Tax Working Group Public Submissions Information Release

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SUBMISSION

My Submission

1. My submission is that the Tax Working Group recommend in favour of the introduction of a comprehensive capital gains tax (CGT).

2. That said, the purpose of my submission is more limited and is to argue for a CGT to be part of a comprehensive package to address:

   (a) housing affordability; and

   (b) rental housing affordability, quality and security of tenure.

3. I see other parts of the package being:

   (a) increasing housing supply;

   (b) loan to value ratios applying to property purchases;

   (c) ring -fencing property losses as has been proposed.

4. I see the package as being aimed primarily at investment in property for speculation. By speculation, I mean investment in assets that is funded by substantial borrowing where the purpose is to make a gain on disposal that is the result of inflation rather than any enhancement of the asset. Speculation does not add to the wealth of an economy; it simply enables the speculator to benefit at the expense of future buyers. There is no justifiable economic or moral argument for speculation. I draw a distinction between investment for speculation, which I see as being without merit, and investment for development and/or income, which I see as desirable and the lifeblood of a thriving economy.

CGT – Structure

5. In my view a CGT should:

   (a) apply to all gains from all property, including the family home ie. there should not be any exceptions;

   (b) apply at the same rates as apply to income;

   (c) apply irrespective of how long the property is held;

   (d) nevertheless only apply to realised gains but (reflecting (a) to (c) above) otherwise not be concessionary;

(e) only apply to gains accruing from a prospective implementation date.

CGT- Issues

6. Those opposed to a CGT on real property raise the following arguments:

Conceptual

(a) A CGT dis-incentivises investment;

(b) A CGT does not interact well with other taxes, which are designed to raise revenue, without dis-incentivising economic activity, and are not primarily designed to achieve wealth distribution or to impede transactional activity;

(c) Revenues from CGT are uncertain/volatile/minimal;

(d) A CGT is a tax grab, so if it is to be imposed it should be accompanied by reductions in other taxes;

(e) A CGT is also a wealth tax that should not be used to address inequality issues;

(f) If a CGT is levied on realised gains, people will stop selling assets to avoid paying GST, ie the lock-in effect;

(g) Capital gains are affected by inflation so should not be taxed;

(h) A CGT on companies poses double taxation issues;

(i) A CGT is administratively difficult to implement and operate;

(j) If a CGT is imposed people will take their capital offshore.

Property Based

(k) A CGT on real property is unnecessary because housing affordability is primarily a problem of supply, not demand;

(l) A CGT will not solve housing affordability;

(m) A CGT nevertheless adversely impacts the housing rental market by forcing landlords out of that market, thereby reducing the supply of rental accommodation;

(n) A CGT should not be used to try and modify behaviour in any case;

(o) If we are to have a CGT on property it should at least be concessionary, like Australia.

My Approach

7. I consider that conceptual issues should not be a barrier to GST. Tax should apply to all gains, whether they be income or gains from the disposal of capital. Otherwise, people are incentivised to invest in capital for the gains to be obtained from its disposal rather than the gains to be made from its development and/or use.

8. Any argument that a CGT is a disincentive to investment is out-dated. Historically the belief was that a CGT would discourage investment in favour of consumption. But this ignores the reality that investment is largely made by those who want to make money rather than spend it. Often the consumption needs of these people have already been satisfied. For these people, investment for profit (albeit where the profit from any gain on disposal would now be taxed) will normally still be a more attractive proposition than making money from wages and salary.

9. The only form of investment that is likely to be discouraged to any significant extent is speculation. As I have said, by speculation I mean investment in assets that is funded by substantial borrowing where the purpose is to make a gain on disposal that is the result of inflation rather than any enhancement of the asset. Speculation does not add to the wealth of an economy; it simply enables the speculator to benefit at the expense of future buyers. There is no justifiable economic or moral argument for speculation.

10. I consider that a CGT interacts with other taxes in a complementary way. It broadens the tax base by closing a loop-hole that allows capital gains to be favoured over gains in the form of income. It should not discourage investment for production so long as the CGT makes an allowance for asset enhancement. The only investment it should discourage is speculation where what would be an after tax return does not cover the cost of that speculation.

11. A CGT is also not a wealth tax; it is a tax on the gains that accrue to wealth. Also it is not a transaction tax; it taxes gains from transactions.

12. Therefore, I see a CGT as interacting positively with other taxes to broaden the tax base while closing a loop-hole.

13. I believe it does have to be accepted that revenues from a CGT are potentially volatile and difficult to predict. A CGT may not prove to be a substantial source of revenue. But I do not see revenue raising as its primary purpose. Its primary purpose should be to discourage speculation which serves no purpose other than to enable the speculator to benefit at the expense of others.

14. I think it is open for debate as to whether a CGT should be applied in a revenue neutral way, ie whether it is used simply to reduce other taxes. If revenue neutrality is the political price that needs to be paid to get acceptance for a CGT then that, in my mind, is worth considering.

15. Notions that a CGT is a wealth tax need to be firmly dispelled. But equally, because it is not a wealth tax, I believe it is misleading to portray a CGT as being primarily designed to reduce inequality. It only reduces inequality by discouraging speculation. It does not stop gains accruing to capital and generally speaking these will continue to exceed income gains.

16. I think it would be a mistake to tax capital gains other than on a realised basis. Capital is usually held for a period. Taxing gains to capital on an accruals basis can result in cash flow issues. For me, interim taxes levied on a risk free rate of return basis are not an answer. I do not favour land taxes.

17. I believe arguments based on lock-in, capital assets suffering from inflation and double taxation also tend to be exaggerated by those seeking tax purity. Should I be wrong then I would still leave them for the future. I think it is important that a CGT not be seen as being too complex.

18. Arguments that a CGT is difficult to implement and administer are exaggerated. Any tax system requires a lot of administration. That is not a justification for not having a CGT. It is not an argument that has prevailed in most countries.

19. A CGT is not revolutionary by world standards. It should therefore not result in any wholesale movement of assets offshore.

20. This leaves the property based arguments against a CGT. Before commenting on these, I set out below my arguments for advocating a CGT on realised gains from property.

A Societal Problem

21. I consider that a CGT is needed as part of a solution to house price inflation. Despite recent trends, I see this as a major unresolved problem that will continue to be a major contributor to housing unaffordability and problems of supply, cost, quality and security of tenure in the rental housing market.

22. There can be no doubt that house price inflation and the associated increase in debt was the major contributor to the GFC of 2007/2008. Since the GFC house prices have more than doubled in many western countries. It would be naïve to think that the current levelling in prices indicates that the problem has been solved.

23. Nevertheless, despite the evidence, a combination of ideology and vested interest tries to persuade us that all this is part of a cycle; that we have gone through these cycles before; and so we should expect to experience them again in the future.

24. The reality is otherwise. Notwithstanding the GFC, the rubber band continues to be stretched. Average house prices in Auckland are now about 10 times the average wage. This scenario is being sustained by interest rates that are ridiculously low by historical standards, an ability to off-set property losses against other income, and the absence of a capital gains tax. The result has been increasing house prices and a rate of home ownership that continues to fall.

25. Simple economics tells us that house price inflation is a problem of supply or demand or both. While the answer is clearly both, housing supply has been a continuous problem throughout the years, while rational and irrational demand has fluctuated, with corresponding fluctuations in house prices. Clearly the massive spikes in house prices are first and foremost a problem of demand; although there is clearly also a problem of supply.

Development versus Speculation

26. Some argue that CGTs are an unwarranted fetter on market activity. But what is the nature of the activity at issue here? Is it an entrepreneur spending money to produce something? In the context I am talking about the answer is no. While a comprehensive CGT would apply to all gains it should only discourage speculation, where the gain is all that supports the borrowing and subsequent loss making activity. In these situations the investor spends borrowed money, produces nothing, does little or nothing else, and waits for the price to go up. This simply allows people to

benefit at the expense of future buyers. This is not justifiable on normal business principles, let alone on moral grounds.

27. People should still be incentivised to make money out of developing properties and/or using them for income. If they buy and develop they should obviously get a deduction for the cost of development when determining the gain to be taxed. But the gain, and especially any inflationary component of that gain, should be taxed.

Importance of Real Property?

28. Why single out real property for special attention? Because it supports housing, one of the essentials of life. Its supply is limited in the short to medium term, and it has the potential for rapid price escalation. None of the other common consumption and investment asset classes has this unique set of characteristics.

29. Food is obviously essential to life, but supply is not a major issue in modern western democracies. Price can be an issue when the international price is allowed to dictate the local price. But the low level of the CPI over many years is a testament to the fact that the markets for housing and food work in quite different ways.

30. Stocks and bonds are also different. The capital they provide is obviously essential to business. But investment in stocks and bonds does not have the potential to deprive others of the essentials of life. Moreover, investment in these markets is not debt funded to anywhere near the same extent as the housing market. By and large, people accept any losses they suffer, and market fluctuations are not calamitous. The reasonably rapid recoveries from the 1987 stock market crash and the 2000 tech boom crash are testament to this point. These are markets that, by and large, can be left to themselves.

31. Housing is a different story. Not only do we need it, it is also in limited supply in the short to medium term. Cheap debt funding in the absence of a CGT tends to fuel demand.

32. We are now well past the point where the ever-present propensity for house price inflation can be ignored. House price inflation over the last 10 years has been a substantial contributor to rising housing unaffordability. Arguments in defence of the current position that this is a worldwide problem, that it is cyclical, and that it has happened before, are hollow excuses.

33. The reality is that all sides implicitly accept that there is a problem. The issue is that most choose to ignore it, or attempt to portray it as predominantly a problem of supply. The flaw with this argument is that

supply was an issue before and after bouts of house price inflation. That inflation is primarily the product of excessive demand. Any solution has to focus on demand, albeit that this should not be an excuse to ignore the problem of supply.

CGT is Only Part of the Solution

34. I am not suggesting that a meaningful CGT regime is guaranteed to solve the problem of house price inflation. Even a punitive tax might not work. In an era of low income growth, where we have become accustomed to making money from property, it is possible that people will continue to treat housing as the easier option, even if it becomes less attractive financially than wages and salary.

35. Therefore, I see a comprehensive CGT regime as only part of a package. Other demand-focussed measures are necessary. These include loan to value ratios on property and ring-fencing property losses as has been proposed.

36. Note that I would not ignore supply-focussed measures as part of a package. Undoubtedly there are problems with land banking, and supply not keeping up, and addressing these problems would undoubtedly help with the problem of house price inflation. But these problems have been a constant, and yet house price inflation has undergone repeated bouts of rational and irrational exuberance. Moreover the problem of a lack of supply takes a long time to remedy, and problems with shoddy construction show that imperfect solutions can create even bigger headaches. Despite what some lobby groups argue, there seems little doubt that house price inflation is first and foremost a demand issue and one that the market has been unable to resolve.

Effect on the Rental Market

37. Some say that a CGT will lead to a reduction in the supply of rental housing. This risk is real. But it needs to be looked at in the context of what is happening in the absence of a CGT.

38. Presently, the rental housing market is largely a by-product of investment in property for capital gain. It works up to a point, but not particularly well. It is affordable to those who are on the ladder to property ownership or, increasingly, those who are comfortably off and see it as a substitute for home ownership. But for many on low incomes, it has become an uncertain road to nowhere. Landlords looking for capital gain have little incentive to provide quality accommodation or security of tenure.

39. Despite the imperfections in the rental housing rental market it has become a tool to castigate those who advocate for a CGT. But the reality is that is a second problem that also needs fixing. Trying to justify not taxing capital gains on property by suggesting that this might adversely affect the housing market is not a solution, it simply ignores two problems.

40. Both problems need fixing. The reality is that house price inflation has made both home ownership and being a landlord unaffordable for most without substantial subsidy. Home ownership is subsidised by depositors being paid at low interest rates and the absence of a capital gains tax. Rental returns that represent a modest return on inflated capital costs are subsidised by capital gains on realisation. The result is house prices that are unaffordable, and poor quality rental housing that offers no security of tenure.

41. As the home ownership policies start to bite, there are risks to the housing rental market. Without the subsidy of the absence of a capital gains tax (and not being able to offset property losses against other income), many landlords may leave the market or seek to increase rents. But this is no reason for not pursuing the home ownership policies. However, any risks to the housing rental market also need to be addressed.

42. The cross subsidy that capital gains from home ownership provides to landlords points to a wider problem in the housing rental market. That market suffers from being a by-product of the pursuit of capital gains from home ownership. The rental housing stock will need to be held by moderately geared institutional investors prepared to accept modest returns. While the home ownership policies are designed to arrest the increasing unaffordability of housing, the rental market stands to remain a substantial portion of total housing. Irrespective of what happens with home ownership, the rental housing market needs to be a viable standalone market that works for landlords and tenants.

43. House price inflation in recent years means that the rate of home ownership continues to fall. As Germany, Switzerland and other European countries show, this need not be a bad thing. But the transition out of home ownership needs to be managed.

44. A CGT and the other home ownership policies are likely to mean the transition will include some current landlords. Highly geared landlords who have entered the market in the last few years are the most likely to join the transition. The issue becomes who will be prepared to enter a tougher market in their place.

45. While there might be some role for the State here, the German experience indicates that the market should continue to have a major private sector component. The essence of a solution here is for any vacuum left by

departing landlords to be filled by reasonably geared housing rental property specialists funded by investors prepared to accept modest but stable returns.

46. As with any situation where over-geared vendors need to sell, part of the answer is likely to be a softening in prices received by vendors. It might also involve rental increases (which are likely to happen anyway when house price inflation takes off again). State subsidies to tenants might also be needed, but better a subsidy that doesn't directly fuel property prices.

47. The housing rental market needs to become more stable, and less risky. The focus needs to be on making the market more attractive to conservative investors prepared to accept modest returns, rather than trying to convince speculators to remain in the market.

48. The transition will not be easy, but the experience of Germany, Switzerland and other countries shows that it is possible.

The Principal Purpose of CGT need not be to Raise Revenue

49. In my view the principal purpose of a CGT should not be to raise revenue. Given the volatility of the activity on which it is levied, trying to predict the revenues from a CGT would be difficult. Moreover, if a CGT is to work it should discourage that activity and make revenue from a CGT even more uncertain.

50. Therefore, the purpose of a CGT on property needs to be clearly spelt out. Its purpose should be to dis-incentivise speculation. Such activity does not add to wealth; it simply transfers it to speculators at the expense of those who cannot afford or otherwise choose not to speculate. Increasingly, that transfer is becoming generational. There is simply no economic, let alone moral, reason for allowing the more senior members of this generation to continue to gain at the expense of our youth and future generations.

51. It would help to reinforce the real purpose of a CGT if its proponents were to accept that its primary purpose is not to increase the tax take; and that any revenue from a CGT might be redistributed to reduce tax in other areas.

Why CGTs have Failed in the Past.

52. Opponents of a CGT say they don't work. Australia is often cited as an example. This overlooks the fact that Australia's CGT regime is

concessionary. Any regime that allows for the possibility of 50% of gains on sales made after one year to go untaxed is effectively designed to fail.

Grandfathering – Striking the Right Balance

53. If a CGT regime is to bite, it must not be concessionary, and it must have limited grandfathering provisions. That said, it needs to be fair, so it should not be retrospective. It must also not impose substantial deflation on an over indebted population. Therefore it is important to strike the right balance. Don't do enough and a CGT will fail. Do too much, and you create a potentially bigger debt deflation problem.

A CGT Needs to be Sold to the Public

54. A CGT is a tough concept to sell to the public. It tends to turn off voters of all stripes. For some, a CGT puts the brakes on their ability to make money. For others it is a challenge to their security in retirement. These concerns have been exacerbated as real incomes for most have fallen over the past 30 years or so.

55. It is important to continue to emphasise that speculation does not benefit an economy. It is simply a means of transferring wealth to speculators. That transfer benefits current generations at the expense of future generations.

56. As a CGT would be introduced on a prospective basis, current benefits would be preserved. The superannuation is safe, albeit that it might not grow as fast in the future. That has to be an acceptable compromise to the current generation of property owners. Given what has been allowed to happen, it is arguably too generous. But for a populace saddled with debt there is arguably no alternative. We have to be aiming to come to a soft landing and avoid too much deflation. But doing nothing is not an option.

Allan McRae