HOUSING, THE 'GREAT INCOME TAX EXPERIMENT', & THE INTERGENERATIONAL CONSEQUENCES OF THE LEASE

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Berlin's wall crumbled
We taxed savings, not houses
Locking out the young.

INTRODUCTION

New Zealand has one of the most distortionary tax environments for housing markets of any country in the OECD. The primary reason is not the failure to tax capital gains or the imputed rent from owner-occupied housing (the implicit rent an owner-occupier earns from leasing their own house to themselves), for most countries do not tax the capital gains or imputed rent from owner-occupied housing. Rather, it is because New Zealand taxes income from owner-occupied housing on a different basis than it taxes all other capital income. This is not true in most other OECD countries, where owner-occupied housing is taxed on a similar basis to a wide class of other assets. New Zealand and the rest of the OECD have not always been so different. The difference began in 1989, when New Zealand began taxing funds placed in retirement income accounts on an income-tax basis rather than an expenditure-tax basis, but did not change the way it taxed owner-occupied housing.

What is the key distinction? Income can either be taxed when it is earned (an income tax), or taxed when it is spent (an expenditure tax). Expenditure taxes can take several forms, including goods and services taxes and cash-flow taxes. Cash-flow taxes are typically implemented by applying a progressive tax to a person's income adjusted for the net purchase and sale of certain assets, on the basis that this total is close to a person's expenditure on consumption goods and services. For example, if someone earned $100,000 and saved $15,000 in a retirement account, they would pay tax on $85,000.

DISTORTIONARY AND NON-DISTORTIONARY TAXES

Taxes can be distortionary or non-distortionary. Capital income can be classified into three classes and if all three classes are taxed consistently on an income or expenditure basis the tax system will not distort investment choices. In practice, few tax systems are non-distortionary. Most OECD countries adopt an expenditure tax system but only provide expenditure tax treatment to two of these classes, for example. The first class is earnings that are placed in a government-sanctioned retirement saving fund. In the vast majority of OECD countries, these are taxed on an expenditure basis by adopting an 'Exempt-Exempt-Taxed' (EET) rule. Income that is placed in a fund is not taxed when it is earned; interest and dividend earnings and any capital gains are not taxed when they accumulate in the fund; but when assets are withdrawn from the fund upon retirement, they are taxed. The second class is owner-occupied housing. In this case, a prepayment or 'Taxed-Exempt-Exempt' (TEE) expenditure tax rule is adopted: the house is purchased or paid off from income that is taxed when it is earned, but no tax is paid on the imputed rent produced by the property or any capital gain that accrues to the owner. The third class is income from any other investments, including leased residential housing. This is taxed on an income tax or 'Taxed-Taxed-Exempt' (TTE) basis: income is taxed when it is first earned; it is taxed as it accumulates; but it is not taxed when it is withdrawn and spent. Overall this tax regime distorts against the 'other' investment class, but because it provides people with the opportunity to hold many classes of investments in sanctioned retirement income funds on an equivalent basis as owner-occupied housing, it provides few incentives to over-invest in housing.

If a country wishes to tax capital income on a neutral income-tax basis, it needs to do three things: tax retirement income accounts on a "Taxed-Taxed-Exempt" basis; tax all capital gains (including those from owner-occupied housing) on an accrual basis; and tax the imputed rent from owner-occupied housing. New Zealand attempted to move to a non-distortionary income tax system in 1989. However, only the first of the three changes were implemented. As a result, rather than eliminating the distortions associated with the standard OECD approach, it created a new set of distortions. In particular, owner-occupied housing was taxed at much lower rates than other assets, and leased residential housing was taxed advantageously relative to debt instruments.

CONSEQUENCES OF THE 1989 CHANGE

This paper adopts a 'relative institutions' approach to analyse the consequences of the 1989 change. Since 1989, the favourable tax environment for owner-occupied housing relative to other assets has provided incentives for households to live in larger houses than they otherwise would, and to bid up the price of land in locations that are conveniently located to desirable amenities. The favourable tax environment for investments in leased residential housing provides incentives for rent/price ratios to fall, either through a reduction in rents (if the supply of residential property is elastic) or through higher house prices (if the supply of residential property is inelastic.) Home owner-ship rates should fall. It is plausible that since 1989 the changes in the tax regime have provided incentives for people to increase the size of their houses by 25%, and to pay twice as much for land in areas where there is significant transport congestion.

New Zealand's property markets have changed in a manner consistent with these incentives since 1989. The average size of newly constructed houses has increased faster than in Australia or the United States and is amongst the largest in the world. Property prices have soared, rent/price ratios have declined sharply, and the number of private landlords has increased substantially. However, it is not possible to definitively attribute these changes to the tax changes, as other factors that affect housing markets such as the international decline in interest rates and rising incomes have also changed since 1989. The paper attempts regression analysis to unpick the importance of the various affects, but

concludes it is not possible to estimate the role of the tax changes. The evidence is consistent with the conjecture that the tax changes are part of the cause of the change, but cannot prove it.

What are the distributional consequences of the 1989 tax change? When housing is taxed on an expenditure basis but other assets are taxed on an income basis, housing is taxed on an advantaged basis. Standard theory suggests this should lead to higher land prices and a boon for the first land owning generation. But the benefits accruing to the land-owners of one generation do not come for free. They are offset by large costs that are imposed on all generations born after the tax change was introduced. They generate a higher net international debt position than would otherwise occur. And they are regressive, falling disproportionately on first home owners with low equity and renters.

CONCLUSION

Since 1989, several investigations of New Zealand's tax system have concluded that it favours owners of housing assets by not taxing imputed rent or the capital gains on owner-occupied housing. These investigations have typically concluded it is not politically possible to introduce these taxes. This may be the case – few countries have these taxes. But it should not be concluded that successive generations of New Zealanders have to suffer the distortionary effects of a tax system that is regressive, that places upward pressure on house prices, that encourages excessively large houses, and which imposes large costs on all cohorts than the first generation of land-owners. The root cause of the problem is taxing housing on an expenditure basis while other assets are taxed on an income basis. New Zealand could correct this distortion by taxing other assets on an expenditure basis, the solution adopted by most other countries. But if nothing is changed, and the distortion is not corrected one way or the other, New Zealanders will continue to have one of the most distortionary tax environments for housing in the OECD.

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