Tax Working Group Public Submissions Information Release

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Young IFA Network

30 April 2018

Tax Working Group Secretariat
PO Box 3724
Wellington

Dear Secretariat

Tax Working Group Future of Tax: Submissions Background Paper

We were grateful for the opportunity to present to the Tax Working Group (TWG) earlier this year about intergenerational fairness, environmental taxes and other tax policy issues as representatives of the Young International Fiscal Association Network. Our submission therefore focuses on selected other issues that are of significant interest to our membership. The submissions in this letter represent the views of the authors and do not necessarily represent the views of IFA or of each author's employer. Our comments are set out in five appendixes:

1. The role of the tax system in supporting saving for retirement.
2. The role of the tax system in promoting housing affordability.
3. Design aspects of a capital gains tax.
4. The merits of introducing a land tax.
5. The opportunities for environmental taxation.

We would welcome the opportunity to make an oral submission to the TWG on the contents of this submission.

Kind regards

Young IFA Committee
(Jeremy Beckham, Polina Belykh, Elizabeth Elvy, Elena Kong, Jai Nario, Matt Woolley)

Appendix 1: The role of the tax system in supporting saving for retirement

Question from submissions background paper: Should the tax system encourage saving for retirement as a goal in its own right? If so, what changes would you suggest to achieve this goal?

1.1. The TWG has asked about the role of the tax system in encouraging saving for retirement. We welcome the TWG's review of this area and are supportive of measures delivered through the tax system that are designed to encourage retirement savings. We consider that New Zealand's current approach to the taxation of retirement savings is at risk of undermining intergenerational fairness and is in need of revision.

Tax disparity between savings types

1.2. New Zealand's approach to the taxation of retirement savings is out of step with international norms. As noted in the 'Future of Tax' Submissions Background Paper (at page 26), concessions offered in most other OECD countries mean that contributions to retirement savings are made out of income that is not taxed. Investment earnings on retirement savings are also often exempt. The relevant taxing point is instead when funds are withdrawn (referred to as EET or Exempt-Exempt-Taxed).

1.3. In line with our broad-base, low-rate (BBLR) framework, our comprehensive income tax in New Zealand ensures that contributions to retirement savings are made out of income that is taxed. Income earned from investment earnings is also taxed. Savings however are not taxed again when withdrawn (referred to as TTE or Taxed-Taxed-Exempt).

1.4. It could be argued that our current approach of relying on our comprehensive income tax (or TTE approach) ensures that economic distortions to save in a retirement account instead of through other savings are minimised. However, we note that our BBLR framework already fails to deliver neutrality between different forms of savings. Owner-occupied and rental housing are significantly undertaxed relative to other assets (supported by figure 21, page 40 of the Submissions Background Paper).

1.5. The impact of disparate marginal effective tax rates of savings types on wealth inequality in New Zealand is a key concern for us. Generally, there is a greater concentration of wealth among older age cohorts as most people tend to accumulate wealth over their working lives. Housing, as a significant form of wealth is of particular concern as issues with housing affordability mean this type of savings is inaccessible to many (and has wider social impacts). We believe that maintaining the current range of effective marginal tax rates for savings could be worsening inequality in New Zealand. As wealth becomes increasingly inherited and not earned, the risk is that any impact on inequality will also become entrenched into future generations.

1.6. We accept that the Terms of Reference for the TWG specifically exclude any recommended changes to the tax treatment of owner-occupied housing. However, it should be recognised that investment in housing (owner-occupied and rental properties) is increasingly viewed and accepted as a form of retirement saving. Given that housing is also tax preferred, we would encourage the TWG to consider how alternative measures can be delivered through the tax system to encourage retirement savings that are accessible to all.

Ageing population and fiscal pressures

1.7. The pressures on our tax and transfer system are set to increase in the future as New Zealand adjusts to an ageing population. From a fairness perspective, it is important to note that our tax and transfer system operates under an implied intergenerational contract. This contract assumes that people generally pay most taxes during their working lives, but less at the beginning and the end of their life where they are more likely to receive benefits funded by taxpayers. In particular, this contract underpins the approach of funding NZ Super from current taxes, which (with the welcome exception of the NZ Superannuation Fund) is largely run on pay-as-you-go principles.

1.8. We are concerned about the sustainability of this intergenerational contract. Long-term fiscal projections published by the Treasury suggest that some combination of increased taxes or a reduction in spending on transfers and other publicly provided goods and services is inevitable for the tax system to support a sustainable revenue base in the future to fund Government expenditure. The Government may well need to consider means-testing NZ Super and moving away from the current pay-as-you-go approach and towards a save-as-you-go system. We note that, if this eventuates, then there will be a transitionary period where one generation will continue to fund NZ Super and cannot reasonably expect to receive the same entitlement in return.

1.9. The Submissions Background Paper (at page 10) also concludes that change is needed to support our ageing population. It is likely that the cost of this change will fall to future generations. There is a case for considering these issues now and for using the tax system as a vehicle to pre-empt this shift and lessen the burden on future generations by incentivising retirement savings (most likely on an individual rather than communal basis). We believe the opportunity should be taken to plan now for a managed transition.

Appendix 2: The role of the tax system in promoting housing affordability

Question from submissions background paper: How, and to what extent, does the tax system affect housing affordability for owners and renters? Is there a case to change the tax system to promote greater housing affordability? If so, what changes would you recommend?

2.1. The problem of New Zealand housing affordability is well known and has been widely discussed. The nationwide median house price rose 6.9% year-on-year to $530,000 in February 2017 according to the Real Estate Institute of New Zealand. Auckland has the country's most expensive housing with the median price of $858,000. New Zealand housing was rated as "seriously & severely unaffordable" according to the 14th Annual Demographia International Housing Affordability Survey 2018 (examining the nine developed nations, including Australia, Canada, China (Hong Kong), Ireland, Japan, Singapore, the United Kingdom and the United States).

2.2. On average, New Zealand households are spending more than 30% of their income on housing. Currently, an average young couple in Auckland spends 47% of their household income on mortgage payments. Home ownership rates are also dropping – nationwide, only 63.2% of people today live in their own homes - the lowest rate since the 1951 Census and lower than home ownership rates in Australia, the United Kingdom and the United States.

2.3. House prices are influenced by a number of factors, such as the fundamental demand and supply (in terms of both quantum and speed), migration swings, fiscal and monetary policies. We consider the taxation of property transactions combined with broader taxation framework settings also play an influential role. The following aspects and influences are of particular importance:

- Capital gains on housing disposals are generally not subject to tax. This increases the attractiveness of investing in housing (over financial assets, for example) and, consequently, impacts its affordability.
- The issue of negative gearing - at present, investors bear short-term tax subsidised losses on their rental properties (as nominal interest (exceeding real borrowing costs) for which a full tax deduction is currently available outweighs rental returns) with the expectation of ultimately making a tax-free capital gain in the long-term. While increasing house prices, arguably, this should put downward pressure on rents being charged.
- Equity-funded investments in owner-occupied housing are favoured as no tax is imposed on imputed rental values. Additionally, the existing main home exclusion from the bright-line test and proposed family home / land under the family home exclusions from any potential capital gains tax / land tax regimes (as per the TWG – Terms of reference) further compound the tax environment distortions impacting the New Zealand housing market.
- Local authorities impose rates by reference to the rateable value of the land, being the annual value, the capital value or the land value. While this should somewhat level the playing field by effectively acting as a tax on property ownership, we do not consider this impact is significant.

2.4. In terms of the first two items (capital gains and negative gearing), we are supportive of the recent bright-line test extension to 5 years. We are also supportive of the Government's intention to address the existing problem of negative gearing through the proposed ring-fencing rental losses measures. Both of these issues were previously highlighted by us at the Future of Tax Profession symposium hosted by the University of Auckland.

2.5. In terms of the broader question concerning the effect of the tax system on housing affordability, in our view, while correlation undoubtedly exists, the exact dependencies are difficult to quantify.

The increase in house prices will in part be due to a number of factors other than the tax treatment of housing.

2.6. International literature suggests that the presence or absence of a capital gains tax is not a decisive factor in explaining house price behaviours. For example, the Annual Demographia International Housing Affordability Survey notes that most of the “unaffordable” housing jurisdictions have capital gains tax regimes, however, the same issues persist. Additionally, modelling for the previous 2010 TWG suggested that a capital gains tax of 20% (with an exemption for owner-occupied housing) would only have a modest impact on the New Zealand housing prices. As such, we recommend the TWG consider the issues surrounding housing more broadly than just in the context of a capital gains tax.

2.7. The taxation framework alone will not solve the problem of housing affordability due to a range of other policies and influences having a more pronounced impact on the housing market. However, in our view, certain property focused tax measures (similar to ring-fencing of rental losses and extension of the bright line test) should be considered to the extent they improve the coherence, integrity and fairness of the New Zealand tax system. If designed well, such measures will likely increase tax revenue and, consequently, provide scope for a potential reduction in other taxes.

Appendix 3: Design aspects of a capital gains tax

Question from submissions background paper: Should New Zealand introduce a capital gains tax (that excludes the family home)? If so, what features should it have?

Design issues with a capital gains tax

3.1. In designing a capital gains tax, the TWG has an opportunity to create a coherent, fair and relatively simple regime for taxing capital income. The design of a capital gains tax will also inform the potential distributional impact of the tax system, including the intergenerational impact. Our submission does not express a general view on a capital gains tax, but rather highlights a few design considerations for the TWG.

Should capital gains be taxed on an accrual basis or only when realised?

3.2. We would like the TWG to also consider a third or "hybrid" approach. A hybrid approach consists of taxing on realisation those assets where valuation and/or cash flow are a problem, and taxing other assets on an accrual basis. We acknowledge that different approaches for different asset types could create additional distortions (as is the case with the tax treatment of savings vehicles). For example, if publically listed shares are taxed on accrual and unlisted shares on realisation, there will be a tax created incentive for companies to delist. Nonetheless, the benefit of considering a hybrid approach is that some of the issues created by taxing gains on a realisation basis can be removed for some assets. The most prevalent problem with taxing gains on realisation is that it creates a strong incentive to hold onto appreciated assets to avoid the tax – the so-called "lock-in effect".

Should the CGT include just rental properties, shares, collectibles, private assets such as cars?

3.3. One of the common criticisms of the existing income tax base is that it arbitrarily taxes some capital gains but not others – a capital gains tax with a narrow base is likely to face the same criticisms and contribute little to perceptions of fairness in the tax system. Further, a narrow base CGT is likely to increase compliance costs and Government administration costs, while potentially sacrificing simplicity (by giving rise to uncertainty and enforcement concerns for issues at the boundaries), all the while raising little additional revenue to offset these additional costs. We therefore recommend that in designing a CGT, the TWG carefully weigh up any additional costs of allowing exemptions to the CGT, which are likely to increase administrative costs for Government and diminish the effectiveness of the tax for revenue collection.

Should the CGT be a separate tax or part of the income tax?

3.4. Regardless of whether a CGT is a separate tax to income tax, the TWG should consider how the existing tax administration rules and processes might apply. An attractive feature of the New Zealand tax system is that the common disputes procedures, penalties, and taxpayer responsibilities are the same for a range of taxes. The TWG should keep those rules in mind when designing a CGT as the efficiency and effectiveness of tax administration rules can impact perceptions of fairness in the tax system just as much as the rules defining when CGT applies. Further, we strongly advise against the use of misaligned rates of tax on capital gains versus income earnings. New Zealand has first-hand experience of the raft of problems that can arise when tax rates are misaligned on transferable or substitutable earnings; and while a lower rate of tax on capital gains may have appeal (whether political, or in comparison to precedent from overseas jurisdictions), we consider that misaligned rates of tax will both add another layer of administrative complexity and erode tax system efficiency as the current incentive to invest in capital is maintained.

Administrative solutions to support CGT

3.5. It is not controversial to suggest that a comprehensive CGT with no exceptions is the best way to remove the distortion in our current system, as it ensures a broad base for the CGT. However, given the clear terms of reference have expressly removed the possibility of taxation of the family home or the land under it, we consider that the TWG should carefully consider designing alternative solutions to buttress the narrower base CGT to ensure that efficiency in administration is maintained notwithstanding this significant exemption.

3.6. Examples of such solutions could include an administrative mechanism to mandate the need to record the determination that something is the "family homes" and of purchasers' IRD numbers upon purchase, to prevent taxpayers from claiming multiple "family homes" and to aid Inland Revenue in tracking purchasing behaviour.

3.7. To overcome the "lock-in" effect, a monetary threshold could be introduced, so that a family home that triggers a capital gain over a certain amount (for example +$1m capital gain) could immediately be brought into the rules irrespective of the family home exception. While such a rule does clearly tax the "family home", it may nevertheless be a plausible recommendation as a reasonably high threshold would still exclude the majority of New Zealand home owners who are unlikely to make such large gains.

Appendix 4: The merits of introducing a land tax

Question from submissions background paper: Should New Zealand introduce a land tax (that excludes the land under the family home)? If so, what features should it have?

Design issues

4.1. A land tax imposes an annual tax liability on landowners, calculated by reference to the value of land owned by them. As there is a fixed supply of land, a universal land tax is generally seen as efficient with low administration and compliance costs. Given the immobile nature of land, it can be a reliable source of tax revenue. However, a land tax may be perceived as unfair as it targets a single type of natural capital asset, affecting those that hold land. This would result in a wealth loss for landowners (if the tax cannot be passed on to others) compared to holding other capital assets and would have a disproportionate impact on taxpayers that hold land. In addition, the intended outcome of improving housing affordability is unlikely to be realised due to the exclusion of owner-occupied housing.

4.2. Consistent with the BBLR framework for the New Zealand tax system, a land tax should be low-rate and comprehensive to be most efficient and generate the most revenue (if that is in fact the purpose of introducing a land tax). While the terms of reference exclude land under the family home, that exclusion will result in less tax revenue as this land forms a significant share of the land tax base. Further exclusions that have previously been raised in the context of land tax that may be considered, such as land for public use, conservation and Māori land, will also have the same impact of reducing tax revenue.

4.3. A question arises as to whether a land tax should be calculated by reference to the value of the land, with reference to expected annual rent or expected sales value. Most jurisdictions that have land taxes have used the expected sales value approach. While local authorities have a land valuation system for imposing rates, this is not updated annually. It would therefore be an additional cost for the Government to obtain annual property valuations to enable tax on the current property values, increasing the compliance costs of administering a land tax. Further, the property valuations can be arbitrary and will not necessarily represent the actual market value of the land. For these reasons, we consider that adopting an expected sales value approach (consistent with most other jurisdictions) would be preferable.

Drop in land and property values and impact on housing affordability

4.4. The introduction of a land tax would likely result in a one-off drop in property values and be borne by those who hold land at the time the land tax is introduced. Work done for the 2010 TWG suggested a 1% land tax could result in a fall of anywhere between 16.7% and 26.4% in affected land values (with Inland Revenue concluding at the time the lower estimate could be optimistic)[1]. The devaluation of land is likely to create a significant economic shock. Potential purchasers of land are likely to price in the ongoing land tax cost in future purchases of land. These flow on effects should be taken into account in considering whether land tax should be introduced in New Zealand.

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[1] https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/publications/3-taxation-of-capital-gains-ird_treasury.pdf

Appendix 5: The opportunities for environmental taxation

Question from submissions background paper: What are the main opportunities for effective environmental taxation?

5.1. New Zealand currently collects little revenue from environmental taxes relative to other OECD countries as illustrated in the graph included in the 'Future of Tax' Submissions Background Paper (figure 22, page 50). We are supportive of the TWG considering environmental issues and potential environmental taxes.

5.2. The Submissions Background Paper refers to the TWG's use of Treasury's Living Standards Framework to measure well-being and the impact of potential changes to taxation in a more comprehensive manner than simply looking at income. We consider the use of this framework to be an important way to assess the impact the overuse of New Zealand's natural resources has on well-being and the impact current policy settings as well as any new taxes could have. The overlay of the traditional criteria that underpin a tax system (coherence; integrity; fairness) is also important when considering the case for environmental taxes, in particular the impact on intergenerational fairness of the current limited use of environmental taxes.

5.3. Environmental challenges and seeking to address these challenges is a key concern for us. Future generations are likely to bear a greater burden of environmental degradation and the associated costs to address environmental restoration.

5.4. It seems that short-term personal/business interests often take prevalence over longer-term environmental concerns as the benefits that can be received from the use of the environment (despite potential degradation occurring as a side-effect) currently outweigh the perceived costs of preventing environmental degradation. This discrepancy creates a challenge to intergenerational fairness as the costs of today's actions are carried by future generations.

5.5. Given the current disregard for environmental impacts in favour of personal benefits, some form of incentive is likely required to facilitate change in behaviours.

5.6. We recommend broadening the current use of environmental taxation to:

- Place emphasis on the areas of environmental change that are seen to be of key importance to New Zealanders;
- Trigger a change in society's perception and behaviour regarding environmental issues; and
- Generate additional tax revenue. However, we do not consider direct hypothecation or ring-fencing of the revenue generated by any additional taxes as beneficial as this could unfairly limit the level of funds attributed to correcting environmental challenges and disregards the fact that the environmental damage caused by certain economic activities often has spill-over effects which reach far wider than the immediate location of the activity.

Taxes vs regulations

5.7. New Zealand already utilises regulation to assist with aspects of environmental protection. Where behavioural taxes could be helpful is where they will actively reach a wider portion of society as well as operating as a type of education campaign. There are benefits and disadvantages to using behavioural taxes, which would need to be considered in the context of the particular environmental issues to be addressed.

5.8. Behavioural taxes could be of benefit as they encourage change in individual behaviours through price signalling and assist the public to understand the need and benefit of the tax. Disadvantages are that the taxes can be expensive if poorly targeted, and they can increase the overall tax burden on taxpayers if there is no reduction in other taxes in proportion to the behavioural tax introduced or if the good or service taxed has few alternatives. Where behavioural taxes are used to incentivise changes in behaviour, longevity of the tax revenues raised cannot be expected.

5.9. Environmental taxes do not need to be considered in isolation. Taxes introduced to address other aspects of the tax system could also help address environmental challenges. One example could be a land or other resource tax, which while designed primarily to address equity in the tax system could also be designed to collect taxes on an environmental basis with the tax level based on the level of resource usage or level of degradation expected by the activity. Further Government wide policy reform could also assist in this regard, for example the introduction of stronger waste regulation and banning of single-use-disposable plastics.

5.10. Another key opportunity for taxation is to incentivise innovation towards more environmentally friendly technologies and processes to limit future environmental impacts. In this regard, we recommend considering taxes to challenge certain behaviours and raise tax revenue, but also considering the use of tax benefits that could incentivise taxpayers to change their processes. Some examples may be the recently announced R&D Tax Incentive or accelerated depreciation deductions for environmentally friendly technologies.

5.11. We are supportive of the TWG's consideration of environmental taxes. We recommend that the introduction of behavioural taxes is considered to address specific environmental concerns and consideration is given to widening of other taxes to incorporate a portion of environment taxation.