



*Tax Working Group*  
*Te Awheawhe Tāke*

**Tax Working Group Information Release**

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

# Coversheet: Potential revenue-neutral packages

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*Position Paper for Session 21 of the Tax Working Group  
26 October 2018*

## Purpose of discussion

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Decide at a high level what measures to recommend in the Final Report as part of a revenue-neutral package.

## Key points for discussion

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1. The revenue from taxing more capital gains builds up slowly.
2. As a result of this, there are trade-offs in what measures can be recommended for a revenue-neutral package over the short-medium term.
3. Measures can be traded off by either not implementing some measures, or by deferring the application date of some measures (so they apply when there is greater revenue from taxing more capital gains). The Group can also recommend multiple packages that the Government could choose from depending on their priorities.
4. Any tax package should be cohesive. Many of the measures the Group are considering are complementary with taxing more capital gains and can mitigate some of the potential negative impacts.

## Recommended actions

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We recommend that you:

- a Note that the Secretariat's preliminary revenue forecast from taxing more capital gains provides \$10.5 billion of revenue over 5 years.
- b Note that this revenue forecast is preliminary. The Secretariat intends to do further quality assurance of the model and will update it following further design decisions from the Group.
- c Note that because of the slow build up of revenue there are trade-offs in what measures can be included in a revenue neutral package.
- d Note that these trade-offs can be managed by not recommending some measures or deferring the application date of some measures. The Group could also recommend multiple packages that the Government could choose from depending on their priorities.

- e Agree at a high level which of the following measures to include in a revenue negative package:
  - i. Remove ESCT on employer's matching contribution of 3% of the salary to KiwiSaver for members earning up to \$48,000 per year (already agreed to by Group)
  - ii. Reduce lower PIE rates by five percentage points for KiwiSaver (already agreed to by Group)
  - iii. Restore depreciation on commercial, industrial and multi-unit residential buildings
  - iv. Expand "black hole" expense deductibility
  - v. Remove rental loss ring-fencing restrictions
  - vi. Reduce restrictions on loss carry-forwards when a company is sold
  - vii. Income tax reductions
  
- f Note that the Group is also considering options regarding seismic strengthening and compliance cost savings that are revenue negative.
  
- g Note that the revenue forecast is uncertain and that actual revenue from taxing capital gains is likely to be volatile.
  
- h Agree that the final report comment on the uncertainty and volatility of revenue from taxing more capital gains and recommends that the Government take appropriate fiscal management and be flexible regarding revenue negative measures in case revenue is less than forecast.

# Potential revenue-neutral packages

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*Position Paper for Session 21  
of the Tax Working Group*

October 2018

*Prepared by the Inland Revenue Department and the New Zealand Treasury*



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## Executive Summary

This paper seeks high-level decisions from the Group on what package of measures to recommend in the Final Report.

The Minister of Finance and Minister of Revenue requested the Group recommend measures that could result in a revenue neutral package. We have written this paper on the basis that revenue from taxing more capital gains is used to fund a complementary package of revenue negative measures.

We are interpreting revenue neutral to mean that revenue gains match revenue costs when added up over a five-year period. There are alternative ways of interpreting revenue neutral that the Group may want to consider. The Group may wish to consider how their proposals would affect New Zealand over a longer period consistent with the Terms of Reference.

Based on updated Secretariat modelling the forecast revenue from taxing more capital gains builds up slowly and brings an estimated \$10.5b of revenue over the first five years following introduction. In contrast, many of the measures the Group are considering have immediate fiscal costs. As a result, the Group will need to prioritise their objectives.

These trade-offs could be managed by:

- Prioritising some objectives over others. The Group could prioritise a package focusing on
  - social capital, fairness and distributional objectives; or
  - financial and physical capital through business tax measures, housing affordability, savings, or some combination of these; or
  - a combination of these.
- The Group could prioritise objectives through either implementing some measures but not others, or through deferring the application date of some measures or phasing them in.
- The Group also has the option to recommend different packages that the Government could choose from depending on the Government's objectives.

Any package of measures should be cohesive when considered alongside taxing more capital gains. Different measures can mitigate some of the negative effects of taxing more capital gains or strengthen some of its advantages.

In particular, taxing more capital gains by itself could have negative implications for New Zealand's overall efficiency and long-term productivity. This is because while taxing more capital gains would likely improve the allocation of investments it would also increase the total tax cost of investment, create compliance costs and lock-in effects. As a result, the total effect on efficiency and the long-term productivity for New Zealand of taxing more capital gains is unclear.

The Secretariat consider it important that an overall package of measures mitigate the negative impacts of taxing more capital gains.

We have prepared three illustrative packages for discussion purposes.

Natural capital is not the focus of the packages presented here, and we have scoped the packages in this paper as revenue neutral excluding environmental tax measures. This is because the Group has already agreed to recommend a package of measures to support natural capital through expanding the use of environmental taxes and recycling revenue from these to support natural capital initiatives and provide for just transitions. The Group has also agreed to new tax concessions to support natural capital. The environmental tax package may or may not be revenue neutral, depending on how environmental tax revenue is recycled.

	<i>Social capital</i>	<i>Human capital</i>	<i>Financial/physical capital</i>		
	<i>Progressivity and reducing inequality</i>	<i>Work incentives and incentives to build human capital</i>	<i>Efficiency and productivity</i>	<i>Housing affordability</i>	<i>Effect on private savings</i>
<b><i>Package 1 – implement all measures at 1 April 2021, income tax reductions of \$1.3 billion per annum</i></b>	<p>Taxing more capital gains is likely to increase vertical equity. This may make it better achieve the Government’s vertical equity goals over the status quo. Moderate income tax reductions targeted at lower income households will also be progressive.</p>	<p>Income tax reductions can increase incentives to enter job market.</p>	<p>Positive efficiency impacts of business tax measures could provide a significant offset to potential negative economic effects of taxing more capital gains (which depend on design of taxing more capital gains)</p>	<p>Depreciation deductions and removal of loss ring-fencing likely to mitigate effects of taxing more capital gains. Income tax reductions can moderate any impact on renters.</p>	<p>Taxing more capital gains will increase taxes on savings for higher income earners. For lower income earners the effect of savings concessions outweighs the effect of taxing more capital gains.</p>
<b><i>Package 2 – implement savings measures and income tax reductions of \$1.85 billion per annum at 1 April 2021</i></b>	<p>This is likely to be the most progressive package.</p>	<p>Income tax reductions can increase incentives to enter job market.</p>	<p>The personal tax cuts are likely to have a smaller efficiency benefit than business tax measures. With no other offsetting efficiency-enhancing tax changes, this package does less to mitigate the negative economic effects.</p>	<p>Taxing more capital gains could potentially increase rent and decrease house prices. This package does not have positive housing supply tax changes, but it has greater scope for tax cuts to support those on lower incomes.</p>	<p>Taxing more capital gains will increase taxes on savings for higher income earners. Both savings concessions and income tax reductions will reduce the tax rate on savings for low-income households.</p>
<b><i>Package 3 – Implement all measures with income tax reductions of \$1.5 billion per annum. Income tax reductions and savings measures implemented at 1 April 2021, business tax measures implemented at 1 April 2023</i></b>	<p>Taxing more capital gains is likely to increase vertical equity. This may make it better achieve the Government’s vertical equity goals over the status quo. Moderate income tax reductions targeted at lower income households will also be progressive.</p>	<p>Income tax reductions can increase incentives to enter job market.</p>	<p>This package has an intermediate amount of offsetting efficiency enhancing measures to offset potential negative economic effects of taxing more capital gains (which depend on design of taxing more capital gains)</p>	<p>Intermediate effects between Package 1 and 2.</p>	<p>Taxing more capital gains will increase taxes on savings for higher income earners. For lower income earners the effect of savings concessions outweighs the effect of taxing more capital gains</p>

# 1. Introduction

## **Purpose**

1. This paper seeks high-level decisions from the Group on what package of measures to recommend in the Final Report.
2. We have written this paper on the basis that revenue from taxing more capital gains is used to fund a complementary package of revenue negative measures.
3. The Group has another session on 22 November to make final decisions on the detail of any package. The Secretariat will provide updated revenue estimates of taxing more capital gains for this meeting that refine the estimates and take into account further decisions from the Group.
4. This paper provides additional information on the effects of taxing more capital gains alongside other potential measures that could form a revenue-neutral package. This is to help support the Group in making an overall cohesive package and to comment on the uncertainty and expected volatility of revenue from taxing more capital gains.

## **Content and scope**

5. Part 2 of this paper provides updated modelling of the anticipated revenue from taxing more capital gains.
6. Part 3 provides additional information on the overall distributional, efficiency, and housing market impacts of taxing more capital gains alongside other revenue negative measures.
7. Part 4 provides a summary of a range of illustrative revenue-neutral packages using the forecast revenue from taxing more capital gains.
8. Part 5 provides further information on the fiscal effect of taxing more capital gains.
9. Some of the information provided in these papers, in particular the fiscal impacts, are still undergoing quality assurance. As a result, the results should be considered indicative and for the purposes of discussion.

## 2. Forecast revenue

### Forecast revenue from taxing more capital gains

10. An updated forecast of the revenue from taxing more capital gains is below. The modelling for this forecast updates that previously provided to improve the methodology and correct an error identified with the previous estimate<sup>1</sup>.
11. We have also updated the modelling to include assumed behavioural change from taxing more capital gains through a lock-in effect. We have modelled this through assuming that the turnover rate decreases by 20% for all assets because of taxing more capital gains<sup>2</sup>. We are working to source further information to refine this assumption.
12. We have incorporated rollover relief for inheritances, relationship property settlements and insurance proceeds in the forecast revenue. We have done this by assuming that approximately 8% of land transactions and 5% of share transactions on average are subject to these rollover relief provisions<sup>3</sup>. The forecast below does not incorporate design decisions such as a small business de minimis or alternative tax treatments of managed funds as these are still to be decided.

(\$b)	1	2	3	4	5	6	7	8	9	10
Residential investment	0.17	0.44	0.70	0.94	1.18	1.41	1.64	1.86	2.09	2.32
Commercial, industrial and other property	0.14	0.35	0.55	0.75	0.94	1.13	1.32	1.51	1.69	1.88
Rural property	0.09	0.22	0.34	0.46	0.56	0.67	0.76	0.85	0.94	1.02
Shares	0.17	0.41	0.60	0.76	0.89	1.00	1.10	1.18	1.25	1.32
<i>Total</i>	<i>0.57</i>	<i>1.42</i>	<i>2.19</i>	<i>2.90</i>	<i>3.57</i>	<i>4.21</i>	<i>4.81</i>	<i>5.40</i>	<i>5.97</i>	<i>6.54</i>

13. The remainder of this paper uses this forecast revenue to analyse potential revenue neutral packages. However, the actual revenue from taxing capital gains is uncertain and dependent on design features. The Secretariat intends to provide updated estimates to:
- incorporate further design decisions by the Group<sup>4</sup>;
  - update asset values to the latest available figures;

<sup>1</sup> The turnover rate for shares has also been decreased to reflect better data sourced by the Secretariat.

<sup>2</sup> The 20% figure is a rough assumption made until better information is available to the Secretariat.

<sup>3</sup> Based on an estimate by the Secretariat of the value of inheritances, relationship property settlements and insurance.

<sup>4</sup> The forecast revenue provided for shares include estimated revenue from taxing shares held by PIEs on realisation. The Secretariat will update the revenue estimate following decisions by the Group regarding taxing managed funds. The estimate does not include the impact of a de minimis or small business concession.

- obtain further information to inform assumptions such as the effect of rollover relief and lock-in; and
- incorporate any further changes arising from further independent quality assurance being sought by the Secretariat.

### Forecast revenue from applying fair rate of return method

14. Information on the fiscal impact of the application of the fair rate of return (FRR) method to residential property was provided in the previous Secretariat paper (*Risk-free return method of taxation*), including the assumptions and caveats for the modelling. The Group requested forecast revenue that excluded baches. This is below. An FRR with a 3.5% rate provides more revenue over the first 5 years than taxing more capital gains. However, taxing more capital gains provides more revenue in subsequent years.

Fiscal year (\$m)	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31
3.5% risk-free rate	877	884	1,017	1,100	1,191	1,292	1,392	1,502	1,611	1,739
1.7% risk-free rate	77	44	127	160	192	224	264	313	352	400

15. For ease of analysis, the remainder of this paper focuses on packages utilising revenue from taxing more capital gains.

### 3. Potential effects of packages

16. The purpose of this chapter is to provide a summary on the potential distributional, efficiency, and housing market impacts of taxing more capital gains and the impact of potential revenue negative measures alongside them.
17. The Secretariat has previously provided advice on the broad economic and fiscal effects of taxing more capital gains (*Potential high-level effects of proposals to extend the taxation of capital income*) and the potential distributional impacts of taxing more capital gains (*Distributional analysis and incidence*). This advice indicated that taxing more capital gains could broadly be expected to have the following impacts:
  - *Progressivity and inequality*: Taxing more capital gains is likely to be progressive and reduce inequality. However, as with any tax change some of the economic incidence may fall on those who are not legally liable to pay the tax. Some elements may be passed on to other people, for example it could result in higher rents
  - *Efficiency and investment*: Taxing more capital gains would likely improve the allocation of investments, but it would also increase the total tax cost of investment, create compliance costs, and lock-in effects. As a result, the total effect on efficiency and productivity is unclear.
  - *Housing markets*: The Secretariat's view is that taxing more capital gains may decrease the price-rent ratio. However, we expect the impact of this to be modest. In the Secretariat's view the evidence strongly suggests that tax changes are unlikely to substantially affect the housing market and that other factors in the housing market can outweigh the impact of tax changes.
18. Taxing more capital gains has other important longer-term benefits that we do not discuss in this chapter. One is that taxing gains on shares would shore up the tax system so that companies cannot be used easily to shelter income from higher rates of personal tax.
19. Officials have in the past consistently opposed reductions in the company tax rate or increases in higher personal tax rates in part because of the additional integrity pressures these tax changes would generate in the absence of any tax on capital gains. This position may be increasingly difficult to sustain if other countries continue to cut their company tax rate or future governments wish to raise higher rates of personal tax. Taxing more capital gains can help with the longer-term sustainability of the tax system and give future governments greater scope to vary these tax rates.
20. The overall effect of packages will depend on the economic effects of taxing more capital gains alongside the impact of revenue negative measures. This chapter provides further information on these with detail provided in appendices.

### **Progressivity and inequality (Social capital)**

21. Higher income and net worth deciles would pay most of the cost of taxing more capital gains. As a result, taxing more capital gains would likely be highly progressive and reduce inequality in New Zealand.
22. There is the possibility that taxing more capital gains could put some modest upward pressure on rents. However, the Secretariat has found no strong evidence of taxes on capital gains resulting in significant increases in rents and so we do not believe that this risk is significant. Any potential increase in rents would disproportionately affect low-income households.

#### ***How package measures could affect this***

23. Income tax reductions targeted at lower income households and the savings measures recommended by the Group would be progressive and result in a greater inequality-reducing package of measures. Income tax reductions may encourage people to re-enter the workforce. However, the extent of this depends on the design of income tax reductions.
24. Any upward pressure on rents could also be mitigated through changes to encourage more investment in housing such as allowing depreciation on multi-unit residential properties and removing rental loss ring-fencing.

### **Savings (Financial and physical capital, social capital)**

25. Taxing more capital gains is likely to make the tax treatment of different forms of financial and physical capital more neutral. However, taxing more capital gains will also increase the amount of tax on savings.

#### ***How package measures could affect this***

26. The Group has recommended changes to reduce the tax on savings targeted at lower income households. Overall, the combined effect of taxing more capital gains alongside these savings changes will reduce the overall tax on savings for low-income households. Taxing more capital gains would impose tax of approximately \$15 million per annum across KiwiSaver members with annual income of less than \$48,000 while these measures would reduce tax by about \$215 million per annum for KiwiSaver members earning less than \$48,000 per year.
27. In addition, any income tax reductions on lower income earners will reduce the tax rate on their savings. This would further reduce any combined impact on the tax rate on savings for low-income households.

### **Efficiency and productivity (Financial and physical capital)**

28. The impacts of taxing more capital gains on efficiency are complex and difficult to measure. However, broadly taxing more capital gains, by itself, would likely:

- decrease the total level of investment as it increases the effective tax rate on investment;
  - improve the allocation of investments, as a tax preference for certain investments is removed; and
  - create inefficiencies through lock-in.
29. It is difficult to know what the overall impacts of this will be. These impacts will depend on design decisions regarding taxing more capital gains.

***How package measures could affect this***

30. The overall effect on efficiency and productivity of taxing more capital gains depends on the design of taxing more capital gains and what the revenue generated from taxing these capital gains is used for. The Secretariat considers that if the business tax measures being considered by the Group were implemented alongside taxing more capital gains, this is likely to provide a significant offset to the negative impact of taxing more capital gains. The overall impact of the package will depend sensitively on the final design details of taxing more capital gains, which have not yet been made.
31. Several measures that the Group are considering for a package are complementary with taxing more capital gains because they allow deductions for capital losses when capital gains are taxed, or because the risks associated with the measure are reduced when more capital gains are taxed. These include:
- ***Black-hole expenditure:*** Allowing deductions for black-hole expenditure allows deductions for capital losses when capital gains are taxed.
  - ***Residential loss ring-fencing:*** The rationale for ring-fencing losses for residential property is reduced when all of the gains from residential property are taxed (although on a realisation basis so there is a timing advantage).
  - ***Depreciation on buildings:*** Taxing more capital gains means any depreciation on buildings would be deductible on sale. Allowing depreciation on these buildings allows taxpayers to deduct the costs as they accrue.
32. The accompanying paper *Expenditure* considers these issues more fully. Appendix A of this report also contains further information on tax neutrality. The appendix shows that there is a substantial body of literature suggesting the importance of tax neutrality in promoting economic efficiency and productivity.

**Housing market impacts (Financial and physical capital)**

33. The Secretariat previously provided information on housing market impacts of taxing more capital gains. This advice showed that the standard theoretical expectation from simple economic models that ignore risk and uncertainty is that taxing more capital gains would reduce house prices, increase rents, and increase home ownership. However, there are a number of reasons to be cautious with this theoretical expectation:
- there are a range of different results arising from different economic models;
  - taxing more capital gains (and allowing losses) may not have a large impacts on rents as it reduces investors' risk; and

- the empirical evidence available (although limited) does not suggest that taxing capital gains is associated with markedly different house price or rent developments.
34. The Secretariat has not been able to find international evidence that taxing capital gains leads to large impacts on rents or house prices. We have reported to the Group on this earlier. Since then, the Secretariat has undertaken further analysis using econometric modelling of the housing market impact of capital gains taxes implemented overseas. Again, we have been unable to find evidence of strong rent or house price impacts of taxing more capital gains internationally through this econometric modelling. Appendix A contains further information on this modelling.
35. The Secretariat accepts that taxing more capital gains may put upward pressure on rents and downward pressure on house prices. However, we expect these effects to be modest.

***How package measures could affect this***

36. Other package measures could help mitigate any effects on rents.
37. Restoring depreciation for multi-unit residential accommodation as well as removing residential loss ring fencing could reduce any potentially negative housing market impacts through increasing housing supply. Income tax reductions may mitigate any effect that rent increases could have on low-income households. Transfers could also play a role in helping these households such as increasing the Accommodation Supplement.
38. In addition, the total impact of taxing more capital gains will depend on what other measures the Government undertake alongside taxing more capital gains. The Government has a number of policy initiatives with the goal of increasing housing supply. These initiatives could outweigh the impact of any tax changes on housing affordability.

#### 4. Potential revenue-neutral tax packages

39. The Minister of Finance and Minister of Revenue requested the Group recommend measures that could result in a revenue-neutral package.
40. For this paper, we have interpreted revenue neutral to mean that over a five-year period the total revenue from taxing more capital gains must equal the revenue loss from other measures. Based on the fiscal estimate provided in chapter 2 there is approximately \$10.5 billion of revenue over five years from taxing more capital gains to finance revenue negative measures.
41. Beyond this five-year period, the revenue from taxing more capital gains continues to build up and a package using this definition will be strongly revenue positive from the sixth year onwards. This build-up of revenue means that the full fiscal benefits of the tax will not be evident if we constrain ourselves to looking at a 5-year window.
42. In addition, the Group in its terms of reference was asked to consider how best to improve the tax system over the long-term considering the economic environment over the next 5-10 years. As a result, even when considering a revenue neutral package over a shorter period, the Group may want to consider the impact of their recommendations over a longer period.
43. In principle, revenue neutrality might best be defined taking account of the full present value of expected future taxes. An intermediate alternative definition of revenue neutral would be that annual revenue costs need to match annual revenue gains in the fifth year. Based on the fiscal estimate provided in the previous chapter this would enable revenue negative measures with an approximate annual cost of \$3.5 billion a year (or \$17.5 billion over five years).
44. Natural capital is not the focus of the packages presented here, and we have scoped the packages in this paper as revenue neutral excluding environmental tax measures. This is because the Group has already agreed to recommend a package of measures to support natural capital through expanding the use of environmental taxes and recycling revenue from these to support natural capital initiatives and provide for just transitions. The Group has also agreed to new tax concessions to support natural capital. The environmental tax package may or may not be revenue neutral, depending on how environmental tax revenue is recycled.
45. The interim report outlined that the Group is considering the following revenue negative measures that could form part of a revenue-neutral tax package.

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<i>Item</i>	<i>Key benefit</i>	<i>Approximate annual fiscal cost (first year)</i>	<i>Approximate cost over 5 years<sup>5</sup></i>
Remove ESCT on employer’s matching contribution of 3% of the salary to KiwiSaver for members earning up to \$48,000 per year	Provide support to low-income savers	\$180 million	\$955 million
Reduce lower PIE rates by five percentage points for KiwiSaver funds	Provide support to low-income savers	\$35 million	\$185 million
Restore building depreciation on commercial, industrial and multi-unit residential buildings  <i>Fiscal costs in this table are with a 1% diminishing value depreciation rate.</i>	Increase neutrality of investment by reducing tax cost of investing in buildings and building-owning businesses. Would promote supply of multi-unit rental accommodation	<i>Commercial</i> \$180 million <i>Industrial</i> \$85 million <i>Multi-unit residential</i> \$30 million	<i>Commercial</i> \$765 million <i>Industrial</i> \$355 million <i>Multi-unit residential</i> \$150 million
Expand “black hole” expenses deductibility <i>Fiscal costs in this table are with a five year spreading of expenses.</i>	Increase neutrality of investment by improving incentives for innovation and risk-taking	\$10 million	\$120 million
Removing rental loss ring-fencing restrictions	Reduce upward pressure on rents, and encourage more investment in rental housing	\$200 million <sup>6</sup>	\$1 billion
Reduce restrictions on loss carry-forwards when a company is sold	Improve incentives for innovation and risk-taking	\$45 million <sup>7</sup>	\$240 million
<i>Total fiscal cost excluding income tax reductions</i>		\$750 million	\$3.8 billion
Income tax reductions (in particular targeted at lower incomes)	Support those on lower incomes. Depending on design can result in modest improvements in incentives to work and save	Depends on level of income tax reduction	

46. The Secretariat has also provided a paper outlining options for allowing deductions for seismic strengthening (*Expenditure*). The options for this have fiscal costs ranging from \$63 million to \$650 million over five years. The Group is also considering compliance cost savings measures that have fiscal costs. The packages considered in this paper do not include all these options because the Group has not yet considered them.

47. When looking at revenue-neutral package over 10 years the projected revenue from taxing more capital gains would provide funds all of these measures in addition to approximately \$3 billion of income tax reductions (per annum). However, in early years after introduction, the amount of revenue provided by taxing more capital gains

<sup>5</sup> We have costed many of the measures on the assumption that the cost of the measure increases by 3% per annum.

<sup>6</sup> We have calculated the fiscal cost for removing rental loss ring-fencing on basis that it is forecast to raise \$200m a year, and removing it would likely cost \$200 million. However, we plan to review this and so this fiscal cost should be considered preliminary.

<sup>7</sup> The \$45 million fiscal cost is based on using a same or similar business test. The Group previously considered that a more tightly defined test should be used for this which would have a lower fiscal cost.

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is more limited. As a result, the Group will need to prioritise their objectives and the measures to support these objectives.

48. These trade-offs could be managed by:

- Prioritising some options over others. The Group could prioritise a package focusing on distributional objectives, business tax and productivity, housing affordability, savings, or some combination of these.
- The Group could prioritise objectives through either implementing some measures but not others, or through deferring the application date of some measures or phasing them in
- The Group also has the option to recommend different packages that the Government could choose from depending on the Government's objectives.

### Potential packages

49. The tables below outline three potential packages for discussion purposes. The key difference between the illustrative packages is how much revenue is allocated towards income tax reductions and how much is allocated towards business tax measures. The packages therefore reflect different potential prioritisations from the Group between progressivity and efficiency focused measures.

#### *Illustrative package 1 –financial/physical capital, business tax focus<sup>8</sup>*

50. Under this package, all of the measures are implemented in full at 1 April 2021 with income tax reductions having a fiscal cost of approximately \$1.3 billion per annum<sup>9</sup>.

<i>Measure</i>	<i>Total cost over 5 years</i>
Removing ESCT on employer's matching contribution to KiwiSaver for those earning less than \$48k	\$955 million
Reduce the lower PIE rates for KiwiSaver funds by five percentage points	\$185 million
Reinstating depreciation on industrial buildings (1% rate)	\$355 million
Reinstating depreciation on commercial buildings (1% rate)	\$765 million
Reinstating depreciation on multi-unit residential buildings (1% rate)	\$150 million
Enabling deductions for black-hole expenditure	\$120 million
Loss continuity	\$240 million
Removing rental loss ring-fencing	\$1 billion
Income tax reductions	\$6.5 billion

<sup>8</sup> Some of the fiscal estimates are on the assumption that the cost of the measure increases by 3% per annum. The fiscal cost of depreciation declines over time as capital losses are already built into the fiscal estimate of taxing more capital gains.

<sup>9</sup> The annual fiscal costs for income tax reductions are indicative. They have been calculated by taking the five year cost and dividing by five. The actual cost of any single tax reduction is likely to increase over time as the population and incomes increase.

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<b>Total</b>	<b>\$10.3 billion</b>
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51. Over a ten year period, a similar revenue neutral package would enable income tax reductions totalling \$3 billion per annum rather than \$1.3 billion per annum.

***Illustrative package 2 – social capital /human capital, distributional and savings focus***

52. This option implements solely the savings tax measures and income tax reductions. The implementation date for both measures is 1 April 2021. Income tax reductions total approximately \$1.85 billion per annum.

<b>Measure</b>	<b>Total cost over 5 years</b>
Removing ESCT on employer's matching contribution to KiwiSaver for those earning less than \$48k	\$955 million
Reduce the lower PIE rates for KiwiSaver funds by five percentage points	\$185 million
Income tax reductions	\$9.25 billion
<b>Total</b>	<b>\$10.4 billion</b>

53. Over a ten year period, a similar revenue neutral package would enable income tax reductions totalling \$3.5 billion per annum rather than \$1.85 billion per annum.

***Illustrative package 3 – social capital, human capital, financial and physical capital balance***

54. This option implements all of the measures. However, all of the business tax measures are deferred so they apply from 1 April 2023. Income tax reductions total approximately \$1.5 billion per annum (from 1 April 2021).

<b>Measure</b>	<b>Total cost over 5 years</b>
Removing ESCT on employer's matching contribution to KiwiSaver for those earning less than \$48k <i>Applying from 2021</i>	\$955 million
Reduce the lower PIE rates for KiwiSaver funds by five percentage points <i>Applying from 2021</i>	\$185 million
Reinstating depreciation on industrial buildings (1% rate) <i>Applying from 2023</i>	\$260 million
Reinstating depreciation on commercial buildings (1% rate) <i>Applying from 2023</i>	\$545 million
Reinstating depreciation on multi-unit residential buildings (1% rate) <i>Applying from 2023</i>	\$105 million
Enabling deductions for black-hole expenditure <i>Applying from 2023</i>	\$50 million
Loss continuity <i>Applying from 2023</i>	\$150 million
Removing rental loss ring-fencing	\$625 million

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<i>Applying from 2023</i>	
Income tax reductions <i>Applying from 2021</i>	\$7.5 billion
<b>Total</b>	<b>\$10.4 billion</b>

55. Over a ten year period, a similar revenue neutral package would enable income tax reductions totalling \$3 billion per annum rather than \$1.3 billion per annum.

**Effects of different packages**

56. Any package of measures should be cohesive and revenue negative measures should be complementary alongside taxing more capital gains. Some of the measures the Group are considering can further support the benefits or mitigate the potential downsides of taxing more capital gains.

57. The table below provides a brief comparison of the different impacts of packages when considered alongside taxing more capital gains. We have used simplified analysis of impacts in the table for comparison purposes.

	<i>Social capital</i>	<i>Human capital</i>	<i>Financial/physical capital</i>		
	<i>Progressivity and reducing inequality</i>	<i>Work incentives and incentives to build human capital</i>	<i>Efficiency and productivity</i>	<i>Housing affordability</i>	<i>Effect on private savings</i>
<b>Package 1 – implement all measures at 1 April 2021, income tax reductions of \$1.3 billion per annum</b>	Taxing more capital gains is likely to increase vertical equity. This may make it better achieve the Government’s vertical equity goals over the status quo. Moderate income tax reductions targeted at lower income households will also be progressive.	Income tax reductions can increase incentives to enter job market.	Positive efficiency impacts of business tax measures could provide a significant offset to potential negative economic effects of taxing more capital gains (which depend on design of taxing more capital gains)	Depreciation deductions and removal of loss ring-fencing likely to mitigate effects of taxing more capital gains. Income tax reductions can moderate any impact on renters.	Taxing more capital gains will increase taxes on savings for higher income earners. For lower income earners the effect of savings concessions outweighs the effect of taxing more capital gains.
<b>Package 2 – implement savings measures and income tax reductions of \$1.85 billion per annum at 1 April 2021</b>	This is likely to be the most progressive package.	Income tax reductions can increase incentives to enter job market.	The personal tax cuts are likely to have a smaller efficiency benefit than business tax measures. With no other offsetting efficiency-enhancing tax changes, this package does less to mitigate the negative economic effects.	Taxing more capital gains could potentially increase rent and decrease house prices. This package does not have positive housing supply tax changes, but it has greater scope for tax cuts to support those on lower incomes.	Taxing more capital gains will increase taxes on savings for higher income earners. Both savings concessions and income tax reductions will reduce the tax rate on savings for low-income households.
<b>Package 3 – Implement all measures with income tax reductions of \$1.5 billion per annum. Income tax reductions and savings measures implemented at 1 April 2021, business tax measures implemented at 1 April 2023</b>	Taxing more capital gains is likely to increase vertical equity. This may make it better achieve the Government’s vertical equity goals over the status quo. Moderate income tax reductions targeted at lower income households will also be progressive.	Income tax reductions can increase incentives to enter job market.	This package has an intermediate amount of offsetting efficiency enhancing measures to offset potential negative economic effects of taxing more capital gains (which depend on design of taxing more capital gains)	Intermediate effects between Package 1 and 2.	Taxing more capital gains will increase taxes on savings for higher income earners. For lower income earners the effect of savings concessions outweighs the effect of taxing more capital gains

*Secretariat recommendations*

58. Taxing more capital gains, by itself, is likely to be highly progressive. However, taxing more capital gains has risks for the efficiency and productivity of the New Zealand economy. These risks mean that it is unclear whether taxing more capital gains by itself would overall improve the efficiency and long-term productivity of the New Zealand economy.
59. The Secretariat considers it important that some of the potential negative impact of taxing more capital gains are offset by some efficiency enhancing measures. This can be done through the business tax options outlined in packages 1 and 3. Both packages would mitigate potential negative impacts of taxing more capital gains, while being progressive and provide revenue to enable income tax reductions. However, final conclusions on the overall effect on productivity and efficiency of a package would depend on the final design of taxing more capital gains.

*What business tax measures are highest priority?*

60. Within the business tax measures, we consider the measure likely to have the greatest benefit relative to fiscal cost to be reintroducing building depreciation. This is because building depreciation has the most potential to result in greater tax neutrality. Greater tax neutrality is likely to be the most efficiency enhancing measure available for New Zealand's tax system and most consistent with horizontal equity. In addition, enabling building depreciation would also help address issues with seismic strengthening and would likely help with improving housing supply.
61. Following building depreciation, the Secretariat considers removing residential loss ring-fencing is likely to be the next measure with the highest value for fiscal cost. This is because this measure also helps improve tax neutrality, the justification for the loss ring-fencing is reduced when the gains on residential housing are taxed, and the measure could have potential benefits for improving housing supply. Beyond these, we consider that black hole and loss continuity are likely to be the next most important measures.

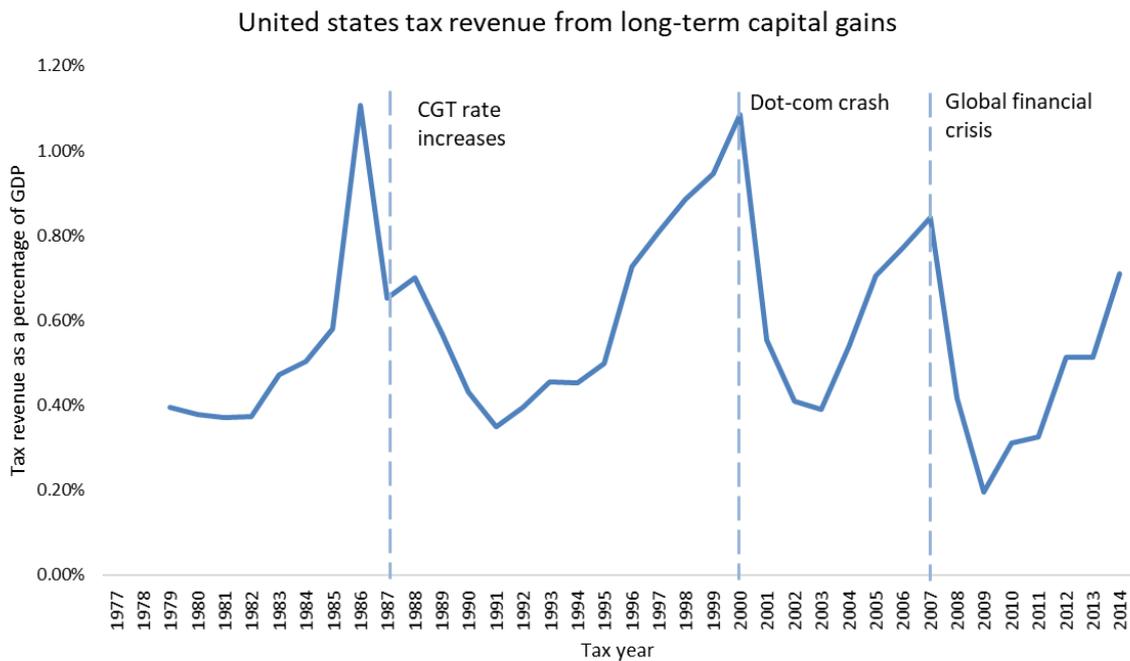
## 5. Revenue volatility and uncertainty

### Further information on revenue uncertainty

62. The forecast revenue from taxing more capital gains outlined in Part 2 of this paper is based on a number of assumptions (outlined in Appendix B). The actual revenue from taxing more capital gains is likely to be uncertain.
63. In the final report, the Secretariat would recommend that the Group suggest that the Government consider this uncertainty when implementing any revenue-neutral package. The Government may need to change a package to accommodate any reduction in revenue if actual conditions are different to those assumed in the forecasts.

### Further information on revenue volatility

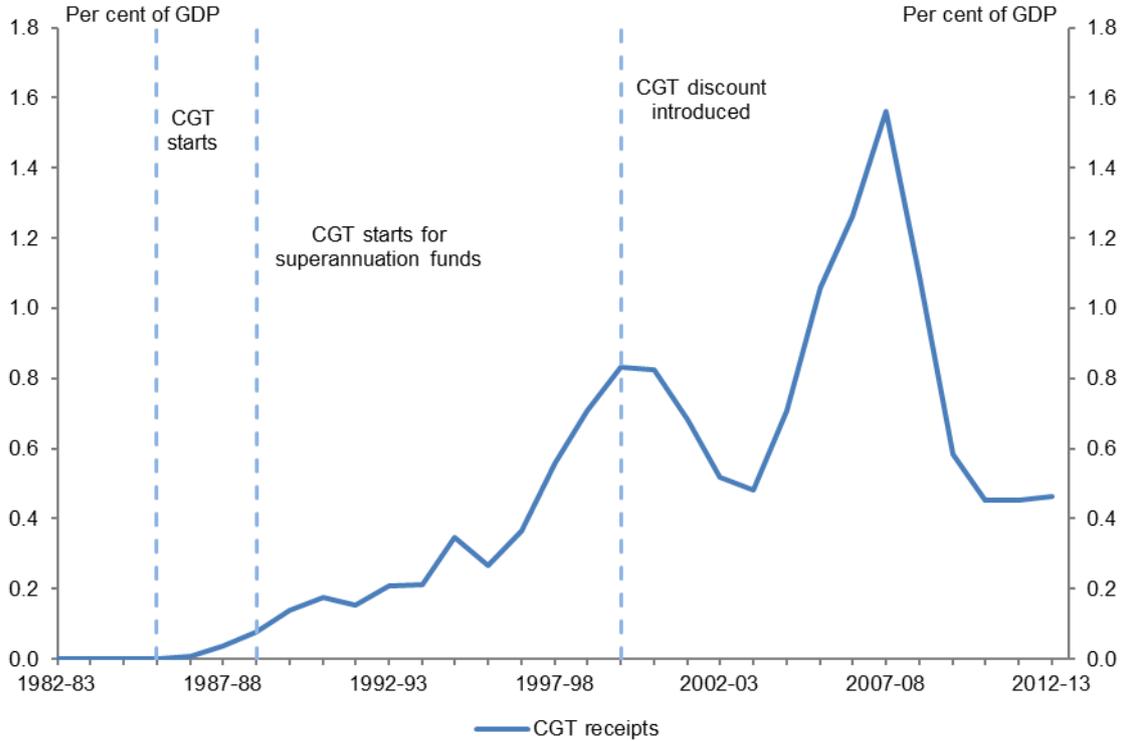
64. The revenue from taxing more capital gains is also likely to be volatile. For example, revenue from the capital gains tax on long-term capital gains in the United States has historically been highly volatile.



U.S. Department of the Treasury, Office of Tax Analysis

65. Revenue from Australia’s capital gains tax has also been volatile.

**Australia CGT receipts as a proportion of GDP**

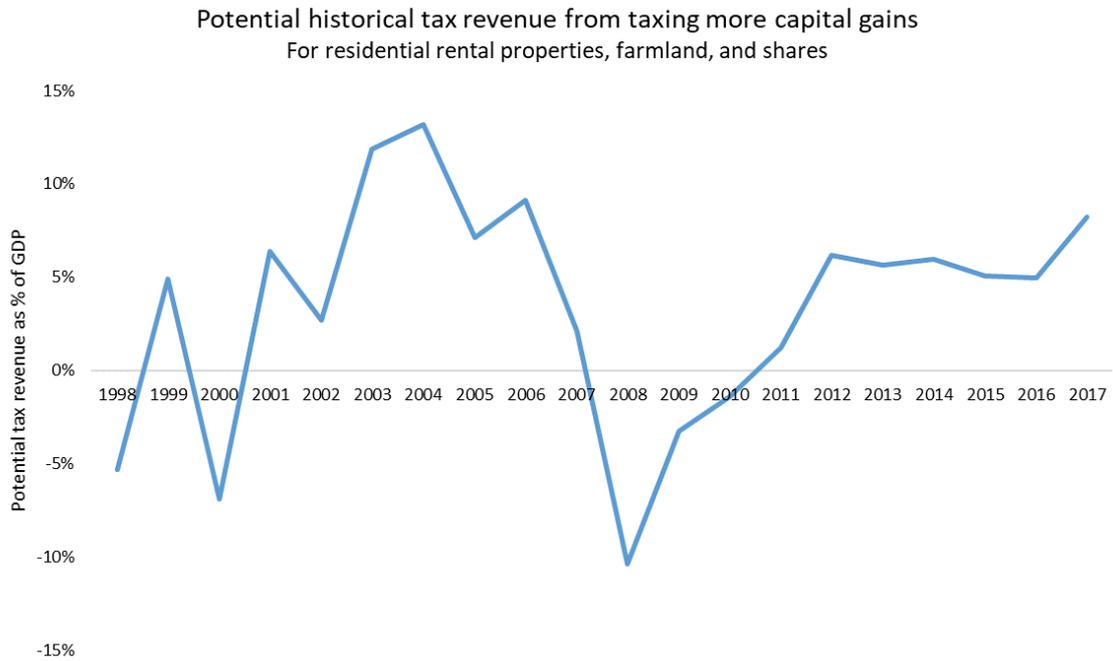


Sources: PBO based on data from the ABS and Treasury

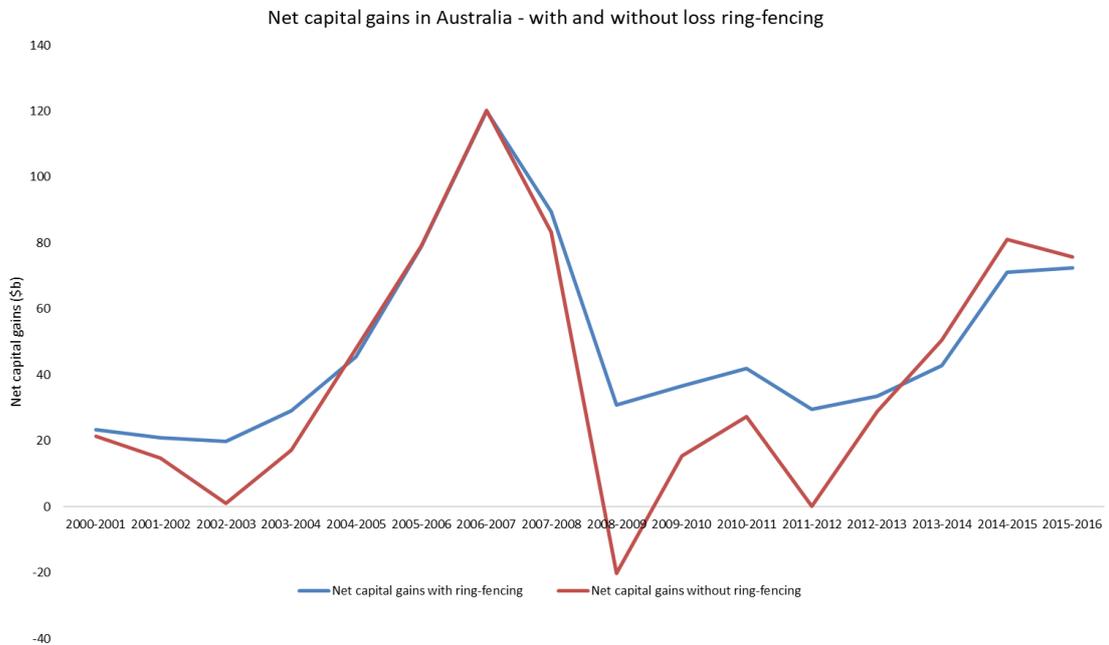
Note: CGT became applicable to superannuation funds with the introduction of the 15 per cent tax on earnings implemented from 1 July 1988.

66. In New Zealand, asset prices are similarly volatile and we would expect similarly volatile revenue from taxing more capital gains. The chart below shows an estimate of the historical potential tax revenue from taxing more capital gains on an accruals basis in New Zealand<sup>10</sup>.

<sup>10</sup> This estimate is imprecise and for illustrative purposes only. It uses a 25% tax rate and assumes no behavioural change.



67. In addition, if the Group agrees not to include extensive loss ring-fencing this will likely make revenue more volatile than in many other countries with capital gains taxes. The chart below compares net capital gains in Australia with loss ring-fencing (current policy) and the Secretariat’s calculation of what net capital gains would be without loss ring-fencing<sup>11</sup>.



<sup>11</sup> The calculation of net capital gains without loss ring fencing does not include any potential behavioural changes. The calculation is for individuals, companies and superannuation funds. The calculation does not include trusts due to data not being available for the some of the years.

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68. This volatile revenue has two main impacts:

- it makes the tax *counter-cyclical* and acts as a fiscal stabiliser; and
- it makes Government revenue more volatile.

69. Overall, there are some benefits to New Zealand having more automatic stabilisers, in particular if there continues to be less scope for monetary policy to act as a stabiliser. However, as the revenue from taxing more capital gains is likely to be relatively small relative to the size of the economy, the impact of taxing more capital gains as a stabiliser effect is also likely to be modest.

70. The degree of impact of volatility on forecast revenue from taxing more capital gains is difficult to forecast as it relies on projections regarding future asset prices and realisation rates. However, generally it means that taxing more capital gains requires fiscal management by the Government. The Government will need to ensure it saves sufficient revenue during times of high revenue in order to utilise during times of low revenue. It also means that the Government should be conservative when embarking on revenue negative measures financed from future taxes on capital gains. The Secretariat will provide further analysis of the stabilisation effect of taxes in a future paper.

## Appendix A: Further information on efficiency and housing market impacts

### Efficiency impact of taxing more capital gains

#### *Efficiency gains from taxing more capital gains – investment allocation*

71. New Zealand is better off when New Zealanders choose to invest in the most productive investments from a social perspective. In the absence of externalities or other market failures this will usually be those that provide the highest pre-tax return.
72. However, if effective tax rates on different investments vary, then investors may choose investments that earn a high post-tax return, but a low pre-tax return. In the absence of externalities or other market failures then this creates a loss of potential income to New Zealand. Taxing income more neutrally is likely to promote more efficient investment allocation and capital productivity.
73. The available evidence suggests that inconsistent taxation of capital income is creating wide variation in effective tax rates across firms and industries (see Secretariat paper *Effective Company Tax Rates*). Taxing more capital gains means that investment in industries that do not earn capital gains would likely increase relative to the amount of investment in industries which earn capital gains.
74. The impact of this is potentially significant. There is increasing international empirical evidence, using firm-level data, that suggests that inconsistent effective tax rates across firms and asset types is associated with resource misallocation, and lower productivity (IMF, 2017).
75. (IMF, 2017) also emphasises the importance of taxing business income as neutrally as possible. IMF says regarding the design of tax:

*“Upgrading the design of their tax system can help countries chip away at resource misallocation by ensuring that firms’ decisions are made for business and not tax reasons. Governments can eliminate distortions that they themselves have created. The chapter (in IMF 2017) provides evidence that significant total factor productivity gains can be achieved if countries address tax treatments that discriminate by asset type, source of financing, or firm characteristics such as informality and size”*
76. Taxing more capital gains would help reduce these types of tax distortions. In addition other revenue negative measures can also help reduce these types of distortions such as restoring building depreciation, allowing deductions for black-hole expenditure and the treatment of losses. In addition, the Group has recommended improvements to Inland Revenue’s enforcement in the hidden economy that can also help reduce these distortions.
77. IMF also acknowledges the importance of potential externalities. IMF states:

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*“It is important to acknowledge differences in treatment across firms may not be feasible or desirable in all cases. Tax policy might want to influence resource allocation when firms do not take into account their externalities – the full economy-wide benefits and costs of their activities”.*

78. Differential tax treatment across firms can occur because of firm characteristics, not just tax design, to the detriment of productivity (Bartolini, 2018). Bartolini also reinforces the point made by the IMF regarding the importance of tax neutrality. The paper provides a cross-country study finding that lower effective tax rates are generally associated with firms being more productive and producing closer to the productivity frontier. Reducing inter-asset biases as broadly as possible can be particularly important given New Zealand’s relatively high company tax rate, as biases will increase with the tax rate on investment.
79. Firm-level productivity analysis for New Zealand finds that there is a wide dispersion of firm productivity levels and that the allocation of resources across firms detracts from aggregate productivity, especially in some service industries (Conway, 2016).
80. As a result, the potential gains from reducing resource misallocation are uncertain, but large. The IMF (2017) found, using a cross-country firm-level dataset, the potential productivity gains from lifting firms’ efficiency to the level of a “top performer” is 16 per cent for the average advanced economy.
81. However, tax is likely a small factor in the overall issue in New Zealand regarding misallocation of resource and its implications for productivity. A more neutral tax system will help address these issues but will not fix them.
82. While the Group has decided against any cut in the company tax rate, it is a key reason for considering reductions in business taxes that improve the neutrality of the base as part of any package of changes. If a future Government were to wish to cut taxes on businesses, in the absence of identifying other non-neutralities that could be reduced by allowing more deductions, the appropriate response would be to lower the company tax rate.

### ***Efficiency costs of taxing more capital gains***

83. There are potential downsides for efficiency and productivity from taxing more capital gains. In particular, taxing more capital gains would increase the overall tax rate on capital income and reduce incentives to save and invest. In addition, there are efficiency costs from taxing more capital gains in the lock-in effect it can create and through the additional compliance and administration costs created.

## **Housing market impacts of taxing more capital gains**

### ***What economic models say about housing market impacts of taxing more capital gains***

84. The Group previously reviewed preliminary modelling by Andrew Coleman (the Coleman model) and modelling published by Westpac (the Westpac model).
85. Key conclusions of the Coleman model are that:
- the key effects of taxing more capital gains are highly uncertain;
  - taxing more capital gains will decrease the price-rent ratio on housing;
  - taxing more capital gains will increase rents and homeownership rates in the long run; and
  - the price of housing increases slightly.
86. The Westpac model predicts that taxing more capital gains would increase rents and decrease house prices. Other models (including Coleman and Scobie (2009) and Hargreaves (2008)) also find that reducing tax advantages for landlords will result in reducing house prices and increasing rents.
87. These models help show how taxing more capital gains can change people's decisions and impact the housing market and show the degree of uncertainty in working out the impacts of taxing more capital gains. The models however cannot provide precise indications of what the effect of taxing more capital gains would be and should be taken with a high level of caution. The models are inherent simplifications of reality, which rely on the assumptions and parameters built into the model and there are a number of other factors that affect housing markets that they cannot incorporate.
88. These models all tend to suggest that even small tax changes that increase taxes on rental housing can lead to large decreases in the ratio of prices to rents. However, the Secretariat has been unable to find any example internationally where this has actually happened.
89. In addition, the results do not appear consistent with what has happened in New Zealand when it cut personal tax rates and eliminated building depreciation in 2011. It is also inconsistent with what occurred in other countries' housing markets when they have introduced capital gains taxes (CGT). The effect that the introduction of a CGT had in other countries is discussed further below.

### ***The international experience***

90. The section below provides analysis on the impact that the introduction of a CGT in Canada, Australia and South Africa had on house prices, rents, and price-rent ratios. This information replicates information previously provided to the Group in *Potential high-level effects of proposals to extend the taxation of capital income*.
91. All three of these countries introduced a CGT that applied to residential property, but contained an exemption for owner-occupied houses. In all of these countries,

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economic theory would have suggested that there should be a significant decrease in the price to rent ratio, and a significant increase in rents and decrease in house prices.

**Summary table**

	What economic theory would suggest happens	Was what happened consistent with the theory?		
		Canada	Australia	South Africa
<b>Impact on price-rent ratio</b>	Decrease in price-rent ratio	✗ Increase in price-rent ratio (although remained roughly flat in first three quarters)	✓/✗ After 2 years the price-rent ratio decreased 8% After five years, the price-rent ratio had increased 10% (from introduction).	✗ Starting from 2002 (one year after the tax) the price-rent ratio rose.
<b>Impact on rent</b>	Increase in rent	✗ Decrease in rent	✓ After two years rents had increased 3% After five years rents had increased 8% (from introduction)	✗ Decrease in rent one year after the tax
<b>Impact on house prices</b>	Decrease in house prices or at least a fall in house prices relative to rents	✗ Increase in house prices (although remained flat for first three quarters)	✓/✗ After 2 years, real house prices decreased 4% After five years house prices increased 23% (from introduction)	✗ Stable in period immediately after introduction, large increase subsequently
<b>Other factors likely influencing housing market</b>		Impacts likely influenced by rent controls in place at the time <sup>12</sup> .	Australia's CGT only applied to assets acquired after 20 September 1985 <sup>13</sup> .	

92. There is no clear trend visible from this analysis of other countries' housing markets after the implementation of a CGT. The key outcome from economic models suggest that the price-rent ratio should decrease following an introduction of a CGT. However, these countries do not provide consistent evidence of this.

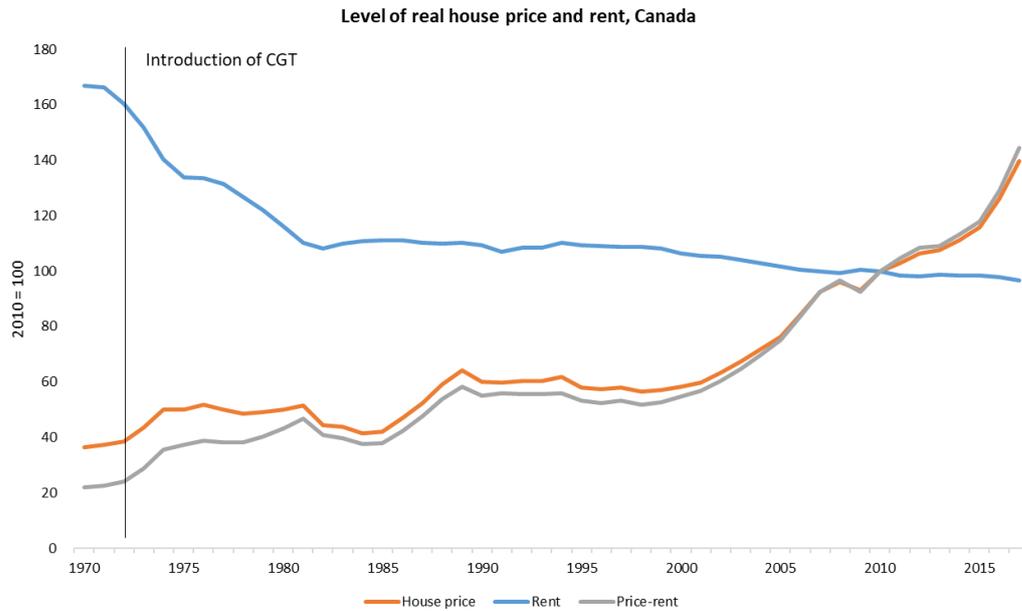
*Canada*

93. Canada introduced a CGT that applied to non-owner occupied houses from 1 January 1972. The chart below displays the trend in both house prices and rents in Canada following the introduction of the CGT. In the period after Canada's CGT came into effect, the price-rent ratio increased (although it remained flat for the first three quarters after introduction).

<sup>12</sup> However theory would predict that even if rents cannot rise, the price-rent ratio should still fall and there should be a bigger fall in house prices.

<sup>13</sup> This likely decreased impact on housing market in the short run. In the long run however, impacts still were opposite to that expected.

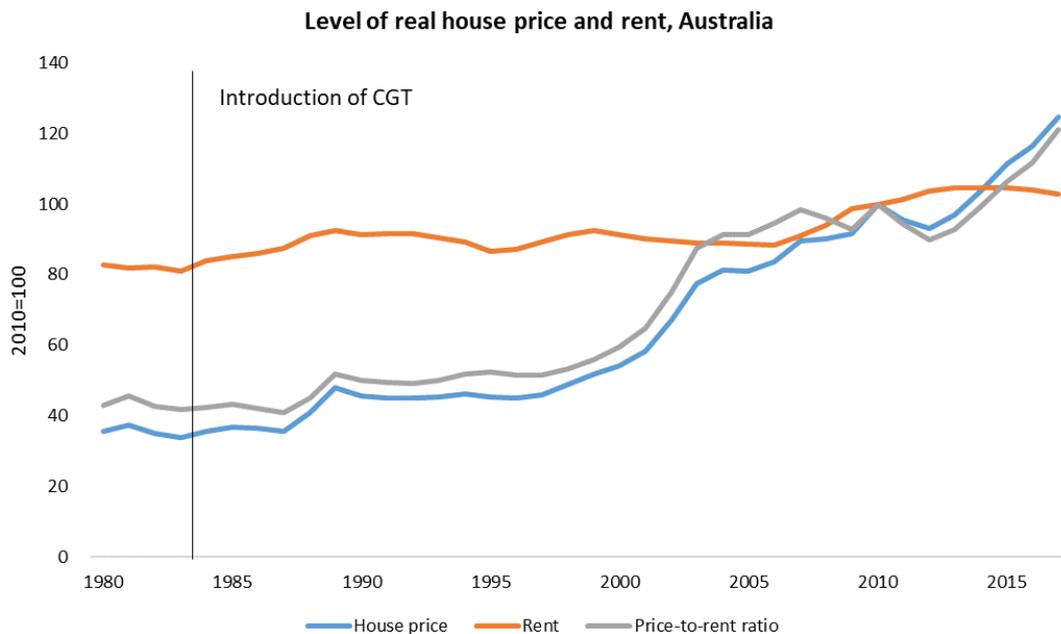
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94. Other policies occurring at the same time can explain some of this downward trend in rents, but not the absence of any fall in the price-rent ratio. Some Canadian provinces had rent controls at the time of the implementation of the CGT, and all Canadian provinces had rent controls in place in the mid-1970s, at the request of the federal government. While these were later rolled back in the 1980s, these rent controls would have put downward pressure on average rents at the time.

### *Australia*

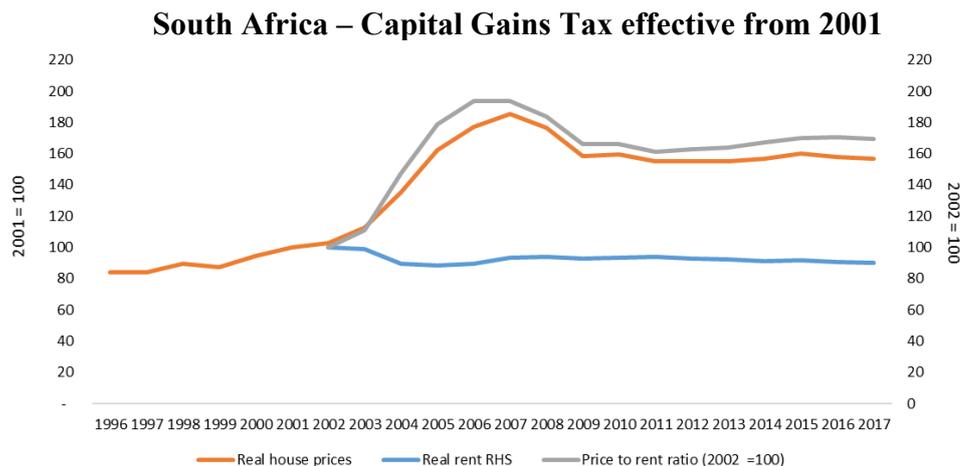
95. Australia introduced a CGT that applied from 1985. The chart below displays the trend in house prices and rent following its introductions. There was no noticeable change in the price-rent ratio for the two years following its introduction.



96. Australia had a grandfathering provision for its CGT, which meant that the tax did not apply to assets acquired prior to 20 September 1985. This would likely have mitigated the short-term impact that the tax had on the housing market.

*South Africa*

97. South Africa introduced a CGT in 2001. Data on rents is only available from 2002 for South Africa. The chart below shows that from 2002, the price-rent ratio increased as rents fell and house prices increased.



Source: OECD and subsequent Secretariat analysis

98. Ultimately, nothing conclusive about the effect of a CGT on the housing market can be drawn from this simple analysis. One potential danger in looking simply at the data is that it may miss other things that were happening at the same time including changes in interest rates. In order to further test this finding, we have developed an econometric model in an attempt to better understand the correlation between the introduction of a CGT and the housing market.

***Econometric modelling***

99. The Secretariat has undertaken simple econometric analysis of this international data to better ascertain the effect that the introduction of a CGT has on the housing markets in Canada, Australia, and South Africa. This econometric analysis allows us to control for other factors that might be influencing the housing market, such as interest rates, GDP, and previous year trends in the housing market variables.

100. The results of this econometric analysis provides similar conclusions to those made by the observations outlined above. The econometric analysis found no statistically significant impact on real house prices, real rents, and the rent-to-price ratio as a result of introducing a CGT in these countries.

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101. The only factors that did appear to generally have an impact on real house prices, real rents, and the rent-to price ratio were:
- what real house prices, real rents, and the rent to price ratio were in the previous year (e.g. house growth in the previous quarter was positively correlated with house price in the current quarter); and
  - real interest rates (higher real interest rates led to higher house prices and rents).
102. This lack of statistically significant results indicates that the economic models may be overestimating the effect that taxing more capital gains would have on the housing market.
103. The design of this econometric analysis does suffer from some deficiencies that may weaken its usefulness. These include announcement lag and the possibility that the analysis does not include other important variables affecting the housing market. In addition, the econometric analysis looks at whether there are immediate changes in the rent to price ratio, and may ignore the long-run effects of change.
104. The announcement lag effect arises because there is often a significant gap between when a CGT becomes a possibility, when a CGT is announced, and when it comes into effect. For example, a Canadian Commission recommended a CGT in 1966; Canada passed the CGT into law in 1971 and the CGT came into effect in 1972. In this case, we would expect that the CGT would affect the housing market before 1972. We would expect investors to start changing their investment behaviour in expectation of the introduction of a CGT. Our econometric analysis will not capture these effects.
105. In addition, other factors that could explain housing market changes may not have been included in our econometric analysis. This would reduce the accuracy of our estimates and the usefulness of our findings. In an attempt to combat the possible weaknesses in our analysis, we have also looked at international evidence around the effect of changing the rate at which capital gains are taxed, rather than just introducing a CGT.

### *Further international evidence*

106. There is limited international research on the effect of introducing a CGT on housing markets. This is primarily because not many countries have recently introduced a CGT, and when they have, the focus of subsequent research has not been on the effect that the introduction had on the housing market. However, there has been some research on the effect on the housing market of other housing-related tax policies.

### *US tax reform*

107. The United States (US) had two significant tax reforms in the 1980s that would have had an effect on the US housing market. In 1981, the Economic Recovery Tax Act was passed, while just 5 years later, the Tax Reform Act was also passed, making

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a number of other changes to the US tax system, including reversing some of the changes in the 1981 reforms.

108. The reforms were wide ranging, and touched on a number of aspects of the US tax system. The tax reforms that affected the housing market, and their expected effect according to the relevant literature, were:

	<b>Tax change</b>	<b>Expected impact on housing market</b>	<b>What actually happened</b>
<b>1981 reform</b>	<i>Decrease marginal tax rates</i>	Reduce house prices <sup>14</sup>	Real house prices reduced by 3% between 1980 and 1983
	<i>Accelerated depreciation for rental properties</i>	Reduce house prices	<i>Modest change in direction that would be expected</i>
	<i>Decrease CGT rate</i>	Decrease in rents	Rents increased by around 8% from 1982-1986  <i>Significant change in opposition direction that would be expected</i>
<b>1986 reform</b>	<i>Increase in standard deduction<sup>15</sup></i>	Reduce house prices	Real house prices reduced by around 5% from 1986-1988
	<i>Removing accelerated depreciation for rental properties</i>	Reduce house prices	<i>Moderate change in the direction that would be expected</i>
	<i>Increase CGT rate</i>	Increase rent	Rents are relatively stable from 1986-1990
	<i>Residential loss ring-fencing</i>	Increase rent	

109. Under standard economic theory, some these changes should have a greater housing market impact than introducing (or removing) a CGT. This is because, unlike a CGT, these changes would not have the mitigating impact of decreasing risk. Despite this greater theoretical case, the changes do not appear to have resulted in the

<sup>14</sup> This was expected to reduce house prices as it reduces the tax benefit of the mortgage interest deduction.

<sup>15</sup> The standard deduction is a fixed tax deduction that a person or persons can take to reduce their income tax liability in the United States. If the filer take the standard deduction they are not able to take other deductions. As the US allows deductions for mortgage expenses, an increase in the standard deduction means less people will take mortgage deductions. This will decrease the tax subsidy for mortgage interest, which was expected to reduce demand for housing.

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expected impacts on the house prices and rent. As a result, they provide no evidence of major and concerning impacts on rents or prices from housing tax changes.

110. There were other factors influencing the US housing market that were more likely to be the driver of these results. Commentary at the time noted that the increase in rents from 1982-1986 was primarily due to low vacancy rates of rental accommodation in the early 1980s. The relatively stable rents from 1986-1990 are likely to be primarily due to relatively higher vacancy rates over this period. In addition, other factors such as large decreases in inflation, and increases in the real after tax interest rate are likely to have been influencing the housing market.

### *Secretariat conclusion on housing market impacts*

111. The Secretariat's overall conclusion is that there may be some small pressures in the directions that have been predicted by the various theoretical models
112. However, the evidence strongly suggests that tax changes are unlikely to have substantial effect on the housing market and that other factors in the housing market can outweigh the effect of tax changes. We have been unable to find any instances where there has been a large change in rents or house prices in the direction that theory may predict.
113. To the extent that taxing more capital gains has housing market impacts, this is likely to lead to small welfare decreases for renters, and small welfare increases for those looking to purchase homes with little of their own equity. The reasons for this are explained further below. However, this impact is expected to be minimal

### **Housing market incidence**

The current tax rules create biases for those investing in housing. The biggest bias is for owner-occupiers with equity in their house. This is because we do not tax imputed rents, while other investments made by owner-occupiers are taxed. This provides an incentive for people to invest in their own home.

In a simple theoretical model we would expect:

- owner-occupiers who are able to finance housing with their own equity to be willing to pay the most to acquire a property.
- the Group next most willing to pay the most for a house are landlords with substantial equity. This is because the interest rate on lending is less than the interest rate on borrowing.
- the Group next most willing to pay the most for a house are landlords that need to borrow to invest in housing
- finally the least advantaged group are likely to be first home buyers or others buying a house to live in who have little of their own capital. This is because even though these purchasers are not taxed on their imputed rental income, they also cannot deduct interest.

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Taxing capital gains on non-owner occupied properties is likely to improve the position of this fourth group of potential owner-occupiers with little of their own capital. As a result, this is the group likely to benefit from any potential housing market impacts of taxing more capital gains. However, as explained above, we expect this impact to be small

## Appendix B: Assumptions in forecast revenue for taxing more capital gains

*Assumption: Growth rate*

114. Residential investment property is assumed to grow at a 3% nominal annual rate (2% inflation plus 1% real growth rate) similar to what is projected in the 2018 Budget Economic and Fiscal Update.<sup>16</sup> That rate is also used for other categories of real property.

115. New Zealand shares are assumed to appreciate at 3% per year.<sup>17</sup>

*Assumption: Size of base*

116. The table below shows how initial values (from 1 April 2021) were derived from the most recently available data. From the most recent data available, prices are assumed to increase at a rate of 3% per year until 1 April 2021. In addition, the base for residential investment property and commercial and industrial are presumed to increase by an additional 2.8% to reflect additional building investment.

Base	Data Source	Observation Date	Value at Observation Date (\$Billion)	Grossed-Up Value at 1 April 2021 (\$Billion)
Residential rental property	Reserve Bank Household Balance Sheet	December 2017	269	324
Commercial, industrial and other property	Corelogic	October 2017	217	261
Rural	Corelogic	October 2017	181	199
Domestic shares	Reserve Bank Household Balance Sheet and Managed Fund Assets	March 2018	131	143

*Assumption: Turnover rate*

117. The costing incorporates a realisation basis. For real property categories, average holding periods are taken from Core Logic data as of the first quarter 2018. These are:

<sup>16</sup> BEFU 2018 projects house prices to increase by 3.4% in 2021 and 3.7% in 2022.

<sup>17</sup> NZX capital index information shows New Zealand shares appreciated by 3.7% per year on average from 1990 – 2017.

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- Residential investment property – 6.40 years;
- Commercial and industrial property – 7.12 years;
- Agricultural property – 6.90 years.

118. New Zealand shares are assumed to have an average turnover rate of 33% (based on data from World Federation of Exchanges).

*Assumption: lock-in effect*

119. The costings assume that taxing more capital gains will cause behavioural changes through a “lock-in effect”. The costings assume that the turnover rate will reduce by 20% as a result of this lock-in effect. The Secretariat are working to source better data to refine this assumption.

*Assumption: rollover relief*

120. The Group has agreed to provide rollover relief for inheritances, relationship property settlements and involuntary disposals. The costings assume that 8% of land transactions and 5% of share transactions are subject to these rollovers. This is based on analysis by the Secretariat on the estimated values of these in New Zealand.

*Risks: Risks that the forecast revenue could be understated*

121. **Unknown parts of the base** – The forecast base uses elements of the base that are known through published statistics – values of real property and New Zealand shares. Some elements of the base are not known and so are not costed. These include – residential property that is not owner-occupied housing or residential investment property (eg, second homes), shares in Australian listed companies, and shares in private companies and intangible property such as goodwill, brands, trademarks and intellectual property.

*Risks: Risks that the forecast revenue could be overstated*

122. **Overlap with current revenue account property** – Some property is already subject to tax on gain when sold (revenue account property). The most significant of these are real property sold by developers and dealers. This is not adjusted for due to lack of information. This also includes property subject to the brightline rule and taxable under the intention test.

*Risks that could either overstate or understate the forecast*

123. **Variation from assumptions** – actual conditions may vary from what is assumed. In particular, the actual appreciation rate is likely to vary over time and be both above and below the assumed growth rate at times. Other factors, such as size of the base and turnover rates, could also vary from the assumptions.

## References

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