Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

February 2019

taxworkinggroup.govt.nz/key-documents

This paper has been prepared by the Secretariat to the Tax Working Group 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 whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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Coversheet: Extending the taxation of capital income in a supply-constrained housing market and phasing in implementation

Background Paper for Session 18 of the Tax Working Group
14 September 2018

Purpose of discussion

This paper discusses the impact on rents and house prices if there is an extension of capital income taxation when the supply of housing is constrained. This paper also discusses the use of phasing as a means to moderate the impact of additional taxation on housing.

Key points for discussion

- The Secretariat has reached the following judgements in this paper:
    - In a constrained market – where the supply of housing is likely to be relatively unresponsive to changes in demand – an extension of capital income taxation is likely to have *less* of an impact on rents than would otherwise be the case.
    - Phasing could be used an option to smooth the transition towards greater capital income taxation. The Secretariat judges that the benefits of phasing are likely to be outweighed by the costs, and recommends against the use of phasing.
    - The Secretariat also does not recommend a phasing approach to the introduction of different regimes. The Secretariat recommends instead that development of the consequential changes to taxing capital gains should proceed under the Generic Tax Policy Process, under the expectation that they would come into force at the same time as the broader change.
- Does the Group agree with these judgements?
- How does the Group wish to deal with these issues in the Final Report?

Extending the taxation of capital income in a supply-constrained housing market and phasing in implementation

Background Paper for Session 18
of the Tax Working Group

September 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

Executive summary

The Group has requested advice on the impact of extending the taxation of capital income in a supply-constrained housing market. The Group also asked for advice on the impacts of phasing in the introduction of additional capital income taxation.

Housing market impacts

If housing were solely rental housing and the supply of housing was completely constrained, the entire impact of extending the taxation of capital income would be on reducing house prices, rather than increasing rents. If any higher price were charged, supply would exceed demand.

If, on the other hand, the supply of rental housing was perfectly elastic (i.e. as soon as there was any new demand for housing units, they were built at current prevailing prices), in the longer run the entire impact of extending the taxation of capital income would be on increasing rents. There would be no additional supply of rental housing until rents had risen sufficiently to fully offset the impact of extending the taxation of capital income.

New Zealand's housing market looks more like the first situation – a constrained market with the impact more on price rather than rents.

A complicating factor is that by excluding owner-occupied housing, the impact on prices and rents is influenced by another factor: the extent to which owner-occupation is substitutable for renting. This means that even in the short-to medium run, a tax on capital gains could put some upward pressure on rents even if the market is constrained.

Phasing

Phasing in of this extension might be considered as a way of smoothing the transition.

Phasing in the extended tax on capital income is unlikely to have much impact on rent and price adjustments resulting from the tax unless the phasing occurred over an extremely lengthy period. Investors would look ahead to the impact of the fully-implemented tax when making judgements about prices and returns. Even if they made allowance for the impact of delayed implementation, that would make only a small difference.

The Secretariat does not consider that there is any need to consider deferring the implementation of other regimes supporting extending the taxation of capital income. These regimes could be developed alongside the general regime and decisions on delaying implementation could be made later if it appears necessary.

There are also other complexity, behavioural, and efficiency consequences to phasing which mean it is likely to be disadvantageous in practice.

Extending the taxation of capital income in a supply-constrained housing market and phasing in implementation

1. The Group has requested advice on the impact of extending the taxation of capital income in a supply-constrained housing market. The Group also asked for advice on the impacts of phasing in the introduction of additional capital income taxation.

Supply constrained housing market

2. The Productivity Commission (2017) has set out why housing markets in New Zealand are constrained[1]:

> New Zealand's current planning system is not well set up to deal with change. Processes for updating land-use rules are slow and uncertain. There is too much unnecessary, poorly-targeted regulation. Many councils have sought to manage or direct the evolution of cities in highly-detailed and prescriptive ways. Resistance to change from local residents and barriers to funding new infrastructure also inhibit a city's ability to grow and respond to change.
>
> The system's problems are rooted in both its design and implementation. Ambiguous and broad language in the Resource Management Act (RMA) has led to overly restrictive rules in urban areas, 'scope creep', and an under-emphasis on the built environment. The Act does not give prominence to urban issues, and it is difficult to set clear priorities for the natural environment. The lack of central government guidance has led to decisions that suit local interests, but which have negative wider impacts, such as rising land and housing prices.

3. The result of the above has meant that the supply of both developable land and new housing is relatively unresponsive to increases in demand (in the language of economics, the *price elasticity of supply* is low). Compared to more responsive supply, rents and house prices are higher than they would otherwise be.

4. The economic incidence of taxes depends on the relative responsiveness of the supply and demand of the taxed good or service to changes in price. Tax incidence falls mostly on the group that responds *least* to price.

5. In simple theoretical models, an extension of capital income taxation that is effected by taxing capital gains will affect the housing market by changing the ratio of rents to prices. Landlords require a higher rent-to-price ratio to compensate them for the additional tax. The Secretariat considers that there may be some upward pressure on the rent-to-price ratio and on rents as a result of taxing more capital gains, but this is likely to be slight even if there are no substantial offsets (such as restoring depreciation for multi-unit building or removing loss ring-fencing). The discussion below ignores any of these offsets.

6. Any upward pressure on the rent-to-price ratio is likely to be offset by the fact that taxing capital gains reduces the risks as well as rewards of investing in assets that

[1] Productivity Commission (2017), *Better Urban Planning,* https://www.productivity.govt.nz/sites/default/files/CTTC%20better%20urban%20planning%20final%20report%20v2.pdf

may appreciate and we have been unable to find evidence of upward pressure in the rent to price ratio for other countries that have introduced a tax on capital gains.

7. Nevertheless we consider the possibility of an increase in the hurdle rent-to-price-ratio[2] and the implications of a constrained market below. If housing were solely rental housing and the supply of housing was perfectly inelastic (i.e. completely constrained – no new housing at any price), the entire impact of extending the taxation of capital income would be on reducing price, rather than increasing rent. This is because the rental price would be determined by what tenants are willing to pay for the quantity of housing that is available. If any higher price were charged, supply would exceed demand.

8. If the supply of rental housing was perfectly elastic (i.e. as soon as there is any new demand for housing units, they are built at current prevailing prices), in the longer run the entire impact of extending the taxation of capital income would be on increasing rents, rather than reducing prices. This is because rental housing would no longer be constructed until landlords obtain the return after tax they demand. There would be no additional supply of rental housing until rents had risen sufficiently to fully offset the impact of extending the taxation of capital income. In the long run, the price of new housing to a landlord would be determined by the fixed cost of constructing new housing.

9. Given supply constraints, New Zealand's housing market looks more like the first situation – a constrained market with the impact more on price rather than rents.

10. A complicating factor that will moderate the position above is that by excluding owner-occupied housing, the impact on prices and rents is influenced by another factor: the extent to which owner-occupation is substitutable for renting. This means that even in the short-to medium run, a tax on capital gains could put some upward pressure on rents even if the market is constrained.

11. However, the fact that the market is constrained will still mean that taxing more capital gains is likely to have *less* of an impact on increasing rents and *more* of an impact on reducing property prices than would otherwise be the case. At the same time a constrained market can mean that the level of rents and of prices is higher than would be the case if there were less constrained supply.

Phasing in the impact of extending taxing capital income

12. Nonetheless, there is a question as to whether phasing in the introduction of additional capital income taxation could smooth the transition. Phasing is unlikely to have a large impact on any rent or price adjustments resulting from the tax unless the phasing is very gradual. Also there are also other complexity, behavioural, and efficiency consequences to phasing in the tax which are likely to be problematic.

[2] The ratio of the rent to the price required before a landlord will purchase the property and offer it for rent.

13. Phasing could be effected in two ways: (i) in terms of the amount of gains that are taxable; and/or (ii) in terms of the tax rate that would apply. Either of these approaches could have a similar impact on the taxpayer and the revenue, but phasing in the amount of gains would be a simpler approach, and would ensure the progressive tax scale continues to apply to capital gains as well as other income.

14. As an example, capital gains taxation could be phased in over three years by providing that 1/3 of gains would be taxable if an asset is sold in the first year after the tax is introduced, 2/3 of gains would be taxable if an asset is sold in the second year, and all of the gains would be taxable if an asset is sold in the third year or later.

Transitional rules already have an element of phase-in

15. We note that the transitional rule discussed by the Group – the valuation date – already has an element of phase-in. This is because a maximum of one year of appreciation would be taxed when an asset is sold in the first year, a maximum of two years' appreciation in the second year, and so on. The is reflected in the estimated revenues which show low revenues initially that increase over time. This ensures that the costs for taxpayers in terms of cash flow costs of the tax will be low in the early years, but could be higher in later years.

Phase-in would be unlikely to reduce price and return adjustments from the tax change very much unless the phase in is extremely gradual

16. Wider economic effects on prices and rates of return are unlikely to be materially affected by phase-in unless the phase in is extremely gradual. These impacts result from changes in taxpayer expectations. If the tax is enacted with a phase-in, investors are likely to change their behaviour in anticipation of the fully implemented tax. For example, if any phase in is over a small number of years, the impact on rents and house prices is likely to be almost the same whether the tax is implemented in full or is phased in.[3]

The phase-in period will distort taxpayer behaviour more than complete implementation

17. While empirical studies of lock-in have produced mixed results in how much lock-in results from a stable capital gains tax, the evidence is strong that changing the tax rate or base results in a substantial behavioural impact around the time of the change. For example, while the tax is being phased in, the reverse of the expected lock-in pattern would apply, with the sale of appreciating property being accelerated to take place before the next base increase, and the sale of depreciating property deferred until after the next base increase. This behavioural impact is likely to be inefficient and reduce revenues.

[3] An exception would be if taxpayers expect the transition will not be completed, with phase-in base reductions becoming permanent. This is related to political risk in implementation. It is also possible that during the phase-in there could be some small difference resulting from discounting the full impact of the tax change expected in the future, but this is not likely to be a large difference.

Phase-in will increase complexity and compliance costs

18. Although taxing capital gains will increase compliance costs overall, one of the compliance cost benefits is reducing the importance of the capital / revenue boundary and not having to apply some of the subjective rules to determine if something is held on capital account or revenue account. During phase-in, it would still be necessary for taxpayers to determine if something is held on capital account or revenue account because different portions of the gains would be taxable. It will also be necessary to determine this for properties sold at a loss, as more loss ring-fencing or a phase-in of limited loss deductions would be needed for capital losses during the phase-in period.

Phase-in increases political implementation risks

19. During the phase-in period, the merits of taxing capital gains would continue to be debated, and some would call for the phase-in to be stopped or made permanent on the basis that a concessionary rate or base treatment is common in other countries, and it helps deal with issues of lock-in and inflationary gains. (These matters were considered by the subgroup which is recommending that full rates and base should apply regardless).

Phasing in implementation of certain regimes

20. Another area of phase-in raised by the Group was in respect of changing particular regimes that may be consequential to taxing more capital gains, and require consultation and technical knowledge to develop. Livestock and managed funds (including KiwiSaver) were mentioned as areas where this could be relevant.

21. The Government announced that taxing capital gains will not take effect until after the next election, expected to be in 2020, and so the most likely effective date is 1 April 2021. This gives officials, using consultation under GTPP, time to work through the issues for complex regimes. It seems too early now to make recommendations now on whether any particular regime amendment should be deferred. The base legislation could still be introduced in Parliament next year while secondary regime-specific issues are still being worked on under GTPP.

22. If it does appear to be the case that outstanding issues for some regimes could not be resolved by 1 April 2021, then a decision could be made at that time on how to proceed. For example, if a regime, such as livestock, could potentially operate as currently without impacting a wider regime for taxing capital gains, perhaps that could be implemented later. If a regime is more integral to the whole system, such as taxing the gains on shares held by a managed fund, then it may be necessary to defer the entire wider change until this could be resolved.

23. At this stage, however, it is too early to determine this. The Secretariat recommends that development of the consequential changes to taxing capital gains should proceed under GTPP with the expectation that they would come into force at the same time as the broader change.