Memo

To Steven Mitchell, Secretariat, Finance and Expenditure Committee
From John Ballingall
Date 22 January 2018
Subject NZIER submission on Overseas Investment Amendment Bill

This memo provides some brief comments from the New Zealand Institute of Economic Research (NZIER) on the Overseas Investment Amendment Bill [the Bill] from an economic perspective.

NZIER is an independent, not-for-profit think-tank and consultancy. NZIER was established in 1958 to undertake independent economic analysis and encourage debate on economic issues affecting New Zealand society.

This memo represents NZIER's own views, not necessarily those of our members.

Key findings

We understand why this Bill has been introduced. We understand why Treasury has written a Regulatory Impact Statement (RIS) that contains very little evidence. We too would like it to be easier for first home buyers to get into their own home.

But none of these things detracts from the fact that, from an economic perspective, this Bill is a poorly-designed solution to a poorly-defined problem. As a result, NZIER opposes the Bill.

We recommend the Select Committee considers the scope for exemptions from the sweeping provisions of the Bill in terms of investment in certain regions or in certain types of residential development that would add to New Zealand's housing supply and are less likely to be thought of as sensitive.

Given the lack of empirical evidence and poor data quality around overseas investment in existing houses or residential land, we recommend a timely and well-publicised monitoring and evaluation process to ensure the Bill does not have unintended consequences.

Context

We understand that the Bill has been developed in order to:[1]

- Partially fulfil a Labour Party 2017 election commitment to ban foreign buyers of existing New Zealand houses within the first 100 days of being in government. This commitment is based on a belief that overseas speculators have been artificially inflating New Zealand house prices, especially in Auckland, to the detriment of Kiwis seeking to buy their own home.
- Find a solution to implement the ban whilst also allowing New Zealand to commit to the provisions of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in late 2017.

We also understand that the Regulatory Impact Statement (RIS) prepared by Treasury was completed in haste, which precluded any degree of empirical analysis on the costs, benefits and risks associated with the proposal.

1 See sections 2.3 and 2.4 of the RIS.

We have a great deal of sympathy for Treasury – it was effectively railroaded into delivering a RIS to implement a proposed legislative change with which it likely disagrees, and it would have been very difficult from a relationship perspective for Treasury to develop a RIS that explicitly advised against the new government's proposal.

What's the economic problem, exactly?

In a RIS, the problem definition should clearly identify the market or policy failure that needs to be addressed, what is causing the problem, and – ideally – how material the problem is. The problem definition is the foundation on which any RIS should be built, because it clearly explains why change is required at all.

The problem definition in Treasury's OIA Bill RIS falls well short of best practice. In fact, it is almost non-existent. It contains almost no information or empirical content. It merely states that the new government has a stated policy commitment to "ban overseas speculators from buying existing houses" and the RIS is all about how to implement the political proposal.

This is effectively Treasury waving the white flag from a policy analysis perspective. It seems clear that Treasury were not asked to analyse whether the proposal makes any economic sense based on first principles.

An evidential void

Obvious questions that have not been considered are:

- What empirical evidence is there that overseas speculators are pushing up house prices in New Zealand? Which countries' speculators are having the greatest influence?[2]
- In the absence of empirical evidence, recognising the limitations of existing LINZ data sets, how reliable is the anecdotal evidence on the role of overseas speculators in artificially inflating house prices?
- How significant is this inflationary effect, compared to other potential drivers of house price inflation, such as supply-side constraints and land availability?
- Why is home ownership 'better' for Kiwis than renting? (i.e. what is the welfare loss to Kiwis attributed to the current legislative framework?)
- What does the desired 'future state' look like, and how likely is the proposal to contribute to this state?

Without at least initial answers to these questions, it is very difficult to judge whether the proposal will make any material difference to home affordability for Kiwis at all.

Or as Treasury puts it more subtly: "We have greater certainty around some of the costs of this policy, however have limited certainty around benefits" (p.4) and "it is difficult to assess the extent and nature of the behavioural responses that will result from this policy" (p.5).

It would be interesting to know how confident officials and politicians are that this Bill will actually improve home affordability for New Zealand residents and citizens, and by how much.[3]

[2] LINZ data indicates that 1,293 (3%) of property transfers in the September 2017 quarter listed a non-New Zealand tax resident as a buyer. Removing Australian tax residents from this figure leaves 972 purchases by non-New Zealand or non-Australian tax residents, or 2.2% of the total.

[3] Treasury rates its "Evidence certainty" as "Low" on this point in the table in section 5.2, with the "Impact" listed as "Unclear".

Regulatory uncertainty presents a risk to New Zealand's attractiveness to foreign investment

New Zealand relies on foreign investment to fill the gap between domestic investment needs and domestic saving. New Zealand also faces challenges in attracting high quality foreign investment, due to its lack of scale and distance from key markets.[4]

Foreign investors of all types place a high value on the certainty of the regulatory environment. An investment proposition looks more attractive when there is little chance of the host government making unforeseen or arbitrary changes to the 'rules of the game'.

The changes contained in the Bill make investing in residential property in New Zealand more difficult and uncertain. The application process and discretionary nature of the decision-making process for investments in sensitive land will – at the margin – make New Zealand a less attractive place for foreign investors.

This is what the government wants, of course. But as well as preventing single-purchase investments by overseas persons, the Bill also makes it more difficult for foreign investors, including New Zealand-domiciled companies with more than 25% foreign ownership, to invest in large-scale residential projects. This is at a time when New Zealand has relatively few large-scale property development companies and New Zealand banks are increasingly tightening up on development funding.

This will reduce the supply of housing beneath what it might otherwise have been, pushing up prices for New Zealand resident and citizen buyers, including first home buyers. The Bill could therefore have precisely the opposite effect of what is intended.

There is also a risk of contagion to other types of investment. Foreign investors in other parts of the New Zealand economy, such as in non-residential investment or infrastructure, may see this Bill as an example of how New Zealand's investment regulations can change very quickly due to political preferences, and with very little evidential basis. The natural reaction is to look less favourably on New Zealand as an investment option, or to demand a higher risk premium.

For a country that relies on foreign investment, this should be a worry.

Existing home owners' property rights are impinged upon

The RIS pays no attention to the impact of the Bill on existing home owners' property rights. Without the Bill, a home owner could sell to the highest bidder, be that from a New Zealand resident or from overseas.

The Bill's proposed changes will prevent this from happening. A home owner will be able to sell only to New Zealand and Australian citizens and permanent residents. This reduces their available options, and may result in sellers 'leaving money on the table' – selling for below the true market value in the absence of the Bill.

This 'option value' will have existed when many home owners purchased their properties, and would have been built into the price paid. These home owners now face a loss of wealth as their homes will be worth less than would have otherwise been the case without the Bill's provisions.

Economics tells us that households' spending on goods and services is at least in part determined by their perceived wealth. The Bill is therefore likely to result in marginally lower household spending by these home owners, which could have negative impacts on economic activity, job growth and income growth. These effects may not be huge, but are unlikely to be non-existent.

[4] Or as ANZ puts it, "Current angst over foreign ownership also deflects attention from New Zealand's poor savings record, resulting reliance on foreign saving and poor relative investment returns" (ANZ. 2017. 'Changing of the guard', ANZ Agri Focus, December 2017, p.1).

As such, Treasury's claim that "the expected beneficiaries of this policy are the New Zealand public" (p.2) seems very broad-brush.

In addition, there is a risk that baby boomer home owners who had planned to sell up and downsize, rent, etc, may now decide that they won't get the return on their investment that they had been planning on when they had the option of selling to foreign buyers. This will reduce the supply of homes for sale, at least in the short-term before these home owners get too old to maintain a larger house, or die – placing upward pressure on house prices.

Perhaps these effects are what Treasury is referring to when it states: "there are a number of implementation risks, these include: some of the design choices may be sub-optimal or have unintended consequences" (p.3).

Additional challenges for some first home buyers

While these wealth impacts may not pose significant problems for high-wealth home owners with low mortgages relative to the value of their property, this will not always be the case.

Consider, for example, a first home buyer who has taken out the maximum allowable mortgage after scrimping and savings for years to build a deposit, and who bought near the top of the property cycle. Any reduction in house prices caused by the Bill's provisions could potentially place them under significant financial pressure.

Under such a scenario, those looking for their first home after the Bill's proposals are put into place will benefit at the expense of those who had the misfortune to buy just before the Bill was announced.

Will the OIO have the capacity to deal with 3,000% more screening applications?

The Overseas Investment Office (OIO) has been facing capacity constraints for many years. Foreign investors have been frustrated with the slow pace of application processing.

The Bill's proposals will only add to the OIO's paperwork burden, since all potential foreign purchases of residential land will now need to go through a comprehensive screening process. Treasury estimates[5] that the current number of screening applications, around 150 per year, could rise to as much as 4,700 per year – a 3033% increase.

While the OIO is to receive additional funding to help manage this change, it remains to be seen whether applications can be processed in a timely and transparent manner.

If administrative capacity constraints continue to frustrate foreign investors, this again reduces the attractiveness of New Zealand as an investment destination.

Is this *really* how we want to be regarded in trade negotiations?

As noted above, a key reason for the Bill was to develop a solution to a very tricky problem: the new government committed to banning foreign buyers of existing New Zealand homes, but the CPTPP (as it is now known) trade agreement that New Zealand had already agreed to would not have allowed it. The same problem existed with New Zealand's existing trade agreements with China, Singapore, Taiwan and Korea.

The Bill managed to solve this problem, ensuring that New Zealand consumers and exporters continue to benefit from these trade agreements. That's a good thing.

5 See section 6.1 of the RIS.

But put yourself in the shoes of our trade agreement partners. They had signed up to agreements with New Zealand that aimed to encourage greater trade, investment and other types of economic integration. Many of them have been in place for years, and they posed no restrictions on investment in existing New Zealand homes.

And now New Zealand has suddenly decided that in fact those countries' investors *can't* actually invest here in existing residential property any longer, and face a potentially lengthy and uncertain screening process if they want to build new properties.

Is this legally permitted under these agreements? Well, yes, just.[6] Is it the sort of thing that New Zealand usually does? Absolutely not.

It's hard to imagine this will be received well in the capitals of our trade agreement partners. There will no doubt be some difficult diplomatic conversations to be had.

If the shoe was on the other foot, and additional restrictions were imposed on New Zealand exporters or investors after a trade agreement was signed and implemented, New Zealand officials and investors would be shouting from the rooftops at the injustice of it all.

New Zealand has always been regarded in international treaty negotiations as a constructive country that plays by the rules (because as a small country we benefit most from the rules) and encourages transparency and openness. We have always had a reputation as being one of the good guys.

The Bill will certainly put a dent in that reputation.

Auckland ≠ Timaru: one blunt rule to capture them all?

The Bill appears to have been driven primarily by concerns over the role of foreign speculators on the Auckland housing market. Certainly, the Labour party's narrative during the election campaign was centred on Auckland. And the public debate often centred on Chinese investors (although this was less prominent politically in the aftermath of the 2015 "Chinese-sounding names" incident).

There's no doubt that the Auckland housing market is overheated, and buying a home there is a huge challenge for most families.

The role of Chinese speculators in this overheating is not known at all beyond anecdotes. LINZ data indicates that in Auckland, investors with Chinese tax residency accounted for 294 of 11,667 property transfers in the September 2017 quarter, or just 2.5%.

This raises a question of why New Zealand should be banning investors from *all* countries from buying existing homes in *all* parts of New Zealand (or making them all jump through expensive screening processes to buy residential land anywhere in Aotearoa).

Timaru is not Auckland. The UK is not China. A rent-seeking foreign property speculator is not the same as a well-established New Zealand-based company that has slightly more than 25% foreign ownership.

Yet this Bill allows no discretion to differentiate between any of them in terms of buying existing homes.

[6] It appears that the proposed changes are permitted under New Zealand's existing trade agreements, and CPTPP, although the Singapore-New Zealand Closer Economic Partnership will need to be renegotiated (or New Zealand will be in breach of its commitments) and Australians are exempt under the CER.

Come to New Zealand – we welcome skilled migrants (but only if you don't buy an existing house)

New Zealand continues to experience significant skills shortages, per NZIER's *Quarterly Survey of Business Opinion*.

We need foreign workers to fill the gaps left when Kiwis travel overseas and provide experience and expertise in sectors where we do not train enough workers and managers domestically. The tech sector in Wellington is a good example of where New Zealand 'imports' expertise to work with New Zealand ideas and innovations.

The Bill's provisions make it more difficult to attract the best and brightest of the global talent pool.[7]

While the provisions' impacts may seem relatively minor, remember that New Zealand already faces challenges attracting high-skilled workers due to our geographical location (far away from family members) and relatively low wages (offset somewhat by our high quality of life). Any deterioration at the margin in New Zealand's attractiveness as a place to work and live will cause some globally mobile workers to look elsewhere instead.

Conclusion

Improving home affordability for New Zealand residents or citizens is a laudable goal. But it needs to be approached carefully so as to avoid unanticipated consequences.

There is almost no evidence at all to justify the ban of foreign buyers of existing homes proposed under the Bill. In lieu of such evidence, in our view, the Bill's provisions – if passed – should be applied with flexibility, rather than bluntly applied to all investors from all countries to all investments. We wonder if there is scope for any exemptions – perhaps by region or type of investment – in the regulations.

As improved data becomes available, any ban on foreign buyers and additional screening requirements for investment in new residential developments should be closely monitored and evaluated, with a view to adjusting the regulatory settings if it appears they are not having the desired effects, or are having unintended consequences. The timeframes for such a review should be announced publicly, and as a soon as possible.

Ends

7 Admittedly, concessions have been made to allow resident visas holders to buy a house to live in, provided they meet the 'commitment to reside in New Zealand' test, but they must sell it when they leave the country.