Insights

Topical commentary on the Auckland economy

April 2021

An interest-ing change in housing policy

- Recent housing policy announcements have been met with mixed responses.
- Rents probably won't rise sharply, the bright line tax extension will make little difference, but interest deductibility will slow house price ***growth***.
- Developers who have recently purchased land may pause to re-evaluate the feasibility of their development, but established developers are likely to push ahead.

Tax deductibility of interest costs

By far the most impactful of the announcements was removing interest deductibility from investment property tax liabilities. The law was to be applied almost immediately to new property purchases, thwarting any sudden surge in investor buying. Existing investment properties will be phased into this tax treatment over four years.

By way of example, an $800,000 property secured by a 60% mortgage, interest-only at 2.5% a year has interest costs of around $12,000 a year. As a result, the investor will pay up to $4,680 extra in tax (39% tax rate). Some will not have the cashflow to continue being landlords and will have to sell.

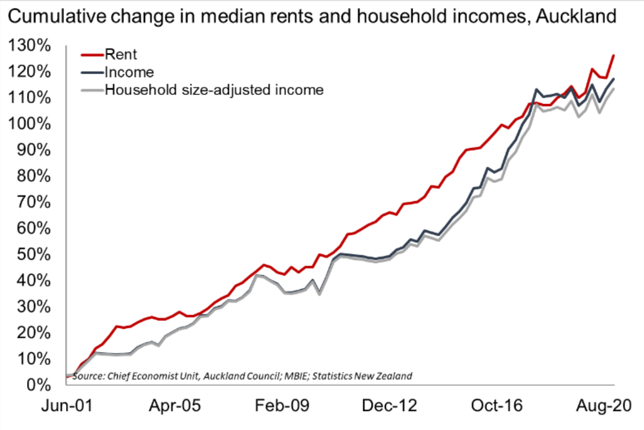
In the context of strong house price growth, we expect the policy to reduce house price ***growth*** through 2021. In early 2022, assuming borders to our main migrant sources (China, India, the Philippines, South Africa) remain largely closed, annual house price growth will likely turn briefly negative as the rules bite and interest rates lift. But given the level of house prices, even small capital gains will easily offset any tax implications. Those who can find the extra $4,680 in cashflow will try to hold on to their properties.

Mythbusters

Every time a policy change occurs that pushes up the costs for landlords, some argue that (1) this will push rents up, and that (2) rental housing will disappear. There is little evidence for either of these claims.

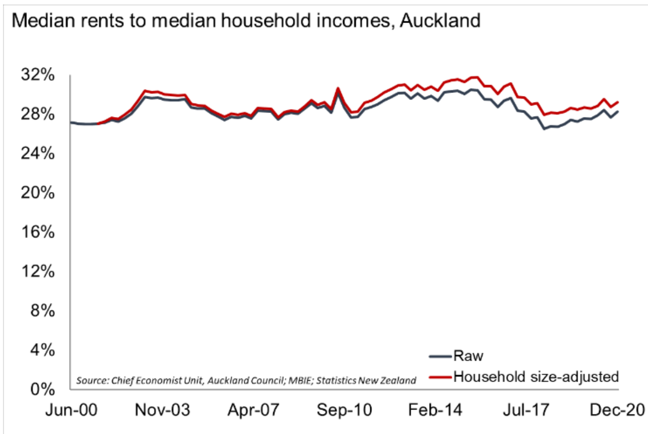
Every business wants to pass on higher costs, but landlords are already charging prices set by what renters can pay. Over the last 20 years, rents in Auckland have risen at almost the identical rate as household incomes, despite increased costs such

Chief Economist Unit | Auckland Council Te Kaunihera o Tāmaki Makaurau



Cumulative change in median rents and household incomes, Auckland

Source: Chief Economist Unit, Auckland Council; MBIE; Statistics New Zealand



Median rents to median household incomes, Auckland

Source: Chief Economist Unit, Auckland Council; MBIE; Statistics New Zealand

as the removal of the Loss Attributing Qualifying Company (LAQC) loophole in 2011 or healthy homes standards requiring better heating and insulation.

Even adjusting for growing household sizes (arguably because rents rose), annual household incomes rose at a rate similar to rents. Over time, rent to income ratios have moved in a narrow band as a share of income. Bearing in mind also that income inequality (rather than ***wealth*** inequality, which has worsened) has been largely unchanged in New Zealand for 25 years, even at lower points than the median income, this relationship has likely held.

In relation to the second claim, some investors will sell their properties for a lower price than would be the case if this policy did not get introduced. Some of these offloaded properties will be bought by other investors at the lower sale price. Others will be bought by owner-occupiers who can afford the lower house price. These houses don't disappear when they stop being rentals; they become owner-occupied homes.

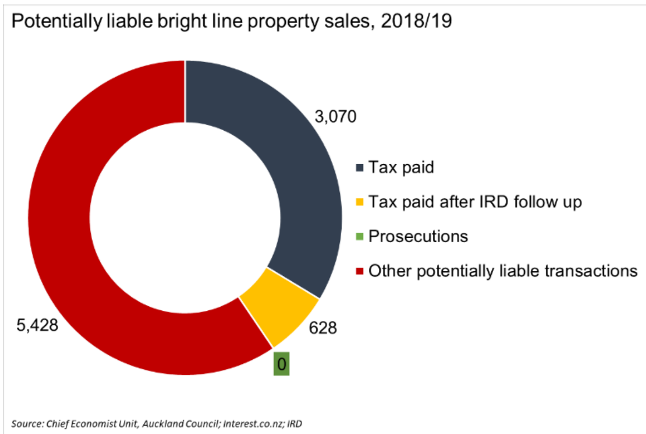
Distortions

As a policy to slow house price growth, the deductibility rule will be effective. However, it introduces other distortions. Some asset classes have capital gains that are comprehensively taxed (like shares), and others do not (investment properties). Other business loans have interest deductibility, but investment properties do not. The more distortions we introduce, the more likely we get perverse outcomes.

There has been talk of a further distortion – controlling rents – if rent increases materialise. We don't think rents will rise more than they would have anyway, but introducing another distortion (rent controls being literally the textbook example of a policy that does not deliver more affordable housing, for instance) would simply compound the perverse outcomes.

The capital gains tax that couldn't

The bright line has also been extended to 10 years from five. The test could be useful if vigorously enforced (the evidence from the latest available year suggesting it is not), but is the poor cousin to a comprehensive capital gains tax. In 2018/19, a total of *zero* prosecutions occurred for bright line test tax obligations.



Potentially liable bright line property sales, 2018/19

Source: Chief Economist Unit, Auckland Council; interest.co.nz; IRD

We suspect the lengthening of the holding period will have little impact on prices or equalising asset classes without more enforcement.

$3.8 billion in housing acceleration funding

The government announced that it will contribute a further $3.8bn toward the nation's infrastructure shortfall to boost housing supply, following $12 billion announced in the NZ Upgrade programme and $3 billion in shovel-ready funding for COVID recovery announced in the last 15 months.

More money for infrastructure is very welcome, but some of the detail remains unclear. Will this be a loan, or cash-in-the-hand? Cabinet is yet to decide on criteria; that only happens in June, before projects can be considered for funding. How long until we see shovels in the ground? How will value be determined across the myriad of projects it ***could*** fund? Will Auckland get a share broadly commensurate with its share of growth and contribution to the tax take?

Some have suggested much of the funding will be used to fund Kainga Ora programmes. From a Council Group perspective, what gets funded may have consequences for additional or out-of-sequence spending it might trigger that may not have been budgeted for, so again, the detail will matter.

First Home Loan Grant will boost lower quartile house prices

The final part of the housing policy announcement was an increase to the maximum dwelling price and the maximum income thresholds below which applicants can receive a grant to help purchase their first home.

The impact of a policy that makes money available to a bigger pool of people in a limited price range is likely to be house prices in that range lifting toward the top of that range. The result can be much the same as increasing accommodation supplements, which in times of housing shortages, flow through to landlords, as they can be used for no other purpose. While median house price growth may be moderate due to the interest deductibility rules, we may well see prices in the lower quartile of housing rise.

Where does this leave development?

Ironically, strong growth in house prices gets more housing built. The impact of the interest deductibility change will be increased uncertainty in the housing market. This is already being observed in auction results over the last three weeks. We suspect house prices over the next while will still be up strongly over the same month last ***year***, but annual growth rates will fall from the dizzy heights of 19% in March and 24% in February 2021.

Developers who have recently bought land will query whether their completed developments will fetch the prices they need to return a profit. Construction costs continue to rise, so slower house price growth means slower land price growth. Developers who have owned land for some time, however, will still likely progress.

Further certainty on where and when extra infrastructure will be funded would be useful for councils and developers, and could accelerate development, but clarity and timing are fundamentally important.

David Norman
Chief Economist