Nick Wilson

Fixing the housing crisis: the role of intergenerational policy design in addressing the issues

This article looks at the intergenerational issues associated with housing in New Zealand. Election year is again upon us (Covid-19 permitting) and, with the problems surrounding KiwiBuild, housing affordability is under the spotlight. It is no secret that New Zealand has a housing affordability problem and many causes are feeding this.

Two of these causes – capital taxation inconsistencies and infrastructure issues – will be the focus of this article. Inconsistencies in the taxation of capital income are a major source of the problem, causing intergenerational transfers from younger to older generations. A land tax is a possible solution. Complementary policies targeted at addressing infrastructure bottlenecks also have an important role to play.

Nick Wilson is a graduand in public policy and commercial law at Victoria University of Wellington.

Some causes of high property prices

Capital taxation inconsistencies are an important cause of high property prices. Andrew Coleman (2018) discusses – with specific emphasis on the 1989 changes – how the current composition of New Zealand's tax system contributes to the predicament we are faced with.

The 1989 tax reforms created conditions in which property income became taxed at lower rates than income on other assets, giving property income a relative tax advantage. Owner-occupied housing became taxed relatively lightly, and residential landlords who borrowed to invest also received a significant effective subsidy under the new conditions. Meanwhile, even the inflation on interest-earning securities became taxed, which caused real investment income tax on these to be very high. This disjunction caused people to overinvest in property, driving up property prices to an artificially high level – New Zealand's inflation-adjusted post-1990 property prices increased faster than those in other countries for which similar data exist – and these changes are believed to have contributed to that.

Most theorists agree that, in situations where the price elasticity of the demand for property is not extremely high, as is the case in New Zealand, circumstances in which property taxes differ from taxes on income from other assets will cause the property prices to capture the differences, and this appears to have eventuated. While homeowners at the time of the changes benefited, this created a negative intergenerational transfer to non-homeowners and to all younger generations in the form of artificially high property prices (Coleman, 2018).

A separate cause of high property prices relates to the fundamental economic concepts of supply and demand – the supply/demand ratio is too low. Therefore, an obvious fix would be to build more houses, as KiwiBuild has attempted to do. This begs the question, even if we ignore KiwiBuild and its failures, why are more houses not being built? The main problem appears to be the presence of unnecessary barriers to development. Evidence from the United States suggests that the ability to more easily build upwards and outwards correlates with more affordable housing and vice versa (Darning, 2017). Many factors in New Zealand make such expansions far from easy, and much of this relates to restrictions and perverse incentives facing local and regional councils. One such perverse incentive relates to infrastructure.

Infrastructure issues inhibit councils from approving developments. The relative power and influence of central government on public policy is very high in New Zealand. Apart from rates, councils do not have any significant sources of income. To adequately maintain and create the infrastructure needed for development, councils would need to increase rates or cut spending on other local projects, or both. None of those options would be politically popular. Even just maintaining existing infrastructure is already proving difficult (Krupp, 2015).

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Based on these factors alone, councils are hardly going to be proactive in supporting development. There are, of course, other influences at play as well. One of these is the Resource Management Act, widely considered to be a central issue restricting housing development; another is 'not in my back yard' (NIMBY) opposition to residential development.

A land tax solution

Even just highlighting two of the many causes of high property prices indicates that change is necessary. Just as there are many causes, there are also many different options that can be used to address the issue. One option that may be more viable than others (if implemented correctly) is a centrally levied land tax; this can help counter both of the aforementioned causes.

First, a land tax can be used to tax residential property, which, it has been argued, is relatively lightly taxed. In New Zealand's housing market, where the price elasticity of the supply of housing is low, this would reduce the relative tax advantage of residential property over other capital assets (Coleman, 2018). Therefore, the extent to which property is over-invested in, driving prices up to artificially high levels, would also be reduced.

In addition, if it is implemented correctly, increased tax revenue that stems from the land tax can help reduce property prices. Putting the extra tax revenue into infrastructure investment could offset the extent to which infrastructure is currently underinvested in. Because housing developments need this critical infrastructure, councils – despite still facing other incentive issues – will be more inclined to approve developments that they may not otherwise have approved, making it easier to build (Crampton and Acharya, 2015). As a consequence, the supply of housing would increase, resulting in enhanced housing affordability.

The benefits

While other policy options for addressing this issue are available, a land tax has many benefits. A capital gains tax is one option that has often been proposed, but this has been rejected by the current, Labour-led government, partly due to its political unpopularity (Bowker, 2019). Meanwhile, flat-rate property taxes can behave similarly to capital gains taxes in this context (Coleman, 2018). Rosen (1982) highlights more generally, in an overseas context, how these property taxes can be effective. With land tax working in effectively the same way, it is a potentially more palatable substitute for a capital gains tax.

Younger cohorts would likely support a land tax for the same reasons that many take out student loans: while they would pay more in the future, it would be better to benefit from reduced property prices now, to put them in a more stable position where they are more able to pay in the future. A land tax is also a win in both equity and efficiency terms. Land is a form of wealth and the burden of the tax tends to fall mostly on landowners, making it equitable (Coleman, 2018). While many equity gains come at the expense of efficiency, land is fixed and exists whether it is taxed or not, making the price elasticity of supply inelastic. This minimises the deadweight cost, making it efficient, too. These factors are likely to make a land tax relatively popular.

The issues

Despite the potential relative popularity of this option, there will be issues and objections. Property owners stand to lose from land taxes (ibid.). That land taxes are more appealing than alternatives will not stop people opposing change altogether in order to retain high property prices.

People who became property owners post-1989 could get the double negative of buying at an artificially high price and then having to pay land taxes and would want to avoid this. Pre-1989 owners who still own that property would also want to retain the intergenerational transfer that has benefited them – a classic example of different cohorts' interests clashing and providing a friction that slows or stops policy change even if it may produce a net benefit.

Self-interest will lead to inevitable opposition, which is quite likely to carry political influence, especially when supporting emotive arguments are available. The prospect of grandma losing her family home because of being unable to pay these taxes is something that opponents of such taxes would be stupid to ignore.

In addition, the current tax terms of reference rule out land tax on owner-occupied housing. Retaining this prohibition would create distortions and undermine the effectiveness of the policy (ibid.).

Overcoming the issues: intergenerational design considerations

The extent to which these issues would affect a land tax being introduced would determine what design and implementation measures would need to be taken to give effect to it. The simplest case is that it would be sufficiently supported on its own merits, in which case the best course of action would be to merely remove

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the part of the terms of reference that prevents owner-occupied housing being included. Regardless of other measures, this removal would be necessary to ensure the effectiveness of the land tax. However, given that political considerations are a major issue with land taxes, matters may be more complicated (ibid.).

While specific issues, such as elderly people not being able to afford to keep their family home, could be solved by products such as reverse mortgages, this is unlikely to satisfy opponents. If opposition from homeowners would otherwise preclude land taxes from occurring, consideration of how to win them over is necessary for the sake of younger generations, and intergenerational policy can be utilised for this purpose. While easier said than done, the blackboard ideal would be to strike the right balance by which you give just enough to potential opposition to reduce their fightback such that political sustainability can be achieved.

In terms of designing intergenerational policy, there are many options that could be developed that would have different pros and cons. One option is a cohort-based policy that would simply exempt from the tax (until the owners' deaths or for a stated number of years) pre-possessed property owned by people born prior to a certain year (at the time of the change announcement). As older people tend to have higher home-ownership rates, this would likely reduce the opposition to such changes from these exempted people, which might be enough to get the required political support.

Restricting the exemption to pre-possessed property also restricts loopholes such as people getting their parents to purchase property on their behalf. A downside of such a policy is that this further favours people who have likely already had intergenerational benefits in the form of gaining from the 1989 tax changes at younger cohorts' expense. It would also slow the effect of the change to a more gradual pace. Yet, if compromise needs to be made to enable change, such options are worth exploring.

This is just one of many potential interventions that could be explored. The purpose of such explorations is not to definitively convince people that any specific idea is a good one. Any idea would need to be assessed in terms of what specific figures, ages or time frames (or any other desired measures) would be appropriate to maximise the effectiveness of the land tax policy, and ideas would need to be compared based on the resulting information.

The purpose of this example, rather, is to highlight that there are options for engaging in constructive intergenerational conversations about public policy. Such conversations could help reduce intergenerational tensions that could otherwise prevent the development of enduring beneficial policies. It is also to give an indication of some of the necessary considerations.

Some may still point out the tendency for arbitrariness in deciding age, cohort or generational cut-offs in designing intergenerational policy; people in similar circumstances may well face different obligations or exemptions. Yet, as evidenced by the highlighted downsides in the above example, this may be a necessary cost of introducing and sustaining a policy that is expected to produce a net societal benefit. It is a rare policy that leaves everybody winning and nobody losing.

Conclusion

It is clear that New Zealand faces a large housing issue, one that is intergenerational in cause and can also be intergenerational in solution. Capital taxation inconsistencies, caused by the 1989 tax changes that created an intergenerational transfer from younger to older generations, along with infrastructure issues have contributed significantly to the house price problem and land taxes are a potential option to address this issue. Yet land taxes do not come without their perceived deficiencies. Nevertheless, the contribution of such interventions to intergenerational equity, despite not being ideal, may help overcome some of these objections, towards restoring house prices to more affordable levels.

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