Tax Working Group Public Submissions Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

30 April 2018

Tax Working Group Secretariat
PO Box 3724
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New Zealand

Dear Members of the Tax Working Group,

Taxation of capital and housing affordability

One of the work areas of the Tax Working Group is the taxation of capital and one of the issues of interest is the impact of the tax system on the housing market, in particular housing affordability. The Tax Working Group is also interested in how the tax system can encourage retirement savings.

A simplistic view of the world is that introducing some form of capital tax, such as a capital gains tax or an asset tax, will have a dampening effect on house prices and thus improve housing affordability. However, we do not live in a simple world and changes to taxation have complex consequences. It is therefore important to try to understand these consequences.

The previous 2009 Tax Working Group, which issued a final report in January 2010, commissioned various background papers on taxation issues. One paper by Coleman, Andrew, "The long term effects of capital gains taxes in New Zealand," Motu Working Paper 09-13, August 2009 (available from: https://www.victoria.ac.nz/sacl/cagtr/twg/publications/3-long-term-effects-of-cgt-coleman.pdf) considered the prospective effect of various capital gains tax regimes on various indicators, including house prices and rental levels.

In addition to examining various capital gains tax regimes, Coleman (2009) also considered a tax system where the inflation component of interest income was exempt from income tax, both as assessable income and as a deductible expense.

> *"Coleman (2008) argued that the tax system would have less effect on the housing market if the inflation component of interest income were exempt from income tax. He argued that by exempting the inflation component of interest income from tax, and by only allowing the deduction of real rather than nominal interest payments, landlords would have less incentive to enter the property market when the inflation rate was positive, raising rents and home ownership rates."*[1]

[1] Page 15, Coleman, Andrew, *"The long term effects of capital gains taxes in New Zealand,"* Motu Working Paper 09-13, August 2009.

Tables 2a, 2b and 2c of Coleman (2009)[2] show the results of modelling the following three tax regimes:

1. Capital gains tax at a flat rate of 20%, owner-occupied housing exempt;
2. Capital gains tax at marginal rates of 20% and 33%, owner-occupied housing exempt; and
3. Inflation part of interest tax exempt,

under three supply elasticity and construction cost scenarios.

The following points taken from these tables are notable:

1. All three tax regimes project increases in household rents ("Rent" line in the tables) and in house prices, for both small and large houses ("P^F" and "P^H" lines in the tables) under all three scenarios. (I.e. a capital gains tax makes housing affordability – both owning and renting – worse.);
2. Tax regime 2 above (capital gains tax at marginal rates of 20% and 33%, owner-occupied housing exempt) has the greatest projected effect on increasing rents and house prices of the three tax regimes examined in Coleman (2009), under all three scenarios evaluated;
3. Tax regimes 1 (capital gains tax at a flat rate of 20%, owner-occupied housing exempt) and 3 (inflation part of interest tax exempt) have broadly comparable effects on rents and house prices, but tax regime 3 was projected to have a much greater positive effect on household savings ("Net financial assets / GDP" line in the tables). Coleman (2009) notes:

   "This is because exempting the inflation component of interest income from tax raises after tax real interest rates, encouraging saving and capital accumulation among working age agents. Since a capital gains tax does not affect after tax interest rates, after tax returns are higher when the inflation component of interest is tax exempt than when a capital gains tax is introduced."[3]

A tax regime that increases household investment in financial assets is beneficial in helping our nation deal with an increasing aged population and concerns around inadequate self-provision for retirement. With current bank deposit rates being so low, investors realise negative after tax real returns from investing in such financial assets. They are unfairly taxed on compensation for inflation, which is not real income.

Introducing a tax regime that makes the inflation component of interest tax exempt is worthy of serious consideration as not only does this correct for current tax induced preferences for investing in real estate, but it also will help our country improve its savings rate.

Submission points

In light of the above I submit the following points:

[2] Pages 27-29, Coleman, Andrew, *"The long term effects of capital gains taxes in New Zealand,"* Motu Working Paper 09-13, August 2009.
[3] Page 16, Coleman, Andrew, *"The long term effects of capital gains taxes in New Zealand,"* Motu Working Paper 09-13, August 2009.

1. That the Tax Working Group commission comprehensive economic analysis of any prospective tax changes so that the likely effects on house prices, rent levels and household saving and investment behaviour is well understood;
2. That the Tax Working Group gives equal consideration to making the inflation component of interest tax exempt as it does to capital gains tax or other asset tax regimes;
3. That by making the inflation component of interest tax exempt, not only would the government be addressing perceived skewed incentives for households to over invest in property, but it would also be:
    a. providing a fairer method of taxing interest income (such as from bank deposits); and
    b. encouraging household retirement savings in financial assets.

It is acceptable for the Tax Working Group and the Secretariat to contact me to discuss the points raised, if required.

Yours sincerely,

[1]

John Redmayne