Tax Working Group Public Submissions Information Release

Release Document

September 2018

taxworkingroup.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 TAX WORKING GROUP

Tax Working Group Secretariat

[1]

submissions@taxworkinggroup.govt.nz.

30 April 2018

[1]

In summary, my submission is that:

- Social "fairness" should be seen in the context of equal opportunity and reward for personal effort, rather than income equality as is presumed by the TWG.
- The negative consequences of a wealth tax (capital gains tax or land tax) that excludes the family home would be significant.
- Politicising the tax system to enhance social objectives, like racial privilege or environmental activism, will undoubtedly erode public confidence in the taxation system, and especially from the top 20% of taxpayers who already pay the majority of the income tax.
- Applying further exemptions to the GST regime will increase compliance costs, and opportunities for fraud. The argument for exempting GST on building products is as compelling as it is for exempting GST on food.
- A progressive company tax system would add further compliance costs to the dividend imputation regime, and add little if any practical benefit.

General comments

Money flows into the area of least tax.

Typically tax reviews have been guided by tax efficiency principles. The mandate of the Tax Working Group (TWG) differs in that the Terms of Reference require recommendations predetermined by political objectives. In my view that seriously compromises the integrity of the recommendations and predetermines the outcomes that are likely to arise from the review.

Those Terms of Reference are to report:

- *whether a system of taxing capital gains or land (not applying to the family home or the land under it), or other housing tax measures, would improve the tax system;*
- *whether a progressive company tax (with a lower rate for small companies) would improve the tax system and the business environment;*
- *what role the taxation system can play in delivering positive environmental and ecological outcomes;*
- *whether to remove GST from any particular goods*

It is also significant that a purpose is to broaden the tax base, as is evident in the comment that, *"The Government's fiscal objective for the tax system is to support a sustainable revenue base to fund government operating expenditure around its historical level of 30 percent of gross domestic* *product (GDP). If the Government is to continue providing healthcare and superannuation at current levels, then the level of taxation will need to increase."*

The need to increase revenue is highlighted in the Group's report (page 10) when they forecast the government's primary expenses to rise from 28.4% of Gross Domestic Product (GDP) currently, to 31.1% by 2030 and 33.8% by 2045.

The key themes promoted throughout the Background Paper are:

- Wealth redistribution,
- Advantaging those engaged in what they call the "Maori economy",
- Achieving positive environmental outcomes, and
- Making homes more affordable by using the tax system to make investment in rental property less attractive.

That signals a shift from the approach to date, and conventional thinking in prosperous countries, that tax policy is primarily about gathering revenue in a fair and equitable manner without killing the Golden Goose (who, in New Zealand, are the 10% of households with the highest incomes who pay 35% of all income tax, while the bottom 50% of income earners contribute only 19%).

That's why most countries are lowering tax rates. Those rational thinking countries take the view that social objectives are achieved via government *spending*. Muddling those approaches will bring about a seismic shift in the way our central Government collects its revenue, and will, in my view, create multiple negative consequences that will manifest themselves in the long-term.

Essentially the problem with increasing tax revenue is that the increased taxes will be paid by those who already bear the largest tax burden. There will come a point when that group baulks at being milked like a cash cow, and will return to the days when avoidance was a significant influence on business planning.

Income equality and tax

The Report states *"Income inequality is often used as a measure of fairness across society", and makes reference to the …… measure of equality internationally.*

Fairness is a matter for debate, it is not for the Working Group to take as a given. It seems the Group has already formed the view that *fairness* is a society where the tax system creates income equality. This I content displays a prejudicial position by presuming income equality should be used as a measure of fairness *across society.* The logical conclusion is the tax objective of equalising net income after transfer payments, regardless of skill or work ethic. To presume a fair society is one where everyone earns the same regardless of effort or skill should be abhorrent to anyone who believes people should be rewarded according to the results of their personal effort. What would be fair about an indolent spendthrift being rewarded, while those who are diligent and thrifty are penalised via the tax system, be it via income or wealth taxes?

Housing

The Paper notes the top 20% of households have an average net worth of $1.35m (including the home). The bottom 20% has a net worth of $8,000. When the home is excluded, those figures fall to

$601,800 and minus $100 respectively. Clearly, home ownership is a significant factor in wealth accumulation.

That highlights the significant wealth disparity between those who own their own home and those that don't. Home ownership is the key to wealth accumulation and the sooner someone buys a home, the better. It's a truism that should be pretty obvious to those who seek an answer to the question, why do some people accumulate wealth while others remain poor?

Another truism is, the more you *save* the more you *will* accumulate. Politicians would make better use of their time if they turned their attention to those truisms instead of focussing on new ways to squeeze more tax out of those who are already paying it. If they embedded these simple rules into their policy development process, they may come up with wealth creating policies like these:

- Transitioning those who are out of work into work.
- Requiring everyone to save part of every dollar they earn. The reality is that those who most need to save don't.
- Incentivising people to own their own home as quickly as possible.

In February there was media commentary about a state house in Remuera worth $3m. The 81 year-old tenant had lived in the property for 37 years. Turn the clock back to 1981. Had the then 44 year old tenant been required to save into a KiwiSaver account, and through that scheme, had purchased the house from the state, he would today be a multi-millionaire, and financially independent. Not only that, he may well have had a tidy sum to pass onto the next generation so they too can get a step up onto the wealth ladder. That lost opportunity is the true cost of government policies that perpetuate welfare.

What is unfortunate about the *Future of Tax* is the underlying presumption that using the tax system as a lever for social policy is going to solve the major social issues of our time. It won't. It will simply mean the man in the $3m state house will have a few dollars extra a week to make his dependency a little more comfortable.

I endorse measures that encourage home ownership, at an early age. However, this will not be achieved by creating further disincentives to invest in residential property on the expectation that private sector landlords will divest with the effect that houses will become more affordable to first home buyers. The housing shortage has been caused by supply constraints (regulatory controls, lack of skilled workers, restricted finance arising from the additional lending risks attached to the regulatory uncertainties of development), and demand pressures (record high immigration). Addressing those issues directly would be a more efficient way of addressing the housing issue than indirectly via the tax system.

Taxing residential investment property

With respect to the way property is currently taxed, the Report lists no fewer than five ways gains from the sale of residential investment property is taxed. Having detailed the multitude of unique ways that gains from the sale of property are treated as income for tax purposes (in contrast to the tax treatment of shares, farmland, and the sale of a business, which are not taxed), the report concludes, *"real property held for more than [five] years is undertaxed relative to other investments when there are capital gains."*

This conclusion is based on a table of marginal effective tax rates on savings (page 40). This table compares the effective tax rate on a range of investments based on the top marginal tax rate and the rate of inflation. However, when considering rental property they assume gains on the sale of a property are not taxed.

It is notable that the Group's marginal tax rate comparison shows that the least taxed investment - the most advantageous from a tax perspective - is owning one's own home.

There is an inescapable truism in tax policy that no rational person, and few politicians, would dispute: *Money flows into the area of least tax*.

Because the terms of reference have categorically excluded the Group from considering a capital gains tax on the family home, a capital gains tax that does not include the family home will result in the "mansion effect". The *least tax* strategy will be to invest in one's own home, with the intention of down-sizing at some stage in the future to provide a tidy *tax-free* nest egg.

The inevitably consequence is that houses will be become larger and have more features. For many it will be the perfect investment - indulging oneself in luxury and escaping the tax net!

That consequence will be an increase in "unproductive" investment into residential property.

It is my submission that a capital gains tax that is not universal and excludes the family home will have significant negative consequences and increase investment in residential housing.

Land tax

Another wealth tax mentioned by the Tax Working Group is land tax (where owner-occupied land, or presumably a curtilage portion of it, would be exempt). More than likely, this tax would be in the form of an additional "rate" paid to central government via local authorities as a collection agent.

With respect to Maori land in the context of a land tax, in my view there should be no racial discrimination in the tax system - every taxpayer should be taxed according to their means not their ancestry.

I refer the TWG to the publication, "Background paper for Session 3 of the Victoria University of Wellington Tax Working Group", prepared by the Policy Advice Division of the Inland Revenue Department and dated September 2009. [1]

> *Impact on land values*
>
> *A land tax would be expected to cause an immediate fall in the value of land by the net present value of the future land tax liabilities (and so constitutes a lump-sum tax on those who own land at the date of its introduction). An example provided in Coleman and Grimes suggests that the introduction of a 1% land tax should result in a 16.7% fall in land values. But greater falls are likely if there is some ongoing real increase in land rents.*
>
> *The expected fall in land values is very sensitive to the rate of tax introduced and to assumptions made in modelling. In particular, it will tend to be larger the greater is the expected real rate of growth in land rents. The calculation by Coleman and Grimes assumes no real growth in land rents.*

[1] https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/publications/3-land-tax-ird_treasury.pdf

> *A deductible land tax of 1% in conjunction with a 1% annual growth in rents, a 30% marginal tax rate for investors but other assumptions as in the Coleman and Grimes example has been modelled by Inland Revenue, and produces a 26.4% drop in land values.*
>
> *Such falls in land values would have significant effect on existing land owners and others, such as investors and lenders. It might mean that people who currently have heavily geared land end up with negative net equity. This could in turn impact on the balance sheets of mortgage lenders, particularly banks.*
>
> *Fairness*
>
> *A land tax could be criticised as being unfair. It taxes one component of wealth. The impact on land values would be borne only by those who are unfortunate enough to hold wealth in one particular form. Retirees, farmers and Maori authorities would be particularly affected. Tax bases that use broader measures of wealth, income or consumption better meet social conceptions of horizontal equity.*
>
> *Cashflow issues*
>
> *In its simplest form, land tax would be payable on an annual basis. However, land tax does not relate to a flow of income (e.g. income tax) or a transaction (GST).*
>
> *Consequently, payment of land tax may give rise to cashflow issues for some landowners, particularly those who have significant land holdings but lower income levels, such as retired people.*

A land tax is not without merit, if applied universally which has been ruled out in the review's terms of reference.

GST

On the matter of GST, the Group says, *"removing GST from some goods and services is often discussed…as a way to ensure people can afford more of these goods and services".*

No doubt, the calls for GST to be removed on food and other essential products will be renewed. If new exemptions are to be considered then an equally meritorious case could be put for GST exemptions to apply to with respect to 'warmer' and more 'affordable' housing by exempting GST on home insulation, heat pumps, and building materials.

A GST exemption on building materials is consistent with the objective of more affordable housing. According to buildingguide.co.nz it costs about $3,000 per square metre to build a 150 m2 single story home on a flat section with a "medium" quality of fit out. That's $450,000, before GST. The government's tax take would add another $67,500, which takes the cost to $3,450 m2. Clearly GST is a significant detrimental factor in housing affordability.

The only way the Minister will be able to make housing more affordable is to remove the biggest single cost which is GST on new housing. The GST on building materials is a significant source of revenue for central government, making exemption unlikely.

Further exemptions to the GST system would complicate compliance and open the door for tax abuse.

Environmental challenges

On environmental challenges, the TWG says, *"Using the tax system to ensure that consumers and producers face the costs of emissions and other environmental harm could be one way we can meet our international obligations and encourage innovative ways to reduce pollution."*

Here they seem to be referring to farmers with greenhouse gas "emitting" livestock. The decision to include agriculture in the Emissions Trading Scheme appears to have already been made by central government.

The TWG goes on to say, *"Environmental challenges extend well beyond climate…New Zealanders' wellbeing is closely linked to the ecosystem services that natural capital provides. Indigenous biodiversity has rapidly declined and continues to be threatened, especially on private land. New Zealand now has one of the highest proportion of native species at risk, and in a review of 71 rare ecosystems in New Zealand 45 species were found to be threatened with extinction. It is possible for pricing and tax instruments to play a role in addressing these challenges"*

So it seems, the intention is to use the tax system to meet our climate change obligations and save our biodiversity.

It is my submission that positive behaviour is best achieved through incentives, as this is in the nature of encouragement rather than punitive penalties through taxation system, which erodes social wealth when a product or service is demand inelastic. It is my observation that New Zealanders are favourably inclined towards positive environmental behaviours and respond better to a carrot than they do a stick.

Tax and the Maori economy

On the taxation of Maori owned businesses, the Group asks for Maori to comment on:

- *Whether the Maori authority tax regime supports or hinders Maori economic and social development.*
- *Whether there are parts of the current tax system that warrant review from the point of view of te ao Maori*
- *How tikanga Maori might be able to help create a more future-focused tax system.*

Clearly, the Group will consider whether tax breaks should be given to Maori, in addition to those that already exist. I oppose discrimination on the grounds of ancestry, and particularly as it applies to taxation. Not only is discrimination seen by most people as unfair, it also has the potential to undermine the tax system.

Fairness is an important factor in establishing public confidence in the taxation system, and in ensuring compliance. The incidence of avoidance and evasion is likely to be less if a system is seen to be fair. Politicising the tax system to enhance social objectives, like racial privilege or environmental activism, will undoubtedly create dissent and extra work for tax lawyers and accountants.

Company tax

Comment is sought on "progressive company tax", in other words, stepped tax rates based on turnover. In particular on how the scheme "*might interact with our imputation system (and any proposed CGT on the sale of shares) and what consequential changes would be needed to counteract tax sheltering arrangements".*

The imputation system is already beyond the comprehension of most business people. Adding a further complexity in the form of multiple tax rates will inevitably add to compliance costs. I question the benefit of a progressive company tax regime, when in practice the proprietors of small companies already minimise their income tax liability by "distributing" company profits as shareholder salaries.

- END -