Tax Working Group
Te Awheawhe Tāke

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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group of the Government.

This paper also contains an appendix that provides a fiscal estimate of the tax revenue that a Risk Free Return Method (RFRM) tax could generate. This estimate is contained as an appendix to this paper because of an error in the estimate made for the Secretariat paper "RFRM and Land Taxes".

Policy design is still being worked on since the numbers were created, and that further analysis of the options is being undertaken. In the process of doing that numbers might change materially. Because of this, the numbers in the table should not be used as a final estimate of the tax raised from an RFRM on rental property.

Coversheet: Tax and **Housing II**

Position Paper for Session 14 of the Tax Working Group
19-20 July, 2018

Purpose of discussion

The paper considers a number of reforms to the tax system that have been suggested by submitters, the media, or members of the Group to address issues in the housing market.

Key points for discussion

- How does the Group wish to deal with the issue of housing in the interim report?
- Does the Group wish to include any specific actions in the area of housing, beyond the design work presently underway on the design of a capital gains tax?

Recommended actions

We recommend that you:

a **indicate** whether the Group wishes to recommend any of the following options for inclusion in the Interim Report:

   i. tax recognition of depreciation for multi-unit buildings (recommended by the Secretariat).
   ii. tax recognition of capital improvements.
   iii. repeal or amendment of the ten-year rule, subject to decisions on the extension of capital income taxation (recommended by the Secretariat).
   iv. zero-rating GST on new homes.
   v. taxes on undeveloped land and/or vacant homes.
   vi. Tax on second homes

b **indicate** whether the Group wishes to include a discussion of the housing market impacts of local government rates in the Interim Report.

c **note** the Secretariat will provide a paper for the meeting on August 3 that summarises the results of economic modelling of the housing market impacts of a capital gains tax.

d **note** the new fiscal estimates on the risk-free return method.

Tax and Housing II

Discussion Paper for Session 14
of the Tax Working Group

July 2018

Prepared by the Inland Revenue Department and the Treasury

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Executive Summary

This paper follows an initial paper considered by the Group on 23 March on *Tax and Housing.* That paper provided an overview of the relationship between tax settings and the housing market. It also considered a number of options for housing-related reforms to the tax system.

This paper provides a brief discussion of the expected impact of a capital gains tax (CGT) on the effective tax rates for investors in the property market. The immediate effect of a CGT would be to increase the effective tax rates on landlords, and to thereby decrease after-tax rates of return. In response, there is likely to be an effect on house prices and rents. Additional information of these potential effects (including the results from commissioned work using a general equilibrium model) will be provided in a paper for the 3 August meeting.

This paper also provides brief analyses of additional options that have been proposed by submitters to the Group, the media, and members of the Group. The options span income tax reforms, changes to the treatment of GST for new houses, the impact of land and property taxes, and possible changes to local government funding and incentives.

None of these options are likely to have a dramatic effect on house prices or rents. However, most of the options would likely have negative unintended consequences and introduce additional complexity into the tax system.

An option that would encourage the development of land and improve housing affordability would be for local governments to shift rating valuations from a capital to a land basis. However, there are trade-offs with this policy that would need to be considered. These include likely changes in land values in some segments, and an increase in the tax bias towards investment in owner-occupied homes. The Group will also need to consider whether it wishes to note the housing market impacts of local government rates in the Interim Report, or focus solely on the effects of the national tax system.

In the event that the Group decides not to recommend a CGT, the Secretariat would recommend that the ten-year rule is amended so as to remove the incentive for land-owners to withhold land from development until the rule ceases to apply. If the Group does decide to recommend a CGT, the Secretariat would recommend that the ten-year rule be repealed.

The loss ring-fencing proposals that the Government intends to enact has not been considered in this paper. If a capital gains tax is adopted, there is an argument to revisit this policy, as the motivation for the policy will be weakened. The Capital Gains Subgroup will give further consideration to this argument.

It is recommended in the companion paper Appendix C in *Potential revenue reducing options* that tax depreciation be allowed on multi-unit residential buildings. This option would remove a disincentive to intensify land use and is likely to reduce rents. If this option is adopted, then capital improvements on those buildings would also be depreciable.

Attached to this paper is an appendix that outlines revised fiscal estimates relating to the risk-free rate of return method, which the Group asked for at a previous meeting.

1. Introduction

1.1 Purpose

1. This paper explores a number of reforms that could have some impact on the housing market.

2. The Group has already made a number of decisions in relation to tax and housing. These are:

   - To progress work on the design of a capital gains tax (CGT).
   - Not to recommend a land tax.
   - Not to recommend region-specific property taxes or mortgage interest levies.
   - Not to recommend stamp duties.

3. The Group has also requested revised estimates of the revenue potential of an RFRM tax on residential property investments. These are attached in the appendix.

1.2 Structure

4. The paper is structured as follows:

   - Chapter 2 outlines the effect of a CGT on effective tax rates for landlords.

   - Chapter 3 explores a number of reforms to the taxation of housing that have been suggested by submitters or discussed in the media.

1.3 Assessment frameworks

5. The paper assesses the efficiency, fairness, integrity, administration and compliance costs, coherence, and revenue impacts of the options. Efficiency impacts link directly to physical and financial capital, while fairness and integrity impacts provide an insight into impacts on social capital.

2. Effective tax rates

6. Investors in residential property have historically faced relatively low effective tax rates (ETR) compared to holders of other asset classes. The primary driver of this outcome is the extent to which housing investments have generated untaxed capital gains.

7. The tax that landlords pay is made up of income tax on rental income, and local government rates. If housing continues to make capital gains in the future, then new investors will also face a relatively low METR.[1] If housing does not make capital gains, investors will face higher METRs on housing than on other assets, because of the additional tax of local government rates. This dynamic is explained in the Secretariat paper on *Further information on Marginal Effective Tax Rates*.

8. A tax on capital gains that taxed capital income made by property investors would increase their METR. This will make what are now marginal investments into rental property uneconomic. It would also result in investors potentially facing a higher METR than investors in most other investment options, unless the benefit from deferring the capital gains tax until realisation outweighs the additional tax from local government rates.

9. In setting tax rates, the Government should be trying to tax income comprehensively. While the imposition of local rates does increase the METR of housing investment, the Secretariat does not believe that the Government should be trying to adjust the tax system to effectively give credit for local taxes.

10. A CGT would result in a decrease in the after-tax rate of return for landlords. In response, there will be an effect on house prices and rents. We will return to this effect in a later paper, which will include analysis using a general equilibrium economic model commissioned by the Secretariat.

[1] METRs are generally forward looking and affect future investment choices, while ETRs are backward looking.

3. Housing options

11. The Group has already discussed a number of options to address house prices and rents using the tax system. These options were introduced in the initial paper on *Tax and Housing*. These options included taxing capital gains, the risk-free rate of return method, land taxes, taxation of second homes, stamp duties, and denial of expenses. This chapter provides further analysis on some of these options, and explores a number of other reforms suggested by submitters and/or discussed in the media.

3.1 Income tax reforms

3.1.1 Tax recognition of depreciation for multi-unit residential buildings

12. The option which the Secretariat considers to be the most consistent with our income tax framework is to allow tax depreciation on buildings that depreciate, including multi-unit residential buildings. This option would remove a disincentive to intensify land use and would likely reduce residential rents. This option is discussed in more detail in Appendix Co to the companion paper on *Potential revenue reducing options,* and is recommended by the Secretariat.

3.1.2 Tax recognition of capital improvements

13. In 2010, depreciation was removed from all long-lived buildings (i.e. buildings with an estimated useful life of 50 years or more).[2] This included all residential properties. The rationale for removing depreciation was a view that buildings had increased in value over time. To the extent that buildings do lose value over time due to general wear and tear, repair and maintenance costs are deductible if the building is within the tax base. Allowing depreciation deductions for an asset that increases in value, however, is not economically efficient, and is effectively a subsidy.[3]

14. Some submitters have suggested that capital improvements to residential properties should be recognised in the tax system. These submitters suggested that recognition could be implemented by allowing depreciation deductions over a number of years, or by treating capital expenditure like repairs or maintenance (and allowing an immediate deduction for the cost of the improvement).

15. Under an income tax, costs are deductible when they result in a loss of wealth and are connected with the process of earning income. Many capital improvements do not result in a loss of wealth because they represent the exchange of one asset (cash) for another (a capital asset like a newly-insulated house).

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[2] Taxation (Budget Measures) Act 2010.

[3] The general arguments for and against re-introducing depreciation on buildings are discussed in the companion paper on *potential revenue reducing options*.

16. Because many capital improvements and assets do lose value over time, an income tax should spread the expense over the life of the capital improvement and asset. If the cost is spread in line with the economic depreciation of the improvement or asset, the income tax will be economically neutral. In other words, the same decisions that would be made without an income tax will be made with an income tax. This means the expenditure would be made if its expected benefits exceed its cost, and so is socially desirable.

17. Current principles in tax law already differentiate between deductible expenditures (those which maintain the value and functionality of an asset, but do not enhance or extend it) and capital expenditure which extends, enhances or improves an asset. These principles appear to be working well in practice and there appears to be no reason to change them as applied to rental housing.

18. Allowing a deduction for capital expenditure would increase the incentive to improve the quality of rental stock. It would achieve this narrow objective. However, it would do so at a cost of subsidising the landlord's expenditure relative to other business investments. This is likely to reduce productivity.

19. The question of the proper treatment of the capital expenditure must be considered in light of the removal of building depreciation. Capital expenditure on the building is considered to improve the building itself, and so become deductible or depreciable as part of the building. Since buildings are currently non-depreciable, the capital expenditure would be non-depreciable. However, this is a consequence of not depreciating buildings, and that issue is discussed in the *potential revenue reducing options* paper. Even without depreciation, if we were to tax gains on the sale of rental properties, there would be a tax benefit to the capital expenditure in the year the building is sold as the capital expenditure would be deductible as part of the cost of the building.

20. Some submitters argued that depreciation or expensing could be given to specific types of capital improvements that provide positive externalities, such as earthquake strengthening for apartment buildings, or improvements to meet the Healthy Homes Guarantee Act 2017.

21. If these types of improvements do provide a wider benefit to society, and the Government feels there is a case for public intervention, it would make more sense to subsidise these expenses for *all* properties, rather than via an implicit subsidy in the tax system that excluded owner-occupied homes (this is because owner-occupied homes are not typically subject to income tax). A subsidy that excluded owner-occupied homes would mean the socially desirable activity is not being undertaken to the extent it should for the large share of houses that are owner-occupied.

22. The significance of this issue will reduce to some degree if the Group decides to recommend the introduction of a capital gains tax that applies to non-owner occupied houses. Unlike the current income tax system, a capital gains tax would allow deductions for capital improvements when the asset is sold.

23. This is because capital improvements on buildings subject to a capital gains tax would be incorporated into the cost base of the asset, which would reduce the amount of taxable gain at the time that capital gains tax liability falls due. The taxable gain would be calculated by subtracting the cost of the asset and any capital improvements from the sale price. Regardless of this, if capital improvements decline in value, they should still be deductible over time as depreciation.

3.1.3 Repeal of the ten-year rule

24. Land (including bare land and land that contains a property) that is affected by changes to zoning, consents, or other specified changes may be taxed on sale, if the sale is within ten years of acquisition. If at least 20% of the gain on disposal can be attributed to the change, the whole gain is taxable.[4] However, the taxable amount is reduced by 10% for each year the taxpayer has owned the land.

25. The original policy was targeted at activity on the fringes of urban centres and was intended to tax gains made through land use rule changes from rural to residential zoning. The concern was that some people were able to make significant profits by lobbying for zoning and other land use changes. The policy taxes the windfall gains made from those changes.[5]

26. The ten-year rule may have a small impact on land supply. It creates a theoretical incentive for landholders on city fringes to withhold land from development until the rule ceases to apply. The extent to which the rule affects behaviour in practice, however, is unclear. The rule is hard to administer – it is difficult to apportion the extent of the gain that arises from zoning changes – and compliance is probably low. In particular, apportioning the value of a zoning change to the increase in value of a piece of land can be difficult when the zoning change is in response to more general changes, such as new economic activity or an increase in population in a particular area.

27. There are a few ways in which the problems with this rule could be addressed. One of these would be to remove the ten-year limit on the rule, and instead include as taxable income all gains that are attributable to a zoning change, no matter when that change occurred. This would remove the current incentive to not sell land that has substantially increased in value until the ten-year threshold is reached. Enforcing this rule will likely be more difficult however the longer the time difference between the zoning change and the sale. This is because the rule requires that at least 20% of the increase in value of a piece of land relates to a specific zoning, consent, or land use change. This attribution could be more difficult as the distance between the event and the sale increases.

28. Another option would be to remove the rule completely. There would be some benefits from the removing the rule. It would simplify compliance and administration, and the revenue losses are likely to be small. Removing the rule could also allow for

[4] Section CB 14 *Income Tax Act 2007*. This policy came into effect in October 1974.
[5] See Graham Murray (2016) for a more in-depth discussion on the history of s CB 14.

rezoned land to be sold more quickly, increasing housing supply. This impact is unlikely to be significant though.

29. The argument for removing the provision is much stronger if a capital gains tax is introduced. In that case, the rule will only apply to a small subset of cases (i.e. where a primary residence has benefited from re-zoning and then been sold to a developer), and so the scope of land sales that would be caught by the rule will be much reduced. A CGT would also address the fairness concern around people making large profits from zoning changes that was a major argument for the rule. If a capital gains tax is not introduced, removing this rule would allow owners of land that receive substantial benefits from a zoning change to make large, untaxed, windfall gains.

3.1.4 Loss ring-fencing

30. The removal of loss ring-fencing for rental properties should be considered as part of the development of a capital gains tax. Loss ring-fencing proposals that the Government intends to enact will result in losses from rental properties being "ring-fenced" and unable to be deducted against other income. The motivation for this change is significantly weakened if capital gains will be taxed. In general, it is preferable to have as few ring-fencing rules as possible, as they result in arbitrary non-neutralities based on tax law, rather than economic reality. The Capital Gains Subgroup will give further consideration to this question.

3.2 GST reforms

3.2.1 Zero-rating GST on new homes

31. Most property developers are registered for GST and will charge GST when they sell residential property.[6] Furthermore, most home buyers will have a GST exempt activity of renting or occupying the residential property so cannot claim back GST charged on the purchase price of the property.

32. The GST cost on new residential property sales is effectively an upfront payment that is passed through for the life of the property (Benge, Pallot & Slack, 2013). The cost of GST flows through to all homes over time, because of the substitutability between new homes and existing homes.

33. Some OECD countries apply either a reduced rate or a zero rate to the supply of new residential property.[7] Removing GST from new homes would reduce the price of those new homes (depending on the extent to which the reduction in GST is passed on to new home buyers). The reduction in the price of new homes would flow through by dampening prices on the rest of the housing stock over time.

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[6] Alternatively, GST will be incurred on the cost of builders and other inputs when a person who is not registered for GST develops a residential property

[7] The Czech Republic, Italy, Luxembourg, Poland, Spain and Turkey apply a reduced rate, while the United Kingdom applies a zero rate (Buydens, 2016).

34. Zero-rating GST on new housing would be a subsidy with a large fiscal cost, with higher amounts of the tax subsidy going to higher-income households. There are likely to be more cost-effective or better targeted policy options for increasing housing supply or reducing housing costs.

35. This reform is a rather arbitrary means to address housing costs. It would create economic distortions by making it relatively cheaper to do new builds, including by removing buildings as opposed to renovating or expanding existing buildings. It will increase the burden of compliance and administration, and give rise to boundary issues. (For example, there will be strong incentives to characterise major reconstructions of existing houses as 'new builds'). It would also create an incentive to add more to a house at the time of construction, rather than build a basic house and add more to it over time.

36. In addition, granting a GST concession for new residential homes is likely to generate demands for exemptions for other types of goods or services. New Zealand's limited use of special rules for specific types of goods and services helps keep the GST as simple and efficient as possible.

3.3 Land taxes and property taxes

3.3.1 Undeveloped land and/or vacant dwellings

37. Some submitters have recommended the introduction of a tax on undeveloped land in residential areas. These submitters argue that such a tax would encourage further residential development, which would increase the supply of housing. Another proposal with a similar objective is to levy a tax on vacant dwellings. It is possible that such taxes would best be applied at a local authority level where appropriate.

38. The Group has already considered the general merits of land taxes, in an earlier Secretariat paper on *RFRM and Land Taxes* from June 2018. However, apart from general land taxes, the Productivity Commission also explored the merits of 'idle land taxes' during its inquiry into *Using Land for Housing* (NZPC 2015). The Commission concluded that:

    - Idle land taxes are rarely effective because of high administration and compliance costs. It is necessary to decide what types of land are subject to the tax and establish definitions of 'vacant' or 'unoccupied' property. The parameters of the tax are likely to be contentious to define and difficult to enforce.

    - Idle land taxes create integrity risks. They encourage the token (rather than substantive) use of land in order to avoid the tax. Given the degree of judgement involved in defining a property as 'vacant' or 'unoccupied,' the Commission also noted a risk that idle land taxes could be applied in arbitrary or capricious ways.

    - The Commission acknowledged Māori concerns that idle land taxes were premised on certain cultural assumptions about 'appropriate' uses of land that had historically been used to justify the taking of Māori land.

39. A tax on residential properties that are vacant for a significant period of time also has some similar issues. Defining when a property is considered ‘vacant’ would be difficult and contentious, and would likely require either significant costs to administer and enforce, or rely largely on self-compliance. Such a tax could also create incentives for property owners to carry out unproductive activities, such as ensuring some token amount of utilities are used, to avoid the tax. This would be a particular concern if it was cheaper to carry out an unproductive activity than to pay the tax.

40. In light of these disadvantages and concerns, the Commission concluded that it would be preferable to focus on general methods to encourage the efficient use of land, rather than apply narrow taxes to favour certain land uses. The Secretariat agrees with this conclusion.[8]

41. Australia introduced a measure in its most recent budget that denies deductions associated with holding vacant land. While this measure is not a tax on vacant land, it does provide a tax incentive to utilise vacant land for either residential or commercial purposes.

42. Land that is used by the owner to carry on a business, which includes commercial development, will not be subject to this rule. Determining what land is being used for a commercial purpose and what land is vacant will have the same difficulties around definition and enforcement that were identified by the Productivity Commission.

43. Australia also introduced a measure in 2017 that imposes a flat fee of A$5000 on foreign-owned properties that are vacant for more than 6 months and are not genuinely available for rent. This measure will have the same difficulties with identifying whether a property is vacant as discussed above, along with facing additional difficulties around determining if a property is foreign-owned.

3.3.2 Second homes

44. The taxation of second homes might release some housing supply at the margin by reducing the incentive for individuals to own two (or more) homes. The overall impact on the housing market is unlikely to be great, but there could be more an impact in localities such as Queenstown where there are large numbers of second homes.[9]

45. The treatment of second homes depends on the Group’s recommendations regarding the taxation of capital gains.

    - If the Group recommends the introduction of a CGT, then there is an obvious case to include second homes within the base of the tax.

[8] These include land taxes, risk-free rate of return method, and using land values for rating bases.
[9] There are specific ways in which to try to tax second homes that are being utilised to generate income.

- If the Group decides not to recommend a CGT, then an RFRM tax could be a mechanism for taxing the economic income from second homes.

46. Previous Secretariat advice has examined the respective merits of a CGT and RFRM taxes.[10]

3.4 Local government revenue

3.4.1 Rating base

47. Local government rates represent another way in which taxation affects the housing market. The Terms of Reference do not make explicit reference to local government funding, but the Group may wish to acknowledge the housing market impacts of local government rates in the Interim Report.

48. New Zealand is unusual in giving local authorities the ability to choose the basis on which they levy general rates. There are three methodologies for levying general rates:

    - Land value.
    - Capital value (i.e. land and improvements).
    - Annual value (i.e. a measure of what a property would fetch if rented on the open market).[11]

49. The choice of rating system will have some impact on housing supply. Capital value rating is a tax on improving land. It discourages development and lowers the rates liability of those that hold vacant land, relative to using land values, which encourages (or at least does not discourage) the development of bare land.

50. Over the past thirty years, local authorities have moved away from land value rating and towards the use of capital value rating.[12] The arguments usually made in favour of capital value rating are that it is more progressive than land value (although the Productivity Commission (2015) concluded that the evidence indicated that land value is actually more progressive), easier to assess than land value, and a better fit for the benefits received from local government. The 2007 Local Government Rates Inquiry (known as the 'Shand Report') favoured a capital value system on these grounds.

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[10] The Group considered Secretariat papers on *Extending the Taxation of Capital Income* in May 2018, and on *RFRM and Land Taxes* in June 2018.

[11] Annual value is the greater of:

- the rent that the unit could generate in a year, reduced by 20% for buildings or 10% for land, or;
- 5% of the capital value of the unit.

[12] In 2010/11, 36 Territorial authorities (TA) and 8 regional councils (RC) used the capital value method, 27 TAs and 2 RCs used land values, and 3 TAs and 1 RC had no general rates. In 2015/16, 44 TAs and 9 RCs used capital values, while 22 TAs and 2 RCs used land value. No councils used annual value in this time period. In addition, these numbers exclude Auckland Council, as it was going through a transition period in 2010/11 (source: DIA).

51. The Productivity Commission (2015) has strongly disputed these assertions. The Commission argues that land value rating would encourage the more intensive use of high-value land, although it did not quantify the housing market impacts of a return to land value rating.

52. The Commission ultimately decided not to recommend that Central Government legislate for the compulsory adoption of land value rating, but thought it would be desirable from a housing affordability perspective if local governments independently decided to move back to land value rating systems.

53. A revenue-neutral shift from capital valuation to land valuation would likely have little effect on most rate payers. Those land owners with significant capital on their land, such as those with apartments or large houses, would get a reduction in their rates bill, while owners of vacant or underdeveloped land would face a higher cost.

54. If we assume that the cost of rates is capitalised into the cost of land, then any decrease in rates for owners of land with capital improvements would likely result in an increase in value for those properties. The net present value of that land (the dollar value less the net present value of the rates) should remain the same.

55. A shift to a land valuation method would also increase the incentive for owner-occupiers to increase the capital investment in their properties. Because capital investments in owner-occupied houses is already effectively taxed at a relatively low rate, some of the marginal investments that result from a change to land valuation could be economically inefficient investments.

56. A question for the Group to consider is whether it wishes to note the housing market impacts of local government rates in the Interim Report, or whether it intends to focus solely on the effects of the national tax system.

3.4.2 Revenue options for local government

57. Some people believe that taxes create an incentive for governments to favour economic growth and development, because economic growth will increase the revenue base. This assumption does not hold equally true for local authorities because of the unique way in which rates are levied.[13] Local authorities have weaker revenue incentives to pursue growth and development than central government. While local authorities can generate additional revenue from rates in the future by allowing expansion of residential property, some of the extra revenue generated by the economic activity is captured by the Crown instead.

[13] As explained by NZPC (2015), local authorities are required to decide how much they will spend in the coming year, and then set rates to cover those expenses. Property values are used to allocate the burden of rates, and the share of general rates paid by an individual household or business depends on the value of their property relative to the value of other properties. Since rates are linked to the cost and level of service delivery, revenue does not necessarily increase as aggregate property values increase.

58. Constraints on local government revenue and financing are also impeding the supply of the infrastructure necessary to support the supply of housing and urban development. New developments impose upfront spending costs due to the need for new/improved infrastructure before any additional revenue can be generated.

59. Some councils in areas experiencing high population growth and infrastructure demands – notably Auckland, Hamilton and Tauranga – are at or near their prescribed debt limits. They face the risk of breaching covenants on existing debt arrangements if they borrow for further substantial investments in growth infrastructure, or of credit rating downgrades that result in higher borrowing costs for the local authority.

60. There may be a role for the tax system to try and alleviate some of these problems and incentivise local authorities to adopt more policies that promote housing growth. However, the Secretariat believes that any issues around local authority funding are best addressed through a systemic review of local government funding.

61. There are two broad government work areas responding to these challenges: the *Infrastructure Funding and Finance* workstream under the *Urban Growth Agenda*, and the forthcoming *Local Government Funding and Financing Inquiry* by the Productivity Commission.

The Urban Growth Agenda

62. The Urban Growth Agenda (the UGA) is an ambitious and far reaching programme designed to improve outcomes for New Zealanders by addressing the fundamentals of land supply, development capacity, and infrastructure provision.

63. The UGA's main objective is to improve housing affordability, underpinned by affordable urban land. This will be supported by wider objectives to:

    - Improve choices for the location and type of housing;
    - Improve access to employment, education and services;
    - Assist emission reductions and build climate resilience; and
    - Enable quality built environments, while avoiding unnecessary urban sprawl.

Infrastructure Funding and Financing

64. The *Infrastructure Funding and Financing* pillar of the UGA aims to reform the existing system to provide a broader range of funding tools and mechanisms, as well as create alternative financing models. The underlying question is whether there are funding or financing constraints hindering the timely rollout of infrastructure.

65. The work includes exploring the potential for project financing to diversify the available sources of financing. Project financing is the ring-fencing of revenues and liabilities to projects, rather than to ratepayers and taxpayers. The ability to identify

and charge beneficiaries, and to limit lenders recourse to project revenues improves commercial and project selection disciplines also.

Local Government Funding & Financing Inquiry

66. The Productivity Commission will commence an inquiry into local government funding and financing. The terms of reference are yet to be finalised and approved by ministers. The Commission will examine options for new local authority funding and financing tools to serve demand for investment and services in line with the Infrastructure Funding and Financing work under the Urban Growth Agenda.

Appendix: RFRM

At the meeting on 15 June, members queried the initial forecasts of the revenue from an RFRM tax on housing. There were two questions. The first was whether the forecast included revenues from holiday homes, and the second was whether the numbers were consistent with broader net rental yields across the market.

While looking at these issues, we found that previous iterations of this costing used a 'real' risk free rate to calculate the return on equity in residential investment properties. This has been corrected below, and now uses a nominal risk free rate of 3.5%. This has a large impact on the forecast.

The method of forecasting includes revenue from holiday homes. This is because it starts with an estimate of the value of total residential property and then subtracts the value of owner-occupied property. However, holiday homes are not separately specified in the forecast model and so the revenues from those homes cannot be isolated.

The second question raises difficult estimation issues. The most important inputs for estimating the revenue from an RFRM tax are the total value of non-owner-occupied housing, and the aggregate level of debt used to fund the purchase of that housing. There are existing estimates of the first (total value), but none that we are aware of for the second (aggregate level of debt).

In our initial costing, we assumed quite a high level of debt. This was in part to reflect that there are a material number of landlords reporting rental losses (approximately 40%). However, data from Reserve Bank at an aggregate level suggests that debt is quite low (at approximately 30%). However, Reserve Bank data will understate tax equity because it only counts loans made for the purpose of funding investment property. It is common for investors to borrow using both their owner-occupied and investment property as security, and this will not be picked up in the data.[14]

However, we do think our initial estimate of aggregate debt is quite high, particularly when many rental properties will have been bought more than a few years ago, and market values have increased significantly in recent years, which will push equity levels higher.

In the absence of any authoritative source on aggregate debt levels, we present a range:

Forecast net fiscal cost of RFRM tax on residential investment property ($m)[15]				
	2021/22	**2022/23**	**2023/24**	**2024/25**
30% debt	1,295	1,365	1,565	1,725
40% debt	1,025	1,065	1,245	1,385
50% debt	755	775	935	1,055
60% debt	485	485	625	715

[14] Deducting interest in these circumstances is legally correct. If one borrows to acquire income producing assets using private assets as security, under current law the interest is deductible, using a tracing principle. Conversely if you borrow against shares to acquire a bach or a pleasure boat, the interest is non-deductible, even though the borrowings are secured against an income-producing asset.

[15] Assumes a nominal risk free rate of 3.5% and an average marginal tax rate of 26.3%.

Glossary

Capital income. Earnings from investments and savings, including interest, net rental and business income, capital gains, and dividends.

Deduction. Losses or outgoings incurred in producing income or running a business that can be used to reduce taxable income.

Depreciation (economic). The decline in the market value of an asset over its life.

Depreciation (tax). The decline in the value of an asset for taxation purposes, which may differ from economic depreciation.

Economic incidence. The individual or entity which bears the final burden of a tax (or receives the benefit of a transfer), after response effects, such as price and wage changes, are taken into account. This is distinct from the legal incidence of the tax or transfer.

Elasticity. A measure of the responsiveness of one variable to changes in another. For example, the 'price elasticity of demand' refers to the percentage change in the amount of a good purchased ('demand') following a percentage change in its price. If the percentage change in demand is more than the percentage change in price, demand is said to be 'price elastic'; if it is less, demand is said to be 'price inelastic.'

Horizontal equity. Horizontal equity refers to people in similar circumstances being treated in a similar way. For instance, by paying a similar amount of tax in the context of the tax system, or receiving a similar level of benefit in the transfer system.

Legal incidence. The individual or entity legally liable to pay a tax or receive a transfer bears the legal incidence of the tax or transfer. The legal incidence often differs from the economic incidence.

Risk-free rate of return method (RFRM). RFRM is a method for calculating and taxing the income generated by an asset. Under RFRM, the total income generated by the asset is calculated by applying a risk-free rate to the equity held by the owner in the asset; the result is then taxed at the taxpayer's marginal rate.

Vertical equity. Vertical equity is the principle that people with low means should receive greater assistance than those with higher means, and that those with greater economic capacity should have a higher tax burden.

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