

New Zealand Business Roundtable

SUBMISSION

on

New Zealand Productivity Commission Issues Paper
Housing Affordability

August 2011

1. Overview

- 1.1 This submission on the Productivity Commission's Issues Paper, *Housing Affordability* (the Issues Paper), is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall national interests.
- 1.2 The Business Roundtable welcomed the establishment of the Productivity Commission (the Commission). The Commission can play a leading role in improving the overall welfare of all New Zealanders by undertaking independent and high quality investigations into important public policy issues and making sound recommendations. Its inquiries could raise the quality of public debate and decision making, and thereby contribute to better economic and social outcomes.
- 1.3 *Housing Affordability* is the Commission's first inquiry. The outcome of the inquiry may have a disproportionate impact on political and public perceptions of the Commission. This reinforces the need for a rigorous investigation and robust recommendations.
- 1.4 The affordability of housing is an important issue. The quantity, quality and price of housing services obtained through owner-occupation, renting and other arrangements are vital for the overall welfare of all New Zealanders.^{1 2} Spending on housing and household utilities accounts for 25 percent of average weekly household net expenditure.³ An owner-occupied house constitutes the largest investment of many households. Private landlords and central and local government have made significant investments in rental accommodation. Substantial resources are devoted to the maintenance, repair and improvement of the housing stock, the construction of new housing and the provision of related services such as roads, and electricity and water supply. The funding of houses and related construction is also a major activity of the finance sector.
- 1.5 The provision of housing services is subject to extensive government regulation. Central government and, to a lesser extent, local government play an important role in the supply of housing and their assistance programmes are significant.
- 1.6 The Business Roundtable endorses the Commission's adoption of a community-wide perspective. It is equally important that the primary goal in applying that perspective should be to maximise the overall welfare of the community. This is consistent with the principal

¹ We focus on housing services, that is the shelter and related benefits provided by residential accommodation (other than accommodation for the travelling public and that provided by institutions such as hospitals and prisons). Housing services may be obtained via owner-occupied housing, rental accommodation or similar arrangements.

² Note that this is true of all income ranges. Affordable housing is not just a low income issue. It is just as relevant for higher income groups and their standard of living, such as mobile professionals considering whether to stay in New Zealand or migrate here.

³ Statistics New Zealand (2010), *Household Economic Survey Year Ended June 2010*, table 2.

purpose of the Commission which is to provide advice to the government on improving productivity in a way that is directed to supporting the overall well-being of New Zealanders, having regard to a wide range of communities of interest and population groups in New Zealand society.⁴ Housing could, for example, be made more affordable by providing additional subsidies for housing services generally but the preferences of individuals would be distorted, higher taxes would be required, and economic efficiency would be compromised. A focus on advancing the welfare of the community may also be lost when intensification of cities is advocated to minimise travel times or support public transport without having regard to whether such objectives are consistent with welfare maximisation.

- 1.7 There are conceptual difficulties in evaluating whether housing is affordable as there is no objective economic criterion other than the willingness of a person or a household to pay. The value of goods or services to a rational buyer in a voluntary transaction must be at least equal to the price paid. Individuals would buy more and/or higher quality housing services than otherwise at a lower price but that does not necessarily imply that the goods or services in question are unaffordable. Similarly, individuals forgo other goods and services of lesser value to them so that they can acquire housing services at the market price.
- 1.8 Some people cannot afford even a basic standard of housing on an unassisted basis. That does not imply that housing services are generally unaffordable. The main problem facing such people may lie elsewhere, for instance in unemployment, ill health, injury or sole parenthood. Assistance in such cases is provided through the government's welfare programmes.
- 1.9 Rules of thumb may provide a broad indication of the affordability of housing generally and may indicate possible problems with markets for housing services. However, they do not take account of economic factors that affect the demand for, and supply of, housing services in specific localities and therefore prices. Some rules of thumb may be useful in indicating whether housing services are becoming more or less affordable over time.⁵
- 1.10 The cost of housing services is unduly inflated by certain policy-induced distortions. The problem starts with the Resource Management Act 1991 (RMA) and associated planning/zoning regulation, followed by land development and house construction. Rules and regulations, and excessive compliance costs, are the problem in each area. Strict controls over land that can be

⁴ New Zealand Productivity Commission Act 2010, s 7.

⁵ Hugh Pavletich, who has written extensively about housing affordability, defines affordable housing in the following terms, "For metropolitan areas to rate as 'affordable' and ensure that housing bubbles are not triggered, housing prices should not exceed three times gross annual household earnings. To allow this to occur, new starter housing of an acceptable quality to the purchasers, with associated commercial and industrial development, must be allowed to be provided on the urban fringes at 2.5 times the gross annual median household income of that urban market ... The critically important Development Ratios for this new fringe starter housing, should be 17 - 23% serviced lot / section cost - the balance the actual housing construction. Ideally through a normal building cycle, the Median Multiple should move from a Floor Multiple of 2.3, through a Swing Multiple of 2.5 to a Ceiling Multiple of 2.7 - to ensure maximum stability and optimal medium and long term performance of the residential construction sector." See Pavletich, Hugh (2011) 'Definition of an Affordable Housing Market', retrieved 2 August 2011 from <http://www.performanceurbanplanning.org/>.

developed for housing, for example, push up section prices. Genuine rural land often sells at much lower prices than comparable undeveloped land within urban boundaries or nearby land that is expected to be included within urban boundaries over the medium term.⁶ If distortions such as these are addressed housing services would become more affordable and community welfare would be enhanced. We therefore endorse the Commission's statement (on page 8) that a key focus of the inquiry is distortions that adversely affect efficiency. This is consistent with those matters identified for particular attention in the terms of reference for the inquiry.

1.11 The balance of our submission is presented in two sections. The next section (section 2) presents detailed comments on selected matters discussed in the Issues Paper. While those comments are prompted in some cases by the questions raised in the Issues Paper, we have not provided specific answers to most of the questions raised. For ease of reference we have organised our comments under the topic headings contained in the Issues Paper that we wish to address. Our conclusions are presented in section 3.

2. Specific Comments

Recent trends in housing markets

2.1 Statistics on housing tenure need to be treated with considerable caution. As Statistics New Zealand notes, the relevant questions asked in recent censuses have changed.⁷ We suspect that there has been a rise in the proportion of houses held in family trusts and occupied by related parties such as the settlor or beneficiaries of the trust.⁸ The census questions and guidance have not have been sufficiently precise to generate consistent treatment of such trusts over time.⁹

2.2 The Issues Paper reports that the homeownership ratio has declined from 75 percent in 1991 to 67 percent in 2006 (page 19). This arguably gives a misleading impression. The homeownership ratio was remarkably stable at between 65 percent and 70 percent at most post World War II censuses despite large changes in the rates of population growth, family

⁶ Arthur Grimes reported that land just inside Auckland's metropolitan limit was valued at approximately 10 times land that was just outside the limit. However, this estimate understates the real impact of restrictions on land for development because land just beyond the boundary reflects the probability that such land will be brought within the boundary in the future. See Grimes, Arthur (2009), 'Housing: Auckland Supply Issues', presentation to the 2025 Taskforce, 5 October, retrieved 17 July 2011 from <http://www.2025taskforce.govt.nz/pdfs/tfpr-grimes-ahsi-5oct09> and Grimes, Arthur and Liang, Yun (2007), 'Spatial Determinants of Land Prices in Auckland: Does the Metropolitan Urban Limit Have an Effect?', Motu Working Paper 07-09, retrieved 17 July 2011 from <http://www.motu.org.nz/publications/working-papers/2007>.

⁷ Statistics New Zealand (2011), *2006 Census Quickstats About Housing – Tables* (revised 31 March 2011), retrieved 11 July 2011 from <http://www.stats.govt.nz/Census/2006CensusHomePage/QuickStats/quickstats-about-a-subject/housing.aspx>.

⁸ The level of mortgages for investment properties attributed to Brooks and Cunero on page 21 of the Issues Paper may also include family trusts.

⁹ Michael Littlewood and Philip Morrison have examined this issue. For Michael Littlewood see <http://www.rprc.auckland.ac.nz> and for Philip Morrison see Morrison, Philip S (2007), *On the Falling Rate of Home Ownership in New Zealand*, Centre for Housing Research Aotearoa New Zealand, Wellington.

formation, urbanisation, house prices, interest, inflation and tax (the top personal rate of income tax was 66 percent in 1985/86), and changes in regulations relating to the development of housing and government housing assistance. At the three censuses when the homeownership rate exceeded 70 percent it did so by a modest level according to Philip Morrison's data.¹⁰

- 2.3 The Commission should be very careful about basing policy conclusions on the perceived decline in homeownership rates since the peak in 1991 and in the absence of an analysis of the data and of possible explanatory factors.
- 2.4 We also think that community welfare is primarily affected by the level and quality of housing services enjoyed by households. The question of whether housing services are obtained via ownership or renting is a secondary issue. Home ownership may be a poor option for some households, for instance in depressed areas where job opportunities are limited and home ownership might be a barrier to labour mobility, or where mortgage commitments would constitute an excessive burden. We doubt if there are persuasive public policy grounds for promoting homeownership in preference to renting. As far as is feasible, government policy should treat different tenure arrangements on a neutral basis. The issue should be examined in the inquiry.

Urban planning, design and land use policies

- 2.5 The Commission will need to investigate matters under the above heading in considerable depth as part of its focus on efficiency. They are important factors in the cost of new housing and housing related services, and the time required to bring developments to fruition. In particular, it is necessary to examine how existing regulation works in practice and the roles performed by government agencies.¹¹ We have restricted our observations to some preliminary comments.
- 2.6 The RMA is a key statute. Despite comments to the contrary in the Issues Paper (and commonly elsewhere), the RMA is not a planning statute or the "primary land-use planning legislation" or part of the "planning system". It is an environmental statute. Its purpose is "to promote the sustainable management of natural and physical resources."¹² The RMA focuses on the avoidance or mitigation of the adverse effects of activities, consistent with the

¹⁰ According to Morrison, the exceptions were 1951 (61 percent), 1981 (71 percent), 1986 (73 percent), and 1991 (72 percent). Morrison's percentage for 1991 differs from those reported in the Issues Paper, see Morrison (2007), *op cit*, p 14.

¹¹ Some such matters were examined in the *Report of the Minister for the Environment's Urban Technical Advisory Group*, especially chapter 3 on affordable housing. See Dormer, Alan *et al* (2010), *Report of the Minister for the Environment's Urban Technical Advisory Group*, retrieved 12 October 2010 from <http://www.mfe.govt.nz/rma/central/amendments/resource-management-simplify-and-streamline-amendment-bill-2009/report-technical-advisory-group/index.html>.

¹² Resource Management Act 1991, s 5.

recognition of externalities that are noted in the Issues Paper. In passing the RMA, parliament explicitly rejected the planning approach that was reflected in the former Town and Country Planning Act 1953. Implementation of the change in perspective is still being resisted.

- 2.7 The 2025 Taskforce concluded that the RMA continues to be one of the most important regulatory barriers to higher rates of growth in New Zealand. The Business Roundtable endorses this finding. The 2025 Taskforce recommended the following:

... urgent attention be given to further reform of the Resource Management Act, taking it back to its original intent as an effects-based law which is otherwise broadly permissive.¹³

- 2.8 In contrast, the Issues Paper (at page 27) reports the views of the Ministry for the Environment and the OECD which criticise the complexity, fragmentation and uncertainty of the regulatory framework governing the "New Zealand planning system".¹⁴ The Issues Paper (also at page 27) emphasises central planning rather than decentralised decision making by actors subject to rules known in advance (the rule of law) and the discipline of the market in reporting the following:

With multiple participants and decision makers, there is no single mechanism for facilitating engagement, securing agreement among participants and providing information for robust decision making.

- 2.9 Like the 2025 Taskforce, we have major reservations about the RMA and its application from the perspective of the rule of law and liberty. The delegation of virtually unconstrained discretion to the executive is arguably inconsistent with the rule of law.¹⁵ The RMA also gives insufficient recognition to private property rights. The 2025 Taskforce described the fundamental problem with the RMA in the following terms:

... it encourages local government to see the changed use of private land as a privilege that they bestow, rather than a right that might be modified only in narrow and well-specified predictable ways.¹⁶

- 2.10 We suggest that the Commission examine closely the discussion and recommendations of the 2025 Taskforce 2025 on the RMA. We had hoped that the government would make fundamental changes to the RMA as part of its phase II reforms. However, those reforms appear to be drifting. The Commission's inquiry provides an opportunity to address this vitally important subject.

¹³ Brash, Donald T, Caygill, David, Sloan, Judith and Wilkinson, Bryce (2010), *Focusing on Growth: The Second Report of the 2025 Taskforce*, retrieved 2 December 2010 from <http://www.2025taskforce.govt.nz>, p 111. This report is referred to below as *The Second Report of the 2025 Taskforce*.

¹⁴ There are problems of complexity and uncertainty but they are caused by not upholding property rights, unsatisfactory rules, rules that are subject to excessive discretion by the executive, and rules that are too imprecise.

¹⁵ Ratnapala, Suri (2006), *Environmentalism versus Constitutionalism: A Contest Without Winners*, p 33, retrieved 9 December 2010 from <http://www.nzbr.org.nz>.

¹⁶ *The Second Report of the 2025 Taskforce* (2010), *op cit*, p 112.

2.11 The 'zoning' of land for residential development is an important issue. The following comment is an edited version of a perspective provided a member of the Business Roundtable who is active in development:

As soon as a council zones an area or puts a growth boundary, either primary or secondary, around a city, it instantly starts an escalation of the price of land. This typically increases the price of standard farmland by 200-300 percent. Developers typically aim to make a net margin of between 10-30 percent. If enough land were zoned the increase in price would be minimalised but so much land would have to be zoned to achieve this effect that it is unlikely that a council would go this far. On the other hand, councils could stop zoning land automatically, aside perhaps from protecting only potential master roading networks or infrastructure networks by some form of zoning, and leave zoning generally to be implemented as private land changes by developers (which is how developers typically prefer to operate). Developers could then deal directly with rural land at, or closer to, rural land prices. This would enable the developer to offer developed land at a considerably lower price and stop the problem of escalating land prices simply by the fact of zoning, with the super-profit going to either investors or farm landholders who find themselves lucky enough to be located within newly zoned land with developers then having to pay double or even triple the price for the land which has to be passed on to the end consumer.

The essential thrust of this comment is that excessive restrictions on zoning need to be removed to address housing affordability.

2.12 Central or local government is responsible for the provision of most network infrastructure (such as roads and related services, water, wastewater and stormwater) under present arrangements. The government is also responsible for the regulatory framework that applies to its provision. Most of the problems relating to the provision of housing-related infrastructure reflect government failure. The provision of infrastructure generally, including infrastructure charges, should be examined.

2.13 Infrastructure charges in the form of development and financial contributions have become a major source of council revenue in recent years. They are adding appreciably to housing costs. In our view many councils are not applying these charges on a principled basis. In 2010 the Local Government Forum (of which the Business Roundtable is a member) and the Property Council published a report *Taxing Growth and Development: A Critical Review of the Role of Development and Financial Contributions*, which examined these issues. We are pleased to see the report's main conclusions summarised well in the Issues Paper (page 30).

Building controls

2.14 We are sceptical that the recent expansion of occupational licensing, largely in response to leaky homes, is warranted. Unless it has no effect on the supply of tradespeople (which is most unlikely), licensing will put up the cost of inputs into house construction, improvement and repair. The question is whether such cost is outweighed by the benefits. Similarly, whether building standards are justified on a cost benefit basis is a relevant issue for the inquiry.

Role of taxation

2.15 There has been considerable comment on the taxation of housing in New Zealand. Much of it is superficial at best. We note the following:

- It is well known that tax preferences distort resource allocation.
- Owner-occupied housing is treated more favourably than most other classes of assets for income tax purposes. Rental housing is treated somewhat less favourably than many classes of assets. The 2010 Budget removed depreciation deductions for property with a life of 50 years or more, and denied investors the opportunity to offset rental property losses incurred through loss-attributing qualifying companies against their personal income.¹⁷
- Owner-occupied housing and rental housing are treated neutrally for GST purposes. Inputs into both forms of housing are subject to GST.
- Taken together, the above tax provisions imply that aggregate investment in owner-occupied housing is likely to be larger than would be the case with more neutral income tax and GST regimes.
- The information required to apply income and consumption (GST) taxes according to optimal tax models is not known. For this and other reasons it is not feasible to tax some activities at all or to apply tax as neutrally to those activities that are taxed as would be desirable from an efficiency perspective. Practical tax policy reflects these realities.
- The major practical problem in taxing owner-occupied housing is that the level of gross income (rents) cannot be determined by an arm's length transaction. They could be imputed. However, if imputed rents are taxed and if the level of such rents are on average significantly understated (which is a major risk when imputed rents are taxed) the perceived tax preference to owner-occupied housing may be greater than if imputed rents were not taxed at all. This situation arises where tax deductions persistently exceed the level of imputed rents.
- Owner-occupied housing is exempt from income tax and no deduction is allowed for mortgage interest or other expenses incurred. This treatment is long standing. Its effects can be expected to be fully reflected in asset prices such that tax-free returns on owner-occupied housing will tend to equal post-tax returns for taxable assets with a similar risk.
- There is little reason to assume that such long-standing income tax arrangements played a major role in recent house price trends or that the distortion to resource allocation will have been significantly accentuated by tax treatment over the past few years. (As noted below, some tax developments have moved in the opposite direction.) Similarly, perceived inequities ignore the adjustment of prices and expected returns.
- Many countries exempt owner-occupied housing (or at least the principal residence) from income tax. New Zealand's tax treatment is broadly similar to that of Australia, Germany and the United Kingdom. It is less concessional than that of France, Ireland, Italy and

¹⁷ A concern that expenditure of a capital nature may have been treated as repairs and maintenance, and deducted from taxable income, may have encouraged the government to deny depreciation deductions. However, this issue also arises in respect of buildings with a life of less than 50 years.

Spain which provide a tax credit or deduction for at least some mortgage interest but, like New Zealand, do not tax imputed rents.¹⁸

- Contrary to much commentary in the media, capital gains on owner-occupied housing are not typically taxed in those countries where capital gains taxes are generally applied. Examples include Belgium, France, Germany, Ireland, Italy, The Netherlands and Spain.¹⁹ Much the same policy applies in practice in the United States where a high threshold of US\$500,000 for a married couple and US\$250,000 for a single person after two years applies before realised gains are taxed.²⁰
- The Tax Review 2001 raised the possibility of taxing owner-occupied housing (and perhaps other assets) according to the risk-free rate of return method. This approach, which has attractions over imputing rents, was widely criticised and was effectively ruled out by the government within a few days. This experience indicates the political infeasibility of bringing owner-occupied housing into the tax net.
- Since the mid-1980s, the top personal rate of tax has been reduced from 66 percent to 33 percent. This will have halved the perceived tax preference for owner-occupied housing (and human capital and leisure) that applies to those on the top rate of personal tax, other things being equal. The Business Roundtable considers ongoing moves to lower and flatter income taxes over time are the best way to address the preference for owner-occupied houses.
- Income tax has traditionally been applied to investment in rental accommodation in New Zealand. The practical and political sustainability grounds for exempting owner-occupied housing from income tax do not apply to rental accommodation.
- The question of whether rental housing should be treated on a similar basis to owner-occupied housing centres on where the discontinuity in tax treatment best lies. If tenure neutrality is emphasised, rental housing might be treated on the same basis as owner-occupied housing. This would, however, tend to encourage more resources to be committed to housing than otherwise. If neutral tax treatment of close investment substitutes are emphasised, rental housing should be treated on a similar basis to commercial property and financial investments. A concern for the allocation of resources and the close substitution of other investments point to the present treatment. Moreover, the grounds for providing a windfall gain to owners of existing rental accommodation (with higher tax imposed elsewhere to make up lost revenue) seems weak. The primary question for public policy is how to advance to a better policy setting from the present one rather than how present policy compares with some 'ideal' treatment. Thus the starting point is relevant to the best direction in which policy should move.
- The OECD's claim cited on page 39 of the Issues Paper is doubtful. The ability to offset tax losses against other income is not a tax preference. Immediate 'cashing out' of tax losses is the risk neutral tax treatment under a proportional income tax. In those circumstances, the government shares equally in losses and profits.²¹ Governments typically do not allow losses to be cashed out so as to constrain the scope for tax avoidance to drain the treasury. Instead, they generally allow tax losses to be offset against other income (which

¹⁸ Hemmelgarn, Thomas, Nicodeme, Gaetan and Zangari, Ernesto (2011), *The Role of Housing Tax Provisions in the 2008 Financial Crisis*, Taxation Papers, Working Paper No 27, Luxembourg: Office for Official Publications of the European Communities, p 18.

¹⁹ *Ibid.*

²⁰ Poterba, James and Sinai, Todd (2008), 'Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income', *American Economic Review*, vol 98, no 2, pp 84-89, p 86.

²¹ An early discussion is Domar, Evsey D and Musgrave, Richard A (1944), 'Proportional Income Taxation and Risk-Taking', *Quarterly Journal of Economics*, vol 58, pp 388-422. A recent discussion is Kaplow, Louis (1994), 'Taxation and Risk Taking: A General Equilibrium Perspective', *National Tax Journal*, vol 47, No 4, pp 789-798.

is conceptually equivalent to cashing out losses, provided that the taxpayer has sufficient other income) and to carry any loss that cannot be offset forward. This is a penal treatment unless such losses are uplifted by the rate of interest. No such adjustment is made in New Zealand.

- So-called negative gearing is unlikely to be a significant concern from a tax perspective. The economic return from an activity can be computed before interest. Gearing distributes that return among debt holders and equity investors. Restrictions on the level of gearing only constrain investment in a tax-preferred activity in those circumstances where the pre-tax return would not, in the absence of such borrowing, have fully reflected the tax preference. Once the pre-tax return has adjusted there is no additional demand for tax-preferred assets. Restrictions on gearing are also unlikely to be effective because of the fungibility of money.²²

Macroeconomic influences

2.16 Monetary and fiscal policies are notable omissions from the Issues Paper. They are relevant to a discussion of the development of house prices over the past few years. They are also important in examining the erosion of the competitiveness of the tradeable sector and the expansion of the non-tradeable sector (which includes housing). In our view this is a much more likely explanation of persistent current account deficits than inadequate savings and 'over-investment' in housing.

Other issues

2.17 There is very little in the Issues Paper on the range and scope of housing assistance provided by central government and local government. Such assistance impacts on the operation of housing markets, especially the rental market. There is also little mention of the role of government agencies such as the Housing Corporation. Private provision of rental accommodation and consumer choice can be expected to be discouraged by the activities of the Corporation. The cost effectiveness of the government's programmes is also an issue.

3. Conclusion

3.1 In conclusion we highlight the following:

- It is vital that the Commission's first inquiry establishes its reputation for well-researched investigations and robust recommendations.
- The Commission's adoption of a community-wide perspective is endorsed. The primary goal in applying that perspective should be to maximise the overall welfare of the community.
- There are conceptual difficulties in evaluating whether housing is affordable.

²² Cordes, Joseph J and Galper, Harvey (1986), *Tax Shelter Activity: Lessons from Twenty Years of Evidence*, The Brookings Institution, Washington DC.

- The cost of housing services is unduly inflated by certain policy-induced distortions. We agree that the inquiry should focus on efficiency.
- The Commission should investigate the matters discussed under urban planning, design and land use policies in considerable depth. Existing regulation is imposing unduly large costs and delays on housing development.
- There is little reason to assume that long-standing income tax arrangements played a major role in recent house price trends or that the distortion to resource allocation will have been significantly accentuated by tax treatment over the past few years.