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Submission to the Tax Working Group

by

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April 3, 2018

Responses to the Background Paper.

Submission to the Tax Working Group

PREFACE

Your terms of reference have extensive objectives and recognise that there may be issues which will require further reviews in order to explore them sufficiently in order to arrive at a tax system that is truly efficient, fair, simple and collected. Your excellent paper on the Future of Tax (Submissions Background Paper) invites suggestions for such reviews.

Some of my submission will relate to such further reviews or issues which could benefit from being considered in the context of this reviews recommendations. A number of the points I wish to make have arisen from consideration of a Universal Basic Income (UBI) but which are relevant to your present review. Note that “Social Dividend” conveys the purpose of a UBI more accurately and may become the preferred name. I will use it herein.

I will not attempt to deal with minutiae. I believe that these should be considered within the framework of a major restructuring of the system. I am delighted that your Submissions Background Paper clearly anticipates such a restructuring although your Terms of Reference appear to prevent it. Without such a restructuring your review can only result in another of the “fiddles” of the past.

Many of the issues are interrelated but I will divide my responses (I am reluctant to call them answers) to the questions related to the Chapters of the Submissions Background Paper.

CHAPTER 2: THE FUTURE ENVIRONMENT

The risks and uncertainties of the future have been well outlined in the Submissions Background Paper. Simple projections of the past are clearly unwise.

Democracy, Inequality and Environmental Sustainability.

These issues are perhaps the greatest tests for the use of Government’s taxation weapons. These three are related since the wealthy can afford to buy or make use of the things which are in short supply and thereby increase their rate of exhaustion.

Apparent prosperity is currently built on the poverty of sections of the people who, necessarily take a short term view.

I want to emphasise the view that Inequality unchecked will destroy democracy and our civilization as we know it. The will and the means to progress to environmental sustainability may thus be delayed or destroyed. Recent political upheavals lend this view credence. Hence, in my view above all else, the **reversal of the current growth in inequality is essential.** Those who can afford to own the new technology will benefit most from its use unless we develop means of ensuring “trickle down”. Social sustainability is required to achieve environmental sustainability.

My submission does not attempt to suggest any specific environmental taxes.

CHAPTER 3: PURPOSES AND PRINCIPLES OF A GOOD TAX SYSTEM

The notion of fairness

Fairness is a difficult concept. It is very much a matter of how things are viewed and what the purpose behind the view may be. The concept of the “deserving poor” implies that there are also the “undeserving poor” and that the fair entitlement of one is different from the other. And that those of one “class” or ethnicity are more entitled than those of another.

My own view is that a fair system must allow societies “losers” to live with dignity and to be able to reasonably hope to have some “winning” for themselves and their children in the future. Also to feel that those who are better off deserve to be so.

My focus is on the effect of the combined tax and benefit systems on individuals, their families and their associates. Benefits are not a formal part of this review but are, inescapably, connected to it. The net effect on individuals is the difference between what Government “giveth” and what Government “taketh away”.

Apart from exceptional cases my view therefore is that, as far as possible, to be “fair” Government should give all its citizens the same services in terms of education, health, law etc and the same financial payments, concessions and incentives. In return Government should take the same proportion of citizen’s income and their wealth to pay for what Government does or what it redistributes. This principle should be applied as far as possible and used to assess the performance of the system.

I give some examples below of these simplifying concepts which may be relevant to your review or its recommendations for later work. They can be tested for horizontal and vertical equity as well as efficiency and simplicity.

CHAPTER 4: THE CURRENT TAX SYSTEM

GST

GST as currently structured is the best tax system I know of. Its application to goods and services being without exceptions is the reason for this. It is a feature that must be maintained whatever level is set for GST. Making any tax for something dependent on the name given to it is begging for avoidance and evasion. For example reducing GST for “fresh fruit and vegetables” sounds good. But does this apply to frozen vegetables, or ones that have been in a cool store, or ones that have since unfrozen. Even without the adjective “fresh” there is room for argument -Some people do not include pulses - peas and beans etc in the category of vegetables.

Currently GST at present is simple, understandable, visible and efficient. Avoidance by some tradespeople is known but this is unlikely to be a large percentage of the whole. And if the ill-gotten gains are then spent GST is collected on that spending. If the gains are saved then a wealth tax would capture some of them.

One problem is that GST falls most heavily on those who must spend all of their income on survival. This could be partially dealt with by including an estimation of its effect in a Social Dividend.

Retirement savings

In my view there should be no discrimination between savings of various kinds. Why would calling something a retirement saving justify its being taxed differently from saving for a house? Especially as having one’s own house is so important for comfortable retirement?

CHAPTER 5: THE RESULTS OF THE PRESENT TAX SYSTEM &

CHAPTER 6:THINKING OUTSIDE THE CURRENT SYSTEM

The structure of our present personal tax system.

Lower tax rates for lower incomes are beneficial for those on lower incomes but they benefit those on higher incomes more. **Is this fair?** It clearly violates the principle of vertical equity referred to in the Submissions Background Paper.

I would be happy to elaborate further but it is not my purpose here to discuss all the Social Dividend details. However, to a considerable extent, the justification for Social Dividends stems from the above fact and I will have to deal with relevant issues.

The tax cuts proposed by the National Government before the election highlighted this unfairness in our system. Moving the 10.5% rate from $14,000/yr to $22,000 gave no benefit whatsoever to those below $14,000 and $560/yr to those above $22,000 while the move of the 17.5% rate from $48,000 to $52,000 gave those above $52,000 a further $500/yr. The more you have the more you get.

Currently, above $70,000/yr the rate is 33% but such income benefits from all the lower tax rates. The tax saving compared to paying 33% on all that income is $9080. But, for example, on $14,000/yr the benefit from paying 10.5 % instead of 33% is only $3150. The further reductions from 33% for higher incomes are of no benefit to low income earners.

If we paid someone earning $70,000/yr, or above, $9080 but charged them 33% on ALL their income they would be in exactly the same net position as at present. **So why do we not do this for everyone? This would be a tax-free Social Dividend.** It should depend only on age - like superannuation. There would be no surveillance, stigma or substantial administration. Someone with no income would be better off by $9080/yr. The net improvement in income would diminish to zero at $70,000. Everyone would pay the same rate of tax regardless of total income.

There are many arguments about Social Dividends of various kinds ranging from being a human right to degrading the moral fibre of the nation leading to “layabouts” in unprecedented numbers. I see it as largely a matter of securing a fairer, simpler and more readily collectible tax system.

The simple-minded case against such a Social Dividend is the cost. For adults, aged 18 to 64, the annual cost (in 2015 figures) would be some 26 billion. But note that the Income Tax take from these Adults, excluding the Income Tax from Superannuitants, will increase with a uniform 33% rate by roughly $18 billion. This is because, apart from recovery from those on less than $70,000/yr, all those on or over $70,000 per year will be paying an additional tax of $9080/yr on their salary up to $70,000, negating their UBI.

So the cost for an adult Social Dividend of $9080 per year with a 33% tax rate would be only 8 billion per year. It would need the tax rates to be increased or a new tax - possibly specifically for the purpose.

Other benefits could be decreased by the UBI amount but this would still need the administration and other humiliations and complications of these benefits. Should we therefore go a little further and raise the Social Dividend so as to be able to get rid of most of the current benefits and administration.

Of course the cost and the benefits of a Social Dividend depend on the the actual size of the Social Dividend. If it is sufficiently high for adults then many things like the Job Seeker Benefit can be discontinued and help to meet the cost.

The Submissions Background Paper on page 25 shows the present total cost of Social Security and Welfare as about 25 billion. Of this some 14 billion is superannuation. Of the remaining 11 billion the continuation of hardship allowances but with administration savings may result in some 7 or 8 billion in savings from this 11 billion - leaving superannuation unchanged. For a more extensive discussion on this, transition issues, comments on possible tax systems and other matters see a number of my papers at perce.harpham.nz.

In practical terms a Social Dividend of $11,000 per year (instead of $9080) for adults while making no changes to Superannuation or Child (including teens) arrangements will cost about 31 billion. So we would have huge social benefits and the net cost would fall to about 6 billion. We would still need more tax. Alternatively we could increase Income Tax for adults to nearly 38% but then those above about $60,000/yr would be worse off. And the tax would not do anything about the accumulated inequality in wealth.

Various types of taxes have been designed in bygone eras to distribute accumulated wealth. These have been eroded to extinction by avoidance, the establishment of trusts and the exercise of the power of the wealthy.

Property ownership is a good proxy for total wealth. So a good choice for a new tax to maintain fiscal balance with a Social Dividend 0f $11,000 per year for adults could be an Asset Tax of about 0.5% collected together with local-body rates on the improved value of properties. It would be easy to collect and hard to avoid. Whoever paid the rates would pay the tax. This would discourage the use of resources in elaborate housing and, with the Social Dividend, reduce inequality. It would probably also decrease house prices. Note that individuals would get only one Social Dividend regardless of how many houses they owned while companies, trusts and non-resident investors would not get an Social Dividend.

For the reduction of inequality and collection of revenue the virtues of a tax on the whole value of properties should be considered even if the revenue is not occasioned by the introduction of a Social Dividend. As discussed below there should be no exemption for family homes.

An Asset Tax could be easily extended to include assets which are currently registered such as vehicles where the registration fee does not relate at all closely to the value of a car. Yachts and aeroplanes are also candidates but the Wealth taxes in India for example have been made ridiculously complicated and ineffective.

Many taxes are possible. Many fail the fairness tests and exacerbate inequality.

There is a need to protect those with little in the way of assets from the Asset Tax. At first sight this could be by exempting the first, say, $200,000. But this gives the same benefit to all who own their home and does nothing for those who do not have a home. **Is this fair?**

If there were to be a Social Dividend then it would be easy to increase it by an amount to pay the Asset Tax on a property of say $200,000. Since the Social Dividend would be paid to each person then two people sharing a property would be covered for the Asset Tax on the first $400,000. And those without homes would benefit by the increased Social Dividend. This follows the principal enunciated earlier to give everyone the same benefit from any Government tax concession or payment. And those without property will have to pay rent which will probably increase because of the Asset Tax.

But if the Social Dividend approach to dealing with the inequity embedded in the stepwise system of Income Tax is not adopted some other way of achieving that end needs to be developed.

And, clearly, to achieve vertical equity it is necessary to tax those with higher incomes at a higher rate.

The large step in the tax scale at present is in going from 48,000 per year to 48,001. The rate goes from 17.5% to 30%. A 12.5% jump from one dollar to the next.

We should deal with the problems of the current large steps in the tax scale and the application of the lower rates to the higher income earners. One approach is for each level at which the tax rate is raised to apply the new rate to the whole income. There is great scope here for different approaches. Suppose the tax rate up to $100,000/year remained at 33% and then went up to 34%. The first additional dollar would incur a tax of 34 cents plus 1% on $100,000. A sudden slug of $1000. But the second additional dollar and later dollars would only incur the 34 cent charge. Another 1% rise at $150,000 would incur a $1500 charge and so on. Many variations can be considered. And their effect on the taxation revenue calculated.

If there were a Social Dividend and a 33% tax rate to start with then the effect of steps could be greatly reduced from the present even if the new rate were not applied to the whole income. Each step in the case above would then not involve lump sums at the changeover and would only increase the tax rate by 1% instead of the much higher figures at present.

There is a huge simplification possible if we can establish a “fair” income tax system. In this case we can potentially abandon all the little complications which afflict many Government systems such as denial of student loans if the parent’s incomes exceed specific amounts, the claw-back of benefits as incomes rise, the denial of Community Service Cards above certain levels of income and other dis-incentives for people to earn above a certain amount.

Taxation of Family Homes
The idea of exempting family homes from various taxes has an attractive emotional connotation but fails every test enumerated in the Submissions Background Paper - simplicity and efficiency, vertical equity, horizontal equity and fairness.

Defining a family home for tax purposes is far from simple. See the huge efforts and attempts at definition which have been made by IRD for the purposes of the “bright line test”. Also note the work being done by the Law Commision to define the division of property on the break-up of modern, complex, multiple marriages and other forms of association.

Any such tax must be extremely complex and inefficient. Its very complexity will be likely to lead to evasion and avoidance. It will be subject to many amendments and never-ending legal argument - particularly when dealing with family rearrangements and bitter dissolutions.

A tax dispensation for family homes will greatly reduce the tax base and result in reduced Government revenue. For any desired level of such revenue the burden will then fall on the homes that are not owned by the resident family. That is the burden will fall on the many who rent their homes. Those who have more get a dispensation which is not available to the less well off. Horizontal equity is violated. **Is this fair?**

Again, the value of properties varies enormously so any dispensation based on whether or not family homes are exempted has enormously different financial effects. There are said to be “family homes” valued at some $20,000,000**.** For others their ‘family home” may be an old van. Vertical equity is violated by any taxation dispensation based on ownership of a family home. **Is this fair?**

CHAPTER 7: SPECIFIC CHALLENGES

Housing Affordability
It is well accepted that taxes, or the lack of them affect business decisions. The primary driver of house prices is probably the balance between supply and demand. No doubt any change in the tax structure applied to housing will affect the eventual balance level but any change will take considerable time to stabilise.

Anyone considering renting-out a property as a business investment rather than a speculation for capital gain will want to see a return on the investment. So taxes will have to be taken into account as part of the business plan. Taxes on housing will therefore affect rents. This impacts the increasing proportion of those who rent and who may never be able to buy a house of their own.

The immediate effect of imposing taxes on properties may be to reduce their value and may result in houses which are not currently rented being sold more cheaply thereby increasing the supply of houses to rent or allowing a renter to become an owner thusreducing the demand for rentables and so stabilising rents. On the other hand depending on the demand the rents may simply continue to increase but, perhaps, at a slower rate.

The note below on capital gains is relevant as is the one above regarding tax on family homes.

Capital Gains Tax
The questions asked in Appendix 2 of the Background Paper bear testimony to the complexity of such a tax. Apart from the inevitable avoidance and evasion issues there will then be large administrative and legal costs as a result.

If there are to be Capital Gains taxes then in fairness capital losses should, I think, be allowed to offset them. Government revenues will then diminish in an economic downturn at the very time that they will need an increase.

On the other hand a CGT can be a gift to some of the wealthy. Consider the examples of "buy-back" of shares by companies such as the Commonwealth Bank of Australia. They are very complicated but effective ways of buying back at less than the market price so that tax losses can be claimed. These losses are made up by issuing fully franked special dividends to those who agree to the buy- back so that the effective prices paid to shareholders is close to the market price but the tax loss can be offset against other income.

A "stamp duty" applied simply as a percentage of the sale price on property has much to commend it. If it is not complicated by exemptions for family homes and the like it becomes just like GST but is collected every time a property is sold. Easy to understand and easy to collect. Also an Asset Tax as described above can be seen as a kind of progressive CGT paid annually. In my view it would be better to choose other simpler taxes, such as these two, which also reduce inequality instead of a CGT.

Land Tax
The idea of a land tax has been advocated for some centuries and still has some adherents. But it could mean that someone (e.g. an old widow) living in a house sandwiched between two apartment blocks could be paying the same land tax as the owners of the apartment blocks. And the tax base would be much narrower. If the same revenue were to be collected a land tax would bear heavily on farmers and market gardeners. I am not aware of any argument for a tax on the unimproved value of land which does not apply with greater force to the case for taxing on improved value - meaning the value of the property including the land.

We face a major issue of inequality of wealth which means that any balance that there may have been between the competing ideas of land tax or a total property tax should now be resolved in favour of the latter.

Progressive company tax
All that a progressive company tax would do, in my view, would be to lead to fragmentation of larger companies with increased costs of compliance and administration. This would be especially likely if the progression was in large steps.

The present moves to reduce the compliance burdens on start-ups and small companies will do a great deal to assist them. If they are making a profit they are OK but the burden of having to comply with complicated rules and regulations and/or to pay for accounting services can consume time and energy which is desperately needed for survival.

Answers to other questions put to submitters, so far as I feel that I have any, are given above.

QUESTIONS NOT ASKED

WHAT SIZE OF GOVERNMENT SHOULD WE HAVE?

The answer must be that it depends on what kind of society we wish to have. At one extreme Government controls and owns everything. At the other extreme civilization as we know it ends.

The use of proportion of GDP as a measure of Government performance.
GDP is itself a peculiar statistic which increases with calamities such as earthquakes. It has very

little relationship to the efficiency, effectiveness or “right size” of Government. The North European economies that we most admire have a Government Expenditure to GDP ratio of around 50%.

The use of such a ratio as an overarching control on the total of our taxes and therefore the size of our Government seems incongruous. It has been said that “taxes are the price of civilization.”

My limited reading of the budget allocations of the successful European economies indicates that their Governments provide many more services to all free of charge rather than targeted benefits. This approach clearly reduces the effect of inequality as measured in terms of income or wealth because the same services are available to all regardless of the financial differences.

Comparisons of the ratio of Government Expenditure to GDP are clearly also meaningless for other reasons such as the split of responsibilities between national, regional and local governments as well as private/public partnerships and subsidies and other distorting issues.

One of the pernicious effects of adopting this measure as a control target is that it is most easily achieved by reducing services and benefits as has been dramatically demonstrated in recent years. This is exacerbated by including benefits paid along with Government expenditure - OBEGAL. The nature of other expenditure and of benefits is fundamentally different. Government controls the final expenditure in one case but not the other.

In my view a great improvement in the management value of reporting would be to remove the distribution payments (such as some 14 billion of superannuation) from the OBEGAL and to report it separately. This would give us some feeling for how far we are moving to reduce inequality and thereby preserve the “market system”.

And judgments as to whether Government should engage in any activity as well as whether to fund it by immediate taxation or borrowing is a complex matter which should be made on a case by case basis and not be affected by some simple number of doubtful meaning. The decisions and timings for activity also depend on physical and other factors - not merely on the costs.

Why are tax rates for a company different from those of ordinary persons?
Companies are legal persons but have progressively secured many legal and financial advantages over ordinary persons. **Is this fair?**

GST might be considered to be a tax on a company’s income but because of the reclaiming of GST on purchases, although not on staff costs, GST also has a relation to profit. The taxation of any business - sole trader or company - is necessarily complex and to attempt to charge the same tax rate on income for companies as for persons would be very difficult so a tax on profit is clearly required but having a different rate for each does not appear fair.

The usual justification for reducing the tax rate on companies compared to that for people is that this is what other countries do and it is said that we must compete. Again, comparisons are problematic. With the deterioration in public health services it has become more common for NZ companies to provide staff health care insurance and this is much cheaper than in some other countries. Similarly with retirement benefits and many of the taxes which affect company expenses - such as fuel taxes, payroll taxes, customs duties, tariffs etc to say nothing of the cost, availability and productivity of staff. All of these things and more affect the profitability of a company after tax. Such things are considered in deciding where to locate companies.

To reduce compliance costs as well as reducing our tax evasion and avoidance industry we should keep the tax rate the same for both companies and persons. We could also then abandon PIEs.

How do we control the finance industry?
There is great concern world-wide about the behaviour of the finance industry which has led to successive financial crashes. Attempts to control this industry by regulation have not worked and will not work if the regulations are not enforced, and/or not enforced across national boundaries.

Is it possible to device taxes which lead to curtailment of the problems?

Care is needed to avoid getting the wrong effect by making special provisions for any group. We do not charge GST on financial transactions because of perceived difficulties in doing so. I know of one case of a financial institution buying a supplier so as to avoid having to pay GST on the services the supplier provided.

But much of the problem is because of the peculiarity that banks are allowed to lend more than than they can pay. Ordinary company directors are liable if they " trade while insolvent". But banks can lend up to the Bank Ratio that currently applies. Mr Muldoon used to change this frequently. But a bank can legally lend up to, perhaps, 8 times what it is worth.

Financial transaction taxes and "positive money" have long been discussed. The whole matter of banks and the creation of debt is getting world-wide attention and needs its own review. When NZ owned the Bank of New Zealand which had 45% of the NZ banking services we were almost 45% of the way to the "positive money" goal. By properly capitalising Kiwi Bank we could, perhaps, get there again and have Government at least share in the profits from the leagally privileged position of banks.

But if banks paid an increasing tax on the debts that they "sell" would that act as a deterrent to the malpractices and excessive creation of debt? Say 0.5% on the first multiple of debt compared to net worth and rising by 1%, or more or less, for each later multiple.

Clearly this would raise the cost of borrowing but at this time of low interest rates something of the sort ought to be worth consideration.

As an old engineer, having established and run computer software companies in NZ, Australia, the USA and China and spent my business life largely in the design and establishment of computer systems I tend to think of how things work and how different ideas can be made to work. I sympathise with the complex tasks facing the Working Group and would be happy to contribute in any way that I can. Good luck!