Tax Working Group Public Submissions Information Release

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Tax Working Group Submission

This submission addresses the housing affordability issue. It is opposed to a capital gains tax that excludes the family home, but recommends a land tax (that excludes the land under the family home) and recommends reform of local government rating.

There are two methods of improving housing affordability: lower the cost of houses (land and/or buildings); increase the incomes of house buyers. A land tax and/or reform of local government rating will increase the costs of holding urban undeveloped land, referred to as land-banking. The increased holding costs will reduce the returns from land-banking, thereby encouraging the owners to either develop the land or sell to someone who will. The increased supply of land for residential development will lower the market price of that land, and this will have a knock-on effect on the housing market resulting in lower house prices.

Capital Gains Taxes will not Alleviate Housing Unaffordability

A capital gains tax (CGT) that excludes the family home will exacerbate housing unaffordability. Residential housing as an investment is already favoured by the current taxation structure, as graphically illustrated on page 40 of the discussion document. A CGT on investment options other than residential housing will widen the taxation advantages owner occupied housing already enjoys over the alternative investment/savings options. This more favourable taxation proposition will increase demand for and inevitably the price of residential housing, thereby widening the housing affordability gap.

I live in a newish subdivision with 41 homes. Three-quarters of these family-sized homes are occupied by one or two people. The advantage of an unnecessarily large house lies in the resale: a bigger house will, in absolute terms, gain more in value. The recent and dramatic rise in house prices vindicates this investment decision. It is well accepted that New Zealanders have overinvested in housing to the detriment of the productive economy. Excluding the family home from a wide-ranging CGT will make investing in the family home even more attractive for those who can afford to pay the price, but less affordable for those who cannot.

Furthermore, a CGT will reduce the returns from equity and property investment vehicles thereby making it more difficult for first time home buyers to accumulate capital for a deposit.

The discussion document identifies the disadvantages of CGTs: notably, the 'lock-in' effect, and the double taxation of retained earnings. There is no need for me to elaborate on those disadvantages other than to illustrate the negative consequence the lock-in effect will have on housing affordability.

In the long run, the lock-in effect of CGTs will exacerbate land-banking. The optimum time for the owner of bare land with residential development potential to cash in, by sale or development, is when the returns of alternative investments exceed the returns from holding the undeveloped land. Take, for example, a parcel of bare land suitable for residential subdivision that has appreciated in value to the extent that 20% of the sale revenue would be lost to a CGT. If holding the land is perceived to be returning 6% pa, the seller would need to find an alternative investment that returns 7.5% to achieve the same return as holding the land in an undeveloped state. But, in the absence of a CGT, the land-banker would need a return of 6.1% to make cashing in a profitable alternative.

To make matters worse, there is positive feedback loop associated with the lock-in effect. With the example of bare land suited to housing development, the lock-in effect will exacerbate informal land-banking: less land will come to the market causing land values to rise thereby widening the gap between the returns of holding bare land and alternative investments. While it is true that the lock-in effect will not be a factor in the initial years of a CGT, it will most certainly impact on land values in the long term.

Increases in unimproved land value are by far the major driver in rising house prices in the unaffordable housing havens such as Auckland. In the long term, a CGT will only make it worse.

Implementing a Land Tax will Improve Housing Affordability

A tax on unimproved land value has a lot of advantages, foremost is the absence of deadweight loss. The supply of land is fixed, therefore a tax on land cannot affect the supply of land. In addition a land tax is morally justified. It is not the actions of the owner of land that increases the unimproved value of that land, it is the actions of society as a whole; thus society has a morally justifiable claim on the unimproved value of land. Of greater relevance is the positive and immediate effect that a land tax will have on closing the housing affordability gap.

A land tax will increase the costs of holding land. This will encourage if not impel land-bankers to liquidate their holdings, thereby increasing the supply of land available for housing. This will depress the price of land; building a new house will become a better option than buying an existing house. This in turn will cause the price of existing houses to fall. This will be the immediate effect of a land tax.

Design Modifications Required

1. Avoiding the mansion effect.
   A land tax that exempts the family home makes a mansion size section attractive. The artful dodger buys or builds a house on a large section with the intention of subdividing at a later date, but in the interim avoids a land tax on the land destined for sale. This can be avoided by limiting the area of land occupied by a family home that is exempt from the land tax. For example, 1000^2 could be a reasonable threshold. In the case of a family home located on a 3000^2 section, one-third of the land tax would be rebated. In the case of the family home located on a farm, the 1000^2 threshold over the area of the farm would be exempted or alternatively, the 1000^2 on which the house is located could be valued separately.

2. Mitigating the impact of a land tax on farming or forestry.
   In the long run, a land tax is not detrimental to farming, forestry or other avenues of primary production. New Zealand had a land tax when primary production was a bigger part of the economy than it now is. Furthermore, local government rates in many rural areas are levied on the unimproved value of land, which is a land tax. However, introducing a land tax presents a significant and unexpected cost that is entirely unavoidable. The impact of introducing a land tax would be disastrous for landowners with significant debt servicing obligations and would send many of them broke through no fault of their own. This could be avoiding by having a minimum threshold value that is high enough to exclude land best suited for primary production, but not land in primary production that is best suited for residential or industrial development.

3. Mitigating the impact of a land tax on businesses.
   a. A land tax is an additional cost and if not mitigated will have an adverse effect on production and employment. The best way to avoid this effect is to lower company tax to the extent of the revenue gathered from the land tax. This would compensate the productive sector of the economy while still hitting the rent seeking speculators who are

sitting on underutilised land and ultimately profiting from the general progress of society.

b. If company tax was reduced to compensate businesses for the land tax impost, it would only be fair to include land suited to primary production in the land tax net as farmers/foresters can take advantage of the reduced company tax rates by adopting a company structure. However, the land tax could be tiered progressively in recognition that land is a much higher proportion of the income producing assets for farming/forestry businesses and if applied at a uniform rate, would impose a much higher cost on the farming/forestry businesses relative to other businesses.

4. Mitigating the impact on residential rentals
One of the few truisms of economics is that 'price equals cost.' Landlords have been demonised in New Zealand, and policies that are detrimental to landlords are universally popular. Unfortunately, all costs that are imposed on landlords are ultimately passed to the tenants. In the event of a land tax, the short term effect is that landlords will pay and rents, all other things being equal, will not rise. But the imposition of a land tax will lower the profitability of supplying rental accommodation. This will in the long run reduce the supply of rental housing until a shortage causes rents to rise. In which case it is the tenants that will (indirectly) pay the land tax. The solution is to exempt rental accommodation that serves as a primary home for tenants.

Reforming Local Government Taxation will Improve Housing Affordability

Over the past 50 years, local government taxation structures have changed dramatically. Prior to the changes, local government rates were levied on the unimproved value of land; which is, in effect, a land tax. Today, rating on unimproved land value is rare and generally confined to rural areas. In urban centres, uniform charges for services and governance combined with some capital-value rating has dominated rating structures. This has had two effects. If property value is a proxy for income and wealth, rates have become heavily regressive thereby exacerbating inequality. While low income households have suffered from the rating changes, the owners of undeveloped land have benefitted considerably.

Table 1: Urban rating in Carterton.[1]

Property type	Land value $	Capital value $	Current rates $	LV rates $	CV rates $
Low value residential	75,000	165,000	2,758	2,257	1,847
Medium value residential	110,000	290,000	3,111	3,311	3,247
High value residential	120,000	365,000	3,310	3,612	4,086
2000^{m} bare land	130,000	135,000	1,996	3,913	1,511
5.6 ha bare land	530,000	540,000	4,226	15,952	6,045

Table 1 compares the Carterton district council's current rating structure with land-value and capital--value rating systems. The low, medium, and high value residential examples are taken from the CDC's range of property values. The two bare-land examples are specific properties located at 8 Mill Grove and 324 High street south respectively. The Mill Grove property is a fully serviced residential section that has been empty for seven years. The High street property is farmland surrounded by

[1] These are 2014 property values.

housing. For residential property owners, land-value and capital-value rating are less regressive; capital value more so than land-value. But if the intention is to give the owners of undeveloped land a nudge towards putting their land to best use, land-value rating delivers.

Please note that house values in Carterton are much lower than in the main centres. Land value is a much higher proportion of capital value in Auckland than in Carterton. It follows that a shift to land-value rating in Auckland, and other havens of unaffordable housing, will have a significantly larger impact on owners of bare land suited for residential development. I suggest that Tax Working Group investigate this further.

Increasing the holding costs of what is best described as idle land will give the owners/land-bankers a real incentive to make that land available for housing. Returning local government taxation to land-value rating in combination with a land tax would impel the land-bankers to offer more land for residential subdivision to the market. The effect of increased supply will drive the prices down thereby making housing more affordable for Kiwi families. Reforming local government taxation would also strike a blow for the less well off, thereby improving their chance of home ownership.

For the above reasons I recommend the implementation of a land tax combined with the return of local government taxation to land-value rating as the best method of addressing the current housing crises.

Addendum

The Rates Rebate Misconception

The government has recognised that the less well-off have been disadvantaged by the changes in local government taxation structures, and accordingly implemented a rates rebate for low income homeowners. Local bodies often refer to the availability of the rates rebate to justify the increasing rates burden imposed on low-income households.

However, many low-income households are ineligible for the rates rebate. Tenants, who in many cases are low-income people occupying low-value houses, do not qualify because they do not directly pay the rates, which is a key requirement for the rates rebate. However, tenants indirectly pay the rates through their rent. As the economics maxim goes: price equals cost, in the long run. As rates increase, landlords will ultimately pass these costs to their tenants.

Those on the bottom rung of the home-ownership ladder are another group of hard-pressed ratepayers who do not qualify for the rates rebate. Typically, these first-home buyers occupy low- or medium-value dwellings. After meeting their mortgage commitments, they may well have a lower discretionary income than superannuitants living in a freehold house who do qualify. The rates rebate threshold is set on gross income, not disposable income.

In short, the rates rebate is a blunt instrument. Many low-income households do not receive it.

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