2019 Tax Working Group Report |

The question of whether to introduce a CGT or not is now approaching 50 years of discussion. It has been examined by at least eight committees and recommended repeatedly by the OECD, IMF, Treasury and Inland Revenue. Two attempts to introduce a CGT, under David Lange and Roger Douglas in the late 1980s, and during Labour’s unsuccessful 2011 general election campaign, have failed. Several other attempts to significantly extend the ad hoc taxation of capital gains - notably the Property Speculation Tax of 1973 and Robert Muldoon’s Tax Amendment Act (No 2) in 1982 - have been highly unpopular and divisive, contributing to the

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23 St John and Baucher, Fair Economic Return, Fabian society, 28th April 2021.
During this 50-year period, UK introduced CGT in 1965, Canada adopted CGT in 1972, Australia adopted CGT in 1985, and South Africa adopted CGT in 2001. From the house price index growth (Figure 1) it is not clear that these countries have had a markedly different experience in restraining the growth in housing unaffordability, reflecting, no doubt, the complexity of operating any real-world CGT. Canada for example has only recently been usurped by New Zealand at the top of the chart.

All the New Zealand reports, from the Ross Committee in 1967 onwards, have found that the lack of capital gains tax is a serious gap in otherwise good framework. The 1989 Consultative Committee on Taxation of Income from Capital thought a CGT was essential to complete the broad-base, low-rate approach where all income regardless of source is taxed the same. The 1989 report contained the blueprint for a comprehensive CGT that included the family home with a fixed exemption. The idea was formally abandoned on the 20th March 1990 by Labour who appeared to see it as a step too far in an election year.

The next major review was the 2001 McLeod Tax Review. The ‘Issues’ paper floated the idea of a Risk-Free Rate Method (RFRM) as an alternative means of addressing specific problems arising from a capital gains tax (McLeod, 2001a). The RFRM is the precursor to the FER discussed in this paper and treats the income from holding net equity in housing the same as if invested, say in a bank deposit at a deemed rate of return. The idea of a RFRM however was swiftly abandoned by the Minister of Finance Michael Cullen who said it was an idea that was "not dead, but not kicking either". But the final McLeod Review (2001b, p. iv) concluded “Unfortunately, no more viable way of making this aspect of the tax system fairer and less distortionary has been identified.”

The McLeod Tax Review found that an accruals-based CGT while theoretically correct was impractical in the real world, but did not recommend a realisation-based capital gains tax either:

> We do not consider that New Zealand should adopt a general realisations-based capital gains tax. We do not believe that such a tax would make our tax system fairer and more efficient, nor do we believe that it would lower tax avoidance or raise substantial revenue that could be used to reduce rates. Instead, such a tax would increase the complexity and costs of our system. (McLeod, 2001b, p. iii).

In 2007, the OECD recommended that New Zealand consider taxing capital gains. The 2010 Tax Working Group was charged with examining the case for a land tax, a RFRM, and a CGT. They found “…there are numerous problems. Other problems should be addressed first. We don’t recommend a [CGT] at this stage” (Tax Working Group, 2010). The National government decided none of the three options would be introduced, however the OECD and the IMF continued to recommend a CGT.

The next major tax review was commissioned immediately following the 2017 election and was chaired by Sir Michael Cullen. It was clear that the issue of untaxed gains from housing was uppermost in government minds with this comment from Finance Minister Grant Robertson.

> Somebody who goes to work every single day and pays tax on every dollar they earn can look at somebody who is speculating in the housing market and wonder why they’re not being treated fairly - we want to address that issue.  

25 Jacomb, p 147
26 https://www.newsroom.co.nz/tax-working-group-no-revenue-grab-robertson
In responding to 2019 Tax Working Group’s interim report, Grant Robertson requested that the Group in its final report:

- Considers and recommends an overall package of measures. This should include measures that could result in a revenue neutral package.
- Considers a package or packages which reduce inequality so that New Zealand better reflects the OECD average whilst increasing both fairness across the tax system and housing affordability.
- Examines whether a tax on realized gains or the risk free rate of return method of taxation (or a mix of both) is the best method for extending a potential capital income tax across on specific assets with the goal of ensuring NZ’s tax base is fair and balanced. ²⁷

The TWG however did not develop a serious blueprint for a feasible RFRM²⁸ and recommended a comprehensive capital gains tax for New Zealand excluding the family home as they had been instructed (Tax Working Group, 2019). Such a capital gains tax was then decisively dismissed by the Prime Minister Jacinda Ardern who declared....

All parties in the Government entered into this debate with different perspectives and, after significant discussion, we have ultimately been unable to find a consensus. As a result, we will not be introducing a capital gains tax. I genuinely believe there are inequities in our tax system that a capital gains tax in some form could have helped to resolve. That’s an argument Labour has made as a party since 2011. However, after almost a decade campaigning on it, and after forming a government that represented the majority of New Zealanders, we have been unable to build a mandate for a capital gains tax. While I have believed in a CGT, it’s clear many New Zealanders do not. That is why I am also ruling out a capital gains tax under my leadership in the future.²⁹

A minority report from three members of the 2019 TWG rejected the comprehensive capital gains tax for its complexity, noting the distortions from exempting the family home and the high compliance costs that would largely act to enrich tax lawyers, accountants and valuers (Oliver R, Hodge, & Hope, 2018). They argued that the RFRM applied to residential property only was worthy of consideration:

If gains from residential property are to be more fully taxed, then this could be done with some modifications by extending current rules, including the bright-line tests. ... Alternatively, we consider that a simpler option could be to apply the risk-free return method, or something similar, to residential housing. This method taxes net equity in an asset at a fixed rate each year. (Oliver et al, p 2).

In early 2021, in a New Zealand Herald article, Professor Craig Elliffe, also a 2019 TWG member expressed this opinion:

The Government’s Tax Working Group in 2018/2019 carefully considered RFRM as an alternative to a comprehensive capital gains tax. In the end, the majority (of eight members) thought that the best way to future proof a tax system that was going to encounter problems with ageing demographics, reduced labour income and increasing inequality was a comprehensive capital gains tax. The minority (three members) in essence thought the costs of a CGT outweighed the benefits. All 11 members of the tax working group agreed that residential property investment required additional taxation.

²⁷ Hon Grant Robertson, Letter to Sir Michael Cullen, TWG, 18th September 2018, emphasis added.
²⁸ There was one theoretical background paper on the RFRM prepared for the TWG (Inland Revenue Department & TheTreasury, 2018).
²⁹ Capital gains tax abandoned by Government | Stuff.co.nz
Some of the objections to RFRM remain valid (such as singling out an asset class and the possibility of inadequate cash flows to fund the tax). Still, numerous attractions include comparative ease of calculation and certainty of income stream for the government.  

Why not land tax?

A land tax has considerable appeal as a low rate applied to value of undeveloped (and developed) land could raise significant revenue. The historical experience of land tax which had been part of the early tax system was that too many exemptions minimised the base. Land tax was repealed as part of 1980s reforms.

It was not considered by the 2001 McLeod Review, but had gained favour in the 2000s as an idea. Most members of the 2010 TWG “support the introduction of a low-rate land tax as a means of funding other tax rate reductions” (TWG, 2010). As land is an inelastic supply, they expected the introduction of a land tax would cause initial fall in value of land.  

The Interim report of 2019 TWG recommended against land tax for following reasons: That it would have a disproportionate impact on groups & industries that hold a greater share of their wealth in land; it made no allowance for debt and so could apply to heavily geared property owners with negative equity; it would raise cash flow problems for those on low incomes. Māori submitters argued that Māori would be disproportionately affected by a land tax.

If the problem is inequality in housing wealth, a flat rate land tax on gross value is unlikely to make much of an indent. There would be a disproportionate impact for those living in low value housing/ and/or mortgaged homes on high priced sections, while only lightly affecting other for example, those in high priced apartments on minimal land.

What about stamp duty?

Stamp duty is another policy that is often suggested as a way to dampen house price rises. In NZ, stamp duty on residential property sales was repealed in 1988 and on commercial property in 1998. However, it is widely used elsewhere in world – notably Australia, Canada and the UK.

Stamp duty was not considered by any of the 2001, 2010 & 2019 tax reviews. The problem is that it is a transactions tax and applies only when and if there is a sale. It is usually paid for by the purchaser so unless special exemption applies it can be problematic for first home buyers, but ultimately the incidence of this tax depends on the state of the market. It has been seen as a very unfair tax in contributing to lock-in problems in Australia (the NSW has tried, unsuccessfully to move away from Stamp Duty to help mobility in the housing market making up the lost revenue with a much fairer annual property tax.

What about other tools to dampen the boom?

Over the last decade many policies changes have been made to dampen the demand-side of housing and restore some balance. The LAQC regime ended on 31st March 2011 and the deduction for depreciation on residential property was also withdrawn from the same date. This was followed by the introduction of the bright-line test on 1 October 2015 which taxed sales of properties sold within two years of acquisition.

Since 2017, the Labour government has used a number of other tools to fight the housing fire, but not the tax hose. The only hose that has been used is full of petrol (low interest rates and

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30 Taxing residential properties: Is it time to pull the lever? - NZ Herald
31 For further discussion, see Russell and Baucher (2017, p 89-92)
32 Deutsche Bank suggested it should be paid by vendors. Deutsche Bank Konzept Issue 19 Nov 2020 “What we must do to rebuild”.
33 NSW Government Plan to Scrap Stamp Duty Hits Road Block - eChoice
easy credit). On 1st April 2019 loss ring-fencing was introduced for landlords. Loan to value ratios (LVRs) were re-introduced and tightened; the bright-line test was extended on 29th March 2018 to five years and then to 10 years for new purchases from 27 March 2021.

The bright-line test only applies to future purchases and sales. It does not capture the accrued tax-free accumulated capital gains. The rules make it easy to evade or avoid, for example an individual can buy and sell a place they live in twice in 2 years.34 Extending the bright-line test to 10 years is supposed to pick up more taxable capital gains, but may lead to lock-in effects i.e. the increased holding of properties for at least 10 years. It is likely to be controversial as to what costs will be deductible for houses held for just under ten years.

From 1 October 2021, full interest deductibility for rentals will be removed: immediately for new purchases, and over four years for existing rentals held on 27th March 2021. This policy reduces ability to generate losses for leveraged rentals but does not apply to new builds. Accrued tax losses can still be passed forward. It does not impact on 100% equity-financed properties.

The lower period of 5 years bright-line test and the exemption of loss of interest deductibility for newbuilds raise some very complex issues as set out in the IR discussion document.35 These changes may have some transitional impact but are unlikely to have much impact on house prices. The FER reform discussed next would be a great simplification.

Other tools such as Debt to Income limits and removal of interest-only loans may have a role to play but they are insufficient to bring about the large change that only the use of the tax hose can achieve.

6. The Fair Economic Return

While the likelihood of a comprehensive capital gains tax is now negligible, the task set for the 2019 TWG is still valid. They had been asked “to consider a package or packages of measures which reduces inequality, so that New Zealand better reflects the OECD average whilst increasing both fairness across the tax system and housing affordability”. The FER outlined here is derived from the RFRM would help meet these objectives by broadening the income tax base to include untaxed housing income.

The foreign investment fund regime

NZ already has an example of how the RFRM or deemed rate of return works. Following superannuation changes in the late 1980s, a foreign investment fund (FIF) regime was required to ensure New Zealand resident funds were not disadvantaged relative to overseas funds.

The initial FIF regime taxed on an accrual basis and had numerous country exemptions but was very unpopular and it was suggested that NZ should wait for general capital gains tax. After the top tax rate was increased to 39% in 2000, the attraction of low dividend yielding overseas companies grew as capital gains were generally not taxable (Russell & Baucher, 2017).

A reformed FIF regime was implemented in 2007 that “effectively made all non-Australasian equity investments such as shares, unit trusts and similar products subject to a de-facto CGT in the form of a deemed 5 per cent return (the so-called ‘fair dividend rate’)” (Russell & Baucher, 2017,p 81). Box 2 sets out with an example of how the FIF regime works in NZ.

34 The bright-line property rule (ird.govt.nz)
Box 2  Foreign Investment fund (FIF) regime

There are two methodologies to calculate FIF income. Lesser of:

- **Fair Dividend Rate (FDR)** 5% of the market value at start of tax year, Or
- **Comparative value (CV)** the difference between the market values at the beginning and end of the tax year plus all gains & dividends less acquisitions

**Example**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value 1 April 2021</td>
<td>$100,000</td>
</tr>
<tr>
<td>Closing value 31 March 2022</td>
<td>$103,000</td>
</tr>
<tr>
<td>Dividends received in year</td>
<td>$4,000</td>
</tr>
<tr>
<td>FDR = 5% x $100,000</td>
<td>$5,000 income</td>
</tr>
<tr>
<td>CV = $103,000-$100,000 +$4,000</td>
<td>$7,000 income</td>
</tr>
</tbody>
</table>

Income reported $5,000 – Note 5% is a MAXIMUM

KS funds, the NZ Superfund and companies must use FDR. Others and trusts can opt to use CV. The FDR is for determination but 5% consistent with other asset classes.

Design of FER for NZ

A FER reform requires removing the pernicious and entrenched tax distortions in line with the following criteria:

- Be progressive in design.
- Encourage a better rental market.
- Produce revenue for redistribution and/or social investment.
- Be simple, fair and above all doable.

The rational for FER is that funds held in housing should generate at least as much as having the same funds in the bank or similar conservative investment. In FER, the value of all housing (and associated residential land) held by an individual is aggregated and registered mortgages deducted.\(^{36}\) Net equity treated as if it was on term deposit earning a FER rate (say 2-3%). All housing income under FER is then added to taxable income and taxed at individual’s marginal tax rate. FER needs to be supported by all the other tools such as tighter bright-line tests for short term gains, tighter LRVs (and possibly the removal of interest-only loans and introduction of thin capitalisation rules).

FER would be designed to affect only the wealthiest top 20% of property owners and absentee owners. An exemption of up to $1m of net equity per resident would mean that the vast majority who are basic homeowners are unaffected. The impact is made even more progressive by the taxation of FER income at the owner’s marginal tax rate.\(^ {37}\)

The FER would use official CV valuations that capture capital gain in the equity base over time. Such valuations are readily available and uncontentious and usually err on the low side. Between the three yearly CV reviews valuations could be indexed to a housing price index to reflect interim changes in value.

The FER rate itself can also be a tool that can increase progressivity. It may for instance have a possible range of 1-3% under conditions prevailing in the early to mid-2020s. It could be introduced at a rate between 1-2% and then the rate gradually adjusted upwards but with

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\(^{36}\) Soft loans from Mum and Dad at less than the FER rate should be attributed to the net equity of Mum and Dad.

\(^{37}\) An associated reform might see all PIE income treated as dividends, removing the 28% advantage for top incomes.
flexibility to respond to the state of the market with a range that is above the term deposit rate at the bank but below a first home mortgage rate. Then rate itself could rise with individual net equity- again ensuring more progressivity. However, the very wealthy have very high net equity and so would pay substantial amounts of extra tax without the complication of a progressive rate.

Under FER, there are no interest cost write-offs for rentals and arguments about boundary issues that affect the deductibility of renovations and repairs disappear. Landlords will no longer pay high-priced accountants to minimise rental profits or generate losses. Losses therefore cannot be carried forward to reduce future FER income. Nor will holding empty land and houses for future gain be so profitable. By the same token, serious landlords may find themselves encouraged under a FER approach by a lower overall tax burden and simpler, cheaper compliance. This can mitigate any perceptions that the FER is designed to attack and undermine the rental market.

By making explicit the imputed returns from housing investment, resources are likely to be diverted from luxury owner-occupied housing and second homes, and the culture of treating housing as an investment commodity traded for gain is undermined. A better use of the existing housing stock should follow. For example, those with houses that are too large for their needs would be encouraged to downsize, and investors would reduce their holdings of real estate in favour of other asset classes38.

There are a range of design issues to debate.

Should any exemption apply only to the family home?

New Zealand has a culture of home ownership and confining any exemption to the family home may be seen as desirable by some. But defining a family home can be highly problematic (see (Tax Working Group, 2019). The new 10-year bright line test under discussion in June 2021 demonstrates some of the complexities of exclusion.39

Any special treatment of the family home raises horizontal equity issues. For example: Suppose Paul and Wiri have $1m each. Paul buys a $1m home to live in, while Wiri buys a home for $1m and rents it out for $25,000 pa (taxable). But Wiri pays $25,000 rent himself (non-deductible) because he has to live elsewhere for work reasons. On the face of it, a net equity exemption on the family home of $1m to Paul is unfair to Wiri who does not have a ‘family home’ as he is not living in it.

Some may worry that a blanket exemption is too kind to landlords. However, any resident landlord in NZ is likely to have their own home as well as the rental(s) so that only if net equity in the family home is less than $1m will a blanket exemption reduce the net equity for FER held in rentals. There is room for design options that discourage multiple holdings. For example, if an individual owns one or two properties the full exemption could apply, if three maybe half, four maybe zero. A thin capitalisation regime might ensure that no property can be more than 50% geared.

Second homes or baches are common among older New Zealanders and many are empty for much of the year. The second home contributes to real resource problem and the growing wealth divide and would be included in full for FER. In the UK, the prevalence of owner occupiers to own a second home is seen by some as the cause of homelessness, rather than the lack of supply of housing:

But just as homelessness is the extreme and visible symptom of a much bigger problem, so are second homes. Though we need to build far more social homes, the underlying reason for high house prices is not the lack of supply. The number

38 Investing in bitcoin, gold, art or shares would be arguably less damaging.
39 See submission on the proposed 2021 changes (Baucher, 2021 forthcoming)
of dwellings in the UK has been growing faster than the number of households, and there are now more bedrooms per person than ever before.⁴⁰

Practicality of FER

A feasible timetable could see the FER implemented from 2024/5 following the election in late 2023. The FER would be based on current CVs (government valuations) that are updated every three years. (The 2020 update was delayed to 2021). The FER would be based on net equity aggregated as at 1 April 2024 using the 2021 CVs. By 2025, new CVs (as reviewed in 2024) should apply and for each of the following 2 years the CVs could be indexed to a house price index.

Taxable income (see Box 3) is determined by Net equity*FER rate, but resident taxpayers only would qualify for any individual exemption. Over time the incentives should be to maximise housing use (any Airbnb, boarders, rentals ignored).

**Box 3 FER in practice**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Couple own a home CV =</td>
<td>$5m</td>
</tr>
<tr>
<td>Bach CV =</td>
<td>$2m</td>
</tr>
<tr>
<td>rental CV =</td>
<td>$800,000 less $200,000 first mortgage</td>
</tr>
<tr>
<td>Total net equity</td>
<td>$7.6m</td>
</tr>
<tr>
<td>each person</td>
<td>$3.8 m</td>
</tr>
<tr>
<td>after exemption</td>
<td>$2.8m</td>
</tr>
<tr>
<td>FER taxable income @ 1%</td>
<td>$28,000 each of additional taxable income</td>
</tr>
<tr>
<td>FER taxable income @ 2%</td>
<td>$56,000 each of additional taxable income</td>
</tr>
</tbody>
</table>

Each house (including residential land) in New Zealand is owned by somebody, either a resident or an overseas owner. Inland Revenue could hold a register of housing interests for each taxpayer. This can be cross-checked against a list of all titles of NZ property.

How much revenue is possible?

The revenue collected by FER is a function of the total net equity after the individual exemption, the FER rate, and the MTR of property owners. Obviously, the first two parameters need to be set before revenue can be estimated. The intent of having a relatively high per person exemption is to limit the impost of the FER to the top part of the wealth distribution. The vast bulk of ordinary home-owners should not be impacted. But the higher the exemption the less the revenue.

Given around $1 trillion in net housing equity⁴¹, the top 2 deciles own an estimated 87% (see Figure 5), say net equity of $870 billion. If there is no exemption, the taxable income produced by a 1% FER is estimated to be around $8.7 billion. Assuming the top decile owns 70% or $700 billion, and the top 1% owns 25% or $250 billion. For an adult population of 4 million, each decile is 400,000 people and the top 1% is 40,000 people. For a million-dollar exemption, the

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⁴¹ This is a conservative estimate. Corelogic claims that the gross $1.37 trillion figure on which this estimated cost is made ‘streaked past’ $1.5 trillion by the end of June 2021. Housing net equity is estimated to be $1.186 trillion. [https://www.corelogic.co.nz/news/corelogic-hpi-shows-market-momentum-continues-fade#.YOAdFOqzaU].
FER of the top 1% would be based on net equity of $210 billion. Of the other 90% of the top decile or 360,000 people, net equity would be conservatively estimated at $90 billion ($450 billion less $360 billion exemption). The net equity base is then at least $300 billion. A 1% FER is estimated therefore to produce around $3 billion taxable income, 2% $6 billion, and 3% $9 billion.

In terms of tax revenue, assuming the top wealth earners have a tax rate of 33 or 39% a 1% FER is estimated therefore to produce around $1 billion tax, a 2% FER $2 billion, and 3% $3 billion. However, as FER is proposed to be a complete regime in itself, this potential tax revenue would include the existing tax revenue from rental income. Nevertheless, from the sparse statistics available a FER can be expected to represent significant additional tax revenue.

Net equity grows with capital gains and mortgage repayments and over time the revenue will grow too. The speculative housing boom of the 2020s is likely to have significantly increased the housing wealth held by the top two deciles further augmenting the base.

7. Specific difficulties of FER- can they be overcome?

Houses held in trusts or companies of beneficial interest to the individual.

How would our proposed Fair Economic Return approach deal with multiple properties owned by combination of trusts, companies and individuals?

Taxing by entity could be advantageous for individuals taxed at the maximum 39% rate because lower tax rates would apply. For example, the trust income tax rate currently is 33% (even lower if FER income is distributed to individual beneficiaries on lower tax rates), and the company income tax rate is 28%. What we propose is for entity taxation to be the default position with no exemption but require attribution if an individual wanted to make use of his or her $1 million exemption (because the family home is in a trust).

If attribution is chosen the net equity in each property can be attributed to an individual achieved by using the existing “associated persons” tax rules. These rules are used to counter attempts by a person to secure a tax advantage, through the use of ostensibly separate entities having common economic or social connections with that person. The rules deem the entities to be associated and in doing so eliminate the attempt to secure an advantage.

For example, a settlor of a trust is deemed to be associated with the trustees of the trust. Accordingly, the value of the property within that trust would be deemed to be that of the settlor. Similarly, a shareholder in a property holding company would be deemed to hold the same proportion of the property assets of the company equal to his or her shareholding. (A shareholder with 50% of the shares in a property holding company would be deemed to hold 50% of the value of the underlying property owned by the company.

The associated persons rules sometimes apply on a daisy-chain basis – if A is associated with B and B is associated with C then A and C are associated. Existing associated persons rules introduced in 2009 and are practically unbreakable. For an example, see Box 4.

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42 The 2019 TWG final report included some numbers on a potential RFRM on residential investment property (Chapter 5, para 37 onwards). The estimates exclude the family home and a second home and thus are narrower in scope than the FER. Based on 2018 numbers & a 1.7% rate it estimated $148m of revenue and a 3.5% rate, $998. The background paper explains the assumptions and the deductions for foregone rental income.

43 The provisions are contained in sections YB1 to YB 14 of the Income Tax Act. An example would be sections CB 9, CB 10 and CB 11 in the land taxing provisions which tax certain land disposals made within ten years by associated persons.
Box 4. Associated persons example for the FER

John is settlor of trust and is therefore associated with the trust

The trust is associated with the rental property company as it has a shareholding greater than 25%

Therefore as John is associated with the trust and the trust is associated with the rental property company, the company is associated with John

<table>
<thead>
<tr>
<th>John’s net equity liable for the Fair Economic Return is therefore:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net equity in family home</td>
</tr>
<tr>
<td>Net equity in company</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Less annual exemption</td>
</tr>
<tr>
<td>Total liable for FER</td>
</tr>
</tbody>
</table>

Property held in trusts with no settlor

Where no resident settlor exists (either because the settlor is foreign resident, or the previous New Zealand resident settlors have died), then the liability will fall on the trustees. Furthermore, there will be no $1 million exemption, the full amount of the net equity will be subject to FER.

What about raising a mortgage against one’s own home for business purposes?

Debt tracing was identified as an issue with the 2021 proposed interest cost limitation rules. It’s a long-standing issue within the tax system so there are existing reasonably well-developed principles to deal with it. We consider two options. Where debt can be shown to have been secured against the family home but applied to a business (for example providing working capital or used to create an income generating asset), the value of such debt is non-deductible from the gross home equity for FER purposes, while interest deductions are available to the business for income tax purposes. When a mortgage has been raised against the home (say for improvements) the debt is deductible from the gross home equity for FER while of course as at present no interest deductions are available for income tax purposes. Eventually the improvements will be reflected in a higher CV limiting the impact on net equity for FER.

In the case where the loan has been for consumption, (eg reverse mortgages), net equity for FER is reduced by the size of this borrowing, but non-deductible interest (which would be at a higher rate than the FER rate) is payable on the loan making the process self-limiting.

A soft loan from family at low or no interest rate should be either non-deductible for the homeowner or included as part of net housing equity of the contributing family member. Such loans do not reduce the net equity held in housing for FER purposes. Indeed, all loans made below market value to associated persons should be treated as non-deductible for FER purposes.

What if there is no income to pay the tax?
A caveat over the property so that the accumulated tax and interest is recovered on sale or death may be made available in some circumstances. There are precedents for this, for example for accessing rest home services when the value of the main home exceeds the exemption for subsidies. Because the FER is aimed to impact on the wealthiest only such situation should be rare.

What about a higher exemption for a single person?

An individual exemption that is not determined by relationship status is simplest. It overcomes definitional problems of who is married and messy circumstances when there is a separation. It also provides an incentive for single high wealth people to share/part-rent their now too ‘large’ home or downsize. When there is death of one spouse, it would be possible to grant a period of relief—maybe phased out, for example, from $2 million for the year of death and the following year, then drop to $1.5 million in 3rd year and to $1m in 4th year.

8. Conclusion

This paper has highlighted that housing market problems are systemic and long-standing and that the New Zealand housing bubble is unenviably placed as the worst in the developed world. Moreover, the social and intergenerational consequences for the current housing crisis of rampant speculation and over-investment for some in the context of extreme housing deprivation for others is untenable and dangerous. The option of doing nothing is not an option.

It is impossible to ignore the despair among the young of working age shut out of the market. Here is the conclusion of an opinion piece from a leading economic commentator Bernard Hickey who essentially argues that current policy effectively ‘eating our young’:

Now anyone without parents able to help them with a big dollop of equity, or unable to marry into wealth, have no hope. Professor Morton has noticed in it in the ongoing study of those kids born in 2009 and 2010, who are now seeing the effects of unaffordable and unhealthy housing in their school results and wellbeing.

“One of the things that I guess I’ve found really most difficult about this over the last few years is that by the time the families have experienced the greatest poverty and disadvantage, by the time the children are four and a half, ready for school, ready for those opportunities that school presents, we’re seeing those hopes start to be blunted,” Morton told me.

...Morton, amazingly, still has hope the results of her study might convince politicians and bureaucrats and voters to change. I don’t see that chance any more. The median voter remains supreme. The government has in recent weeks prioritised “keeping a lid on debt” over infrastructure to ensure houses are built.

Those parents still renting and those just graduating into Covid without assets should move now. Giving up hope seems a capitulation. It is. But sometimes discretion is the better part of valour. Sometimes there is no hope. Move to Australia and you’ll find wages are 30-40% higher and rents have fallen $50-100 in the last year.

At the end of May the median house price was $820,000, up 30% in a year and not slowing down despite the government’s actions in November and March to address supply and demand, again without any real intent to lower prices. And the median rent was $550 a week, up $150 a week since the election of the Labour-led government.

These prices are predicated on home buyers being able to handle mortgage rates of at least 6%, which is the affordability threshold set by bank lending managers. Any shift lower in that affordability threshold towards 4%, which is likely as interest
Existing policy options have so far not worked to achieve government’s clear aims of a fairer more sustainable future and more equality. The debates over capital gain tax have been tedious and unresolved over a very long period. Short term realised gains can be captured in some cases under existing bright line rules, but a CGT can apply to only future gains not the accumulated ones and would be years in the design and implementation. But while the time for CGT has long past, and also CGT has been decisively rejected politically, the issues have not gone away.

The proposed Fair Economic Return is a circuit breaker. It taxes the accumulated gains which a CGT cannot and thus can begin to address wealth inequality and to make the inequality more visible. It is much simpler than a comprehensive capital gains tax or wealth tax. It builds on readily available CVs, existing tax rules in FIF regime and associated persons and so can be implemented quickly.

Crucially it has a sound economic rationale that seeks to treat income from all sources the same by including all capital income. By doing so, it helps to level the playing field and remove the distortions in the taxation of housing that have seen an inefficient and inequitable allocation of housing resources.

It is well targeted to the top deciles of housing wealth and is highly progressive in its impact. At moderate rates it should generate a steady source of government revenue that can be used to address critical social issues and help ameliorate the wealth inequalities in a way that is seen as fair.

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New Zealand Treasury. (2020). Experimental estimates of New Zealand’s wealth distribution Retrieved from


