Tax Working Group Public Submissions Information Release

Release Document

September 2018

taxworkinggroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Submission to Taxation inquiry; A Rolling Capital Gains tax for Housing

Sean Devine*

[1]

April 29, 2018

1 Summary

- This submission argues that housing and property should be the key focus of a capital gains or similar tax. Figures that have been reprocessed from those in Thomas Piketty's "Capital in the 21st Century" [1] conclusively show that, in contrast to productive investment, capital gains on un-productive investment, such as housing and property, has seriously distorted several European economies over the decades. Unearned capital gains is economically destructive.
- The solution is an appropriate tax, but the purpose of such a tax cannot be to increase tax revenue. Its primary purpose must be to constrain a section of the population gaining unearned income at the expense of the productive sector. If such a tax is successful, capital gains will be minimal, the economy will thrive, but there will be little tax revenue
- The removal of an economic distortion due to investment in assets that capture unearned income, will generate far more economic benefits than any income redistribution possible from a higher tax take.
- The recommendation is that a rolling capital gains tax, on most houses and property, where each year a relatively low provisional tax would be applied on estimated capital gains, similar to the way rates are calculated. The debits and credits of the tax would be carried forward and, at the time of sale, a full capital gains tax would be applied, taking into account the

*Dr Sean Devine's has worked as a scientist and science manager. He studied economics in the mid 1980s leading to taking on the role of Programme Manager at the Foundation for Research Science and Technology. He later became Executive Director of the Association of Crown Research Institutes. He has been involved with two technological companies and has, more recently lectured in strategy to postgraduate students. Sean is now retired.

accumulated debits or credits over the years. The aim is to dis-incentivise property investment by an immediate tax now to clearly signal a further tax will be collected later.

2 Introduction

2.1 The critical term β used in the submisison

β = the Capital to Income ratio of an economy. If β is roughly flat over the decades, it indicates that incomes from investments are growing in proportion to the investments. If, on the other hand, β is rising, incomes are not rising with investment and the fruits of productivity are not being distributed justly.

2.2 The core issues

The value of our current house would have been $15,000 in 1970. Some 47 years later it is now worth more than $600,000. Yet, even allowing for general inflation, this wealth increase is unearned and is unrelated to any productive activity. Irrespective of fairness, economies that allow capital gains to divert investment from productive to non-productive activities, such as housing fail, their citizens.

This submission is focussing on the taxation of unearned wealth, which is defined as wealth that is not related to increased production. As in the housing and property market in New Zealand, unearned capital gains redistributes the fruits of production to the non-productive sector.

This submission is based on evidence from the on-line data used in Thomas Piketty's book "Capital in the 21st Century" [1] but Piketty's figures have been redrawn to separate out productive and housing wealth for three European nations. Because Piketty's analysis has not separated productive from unproductive wealth, his narrative fails to diagnose the situation adequately. Piketty's concern is about "Who owns the investment?" rather than the concern here, which is "Who gains the benefits from the investment?".

The critical issue is illustrated in in Figures 1, 2 and 3, . These figures use Piketty's on-line data, but separate productive from housing investment. Where the Capital to Income ration β is roughly constant over the decades, as is the case for productive investment, society as a whole gains with increasing investment. Here productive investments is taken to be investments where the Capital to Income ratio β changes little over the decades. Non-productive investments are characterised by a sharply rising β over the same period.

When β is rising sharply, as it does for France's housing (see figure 1), and to a lesser extent for the UK and Germany, benefits are not being distributed widely. Instead the benefits of unearned wealth are accumulating to property owners. The problem is not the failure to tax unearned capital gains, the failure is to allow a section of the community to extract wealth from the productive sector.

As Piketty failed to distinguish investment in existing housing from investment that increases productivity, his conclusions are flawed. This oversight allows Piketty to wrongly attribute the sharp rise in β for France the UK and Germany to both productive and non-productive investment as can be seen in the graphs from "Capital in the 21st Century" [1] reproduced in the Appendix. Because Piketty has not separated these two types of investment, the very investments we need to create jobs and to increase productivity, share the blame with housing for poor economic performance.

This submission analyses the data from Europe to show that unearned wealth is economically destructive, effectively taking income from the wealth creators, including employees, and distributing it to those who are just recycling existing wealth. If a Picasso costs \$1000 in terms of time spent producing the art work, but later sells for \$1 million, no more wealth has been created, rather wealth has just been redistributed. In contrast to housing, this increase in wealth is not critical as few need a Picasso, yet all need a home to live in.

The long term issue is is to constrain investments for capital gains in favour of investments in productive enterprises. A failure to do so penalises the productive sector of the economy by not only reducing productive economic activity, but misappropriating the income from production.

3 Piketty's figures show only housing is the problem

Figures 1, 2, and 3, , are reproduced from Piketty's on-line data. However, in contrast to Piketty's own figures [1] reproduced in the appendix, the figures here, which separate the value of β for productive activity and none-productive activity, show housing and only housing is the problem. This separation makes it clear that for France, the UK and Germany, β, the Capital to Income ratio for productive investment (the blue curve), has been relatively stable since WWII, showing there is little, if any, economic distortion with productive investment. However as for these economies β for housing (the red curve) has been sharply rising, housing is extracting wealth from the productive sector. France has the worst housing problem where the sharp rise in β indicates a seriously unbalanced economy. This may be an important factor contributing to France's unemployment level of 10% despite. The level is concerning as France came out of the Global Financial Crash well compared with the UK.

It is when β is rising sharply, not when the rate of return on capital is greater than GDP growth, as Piketty claims that unearned income accumulates. These

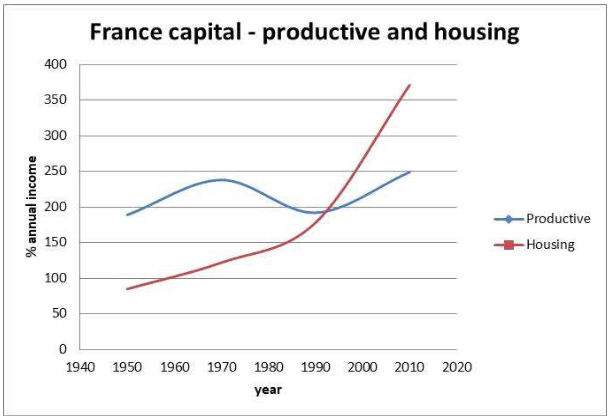

Figure 1: productive and non-productive capital for France

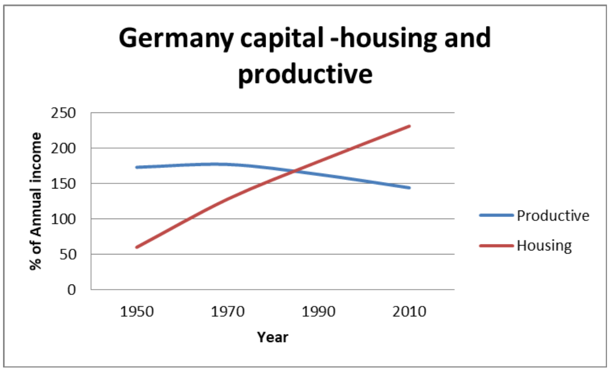

Figure 2: productive and non-productive capital for Germany

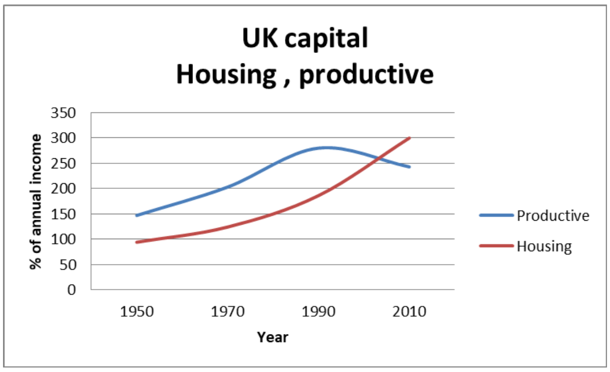

Figure 3: productive and non-productive capital for the UK

figures show the economic distortion occurring when β is allowed to rise sharply, as the as is the case for housing in these three economies, benefits of investment are accumulating to a few and are not distributed to the wider economy. On the other hand, the benefits of the investment in the productive sector are not accumulating, and there is no problem to be solved. Where β is roughly flat, investment in more factories and technologies, not only increases returns to the owner, but creates more jobs increasing national income. The next section shows how this understanding affects taxation policy.

3.1 Taxing housing capital gains

The position here is that the taxation focus must be on removing the economic distortion of capital gains on housing, not on increasing the tax take. The aim is to reduce capital gains to zero, and in so doing stimulate the economy. The economic benefits in doing this far outweigh the benefits of an increased tax take, to redistribute.

Furthermore, as a normal capital gains tax is collected in the future, it provides little immediate incentive to change investment behaviour. Furthermore, those needing to sell and buy a similar house will find it financially difficult if in doing so they must pay a large tax on capital gains.

As many home owners buy to achieve capital gains, a tax regime needs to discourage this practice. A variable tax rate or no tax at all can be applied to lower value houses.

This leaves two taxation possibilities. The first is the Morgan Foundation's "Capital Comprehensive Tax"; the second is a "Rolling Capital Gains Tax" that tracks debts and credits over the years as a provisional tax, to be offset against a later capital gains tax. Each has issues that need to be considered as outlined below.

3.1.1 The Capital Comprehensive Tax (CCT)

Others will no doubt provide submissions on the CCT, but the basic idea is that certain assets, such as housing, pay an annual tax, similar to rates, based on the value of the asset. In this case the suggested tax is 6 % per annum. But the purpose should not be to collect more tax or redistribute income, its primary purpose should be stop the leakage of earned wealth to those who have not earned it.

The difficulty is that many New Zealanders will not have available income to pay such a tax. Furthermore, if the tax works, there may be no increase in capital to borrow against a mortgage to pay the tax. Quite simply a 6% tax say on $ 1 million Auckland hme would be unsustainable, and no Government implementing such a tax is likely to stay in power.

Also, a CCT for productive assets is likely to be counter productive even if offset against other tax paid, because of the difficulty in assessing what actually needs to be taxed. What appears to be increased value today may be intended to generate taxable income tomorrow. A CCT on productive assets could well discourage company investment. The figures for France, Germany and the UK, and therefore probably for New Zealand, show that at the economy level there is not taxation problem to solve.

The CCT might work if the level was low, similar to the level of rates, and could be adjusted depending on the rise of house prices. But the aim should not be to redistribute wealth, but to constrain investment in existing housing.

It would be unwise to apply the CCT for other assets such as shares in the meantime, until there is certainty it will not do harm.

3.1.2 The preferred option, a Rolling Capital Gains Tax

Rather than taxing capital gains in the future, which will have little effect on current behaviour, a rolling capital gains tax could be instituted based on a tax on the current housing inflation rate. The tax collected annually, should involve debits when prices rise. and credits when prices fall, and the accumulated debts and credits tracked until the house is sold. At that time, a final higher level of tax could be collected, taking into account tax already paid.

If the rolling tax is not too high, house owners with reasonable equity could expect the bank top provide a loan to pay the rolling tax using the mortgage as collateral.

For example, if a $1 million house inflates at 5% per year, the assumed income is $50,000 and the tax would be a percentage of this, say 5%. In the initial stages it should be similar to the level of rates, until the system beds in. If house prices continue to rise, the percent level should increase accordingly until the incentive to invest in housing decreases.

In other words adjust the level to achieve the desired aim of low inflation for houses investment

3.1.3 Warning: The "first do no harm" principle

An economy is a complex system and the rule for intervening in a complex system follows the rule of the physician encapsulated in the Hippocratic Oath; " First do no harm". The following are possible harmful effects that need to be taken into consideration, suggesting any change in the tax regime should be implemented gradually at lower levels.

- Current low interest rates incentivise property investment, as real returns after tax and inflation make saving for retirement difficult. As even a nest egg of $500,000 returns little, it is rational for the individual to invest in housing, even if it is disastrous from the societal view point.

- Property developers are creating new wealth and should already be paying tax on profits. A new form of tax, if applied to property developers, could constraining building construction as it might become too risky.

- Retirement villages are based on the premise that homeowners can sell their home to buy assets in the retirement village at a reasonable price. But the profitability of retirement villages depends on the capital gains on the retirement units when ownership passes back to the village, at a price related to the initial purchase price. However, as retirement villages or homes are becoming a major part of our housing stock, the impact of a capital gains tax on these needs to be carefully considered.

- The rental charged by owners of good rental properties (rather than slums) are often low relative to costs, as investors expect the capital to gains to compensate for low rental returns. Rents will probably need to increase in the short term, once housing inflation stabilises.

4 Recommendation

- A rolling capital gains tax should be applied at a modest level to ensure that it is not removed by any subsequent government. Coupled with this is a final capital gains tax based on the increase in house value when sold. The debits and credits of the rolling tax can be treated as a provisional tax to be offset against the tax on gains at the time of sale.

- The levels can be adjusted to maintain low house inflation.

5 Appendix:Piketty's Graphs

The data used in figures 1, 2 and 3 and have been extracted from data used in the following graphs from Piketty. See figure 4 below the bibliography. However the data of concern starts from 1950 rather than the earlier dates in Figure 4. The point to notice is that Piketty's graphs do not separate productive from unproductive investment, and therefore the graphs fail to indicate that only housing is the source of rapidly increasing Capital to Income ratio β. The values of β or Capital to Income ratio are given on the y axes in the figures below.

References

[1] T. Piketty. *Capital in the Twenty-First Century.* Harvard University Press, ISBN 978-0674430006, Cambrdige, Massachusetts, 2014.

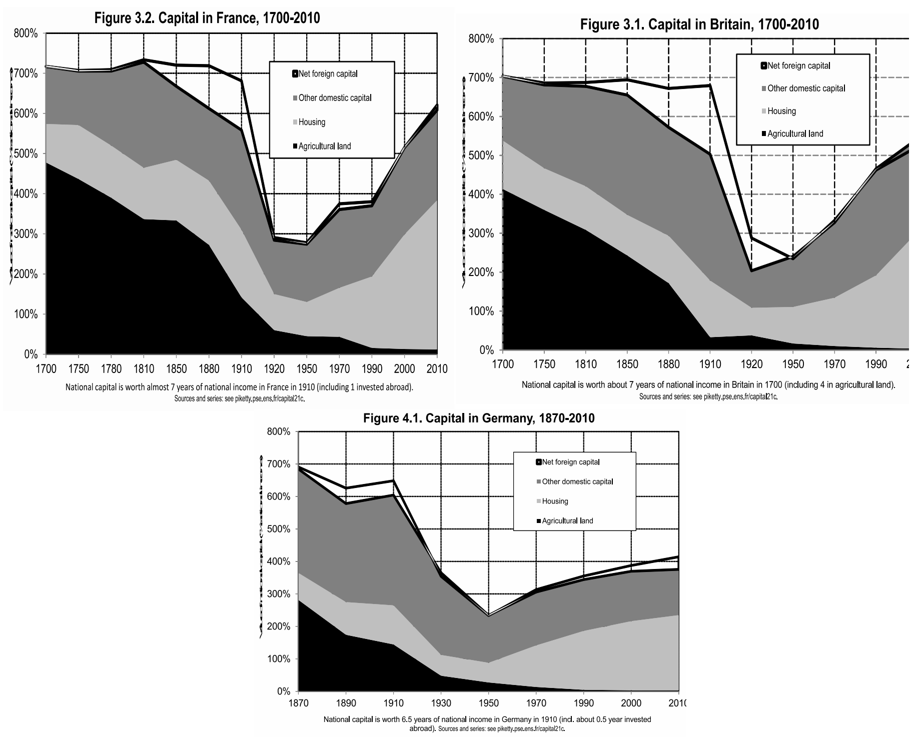

Figure 4: Capital France, 1770-2010, UK 1700-2010 and Germany 1870-2010 [1]