Tax Working Group Public Submissions Information Release

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25 April 2018

Tax Working Group Secretariat
PO Box 3724
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By email

Dear Tax Working Group Secretariat

Submission on *Future of Tax: Submissions Background Paper*

Thank you for the opportunity to submit on the above paper. We strongly consider that our country's tax settings and their everyday effects are central to New Zealanders' wellbeing, as individuals, and together as a society.

We think the Tax Working Group's Background Paper is a clear, well-written piece that accurately summarises the features of New Zealand's tax system and the challenges it faces. We agree with the Government's objectives for the tax system and the criteria for evaluating tax reform as outlined in the Background Paper, though we would prioritise the objective of equal treatment of all forms of income and assets over the objective of system coherence. Indeed, we do not think that a tax system can be coherent if it treats different investments inconsistently. For the reasons outlined below, we would also put a premium on improving the vertical equity of the tax system, particularly given the dominance that capital ownership and investment has had over labour.

Our submission focuses primarily on what we consider to be the most significant failing of the tax system, and the largest impediment to achieving those objectives: the failure to tax wealth and the inconsistent tax treatments of different investments – in particular, the treatment of housing as compared with other investments. At a time when the nature of work is changing, and meaningful work is becoming increasingly harder to come by, this fundamentally advantages capital over labour. We have also responded to some of the Working Group's consultation questions in the appendix to this letter.

We echo the Working Group's view that, if New Zealand's broad-based, low-rate system was working well, there should be only minor (or no) differences in the tax treatment of different forms of investment. There should ideally be no difference in marginal effective tax rates between different types of investments. This ideal scenario is unfortunately a far cry from the reality of our tax system today, which does not treat wealth or housing the same way as it does other forms of income.

The marginal effective tax rate on owner-occupied equity in New Zealand is a fifth of the tax rate on investing in any business assets or long term savings vehicles. The tax rate on investing in rental properties is around half the rate of investing elsewhere. This combined with the ability to leverage the investment of equity in either one's own home or rental properties means there is just no contest. Our tax system effectively directs anyone with spare money to invest it in housing to make super-charged, tax-free capital gains. Indeed, as commentator Bernard Hickey points out, for such people to do otherwise would be economically irrational.

The effects of this unbalanced tax treatment have been well documented and are becoming more visible in New Zealand every day: rampant house-price inflation relative to wage growth; woeful productivity due to systematic underinvestment in everything except house purchasing and renovating; a record of poor savings and current account deficits with net foreign debt at over 55 percent of GDP; and increasing inequality and segregation of society into those with houses and those without houses. It is hard to overstate the seriousness of these effects. In practice, they manifest in the form of ever increasing numbers of people sleeping in cars; astronomical prices for poor quality housing; property managers auctioning off tenancies to the highest bidding tenants; and nurses, teachers, social workers, and other essential service employees being priced out of Auckland.

Worse yet, as housing entrenches itself as the main means of making it in New Zealand, and more and more people put what money they have in houses, the housing bubble inflates further, and the political pressure on the Government to <u>not</u> alter the current policy arrangements mounts. This perpetuates the negative effects mentioned above, and puts us in a worse position to respond to the future challenges the Working Group correctly identifies, including the increasing costs of caring for an aging population, falling company tax rates around the world, and the need to invest (and divest) in response to environmental challenges.

We are first home owners and we sympathise with those in our situation who fear the undesirable hypothetical of government intervention reducing the value of their houses to below the cost of their mortgage. However, we do not think this fear justifies total inaction in reviewing and revising the tax system, particularly given the increasing severity of the negative effects noted above. We applaud the Government's Kiwibuild supply-side response to New Zealand's housing crisis. However, we strongly consider that a demand-side response in the form of changes to the tax system is necessary to properly address the distorted incentives and negative effects noted above. In particular, we favour the adoption of a land tax or a comprehensive capital gains tax that operates on an accrual basis rather than on realisation. Without such a response, there is too much risk of Kiwibuild perpetuating the current one-dimensional approach to investment, despite the safeguards the Government would seek to put in place.

New Zealand is not alone in the world in facing the negative effects of untaxed wealth and capital gains. In what is perhaps the most comprehensive analysis of developed countries' economic data, Thomas Piketty forcefully demonstrates that the rate of capital return in these countries is persistently greater than the rate of economic growth. Piketty concludes that this will cause wealth inequality to increase. To confront this challenge, Piketty proposes redistribution through a progressive global tax on wealth. We see significant parallels in the negative effects of, and the most viable solution to, New Zealand's housing crisis.

Shamubeel Eaqub has said, "At its core, tax is about pooling our resources and redistributing, so that society is better off. Tax is love." We endorse that view, but we sympathise with those who have felt little but anger at the unjust nature of the current tax system. This is ultimately about the sort of society we want for New Zealand. In that respect, changing the tax system in a manner that helps address the negative effects discussed above, and equips New Zealand to deal with the impending challenges of the future, would make our society far better off.

Sincerely,

Jude and Helen Murdoch

Appendix - responses to consultation questions from *Future of Tax: Submissions Background Paper*

Chapter 3: Purposes and principles of a good tax system

How would you define ‘fairness’ in the context of the tax system? What would a fair tax system look like?

In principle, an effective tax system is one that meets the established criteria set out on page 19 of the Background Paper. For the reasons outlined in the body of our submission, we would actually put more weight on the criterion of ‘fairness and equity’ – in particular, the equal treatment of all forms of income and assets, and improving the vertical equity of our tax system – than the other criteria.

One practical aspect of a fair tax system would be its consistent marginal effective tax rates for different types of investments.

Chapter 4: The current New Zealand tax system

Should there be a greater role in the tax system for taxes that intentionally modify behaviour? If so, which behaviours and/or what type of taxes?

There may well be a greater role for taxes that intentionally modify behaviour, particularly in targeting environmental externalities. ‘Polluter pays proportionately’ can be a useful guiding principle in this regard. Care should be taken to ensure such taxes do not themselves entail other harmful externalities or unintended consequences. However, where there is a net benefit from such taxes, externalities and potential unforeseen consequences should not be treated as insurmountable hurdles. Instead, to the extent possible, externalities and consequences should be catered for in tax design and implementation.

Chapter 5: The results of the current tax system

Does the tax system strike the right balance between supporting the productive economy and the speculative economy? If it does not, what would need to change to achieve a better balance?

As outlined in the body of our submission, our tax system’s inconsistent treatment of capital as compared with other types of investment effectively directs anyone with spare money to speculate (unproductively) in housing and make super-charged, tax-free capital gains. For such people to do otherwise and invest their money in the productive economy would be economically irrational. In this respect, our tax system is entirely unbalanced in its favourable treatment of the speculative economy as compared with the productive economy.

Changing the tax system so that marginal effective tax rates are as consistent as possible across different types of investments would greatly assist in addressing this imbalance, and levelling the playing field for investment decisions.

Does the tax system do enough to maintain natural capital?

No. The *Living Standards Framework*'s recognition of natural capital is a positive step. However, alongside the alarming environmental statistics and indicators noted in the Background Paper, we note the OECD's findings from its latest assessment of New Zealand's environmental performance:

a) our nitrogen balance deteriorated more rapidly between 1998 and 2009 than any other OECD country, which poses a significant risk to freshwater resources that are already under pressure
b) we have one of the highest species extinction rates in the OECD
c) we are losing soil at around 10 times the average global rate
d) we have the highest number of cars per capita in the OECD.

For a resource-based economy, these statistics and indicators show that our policy arrangements, including our tax system, have not valued our natural capital enough. The tax system can and should be part of the answer to this state of affairs. In particular, the tax system can assist in aligning incentives and 'internalising' externalities: those that benefit from the environment and those that contribute to its degradation need to face the costs of doing so.

Chapter 6: Thinking outside the current system

What are the main inconsistencies in the current tax system? Which of these inconsistencies are most important to address?

As outlined in the body of our submission, our tax system substantially favours unproductive investment in (mostly) pre-existing capital, particularly housing, over other forms of more productive investment such as growing business and innovation. Resolving this situation is perhaps the most important policy matter before the Government.

Is there a case to consider the introduction of any new taxes that are not currently levied? Should any taxes be reduced if new taxes are introduced?

We favour whatever changes are necessary to bring our tax system into line with the established criteria noted in the Background Paper, and to address the negative effects discussed in the body of our submission. Provided such changes brought about consistent marginal effective tax rates across different types of investments, it would be appropriate to lower taxes on productive activities (such as income) to at least partially offset increased revenue from the other tax changes. The problems giving rise to the negative effects noted above are not about how much we tax, but about what we tax, and what we don't tax.

Chapter 7: Specific challenges

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?

As detailed in the body of our submission, the unbalanced tax treatment of housing (and wealth) compared to other forms of investment has substantially reduced housing affordability for owners and, consequently, renters. This in turn has resulted in the negative effects discussed in the body of our submission. There is clearly a case for reform to close this tax loophole and promote greater housing affordability. We favour whatever changes are necessary to bring our tax system into line with the established criteria noted in the Background Paper, and to address the negative effects discussed in the body of our submission.

Should New Zealand introduce a capital gains tax or a land tax (that excludes the family home)? If so, what features should it have?

We favour the adoption of a land tax or a comprehensive capital gains tax that operates on an accrual basis rather than on realisation.

We understand the political unpalatability of a tax on the family home. However, to exempt the family home would substantially miss the point, and not deal with the negative effects outlined in the body of our submission. The vast majority – some 60% – of those benefiting from the loophole at the heart of our unbalanced tax system are people that own their own homes. Exempting the family home would therefore deal with less than half of the problem.

Using an example to illustrate, if we saved to buy a house or simply had idle money in the bank, we would receive interest which itself would be taxed. We could spend the remainder of the income from the interest on whatever we chose, however, we would have paid income tax on the money we saved and tax on the interest those savings generated. However, if we had enough savings to buy a house, we would avoid the second of two taxes noted above. The savings we invested in the house would return us at least two significant benefits: firstly, a house to live in – imputed rent – and secondly, the untaxed capital gains if the house appreciated in value. No money changed hands, so no tax is paid. In aggregate, this seriously distorts how New Zealanders, including us, invest our savings.

A capital gains tax that included the family home would be a step in the right direction. However, such a tax would only capture an appreciation in the house price, while the owner's benefits from imputed rent would go untaxed.