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Economic Policy Centre

The University of Auckland Business School

Fair Economic Return Revisited[1]

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Economic Policy Centre

Pensions and Intergenerational Equity Hub

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[1] This PIE Policy paper provides a commentary on the authors' original paper Fair Economic Return Restoring equity to the social fabric of New Zealand for the changed housing climate of 2022. The authors thank Brian Easton, Robin Oliver, Brian Fallow, Andrea Black, Michael Rehm, Craig Elliffe, Michael Littlewood (Law), John Shewin, Max Rashbrooke, Rob McLeod and others for their comments on the 2021 FER paper. This in no way implies endorsement and the paper and errors within remain the sole responsibility of the authors. Comments on this update are welcome.
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Introduction

In the working paper *Fair Economic Return (FER) Restoring equity to the social fabric of New Zealand* St John & Baucher, (2021) outlined why currently untaxed housing income should be included in the tax base and how that could be achieved. The intent was to provide a different, yet principled, approach in the light of the failure over many years to implement a Capital Gains Tax (CGT) in New Zealand.

Investment in real estate has been a prime vehicle for wealth accumulation in New Zealand and housing is viewed by many as a tradeable commodity and store of wealth, rather than a human right or a basic human necessity. Accumulated fortunes in real estate have enabled and entrenched a 'landed gentry'[4] whose incentives to work and contribute in a meaningful way are blunted. Price signals no longer, if they ever did, direct resources where they will produce the most social good. With no comprehensive capital gains tax, inheritance tax or death duties, wealth advantage flows through to the children of the wealthy with implications for further class stratification, lowered productivity and for gross intergenerational unfairness (Rashbrooke, 2021).

The dangerous speculative housing bubble that peaked in 2021 has been attributed to tax distortions, loose monetary policy along with supply issues in the New Zealand housing market.[5] But the Labour government (2017-) has believed that neither a capital gains tax, nor a land tax, nor stamp duty, nor a wealth tax is necessary, preferring a range of modest restraints such as bright-line tests, loan to value ratios (LVRs), and non-deductibility of interest for certain landlords. The National party in Opposition see the crisis as a purely supply-side problem and has vowed to remove most of even these modest demand-side tweaks.

In mid-2022, while the peak has passed with falling house prices across New Zealand, the tax subsidisation of housing income remains a potent incentive for over-investment in owner-occupied and rental/investor housing. The widespread unease that the growing wealth divide, especially in housing is socially and economically damaging suggests that taxation of wealth will be a 2023 election issue.

To minimize economic distortions, in theory, all personal income regardless of source should be treated the same for tax purposes. In this spirit a Fair Economic return (FER) approach includes currently untaxed housing income in the tax base, building on the low-rate broad base approach taken since the late 1980s and 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 well accepted Foreign Investment Fund regime (FIF).

The changed housing market of mid-2022 suggests even more urgency for a FER approach to be implemented, best posited within an overall, overdue rebalancing of the tax system.[6] FER overcomes many of the disadvantages of introducing a Capital Gains Tax (CGT) which, in any case as outlined in detail in St John & Baucher (2021), has proven to be not politically acceptable at this or any other 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 by taxing imputed housing income at the marginal tax rate of the individual after deducting a

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[4] The term **landed gentry** was first used in relation to a largely historical British social class of landowners who could live entirely from rental income, or at least had a country estate. While distinct from, and socially below, the British peerage, their economic base in land was often similar, and some of the landed gentry were wealthier than some peers (Wikpedia).

[5] See report from Te Tai Ōhanga the Treasury, Te Tūāpapa Kura Kāinga the Ministry of Housing and Urban Development and Te Pūtea Matua the Reserve Bank, 2022, Joint report casts new light on housing prices (treasury.govt.nz).

[6] See for example, St John S. If We Want a Fair System, We Must talk about GST | Newsroom 30th August 2022

realistic per person net equity exemption so that only the top deciles of residential housing net equity owners are affected. Its progressive impact has the potential to reduce housing wealth inequality over time and to help shift scarce economic resources away from high-end housing to state and social housing.

One year on from the 2021 working paper, this update reflects on the feedback and questions raised as to the practicality of FER. It asks whether the original proposition is still sound, given that New Zealand's patchy post lockdown recovery in early 2022 has now become a significant slowdown if not a recession, with falling house prices, high inflation and rising interest rates.

We conclude that the case for FER is stronger than ever to provide systemic corrections to the under-taxation of real estate, to moderate future boom/bust cycles, and provide revenue for the pressing fiscal needs of the 21st century. These needs include policies for climate change, care of the ageing population, child and family poverty, health and education as well as state and social housing.

The Speculative bubble

The boom/bust cycle in the New Zealand housing sector has become both entrenched and extreme, portending a serious resource mis-allocation problem, a serious social problem, and a serious inequality problem.

Using recursive econometric tests, Greenaway-McGrevy & Phillips (2021) noted the Fear of Missing Out (FOMO) was a driver of recurrent 'speculative exuberance' in the Auckland and Wellington housing markets in 2004-2006 and 2015-2016 and found that the evidence suggested another bubble was emerging in early 2020:

> ***…the latest data for Auckland and Wellington suggest a renewal of explosive behaviour in these two real estate markets in the final quarter of 2020, confirming widespread anecdotal and media evidence in late 2020 of intensive demand pressure and resulting FOMO in real estate activity in New Zealand.***

Greenaway-McGrevy & Phillips go on to warn:

> ***The regular recurrence over decades of heated property markets, … has led to bewilderment about the effectiveness of conventional monetary, fiscal, and even well-directed macroprudential measures to control house prices, coupled with concerns about the real-economy impact of a housing market collapse that might be induced by the use of more extreme policy measures.***

While better and early identification of speculative bubbles might allow for their more effective containment, we argue that systemic tax changes are also needed to prevent damaging boom/bust cycles emerging in the first place. The latest speculative boom has been particularly excessive.[7]

On 27th March 2021, changes in New Zealand 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.[8] Despite these policies however the upward pressure on prices continued into 2021. Conway, (2022) shows in Figure 1 how following the GFC, New Zealand nominal house prices continued to rise faster than elsewhere in the OECD to become the leader of the pack internationally.

The OECD (2021) warned:

> ***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,***

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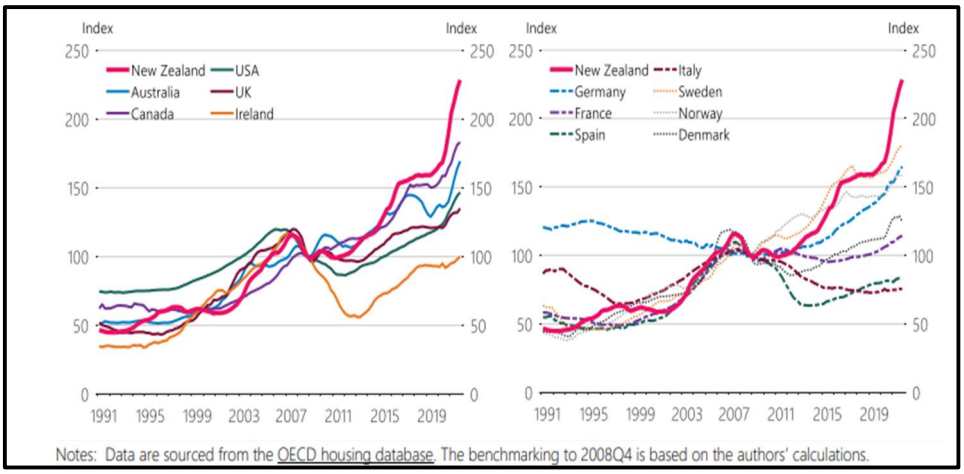
[7] Core Logic (November 2021) The Real Estate Institute of New Zealand (REINZ) data showed that for the 12 months to May 2021 housing prices in New Zealand increased an astonishing 30% nationwide.

[8] The next steps in Labour's housing plan - NZ Labour Party

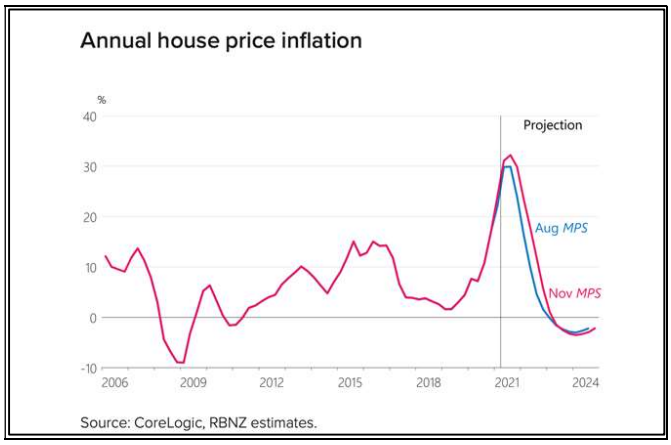
Canada and New Zealand. Ten years ago, they reached similarly dizzying heights against rents and incomes in Spain, Ireland and some American cities, only to endure a brutal collapse.[9]

Figure 1. Nominal price index[10]



The rise in interest rates to curb inflation in 2022 signaled the start of a slowdown/contraction in housing prices. The expectations mid- 2022 are indeed that the housing market has turned sharply, and that annual house price inflation will be in negative territory by the end of 2022 as shown in Figure 2. Whether or not this will become a 'brutal collapse', fundamental changes are needed to moderate future boom/bust cycles.

Figure 2 Annual house price inflation[11]



The economic damage to the economy of the latest extreme boom/bust cycle is likely to playout in reduced economic performance for decades to come. As the Economist (28th July, 2022) notes:

In recent years another strand of research has emerged, which, rather like the political economists of yore, attributes many long-standing economic ills to land. It explores how high and rising land prices affect lending, investment and ultimately productivity, and much of it looks closely at China's long property boom. The worrying conclusion is that high and rising property prices can also have damaging economic effects, by crowding out productive investment and leading to a misallocation of

[9] Global house prices | The Economist April 16th 2021
[10] Paul Conway June 2022 Housing (Still) Matters – The Big Picture - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)
[11] Based on House Price Index | CoreLogic New Zealand see Monetary Policy Statement February 2022 (rbnz.govt.nz) p 12

> ***capital. In the most extreme cases, inflated land prices may already be the cause of a protracted slowdown in productivity growth.***[12]

Bernard Hickey has a bleak take on New Zealand's housing market in mid-2022 seeing little to restrain a strong rebound by 2023, especially if "mortgage rates are falling and there's National-ACT Government by then."

> ***Our economy is already a housing market with bits tacked on and has been for 20 years. The market's ups, downs and ups again from 2020 to 2025 are set to extend that maxim to being: Aotearoa-NZ's entire society and future is a housing market with bits tacked on.***[13]

The investor driver of the speculative bubble

Two Auckland academics, Rehm & Yang (2020) researched rentals in Auckland bought between 2002-2016 and modelled the landlord's expected returns. 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 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 7)***

In early 2021 Mum and Dad investors and professional landlords (multiple property owners) were responsible for over 40% of all purchases and 37% of new builds.[14] There is a dearth of data on New Zealand's rental stock and who owns it. 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. The counterpart to these figures is falling homeownership rates especially for those in their 20s and 30s:

> ***In 1991, 61 percent of people aged 25 to 29 years lived in an owner-occupied home. By 2018, this had dropped to 44 percent. Similarly, for those aged in their late 30s, the rate dropped from 79 percent in 1991 to 59 percent in 2018. (Statistics NZ,2021)***[15]

Inland Revenue[16] 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 was $1.09 billion of taxable profit on an estimated $300 billion rental stock (see Tax Working Group 2019, p 109). An average return of 0.33% reinforces the claim that investors rely on capital gains to make their investment worthwhile. More recent Inland Revenue data collected on a slightly different basis shows that net rental income (ignoring brought forward losses) was scarcely higher at $1.2 billion for 2020 and $1.4 billion for 2021.[17] In light of the growth in housing value, and despite other demand-side policies such as loss ringfencing it can be inferred that returns remain abysmal.

Worrying too is the concentration of ownership in a few hands. Inland Revenue has little data on this, but Figure 3 is based on an independent analysis by Valocity that shows 264,366 investors own between 3 and 5 dwellings, about 120,000 investors own more than 6 houses, and 22,000 own over 21 houses.

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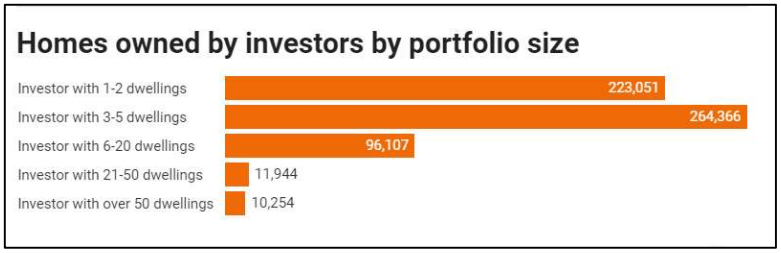
[12] How high property prices can damage the economy | The Economist
[13] The Kaha Bernard Hickey (August 2022).
[14] Property Data & Analytics | CoreLogic
[15] https://www.stats.govt.nz/news/homeownership-rate-lowest-in-almost-70-years
[16] See OIA response for A O Sullivan 18 Jan 2021.pdf (fyi.org.nz)
[17] See OIA response for T. Baucher, 29th August 2022

Figure 3 Concentration of ownership (Valocity, 2022) [18]



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.[19] But these losses can be carried forward and deducted against future rental income. Changes in 2021 phase out interest deductibility for some rentals over four years and that will affect future tax revenue.[20] But new builds are exempt, and a change announced in August 2022 also exempts build to rent houses from the loss of interest deductibility.[21] In relation to returns on net equity in rentals, average landlord taxable profit in 2022 is likely to continue to be much lower than returns on term deposits at the bank.

Real resource allocation problem

From an economics perspective, as St John & Baucher 2021 discuss, the housing market illustrates 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 not only in investment properties but 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.[22] 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.[23] When scarce materials are diverted to over-investment in renovations, over-sized houses, unaffordable new builds, helipads and swimming pools, they are not available to build, repair and maintain the kind of houses appropriate for low-income families.

As Bernard Hickey (June, 2021) remarked:

> ***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.*** [24]

In the meantime, the numbers in severe housing need mushrooms with thousands of families living in unsafe motels and even cars with few desperately needed state and social houses available as discussed below. The New Zealand economy

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[18] Mega Landlords: Over 22,100 homes owned by small group of very large investors | Stuff.co.nz
[19] Ring-fencing of residential rental property losses | BDO NZ
[20] https://taxpolicy.ird.govt.nz/publications/2021/2021-other-interest-limitation-and-bright-line-rules-q-and-a
[21] See Terry Baucher 2022A big tax break for build-to-rent developers – Baucher Consulting Limited
[22] A May 2021 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
[23] See for exampleSir John Key's former Parnell mega mansion listed for sale - NZ Herald and Sir John Key's former Parnell mega mansion sits empty and neglected - NZ Herald. Australia also reports unoccupied houses amid homelessness: https://www.abc.net.au/news/2022-07-20/homeless-crisis-million-homes-vacant-in-australia/101234424
[24] The week that was for the long weekend - The Kākā by Bernard Hickey June 2021(substack.com)

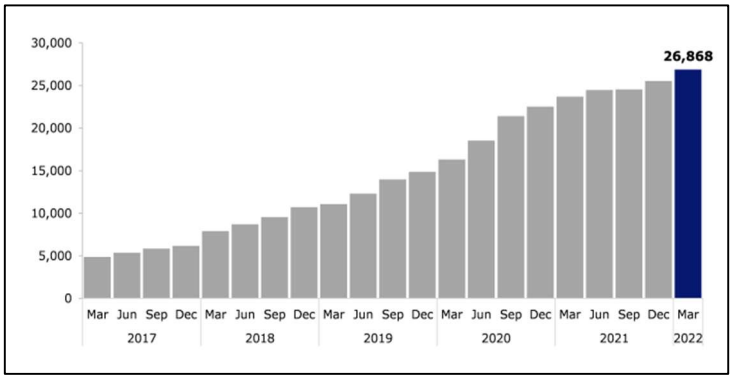
is much the poorer for the waste implied by the current situation. A further widespread complication is that, along with supply chain hold-ups of building materials in a COVID-constrained world, the widespread remediation of leaky buildings is putting the building sector under further pressure.

Unacceptable social stress

One of the major contributors to the intractable problem of child poverty in New Zealand[25] 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.

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 despite the recent economic slowdown.

Figure 4. The number of households seeking public housing through MSD[26]



Ninety two 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 (8%) have a "serious housing need". 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.

Wealth inequality

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".[27] 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.

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[25] Based on the equivalised household median, moving-line after housing costs measure, see Latest child poverty figures • Child Poverty Action Group (cpag.org.nz) 322,900 children (28.1%), 236,900 children (20.6%) and 150,400 children (13.1%) were under the 60%,50%,40% after-housing costs poverty lines respectively. In the year to March 2022, the impact of COVID is expected to show a deterioration in some of the government's child poverty stats see Child Poverty Report 2022 - Budget 2022 - 19 May 2022

[26] Housing Register - Ministry of Social Development (msd.govt.nz)

[27] Treasury 2016 High Net Wealth Review, OIA Andrea Black, 2018

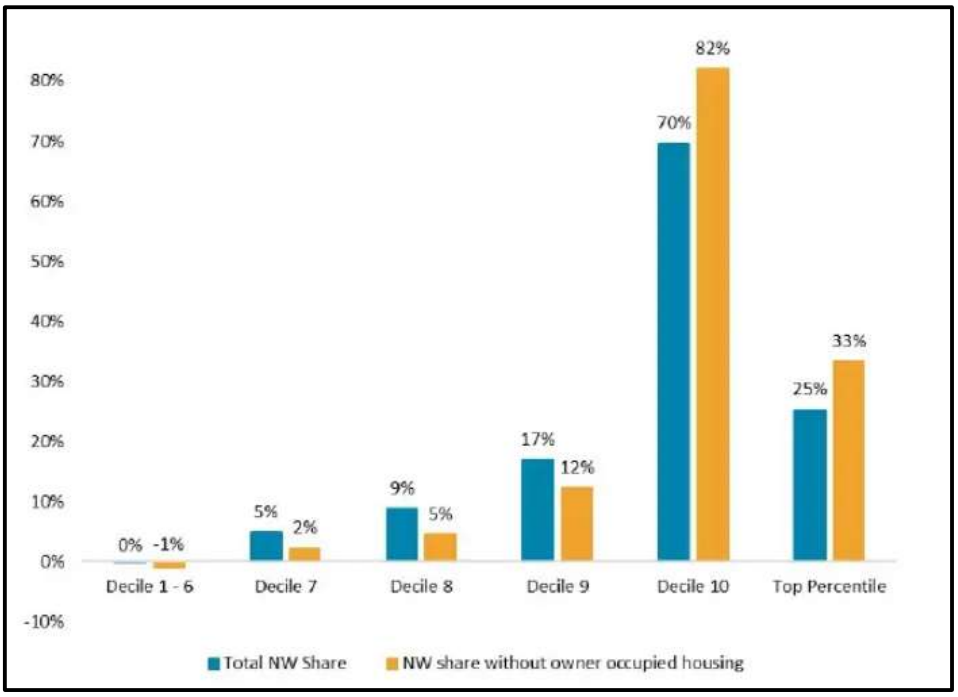
The three-yearly household economic survey (HES) data, used to estimate the distribution of net wealth in New Zealand have a well-recognised underestimation problem for wealth held by high wealth individuals (HWI). In the 2021 budget, the Minister of Revenue, the Hon David Parker allocated $5m to Inland 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.***[28]

To begin to address this problem, Treasury has used updated methodology to augment HES data.[29] 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[30] excluded, the top 2 deciles of individuals own 94% of total net wealth and the top 1 percentile owns 33%. The inclusion of owner-occupied housing has an equalising effect, but the top 2 deciles still have 87% 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, including investor housing is held in decile 9 and 10. And, in terms of asset classes, residential real estate is by far the largest. 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.

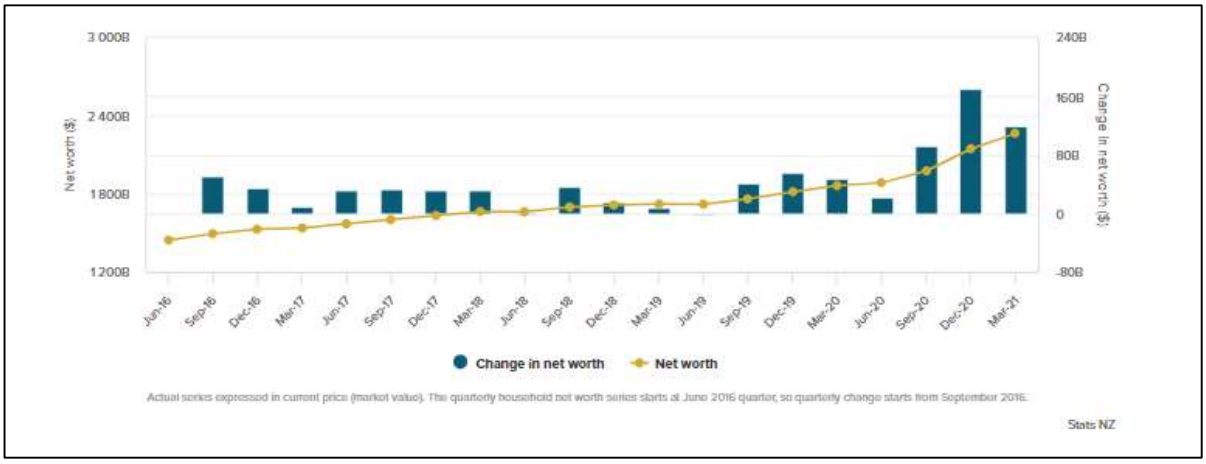
Figure 5: Wealth share with and without owner-occupied housing, using the capitalisation method. (New Zealand Treasury, 2020)



[28] https://www.interest.co.nz/news/110809/revenue-minister-david-parker-says-demands-tax-cuts-arent-realistic-or-responsible-they 21st Jun 2021.
[29] In experimental estimates, survey data is augmented with media rich list, and the capitalisation of taxable income. Treasury Advice (scribd.com) High-wealth individuals research project (ird.govt.nz)
[30] Data for owner-occupied housing is a HES estimate based on self-declared principal dwellings held by owner or family trust.

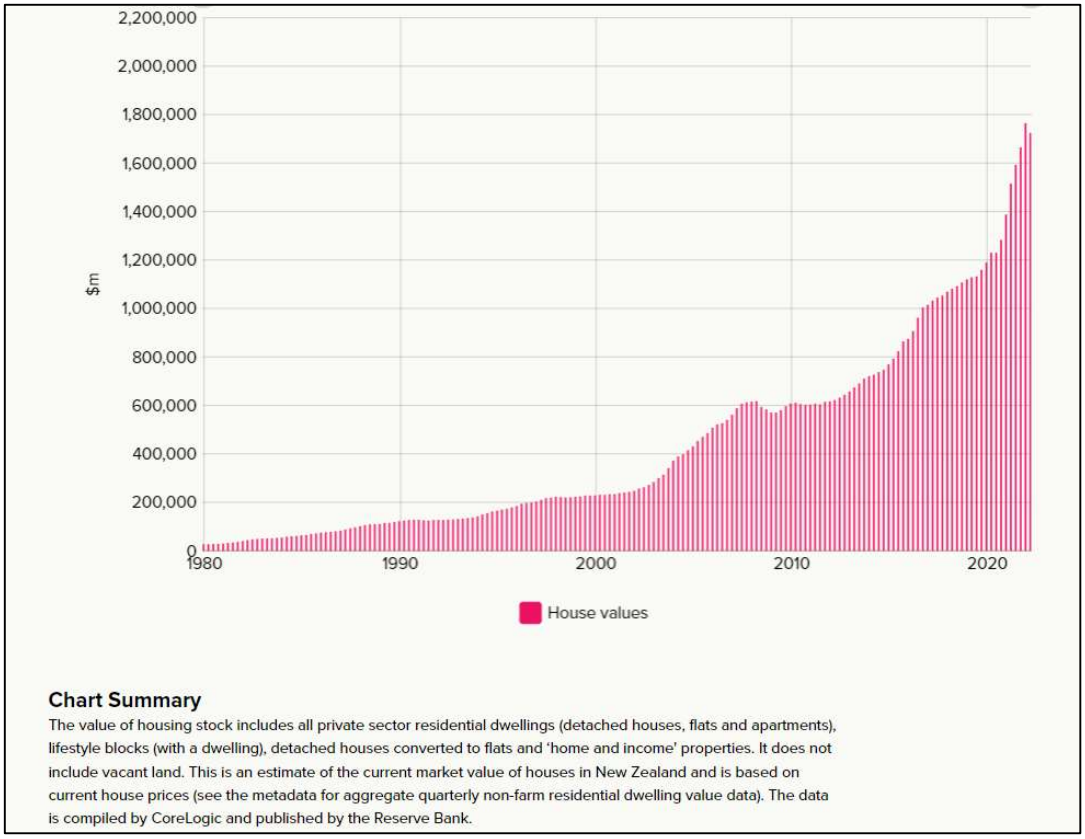
Figure 6 shows the rapid changes in net household wealth (value of all assets owned by households less the value of all their liabilities) since Jun-20 and shows an overall net worth of around $2.3 trillion as at 31 March 2021.

Figure 6 Household net worth and the change in net worth (Stats NZ)[31]



The total value of residential real estate was $1.73 trillion at the end of 2021, but by the end of Q2 2022 had fallen to $1.69 trillion (see Figure 7). With mortgages secured against 20% of real estate value, excluding vacant land, net equity in housing in mid-2022 is around 1.35 trillion.[32]

Figure 7 Value of the housing stock (Reserve Bank)[33]



[31] New data shows household net worth increases on the back of rising asset values | Stats NZ
[32] Multiple challenges to test NZ's declining market for rest of 2022 | CoreLogic New Zealand
[33] Housing - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)

Why no capital gains tax in New Zealand?

St John & Baucher (2021) outlined how the reforms of the late 1980s were supposed to treat all forms of income the same. The failure to implement a capital gains tax along with other subsequent housing-favoured tax changes meant that housing became the tax-preferred way to save.[34] The Tax Working Group (2019) wrestled with these problems in their extensive report on how to implement a comprehensive capital gains tax for New Zealand. Their recommendations were not adopted, not even for the main asset class of real estate which all members of the Tax Working Group supported.

The Reserve Bank (2022) was in no doubt:

> ***If the tax system had been more 'neutral' in its treatment of housing, house price increases would have been milder over the two decades to 2021 as interest rates fell.***[35]

Total realised tax-free gains since the 2017 election to December 2020, were $60.8b[36] suggesting foregone tax revenue of around $20b+. But little of that capital gain would be taxable under a comprehensive capital gains tax such as the 2019 TWG envisaged. 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. Also, much of the capital gain would be on the family home that was to be exempt.

Even if a CGT could be devised for New Zealand, it could apply only for houses bought and sold in the future and would exclude the family home. In 2022/23, capital losses may be experienced that, coupled with the ability to pass capital losses forward, may limit the generation of significant revenue for many years if not decades. Importantly, any feasible future CGT on a realisation basis has no impact on the accumulated untaxed capital gains in housing (including owner occupied) that have compounded over years of neglect to date, and is thus limited, if not impotent, to address the root harm of housing inequality.

The Risk-Free Rate Method

As outlined in St John &Baucher (2021) the Risk-Free Rate Method (RFRM) has a long history. It was first discussed in the 2001 McLeod Tax Review as an alternative means of addressing specific problems arising from a capital gains tax (McLeod, 2001). The RFRM is the precursor to the FER 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.

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,***

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[34] A regime of Tax/ Exempt /Exempt (TEE) for housing was highly favourable when other saving was taxed under the bank model Tax/Tax/Exempt (TTE)

[35] Housing (Still) Matters – The Big Picture (rbnz.govt.nz)

[36] Corelogic, 2021 as quoted in St John &Baucher 2021

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.

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. [37]

The Fair Economic Return

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.[38] Net equity treated as if it was on term deposit earning a FER rate (say between 2- 4% in 2022). 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.[39]

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 could rise with individual net equity ensuring even 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 more progressive FER 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.

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[37] Taxing residential properties: Is it time to pull the lever? - NZ Herald

[38] Soft loans from Mum and Dad at less than the FER rate should be attributed to the net equity of Mum and Dad.

[39] An associated reform might see all PIE income treated as income taxable at the person's marginal tax rate (offsets for imputation credits), removing the 28% advantage for top incomes.

By making explicit the deemed returns from housing investment, resources are likely to be diverted from luxury owner-occupied housing and second homes, undermining the culture of treating housing as an investment commodity traded for gain. 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 classes.[40]

Should the family home be exempt from FER?

New Zealand has a tradition of encouraging home ownership and exempting 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 demonstrates some of the complexities of defining the family home.[41] High worth people may use the family home as a store of wealth and exempting the family home in total from FER would probably encourage over investment in luxury end housing.

Any special treatment of the family home raises horizontal equity issues. The $1m net equity exemption under FER is not specific to the family home. 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 for 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.

Should landlords have access to the exemption?

Some may worry that a $1m net equity 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.

Why are second homes not given preferential treatment?

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 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.***[42]

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 2022). The FER would be based on net equity aggregated as at 1 April 2024 using the 2022 CVs. By 2026, new CVs (as reviewed in 2025) should apply and for each of the following 2 years the CVs could be indexed to a house price index.

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[40] Investing in bitcoin, gold, art or shares would be arguably less damaging in a resource allocation sense.
[41] Exclusions to the bright-line rule (ird.govt.nz)
[42] George Monbiot Second homes are a gross injustice, yet the UK government encourages them Guardian, 23rd June 2021

Taxable income (see Box 3) is determined by Net equity*FER rate. The rate might be introduced at 2% rising to 4% over time as interest and mortgage rates dictate. Only resident taxpayers would qualify for any individual exemption. Over time the incentives should maximise housing use (Airbnb, boarders, or rental income are ignored in FER). The complex existing tax rules for mixed use assets would no longer be needed. Each house (including residential land) in New Zealand is owned by somebody, either a resident or an overseas owner so the FER is hard to avoid. Inland Revenue could hold a register of housing interests for each taxpayer that can be cross-checked against a list of all titles of NZ property.

Box 1 FER in practice

As at 1 April 2024,
Couple own home CV = $5m
bach CV = $2m
rental CV = $800,000 with mortgage of $200,000

Total net equity = $7.6m
each person = $3.8 m
after exemption = $2.8m
FER taxable income @ 2% = $56,000 each additional taxable income
FER taxable income @ 4% = $112,000 each additional taxable income

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 Marginal Tax Rate (MTR) of property owners. Obviously, the parameters need to be known before revenue can be estimated. The intent of having a relatively high per person exemption is to limit 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 $1.35 trillion in net housing equity in mid-2022 (see page 7), the top 2 deciles own an estimated 87% (see Figure 5) or $1176 billion. If there is no exemption, the taxable income is estimated to be around $23 billion for a 2% FER, and $47.04 billion for a 4% FER.

Just considering the top decile alone: there is an estimated 70% or $823 billion net equity in housing. The generation of taxable income under FER depends on the spread of ownership within the decile. If the top 1% owns 25% (see figure 5) their net equity base is approximately $294 billion. For an adult population of 4 million, each decile is 400,000 people and the top 1% is 40,000 people. A million-dollar exemption for each person in the top 1% is $40 billion, so that the FER would be based on net equity of $254 billion. Of the other 90% of the top decile or 360,000 people, net equity would be conservatively estimated at $169 billion ($529 billion less $360 billion exemption). The net equity base for the top decile of net equity holdings alone is then at least $423 billion. With contributions from the 9th decile and remembering that housing assets held in trusts will not usually get any exemption, a taxable base of $500 billion seems a reasonable ball park figure.

A 2% FER rate on this base is estimated therefore to produce at least $10 billion of taxable income, a 3% FER, $15 billion, and a 4%FER $20 billion. In term of tax revenue, assuming the top wealth earners have a tax rate of at least 33%, a 2% FER is estimated to produce around $3.3 billion tax, a 3% FER, $5 billion, and a 4% FER, $6.6 billion. However, as FER replaces landlord rental returns, the actual tax revenue must subtract the existing tax revenue from rental income.

Given the likely low returns on landlord equity, this offset may be minimal.[43] From the sparse statistics available a FER can be expected to represent significant additional tax revenue.

Why not a wealth or land tax?

The problem identified by Rashbrooke (2021) is total wealth inequality and the lack of tax paid by the wealthy as a whole (not just on their property wealth). While we agree that total wealth is the preferable tax base, compared to other paper assets, art, etc, it is the non-taxation of housing that distorts the use of scarce housing resources. We also suggest there is no indication that a total wealth tax could be an immediate possibility. FER could be a much more straightforward change and provide a useful "stepping stone" to encompass more assets over time. NZ must be seen to be actually doing something about the wealth divide and FER is a good start.

A land tax is a form of wealth tax that has considerable appeal as a low rate applied to value of undeveloped (and developed) land could raise significant revenue and appears much simpler than either a wealth tax or FER.

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 gained favour throughout the 2000s as an idea. Most members of the 2010 Tax Working Group (TWG, 2010) "support the introduction of a low-rate land tax as a means of funding other tax rate reductions" As land is an inelastic supply, they expected the introduction of a land tax would cause an initial fall in value of land.[44]

The Interim report of the 2019 TWG recommended against land tax for the 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.

A flat rate land tax on gross value is unlikely to make much of a dent in the misallocation of resources problem. But 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 others, for example, those in high priced apartments on minimal land.

It is much harder to make a flat land tax progressive but nevertheless its likely to be attractive because of its simplicity. Bernard Hickey, for example, has argued recently for a flat rate of 0.5% tax on all residential land. If there are no exemptions, he estimates the land tax would yield $6 billion in tax.[45]

While raised for a different purpose, local government rates include a land tax component. Based on the capital value of household real estate, the 2022 rate adjustments largely reflect the increase in the value of the land base. As there is no allowance for mortgages, low-income families on larger sections with a large debt are particularly hard hit. They would be doubly affected by a 0.5% land tax raised for national revenue purposes.

For example, take a low-income family living in a rundown house in Ellerslie with a backyard and a $400,000 mortgage. The CV has risen to $1.8m in 2022 but the house value is only $125,000. With a 0.5% rate they would have to pay $8375 in land tax. This would be a very tough on top of general rates of $4000 and mortgage costs. For someone on a higher

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[43] Based on information supplied by Inland Revenue the net residential investment property income for the year ended 31st March 2021 was $1.425 billion which at an assumed 33% tax rate would be $470 million.
[44] For further discussion, see Russell and Baucher (2017, p 89-92)
[45] Bernard Hickey: All roads lead to a land tax | The Spinoff

income in a city apartment with a CV= $1.8m but no mortgage and the land valued at only $280,000, land tax at 0.5% would be only $1400.

A land tax attaches to the land itself and is not tailored for individual circumstances. In contrast for the low income family above, if comprising one adult, under FER at 2% on net equity of $400,000 would have a taxable income of $8000 and $2400 tax at a 30% tax rate. A couple would have zero FER income and zero tax to pay.

Given that we have an effective land tax already in the rates we pay and that it has the potential to be regressive, it is hard to see that introducing an additional land tax, even at a low rate would be acceptable.

What about stamp duty?

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,46 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.[47]

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 capital gain 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 hose that was liberally used was full of petrol (low interest rates and 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.[48] 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. It is also politically vulnerable with National vowing to reduce the ten years to two.

From 1 October 2021, full interest deductibility for rentals was removed: immediately for new purchases, and over four years for existing rentals held on 27th March 2021. This policy reduces the ability to generate losses for leveraged rentals but does not apply to new builds. The lower period of 5 years bright-line test and the exemption of loss of interest

[46] Deutsche Bank suggested it should be paid by vendors. Deutsche Bank Konzept Issue 19 Nov 2020 "What we must do to rebuild".
[47] NSW Government Plan to Scrap Stamp Duty Hits Road Block - eChoice
[48] The bright-line property rule (ird.govt.nz)

deductibility for newbuilds raise some very complex issues as set out in the IR discussion document.[49] Accrued tax losses can still be passed forward. The loss of deductibility does not impact on 100% equity-financed properties.

In August 2022, the policy for interest deductibility was widened to include build to rent complexes of more than 20 units.[50] This policy has dangers of inconsistencies and anomalies over time as properties are bought and sold and new builds grow older.

These changes may have some transitional impact but are unlikely to have much impact on house prices. 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.

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

Multiple properties may be 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. If an individual wanted to make use of his or her $1 million exemption when the family home is in a trust then attribution would be required.

As set out in an example in St John & Baucher 2021, if attribution is chosen the net equity in each property can be attributed to an individual by using the existing "associated persons" tax rules.[51] 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.

Currently the non-alignment of the top tax rate 39%, the trust rate 33% and the 28% company rate opens avenues for potential tax planning. The FER may be introduced with some offsetting changes that improve the tax neutrality intended by the late 1980s tax reforms where a 33%/33%/33% alignment was envisaged. The introduction of FER might allow the reduction of the top rate to 36% along with a lift of the trust rate to 36%. Anti-avoidance rules for trusts holding shares in property owning companies already exist.[52]

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

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[49] See https://taxpolicy.ird.govt.nz/publications/2021/2021-dd-interest-limitation-and-bright-line-rules
For discussion of complexities see https://www.interest.co.nz/news/110819/terry-baucher-dives-14-chapter-143-page-discussion-document-design-bombshell-interest. https://taxpolicy.ird.govt.nz/publications/2021/2021-other-interest-limitation-and-bright-line-rules-q-and-a

[50] 'Build to rent' landlords get tax reward for offering tenants long-term tenancies and more flexibility | Stuff.co.nz

[51] 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.

[52] For example, a 5% dividend withholding tax may apply.

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 home-owner 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?

The same criticism that there may be no income stream to pay the tax can be made of land tax or any wealth 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 the 4th year.

Conclusion

One year on from the original FER paper, the housing market problems remain systemic and long-standing. The 2020/21 New Zealand housing bubble has been, unenviably, the worst in the developed world. The social and intergenerational consequences of rampant speculation and over-investment for some in the context of extreme housing deprivation for others is untenable and dangerous. A correction in prices in 2022 is welcome, but currently New Zealand has very little in place to contain the next housing boom which some are already predicting.[53]

The option of doing nothing is not an option as it is foolish to ignore the despair among the young of working age shut out of the market. Here is the conclusion of an opinion piece from Bernard Hickey who essentially argues that current policy is 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…***
>
> ***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.***[54]

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[53] See for example Bernard Hickey, the Kaha August 2022

[54] Bernard Hickey: How hope for a generation was lost | The Spinoff June 25th 2021

While total wealth inequality is the problem identified by Rashbrooke (2021) and the lack of tax paid by the wealthy as a whole (not just on their property wealth), we argue there is no indication that a total wealth tax is an immediate possibility. FER could be a much more straightforward change and provide a useful "stepping stone" to encompass more assets over time. While we agree with the sentiments re total wealth, other paper assets, shares, art, etc do not have the same capacity for resource misallocation. Over time FER should be a good source of revenue but that is not its sole purpose.

We argue the FER rate can be set as a policy tool—it should be below the mortgage rate. We think it should come in at a low rate of 2% to get people used to it but make it clear it may rise over time. We should start somewhere to get the price signals right and wean New Zealanders away from housing as an investment for capital gain.

We note the data is nowhere near as comprehensive as we would like. Our ball-park estimates assume a net equity after exemptions of around $500 billion. A FER of 2-4% on this base would raise approximately $3.3-6.6 billion of tax.

No one knows what the behavioural response will be, but the more valuable and less used the house is, the more expensive it is to hold it. For example, John Key's empty $23m house owned by a foreigner with 2-4% FER would be $460,000-$920,000 of extra taxable income. If the property is held in a trust this would yield $152,000- $304,000 tax per annum.

Any deemed rate of return tax is difficult to explain to the public, relying as it does on the idea that an income is imputed, based on some assumed rate of return, and that this theoretical income is then going to be taxed. But because of the high exemption, it is clear that FER is aimed at the holdings of real estate for wealth purposes, not at the use of housing to provide adequate shelter. Most ordinary home-owners would be unaffected by a FER approach.

In a CGT, revenue may fall or disappear in times of falling house prices. In contrast, under FER, if net equity goes down, the base and its unequal holding will still be large, and the FER will still provide a steady stream of revenue. It is far simpler than a comprehensive CGT that exempts the family home and greatly simplifies the taxation of rentals. If the voters in 2023 agree that NZ needs to raise more tax to address inequality in all its forms and to support an ageing population, a creaking health system, the costs of climate change, then FER maybe an attractive way to do this by tapping into an untaxed wealth base. In turn it may lead to a better use of housing resources, while not discouraging good landlords.

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