Tax Working Group Public Submissions Information Release

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Submission

to the 2018 Tax Working Group

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[1]

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Summary

The TWG is tasked with recommending improvements in the structure, fairness and balance of our tax system and preparing it for a changing future.

In doing so it will want to follow the rules of good tax design – keep tax simple, broad-based and low rate.

Previous tax reviews have commonly pointed to the notable gap in New Zealand's tax system – the absence of tax on wealth.

Filling that gap with a well-designed, simple, broad-based, low rate tax would meet the TWG's mandate.

The best way to do that would be to introduce a tax on all wealth at a low rate – say 0.5%. This would:

- greatly improve vertical and horizontal fairness;
- improve balance across the sectors of income generation and investment, and
- substantially broaden the tax base protecting it against challenges from changing demography and labour markets.

I would be happy to discuss this submission.

Discussion

Historically New Zealand's central government has taxed income, not capital. Where we have drifted towards taxing capital, we have done it by redefining income e.g.: determining that if an entity is in the business of trading capital items, the profits derived from that activity will be defined as 'income' and liable for tax. Accordingly a lot of the work of accountants and tax lawyers has gone into detailing distinctions between the two and finding ways to shift income into non-taxable capital gain and maximise deductions from the remaining income. While the cost of this professional activity is counted as an addition to GDP, no benefit accrues to the well-being of New Zealanders.

The recent housing bubble has attracted more attention to the gap in our tax system, but the business of structuring enterprises for 'tax efficiency' has been gathering steam for decades. It was in the 1980s that one of NZ's richest men (Bob Jones) commented that for the rich, paying tax was optional – because they always had the option of structuring their affairs to grow their capital and live off it rather than generating current income and paying tax on it.

This distortion has many serious effects.

The most important is that it undermines the perception of ‘fairness’ in New Zealand society. Those that consider themselves less than wealthy will look for their own ways to compensate for the unfairness. Trust in society is eroded, with consequences for efficiency.

Unfairness is becoming more obvious. Wealth inequality in New Zealand has increased dramatically even while income inequality has recently remained fairly steady - not surprising when income is taxed and capital gains are tax-free.

Houses have been the major focus for Kiwi investment – because they are the easiest way for most Kiwis to access tax-free capital gains and the obvious path to an asset base for retirement.

But housing affordability has fallen: fewer young Kiwis can imagine owning their own home, and more therefore depend on the rental market. Because New Zealand has had very high rates of home ownership the rental market has never developed the level of sophistication and fairness that is found in other OECD countries. Reliance on a landlord-biased rental market can be a big factor in deepening the difficulties of young, low-income, solo-parent or blended families. Small, cold, mouldy housing contributes to child sickness, low school attendance and poor school achievement: that has life-long effects for the child, their enjoyment of life – and their ability to contribute to society. Rental insecurity and frequent shifts from one house – and school – to another, exacerbate this.

Rates of home ownership are falling. Historically New Zealand’s high rates of home ownership have been a solid bulwark against poverty among the elderly. As that changes, more and more of the elderly will be trying to pay rent out of current levels of superannuation – just as demography puts more pressure on the sustainability of those levels.

Unless these trends change, New Zealand will have to deal with poverty at both ends of the age range. Combine that with perceptions of unfairness and the cohesion of society comes under more pressure.

The tax system has contributed to the development of these problems and it needs to contribute to their resolution – both in fact and in perception.

We need a tax system that is less easily avoided – so that people see that paying tax is fair. And our future needs one that is more balanced across the sectors of the economy – so that investment decisions are not distorted by tax avoidance. To support those aims we need a tax system that sticks to the basic principles of good tax design: simple, broad and low rate.

Judged against those criteria:

- the ‘bright line test’ would not have significant effects on either tax avoidance or housing affordability;
- a stamp duty is a simple, broad, efficient tax but would not make a substantial difference to fairness or balance; and
- a financial transactions tax could be a simple, broad-based tax but would be ineffective if New Zealand alone introduced it.

That leaves four taxes that could make a significant difference to our tax system:

- a Capital Gains Tax (CGT) that taxes realised gains in capital value
- a Risk Free Rate of Return (RFRR) tax that taxes imputed income from capital;
- a land tax that taxes the value of one class of assets; and
- a wealth tax that taxes the value of all classes of assets.

CGT and RFRR fit within the New Zealand tradition of broadening the tax base by redefining the distinction between wealth and income. But the inherent calculations and complications (as indicated in Appendix 2 of the TWG Background Paper) take them some distance from the ideal of simplicity: time and money will be spent testing the limits of the new definitions – adding little to GDP or well-being.

A Land Tax could meet the criteria better – if it were designed as a low rate tax on 'unimproved' value of all land. Any exemptions or variations in rate would allow room for similar waste in attempts to minimise tax liability. But it does not meet the test of balance – it taxes only one form of capital and therefore distorts investment between sectors that rely on land and those that use other forms of capital.

A wealth tax could meet all the criteria. A low level (say: 0.5%) on the value of all capital assets at each year's tax date would substantially broaden the base of the New Zealand tax system.

This would provide opportunities to act on many challenges. Base broadening would improve fairness by reducing the avenues for tax avoidance. It would also reduce reliance on taxing labour income at a time when patterns of employment and remuneration are changing. Housing investments would be brought into the system in a simple and comprehensive way.

The TWG Background Paper presents no arguments against a wealth tax beyond saying that only a few countries have one. A footnote provides a reference to a useful recent OECD study on 'The Role and Design of Net Wealth Taxes in the OECD'. This notes that fewer countries (four in the OECD) now have wealth taxes but that interest has been increasing because of the rise in wealth inequality. It points to some weaknesses but notes, crucially, that the value of a wealth tax to any particular country cannot be assessed in isolation. It concludes that there are 'stronger arguments for having a wealth tax in the absence of broad-based personal capital income taxes and taxes on wealth transfers.' This is precisely the situation in New Zealand.

There are strong arguments for giving serious consideration to a simple, broad, low rate wealth tax in New Zealand.

<u>Exclusion of the Family Home</u>

The terms of reference preclude the TWG from including any form of taxation of the family home in its recommendations. But that will not prevent discussion of the issue. Government decisions on its response to the report will be heavily influenced by a public debate that will continue until election time in 2020. The issue of the family home is an important one; it is not straightforward and there is room for a well-informed debate. The TWG should provide a sound base for that discussion.

Excluding the family home will produce distortions to fairness and sensible investment decisions. It will open the way for legal and accounting arguments around definitions, times and boundaries – all of which are wasteful and unfair to those whose incomes preclude their participation in the benefits.

And there is a simpler solution to the issue – include all property but with an exemption for the first $x.000 at a level related to the average house value. Then both the vertical and horizontal fairness criteria are met. Balance across the sectors of investment is preserved. And the rules of good tax design are observed: the tax is broad, simple and low rate.

The example of GST needs to be followed. NZ raises more than most OECD countries from its GST at a lower rate because it observes those rules.

Its terms of reference may preclude the TWG from recommending taxes on the family home: they do not prevent it from raising issues and informing the public debate.

Final Word

New Zealand needs a better tax system for a changing future. Many tax reviews have pointed the way but failed to follow through. Let this be the Review that at last produces a base for creating a tax system that is fair and efficient – with a simple, broad-based, low rate tax on wealth.