The Treasury

Budget 2021 Information Release

August 2021

This document has been proactively released and is available on

- the **Budget website** from August 2021 to May 2022 only at **https://budget.govt.nz/information-release/2021**, and on
- the **Treasury website** from later in 2021 at **https://treasury.govt.nz/publications/information-release/budget-2021-information-release**.

Information Withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act).

Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[1] 6(a) - to avoid prejudice to the security or defence of New Zealand or the international relations of the government

[23] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[26] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

[36] 9(2)(h) - to maintain legal professional privilege

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

[40] Not in scope

[42] 18(d) - information is already publicly available or will be publicly available soon.

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [23] appearing where information has been withheld in a release document refers to section 9(2)(a).

Accessibility

The Treasury can provide an alternate HTML version of this material if requested. Please cite this document's title or PDF file name when you email a request to information@treasury.govt.nz.

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Impacts of recent housing tax changes on Budget 2021 forecasts

Date:	19 April 2021	**Report No:**	T2021/967
		File Number:	BM-3-6-1

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Note** that the changes to housing tax treatments are likely to have a material impact on the housing market and wider economy.	None

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Dominick Stephens	Deputy Secretary (Chief Economic Adviser)	[39]	[35]	✓
Ben Ching	Analyst, Tax Strategy		N/A (mob)	
Hannah Ouellet	Analyst, Housing and Urban Growth		[35]	
Carlos So	Analyst, Forecasting		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Impacts of recent housing tax changes on Budget 2021 forecasts

Executive Summary

On 23 March 2021 the Government announced that the bright-line test for taxing increases in value of residential investment property would be extended from five to ten years for property acquired after the application date, and made an in-principle decision to limit interest deductions on residential investment property. This Treasury Report focusses on how the proposed changes to interest deductibility affected the BEFU 2021 forecasts of house prices, economic growth, interest rates, and tax revenue. The extension of the bright-line test had little impact on the forecasts and is therefore less of a focus in this document.

We expect the removal of interest deductibility will have a material impact on house prices. Without this tax change we would have forecast an increase in house prices of 34% over the forecast period. Due to the removal of deductibility we revised our forecast to around 14%, a downgrade of around 16%.

More moderate house price inflation is likely to cause more moderate household consumption and residential investment, slowing the economic recovery. In turn, this will make it more difficult for the RBNZ to meet its inflation and employment targets, necessitating lower interest rates for a longer period. And low interest rates will ameliorate the downward impact on house prices. The end result was that the tax changes to interest deductibility decreased the BEFU 2021 forecasts for both houses prices and 90-day rates.

Our analysis suggests that demand for investment properties among highly-leveraged property investors will drop dramatically. However, the price moderation this causes will attract additional demand from owner occupiers and unleveraged investors, who are unaffected by the tax change. It is impossible to determine with any certainty what price level is required to attract these groups into the market in sufficient numbers. Our assessment is that house prices around 16% below the counterfactual will equilibrate the market, but this is highly uncertain.

We expect some increase in demand from owner occupiers, which will increase the rate of home ownership. However, we expect the bigger impact will be a lift in demand from unleveraged (or low leverage) property investors. The side-effects of this include a reduction in both bank deposits and banks loans and a reduction in domestic funds available to other forms of investment such as equities.

There is a proposed exemption from the limits to deductibility for property investors buying new builds. This will ameliorate the impact of removing deductibility on house prices. The importance of the exemption depends on its duration (the BEFU economic forecasts assumed a ten-year exemption). The exemption for new builds is also likely to cause a change in market composition, with leveraged investors moving into the market for new builds, displacing owner occupiers and cash investors into the existing housing market.

To some extent, placing a tax on landlords will lead to higher rents. We believe the scope for rents to increase is relatively small, and will vary by location. Our analysis shows that in the highly constrained and uncompetitive land markets that exist in many New Zealand cities, this tax change will result mainly in lower prices rather than higher rents. In parts of New Zealand where land markets are less constrained and more competitive, then there is more scope for rents to rise over time. Rents are also more likely to rise in locations where rental properties and owner-occupied properties are poor substitutes, such as near universities.

The impact on incentives to build new properties is similarly ambiguous and could vary by location. In locations where land supply is tightly constrained, there is unlikely to be much long-run change in incentives to build. In locations with abundant land supply and/or competitive land markets, it is likely that construction activity will fall as the reduction in house price inflation reduces incentives to build.

As the policy details relating to interest deductibility are yet to be finalised, we do not believe it is possible to calculate an estimate of the fiscal impact with reasonable certainty for inclusion in the 2021 BEFU fiscal forecasts. Instead, we will include a specific fiscal risk (SFR) in the 2021 BEFU document. The SFR will indicate the uncertainty around estimating the fiscal impact at this point in time.

While an estimate of the fiscal impact has not been undertaken for fiscal forecasts, analysis of tax outturns from 2018/19 can be used to indicate the order of magnitude expected from this tax change. We include a preliminary figure, that is subject to high uncertainty and would be likely to differ materially from an official costing. It is expected that there will be more certainty around the design of the policy ahead of the 2021 Half Year Economic and Fiscal Update and that the fiscal impacts will be included at that point.

Recommended Action

We recommend that you:

a **Note** that the removal of interest deductibility for investors is likely to have a material downward impact on house price growth and change the composition of buyers in the markets for new and existing properties. T2021/852 discusses how changes to the house price forecast impacts the wider economy in more detail.

b **Note** that the fiscal impact from the changes to interest deductibility cannot be quantified with reasonable certainty at the present time, and instead will be included as a specific fiscal risk in the 2021 BEFU document.

c **Note** that had the interest deducibility denial been fully implemented in 2018/19, and current interest rates prevailed, it may have potentially generated tax revenue in the order of $800 million higher. This figure is subject to high uncertainty and is likely to differ materially from an official costing.

d **Note** as the removal of interest deductibility is phased in for existing stock, the revenue gain will be limited over the next 3 years.

Dominick Stephens
Deputy Secretary (Chief Economic Adviser)

Hon Grant Robertson
Minister of Finance

Treasury Report: Impacts of recent housing tax changes on Budget 2021 forecasts

Purpose of Report

1. On 8 April 2021 you asked the Treasury to provide information about how the recent housing tax changes affected the BEFU 2021 Economic forecasts. This report addresses that request.

2. This report also sets out the proposed approach to estimating the fiscal impact of the interest limitation proposal for the 2021 BEFU. We do not believe it is possible to calculate an estimate of the fiscal impact of the interest limitation proposal for inclusion in the final fiscal forecasts, which are due to be completed on 30 April 2021. Instead, we will include a specific fiscal risk (SFR) in the 2021 BEFU document.

Background

3. On 23 March 2021, the Government announced its Housing Package, which includes:

    - a $3.8b Housing Infrastructure Fund;
    - extension of the bright-line test from five to ten years for property purchased after 27 March, excluding the main home;
    - an in-principal decision to limit interest deductions on residential investment property, to be phased in for existing stock;
    - increasing First Home Product income and price caps;
    - support for Kāinga Ora to borrow $2 billion extra for land acquisition activities; and
    - extension of the Apprenticeship Boost initiative by 4 months.

Since the announcement, there has been significant public interest in the proposed tax changes and how they will impact both house prices and rents. As such, this paper largely focuses on the market impacts of the tax changes.

4. We do not expect the extension of the bright-line test to have a significant impact on house prices or rents. This is because the extension was applied prospectively (minimising investor opt-out) and only to ten-years. CoreLogic data (2017) suggests that the median ownership period in New Zealand is seven to eight years, and MHUD analysis suggests that the ownership period for property investors is roughly the same. As such, we expect future investors to hold properties for slightly longer than they currently do. This may alter the distribution of property owners, but it does not necessarily imply much price change.

5. We expect that the limitation on interest deductions for residential investment property will have a material impact on house prices. This is because the change is intended to be applied both prospectively and retrospectively (over a four–year phased time-period) and there is no option to avoid the change – except through the new build exemption. This change will affect the real cash flow of leveraged

investors. As such, we can expect a decrease in demand for houses by leveraged investors as they choose not to opt-into the market. Some existing heavily-leveraged investors will also decide to opt-out of the market as cash flows become unattractive.

6. Therefore, our analysis focuses on how limiting and eventually denying interest deductions for residential investment property will impact the housing and rental market.

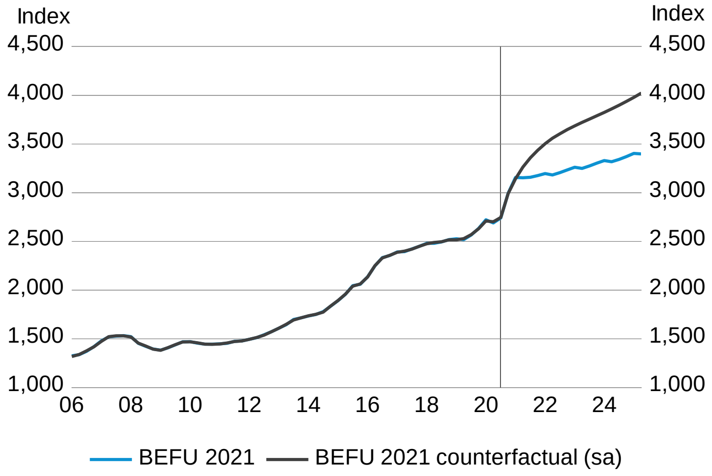
Analysis

House prices have been rising rapidly, but the tax changes are expected to slow the market

7. House prices have been rising rapidly since mid-2020, with annual house price growth reaching 21.5% in February 2021. There have been a variety of causes, including low interest rates. Without the Housing Package, our Budget 2021 economic forecasts would have shown sustained high levels of price growth, with a total increase of 34% over the coming four years, principally due to ongoing low interest rates.

8. The final BEFU 2021 economic forecasts have annual house price growth slowing from 17.3% to 0.9% between June 2021 and June 2022, and subsequently rising back to 2.5% by June 2025. These annual growth rates would be amongst the lowest in the past 10 years and slower than the pace at which wages are forecast to rise over the forecast period.

Figure 1: House prices



Sources: CoreLogic, the Treasury

9. Compared to a scenario without the Housing Package, house prices are around 16% lower by the June 2025 quarter in the final BEFU 2021 economic forecasts.

The tax changes will reduce demand from highly leveraged property investors…

10. Our assessment of the impact of the tax change was based on modelling the investment value of rental properties to highly leveraged landlords. This approach

calculates the net present value of the rental income available to a potential landlord.

11. In recent years the modelled investment value had risen well above prevailing market prices, due to falling interest rates. Hence prices were expected to continue rising rapidly.

12. The removal of interest deductibility dramatically reduces the investment value of property. There are many uncertainties in the modelling, and there will be variability between market segments and geographies. However, our modelling suggests that the investment value of a typical rental property to a leveraged investor (70% loan to value ratio (LVR)) is now 10% to 15% below the prevailing market price.

13. This implies that at today's market prices, highly leveraged property investors will purchase fewer homes. Furthermore, many existing investors will calculate that their investments no longer stack up and will seek to divest. This will increase selling pressure and reduce demand in the market for existing homes.

14. Highly-leveraged investors are a relatively high share of investors. In the year to February 2020 36% of new investors were highly leveraged with an LVR of 70% or more (equivalent to $6.1 billion of borrowing), and 41% of investors had interest-only mortgages (equivalent to $7.0 billion of borrowing). This implies that there is a relatively significant investor population that is highly likely to change behaviour, although this is obviously smaller than the mortgage market as a whole (new lending to investors is usually between 20-25% of total new lending and around 37% of total outstanding debt).

15. There is much less data on the existing stock of homes and the potential impact of disinvestment. IR data suggests that 213,000 <u>taxpayers</u> (not properties) claimed $3.5 bn of interest deductions against residential property last year. Only a proportion of those will be highly geared, and we do not have data on them, but we do know that 36% of those taxpayers made a rental loss in 2019. This implies that there would be at least a moderate level of disinvestment - even a change in the low tens of thousands could represent a significant increase in property transactions (there were around 150,000 in 2020) and therefore put downward pressure on price growth over the next few years.

…so prices will now reflect the value of property to less-leveraged investors and owner occupiers.

16. Owner occupiers and unleveraged property investors are unaffected by the removal of interest deductibility. How far below the counterfactual house prices settle depends on the readiness of these buyer groups to step into the market.

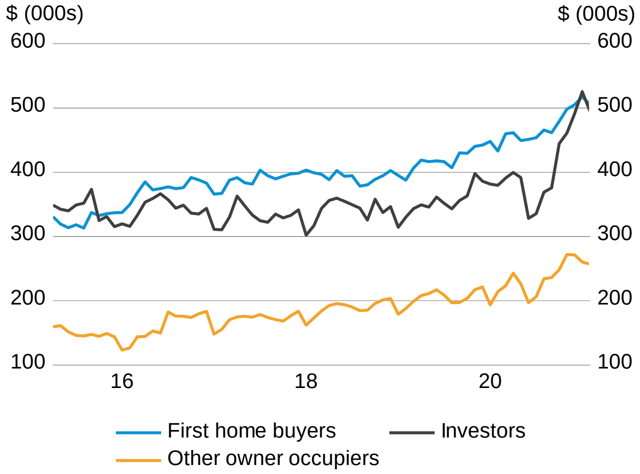
17. We anticipate some additional demand from owner occupiers, leading to a higher rate of home ownership.

18. Average lending to first home borrowers continued to trend upwards in late 2020 and into 2021, broadly matching the peak of about $520,000 average lending to investors in January 2021 (Figure 2). This implies there could be a relatively significant level of demand only slightly below the prices that property investors had been willing to pay prior to the announcement of the Housing Package.

19. We expect the more significant change will be growth in the number of property investors buying with cash or with small loans. Other asset classes such as equities are suffering the same high asset prices as property, and bank deposits

currently offer low returns. As residential property prices stall the returns available will look increasingly attractive to cash investors.

Figure 2: Average lending amounts



Source: RBNZ

20. The recent change to a 39% rate of income tax for income over $180,000 is one factor that could lead to additional housing demand from cash investors. The 39% rate may diminish the after-tax returns on offer for investments that yield predominantly income. In comparison, residential property investment yields mainly tax-free capital gain if held for more than 10 years, and will be offering better returns due to the absence of leveraged investors from the market. However, this effect is likely to be relatively small given there are opportunities to structure property investment through entities that pay lower tax rates (e.g. portfolio investment entities, companies and trusts).

21. Our final judgement was that house prices 16% below the counterfactual would equilibrate the market, but this is subject to significant uncertainty. The impact could be greater or smaller if owner occupiers and cash investors are more or less willing to buy than we have assumed.

Decisions around the exemption period for new builds are yet to be made…

22. Cabinet directed officials to consult with stakeholders on the design details of the new build exemption for interest limitation before seeking final decisions from Cabinet later in the year (CAB-21-MIN-0045 refers). Officials are developing options for the Discussion Document, including the length of the exemption.

…but it is expected that the exemption will ameliorate the impact on house prices.

23. The exemption for new builds will ameliorate the impact on house prices from removing deductibility. Some leveraged investors who now find the existing housing market unattractive due to the tax change will migrate to the market for new builds. The price paid for new builds will be limited by their resale value in the existing home market after the exemption expires. However, the price of new builds will also reflect the value that leveraged investors attach to the returns available *for the duration of the exemption*, which is higher than the counterfactual of no exemption.

24. The importance of the exemption will depend on its duration. Our BEFU house price forecasts assumed a ten-year exemption for new builds. An exemption for 20 years or longer would ameliorate the impact of the tax change by more and would present significant upside risk to our house price forecast.

25. Our modelling suggested that a ten-year exemption would ameliorate the price impact of removing deductibility by approximately 40%. For example, if removing deductibility without exemption would impact prices by 25%, then providing a ten-year exemption will ameliorate that to around 15%.

26. One effect of the new build exemption will be to reorganise buyer types across the housing market. As highly-leveraged investors migrate to the new build market, some owner occupiers and less-leveraged investors will be displaced into the existing home market. To the extent that new builds and existing houses are good substitutes, it is expected that prices across both markets will converge. The new equilibrium price for housing will be lower than without the tax changes, but higher than without the exemption for new builds.

27. The new build market is large enough to accommodate highly leveraged investors' demand for properties, implying that this price convergence can occur. There is no data on exactly how many properties are purchased by highly-leveraged investors, but we can infer from RBNZ data how much money they invest. If all investors over the past year purchased at the lower quartile house price, then that would imply around 20,000 homes purchased. If they purchased at the median house price, then the implication would be 12,000 homes purchased. Both estimates are well below the 40,000 consents for new dwellings issued in 2020.

28. In reality, new builds are not perfect substitutes for existing houses, so this "switch" of buyer type and price convergence will not be complete. In some locations the number of new builds could be low relative to demand from highly-leveraged property investors. Under these conditions, the exemption could cause a price difference between new builds and existing houses to persist.

The overall impact on incentives to build new dwellings is unclear and could vary across different parts of New Zealand.

29. In the short run, slower house price growth is likely to reduce the incentive to build new houses. After this short-run dynamic adjustment, it is unclear how the tax change will affect incentives to build. The impact is likely to vary across New Zealand.

30. In locations with abundant and flexible land supply, this tax change would reduce the incentive to build new houses. House prices would fall relative to the (fixed) price of land, reducing the incentive to build. As noted in the Rental Market section below, under these conditions rents would rise over time, eventually restoring the incentive to build. However, we judge most of New Zealand's houses to be in locations without abundant and flexible land supply.

31. Under conditions of tightly constrained land supply or uncompetitive land markets, which exist in many New Zealand cities, this tax change will reduce the price of land. There would be little impact on incentives to build, because the margin between bare land and a land-plus-house package would not necessarily change.

32. As mentioned in paragraph 28, under certain conditions a price premium between new builds and existing houses could persist. In these cases, the overall effect of the tax change and the exemption for new builds will be to increase the incentive to build new houses. However, we expect these cases will be the exception rather than the rule.

The price impact will be further ameliorated as the RBNZ keeps interest rates lower for longer.

33. Weaker house price growth dampens the pace of the economic recovery by decreasing consumer confidence (less household equity than the counterfactual), which reduces consumption and residential investment growth. A slower recovery implies prolonged accommodative monetary policy would be required for the Reserve Bank to meet its employment and inflation objectives.

34. This would increase the likelihood that monetary policy would need to remain accommodative for a longer period to restore desired labour market outcomes and return inflation to the 2% mid-point target.

35. In turn, lower interest rates will support house prices, ameliorating the price impact of the tax changes, at least over the medium term.

36. In a scenario without the tax changes, our forecasts would have likely shown the 90-day rate rising towards the end of 2022 and reaching around 2.4% by June 2025. Our final BEFU 2021 economic forecasts show the 90-day rate rising from late 2024 and reaching 0.8% by the June 2025 quarter.

37. The outlook for house prices remains highly dependent on the outlook for interest rates. If rising inflation requires the RBNZ to lift interest rates faster than envisaged in the Budget 2021 economic forecast, then house price inflation would likely be lower than our forecast.

Rental Market

38. Denying interest deductibility heightens the risk of rental price inflation for two key reasons:

- The effective cost of supplying a rental property has increased and landowners are incentivised to offset their losses by passing on costs to tenants. However, a landowner's ability to pass on costs is dependent on the competitiveness of the urban land market.
- Due to the tax changes some properties are likely to switch from rental to owner occupied. To the extent that rental properties and owner-occupied properties are not perfect substitutes, this could reduce the effective supply of rental properties (as supply decreases more than demand) and is likely to put some upward pressure on rents.

Ability for landowners to pass on costs

39. Analysis from ongoing work in the Housing and Urban Growth Team suggests that if land markets are competitive then landowners can pass on increasing costs such as rising interest rates. However, if land markets are uncompetitive then landowners cannot pass on costs as the rental market would already be fully extractive (tenants are squeezed and cannot afford to pay more).

40. The Treasury believes that New Zealand's urban land markets are moderately uncompetitive. For example, interest rates have halved since 2010. In a competitive land market, we would have expected a decrease in rental price. Instead, over the past eleven years decreasing interest rates have mainly passed into higher house prices, which have more than doubled in nominal terms since 2010. Rents have actually risen, rather than falling in response to lower interest rates. This suggests that New Zealand land markets are uncompetitive, and that the current tax change is more likely to pass through (predominantly) to house prices rather than rents.

41. Table 1 below summarises the direction of impacts caused by increasing tax obligations for the two limit extremes of fully competitive and fully uncompetitive land markets. The mixed case is somewhere in-between.

Table 1: Impact of an increase in tax on key housing market variables

	House Rents	**House prices**	**Land prices**	**Household utility**
Competitive $\gamma = 0$	Increase (++)	No change	No change	Decrease (- -)
Moderately uncompetitive $(0 < \gamma < 1)$	Increase (+)	Decrease (-)	Decrease (-)	Decrease (-)
Uncompetitive $\gamma = 1$	No change	Decrease (- -)	Decrease (- -)	No change

Note: This technical analysis is currently underway in the Housing and Urban Growth team. This table subject to change as some equations are non-monotonic. We note that land markets in larger cities such as Auckland are more uncompetitive than smaller cities.

a. In a competitive urban land market:

- house prices are set by the cost of construction including land price, materials, consents and legal fees etc.
- rent prices are set by the landowner's cost to supply the rental property including interest rates, taxes, rates, maintenance costs, insurance etc.

b. In an uncompetitive urban land market:

- house prices are set by the Net Present Value (NPV) of tenants' ability to pay. This calculation includes interest rates and taxes as variables that influence house prices.
- rents are set by tenants' ability to pay - a value where household utility is minimised, and rents are maximised. Therefore, a change in households' cash flows (income, benefits, subsidies) is likely to be the largest driver of rents, and changes in interest rates and or taxes would not have an effect.

Substitutability of rental vs owner-occupied housing stock

42. The degree to which the tax change poses a risk of rental price inflation is also dependent on the substitutability of investor and owner-occupied houses. Initial analysis suggests that the average number of people per household is around 2.6 for both rental and owner-occupied house. We note that more granular data around number of households that are rented is required to confirm this. However, this similarity suggests that across the country, on average, rental and owner-occupied homes are substitutable.

We expect that the risk of rental price inflation will be most prevalent in areas with dwelling types that are less commonly owner-occupied, and in locations with a preponderance of rental accommodation, such as multi-bedroom accommodation that is close to universities and or hospitals.

The tax change is likely to increase the rate of home ownership, with positive private and social benefits…

43. On 15 February 2021 Cabinet agreed to set three overarching housing market objectives (CAB-21-MIN-0018 refers). The tax changes within the Government's Housing Package supports Objective Two:

"In the short to medium term, support more affordable house prices by dampening investor demand for existing housing stock, which would allow additional opportunities for first home buyers."

44. By providing first home buyers with additional opportunities through decreased competition in the market, these tax changes are expected to increase the rate of homeownership in New Zealand.

45. Increasing the rate of homeownership has many private benefits, for example owner-occupiers:

- have greater stability of tenure, which promotes independence, stability, and control over their lives - providing a basis for community participation.
- generally, live in higher-quality dwellings compared to renters. Rental properties in New Zealand are more likely to be cold, damp, have mould, and require major repairs.
- can build wealth through growing their equity with mortgage payments, which enhances financial stability. Property is a big part of wealth accumulation; New Zealand homeowners (who own or partly own their home) are typically 14 times wealthier than non-homeowners.
- have larger freedoms and flexibilities including property alterations and owning a pet.
- may enjoy a decrease in real housing costs as mortgage payments remain relatively constant (compared to rental prices) as incomes increase.

46. As homeownership rates increase, we also expect there will be positive societal and indirect effects that flow on from these private benefits. This could include but is not limited to decreasing wealth inequality and better health outcomes, particularly for children.

47. The new build exemption will push owner occupiers into the market for existing houses, while the market for new builds is disproportionately bought by property

investors and rented out. To the extent that new builds are of higher quality, this could result in an improvement in the average quality of rental properties and a deterioration in the average quality of owner-occupied houses.

…but there are also consequences for the financial system that should be considered.

48. Our expectation is that cash-financed investors are likely to step in and partially replace debt-financed investors in the housing market. An increase in cash-financed investors in the housing market implies a substitution of savings from other assets such as bank deposits, share markets or other investments of investable funds. Lower levels of available funds in other asset types could lower the size of balance sheets of banks, with investors interacting directly with property vendors rather than via an intermediary. Banks' overall role in credit intermediation is therefore likely to be reduced.

49. Additionally, reduced savings activity could lead to constraints on growth in other asset markets, such as share markets. With firms' ability to raise capital limited by reduced activity in equity markets and less bank-intermediated credit available, investment and growth options may become negatively impacted unless other forms of funding (such as international credit channels) are used.

50. Reduced bank-intermediated investor activity in the market for existing properties could result in an increase in other forms of financing, such as an increase in the use of mutual housing funds.

Impact of interest deductibility as a specific fiscal risk

51. This section sets out the proposed approach for the fiscal impact of the interest limitation proposal for the 2021 Budget Economic and Fiscal Update (BEFU). We do not believe it is possible to calculate an estimate with reasonable certainty of the fiscal impact of the interest limitation proposal for inclusion in the final fiscal forecasts, which are due to be completed on 30 April 2021. Instead, we will include a specific fiscal risk (SFR) in the 2021 BEFU document.

52. The direct fiscal impact from the changes to the extension to the bright-line test fall outside of the forecast period for BEFU 2021 (2020/21 – 2024/25), therefore it will not impact on the Treasury's fiscal forecasts. However, the revenue from the bright-line test will be included in the fiscal strategy model used to calculate fiscal projections over the medium-term (2025/26 – 2034/35).

53. The increase in tax revenue from the interest limitation proposal will most likely have an impact over the forecast period. However, for inclusion in the fiscal forecasts certain criteria need to be met:

    - the matter can be quantified for particular years with reasonable certainty; and
    - a decision has been taken or a decision has not been taken but it is reasonably probable that the matter will be approved or the situation will occur.

54. If a matter cannot be included in the fiscal forecasts it may need to be disclosed in the Statement of Specific Fiscal Risk (SFR). The Statement of SFR is required by the Public Finance Act 1989 to be published as part of each Economic and Fiscal Update. The SFR disclosure sets out (to the fullest extent possible) all government decisions and other circumstances known to the Government that

may have a material effect on the fiscal outlook, but are not certain enough in timing or amount to include in the fiscal forecasts.

55. Our assessment is that it is reasonably probable that the changes to interest deductibility will progress given the Government's in-principle decision and public announcements.

56. However, we believe that the fiscal impact from changes to interest deductibility cannot be quantified with reasonable certainty at the present time because:

- There are potentially material policy decisions yet to be determined, such as allowing (or not) interest deductions on sale, the parameters for a new build exemption and key definitions such as 'residential land' and 'developer'.
- A quantification would require a technical costing and further time for model development.
- The tax return information from the 2019/20 year has yet to be completed. This year contains important data on loss ring-fencing and on bright-line sales, which would be important in forecasting any fiscal impact.

57. As a result, we do not believe it is possible to calculate an estimate of the fiscal impact with reasonable certainty for inclusion in the 2021 BEFU fiscal forecasts. Instead, we will include a specific fiscal risk (SFR) in the 2021 BEFU document. The SFR will indicate the current uncertainty around estimating the fiscal impact. It is expected that there would be more certainty around the design of the policy ahead of the 2021 Half Year Economic and Fiscal Update and that the fiscal impacts will be included at that point.

58. While an estimate of the fiscal impact has not been undertaken for inclusion in the fiscal forecasts, analysis of tax outturns from 2018/19, suggests that had the measure been fully implemented at that point, and current interest rates prevailed, tax revenue may have been potentially in the order of $800 million higher. However, there are several factors and uncertainties that would need to be considered in a costing, which we have not quantified at this stage:

    a. The measure will result in behavioural changes that may reduce the amount of revenue raised. For example, as noted above, existing investors may divest from residential property, reducing revenue from rental income.

    b. The final design of the new build exemption will be material. For example, if the new build exemption were for a long period and resulted in 20% of existing investment shifting into the new build market, then the revenue gain would be $160million lower.

    c. Future interest rates will materially affect expected additional revenue, potentially on the upside.

    d. Assumptions about the marginal tax rate faced by investors, including their ability to lower this rate by structuring through entities such as companies and trusts, will materially affect any costing.

    e. The latest tax data from the 2020/21 tax year is not yet available and cannot yet be used as the basis of any tax revenue forecast.

f. The interaction of this policy with loss ring-fencing has not yet been modelled, which will further reduce any potential revenue gain. The 2018 Treasury and Inland Revenue Regulatory Impact Assessment estimated that loss ring fencing would increase tax revenue by $190 million per annum. As taxable losses will be lower under the new policy, any costing would be lowered to the extent losses have not been able to be utilised.

g. There are also risks on the upside. For example, if landlords passed the increased costs onto tenants through higher rents the revenue gain may be higher. However as noted in paragraph 44, we think the potential rise in rents is likely small.

59. Furthermore, the measure will be phased in for existing stock, meaning that the revenue impact in the immediate future is limited, being only 25% of the full potential revenue gain in 2022/23.

60. These factors should be taken into account in considering any changes to the Government's fiscal strategy as a result on this measure.

61. We are bringing this approach to your attention as there is likely to be public interest in any official forecast of the extra revenue that the proposal would generate. As such, the absence of a forecast could generate public comment.

Comparison with other views

62. Bank forecasters are expecting a quicker moderation of house price growth compared to their previous forecasts in the near term as a result of the recent housing tax changes. However, there are differing views on the pace of the moderation and what happens to prices over the medium term. KiwiBank expect house price growth to remain in double digit territory over the year ahead before easing while others expect the pace of growth to ease significantly. Westpac expects house prices to begin falling from the middle of 2022, while others expect annual house price growth to settle in the low, single digit range in the years ahead.