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Housing and the Deputy Governor

Michael Reddell | 15 April 2015 |

I had been going to write something about housing this morning, but got distracted in the WEO database. House prices, especially in Auckland, are a political and social scandal.

But now Grant Spencer, Deputy Governor of the Reserve Bank with responsibility for financial stability, is out with a speech on housing, "Action needed to reduce housing imbalances". It is difficult to know where to start in commenting on the speech, although the title will do. The tone of "Action needed" seems to inject the Bank into politics, and the political debate, rather more than is prudent or than its two main statutory responsibilities, price stability and prudential supervision to promote the soundness and efficiency of the financial system would warrant. For better or worse, the Reserve Bank has a variety of statutory powers it can exercise. If it judges those powers should be used it should lay out its case for our scrutiny, and then act. Instead we have a long, but once-over-lightly, rehearsal of a bunch of mostly familiar material, with little or no in-depth analysis of the issues in the Reserve Bank's own areas of responsibility.

We should expect the Reserve Bank to provide in-depth analysis to back its claims around the housing market. But in a 19 page speech, only five paragraphs are devoted to the "housing pressures are a threat to stability" section. And if not everything can elaborated in a speech, we might expect to see links to recent Reserve Bank research in the area – but there are no such links, and not even references to the issue of the Bulletin published only a few weeks ago which cited international research suggesting that housing mortgage loans have rarely played a major role in systemic banking crises. Issues of the Bulletin are generally regarded as speaking for the Bank, so it might be useful for the Bank to clarify just where it stands, and why. New Zealand might be different, but if so why does the Bank think this is likely? Perhaps the Bank can point us to countries in which private sector credit growth of around 5 per cent per annum, from starting levels of PSC/GDP that are still materially below the peaks reached 7-8 years ago, have led to serious threats to financial system soundness, or even to wider economic stability.

The Deputy Governor has been consistently reluctant to engage with the proposition that any financial stability risks must have been much greater in 2007 than they are now. In the years leading up to 2007 we had seen:

- Very rapid nationwide growth in real house prices, on a scale not seen previously in modern New Zealand history

- Very rapid growth in credit and credit-to-GDP, on scales consistent with some of the international indicators that have been taken as suggesting heightened risk of crisis.
- Much lower overall bank capital ratios (actual and required)
- A move (in the adoption of Basle II) towards lower risk weights on housing.
- A long-running period of economic expansion and consistently high levels of optimism
- High levels of real investment in housing
- Rapid growth in commercial property and farm prices, and in the associated stocks of credit.

All of which was followed by one of the nastier recessions New Zealand has seen in the post-war period, and a double-dip recession in 2010. GDP per capita (real and nominal) settled onto a much lower track than had previously been expected – so that many borrowers' income expectations proved to be quite severely disappointed. Nominal house prices did fall during the recession, and by more than the Reserve Bank projected at the time. And yet with all these factors, the soundness of our systemic institutions was never questioned (even in the midst of a global panic centred on concerns around housing) and the level of impaired housing loans rose only modestly to extremely low levels.

The current climate just does not bear comparison. If the Reserve Bank disagrees, it would be helpful for them to lay out their arguments and evidence. All the crisis literature is clear that big changes in credit stocks in short periods are the biggest crisis threat. Not only are we seeing nothing of the sort at present, but – thanks to market pressures and the Bank's efforts – buffers are much bigger than they were before. In many areas of the country – barely mentioned in the Reserve Bank material – real house prices have been falling. The one other bit of the Deputy Governor's speech I'm going to touch on today is tax. In his speech Grant states:

> "The tax treatment of housing is a major factor with potential to influence the demand/supply imbalance in the housing market. As reflected in our submission to the Productivity Commission's inquiry on housing affordability, housing is the most tax-preferred form of investment, particularly when it is highly leveraged. Investors are often setting the marginal market prices that are then applied to the full housing stock within a regional market. Indicators point to an increasing presence of investors in the Auckland market and this trend is no doubt being reinforced by the expectation of high rates of return based on untaxed capital gains. While there are difficult issues and trade-offs to consider in this area, the Reserve Bank would like to see fresh consideration of possible policy measures to

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address the tax-preferred status of housing, especially investor related housing."

This reference to the Bank's submission to the housing affordability inquiry took me by surprise, as I had had some involvement with that submission. So I went back and read it.

TAX ISSUES

Housing is a favoured investment from a tax treatment perspective. This is especially so for unleveraged owner occupiers (see Hargreaves 2008), since owner-occupiers do not pay tax on the imputed rental value of the equity in their houses (although they do pay rates). The inadequate tax treatment of the inflation component of interest, whereby all interest received is taxed and all interest payments by investors are deductible, compounds the distortion and extends it to the rental property sector. With an inflation target centred on 2 percent per annum, a significant chunk of the any interest rate reflects simply the expected general rise in the price level (rather than a real income or real cost).

The tax treatment of housing and savings products varies widely across countries. Tax regimes can be shown to influence both the level and volatility of house prices (see Hargreaves 2008 and van den Noord 2003, for example), especially when supply responses are sluggish. But countries with a variety of tax regimes experienced similar housing booms in the mid to late 2000s. Moreover, it is not clear that, in aggregate, housing is more tax favoured in New Zealand than in other countries. For example, householders in the US can deduct owner-occupier interest payments for tax purposes and in most cases face no capital gains tax. In addition, relatively high local government rates in New Zealand compared to other countries, act as a tax on property ownership.

Some have also argued that the increase in the maximum marginal tax rate in 2000 (perhaps in combination with the change in the inflation target in 2002) played a major role in the last cycle. We are sceptical for a variety of reasons outlined in our 2007 work. At most, we believe it was an exacerbating and amplifying factor. At the time, the underlying regulatory model made new housing supply relatively slow to respond and expectations of persistent future price increases became entrenched for a time. We also doubt that loss-offsetting in and of itself, was more than an amplifying factor, because rental yields at the start of the housing boom were high

> enough (and interest rates relatively low) that large losses were limited. More generally, however, correcting the tax treatment of interest to assess or deduct only real interest would remove the distortion in this area.
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> One tax issue that periodically receives considerable attention is capital gains taxation. Houses bought by investors with the intention to resell are already, in principle, caught by the income tax net, but New Zealand does not have a general capital gains tax. The Reserve Bank has never taken a stance on the general merits or otherwise of capital gains taxes. We have fairly consistently noted (including in the Supplementary Stabilisation Instruments report (Blackmore et al 2006) and the 2007 submission to the Commerce Committee) that there is little evidence internationally that countries with capital gains taxes have experienced less marked cycles in house prices. In the 2007 document, we noted that, in practice, capital gains taxes are only levied on realised gains (rather than accruals), which creates additional distortions and that capital gains taxes usually largely exclude owner occupied houses, even though unleveraged owner-occupied housing is the most lightly taxed component of the housing stock. We summed up that "capital gains taxes are common internationally but are hard to design and implement in a way that works well". To avoid establishing new distortions, any capital gains tax should only tax real capital gains and needs to treat gains and losses relatively symmetrically.

Perhaps the Reserve Bank now reads the evidence differently – but, if so, perhaps they could lay it out for us. For now, the submission they themselves pointed us to makes a couple of important points:

- To the extent that the tax system favours home ownership the advantage is greatest not for investors, but for unleveraged owner-occupiers.
- It is not clear that housing is more tax-favoured in New Zealand than in other advanced countries.
- Tax systems, and the treatment of housing, vary widely across countries and don't seem to explain differences in house price cycles
- Some distortions arise from the existence of positive expected inflation (combined with the non-indexation of the tax system) and yet this issue is not even touched on in the speech.

As a final point, it is worth remembering that the broad features of the tax system have been in place for a long time. If anything, most relatively recent changes – including lower

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maximum marginal tax rates, the introduction of the PIE regime, and successive reductions (and the eventual elimination) of depreciation allowances (on assets than manifestly do deteriorate) have worked to reduce any advantages to owning/investing in residential property.

So when the Bank talks loosely about how it “like to see fresh consideration of possible policy measures to address the tax-preferred status of housing”, it would be helpful if they could be more specific. Do they now favour a real-world capital gains tax (including on owner-occupied houses?), and think it would make a useful material difference to housing markets? Do they favour indexation of the tax system? Do they favour abolishing loss-offsetting provisions in respect of housing investment, thus treating housing differently than any other small businesses? Do they favour a tax on the imputed rental, and if so would they also favour allowing full interest deductibility on owner-occupied mortgages?

Without more detailed and extensive analysis, it is still difficult to escape the conclusion that the Reserve Bank’s approach to housing is being shaped more by impressions of the US last decade than by robust in-depth analysis of the sorts of specific risks the New Zealand economy and, in particular, New Zealand banks and the New Zealand financial system face.

Michael Reddell spent three decades as an economic adviser and manager at the Reserve Bank of New Zealand. He helped devise the inflation targeting regime, ran the Bank's economic forecasting, was Head of Financial Markets, and more latterly was a Special Adviser across a range of policy and analytical functions. Michael also spent time as resident economic adviser at the Bank of Papua New Guinea, the Bank of Zambia, and on secondment at the New Zealand Treasury. From 2003 to 2005, Michael was New Zealand's representative on the Board of the International Monetary Fund. Read more from Michael Reddell at Croaking Cassandra.

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