Tax Working Group Public Submissions Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

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To Tax Working Group

The Past

The NZ economy lacks balance, since financial liberalisation in 1980 asset prices have increase far more than earnings. NZ has become a balance sheet economy; policy settings have generally encouraged speculation on assets as opposed to investment in productive activity.

The economy should not be thought of as a machine following strict rules with highly predictable outcomes. The economy is more like a garden, where things emerge based on the ongoing interactions between the components of the system. Stuff grows or fails in part due to the system settings and given the option people chase the best post tax returns.

If we observe undesirable outcomes in the economy, runaway asset prices relative to earnings for example, we either address the policy bias, or face the fact things are unlikely to change.

There are biases in any given set of policies. The policy aim should not be zero bias, but the set of economic outcomes we want to see. If asset prices outstrip increases in incomes, then what can be done to attenuate one and encourage the other. While some gains are taxed and other are not those parts of the system that can chose to bias payoffs to assets and away from earnings will do so. The outcomes of extant bias are clear to see throughout our economy.

Taking the example of the dairy farming model, it has regressed to the point where earnings largely cover living expenses and debt servicing. Profits are sublimated to capital gain. In fact, this is a self-reinforcing dependency, debt servicing costs balanced by the ability of the farm operational free cash flow to meet those costs essentially set asset price movements. Such a model, given financial deregulation, encourages debt expansion and focus on asset growth not income maximisation. The asset rich, cash poor, farming sector is a proverb.

Why is this? In terms of the garden analogy tax free capital gains push the system to inflate asset values, limited by the ability to debt service. Not every dairy farm in the system will operate in this way but in general the trend[1] is clear, low interest rates turbo charge this tendency.

In the same way, effective macroprudential controls[2] that existed prior to financial deregulation restrained debt growth on housing by directly linking debt to incomes, debt and income were connected by the lending practices based on income of the borrower. Without broader

[1] https://www.dairynz.co.nz/media/5787208/dairynz-economic-survey-2015-16.pdf
[2] Price (interest rates) are insufficient, debt to income and loan to value limits are required.

restraints the cost of borrowing is not sufficient to restrain asset prices, particularly when interest rates are low. Add in other system features that restrict new housing development, or any other sort of supply restriction, over the long run and the system settings generate a perfect storm of sustained asset price inflation.

So we have a system biased to inflating asset values where it can, with a high level debt to income (heavy balance sheet) debt servicing can blunt tax on earnings and pushes more value towards tax free asset value growth. On the other hand, what happens with low asset business, those that can generate millions of sales with assets of a few hundred thousand. For them the picture is very different, they generate profit and that it overloaded with the prevailing tax burden. No easy write offs here, business value is set by earnings not asset inflation, in fact borrowing is quite hard for such business as lenders can make "safe" returns lending to the asset rich sector, not banking "risky" cash flows. The structural problem here is that most of the new economy, tends to come with light balance sheets. As earnings carry too much of the tax burden, our economy is nudged away from activity; less activity leads to lower employment and a broad erosion of productivity.

International financing of inflating asset prices brings upward pressure on the New Zealand dollar, as does the general policy stance to defend asset prices at all cost. God forbid that real estate prices will fall. One way or another a secondary impact on the traded economy, which is far worse for those businesses where revenues are many times asset value (debt). The impact on exporters is clear: lower returns. The impact is ameliorated if you are operating a heavy balance sheet export business; you tend to care more about interest rates than you do exchange rates. The converse is true of light balance sheet, export dependent businesses, where trading returns not capital gains matter most.

The tax take required to pay for any sent of government polices is the starting point, ignoring the balance of policy from one government to the next. How the taxation policy spreads that burden is critical component in how the economy develops. The bias to debt and heavy balance sheets, supports such activity, at the same time those settings push back on business that must rely on healthy income statements.

Value develops quickly in light balance sheet businesses, most must rely on their ability to earn a living, many doing so from exports very early on in their growth, facing the headwinds of an overvalued currency and a disproportionate tax burden. Only very few can convince the markets that their future earnings will justify huge asset values today, despite income statement losses[3].

The outcome is predictable, over the past thirty or so years we have seen the simplification[4] of the New Zealand economy and a contraction in our earnings from intellectual property based elaborately transformed goods[5]. This tends to be self-reinforcing trend, it is hard for a simple economy to make complex things as complex things tend to rely on a related collection of expertise to give them life.

[3] Uber and Xero for example.
[4] http://atlas.cid.harvard.edu/
[5] http://www.johnwalley.co.nz/271-thirty_years_of_manufacturing_.aspx

Take the tax bias, add an overvalued currency to a small, isolated local market and the set of biases against value creating economy becomes almost insurmountable. The garden does not grow what the garden rules do not favour.

The Future

The world is changing quickly. The changing nature of work and more broadly economic activity is different this time round[6]. The industrial revolution replaced human power with machine power. There remained sufficient labour demand for people employed in for thinking and control of that machine power. Once machines supplant cognitive capabilities of people, what is left? The need for some creative talent but how much of that will be needed? Will it be sufficient, I would say not. Read the full thread on the GM v Google link[7]. Add in the impact of climate[8] change, and the world economy will be challenged.

For New Zealand the challenge is amplified as the laboratory[9] not the farm becomes the food producer; challenging all resource-based economies. Clean meat and dairy will be a hard act to counter.

These things will happen in the next decade or so – best be as ready as we can be.

Please, don't kick the can down the road again, grasp the nettle, you can help fix the tax bias threatening the future of the New Zealand economy. It is not going to be easy, there is always great pressure from vested interests chanting "there is no alternative"..

The current winners will be threatened by the change, but it must be done. Our national business model is under threat from: climate change, international light balance sheet enterprise, cheaper, healthier lab grown clean meat[10] and dairy products.

What we have now is not sustainable.

Do what you can to, set the vision for the future, show the changes needed over time so we see an evenly balanced tax burden across a better functioning economy.

Capital gains and income are spent in the same economy, the tax burden should be the same.

We can all hope it happens this time round, the longer we wait the harder it will be.

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[6] https://www.newscientist.com/article/mg23731710-300-the-inequality-delusion-why-weve-got-the-wealth-gap-all-wrong/

[7] http://www.grisanik.com/blog/who-did-better--gm-or-google-/

[8] https://www.westpac.co.nz/assets/Sustainability/Westpac-NZ-Climate-Change-Impact-Report.pdf

[9] https://www.newscientist.com/article/mg23331180-400-tomorrows-menu-termites-grass-and-synthetic-milk/

[10] https://www.cnbc.com/2018/03/23/bill-gates-and-richard-branson-bet-on-lab-grown-meat-startup.html
https://www.independent.co.uk/news/science/clean-meat-lab-grown-available-restaurants-2018-global-warming-greenhouse-emissions-a8236676.html

Questions for Submitters

- Future Environment

Technology change comes with its own threats and opportunities, healthier, cheaper and lower carbon footprint[11] lab grown meat[12], milk, vegetable substitutes will undercut traditional food production and resource-based economies. Digital technology undercuts service provision, job quantity and job location. Given that background any distortions in the tax system that weight towards capital intensive activity and away from income generating activity accelerate the trend to job loss and attenuated job creation.

If the tax base is earnt income and consumption, both are threatened by these trends. A fit for purpose tax system should not pick winners in any asset class. Figure 12 in the report tells its own story; small wonder housing / land has seen runaway inflation given the tax advantages and the essentially unrestrained availability of credit.

Advantaging one asset class, impoverishes the others. Unfortunately, the others tend to earn income from activity, create jobs and increase the velocity of money in the economy.

There are implications for currency stability, greater emphasis on the real economy, deemphasising capital speculation would lead to lower foreign borrowing taking pressure off currency and interest rates. If the economy is to earn more from export activity (as opposed to local untaxed capital gains) currency stability becomes a key enabler for investment decisions in export businesses, jobs, and earnings.

A financial transactions tax would put some sand in the gears of speculation around currency, better matching the speed of the financial system with the real economy. The NZ$ trades more in a single day that the annual total on bilateral trade in goods. Who does that serve? The real economy should not be hostage to finance, even low rates 0.25% are said to be effective in this regard[13]

Finally the global technology giants should be taxed on a revenue basis not in country income net of costs[14] debt loading of local subsidiaries can eliminate any net income. Revenue is easily measure and appropriate tax rate of around 10% of revenue[15].

- Purposes and Principles of a good tax system

Even handed treatment of all asset classes, be as broad as possible (yes include the family home and / or the land under it) all gains in the economy should all share the tax burden.

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[11]https://www.newscientist.com/article/mg23631463-800-grassfed-beef-is-bad-for-the-planet-and-causes-climate-change/
[12]https://thespinoff.co.nz/business/24-10-2017/synthetic-meats-are-on-their-way-and-our-farmers-are-going-to-be-left-behind/
[13] https://www.weforum.org/agenda/2017/05/why-we-need-a-financial-transaction-tax/
[14] https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper
[15] https://www.ft.com/content/9bd2c65a-17fb-11e8-9e9c-25c814761640

Anything less means those gains not so exempt carry a disproportionate tax load.

Get away from the idea that taxation is theft, and recognise taxation is the price we pay for the public goods we use or have the potential to access.

- Current New Zealand tax system

The NZ tax system could be boarder and consequently lower for those paying tax at the moment, the more even handed the lower the burden carried by each contributor. Fairness is a major contributor to compliance; the converse also applies.

Behavioural change targeted taxation has its attractions, but probably stirs up too much controversy, smoking – drinking – drugs – obesity (sugar) – risky activities, where to draw the line. Best to keep it simple and put real effort into telling the tax story and fairness driving tax compliance.

Simple, low and no exceptions, free people make their own decisions, that would include the removal of all incentives for any particular activity, regardless of how worthy it might seem.

The comparison of New Zealand GST with value added taxes elsewhere is a great example of effectiveness flowing from simplicity.

- Results of the current tax system

Far from supporting the real sector our current tax setting encourages speculation, places pressures on the exchange rate that combine to suppress the real sector. The problems do not all flow from the tax setting but those settings in combination with other macroeconomic policies damage the real sector.

The tax advantages of land and buildings coupled with the lack or macroprudential restrains on borrowing, principally debt to income limits, has seen asset value inflate at a many time the growth in incomes. Limited supply of real estate and an essentially unrestricted (absence of prudential control) supply of borrowing the rest is predictable.

The interaction of the tax system and other macroeconomic settings[16] are the core problem. The Dairy NZ Report below shows an average dairy farm ten-year growth in assets from $4.6m to $7.5m paying around income tax $35k a year through that decade. Behaviour follows the rules; value is capitalised, and income minimised. This builds the wrong focus in the investment.

A similar analysis could be written for rental housing, easy to fund (heavy balance sheet) negative gearing costs are deductible against other income and capital tax on realisation can be largely avoided.

[16] https://www.dairynz.co.nz/media/5787208/dairynz-economic-survey-2015-16.pdf

What we have is a balance sheet focused economy, income is avoided, income statement losses embraced, and capital is allocated inefficiently. Good for some but not a good outcome for the broad economy.

Overdoing farming or tourism erodes natural capital, with marginal business based in the natural world the desire to externalise costs is strong – not sure where the "polluter pays" discussion fits in a tax discussion but business should bear the full cost of "emissions" to properly align incentive. Performance suggests that is not the case at the moment.

Capital gains on business sales are more complex, growth in value generally flows from the income statement and investment in people and capital, is this different from real estate based gains – farms and houses.

A broad comparison of two types of business over a decade:

Asset Value		2008	2018
	Farm	$4.5m	$7.5m
	Software	$50k	$200k
Revenue			
	Farm	$1m`	$1m
	Software	$0.5m	$4.5m
Staff			
	Farm 2	2	
	Software	2	16
Tax Paid			
	Farm 35k	$35k	
	Software	$35k	$300k
Disposal Value			
	Farm	$4.5m	$7.5m (asset backing)
	Software	$1m	$7.5m (EBIT multiplier)

How would capital gains tax be calculate on disposal for these businesses? Would the Software business pay more CGT than the Farm? The Farm has value from asset price inflation (real estate / land value issue) there other from real increased value of the business. The software company has paid significant tax over the decade the Farm has paid less tax than the people employed in the business.

Should they be treated in the same way? Particularly when we need more businesses like software and farming is limited by environmental constraints and is under threat from laboratory innovation..

- Thinking Outside the System

As mentioned above a financial transaction tax and a no exceptions tax on capital gains broadens the tax base so all carry the lowest tax burden possible given any set of government spending objectives.

- Specific Challenges

The tax system has exacerbated housing affordability, aided by the broken connection between borrowing and income that came with the financial deregulation on the 1980s. There are significant incentives to invest in a potential tax-free gain and deduct rental losses from other income. Owner occupied housing has a similar attraction, the wealth effect form property value escalation enabling borrowings to sustain lifestyles paid for one day by tax free capital gain. That also comes with a worry about house prices falling and the attendant political pressure.

There is the political investment in the merits of the status quo, current winners will know their losses far better than the potential winners will know their gains. The political third rail of capital gains tax is clear, but change is vital to lower the tax burden on the real sector and return balance to our economy.

  - A capital gains tax on realisation as part of income, tax all capital gains including the family home.
  - Capital gains tax should not be in addition to existing taxes, existing taxes should be sublimated into a straightforward CGT system.
  - Tax should be paid once, if non-residents are taxed in their own country only a balancing local payment if the foreign rate is lower.
  - Capital losses should be ringfenced, applied against capital gains.
  - Roll over relief should apply.
  - Realisation triggers capital taxation.
  - Gifting is realisation so should trigger capital tax. Winnings should be subject to income tax.
  - Capital tax should be at the taxpayer's marginal rate.
  - No allowance for Inflation should be applied.
  - For simplicity a threshold should be used say the national mean house price?
  - The cleaner and simpler the CGT system the cleaner and simpler the administration.
  - Changes should be introduced with sufficient lead-time to enable tax payers to work with the changes.
  - Capital tax should be based on valuation at date of introduction.
  - Trusts should be inside the CGT net.
  - In some way CGT should target asset price inflation (real estate) not value increases from real revenue growth.

With a broad and effective capital gains tax, the that land taxes could be used to target asset price inflation at a higher rate that real capital gains.

Environmental taxation: polluter pays, all gases all emitters carbon taxes seem increasing necessary, however focus on one thing at once and get the CGT done before these other matters. Slightly longer term the technical changes to food production will have a major impact on land based production and carbon emission.

If there is a desire to support small companies, on what basis is small? Tax paid, asset employed, revenue. Don't supporting heavy balance sheet businesses. Back to the dairy farm example ~$7.5m in assets driving ~$1m is sales paying ~$35k in tax employing ~2.5 people, is that a small business? Software business ~$300k in assets driving ~$4.5m paying 300k employing 16 people, is that a small business?

The complications that come with GST exemptions should be avoided: always the same principles: low, broad and capital tax on asset price inflation, not value increases.