POLICY POINT

A risky place to do business

Eric Crampton and Bryce Wilkinson

26 March 2021

On Tuesday morning, 23 March, the Government announced a set of housing policies that, among other things, would substantially change the tax treatment of interest payments on residential investment properties.

The changes to tax policy are substantial. And the process by which they are being legislated almost guarantees that they will have equally substantial undesirable consequences.

The tax changes were not signalled ahead of time. Indeed, Minister Robertson had promised, before the election, that no new taxes were being contemplated.

Normal business taxes are levied on profits: the revenue a business earns after expenses. Excluding the most significant business expense for owners of investment properties indeed amounts to a new tax.

The effects will be substantial and complex.

Despite the significance of the proposed tax changes, Treasury provided no analysis of the likely effects, saying it had not had time to provide proper assessment.

By Wednesday morning, the government had rushed part of its housing package through Parliament. Changes to the bright-line rules mean there is now a penal capital gains tax on investment property.

Previous versions of the bright-line rule plausibly ensured that buyers were not disguising wage and salary income as untaxed capital gain. For example, a person working full time buying and selling properties has always been legally liable for income tax on the (capital) gain. But IRD could have difficulty in proving intent. The bright-line rule reduced the risk of tax avoidance, while also capturing some who should not have been subject to tax.

But a ten-year window cannot plausibly serve to capture hidden labour income. It is a capital gains tax, albeit a very poorly designed one that applies to part of one sector of the economy, and without provision for considering capital losses. A principled tax system will aim to treat gains and losses symmetrically, subject of course to systems that ensure claimed losses are genuine. A highly predatory tax system will not.

It is not easy to see how any Member of Parliament can come to any reasonable assessment of whether the Bill passed Wednesday makes for good law; there certainly was little time to consider things. The bright-line extension adds complexity for little benefit.

A good tax system does not distort decisions or at least tries to minimise distortions. The extension of the bright-line rule, combined with rules taxing any capital gain that accrues while a family's primary residence is rented out, will distort decisions. Families relocating temporarily, for work or family reasons, will often wish to rent out their home while renting a home in their temporary location. Doing so for a period of one year or more introduces tax complexity. The family may then prefer to sell the family home when doing so would not otherwise be best for them or to avoid relocating.

Dr Eric Crampton is Chief Economist with The New Zealand Initiative
Dr Bryce Wilkinson is a Senior Fellow with The New Zealand Initiative

IRD will also need to keep track of whether family homes were rented out, and to apportion capital gains to particular years.

The government also signalled its intention to exclude interest on debt as an allowable expense for residential investment properties, to take effect for properties purchased by future investors, with later extension to all residential investment properties. It is unequivocally predatory towards the rental market. Owners of shares and owner-occupied property are not subject to this system.

Legislation to give effect to this policy has yet to be introduced.

Members of Parliament might reasonably want to know the effects of the change on the rental market. Will they force up rents, as some have argued, or not? What will be the likely effects on house prices, and need we worry about financial stability? How might the changes affect the investment required to get new housing built? Will the quality of the rental stock deteriorate if home improvements become more costly? Might apartment towers convert to commercial office space if the latter is tax advantaged? Will more dwellings be vacant because renting is too problematic?

The policy's intent may be to encourage investors to sell properties to first-home buyers. But the simultaneous change to the bright-line rule might discourage such sales. The policies may then work to cross-purposes.

The normal routes for assessing such issues are being circumvented through haste. The bureaus have been unable to provide advice, and those outside of Parliament who might normally work through the implications of complex legislation have thus far been shut out entirely. We can hope that the eventual legislation will not be passed under urgency, but even a normal select committee process will have difficulty grappling with this issue.

This briefing note does not purport to assess the effects of the policy announced this week, with no detail yet provided on its key features.

It rather warns of the consequences of this approach to policy-making.

Better Process

The principles of good tax policy are well-understood.

Important changes in tax policy need to be well analysed and well signalled. The normal process works through Tax Working Groups, in which experts in accounting, taxation, law and economics consult broadly, take advice, and make recommendations. Tax policy is complex and requires broad expertise and the ability to tease out implications of changes as they work their way through the economy.

Tax policy also requires stability. If the bedrock foundations of tax policy are to change, those changes need to be well signalled. If businesses come to see tax policy as fundamentally unpredictable because ad hoc and under-researched policy proposals are prematurely committed to, that will have consequences.

New Zealand has had a good public policy reputation. The stability provided by the policy framework established in the period from the 1980s through the 2000s made policy relatively predictable. Tax rates might change in minor ways that were usually well signalled during election campaigns. But abrupt unprincipled changes to essential bits of tax policy did not happen. Substantial changes would be proposed with reference to accepted sound tax principles, made after consultation, and would not come as a surprise.

This week's changes are substantial. The change to the tax treatment of interest payment of debt on investments in residential properties effectively changes that from a tax on business income to a tax on revenue. The Government has, we understand, signalled that it would like to find ways of exempting investment in new property development from these changes. But it is difficult to see how such provisions can be made credible, let alone durable. The Government this week found it desirable to suddenly make the tax in existing investment properties much more penal. Why would anyone believe that some future Government will not do the same again?

The Government has just made New Zealand a far riskier place to do business. Investors will price that political risk into the returns they require if they are to be willing to invest here at all.

From Leaky Buildings to Risky Policy

After the leaky building crisis in housing, Government set rules aiming to ensure that better construction processes were followed. Poorly-thought through building regulation risk leaks in the future. Poorly-thought through policy is even riskier.

One discipline for the design of regulatory policy is the Regulatory Impact Statement requirement. For tax policy, it is New Zealand's Generic Tax Policy Process.[1] It requires "a strong consultative component, and has support from the private sector, tax officials, and government ministers".

The equivalent to a final building inspection, for policy, is the submissions process. A well-designed policy is nice, but construction can be poor. The final draft needs to be assessed by officials, and experts outside of the bureaus who might provide warnings about things that the officials had missed.

In this case, for a very substantial tax policy change, Treasury was unable to provide an assessment of the policy's effects. The Regulatory Impact Statement accompanying the government's proposed changes recommended that interest deductibility proposals not progress without further analysis. And the public has been blindsided.

Opportunities for Treasury and public input on changes to interest deductibility may yet arise during a legislative process to come.

But when the 2018 Tax Working Group[2] took a more comprehensive examination of the tax system, it did not identify the deductibility of mortgage interest on investment property as any kind of problem. Owner-occupiers enjoy a tax advantage in not having to pay tax on the rent that they effectively pay themselves as home owners; investors are able to deduct interest expenses while paying tax on income – as is the case for other businesses.

The tax change proposed will have deep consequences; changes of this nature should be canvassed as part of the Generic Tax Policy Process.

To announce a policy is to commit political capital to it. To do so prior to taking advice is a recipe for bad policy. Officials may provide more frank advice about a policy if the policy intention has not already been announced. Because backing down is harder if the policy is already announced, officials

[1] Tax Working Group, 2018. "The Generic Tax Policy Process". https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-3985461-the-generic-tax-policy-process.pdf

[2] Tax Working Group, 2018. "Tax and Housing". https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-tax-and-housing.pdf

may easily judge that providing rigorous advice is picking an unwinnable political battle. Pre-judgement also creates an incentive not to commission an analysis that might produce the ‘wrong’ answer.

These aspects heighten the risk the policy will be enacted without an opportunity for real scrutiny.

To announce a profoundly unsettling change to the structure of the tax system without proper justification is to exacerbate investor doubts about whether it is worth investing in New Zealand.