The implications of removing interest deductibility for investor property.

- The Government has announced that it will remove the ability for property investors to deduct mortgage interest from their taxable income.
- This will significantly change the arithmetic for highly-leveraged investors, tipping the playing field in favour of owner-occupiers and cashed-up investors.
- We estimate that house prices could settle around 10% lower over the long term.
- However, there could be much greater effects in the short term as some investors exit the market.
- Lower house prices will have knock-on effects for activity, spending and inflation. We will be carefully working through the implications for our forecasts.
- Monetary policy will need to remain easy to support the economy through the transition period. A negative OCR remains on the table.
- We support the general direction of this move. We have been highlighting for many years that financial factors, including the tax treatment of property, are the major driver of house price movements.
- However, we think that limiting deductibility, rather than removing it altogether, would achieve the same purpose with a less disruptive impact.

The Government’s announcement this morning is a game-changer for the housing market. Or rather, one change in particular: rental property owners will no longer be able to deduct mortgage interest from their expenses. The other announcements, such as lengthening the bright-line test, are largely tinkering around the edges – and as we’ll discuss later, removing interest deductibility will probably make any other measures to control demand redundant.

For many years we’ve been highlighting the dominant role that financial factors, such as tax rates, play in determining house prices. The removal of interest deductibility cuts to the heart of the issue, in a way that so many of the popular proposed solutions don’t.

So full marks in terms of effectiveness, but there will be consequences for the economy. As the housing market reorients, we could see a sharp fall in house prices, which will weigh on households’ willingness to spend and discourage new home construction. That would put the economy further below its potential, making a sustained return to the Reserve Bank’s inflation target more difficult. Interest rate hikes remain a distant prospect, and indeed, more monetary easing might be needed to support the economy through the transition phase – a negative OCR is still on the cards. We’ll need some time to fully work through how this affects our economic forecasts.

It was never going to be easy to thread the needle between housing affordability and encouraging new housing supply, all without disrupting the economy’s recovery from the Covid-19 shock. However, the think that this change veers too far in one direction. Removing interest deductibility completely goes well beyond what’s needed to tilt the playing field in favour of owner-occupiers, and makes much of the investor market unviable under current conditions. A less disruptive approach would have been to allow partial deductibility, such as a thin capitalisation rule.
Policy details.

The Government has said that it will remove the ability for property investors to offset the interest on loans on residential investment properties as an expense against their income from those properties. This change will take effect from 1 October 2021 for properties purchased after 27 March 2021. For properties bought before that date, deductibility will be phased out over the next four years.

The Government is looking at an exemption for newly-built homes, with the aim of encouraging investment in the housing supply while still dampening demand. However, we suspect that the impact on homebuilding will be negative. New houses will be more attractive relative to existing ones, but not in an absolute sense. The issue is that buyers will have to consider the resale value, and any future buyer will be subject to the no-deductibility rule. Falling house sale prices will discourage development.

A primer on house values.

For many years we’ve used an asset price framework to explain and forecast house prices. This work was first published in 2007. A 2008 discussion paper from the Reserve Bank uses a similar approach, and steps through the logic in more detail.²

The framework shows how financial factors – rental yields, mortgage rates and tax – explain most of variation in house prices over time, with factors such as housing supply playing a more indirect role. The other key insight is that different groups of buyers vary in terms of their willingness to pay for a house. Leveraged buyers are different from unleveraged buyers, and investors are different from owner occupiers. This means some judgement is required about which group is the marginal buyer – that is, which of them dictates the market price.

The tax treatment of investors and owner-occupiers differs in two ways. The first one is straightforward: investors can deduct the mortgage interest expense from their taxable income, whereas owner-occupiers cannot. (This is repeatedly described, incorrectly, as a “loophole”.) The second one, which favours owner-occupiers, is less intuitive. Owner-occupiers effectively pay themselves for a flow of housing services, and that ‘payment’ is untaxed. If those same services were provided a landlord, they would be taxable.

Up until now, the balance of these two forces has been in favour of investors. That’s why we sometimes refer to our approach as an ‘investor value’ framework – it recognises that leveraged investors are the marginal buyer, and their willingness to pay will determine the market price.

Removing interest deductibility tilts the balance dramatically in favour of owner-occupiers, who will now be the ones who determine the market price of houses. A rough calculation suggests that their average willingness to pay is about 10% below current prices, which suggests that house prices could fall by that much in the long term. That in itself is not particularly onerous – it would bring prices back to where they were four months ago.

However, there could be a much greater decline in the short term, while the housing market realigns itself. Without interest deductibility, property investors will need to see a higher rate of return to justify their investments. That could mean higher rents, although that will be constrained by tenants’ ability to pay. The more likely way is that highly-leveraged investors will sell out – at a reduced price – to owner-occupiers or less-leveraged investors.

We saw similar outcomes in the UK, which began to phase out interest deductibility from 2017. House price growth slowed to zero, rents rose to some degree, and housing construction slowed. More recently, the resulting shortage of housing had started to lift prices again, at least until Covid struck.

What about other measures?

We suspect that the change to interest deductibility will be effective enough to make other demand-dampening measures redundant. The Reserve Bank may add debt-to-income ratio (DTI) limits to its macroprudential toolkit, but it’s unlikely that they will need to be activated, as highly-leveraged investors will already have been stopped in their tracks. If anything, the RBNZ’s next step may be to remove loan-to-value (LVR) restrictions again, as there will no longer be a need to restrain the growth in mortgage lending.

An alternative.

The complete removal of interest deductibility came as a major surprise, although we had considered the possibility of a limit on deductibility, known as a thin capitalisation rule. There is already precedent for these rules in some sectors. The aim is to restrict leverage that serves no commercial purpose other than to reduce the tax bill.

We think that a similar approach would be appropriate for addressing the imbalances in the housing market. It would be a question of calibration, but it would be possible to tip the balance in favour of owner-occupiers without excessively disrupting the rental property market.

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