Tax Working Group Public Submissions Information Release

Release Document

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Submission – Tax Working Group NZ

Thursday, 26 April 2018

To : submissions@taxworkinggroup.govt.nz

Status:

This submission is made as a personal, individual submission. While not made as one with specific formal economic nor investment management qualifications, I have been motivated to write due to what I observe as serious and damaging distortions within the economy.

I encourage the working group to make strong and robust recommendations that I believe are required to start New Zealand on a path that will eliminate the distortions within our taxation system that have and are contributing to serious problems in our economic performance, our long term social stability and our capacity as a nation to be economically resilient and dynamic.

There are three broad areas I have focussed upon:

1. Rural land prices
   and the links between economic performance, productivity, resilience and environmental performance. And

2. Housing prices
   As above and, in part, related to the lack of taxation regimes related to land and assets.

3. Hypothecated Taxes
   Taxation regimes to either promote behaviour change, catalyse the capacity to make economic principles drive socially or environmentally necessary outcomes, or to fund the costs required to avoid or remediate the effects of unwanted outcomes.

Fundamental Philosophy:

The above issues have been the subject to repeated and in depth commentary in many forms by many economists in recent years, both nationally and internationally. However, in terms of national debate, the underlying core information has been poorly socialised and usually ensnared in a shallow politically branded left or right wing debate.

For the record, I am very much of the side that markets can and do effectively drive rapid responses to evolving situations. However, I am also very much of the view that most markets operate with incomplete information and within the construct of a framework. If the framework is wrong, the markets can very efficiently deliver the wrong result for society at large, (NZ Inc) in this case. I believe this is where we are now at in NZ in relation to the issues listed.

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1 Rural Land Pricing

As a practicing forestry professional, (currently Environment Manager for a large NZ Forestry Company) I have been involved in not only day to day issues of forestry, but also in land use and land management issues in many parts of NZ, environmental issues related to Carbon / climate change, Nitrogen / water quality, biodiversity protection etc. It has become very apparent that tax distortions are having a (possibly significant) part to play in why we have had, and continue to have, some of the land use and economic efficiency issues we face today.

By way of example:

- Commercial plantation forestry occupies approx. 1.7million ha while the drystock pastoral sector around 10million ha.
- Forestry is known to produce in Net Present Value terms around 2 or more times the average of drystock farming. In a presentation I prepared for the NZ institute of Forestry in 2013, I estimated (from Treasury and Infometrics data) that forestry was producing several times the GDP contribution per occupied hectare relative to drystock farming (see table below).

Kit Richards figures					
Derived from Treasury Document 2009					
Contribution to G	Farm Gate %	Processing %	Total GDP contril	Hectares	Contribution/M h
Dairy	2.899			2,100,000	1.38
Cattle	0.893			10,255,000	0.23
Sheep	0.743				
Wool	0.15				
Other	0.118				
Live Animals	0.458				
Total Pastoral	5.261	3.98	9.241	12,355,000	0.75
Forestry	1.1	1.07	2.17	1,750,000	1.24
Note: Unfortunately Pastoral processing was a combined figure for Meat and Dairy					

- Furthermore, using published data from model farm statistics, it was apparent that large areas of NZ pastoral farming was making a return on capital employed of around 1.5% and at the time such figures were not atypical over a number of years past. Over the same period in the same area there had been effectively no new forest planting.

- Using a spatial economic model developed by Scion (forest research CRI), farm values were reconfigured to represent the value that could be supported if farm returns of 8% pre-tax on capital employed were being sought, a level similar to that required for forest investment at the time. The result was dramatic. The land values had to drop significantly to support that level of return on the farm and in so doing, forestry also became highly competitive - indicating a potential for economically afforestable land to rise from 0% to 40% of the landscape.

- The figures as calculated did not include payments for Carbon. These would have further improved returns to a level completely out of reach of the drystock pastoral sector on similar land.
- The results are illustrated in the maps below.

<table>
<tr>
<td>Forestry NPV's at 8% pre-tax and (then) present pastoral land values with farms in the area broadly making an average of 1.5% ROI</td>
<td>Forestry NPV's at 8% pre-tax after pastoral land values adjusted downward to enable farms to achieve the same 8% return.</td>
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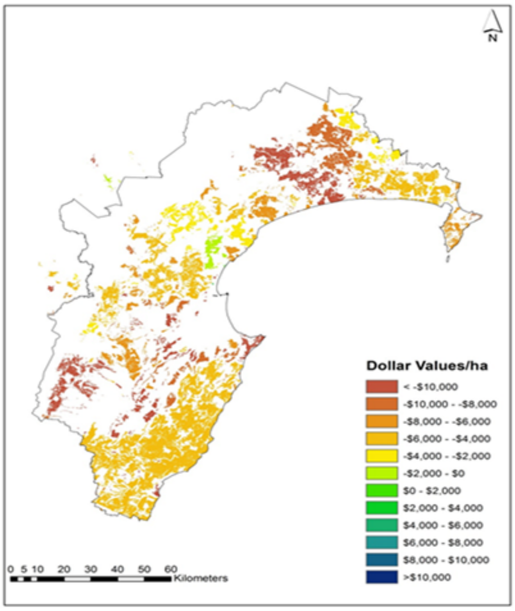
<td>


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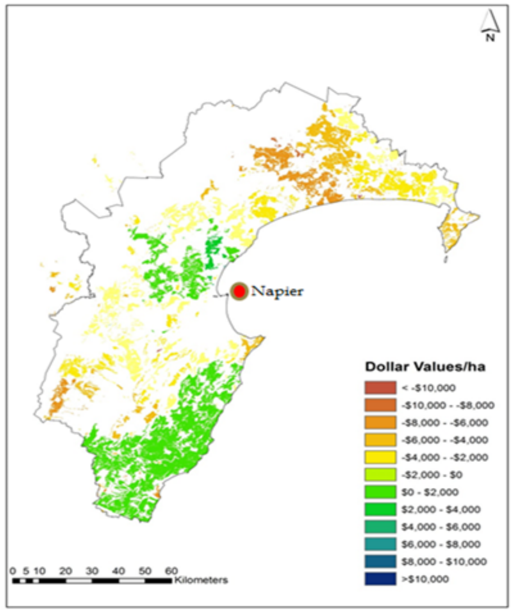

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<tr>
<td colspan="2">Key – Lime green colour through to blue – NPVs' >$0 /ha</td>
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The Problem

- Despite the highlighted disparity, the problem of inflated land values has continued. A study undertaken in 2015[1] by agronomists indicated drystock farm values had continued to increase and that the closest correlation to that trend was the trend in Dairy land prices, not the value generated from the businesses themselves nor the market prices of the meat or wool they sold.
- Over the same period – NZ has in effect, been disinvesting in forestry, as new planting largely ceased and replanting declined to provide for conversion of forest land to (usually dairy) use.
- There has been extensive commentary in the last five years, recognising:
    - The high levels of debt in the dairy sector.
    - The fact that farm valuations were heavily driven by the factors of stock numbers or KG's milk solids per hectare produced with little evaluation of the costs of producing the marginal added Kg milk solids. This has occurred to the extent that many dairy farms were now actually less profitable and more vulnerable than prior to expansion and intensification. However, the land values had continued to climb, at least until the 2015 slump.

[1] The Effect of Environmental Constraints on Land Prices Phil Journeaux, AgFirst Waikato Ltd 2015

- Hand in hand with this expansion and intensification has been the rise of carbon emissions, serious nitrate leaching and water provisioning issues.

Submission

It is hard not to conclude that in the drive to achieve land value appreciation (and tax free capital gain), New Zealand has become good at farming "land value" but at a national level this may have resulted in extensive misdirected investment of scarce financial resources, poorly distributed wealth and less wealth overall as a nation. A direct consequence of that focus has also been vulnerability with high levels of debt associated leveraged investment in patches of dirt and, in lieu of sufficiently robust environmental regulatory controls, poor environmental outcomes borne by all New Zealanders.

I strongly support moves to adjust taxation regimes to remove the inherent incentives leading to what is a potentially toxic combination that is already extremely difficult to deconstruct. If not done, then in the medium to long term the consequence could be self-defeating as land values increase costs so far that the artificially created alternative products that are already appearing on supermarket shelves eventually undermine a significant part of the whole rationale for the current pastoral farming models.

Removal of the latent incentives to capitalise value to land for tax free capital gain will also almost invariably lead to adjustments that may also see more afforestation occurring without further significant Government (taxpayer) support. Given the current realignment of policy objectives to achieve decarbonisation in the economy, afforestation as a least cost option is desirable but difficult in the face of current land values.

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2 Rental Property & House Prices.

The issue of housing price inflation, in part, mirrors much of that already noted above. While undoubtedly, a shortage of supply is a major component of price escalation it seems fairly well established that:

- In recent years a very large proportion of purchasers have been "investors",
- "Negative gearing" and heavy leveraging have been standard and in fact often widely, encouraged strategies to get into housing investment,
- The availability of cheap credit has particularly advantaged those with existing asset bases.
- Extensive coverage given to the issue by competent economics commentators has repeatedly highlighted that damaging risks posed by the current taxation regime.

It is hard not to conclude that the taxation regime in relation to housing investment is a contributing factor to the serious house price inflation witnessed over recent years. The social and health consequences of that inflation, combined with trends toward less stable employment are becoming obvious to all and can only ultimately feed through to very high economic costs to mitigate the problems that have arisen.

The mantra that landlords provide an essential service may well be true if they were building new houses to rent. Clearly however, a very large proportion are not, they are simply buying existing houses, providing no greater or lesser service than would accrue to the first home buyer purchasing the same building for their own use. The difference is they can use the current tax regime to support higher pricing and sustained cashflow losses or very poor returns that no other business could, all on the basis that there will be tax free capital gain at the end.

The public discussion on this issue has always been highly emotional, particularly from those invested in the benefits that have accrued. Seriously deficient has been the requisite balancing component to the discussion – being that a capital or land tax or better still a capital income tax <u>does not have to be an added tax</u> in aggregate in the economy. What it should be is a tax, closing a gap that has allowed many to (legally) avoid paying tax. Once in place, the broader tax base should provide for income based tax reductions. This is most likely to most benefit those in lower and middle incomes (who will nevertheless spend most of it) and or offset increased rental costs that could arise as those still operating as landlords seek to get an appropriate return on capital given that capital appreciation is no longer advantaged.

It may well be that in the short term real rents will rise, but longer term (as has already been reported in Auckland and Rotorua), the threat of tighter standards and possible tax changes is seeing some landlords exit and lower investor activity being replaced by more first home buyers. This in itself has to be an improvement even if the rental situation remains tight. However, if in addition, proposed levels of house construction are implemented, the capacity for rents to inflate will also be curtailed.

Submission

While there may be a case to provide limited time bound tax breaks for the bringing to market of "new housing", the ownership of rental accommodation needs to be clearly defined as a business. The capacity of offset losses against other unassociated income – particularly sustained losses which no other rational nor productive business would do, needs to be curtailed.

The effects of rampant house price inflation pose threats to the wider public through risks to economic stability, misdirected investment and social dislocation.

Capital and income taxes need to be aligned with other economic business activity to curb (as with rural land) the incentives to invest substantial proportions of the nation's capital into what are fundamentally unproductive and speculative enterprise with significant downside costs to wider society.

I strongly support moves to adjust taxation regimes to remove the current distortions that in-part are fuelling the relatively extreme rise in housing costs in many parts of NZ.

It is unacceptable the long term social and economic costs and risks created and borne across wider society can continue through the favoured treatment of housing taxation that in effect is a means of tax avoidance that has and does promote asset wealth amongst a relative few.

Similarly, is undesirable that so much of the Nation's capital continues to be invested in static and unproductive assets. Such diversion will not support a prosperous, dynamic and innovative economy in the long term.

3 Tax Regimes to achieve general public benefit.

Over the years through my involvement in the various landuse, environmental and resource use debates it has become very obvious that:

1. Across a wide range of issues, getting change in directions we all recognise are needed is often very difficult to initiate if market signals are not strong or clear enough. Recycling would be a typical situation. It is ironic that while there is a large debate about the rights and wrongs of bottling free water, no one much is also talking about the enormous carbon footprint being created by the massive use of fossil fuel based plastics and the transport of that water around the world, let alone the incomplete recycling infrastructure we have in the domestic scene. Reinstating the simple concept of surcharges and refunds (as well established in Norway and other developed economies) needs to be integrated more thoroughly into our economy to start to drive the improvements required in so many areas of this far from clean and green nation.

2. As illustrated in the recent dairy boom and consequential mass conversion of forests, if the framework within which the economic signals are given is wrongly structured, responses to such signals can be powerful and far faster than regulation can ever hope to keep up. There is a strong case that had the costs of Nitrogen and Carbon emissions been factored in, many of the conversions would never have happened. Pricing externalities where these are directly attributable is likely to be a far faster and more robust mechanism to achieve change than the grinding wheels of the RMA or other rules will ever hope to achieve. The complete failure of this 20+ year old Act to achieve let alone maintain water quality is testament to this as is the rapid but temporary response of new forest planting with the introduction of the ETS. Just as suddenly as new planting restarted it subsequently stopped having been completely undermined by the importation of "low grade hot air emissions credits" in order to avoid costs sheeting home to the main emitting sources.

3. Hypothecated taxes: increased use of taxes directly connected to the costs of reducing or remediating a problem seems to be a tool far too sparsely used at present, yet the areas in which they might be effective are substantial. The power to reduce the socialisation of costs associated with specific actions of forms of consumption thus alleviating the need for as much expenditure from general taxation seem to be an opportunity missed.

   The arguments of the benefits or otherwise in relation to a sugar tax seem to be a classic case where political motivations and vested interests deliberately obfuscate the debate to the disadvantage of society as a whole. It is very clear that excess sugar in our diets is creating a massive current and future health liability compounding the future costs that will already be imposed upon younger generations faced with an increasing ageing population. The public debate around this issue was managed to focus on disputed evidence of whether a sugar tax would reduce sugar consumption. In reality this is irrelevant, the sugar is creating harm and a tax will have some uncertain impact along a continuum between no effect and completely ending the consumption of products with added sugar. The exact quantum does not matter – what matters is that the greater the consumption, the greater the tax take and consequential redirection of the hypothecated funds to the health and education sectors. The inverse also applies. Additionally, if the tax is of sufficient size it is likely to motivate those involved in the manufacture of highly sugared products to start lowering content to remain cost competitive, thus reducing the latent impact of these products upon society at large. Provided the associated regulatory frameworks are also sound in relation to the safety and labelling of alternative food additives that might be added to reduce direct sugar content, there must be an overall benefit.

International Tourism may well be another case where simply administered border charges could be used to reinvest into the regional infrastructure to manage the now patently adverse effects of the currently burgeoning tourist numbers - not to mention actually assisting in the protection of the biodiversity assets of the current conservation estate that are presently funded solely by the NZ Taxpayer.

Submission

I strongly support moves to make much greater use of targeted tax tools to drive behaviour change either through taxation of unwanted outcomes or redistribution tax takes to incentivise desired behaviours. In particular I support increased use of hypothecated taxes.

There is however, a desperate need to properly socialise the discussion around such taxes so the public at large understand that the finance raised is ring fenced and fed back directly to solving or reducing recognised problems. On that basis it is hard to imagine that there could not be achieved a significant acceptance of the purpose and value that can be derived from the targeted implementation of such taxes. The current response to the fuel tax in Auckland would seem to be a case in point where despite some issues of fairness at the margin, the general tenor after the announcement of the tax has been one of acceptance and the greater good that will arise from a much enlarged transport infrastructure spend on both roads and importantly, public transport.

The tax working group should strive to identify and publish a target list of key areas where hypothecated or other targeted taxation should be applied to achieve better outcomes for the nation. To bring such a list into the public domain may then provide the foundation from which public and political debate can launch.

In Conclusion:

It is my strong belief that the consequences of identifiable failings in the current taxation system in NZ have provided for structural distortions that are destructive to the future social, economic and environmental resilience of the nation. The distortions have become deeply embedded and strongly politicised in the national psyche. Unravelling the in-built consequences of these distortions will not be without pain.

BUT, as a still small nation we can change more easily than most if the initial decisions are made with some urgency. This review, in my view, provides a desperately needed opportunity to start the process of change, a change that can steer the country in a direction that points to a stronger, richer, socially more balanced and environmentally more resilient nation.

I appreciate the opportunity to submit

Yours faithfully,

C R Richards

[1]