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Submission to Tax Working Group: From Dr Murray Horn CNZM   21 April 2018

Introduction, Summary and Recommendations

The current broad consumption and income tax bases developed over the last 35 years work well and should remain the basis of our tax system moving forward. I support the conclusion of the 2001 (McLeod) Tax Review[1] that reforms should focus on incremental improvements to what we have and that deviations from this approach should only be made where a substantial burden of proof is discharged.

I also support the conclusions of both the 2001 and 2010 (VUW)[2] reviews of the tax system that, with respect to taxing capital gains, we should continue with the current practice of including particular capital gains in the income tax base as and when issues arise (as the current government is doing in extending the bright line test).

Given that the arguments in favour of maintaining the current broad base, low rate system and against introducing a comprehensive tax on realised capital gains (CGT) are well canvassed in both the previous reviews, there is no need to explore them further here. The only point specific to the current review is that inheritance tax is excluded, so if a CGT is introduced it should allow roll-over relief when assets are passed to the beneficiaries of current asset owners.

Rather, this submission addresses the question posed by the Tax Working Group (TWG) on land tax: i.e., "Should New Zealand introduce a land tax (that excludes the land under the family home)? If so, what features should it have?"

The 2001 Tax Review found no justification for a selective wealth tax, like a land tax.

A majority of members of the 2010 Review did consider a comprehensive low-rate land tax to be worthy of consideration to fund other revenue changes: i.e., one that applied to all land, including land under the family home. However, excluding the land under the family home undermines both the efficiency and revenue arguments used to support the conclusion of the 2010 Review. It also creates serious additional problems for a land tax, especially given its potential impact on renters. Indeed, an advocate for a land tax who was a member of the 2010 review group concluded that "For a number of reasons (including maintaining the viability of the rental market) it is difficult to see blanket exemption of owner-occupied homes being a viable policy option."[3] The 2010 Review also identified a number of problems with a land tax that were not fully addressed and overlooked others. These are explored in more detail in this submission.

I conclude that New Zealand should not introduce a land tax that excludes land under the family home for the following reasons.

First, it lacks a strong justification. The 2001 Review concluded that a selective wealth tax like a land tax is not justifiable in terms of filling any gap in the income or expenditure base and was effectively

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[1] *Tax Review 2001*: Final Report 2001 and Issues Paper. This was a government appointed Review.

[2] *A Tax System for New Zealand's Future*: Report of the Victoria University of Wellington Tax Working Group, Jan 2010. This Review was set up by Victoria University, with tax officials made available to it.

[3] Dr Arthur Grimes was a member of the 2010 review group and has supported the idea of a comprehensive land tax. This is a quote from page 45 of Coleman and Grimes*, Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes*, Motu Working Paper 09-14, Motu Economic and Public Policy Research, September 2009.

a double tax on income (the only material gap remains owner-occupied housing). Moreover, excluding land under the family home also undermines the 2010 Review's justification in terms of efficiency and revenue generating potential. A "substantial burden of proof" in favour of this tax cannot been discharged.

Second, it is not fair. It imposes a very large and arbitrary tax on the current owners of land and is not fair in terms of horizontal equity. It is also likely to be regressive, although more work is needed to identify just how regressive.

Third, it creates serious cash flow problems for taxpayers that can only be adequately addressed by taxing only the realised gains in value over an initial level: i.e., a CGT on land.

Fourth, uncertainly over the durability and design of a land tax will destabilise land prices for some years and lead to a further loss of efficiency. A land tax will be controversial and vulnerable to repeal and, unlike income tax or GST, repeal is feasible. Even if not repealed quickly, future governments are likely to exempt those it considers unfairly impacted, as the current Government has done already with land under the family home. Exemptions erode potential revenue and make ultimate repeal easier.

Fifth, local authority valuations are not appropriate for establishing a base for imposing a land tax. Limiting application of the tax to land acquired after legislation is passed would provide a solution to this particular problem. It would also prevent land currently held on trust for descendants, and taonga land, from being alienated to pay land tax.

Sixth, a land tax is likely to hold back land development; especially development of agricultural and horticultural land. Land development is likely to be compromised to the extent that a land tax causes an immediate drop in the value of land, requiring cash that could be used for development to be required to reduce debt and restore equity levels. For farmers who are cash constrained, the extra annual tax burden would also reduce the cash available for fertiliser and other investments in productive capacity.

Seventh, contrary to the intention of this Government, the land under the family home will end up paying more land tax, albeit in the form of higher rates because the impact of a land tax on local government's rating base will shift the incidence of the tax.

Eight, integrating a land tax with rates and applying the family home exemption adds to both the administrative and compliance burden of a land tax (and further reduces revenue). The latter arises because there are a number of possible definitions of the land area "under" the family home, and because private and business land use can co-exist on the same defined area, even in the same dwelling (e.g., the home office), each with different efficiency and fairness implications.

Finally, imposing a new land tax will be seen by many as unfairly retrospective: i.e., that existing landowners were not aware of the potential tax liability when purchasing the property. This could be addressed by limiting application of a land tax to land acquired after legislation is passed.

In my view, these considerations should lead the TWG to recommend against the adoption of a land tax that excludes land under the family home. If this is not accepted, then the worst features of a land tax could be reduced to some extent by: exempting home rental, agricultural and forestry land; taxing only the realised gain in value over an initial level; and having a transition that limits application of the tax to land *acquired* after legislation is passed. That would make the tax less controversial but also less useful in terms of revenue generated.

The rest of the submission expands on these nine points.

Background: the 2010 Review

The 2010 Review noted that most members supported a low-rate land tax applied across all types of land as a revenue raising measure, although they were concerned about the political sustainability of such a tax. In support of this tax they argued that a single rate applied to all land without exception would be efficient, raise significant revenue and, if based on rateable values, be easy to administer.

The report argued that a land tax would cause land values to fall by the net present value of the expected future land tax liabilities, which would be a lump sum tax on existing landowners, although they noted that existing landlords may increase rents to cover additional costs.

Land tax lacks a strong justification

The 2001 Review argues that there can be a case for a selective wealth tax, like a land tax, if some gap in the income (or expenditure) base could be identified that this tax could fill. Otherwise a wealth tax, like a land tax, amounts to double taxation of income. The only material gap remains owner-occupied housing, and extending the base in this way has already been ruled out. There is, therefore, no justification for introducing a land tax on this basis.

One of the main reasons the 2010 Review rejected a CGT was the likelihood that owner-occupied housing would be excluded from coverage and yet, when considering a land tax, did not consider that the land under the family home might also be excluded.

This exclusion undermines the assumed efficiency and revenue generating advantages of a land tax.

<u>In terms of efficiency</u>, this exclusion would advantage land used for owner-occupied housing over land used for other uses, including land used for rental housing. This could have serious consequences, especially for renters who would face increased rents even in the absence of such an exemption.

In their quantitative assessment of the *Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes* Coleman and Grimes model the effect of a property tax with an exemption for owner-occupiers which, "… resulted in the virtual complete collapse of the rental market, as the long term costs of renting exceeded the long term costs of home ownership, We do not consider this result to be just an artefact of the model; in reality, a distortion of this nature could severely impact on renters and could have major welfare consequences." (p22)

They also pointed out that exempting land under owner-occupied houses would reduce land tax base by over 40% and create an incentive to avoid tax by shifting housing land into the owner-occupied category that would be "… perhaps the most difficult dichotomy to police … ." (p33)

In summing up the implications of possible exemptions to a flat *land* tax, Coleman and Grimes conclude that: "For a number of reasons (including maintaining the viability of the rental market) it is difficult to see blanket exemption of owner-occupied homes being a viable policy option." (p45)

<u>In terms of revenue potential</u>, the ownership exclusion also undermines the potential revenue generating advantages of a land tax. Coleman and Grimes estimated it would reduce the taxable base by over 40%, similar to the figure that IRD and the Treasury provided to the 2010 Review[4].

[4] *Land Tax*, Background paper for session 3 of the Victoria University of Wellington Tax Working Group, Sept 2009

Extending the exemption to land under rental properties would reduce the land tax base by a further 24%.

Official's advice at the time was that: "The inclusion of the majority of land in the base would be required if a land tax is to be successful." (p.6) There is no reason to believe that that advice would be any different today.

In summary, exempting owner-occupied land from a land tax significantly undermines its efficiency and its revenue generating potential as well as creating real problems for renters.

The proposed land tax is not fair, is likely to be regressive and, for some, oppressive

Land tax is clearly not fair in terms of horizontal equity and is unlikely to be fair in terms of vertical equity because of the owner-occupier exemption. For many rural land-owners, the quantum of tax would often be seen as oppressive.

Land tax is only applied to one form of capital and so disadvantages those who have invested a disproportionate amount of their savings in land, creating serious horizontal equity issues. Land tax mainly impacts those, like farmers and Maori Authorities, who hold most of their wealth in the form of land when other forms of wealth are not taxed. Indeed, a land tax is worse than a CGT in terms of horizontal equity.

The housing owner-occupier exemption only exacerbates this horizontal inequality. Moreover, much agricultural land is also "owner-occupied," which creates different classes of taxpayer even within this narrow category unless owner-occupied farms and other rural holdings were also exempt.

For many land-owners, the annual land tax would be oppressive because it would far exceed what unimproved land could produce by way of rental income. This would be the case, for example, with land zoned and used for farming but close enough to a town for values to be inflated by the expectation that zoning changes may eventually allow more profitable uses. In many cases, a land tax would be simply unaffordable and force sales to speculators who can afford to hold the land in the expectation of future zoning changes. The *Background Paper* notes that we already tax land in this case; if the sale is within 10 years of acquisition and at least 20% of the gain on disposal arises from the zoning change then the whole of the gain is taxable. A land tax would be a poorly targeted way of taxing this particular activity. Better to increase the 10 years to, say, 20 years if the aim is to discourage land-banking speculation and the current law is considered inadequate.

This horizontal equity problem can be largely addressed by exempting land intensive activities. This would, however, also substantially reduce the revenue collected.

In terms of vertical equity, exempting land under the family home means that a land tax is likely to disproportionately impact renters, who tend to be lower income and have little wealth. The official advice to the 2010 Review noted that a flat rate land tax with no exemptions lead to tax payments that are a fairly constant proportion of income as income rises and that farmers in all deciles would pay more land tax than non-farmers.

Owner-occupiers are likely to earn more, and be wealthier, than renters. When owner-occupiers are excluded from land tax and some proportion of the land tax is passed through to renters, a land tax is likely to be regressive.

Indeed, Coleman and Grimes calculate that about 43% of households are renters and this proportion falls as income rises: i.e., poorer people are more likely to rent. More starkly, 96% of households in the lowest net worth quartile (and 66% of households in the second lowest quintile) are renters. Moreover, Maori and Pacific families are both strongly represented in the rental category.

Land tax creates cash flow problems that are difficult to address

Annual payment of land tax raises cash flow problems because it generates immediate tax liabilities that are may not be able to be met from either the income earned from the land (the rental value of the land) or a transaction (sale of the land).

This raises similar issues to taxing capital gains on an accruals basis. In terms of an accruals-based CGT the 2010 Review concluded that: "In practice taxing all capital gains on accrual is not feasible (and no country has implemented it) due to such problems as identifying market values for some assets and the cash flow difficulties that arise when accrued capital gains generate immediate tax liabilities but assets yield no immediate (cash flow) returns." (p.48)

Taxing land on accrual suffers from the same problems. The valuation issue is discussed below. The cash flow issue is discussed here.

The 2010 group suggested a possible solution to the cash flow issue would be to allow these taxpayers to defer the tax (plus an interest charge) until sale or death; albeit "… most estates that seek deferral will have major liabilities for land tax. There would also be lock-in effects for those in deferred payment schemes, although these could be mitigated with some form of roll-over relief." (p. 51)

Deferring the tax until death would be equivalent to imposing an inheritance tax on land-owners and this has been excluded in the TWG's terms of reference. Moreover, it does nothing to address the cash flow issue unless the land is actually sold when the landowner dies.

Deferring the tax until sale does not necessarily address the cash flow problem because it may well be that the total deferred tax liability is greater than the realised value of the land.[5] It may also force a sale if transfers to descendants trigger the tax because the cumulative tax liability would be prohibitive for many after any substantial period of time.

This problem can only be adequately addressed by:

a. only taxing the gain on sale over and initial level so there will always be enough value realised to pay the tax; and
b. not deem land held in trust for descendants as "sold" as long as it remains held for the benefit of those descendants (even if the entity that holds the land in trust changes because, for example, trusts have limited lives).

This latter condition also addresses the question posed by the *Background Paper* about "…what the appropriate treatment of Maori land might be when it is a taonga asset" because it would prevent land from being alienated to pay for deferred land tax as long as it remained held for the benefit of descendants. It also offers non-Maori who want to hold land in trust for their descendants to enjoy the same protection. Finally, it prevents a deferred land tax becoming an inheritance tax imposed on those who own land.

If an objective of policy is to reduce land values and effectively exempt land considered taonga, the easiest way to do that would be via transitional arrangements that only applied a land tax to land

[5] For example, in a simple case of no growth in land values, a 1% land tax and a 4% annual interest charge would mean that the cumulated tax liability would consume the total value of the land after just 40 years.

acquired after the legislation was passed. That would also mean descendants would not have a crippling differed tax liability hanging over their heads and may well enhance political sustainability.

Doubts over political sustainability will create costly uncertainty and instability

The durability and design of a land tax is unlikely to be stable in the face of changes in government and this instability is itself costly. The 2010 Review acknowledged this inherent weakness when it noted, with respect to a land tax, that: "… there are concerns over the political sustainability of such a tax." (p 67)

<u>The problem arises because</u> a land tax is hard to justify, will be seen as unfair by a number of groups and possibly the wider population, and falls disproportionately on people with a concentrated interest in seeking exemptions. There will be votes in repealing the tax and, unlike GST or income tax, such a repeal is feasible.

Even if not repealed quickly, future governments are likely to exempt those it considers unfairly impacted, as the current Government has done already with land under the family home. Exemptions for one group are likely to create pressure to exempt others, eroding potential revenue and making ultimate repeal easier. A land tax is unlikely to be durable in anything other than a form that would yield little revenue.

<u>Uncertainty over durability and design will be costly</u>.

In their advice to the 2010 group, officials noted that there would be strong pressure on future governments to exempt or lower rates for certain groups or sectors. They argued that this uncertainty can lead to a loss of efficiency, when investment decisions are delayed or not made on the basis of their current rate of return but uncertainty about future rates of return. Moreover, if land tax in some form ultimately becomes accepted, the risk that future governments might increase the rate would discourage people from investing in land-intensive ventures.

This instability is likely to create significant volatility in land prices over time. A land tax will cause land values to fall by the net present value of the expected future land tax liabilities. The expectations of future tax liabilities will, in turn, depend on what changes people expect future governments to make.

Given the magnitude of the net present value of land tax, even at very low rates, quite reasonable changes in expectation will drive considerable volatility in land values, at least until durability and design issues are no longer controversial. Given the newness of a land tax, the likely controversy around its introduction, and the initial pressure for relief from highly impacted groups, it is likely to be some years for this to occur.

It may well be, for example, that people initially expect the tax to be short-lived, or that exemptions will be extended, and so land values may not fall as far as initially predicted. If the tax is repealed or significantly amended, land values will rise again. If not, then it is likely that the balance of risk will be for future governments to be tempted to raise tax rates or tighten exemptions (e.g., remove the exemption for land under the family home). This quite reasonable evolution in expectations would see land values driven as much by expectations of future policy changes as by any other factor.

Valuation is difficult and using Local Authority land valuation to set land values is not appropriate

<u>Unless land is sold by willing sellers to willing buyers, valuation has to be established by some other process and is inherently and inevitably an arguable matter</u>. Someone has to then determine the tax base for a land tax in a way that is not true for any other significant tax. It would not be surprising if

the results were perceived by taxpayers as unfair and arbitrary, especially given the potentially large and unpredictable impact that imposition of a land tax would have on land values.

The *Background Paper* notes that "A land tax is generally regarded as having low administration and compliance costs given the existence of local authority land valuation systems for imposing rates."(p.48)

Local authority valuations are not appropriate for establishing a base for imposing a land tax.

These valuations value land by taking observed recent property sales in the area (i.e., land plus improvements) and adjusting for a number of factors to try and identify "like" properties and also adjusting for improvements. Each of these steps requires judgment and estimation that is subject to error. This error is likely to be larger outside city locations with fewer transactions available to make like comparisons.

This error does not matter a great deal when valuations are only used to assess the share of rates that are paid by different landowners (so, for example, land that increases by the average rate should only see their rates increase by the increased expenditure of their local authority). They would matter a great deal if rates increased or decreased by the amount of any change in property values and established a taxable base (as would be the case with a land tax). Indeed, Auckland Council makes a point on their website of saying that "Council valuations do not reflect your property's market value and should not be used for insurance or mortgage purposes."

Moreover, the value of "recent sales" before the imposition of a land tax will be an overestimate because the land tax will have an immediate negative impact on land values. This is unlikely to be either easy to estimate or a one-off reduction in value because, as noted above, expectations of the durability and design of a land tax are likely to drive significant volatility in land values for a number of years.

There are a number of possible ways to address this valuation issue. The easiest and most credible would be to limit application of the tax to land acquired after the legislation was passed. This would mean that the valuation of each piece of land was at least based on a real market price.

A more complicated alternative would be to capitalise the value of rental income from unimproved land and gradually increase the tax rate to the target rate over time. This makes it obvious that a land tax is an additional income tax. It should be more stable than sale values because unimproved rental value will be a proportion of what the land can produce, which is less subject to the volatility created by a land tax. It would address the cash flow problem, as long as a low rate land tax was deductible from income tax and combined with a tax credit for rates, so the total tax burden on income produced from land is not out of step with other income tax rates. However, unless there was a reasonable history of rental income the proportion of total income deemed to be attributed to land rental would require estimation and so suffer from error and, therefore, still be perceived by some as arbitrary. It would also add to administrative complexity and compliance burden.

Land tax is likely to undermine investment in increasing land productivity

A land tax is likely to hold back land development; especially development of agricultural and horticultural land. If the tax was considered durable there will be an immediate drop in land values equivalent to the net present value of the tax, conservatively estimated by officials in 2010 to be about 16% of the land value. In this case, borrowers would then have to inject more equity to make up at least some of this loss in order to stay compliant with their banking covenants.

Land development typically requires significant leverage, so money that would otherwise be used for development would have to be diverted to debt reduction. Given the increased volatility in land values created by a land tax, Banks may require more of a buffer in future rural lending. Other forms of development financing, like sale and lease back agreements, would not be immune because financiers typically require a minimum return and are likely to pass the burden of land tax back to the leasee.

It is also possible that farmers would react to the extra annual cash drain by cutting back on fertiliser and other investments in productive capacity, just because they are cash constrained and, with the reduction in equity, unable to borrow to ease that constraint.

Land under the family home will pay more land tax, albeit in the form of increased rates

The likely impact of land tax on the rates base will shift the incidence of land tax and mean that, contrary to government's intention and at least the spirit of the TWG's terms of reference, the land under the family home will end up paying more land tax, albeit in the form of higher rates.

Land values determine the share of any given local government expenditure that is born by different rate-payers. Assuming the land tax is considered durable, there is a large reduction in the value of all land other than that under the family home. Inevitably, land under the family home will have to pay a larger share of that unaltered local government expenditure.

Integrating with rates and applying the family home exemption adds administrative complexity and compliance burden

Land tax needs to be integrated with local body rates. Removing double tax from this source requires that, for those subject to the tax, rates be treated as a tax credit, rather than a deduction. This adds a measure of complexity and further reduces the revenue generated by a land tax.

Exempting land under the family home adds administrative complexity, especially if rural, urban, business and mixed-use landowners are to be treated equally in terms of the defining the scope of land "under the family home".

The issue arises because of there are a number of possible definitions of the land area "under" the family home and because private and business land use can co-exist on the same defined area.

In the interests of fairness, you would want to treat urban and rural owner-occupiers in the same way. You would also not want to disadvantage owners of businesses on a separate title relative to owners of businesses that shared a title with the family home. You would also want to treat family homes that are owned by family trusts and occupied by the beneficiaries in the same way as family homes that are owned by the people living in them.

The simplest solution to defining an area under the home would be to exempt all of the land on the title on which the family home is located and not differentiate between private and business use. However, this will disadvantage businesses on a separate title and encourage people to shift more of their business activities onto titles shared by the family home (and enlarge these titles to enable that outcome).

This distortionary impact would be reduced by taking the announced policy literally and just exempting the area immediately under the building that is the family home (while not exempting a business that is an extension of this building or on a lower floor). While there would be an incentive to do more business from within this building, the scope for this is relatively limited. However, it is also likely to be the most costly in administrative and compliance terms because all home owner occupiers would need to define the area under the home and pay land tax on the remainder of the title.

Alternatively, IRD recognises the idea of "curtilage" which refers to land under the dwelling and surrounding the dwelling (which, if not fenced, has to be estimated) and that is used for private purposes. The exemption could be defined on this basis.

Exempting the area defined as curtilage would eliminate compliance costs for most urban owner occupiers whose curtilage area is well defined and only used for private purposes.

However, it would still be administratively complex and add to the compliance burden of everyone else, so it would be less equitable in terms of the impact of the tax and associated compliance burden than the narrower definition discussed above.

The size of the area "surrounding the dwelling" depends on each case. The fact that this definition has been subject to a number of court cases demonstrates that it is not a straightforward matter.

Defining what is "for private use" arises when the curtilage has both private and business uses is also complex. This is illustrated by the rules IRD has had to develop to address this problem in the administration of income tax and GST. While rules for differentiating between private and business land use may be simpler, this is yet to be tested (e.g., treatment of land under the "home office").

Whatever definition is used to apply the family home exemption creates compliance and administrative costs, each with different efficiency and fairness implications.

Imposing a land tax on current landowners will be seen by many as unfairly retrospective

Many will see the imposition of a land tax on current landowners as unfair because they were not aware of the potential tax liability when purchasing the property. This could be addressed by limiting application of a land tax to land acquired after legislation is passed.

Conclusion

A land tax with an exemption for land under the family home lacks a strong rationale and creates so many practical problems that it would be very controversial and, therefore, unlikely to be durable in anything other than a form that would yield little revenue.

If specific types of land transactions are considered socially harmful, then better to clearly identify the harm and target this directly with a capital gains tax on sale (as is currently done to discourage speculation in land in the expectation on future changes in zoning).

In my view, the TWG should recommend against adoption of a land tax that excludes land under the family home.