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Inflation and Housing: Three Myths

Recently there have been renewed calls to tax capital gains on housing. Opposition leader Phil Goff has indicated Labour would be open to talks.

Parliament's Finance and Expenditure Committee considered the taxation of housing in its 2007-08 monetary policy inquiry.

It found that the monetary framework was sound, with monetary policy being necessary and sufficient to maintain price stability. Only the Green Party recommended a capital gains tax (CGT) on housing (other than the family home).

Monetary policy is a powerful instrument, contrary to some commentary by the Reserve Bank during the last interest rate cycle.

Tight monetary policy dampened inflationary pressures through 2007. Current loose monetary policy, combined with indications from the Bank that it expects to keep interest rates low well into next year, carries risks of an unbalanced recovery (not led by exports and investment) and a resurgence of inflation.

Could these risks be reduced by altering the tax treatment of housing? Some have suggested that such action could curb house price inflation, reduce the alleged tax advantages of rental housing, and channel investment to more 'productive' sectors of the economy.

These arguments are largely fallacious.

A CGT on housing would not reduce inflation. Inflation is a monetary phenomenon: essentially "too much money chasing too few goods." It is an ongoing increase in the general level of prices, not a one-off change in some prices.

The introduction of GST resulted in a one-off increase in the CPI; it did not lead to ongoing inflation. Similarly, a CGT might reduce property prices initially but it would not affect longer-term inflation.

Moreover, if a CGT on housing were applied only to realised gains as is likely (ie as properties were sold), house prices could even rise. This is because of the lock-in effect, with owners holding on to homes to defer the tax on gains. Anything that reduces supply is likely to lead to an increase, not a decrease, in price.

Empirical evidence confirms what theory suggests: the inflation performance of countries that apply a CGT doesn't differ systematically from countries that don't.

Australia, the United States and the United Kingdom, which tax capital gains, have all had large and volatile house price movements this decade.

A second mistaken assumption is that investment in rental housing enjoys tax privileges.

As the deputy commissioner of Inland Revenue, Robin Oliver, told a select committee in 2007, "Rules about expenses for deducting costs such as interest, upkeep and maintenance, as well as paying tax on income, are the same for investments in shares or anything else. In fact under the housing case ... there are tighter rules regarding what is a capital gain."

People are misled into thinking that rental housing is tax-preferred since highly geared rental property may record tax losses. This is because the full economic income (including the change in the market value of the assets) earned on rental property is not taxed. However, this is a quite general feature of the taxation of real assets, including plant and equipment and farms.

Moreover, any attempt to increase the taxation of investment in rental housing could well push up rents as investors seek to restore after-tax returns.

A third issue is owner-occupied housing. It's true that this category of housing (which represents two-thirds of the housing stock and is typically exempted from CGT proposals) is tax-favoured because imputed rents (the value of housing services to owners) are untaxed.

However, New Zealanders' so-called 'love of housing' may be overstated. The same comments are heard in other countries, and home ownership levels in New Zealand are not exceptionally high.

Interestingly, residential investment in new homes and improvements in existing homes in New Zealand for the period 1970-2005 was 5.1% of GDP, lower than in Australia where the figure was 6.2%, according to the OECD.

Rather than attempt to tax imputed rents (which would logically be the first step) or impose a CGT on housing, my preference would be to lower and flatten the income tax scale, as the 2001 McLeod Tax Review recommended. It did not favour a CGT.

While not eliminating the tax preference for owner-occupied housing, such moves would reduce it whereas the previous government's move to raise the top income tax rate increased it.

There can be fair debate about how far we should tax real capital gains (some, such as gains from trading in shares and property, are already taxed), although in my view the practical problems make major moves unattractive and the revenue gains would be small, given an exemption for the family home.

However, the debate has nothing to do with monetary policy and inflation, which the Reserve Bank has full power to control over the medium term, and myths about tax preferences and their effects should not be perpetuated.

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