Tax Working Group Public Submissions Information Release

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Submission to the Tax Working Group

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29 April 2018

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Personal Introduction

Kia ora koutou, my name is Roland Sapsford. I have a longstanding personal and professional interest in tax issues. In the early-mid 1990s, while working at the Ministry for the Environment, I commissioned some of New Zealand's first modelling of carbon and energy taxes. During the 2001 Tax Review I oversaw preparation of the Green Party's submission to that review. More recent work, for a range of people, has included:

- Providing advice on carbon pricing, and the general concept of ecological tax reform
- Assessing proposals for land taxation and its relationship to ecological tax reform.
- Evaluating the practical options for wealth taxation in New Zealand.
- Reviewing evidence on the incidence of value-added taxes in New Zealand and internationally.

My academic qualifications include a first class honours degree in economic theory, econometrics and financial history. I was awarded the Bernard Murphy prize in economics at the end of my honours year, as well as being offered a PhD scholarship by the New Zealand Treasury, which I declined.

On a more personal note, when I was born in the mid-1960s, my parents were in their mid-40s. Both were themselves born in at the start of the 1920s. Both grew up before and during the Great Depression. Neither family was well-off. My mother was the first person in her family to finish primary school. Her father was the son of German immigrants and a carpenter, apprenticed at age 10. Her mother was war bride, transplanted to a foreign country, who had never attended school. My father's father had been in prison and so was not eligible for welfare relief under the Forbes-Coates' government. My father was several inches shorter than he ought to have been due to malnutrition during his teens. He was also passionate about the need to treat all life well and live within the limits of our planet.

Economics and economic debate is too often lost in theoretical abstraction and ignores the human reality of proposals. I have seen first-hand both the lifelong effects of grinding child poverty and the power of public action to create a better future. My emphasis in this submission to encourage consideration of ideas which raise revenue to support public action while also encouraging and enabling a healthier society within a healthier world.

This is a personal submission.

If there is an opportunity to present submissions in person, I would welcome the chance to do so.

My contact details are: [1]

I am happy for this submission to be made public.

Nga mihi nui

Income Tax

Comment

New Zealand's income tax schedule is has a number of unusual features, including:

- The absence of tax-free band at the bottom
- A relatively low top marginal tax rate
- Increases in the marginal tax rate end at a relatively low level of income (about 1.4 times the median income)

Proposal

1 Introduce a tax-free threshold of $10,000

<u>Brief discussion:</u> Tax free thresholds are expensive to introduce but highly progressive. If consideration is given to reductions in tax rates, introducing a tax free band ought to be high on the list of possible options. Tax-free thresholds also work well with concepts such as a guaranteed minimum income. Making the first $10,000 of income tax free would cost around $3-4 billion per annum, but would deliver significant benefits in terms of social equity and tax simplification. There are a variety of ways to fund such a threshold and it is one of the most effective ways of delivering a significant lump sum benefit to low-income people, including those on benefits.

2 Increase the threshold for the 33% rate to $100,000 and increase marginal rates at higher income levels to compensate.

<u>Brief discussion:</u> New Zealand's top marginal tax rate is 33%, and it begins at $70,000. Consideration could be given to a fiscally neutral increase in this threshold, funded by higher marginal rates on much higher incomes. One could for example, increase the commencement of the 33% rate to around $100,000 (roughly twice the median income) and introducing a rate of say 40% at $150,000 and 50% at $500,000 (three and ten times the median income respectively). Such a revenue-neutral change would help address poverty traps and incentives for middle-income households while providing clear signals around the implied social responsibilities which accompany very high salaries.

Concerns are often raised around income switching between company taxation and individual income taxation with higher marginal income tax rates. As all company profits are either distributions or retained earnings, the core issue is actually the ability to disguise retained earnings, or manipulate accounts to give lower headline profits. These issues are important but not insurmountable from a tax compliance point of view.

Goods and Services Tax (GST)

Comment

New Zealand's Goods and Services Tax is relatively simple and well-designed. It plays an important role in ensuring people who receive income from the "black economy" are captured by the tax system. Although modestly regressive in a technical sense, the exclusion of residential accommodation from the GST base makes the tax relatively neutral. GST is a very important part of an overall progressive and broadly based tax system.

Proposal

3 Maintain a simple, broad base for the Goods and Services Tax and address social equity concerns by using GST revenue to deliver gains to those on low-incomes.

<u>Brief discussion:</u> Increases in exemptions would bring added complexity while also being poorly targeted. Concerns for example about the cost of food for those on low incomes have led to exemptions for some or all food from value added tax in some countries. While such exemptions are (usually) progressive in a technical sense, this hides the fact that the vast bulk of revenue lost is, in an absolute sense, a gift those on relatively high incomes. Similarly the merits of changes in the overall GST rate depend very much on the use to which revenue is put.

To illustrate this point somewhat starkly, consider two scenarios:

1. An increase in the GST rate to 17.5%, with the revenue used to fund a tax-free threshold.
2. A reduction in the GST rate to 12.5% with the reduced revenue replaced by borrowing.

From a social equity perspective, the former reduces income inequality more than the latter. From a long term perspective, the second encourages consumption and borrowing at the expense of saving.

4 Re-examine the financial services exemption for GST

<u>Brief discussion:</u> The exclusion of charges for (some, not all) financial services was originally justified on the grounds of complexity; the ongoing validity of this is worth examining further. Information technology and accounting requirements are both very different and more sophisticated than was the case when GST was introduced 22 years ago.

Ecological Tax Reform

Comment

The case for ecological tax reform has been well documented over many years. The submission of the Green Party to the 2001 Tax Review summarises this case. This is a public document and can downloaded from the archived 2001 Tax Review website. A large number of specific points are dated, but the document does cover the broad rationale for eco-taxes well. The rationales for ecological tax reform include:

- Recovering associated financial costs
- Improved economic efficiency
- Accounting for externalities
- Preserving 'natural capital'
- Setting sustainability limits
- Taxing biophysical flows

From this broad perspective, there are numerous opportunities for ecological tax reform in New Zealand. The argument that some such taxes are not reliable sources of revenue because the tax base will shrink if the tax achieves its aim is an argument about whether to rely wholly on eco-taxes not an argument against using them as part of the tax mix.

Proposal

5 Develop a specific work programme for a suite of ecological tax reforms.

Brief discussion: There are a number of obvious and not so obvious candidates for ecological tax reform in New Zealand. A few examples include:

- *A tax on fossil carbon:* A carbon tax would be both simpler and more effective than the current Emissions Trading Scheme. A hybrid model with a floor price and tradeability is also possible. Whatever the details of the design, there is a strong case for raising public revenue from the introduction of fossil carbon into the atmospheric commons.
- *A tax on non-bio-degradeable plastic and its precursors:* Plastic waste is increasingly identified as a long-term hazard. There is a strong case for a tax on the production (or import) of non-biodegradeable plastic; this would be relatively simple to design and implement at the import and production level.
- *Resource rentals for the use of common resources:* Discharges to air and the abstraction of natural water for commercial use are two clear areas where there is an argument for public revenue to be raised from the use of the commons. This point is distinct from taxes associated with the discharge of contaminants into air or water.
- *Charges for discharges of specific contaminants:* The Resource Management Act is used to set ecological limits on discharges of specific contaminants. However up to those limits there is generally no cost for discharges. National charges on the discharge of contaminants would provide a financial incentive to reduce contaminants.

- *A tax on the sugar content of processed foods:* There are numerous opportunities in relation to human health; a 'sugar tax', levied at the point of production of processed and refined foods is one obvious example. A key caveat is to also ensure that the overall environment for food production supports healthy food, rather than simple substitution of other compounds with adverse long term affects.
- *Charges for the use of novel chemical compounds that do not exist in nature:* In general, novel compounds tends to accumulate biologically. Taxation is one mechanism to encourage reduced use of such novel compounds.

Lump Sum Taxes on Infrastructure Utilities

Comment

At present, New Zealand's large commercial airports and electricity network provides are subject to a form of rate of return regulation. Even in this environment, they are highly profitable, and benefit from some flexibility in the way asset values are calculated. They also operated for many years with no regulation as to returns. The combination of these factors has arguably led to a significant (and ongoing) wealth transfer from the New Zealand public to the private owners of these essential facilities. At the same time, New Zealand faces an immediate need for capital funding for sustainable infrastructure, for example mass transit for travel to and from Auckland and Wellington airports.

Proposal

6 Consider a lump sum tax Auckland and Wellington airports and large commercial electricity lines businesses

Brief discussion: Rather than tighter regulation, one option for these entities is a lump-sum tax. A lump sum tax would be a charge to the balance sheet of these organisations, a one-off return of wealth to the common pool. To avoid perverse incentives, any debt associated with financing the charge would not count against net asset values and nor would any servicing costs be deductible for company tax purposes. This effectively would be a lump-sum capture of future excess profits. A brief inspection of the balance sheets of the two airports above suggests that Wellington could conservatively support a lump sum charge of between $500m and $1 billion, and Auckland a charge in the region of $2-4 billion. A similar analysis is possible for electricity lines businesses.

Land Tax

Comment

The unimproved value of land is at first glance an attractive tax base. Land is largely fixed and its ownership is known. The idea of taxing "unearned income" is attractive to many, as is the idea of reducing the incentives for land banking. In areas where one wants to create an incentive to maximise earnings from land, land tax can be an attractive and effective tool.

However maximising earnings from land is far from a benign policy objective. There are many cases where land has ecological, cultural and social value beyond its income earning capacity. These values include biodiversity, heritage, and the general wellbeing effects from exposure to green spaces and the existence and persistence of familiar urban landmarks. A little reflection on the perspective of tangata whenua will reinforce understanding of the broader values associated with land – these are situational, particular and local. The "whenua" has meaning beyond its capacity to earn money.

Proposal

7 Empower local and regional councils to use land tax to support sustainable transport infrastructure and discourage land banking but avoid a generalised land tax.

Brief discussion: New Zealand's historical experience with land and capital value rating demonstrates the power of land taxes. Land tax ought to be available to finance developments such as light rail in major centres. However, the decision about whether one wants to encourage land intensification in a particular location is fundamentally a local one. Protection of biodiversity on private land, provision of public amenities in private developments and the protection of heritage and character in urban areas[1] are all positive contributions to wellbeing. Land tax penalises this type of long term thinking and incentivises short-term financial gain.

In some times and locations this incentive may be needed. Designing a national tax system that penalises these activities and then trying to manage the resulting adverse effects through regulation and complex exemptions is a poor approach to public policy. We want to encourage a greater sense of social and environmental responsibility in relation to rural and urban land and its use, and support tangata whenua in their role as kaitiaki of their rohe. A generalised land tax emphasises short-term earnings at the expense of these wider values.

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[1] There is discussion around the need for urban intensification in inner-Auckland. Heritage and character values are sometimes seen as conflicting with this, or seen as a smoke-screen for the wealthy to prevent more mixed land use. However this is an Auckland-specific issue rather than a general point. Lot sizes in Wellington, for example, were historically around half of those in Auckland and Wellington inner-suburbs such as Mt Victoria, Aro Valley and Mount Cook have quite high population densities especially if one excludes public reserve land from the area used to calculate density. These suburbs are also a diverse mix of rental and owner-occupied dwellings, with a wide dispersal of incomes. This reinforces the point that land tax is better suited to being a local tool, than a national one.

Taxing imputed rental income from owner-occupied housing

Comment

Imputed income is one of those apparently elegant ideas that bedevils economics. The idea in essence is that, if I own a house, I don't have to pay rent and therefore have an implicit income that ought to be taxed to create equity between renters and home owners. The idea of imputed income is a useful thought experiment for thinking about some issues but it is an economic abstraction, not a tax base. The idea is theoretically incomplete and practical nonsense.

Taxing capital gains is another issue, as is the idea of a wealth tax. Both have considerable merit. But the idea of taxing imputed income from housing is nonsense. Using an economic abstraction as a tax base is, in general, a bad idea.

Proposal

8 Abandon any further consideration of a tax on imputed income from owner-occupied housing

<u>Brief discussion:</u> From a theoretical point of view, the idea of taxing imputed income lacks a time dimension. To own an asset (in this case a house) a person first needs to either save or borrow. There is foregone consumption when one saves for a deposit, mortgages include an interest payment which may exceed the equivalent rental cost, and there is foregone consumption from the capital component of mortgage payments. All these reduce consumption from after tax income *before* the house is owned freehold.

In very simple terms the rationale for taxing the "stream of benefits from home ownership" ignores the fact that to own an asset one has to save (in the sense of foregoing current consumption), or fund the asset through borrowing. This is much clearer if one considers that there is an "untaxed" stream of benefits from any owned asset such as a car, a washing machine, a bicycle or even a toaster. In short, there is a stream of benefits from any asset that lasts for any period of time. This does not create an inequity between renting and buying such an asset.

At a practical level, it is true that people benefit from housing. Shelter is a basic human need. Some people gain financially from buying and selling houses. However that is not the only or, in most cases, the primary reason people own a house. Rather the core motivation for many if not most is the very basic human need for security and shelter. This is not a tax base.

Wealth taxation (including property taxation)

Comment

Growing inequality in both income and wealth has been a feature of the Western world over the last 40 years. New Zealand has been no exception and I don't propose to document this trend or its adverse effects here. I trust both are simply accepted as data.

Taxation of wealth is a simple idea but one which is fraught in detail. This is simply because wealth is fungible and ephemeral. Income over a lifetime contributes to wealth yet wealth is also not as closely correlated with income at any one point in time as might be thought. There are for example, some very wealthy people in the lowest income decile. Asset values are also far more volatile than incomes. New Zealanders think of house prices as rising steadily but this is far from guaranteed, and prices for assets such as gold, art and shares can fluctuate wildly. Wealth also needs to be considered over a lifetime. Older people generally have more assets than younger people.

All this is not to say wealth taxation is impossible or undesirable, simply that it is harder than might be thought to define the tax base in a way that both generates revenue and is socially just. This line of thought often leads people to consider land tax, but as has already been noted it has serious disadvantages as a national tax base. If property is the starting point for wealth taxation, then the capital value of property is much more apt tax base as it delivers many of the benefits with fewer of the drawbacks. While it lacks the theoretical elegance of land tax, its practical implications are very similar.

Proposal

9 Generate more accurate statistics on wealth

<u>Brief discussion:</u> Beyond property and possibly shares and savings, solid data on wealth is hard to locate. Building a more accurate picture of how wealth is held and how its value changes is a necessary pre-requisite to an informed discussion on broadly-based wealth taxation.

10 Introduce a low-level tax on a subset of wealth with a generous exemption threshold

<u>Brief discussion</u>: Property ownership, shareholding and financial assets are reasonably well defined and documented in New Zealand. Personal debt is also well documented within the financial system. A low-level wealth tax (say around 0.25%) on the combined annual value of these, with an exemption for (say) the first $1 million of combined net value, is worth evaluating further. One advantage of a more broadly-based tax than purely property is that it encompasses assets that can be liquidated to pay wealth tax, and therefore liability tends to have some responsiveness to ability to pay (ie if you liquidate assets your future tax bill is lower). A net wealth approach also reflects ability to pay, as if one needs to borrow to pay the tax, the future tax bill is then concomitantly lower. A sizeable threshold level allows for the accumulation and decumulation of assets over a lifetime, while still ensuring the tax helps address structural inequity in wealth.

Capital Gains Tax

Comment

The case for a capital gains tax is reasonably clear. Capital gains represent a form of unearned income which is untaxed. Unlike the imputed rental argument, capital gains are a genuine form of income, albeit unrealised. Realisation-based capital gains taxes can also play an important role in smoothing asset value fluctuations as changes in tax liability move in the opposite direction to prices. Capital gains taxes are complementary to wealth taxes rather than a substitute for them; CGT is a form of income taxation, distinct from tax on accumulated wealth. The relationship between then is through impacts on the value of net wealth, as is the case for all income taxes.

Proposal

11 Introduce a realisation based capital gains tax on changes in the real value of capital assets above a certain threshold

Brief discussion: There is a balance to be struck between avoiding undue imposts due to asset price fluctuations and creating a disincentive to the turnover of assets. Using real values helps reduce this tension as does a realisation basis. However there may be some need for an intermediate or hybrid design which limits the size of accumulated tax liability relative to the value of an asset.

Tax and benefit system integration

Comment

New Zealand's income support system is neither particularly generous nor particularly encouraging. The Working for Families scheme led to a measurable reduction in inequality but creates very high effective marginal tax rates. Base payments are low for beneficiaries and again abatement rates are steep. Family-based income support and individual-based taxation systems can interact in ways that create significant poverty traps.

Proposal

12 Overhaul income support systems to create a more generous and less conditional minimum income and integrate income support better with the tax system

Brief discussion: Others will likely address this approach more fully, but a shift from discrete income support and taxation systems to a more integrated system will generate significant benefits for those on low and middle incomes. The idea of negative income tax has a bad name because of its political origins but the basic concept of defining a minimum income and using the tax system to deliver a gradually diminishing top up has merit as an integrated approach to income support. Defining a universal basic entitlement and then using the system to deliver top ups avoids many of the problems created by the separation of income support and taxation. This approach complements the minimum wage / living wage system. These employment based models ensures enterprise face the true cost of labour, including the social costs.

List of specific proposals

1. Introduce a tax-free threshold of $10,000
2. Increase the threshold for the 33% rate to $100,000 and increase marginal rates at higher income levels to compensate.
3. Maintain a simple, broad base for the Goods and Services Tax and address social equity concerns by using GST revenue to deliver gains to those on low-incomes.
4. Re-examine the financial services exemption for GST
5. Develop a specific work programme for a suite of ecological tax reforms.
6. Consider a lump sum tax Auckland and Wellington airports and large commercial electricity lines businesses
7. Empower local and regional councils to use land tax to support sustainable transport infrastructure and discourage land banking but avoid a generalised land tax.
8. Abandon any further consideration of a tax on imputed income from owner-occupied housing
9. Generate more accurate statistics on wealth
10. Introduce a low-level tax on a subset of wealth with a generous exemption threshold
11. Introduce a realisation based capital gains tax on changes in the real value of capital
12. Overhaul income support systems to create a more generous and less conditional minimum income and integrate income support better with the tax system