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Taxing times (and mortgages)

- **NZ's Finance Minister has floated the idea of a variable mortgage levy as a means to dampen inflation pressures emanating from the housing sector.**
- **Practical difficulties and lack of broad based political support will make it a no-go.**

NZ's Finance Minister mentioned the possibility of a variable levy on residential mortgages in a radio interview this morning. This was one of many "Supplementary Stabilisation Instruments" canvassed in a joint report issued by the RBNZ and the Treasury on 6 April 2006. The mortgage levy was investigated in the report, but was not endorsed by the RBNZ, the Treasury, or the authors of the report. The report effectively wrote off all the alternatives canvassed, concluding: "there are no simple, or readily implemented, options that would provide large payoffs in the near-term, without significant complications and costs."

We attach a very low probability to a mortgage levy being introduced. The Finance Minister says that such a levy would need careful consideration and broad political support. Both are huge hurdles, neither of which the levy will be able to overcome.

Why it is a no-go

- Unintended consequences: Much small-business lending is secured over residential mortgages. So the levy would hit not only the mortgage market but small business funding costs.
- The proposal is for the levy to be applied to all existing fixed rate mortgages. This would be hugely unpopular as it would rightly be perceived as a retrospective tax. People enter fixed rate mortgages for certainty of payments, something that would be taken away from them at a stroke.
- Financial providers could lessen the effectiveness of the levy by extending the term of a fixed rate mortgage or shifting a customer to interest only terms while the levy is in place. Is the Government going to go down the route of regulating individual mortgages to overcome this inevitable outcome?
- There would be disintermediation away from the domestic finance sector. NZ Dollar mortgages could be issued from Australia, Fiji, the Caymans etc. Third country tax treaties would have to be changed to try to ameliorate this disintermediation effect, which could be difficult. The enforcement costs would be very high.
- The levy would be labelled as yet another tax, and would be regressive (with the most impact on low income borrowers).
- Constitutional issues: you either have an unelected body (the RBNZ) levying a tax which is unprecedented, or the Minister of Finance administers the levy and hence has a hand in monetary policy and threatens the perceived independence of the RBNZ.

Some asides

- NZ's monetary policy lever is not broken. Higher debt levels mean that a 30bp rise in the effective mortgage rate is equivalent to a 50bp increase 5 years ago (in terms of impact on debt servicing costs). The 'problem' is that monetary policy takes longer to have its impact. The 'solution' is either more patience or more aggression in the application of monetary policy. Globalisation/deregulation of markets has meant that long-term interest rates are being set globally and less by domestic monetary policy considerations (which has meant tighter spreads and flatter/inverted curves). This phenomena is by no means unique to NZ yet we do not hear of other countries complaining that monetary policy is ineffective.
- The levy is being floated as a way of slowing

Economic Research New Zealand +64 4 470 8250 bodonovan@westpac.co.nz Sydney +61 2 9284 8372 London +44 20 7621 7620
www.wib.westpac.co.nz

construction growth. This is exactly the wrong target. To reduce price pressure in the housing market, housing supply would more usefully be increased than decreased.

- The levy would be a very partial response. It would do nothing to increase savings in financial assets (it would actually diminish them). Too low financial savings is surely the flip-side of 'excessive' investment in housing.
- What is the litmus test for when the levy should be introduced/raised/what level to be set at? Is it only when there is an identifiable bubble? How does one identify a bubble? After all, relative price shifts occur in an economy to ensure a reallocation of resources to where demand is strongest. It is always dangerous from a policy perspective to try to target one price in isolation.

Best areas of focus

The best way to assist the central bank in its ongoing fight against inflation is to raise the growth potential of the economy. Thus, Government should be most concerned with addressing supply-side, rather than demand-side, issues. The key focus, as always, is raising productivity.

Two key areas for ensuring increased productivity are education (basics such as literacy and numeracy, meaningful qualifications that provide a reliable signal to employers, targeted training, and a tertiary education system that focuses on quality rather than quantity) and health. After all, a healthy and educated workforce is paramount. However, other areas the Government could usefully target (and to an extent, generally are) to raise productive potential are:

- Changes to the RMA to reduce obstacles to investment in critical infrastructure areas, particularly electricity generation and supply.
- Reduced compliance costs.
- More generous depreciation rates to encourage investment (particularly R&D).
- A closer look at the interaction of the tax and benefit systems to encourage greater labour force participation.
- Reducing company tax rates to encourage increased investment.
- Targeting of skilled migrants, but ensuring that qualifications (e.g., plumbers, electricians, doctors, engineers) are recognised from a broader range of countries. This is necessary to break down the ‘closed shop’ industry associations. At the least, credits for foreign qualifications should be recognised, rather than having to start from square one to be able to practice.
- ensuring increased competition in key sectors, particularly utilities and communication.
- Ongoing pursuit of free-trade agreements.
- Increasing the disclosure requirements of finance companies, as this is where the riskiest credit creation is occurring.
- A co-ordinated savings focus. Current policies such as the Kiwisaver scheme and abolition of grey list countries are more likely to feed the domestic property market with little or no increase in savings in financial assets.

There is much that the Government can do to assist the Reserve Bank. But the focus should be on the medium term and doing what is right for the economy structurally. Unintended consequences can lurk when policy is short-sighted or interventionist.

Brendan O’Donovan, Chief Economist, Ph: (64-4) 470 8250
Dominick Stephens, Economist, Ph: (64-4) 381 1414