Tax Working Group Public Submissions Information Release

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A Tax on Unearned Income (Capital Gains)

In 1988 I made a submission to the Royal Commission on Social Policy in relation to the untaxed income derived from capital. The Commission was chaired by eminent lawyer and President of the Court of Appeal, Judge Sir Ivor Richardson who has also made an enormous contribution to the tax laws of New Zealand.

I first became aware of the economic distortions which result from the absence of a general tax on income from increases in the capital value of land, while involved in a Northland Resource Study for then Minister of National Development Bill Birch, during my days as a self employed Business Consultant in the early 1980's. I was the economic consultant in a group of three which included a PH.D in geography and a senior Government official.

We modelled the economic and productivity gains which would result from building an irrigation scheme in a dairy farming area of Northland. Clearly such a scheme would allow the dairy farmers involved to increase grass growth and herd size by eliminating or reducing the risk of drought. This would increase the productivity of the farms involved, boost profitability, reduce debt and create new jobs; all positive outcomes.

However our modelling also showed that it would immediately increase significantly the value of the land, creating a significant tax free income for the owners. For that reason, as soon as the irrigation scheme was announced, many of the struggling dairy farmers involved would sell their farms to what, in those days, were called "Queen Street Farmers" i.e. millionaires, looking to make tax free capital gains!

This is hardly what the Minister of National Development had in mind! Had the Government funded an irrigation scheme from taxpayers money they would have immediately created tax free capital income for both the farmer's involved and a group of already rich Queen Street Farmers.

That coupled with the resultant economic inefficiency, put paid to an irrigation scheme. The focus for those involved would have shifted from increasing the productivity of the land – the goal of the study – to the value of the land itself. I saw immediately that the absence of a capital income tax in New Zealand was both unfair from a social policy point of view and economically inefficient. Australia, the UK, Canada, India the USA and many other counties all have capital income taxes, so why is New Zealand any different? Is the lack of such a tax one of the reasons that our per capita productivity lags behind these countries?

When the Royal Commission came along I therefore decided to make a submission, since the absence of a capital income tax on land is also a question of basic fairness. Income from capital such as interest and company dividends is taxed just like any other income so why should income gains from the capital itself not be taxed? It is an important question with a very simple answer "there is no reason and it should be".

Obviously if income from those sources is not taxed but income from all other sources is, then simple logic will ensure that people will put the ownership of land and businesses ahead of other assets shares and that is exactly what has happened in New Zealand for many years. In essence the absence of such a tax skews our economy from productivity to capital gains. The result is that although we probably have more land per capita than most nations on earth the price of land in New Zealand (be it for housing, farming or industry) is very expensive.

Economically this is huge negative. When land prices are forced up because the income gain is untaxed, then buyers are forced to borrow heavily or be shut out of the market completely. It is also a magnet for overseas buyers many of whom cannot believe that the income they derive from their land will not be taxed, when it most certainly is in their homeland!

It is interesting to note that in its social teaching the Catholic Church places earnings from work ahead of earnings from capital gains, because it is through work that the great majority of us support ourselves and our families. A moral issue is therefore also involved.

My presentation to the Royal Commission was followed with fierce interest by Sir Ivor Richardson, who asked a number of important questions and then thanked me for my submission. I gained the impression that he was agreeably surprised to receive a submission on a land income tax.

I began by setting out the definition of "income" as if is defined by economists; namely "the increase in a person's wealth between two points in time" or "the amount of monetary or other returns, either earned or unearned, accruing over a given period of time"(Collins Dictionary). I will use the Collins definition in this submission since is more readily understood by the man and woman in the street, who are sometimes bewildered at terms like "capital gains" let alone "rent seeking".

No distinction should be made between earnings from labour and an increase in wealth by other means. Against that background the taxation of earned income in New Zealand (e.g. the nurse's who work in intensive care) coupled with the total exemption of unearned income which flows from the ownership of capital assets (e. g. land and business owners), is a grave economic and social distortion.

These realities encourage and indeed provide a State subsidy to people to invest heavily in projects which exhibit capital growth such as investment in industrial properties, farms and rental housing. They boost the price of such assets compared with other asset classes such as investments in the financial markets or starting a new business (the source of growth in jobs and the economy), because any increase in their value (a near certainty because God is not making any more land!), is tax free. If much of the available capital is monopolised for new office blocks, endless takeover activity, rental housing and the purchase of land, then it is not available for investment in small businesses, manufacturing and high tech start ups. Yet it is the investment in new plant and machinery and new technology which, drives economic growth, productivity and employment.

In earlier years an argument used against a capital gains tax was that it did not allow for the effects of inflation. That is a valid argument but it is offset by the fact that most capital gains are "locked in" (sometimes for decades) until realised in cash i.e. when the property is sold, whereas the tax on income from labour is mainly PAYE.

A problem does arise however in endeavouring to collect capital income taxes yearly, since unless the assets are sold within a year of purchase, no funds have been realised with which to pay the tax. For that reason the tax on income from capital should not be levied until the assets are realised by sale or gift (gifts are in the category of unearned income so they need to be taxed), transferred to a different entity, or death. (I note that heritage tax is outside of the Working Groups terms of reference, but I am not talking about that. Rather I am referring to the final tax return of a diseased person. This must happen since otherwise unearned income, sometimes in the millions, can be passed from one generation to the next without ever being taxed. I believe that is fundamentally unjust).

However this in turn creates a problem since the owner of the assets then has an incentive not to sell or otherwise dispose of them for as long as possible. It is called “lock in”.

Logically therefore the unearned income from capital that is not already taxed, should be:

1. adjusted for the effects of inflation (which decreases the amount to be taxed) and,
2. subject to compound interest as say the Official Cash Rate (OCR) as it accumulates year by year, until it is realised.

Since inflation and the OCR move in sequence (because OCR movements by the Reserve Bank are adjusted up or down by reference to inflation), then these two elements effectively cancel each other out.

Therefore, to avoid the complications which would arise, the pragmatic thing to do is simply to tax unearned income in the year it is realised and becomes payable.

Logically unearned income from all sources must be taxed even if it belongs to trusts including family trusts (I appreciate that your terms of reference exclude unearned income from the family home; for pragmatic reasons).

So what income from assets should be taxed? The simply answer is everything else!

That includes, land (depreciation could then be reintroduced for rental properties), buildings, shares, farms, art works, precious metals, antique cars, aeroplanes and anything else which gives rise to capital gains, although for ease of administration art and jewellery costing less than $3,000 or so could be exempt.

There should be **no** exceptions and the rate of tax should the same as that on earned income.

In due course the Royal Commission reported back to Government on this issue. They favoured a realisations basis for the tax and accepted that this would mean “some erosion of the tax goals of equity, efficiency and neutrality until the actual realisation where the tax is deferred until actual realisation*. They nevertheless found that “viewed in terms of fairness (and economic efficiency) the argument for taxing capital gains is overwhelming”

Strong words indeed from Sir Ivor Richardson.

The positive scope for such a policy is obvious when the demographics are considered. A comprehensive capital income tax would impact on only that fraction of New Zealanders who own significant and valuable assets; a group which is a minority of the voting public. I believe the vast majority of New Zealander’s would support this tax because they would benefit from it. They could buy houses and farms more cheaply and more capital would be made available to job creating businesses through the capital markets as people moved capital from land to shares and bonds.

Above all it would be fair and just and would be totally consistent with our egalitarian heritage and inbred sense of fair play/social justice. One of reasons our ancestors left the old world (particularly the UK) was to escape the hated class system. But, because unearned income is not taxed, the wealth inequalities in New Zealand mean that we now **have** a class system i.e. the difference between the rich and the poor!

The children of the rich will live in mansions and go to the best schools and inherit huge amounts of money from their parents. Those from poorer families will live in rented accommodation and go to the local schools while their parents will leave them nothing!

This is what Sir Ivor Richardson was saying in supporting a tax on unearned income on the grounds of “equity” and “fairness”.

Over time a tax on unearned income will reduce the wealth gap between rich and poor whilst, through the resultant increase in economic efficiency creating much needed new wealth for the Nation.

Gordon Copeland B.Com

Submission to the Government’s Tax Working Party

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