Home Truths

21 June 2018

The slowdown continues

This month, Home Truths takes a closer look at how various possible tax changes would impact house prices.

But first, the latest goings on in the market. It is now safe to say that the brief market resurgence that began in October last year is over. House sales fell 0.7% in May, and the time it takes to sell a house lengthened. In Auckland, house prices have fallen 2% since February, and are now back to the same level as they were in August 2016. In much of the rest of New Zealand, the pace of house price inflation continues to slow, although it is still above zero.

We have not been surprised to see the market slow – Home Truths predicted this would happen after the "bright line test" for taxing capital gains on resold properties was extended from two years to five. The next hurdle for the market will be the foreign buyer ban, which is set to become law in July. We like to use Toronto as an example – after they introduced a 15% stamp duty on foreign buyers, house prices promptly fell 6%.

REINZ housing data, Westpac seasonal adjustment

	May-18	Apr-18	May-17
House sales, number, s.a.	6434	6476	6333
Mth % chg	-0.7	0.0	0.7
Ann % chg	1.9	12.8	-17.5
Days to sell, sa	37.1	36.7	36.1
House Price Index (s.a.)			
Mth % chg	-0.2	-0.2	-0.2
Ann % chg	3.7	3.7	6.7

The data on foreign buyers released by Stats NZ was interesting on two fronts. It showed that the percentage of foreign buyers had risen from 2.3% to 3.3% since last year's election. This supports the idea that a rush to beat the foreign buyer ban contributed to the housing market resurgence from October last year. The obvious corollary is that there will be a hangover once the foreign buyer ban comes into force. The second area of interest was the regional location of the foreign buyers – they are much more prevalent in Auckland and Queenstown, so presumably the foreign buyer ban will be felt most acutely in those locations.

Tax and house prices

The Tax Working Group, headed by Sir Michael Cullen, is currently investigating various possible tax changes that could affect the housing market. The Westpac Economics Team this week released research estimating how tax change would impact house prices.[1] In New Zealand, property investment is tax advantaged relative to other forms of investment, because capital gains are tax free for long term investors. Treasury and the IRD estimate that property investors pay 29.4% of their after-inflation returns in tax, whereas bank depositors and owners of dividend-paying shares pay 55.7%. Property investors also have a tax advantage over first homebuyers, because property investors receive tax deductions for mortgage interest and other expenses while first homebuyers do not.

These tax advantages have been factored into the price of property, resulting in higher house prices than otherwise. If the tax advantages were altered, the price of property would change.

[1] Click here for tax and house price article

We estimated that a 10% capital gains tax (CGT), applied to all property other than the family home, would reduce house prices by 11% relative to the counterfactual. That could take the form of a sudden drop in prices, or a period of stagnation while the fundamentals catch up – the analysis didn't tell us which. There would be fewer willing landlords, which could cause rents to rise. Higher rents and lower house prices would change the realities of renting versus buying, leading to a higher rate of home ownership.

We found that a 0.5% property tax (similar to rates), or a 1% land tax would have a similar effect – roughly a 10% drop in house prices, higher rents, and a higher rate of home ownership. A land tax would affect houses on big sections more than apartments, and would affect Auckland more than other regions.

Adopting a deemed rate of return approach to taxing property would have a larger impact on house prices. Under this approach, landlords would pay no tax on rental income, and would receive no tax deduction for expenses. Instead, landlords would pay income tax on a fixed percentage (say, 5%) of the equity in a property. We estimate that this would reduce house prices by almost 20%.

Ringfencing losses on rental properties is likely to be introduced, or phased in, next year. Landlords will no longer be able to use losses on rental properties to offset other taxable income. Instead, they will receive tax credits that can only be used to offset future tax on their property portfolio. We estimate that this will reduce property prices by somewhere between zero and six percent.

Finally, we pointed out that house prices are sensitive to income tax rates. The size of the tax advantage of investing in property depends on the gap between the rates of capital gains tax and income tax. That gap can be closed in two ways – by reducing the rate of income tax, or by increasing the rate of capital gains tax. Reducing the top rate of income tax from 33% to 30% would reduce house prices by 2.8%.

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