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PIE Policy Discussion series

The Fair Economic Return (FER) v Land Tax

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Susan St John[1] and Terry Baucher[2]

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Economic Policy Centre

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[1] Susan St John, PIE hub leader, Economic Policy Centre s.stjohn@auckland.ac.nz
[2] Terry Baucher Director, Baucher Consulting Ltd terry@baucher.tax

Abstract

This paper compares the Fair Economic Return (FER) to Land Tax (LT) to clarify the feasible policy choices if another damaging speculative housing cycle is to be prevented in Aotearoa New Zealand. FER would broaden the tax base to help meet the inevitable fiscal pressures arising from the ageing population and climate change. The intent is also to reduce housing inequality and allow the limited real housing resources to be redirected from high end real estate investments to provision of sound, safe, basic housing. On balance, given these objectives, and assessed against a range of suggested criteria, it is argued FER is a preferable approach.

Summary FER

The current housing crisis with over-valued property prices is resulting in a potentially disastrous double-whammy of falling home-ownership rates and rising youth migration as hopes for home-ownership fade.

Even the best designed taxes have behavioural responses, and our housing market reflects decades of under-taxation of capital and property. Aotearoa NZ not only has some of the most expensive houses in the world but also, some of the largest as a significant number of homeowners have invested substantially in their main residence or second homes.

This has led to over-investment in housing which has also crowded out productive investment in businesses and ultimately jobs. One consequence of this is that our export sector remains small relative to other countries of similar size. From an economics perspective, we have a huge misallocation of scarce housing resources, with flow on effects to the rest of the economy.

At the same time Aotearoa NZ faces increasing pressure on its public finances from an ageing population and the attendant rising health costs, with a rapidly growing superannuation bill together with the escalating costs of climate change.

Against this background Fair Economic Return (FER) is designed with four objectives in mind:

- broadening the existing income tax base;
- encouraging more efficient use of resources;
- simplifying the taxation of land and rental housing; and
- enabling a significant, immediate revenue stream.

FER works rather like the existing fair dividend approach in the foreign investment fund regime by applying a set percentage to a person's net equity in residential land and property above a nil-rate band which we suggest starts at $1 million. The net equity is then treated as if invested in a bank deposit, generating taxable income. The box shows an example of a couple’s net equity at the beginning of the financial year and the FER taxable income for that year.

Box 1 Net equity in housing and FER income

Couple own	home	CV =	$5m
	bach	CV =	$2m
	rental	CV	= $800,000 with mortgage of $200,000

Total net equity = $7.6m
each person = $3.8 m
after exemption = $2.8m
FER taxable income @ 2% = $56,000 each additional taxable income
FER taxable income @ 4% = $112,000 each additional taxable income

As the FER regime is based on net equity and with a $1 million exemption per individual, average homeowners would not pay any tax under FER. We have adopted a nil-rate band approach rather than exempting the family home to counter definitional issues and address the issue of over-investment in the family home.

Loans would be deductible when determining a person's net equity but only to the extent the loan is secured against property held by the person. This is intended to counter the use of related party debt as a tax avoidance mechanism. Soft loans from family do not qualify but add to the donor's net equity base.

We propose that no nil-rate band be generally available for property held in trusts or owned by companies (because trusts generally provide asset protection. Companies meanwhile have limited liability). However, settlors of trusts may elect for the net equity of trusts to be attributed to them.

We propose that FER would replace existing systems for the taxation of residential property and the mixed-use asset regime. It would be buttressed by a bright-line test to capture sales within say, 5 years of acquisition.

The gross housing value would be set by the 3-yearly local government valuations with indexation for inter valuation years to help smooth the progression of tax.

Based on available statistics we estimate a 2-4% FER would raise approximately $10-20 billion of taxable income annually. For comparison, net rental residential rental income was approximately $2.2 billion for the 2023 income year and will fall further as full interest deductibility is restored.

FER is consistent with the broad base, low-rate approach taken to tax in New Zealand. It is based on the principle that all income should be in the income tax base. By taking into consideration the total capital value of a property (land and housing) rather than just the unimproved land value, FER can help correct the misallocation of housing resources to high end and speculative housing investment. It is tailored to the individual with a realistic exemption and can thus be highly progressive, while a land tax would be similar to local government rates in impact (ie regressive).

Both FER and Land tax are preferable to a realisation-based CGT because they are simpler, capture the accumulated capital gains in the base and have an immediate revenue raising effect. Short term capital gains should continue to be taxed under extended brightline rules.

Introduction

In an ideal world we would enjoy a multi-party commitment to agreed and sustainable policies to address the under-taxation of capital income in New Zealand. Politically, both a comprehensive Capital Gains Tax (CGT) and comprehensive wealth tax have been fully explored and rejected several times over the past three decades. This paper is written in the spirit of contributing to a possible consensus by identifying and analysing the pros and cons of the two remaining viable policies of Fair Economic Return (FER) and Land Tax (LT).

In the working paper Fair Economic Return (FER) Restoring equity to the social fabric of New Zealand St John & Baucher (2021) outlined why currently untaxed housing income should be included in the tax base and how that could be achieved. The intent was to provide a different, yet principled, approach in the light of the failure over many years to implement a CGT in New Zealand. By grounding FER in the broad base low-rate approach supported by many economists and tax practitioners in New Zealand,[3] the intention is not to introduce a new tax but to include currently untaxed or minimally taxed income in the income tax base in a progressive way that has minimal or zero impact on the vast majority of home-owners.

A second paper in August 2022, Fair Economic Return Revisited asked whether changed conditions in 2022 affected the arguments for FER. We concluded:

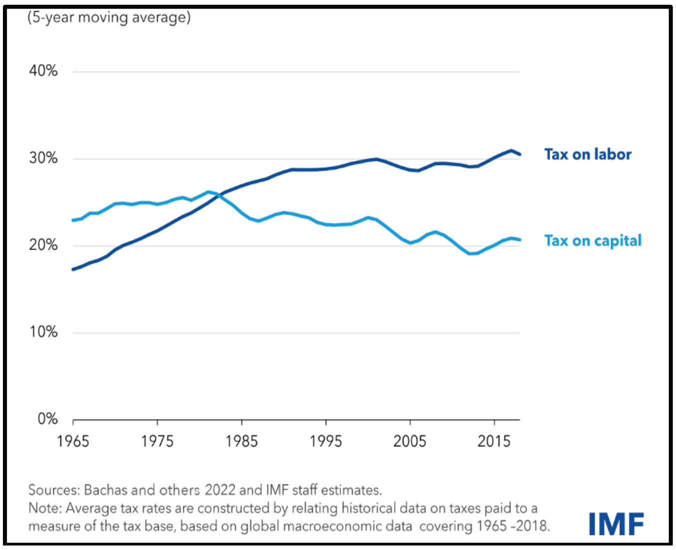
> *…the case for FER is stronger than ever to provide systemic corrections to the under-taxation of real estate, to moderate future boom/bust cycles, and provide revenue for the pressing fiscal needs of the 21st century. These needs include policies for climate change, care of the ageing population, child and family poverty, health and education as well as state and social housing.*

Now, in late 2024 the housing market is continuing to fall from its 2021 peak. There is a greater than ever need to clarify possible mechanisms to raise extra revenue to allow more spending on urgent social and infrastructural issues, reduce rising inequality, address climate change, and bring about a better real resource allocation in housing to combat the housing crisis. We note current global thinking from the OECD[4]:

> *Housing taxes are of growing importance given the pressure on governments to raise revenues, improve the functioning of housing markets, and combat inequality. (OECD 2024)*

A recent 2024 IMF paper, It's time to tax capital more to avoid AI worsening inequality, notes how the balance of tax has shifted markedly from Capital to Labour as shown (see figure 1) The IMF highlights an emerging issue: the impact of disruptive technological change such as AI on inequality and the pressing need to shift the tax burden towards capital.

Figure 1 Average tax rates on Labour and Capital income in advanced economies, IMF 2024



The Economist (June 16th 2024) Why house prices are surging once again, foreshadows a global housing price recovery. In New Zealand house prices are still falling and it may be some time before there any sustained recovery. In this environment, there is a pressing need to be ready with suitable policy in place to dampen or prevent the next housing boom. Unfortunately, most

[3] See Terry Baucher, 28th April 2024, interview/podcast with Robin Oliver, Rob McLeod and Geoff Nightingale.
[4] Housing tax policies in the OECD and options for reform | Housing Taxation in OECD Countries 2022| OECD (oecd-ilibrary.org)

of the recent policy changes in New Zealand will aggravate rather than help to solve the speculative nature of the housing market.

This third paper compares the Fair Economic Return (FER) to off-cited Land Tax (LT) taking account of the current changed market conditions. The authors hope that this paper contributes to narrowing the choices that must be made if New Zealand is to prevent another damaging speculative cycle and re-direct limited housing resources from high end real estate investments to provision of sound, safe, basic housing.

Background

Previous working papers (2021,2022) outlined above, included the detail of the history of Capital Gains Tax (CGT) discussion in New Zealand, and how the failure to implement such a tax contributed to cycles of intense and damaging speculative booms.

The OECD comparative housing figures[5] continue to show New Zealand as an outlier, but not in a good way. Figures 2 and 3 demonstrate the housing gap, real house price growth and how many years of earning at the average rate is needed to equal the price of an average house.

Between 2000 and 2020 the number of years of earning required to equal the average price of house nearly doubled from 10 years to 19 years.

Figure 2 Real Price growth and real house price gap. 37 OECD countries

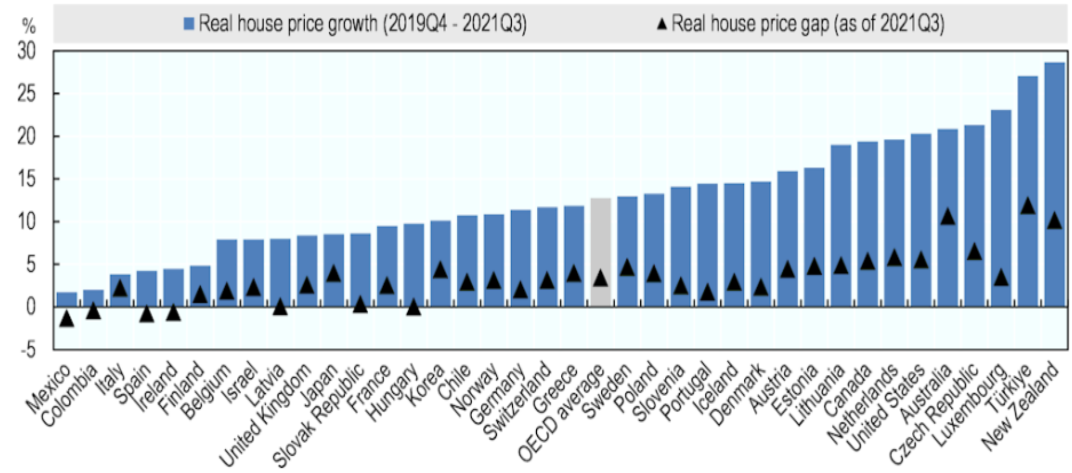
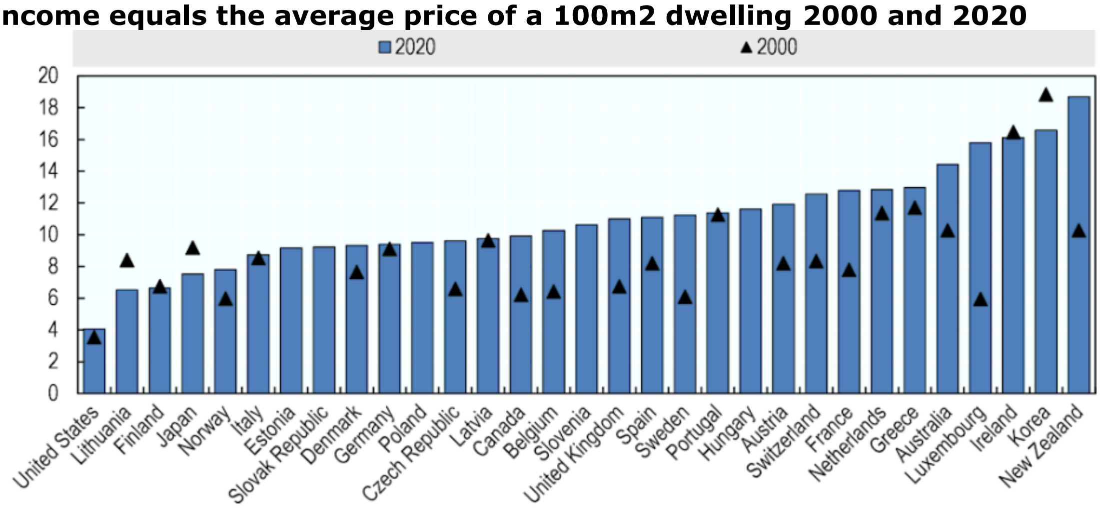


Figure 3. Number of years over which cumulative average household disposable income equals the average price of a 100m2 dwelling 2000 and 2020



[5] OECD Analytical House Price database, OECD, 2022

The sixth Labour Government (2017-2023)

The Tax Working Group (2019) proposed a comprehensive Capital Gains Tax, but this was decisively rejected by the Prime Minister Jacinda Ardern in 2019. In 2021 the New Zealand housing market peaked, putting NZ at the top on the global scene.

St John and Baucher (2022) described how the Labour government relied on a series of ad hoc adjustments to cool the overheated housing market and noted that by late 2022:

> *while the peak has passed with falling house prices across New Zealand, the tax subsidisation of housing income remains a potent incentive for over-investment in owner-occupied and rental/investor housing. The widespread unease that the growing wealth divide, especially in housing is socially and economically damaging suggests that taxation of wealth will be a 2023 election issue.*

Then, in 2023, The IR[6] and Treasury[7] produced new evidence of the extent of wealth inequality and the under taxation of the full economic income of wealthy individuals in NZ. Widespread outrage followed these reports with expectations that the government would respond with some kind of wealth tax.

The May 2023 budget did not hint at such a possibility, but the subsequent release of budget background documents showed that there had been a serious effort to design a 'tax shift' policy entailing a tax-free threshold for income tax paid for by a comprehensive wealth tax. Labour's approach would have levied a 1.5 per cent tax on wealth over $5 million generating an expected $10.6 billion over four years to fund the tax cut. The suggested tax-free income threshold of $10,000 was worth up to a maximum of only $1,050 but would benefit all equally on incomes above the low threshold.

It had clearly been a step too far, both in practical design terms and in its ultimate impact on the problem of inequality.[8] Perhaps given the small payoff, it was therefore no surprise that in July 2023 the then Prime Minister Chris Hipkins distanced himself from this policy, stating:

> *While work was already under way on a potential wealth tax and CGT as part of a tax switch in the Budget, I ultimately made the call not to proceed with it. We simply didn't have a mandate to implement those tax changes. Instead, we have moved to address inequity in our tax system by increasing the top trust tax rate to match the 39 per cent top income tax rate. This will help prevent trusts being used as a tax shelter and ensures the ultra wealthy pay their fair share. It also aligns with the increase to the top tax rate we implemented at the start of the term. I'm confirming today that under a Government I lead there will be no wealth or capital gains tax after the election. End of story.* [9]

One of Labour's problems was its self-inflicted goal of fiscal neutrality. The package of tax cuts would have been fully paid for by the wealth tax. Unfortunately, such an approach precludes a consideration of other more socially valuable uses of the revenue from a wealth tax. Extra revenue is desperately needed in a vast array of areas. For example, in the 2023 Briefing to the incoming government the Treasury raised the alarm over the ageing of the population and climate change implications:

> *Cumulatively, the fiscal position is likely to face more headwinds in the decade ahead than experienced over the past few. This includes a less benign global backdrop, and the changing nature of shocks. Moreover, some of the challenges that could impact on public finances highlighted in successive Long Term Fiscal Statements and the Climate Economic and Fiscal Assessment are here now. The*

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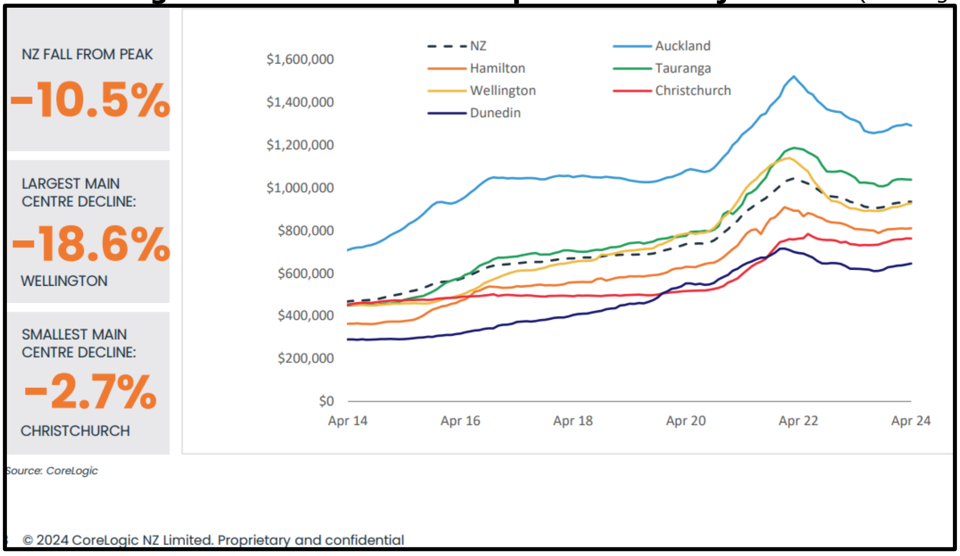
[6] High-wealth individuals research project IRD.
[7] Estimating the Distribution of Wealth in New Zealand (Treasury WP 23/01)
[8] St John, S (2023), All for an extra $20 a week? Daily Blog 17th July 2023
[9] https://www.nzherald.co.nz/nz/politics/election-2023-chris-hipkins-confirms-he-killed-wealth-tax-capital-gains-tax-in-budget/LZNZMSBEBNEQFHUSJKP4637TIA/

*impacts are potentially large. Demographic change and climate change are increasing demand on government expenditures and this will grow over time. Geopolitical tensions and economic fragmentation could increase spending pressures in areas like defence and security. Higher debt and interest rates would see finance costs trend up. Given these pressures, a programme of work to identify enduring savings options and future policy settings would help support longer-term fiscal sustainability. (*Treasury briefing to the Incoming Government. Economic and Fiscal Context, 2023)

And now it is 2024

In late 2024, a serious recession[10] intensified by austerity measures grips the country. On most measures across practically all regions there has been a substantial slowing in the housing market with falling median prices and extended times taken to sell properties.

Figure 4 Documenting the fall from the 2021 peak as in major cities (Corelogic, May 2024).[11]



There are desperate unmet needs for infrastructural, healthcare, social housing and education spending, and a fraying of the social fabric is evident in crime and homelessness. Nevertheless, after the 2023 election the Coalition Government parties of National, New Zealand First, and the Act party will have no truck with either a wealth tax or capital gains tax. In late September, both the Prime Minister and the Finance Minister vigorously rejected remarks by ANZ Bank CEO Antonia Watson when she suggested "the time has arrived for a capital gains tax."[12]

The Coalition also set about abandoning most of few constraints there had been on speculative activity in the housing market. The 10-year brightline test was abolished leaving a two year one in place, along with the re-instatement of mortgage interest as a deductible landlord cost with an expected $2.9 billion cost over 4 years.

While Te Putea Matua Reserve Bank of New Zealand requires banks continue to meet [Loan value ratios (LVR)] and has confirmed in addition, that [Debt To Income (DTI) limits] will apply from July 1, the point of these lending restrictions is to limit lending growth when interest rates fall.[13] We note that much high end housing investment is immune to cost of debt considerations.

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[10] June 2024 marked the seventh consecutive quarter of stagnant or declining per capita economic activity. New Zealand facing a second Great Recession | interest.co.nz

[11] CoreLogic_HousingChartPack_May_2024_FINAL.pdf

[12] Interview with Guyon Espiner https://www.rnz.co.nz/news/in-depth/528917/time-has-arrived-for-a-capital-gains-tax-says-anz-boss-antonia-watson

[13] The DTIs will affect investors most.

Real Resource misallocation

> *The worrying conclusion is that high and rising property prices can also have damaging economic effects, by crowding out productive investment and leading to a misallocation of capital. In the most extreme cases, inflated land prices may already be the cause of a protracted slowdown in productivity growth. (The Economist, 2023)*[14]

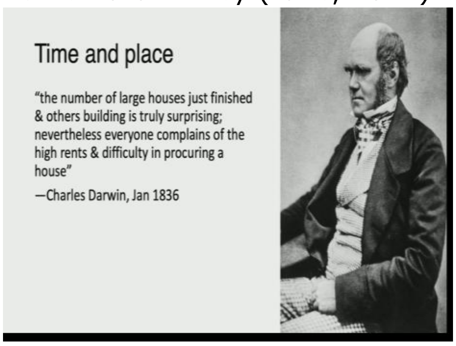
From an economics efficiency perspective, as St John & Baucher 2021 discuss, the current housing market illustrates a woeful misallocation of resources and lost opportunities. Land, labour, architects, wood, steel, concrete, infrastructure are the scarce housing resources that market signals are supposed to allocate to their highest use.

A well-functioning housing market is critical to a sound economy. Its malfunctioning also drives wide income and wealth disparities highly damaging to social cohesion as well as the efficient allocation of scarce resources. Instead, high end housing developments continue to abound: a Queenstown property, for example, sold in 2023 for well over $40 million – making it the country's most expensive house of all time.

Many New Zealanders own second homes and many of these are vacant. For the wealthy. housing has been a tax-effective store of value well beyond its use as a place to live well. St John and Baucher (2021) observed:

> *Faulty market signals have resulted in an over-investment not only in investment properties but in family and second homes: many have become mansions well beyond the need for modest shelter and the source of fortunes for those in these markets. In spite of declines in average household size, by 2018 almost a third of occupied private dwellings had four or more bedrooms compared with less than a fifth in 1991(Statistics NZ 2020, p 20). Some of these mansions are empty or under-rented, often with overseas owners. When scarce materials are diverted to over-investment in renovations, over-sized houses, unaffordable new builds, helipads and swimming pools, they are not available to build, repair and maintain the kind of houses appropriate for low-income families.*

As Bernard Hickey (June, 2021) remarked, there is strong incentive to increase house size:



> *Most houses are built by smaller builders or franchisees who don't have the engineering and earthworks skills or equipment to do this type of building. These types of projects are also more complex from a consenting and planning point of view, which further delays housing supply. Their entire business models are based on buying lumps of land, building spec houses on them and making profits from land price appreciation and a margin from building a large house.* [15]

The top end of the NZ housing market appears impervious to the effects of high interest rates and property price falls. For example, here is a recent $3.2 million tax-free gain:

> *The former ANZ New Zealand chief executive David Hisco and his wife Deborah Walsh have sold the spacious Ōmaha Bay beach house the couple bought from former Prime Minister Sir John Key and doubled their money. (NZH,27th June 2024)*[16]

[14] How high property prices can damage the economy (economist.com)
[15] The week that was for the long weekend - The Kākā by Bernard Hickey June 2021(substack.com)
[16] Former ANZ boss David Hisco doubles his money selling ex-PM Sir John Key's old bach - NZ Herald

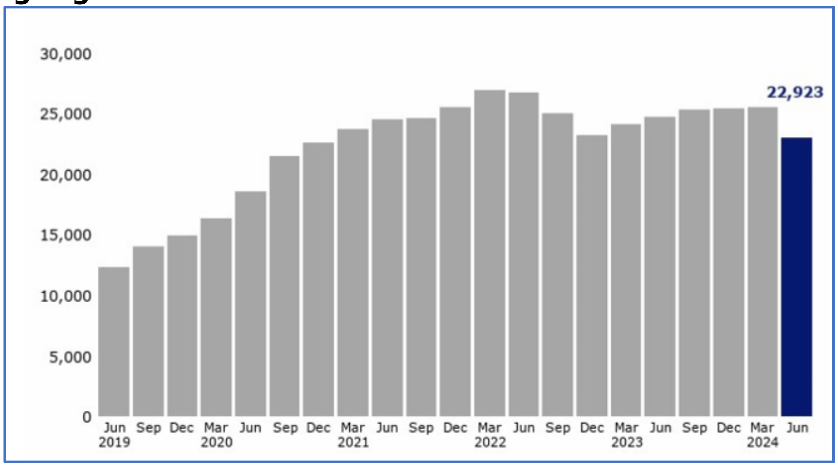
An article in the NZH Feb 2024[17] describes the overconsumption of housing:

> *Mega-mansions are dotted around New Zealand, owned by people with so much money they probably own more than one. Inside these sprawling trophy estates you'll likely find: pool houses, guest houses, fully equipped gyms, walk-in fridges, kitchens within kitchens, outdoor kitchens, present-wrapping rooms, games rooms, music rooms, cinema rooms, wine cellars, six-car garages stacked with designer cars, panic rooms, golf simulator rooms and art galleries… walk-in fridges the size of a triple closet were now a thing and there were houses where the designer kitchen was just for show with the cooking done in the scullery.*
> *[Some] have multiple properties, such as a lake house or a beach house, or both, and follow the seasons, which leaves some properties empty for parts of the year.*

To further illustrate the massive concentration of wealth in property, information obtained from local councils under the Local Government Official Information Act revealed as of 30th June 2023 that Queenstown Lake District has 570 residential properties with capital rating values above $5 million, more than any other council except Auckland. The aggregate capital value of these 570 properties was $5.68 billion, an average of $10m each.[18]

In the meantime, desperate housing need is getting worse and underpins the lack of productivity and growth. The 2024 housing register[19] has around 23,000 applicants in severe housing need as shown in Figure 5.

Figure 5 Housing register June 2024



Capital Gains Tax is not the answer

New Zealand has an intractable problem of inequality and a serious wealth divide. There are regular calls for a CGT to help address these issues. However, one of the key design drawbacks of a CGT is it applies only on realisation and ignores accumulated gains prior to introduction. As we noted in our 2022 paper:

> *Importantly, any feasible future CGT on a realisation basis has no impact on the accumulated untaxed capital gains in housing (including owner occupied) that have compounded over years of neglect to date, and is thus limited, if not impotent, to address the root harm of housing inequality.*

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[17] One Roof. Succession NZ: How the super-wealthy live – mega-mansions that can lie empty half the time, All things property,

[18] Queenstown Lakes Council OIA response dated 25th September 2023

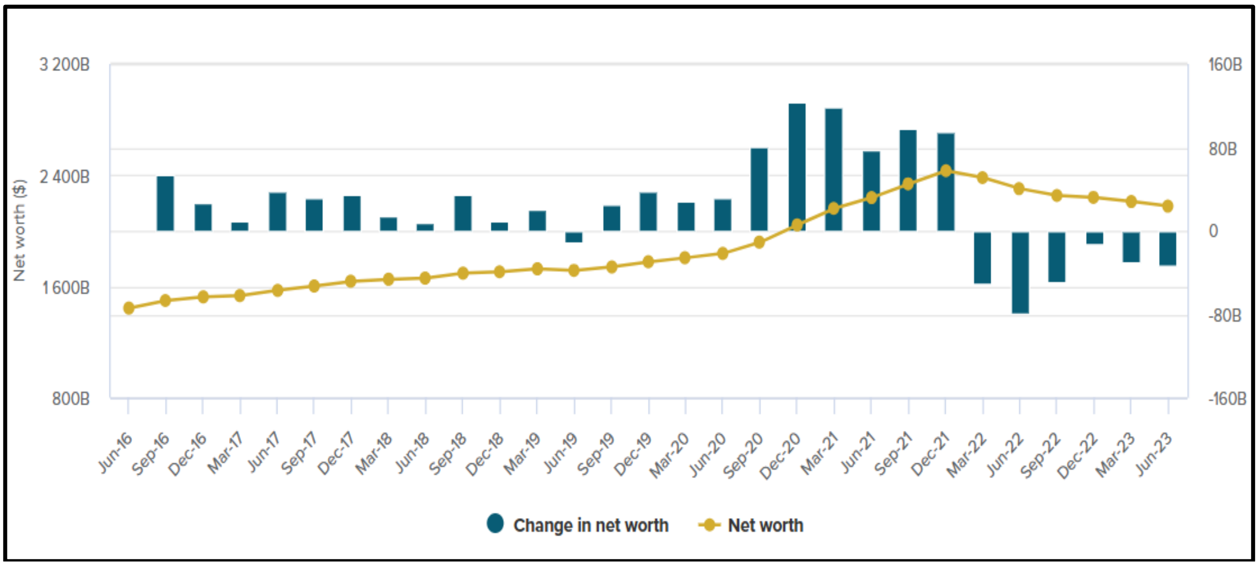
[19] Housing register - Te Tūāpapa Kura Kāinga - Ministry of Housing and Urban Development (hud.govt.nz)

Nevertheless, we consider short terms gains should be taxed as at present under the bright-line test, but the period is arguably too low at two years and could be reset at 3-5 years to accompany a FER or LT.

Residential real estate

Figure 6 shows the total net worth of households and how it has changed since 2016.[20] The strong boom in wealth from Dec 2019 to Dec 2022 has been followed by a steady decline.

Figure 6 Household net worth and change in household net worth June 2016-June 2023 Stats NZ 2023[21]

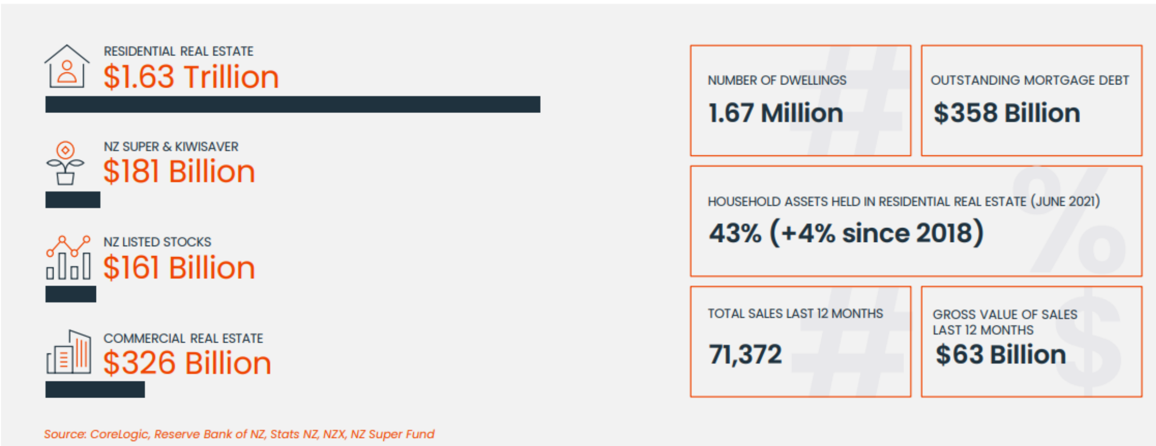


The June 2023 quarter's decrease in household net worth was attributed to continuing net falls in equity and investment fund shares and value of owner-occupied property and rental property as well as a rise in household loans.

Of household net worth, residential real estate is by far the dominant category.

Figure 7 shows the total value of residential real estate held by households was $1.63 trillion in mid-2024. With mortgages secured against 20% of real estate value, excluding vacant land, net equity in housing is around $1.27 trillion.[22]

Figure 7 Residential real estate is a key part of NZ's household wealth (Core logic May 2024)



[20] Household net worth falls for sixth consecutive quarter | Stats NZ
[21] New data shows household net worth increases on the back of rising asset values | Stats NZ
[22] CoreLogic_HousingChartPack_May_2024 FINAL.pdf

While 3 yearly CVs allow us to see how big the housing base is the value of housing is inextricably linked to the land that it is on.

Roughly speaking, based on 2015 Productivity Commission report[23] about one half of the CV valuation on average can be attributed to housing and one half to land. This would give an estimate of the value of residential land at about $0.8 trillion.

The Fair Economic Return v Land Tax

Summary of FER

The rational for FER is that funds held in housing should generate at least as much as having the same funds in the bank or similar conservative investment. In FER, the value of all housing (and associated residential land) held by an individual is aggregated and registered mortgages deducted.[24] Net equity treated as if it was on term deposit earning a FER rate (say 4%). All housing income under FER is then added to taxable income and taxed at individual's marginal tax rate. FER needs to be supported by all the other tools such as tighter bright-line tests for short term gains, tighter LRVs (and possibly the removal of interest-only loans and introduction of thin capitalisation rules).

FER would target only the wealthiest top 20% of property owners and absentee owners (persons who are not tax residents of New Zealand). An exemption of up to $1m of net equity per New Zealand tax resident would mean that the vast majority who are basic homeowners are unaffected. The impact is made even more progressive by the taxation of FER income at the owner's marginal tax rate.[25]

The FER would use official CV valuations that capture capital gain in the equity base over time. Such valuations are readily available and uncontentious and usually err on the low side. Between the three yearly CV reviews valuations could be indexed to a housing price index to reflect interim changes in value.

The FER rate itself could rise with individual net equity ensuring even more progressivity. However, the very wealthy have very high net equity and so would pay substantial amounts of extra tax without the complication of a more progressive FER rate.

Under FER, there are no interest cost write-offs for rentals, and arguments about boundary issues that affect the deductibility of renovations and repairs disappear. Losses therefore cannot be carried forward to reduce future FER income. Nor will holding empty land and houses for future gain be so profitable. Serious landlords may find themselves encouraged under a FER approach by a lower overall tax burden and simpler, cheaper compliance. This can mitigate any perceptions that the FER is designed to attack and undermine the rental market.

By making explicit the deemed returns from housing investment, resources are likely to be diverted from luxury owner-occupied housing and second homes, undermining the culture of treating housing as an investment commodity traded for gain. A better use of the existing housing stock should follow. For example, those with houses that are too large for their needs would be encouraged to downsize, and investors would reduce their holdings of real estate in favour of other asset classes.[26]

New Zealand has a tradition of encouraging home ownership and exempting the family home may be seen as desirable by some. But defining a family home can be highly problematic, as

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[23] Using land for housing, Productivity Commission 2015, p49

[24] Soft loans from Mum and Dad at less than the FER rate should be attributed to the net equity of Mum and Dad.

[25] An associated reform might see all PIE income treated as income taxable at the person's marginal tax rate (offsets for imputation credits), removing the 28% advantage for top incomes.

[26] Investing in bitcoin, gold, art or shares would be arguably less damaging in a resource allocation sense.

shown by the Tax Working Group (2019). The bright line test demonstrates some of the complexities of defining the family home.[27] High worth people may use the family home as a store of wealth and exempting the family home in total from FER could exacerbate the existing issue of over investment in luxury-end housing.

Any special treatment of the family home raises horizontal equity issues. The $1m net equity exemption under FER is not specific to the family home. For example: Suppose Paul and Wiri have $1m each. Paul buys a $1m home to live in, while Wiri buys a home for $1m and rents it out for $25,000 pa (taxable). But Wiri pays $25,000 rent for himself (non-deductible) because he has to live elsewhere for work reasons. On the face of it, a net equity exemption on the family home of $1m to Paul is unfair to Wiri who does not have a 'family home' as he is not living in it.

Some may worry that a $1m net equity exemption is too kind to landlords. However, any resident landlord in NZ is likely to have their own home as well as the rental(s) so that only if net equity in the family home is less than $1m will the exemption reduce the net equity for FER held in rentals. There is room for design options that discourage multiple holdings. For example, if an individual owns one or two properties the full exemption could apply, if three maybe half, four maybe zero.

Second homes or baches are common among older New Zealanders and many are empty for much of the year. The second home contributes to real resource problem and the growing wealth divide and would be included in full for FER. In the UK, the prevalence of owner occupiers to own a second home is seen by some as the cause of homelessness, rather than the lack of supply of housing:

> *But just as homelessness is the extreme and visible symptom of a much bigger problem, so are second homes. Though we need to build far more social homes, the underlying reason for high house prices is not the lack of supply. The number of dwellings in the UK has been growing faster than the number of households, and there are now more bedrooms per person than ever before.*[28]

Practicality of FER

Given the political will, FER could be implemented from 1 April 2026. Since the political will is currently unlikely, a well-prepared incoming government might be ready to implement from 1 April 2027.

The FER would be based on current CVs (government valuations) that are updated every three years. The FER would be based on net equity aggregated as 1 April for an individual using the readily available CVs. By 2026, new CVs (as reviewed in 2025) should apply and for each of the 2 years following revaluation the CVs could be indexed to a house price index.

Taxable income (see Box 3) is determined by Net equity*FER rate. The rate might be introduced at 2% rising to 4% over time as interest and mortgage rates dictate. Only resident taxpayers would qualify for any individual exemption. Over time the incentives should maximise housing use (Airbnb, boarders, or rental income are ignored in FER). The complex existing tax rules for mixed use assets would no longer be needed. Each house (including residential land) in New Zealand is owned by somebody, either a resident or an overseas owner so the FER is hard to avoid. Inland Revenue could hold a register of housing interests for each taxpayer that can be cross-checked against a list of all titles of New Zealand property.

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[27] Exclusions to the bright-line rule (ird.govt.nz)

[28] George Monbiot Second homes are a gross injustice, yet the UK government encourages them Guardian, 23rd June 2021.

Box 1 FER for 2026/27 tax year on net equity held 1April 2026

Couple own	home	CV =	$5m
	bach	CV =	$2m
	rental	CV	= $800,000 with mortgage of $200,000

Total net equity = $7.6m
each person = $3.8 m
after exemption = $2.8m
FER taxable income @ 2% = $56,000 each additional taxable income
FER taxable income @ 4% = $112,000 each additional taxable income

How much revenue is possible?

The revenue collected by FER is a function of the total net equity after the individual exemption, the FER rate, and the Marginal Tax Rate (MTR) of property owners. Obviously, the parameters need to be known before revenue can be estimated. The intent of having a relatively high per person exemption is to limit the FER to the top part of the wealth distribution. The vast bulk of ordinary home-owners should not be impacted. But the higher the exemption, the less the revenue.

Given around $1.27 trillion in net housing equity in mid-2024, the top 2 deciles own an estimated 87% (see St John and Baucher 2022) or $1105 billion. If there is no exemption, the taxable income is estimated to be around $23 billion for a 2% FER, and $46 billion for a 4% FER. S John and Baucher (2022, p 13) estimated that after allowing for the per person exemption a taxable net equity base of $500 billion could be considered reasonable ballpark figure.

A 2% FER rate on this base is estimated therefore to produce at least $10 billion of annual taxable income, a 3% FER, $15 billion, and a 4% FER $20 billion. In term of tax revenue, assuming the top wealth earners have a tax rate of at least 33%, a 2% FER is estimated to produce around $3.3 billion tax, a 3% FER, $5 billion, and a 4% FER, $6.6 billion.

However, as FER replaces landlord rental returns, the expected tax revenue must subtract the existing tax revenue from rental income. According to Inland Revenue data the residential rental income for the 2022-23 tax year was $2.206 billion (net of $1.212 billion of allowable interest deductions).[29] The tax foregone on net rental income is likely to be under a half a billion dollars or less once deductibility of interest income is fully restored. From the sparse statistics available, a 4% FER can therefore be expected to generate significant additional tax revenue.

Land tax summary

Background

A land tax is a form of wealth tax that has considerable appeal as a low rate applied to value of undeveloped (and developed) land could raise significant revenue and appears much simpler than either a wealth tax or FER.

The historical experience of land tax which had been part of the early tax system was that too many exemptions minimised the base. Land tax was repealed in 1990 as part of the Rogernomics reforms. A 2018 PhD thesis[30] by Dylan Hobbs, Victoria University of Wellington, explored the history of Land tax in New Zealand and the practicalities that explain its lack of wide adoption. in New Zealand:

> *There is a widely held view that a land value tax is an economically efficient means of taxing wealth and of encouraging land development. The arguments presented in the policy and academic literature tend to concentrate on the*

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[29] Information supplied by Inland Revenue under the OIA in letter dated 7th June 2024

[30] The Use of Land Value Taxation In New Zealand (1891 - 1991) (wgtn.ac.nz)

compelling theoretical case, but most do not consider the detail of how such a tax might be implemented. Indeed, land value taxation is not widely implemented as a standalone real estate tax despite the strong theoretical rationale for its use.

LT was not considered by the 2001 McLeod Review[31], although the McLeod Review Issues Paper raised the possibility of applying the Risk-Free Return Method to tax the net equity component of rental houses. The issue of land taxation gained favour throughout the 2000s as an idea. Most members of the 2010 Tax Working Group (TWG, 2010) "support the introduction of a low-rate LT as a means of funding other tax rate reductions" As land is an inelastic supply, they expected the introduction of a LT would cause an initial fall in value of land.[32]

Over the years there have been many proponents of LT as the solution to the under-taxation of capital in NZ. Usually, the superiority of LT is asserted on efficiency grounds. Andrew Coleman and Arthur Grimes (2009)[33] claimed that LT was more efficient than a land plus improvements tax:

Land taxes are known to be amongst the most efficient forms of taxation since land is an immobile factor; property (capital value) taxes are less efficient owing to the tax on improvements. (pii)

The Interim report of the 2019 TWG recommended against land tax for the following reasons: that it would have a disproportionate impact on groups and industries that hold a greater share of their wealth in land; it made no allowance for debt and so could apply to heavily geared property owners with negative equity; it would raise cash flow problems for those on low incomes. Māori submitters argued that Māori would be disproportionately affected by a land tax.

A flat rate land tax on gross value is unlikely to make much of a dent in the misallocation of housing resources problem. But there would be a disproportionate impact for those living in low value housing/ and/or mortgaged homes on high priced sections, while only lightly affecting others, for example, those in high priced apartments on minimal land.

It is much harder to make a flat land tax progressive but nevertheless it is likely to be attractive because of its simplicity. Bernard Hickey, for example, has argued recently for a flat rate of 0.5% tax on all residential land. If there are no exemptions, he estimates the land tax would yield $6 billion in tax.[34] (This implies a total land value of $1200 billion).

At current land values, a 0.5% tax on residential land values would raise an extra $6b, and effectively increase the government's tax rate from 30% of GDP to 32% of GDP. It could service around $120b in extra government debt over the next 30 years with an interest rate of 5%. That would increase Aotearoa's net debt from around 30% of GDP to 40-50% of GDP by 2050, depending on the interest rates and economic growth rates. That would still be significantly lower than net debt levels for other countries with similar economies and credit ratings such as Australia, Britain, Canada and the United States. They are all expected to have debt levels of 50-100% of GDP over the next 30 years.

Similarly, The Opportunities Party (2023)[35] has argued:

We will use bold tax reform to re-orient our economy towards productive work and away from unproductive land ownership with:

- *A land value tax at 0.75% of the value of urban residential land, paid annually.*
- *Commercial, rural, conservation and Māori land would be excluded.*

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[31] See https://www.treasury.govt.nz/sites/default/files/2007-11/taxreview2001-report.pdf.
[32] For further discussion, see Russell and Baucher (2017, p 89-92)
[33] Coleman and Grimes, (2009) Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes | Motu
[34] Bernard Hickey: All roads lead to a land tax | The Spinoff
[35] A Fair Tax System - TOP

- *Superannuants could opt to defer payment until there is a change in ownership of the property.*

The tax switch is estimated to raise approximately $7 billion p.a. - making our three-part plan fiscally neutral.
We recognise that a Land Value Tax is a big policy change for a culture and economy based on home ownership. But it's the right thing to do. Our dysfunctional housing market is slowly separating our country into have & have not's and holding back our economic potential. We owe it to the generations of Kiwis who come after us, to change it now.

Arthur Grimes has written extensively on land tax in the New Zealand context.[36] His recent paper on the NZ experience for the UK Economy 2030 inquiry report (Navigating economic change New Zealand: Lessons on economic reform from a distant relative (2023)[37] suggests:

> *….the New Zealand housing 'model' requires far reaching reform. Ensuring an adequate supply of affordable housing is vitally important for current and future equity, as well as overall economic performance. A key aspect of policy that has been lacking at times in recent decades in New Zealand is large-scale construction of public housing. Political views on the role of government in providing public housing have differed sharply between Labour-led and National-led administrations, and this has caused a stop-start (and occasionally a reverse gear) approach to public housing provision. More generally, planning rules that restrict housing development have resulted in constrained supply and hence higher house prices favouring existing houseowners. Tax settings have also resulted in wealth gains for owners at the expense of renters. There is no reason to support the differential tax treatment of housing (whether owner-occupied or investment housing) relative to other assets. The tax system needs to be reoriented so that housing is no longer tax preferred, with imputed rents and (real) capital gains each becoming subject to income tax. A more far-reaching rebalancing of taxation towards a land tax – potentially with reductions in income tax and/or GST – would further reduce the price of dwellings, especially those situated on more expensive land.*

While raised for a different purpose, local government rates include a land tax component. As there is no allowance for mortgages, low-income families on larger sections with a large debt are particularly hard hit. The rates increases announced in 2024 by many councils reflect the need for extra revenue and are impacting on the cost of living pressures for homeowners and renters alike. They would be doubly affected by a 0.5% land tax raised for national revenue purposes.

For example, take a low-income family living in a rundown house in Ellerslie with a backyard and a $400,000 mortgage. The CV has risen to $1.8m in 2022 but the house value is only $125,000. With a 0.5% rate they would have to pay $8375 in land tax. This would be a very tough on top of general rates of $4000 and mortgage costs. For someone on a higher income in a city apartment with a CV of $1.8m but no mortgage and low rates and the land valued at $280,000, land tax at 0.5% would be only $1400.

A land tax attaches to the land itself and is not tailored for individual circumstances. Given that we have an effective land tax already in the rates we pay and that it has the potential to be regressive, it is hard to see that introducing an additional land tax, even at a low rate would be acceptable.

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[36] See for example, A Coleman & A Grimes, Betterment Taxes, Capital Gains and Benefit Cost Ratios, Economics Letters, 109(1), October 2010; A Coleman & A Grimes, Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes, New Zealand Economic Papers, 44(2), July 2010.
[37] New-zealand-lessons-on-economic-reform.pdf (resolutionfoundation.org)

Criteria for assessment

A real estate tax requires removing the pernicious and entrenched tax distortions in line with the following criteria:

- Be progressive in design to contribute to a narrowing of the Wealth divide
- Discourage the use of residential real estate as a store of untaxed wealth
- Generate a useful amount of revenue for redistribution and/or social investment.
- Encourage a much better use of scarce housing resources and facilitate a more equitable distribution of housing
- Encourage a better rental market.
- Have relatively simple base of valuation that is regularly adjusted
- Be simple, fair and above all doable without excessive delays.

FER v Land Tax

FER is progressive in design and should make it less advantageous to invest in housing as a store of value or to hold unimproved residential land. We estimate a FER rate of 2-4% could generate between $3-$6 billion of tax revenue. Good landlords are not penalised and may gain from the simpler approach to the taxation of their profits. The current CV adjusted every three years are a simple base for valuation. The scheme could be phased in starting in 2026.

A Land tax is associated with the land not the individual and is not progressive. A land tax does not make it less advantageous to invest in housing itself as a store of value but will discourage holding unimproved residential land. A land tax rate of 0.5 % is in theory capable of generating $6 billion of tax revenue but may have a highly regressive impact as there is no exemption built in. A land tax may encourage the development of land for housing but not necessarily of more affordable housing. There is no simplification for taxation of landlord's profits. The current CV separates land and improvements and is adjusted every three years provides a simple base for valuation. The scheme could be phased in starting in 2026.

New Zealand's tax policy since the late 1980s has followed, with one notable exception, the "broad-base, low rate" principle. The exception has been the taxation of capital gains most notably around housing. FER addresses that exception and fits in with the broad-base, lowrate principle. By taxing all residential property, it also tackles another, often unacknowledged, issue about overseas ownership. Those overseas owners are typically subject to capital gains tax or wealth taxes in their home jurisdictions. This results in many disposals of New Zealand property being taxable overseas, yet untaxed in New Zealand. It is only appropriate to capture some of that lost value for all New Zealanders.

Conclusion

In 2024 housing market problems remain systemic and long-standing. The 2021 New Zealand housing bubble was, unenviably, the worst in the developed world. The social and intergenerational consequences of rampant speculation and over-investment for some in the context of extreme housing deprivation for others is untenable and dangerous. A downwards correction in prices in 2024 is welcome, but currently New Zealand has very little in place to contain the next housing boom which some are already predicting.

As we said in 2021 the option of doing nothing is not an option as it is foolish to ignore the despair among the young of working age shut out of the market. Here is the conclusion of an opinion piece from Bernard Hickey who essentially argues that current policy is effectively 'eating our young':

> *Now anyone without parents able to help them with a big dollop of equity, or unable to marry into wealth, have no hope…*

> *Those parents still renting and those just graduating into Covid without assets should move now. Giving up hope seems a capitulation. It is. But sometimes discretion is the better part of valour. Sometimes there is no hope. Move to Australia and you'll find wages are 30-40% higher and rents have fallen $50-100 in the last year.*[38]

We argue the FER rate can be set as a policy tool—it should be below the mortgage rate. We think it should come in at a low rate of 2% to get people used to it but make it clear it may rise over time. We should start somewhere to get the price signals right and wean New Zealanders away from both housing and land as an investment for capital gain.

We note the data is nowhere near as comprehensive as we would like. Our ball-park estimates assume a net equity after exemptions of around $500 billion. A FER of 2-4% on this base would raise approximately $3.3 to $6.6 billion of tax per annum.

No one knows what the behavioural response will be, but the more valuable and less used the house is, the more expensive it is to hold it.[39]

Any deemed rate of return tax is difficult to explain to the public, relying as it does on the idea that an income is imputed, based on some assumed rate of return, and that this theoretical income is then going to be taxed. But because of the high net equity exemption, it is clear that FER is aimed at the holdings of real estate for wealth purposes, not at the use of housing to provide adequate shelter. Most ordinary home-owners would be unaffected by a FER approach.

A land tax would be problematic to sell as it is regressive. Its impact is similar to rates and does not allow for differing individual total circumstances, especially mortgage debt.

If the voters in a future election agree that New Zealand needs to raise more tax to address inequality in all its forms and to support an ageing population, a creaking health system, and the costs of climate change, then FER maybe an attractive way to do this by tapping into an untaxed wealth base. In turn it may lead to a better use of housing resources, while not discouraging good landlords.

Comments welcome

s.stjohn@auckland.ac.nz and terry@baucher.tax

[38] Bernard Hickey: How hope for a generation was lost | The Spinoff June 25th 2021

[39] For example, John Key's empty $23m house owned by a foreigner (see St John and Baucher 2022) with 2-4% FER would be $460,000-$920,000 of extra taxable income. If the property is held in a trust this would yield $179-$360,000 tax per annum.