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THE TREASURY
Kaitohutohu Kaupapa Rawa

To: Minister of Finance
Minister for Social Development and Employment
Minister of Revenue

IMPACT OF TAX CHANGES ON THE HOUSING SECTOR

This paper summarise the impact of the package of proposed tax changes on the housing sector. The key finding is that we believe any changes in rents and house prices are likely to be modest.

Key findings/issues

- The main element of the tax package that will impact on the housing sector is the removal of the ability to claim depreciation as a tax deduction on rental properties.
- This will reduce the return to owners of rental properties and will result in higher rents and lower house prices than would otherwise be the case.
- Treasury estimate that the impact on rents and house prices is likely to be modest, with rents rising by perhaps 0.7% more, and house prices increasing by perhaps 0.3% less, than they would do otherwise over the next three to five years.
- The tax package contains a significant number of measures with different impacts that are being introduced over different timeframes. As a result, the net impact on the housing sector over time is uncertain. It is possible that the impact could be larger than that suggested here.
- Some analyses of the housing market suggest a potential supply shortage, in particular in the Auckland region. The modest impacts of the tax package on rents and house prices could add to these supply shortages in a small way.

Background

1. The element of the tax package that most directly impacts on the housing sector is the removal of the ability to claim depreciation as a tax deduction. The main elements of the tax package will also impact on landlords and tenants to some extent, adding uncertainty to the overall impact of the package. In particular, the other base broadening measures that affect rental property (including potential changes to LAQC rules and the introduction of a bright line test) may change these estimates of the impacts on rents and house prices.

2. Removing the ability to claim depreciation as a tax deduction on rental property is likely to result in an increase in rents and/or a reduction in house prices over time. Treasury estimates that, if the full impact were felt as increased rents, rents could increase by a maximum of 2.2% more than they would have otherwise, over the next three to five years. However, the Department of Building and Housing estimate that this maximum impact on rents could be up to 6%, depending on assumptions around the nature of property investors – in particular their marginal tax rate and the mix of debt and equity finance.

3. The size of the actual impact is difficult to quantify as it will depend on a range of factors including the behaviour of landlords and tenants, the impact on construction of new houses, and the approach taken to enforcement of the new rules. We have used a simple model to reconcile the different responses of landlords, investors and tenants to assess the overall impact on the housing sector. Treasury's best estimate is that rents are likely to

increase by about 0.7% more, and house prices are likely to increase by 0.3% less, than they would have otherwise, over the medium term.

4. We have limited information on how rents and house prices will adjust, but any changes are likely to occur gradually over time, rather than as an immediate reaction to the tax package.

5. Removing the ability to claim a tax deduction for depreciation will reduce the post-tax return for rental investors. Rental investors can respond to this by:

- Increasing rents to restore their yields
- Reducing investment in rental property to reflect the lower yield
- Reducing the volume of future rental property investments
- Paying a lower price for future rental property acquisitions

6. The extent to which rental investors can increase rents over time to offset the lower post-tax return will depend on the wider balance of supply and demand for (rental) property and the ability of tenants to pay higher rents. Tenants can respond to the prospect of higher rents by:

- Trading down the quality of their rental property to a lower rent level
- Increasing the average household size
- Delaying household formation decisions (e.g. staying at home with parents for longer or not forming independent households)
- Switching tenure to owner-occupation (i.e. buying a house).

7. International research suggests that, over time, rents tend to move in line with household income. This may suggest that tenants have limited ability to pay higher rent, at least in the short term. This is particularly true for lower income households.

8. Removing depreciation will not directly impact on property developers, leaving the supply of new housing largely unchanged. DBH are concerned by analysis that suggests that current housing supply is inadequate to meet expected demand and that these pressures are particularly acute in Auckland. A key issue is whether the low current level of consents and construction is a cyclical low, or reflects a permanent structural reduction in housing supply.

9. To the extent that rents are higher, the impact on low income households will be mitigated by the Accommodation Supplement and the Income Related Rents policy. These impacts are covered in more detail in the joint note on Accommodation Supplement dated 18 March 2010.

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