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Submission to the Tax Working Group

Taking a child-focused lens to tax

Prepared for
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Child Poverty Action Group (CPAG) is an independent charity working to eliminate child poverty in Aotearoa/ New Zealand through research, education and advocacy. CPAG believes that New Zealand's high rate of child poverty is not the result of economic necessity but is due to policy neglect and an ideological emphasis on flawed economic incentives. Through research, CPAG highlights the position of tens of thousands of New Zealand children, and promotes policies that address the underlying causes of the poverty they endure.

We would like the opportunity to present an oral submission.

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Introduction

Child Poverty Action Group (CPAG) agrees that the tax system is no longer fit for purpose. It does not fulfil the 1980s promise of broad base/low rate and no longer serves the needs of families well.

The new Government has promised to place child wellbeing at the heart of policy-making and **CPAG believes that such a focus is required in any reconsideration of tax policy.**

This submission takes a child-focused lens and submits that:

- **The taxation of housing** must be **radically** reformed to improve affordability and reverse the trends to growing wealth inequality. Housing-related poverty is a significant and growing cause of child poverty.
- **The interface between the tax/transfer system** has produced high and damaging effective marginal tax rates (EMTRs). The high work disincentives, that are inherent in the interface, act against the interests of the poorest children and their families.
- **The use of tax measures to influence behaviour** is a focus of the Tax Working Group It is therefore critical that they examine the role of the IWTC which has failed the poorest children miserably. CPAG also supports a well-designed tax on sugary drinks to improve child health.
- **The design of transfers** cannot be isolated from that of tax. Seeing the two issues in silos in the past decade has undermined child well-being.
- **The definition of income** in the tax/transfer system needs to be consistent and more generous for child-related tax credit;
- **IRD's latest simplification exercise** should be reviewed in light of the potential for it to cause harm to children.
- **Miscellaneous matters re progressivity should be addressed.** New Zealand's tax system has harsh impacts on poor families, with no income tax exemption and GST at a high rate on almost all goods and services.

CPAG's full list of recommendations is compiled on page 11 of this Submission.

Background to review

The Government-appointed Tax Working Group (TWG) has invited Submissions with detail set out in the Future of Tax submission background paper.

TWG will use Treasury's Living Standards Framework of four 'capital stocks' to broaden assessment of the impact of tax

- Financial and physical capital, such as roads, factories, and financial assets.
- Human capital, such as skills and knowledge.
- Social capital, such as trust, cultural achievements and community connections.
- Natural capital, such as soil and water.

CPAG argues that strengthening social capital also requires a well-being of children dimension.

The TWG has identified the main criteria that have been used in past tax reviews to assess tax reforms:

- Efficiency: minimise impediments to economic growth and avoid distortions (biases) to the use of resources.
- Equity and fairness: achieve fairness including through 'horizontal equity' (the same treatment for people in the same circumstances) and 'vertical equity' (higher tax obligations on those with greater economic capacity to pay).
- Procedural fairness is also important for a tax system.
- Revenue integrity: minimise opportunities for tax avoidance and arbitrage.
- Fiscal adequacy: raise sufficient revenue for the Government's requirements.
- Compliance and administration costs: minimise the costs of compliance and administration, and give taxpayers as much certainty as possible.
- Coherence: ensure that individual reform options make sense in the context of the entire tax system.

This submission will be based on the living standards framework with a child-focus, and the TWG chosen criteria.

The taxation of housing

New Zealand is in the grips of an extraordinary speculative housing bubble. Table 1 (see following page) shows how New Zealand's housing market became dangerously out of step in the 2000s. Using the Economist's interactive tool to show different aspects of this bubble, Table 2 shows the evolution of real price rises since 2000.

The inevitable divide between children who thrive and those who don't is now strikingly along housing lines. Good basic housing that is affordable is critical to child well-being.

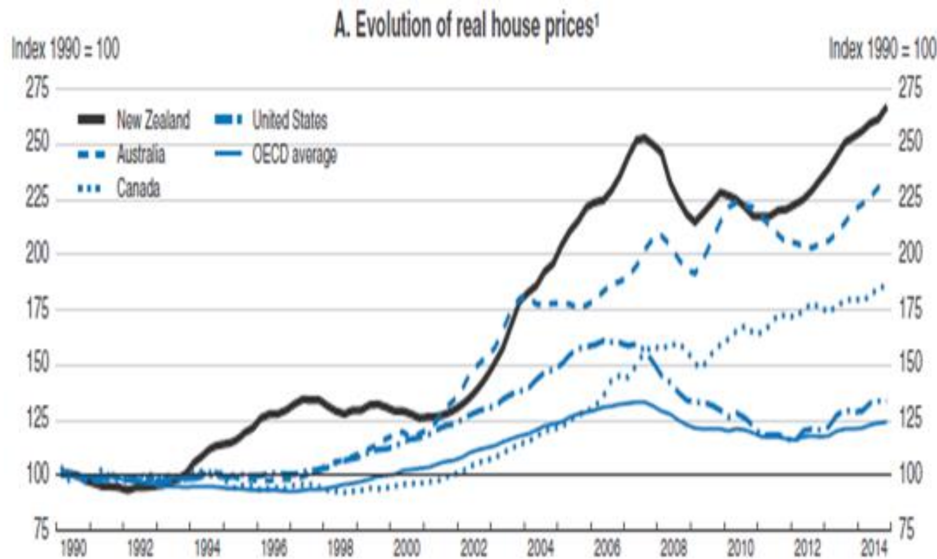
New Zealand has an ample supply of housing overall, but it is poorly distributed in terms of size and price. Increasingly large gains in house values are accruing for the already wealthy while the poorest households suffer excessive rents or lose housing access to housing altogether.

Taking the balance sheet approach required by a social capital lens suggests a grave deficit especially from the child's perceptive.

CPAG submits that the lack of a principled-based approach to the taxation of housing has been a prime driver of the now precipitous state of our housing market which has in turn perpetuated rising inequality and deep child poverty.

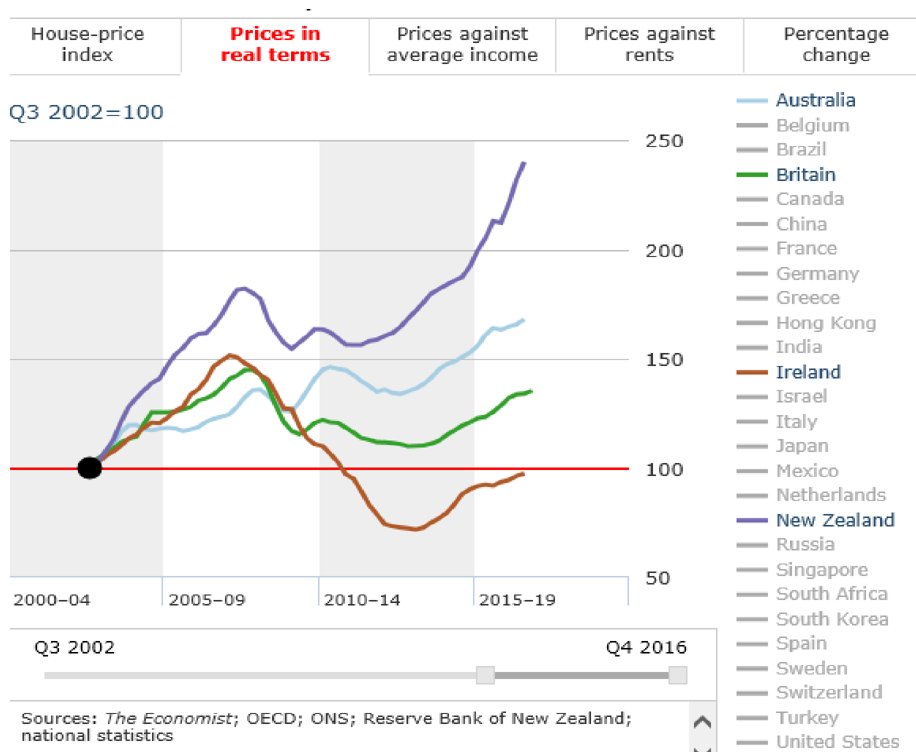
A suitable tax regime for taxing housing is suggested in this paper and is capable of generating enough income to allow for a significant shift away from the taxation of income overtime. This shift in the longer term is essential to begin to reduce the high tax rates faced by many working poor families.

Table 1 New Zealand's unsustainable housing bubble



(OECD 2015)

Table 2 The Economist (2017) House Price Index



Why not a capital gains tax?

CPAG does not believe it is appropriate, now, at the height of the boom, to solve the under-taxation of housing with a broad capital gains tax (CGT). Even if a CGT was agreed, it will be years before it is implemented and then affect only capital gains from the date of its introduction. There will be countless arguments over how to measure capital gains, but it is likely to apply only to realised gains giving rise to the lock-in effect. In the meantime, the wealth accumulation of the wealthiest households continues exponentially, and the accruing income is untaxed apart from easy-to-avoid bright line rules around truly speculative property investment.

In the past CPAG has argued in several forums[1] for a radical shift in the taxation of all housing based on a net equity approach along the lines of that discussed in the 2001 McLeod Tax review (Risk-Free Rate Method - RRFM) [2]. More recently the Morgan Foundation have proposed a version of this net equity approach.[3]

CPAG argues that while the RFRM was rejected by the Government under Michael Cullen in 2001, there remain good reasons to revisit the idea. There may be a higher degree of political and public acceptability for such an approach now because of the widespread concern over intergenerational housing equity issues. There are numerous ways to do such a tax. It is suggested here that it applies to housing as an asset class rather than more broadly to include other assets such as shares and commercial property.

The accumulation of untaxed property income offends all the TWG's criteria. Of these, offence against horizontal equity, vertical equity and intergenerational equity are obvious. In addition, fast-growing untaxed capital gains have grossly distorted economic signals, large untaxed gains redirect resources away from other more productive investments into speculative activity. Housing, once considered a basic need, is now prioritised as an income-generating asset over other forms of saving and investment.

If this imbalance is not addressed, child poverty in New Zealand may not only persist, but increase. This in turn will further undermine the efficiency of the economy and social stability.

CPAG suggests that the five-year 'bright line' test should still be used to capture short-term gains, but is not enough on its own. Under the net equity (RFRM) approach, landlords will no longer be subsidised through tax concessions to invest for capital gains, and some may withdraw from this market. While that leaves more houses for genuine first home buyers, a price correction is not to be avoided if the biggest housing bubble in the western world is to be contained. The best to hope for is gradual adjustment, not a precipitous fall such as experienced in Ireland after their strong bubble 10 years ago.

Currently landlords can deduct costs including full nominal mortgage interest costs against other income for tax purposes.

The present Government's proposal to ring fence-losses from rental property investment is a very partial and inadequate response. Losses from one property are still able to be offset against others that make profits, or carried forward and written off eventually.

Under the net equity approach any incentive for landlords and property investors to engage in intricate tax avoidance is removed. Moreover, as past capital gains are captured in the net equity base as they accrue with each new valuation, the wealth gap may narrow at last rather than continue to grow exponentially.

The present Government has taken the owner-occupied home off the Tax Working Group's table. The danger is that elaborate owner-occupied housing becomes even more attractive as a result. It would be better to allow a generous exemption for a home, say up to say $1 million net equity per person but to still include owner-occupied housing in the tax net. That

[1] See for example: St John, S and Johnson A, Hit housing bubble through tax NZ Herald, August 12th 2016, St John, S The huge white elephant landlord in the tax living room, Daily blog 3 April,2018,and St John, Landlords save your crocodile tears, Newsroom,19 April 2918.

[2] See The Issues paper 2001 for discussion of the risk free rate of return method (RFRM).

[3] Gareth Morgan's new party policy reiterates call for tax on equity

way very high value owner-occupied mansions will be included but modest homes fall outside this net.[4]

Recommendation:

- **The Government should set up an expert group to design a net equity housing tax.**

The interface issues of the tax/transfer system

Tax reform since the 1980s has shifted high EMTRs from high income earners to low and middle-income earners, and especially to working families. A more universal approach to transfers reduces this EMTR problem but requires a more progressive income tax schedule.

Piecemeal policy making has recently worsened the already high and damaging EMTRs. This issue cannot be ignored when tax efficiency is considered. The high work disincentives inherent in the interface act against the interest of the poorest children in working families.[5]

Cumulative abatements

When extra income is earned, tax is levied, but there may be other consequences that further reduce disposable income from earning that extra income.

Overlapping tax and abatements arise from six main sources

1. Tax (rate paid at 17.50-33% + ACC)
2. Accommodation Supplement (abatement at 25%)
3. WFF (abatement at 25%)
4. Student loans (repayment at 12%)
5. Best Start (abatement at 20.8%)
6. Child support (levied at 18-30%)

These sources compound to form a high effective marginal tax rate (EMTR) which can affect low income working families over very long income ranges. From a joint family income of $42,700 when WFF starts to abate, it is possible for these EMTRs to be well over 80%. The income range is greatest for larger families who have more WFF to abate.

Families might not be able to do the sums, but they know that the extra effort they put into earning more is just not worth it. They are caught out by income that is too low if they don't increase their work hours and by clawbacks if they do.[6]

Tax thresholds

Increasing the tax thresholds for low-income earners could be tabled by the Tax Working Group. Working parents who earn over the $48,000 threshold face a big jump from a tax rate of 17.5% to one of 30%. A reduced abatement rate for Working for Families tax credits to

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[4] For some older people in large homes with little cash flow this may seem unfair, but the tax liability could accrue against the eventual sale/transfer of the property

[5]St John, S (2017) "Tax and family assistance" in Progressive thinking: Ten perspectives on tax, eds R Thomas and K Windelov, PSA, Wellington, May 22nd 2017

[6] See for example St John, S (2017) What would you do Prime Minister English? Daily Blog March 19,2017.

20% (currently set to rise from 22.5% to 25% on July 1, 2018) would help but not fully compensate without other changes.

The fiscal cost of increasing the $48,000 tax bracket to, for example, $52,000 has a ballpark cost of $560 million[7]. Unless this cost is recouped by higher tax rates on high income earners, CPAG thinks on balance the problem is best addressed by reforming the overlapping abatements.

Recommendations:

CPAG recommends a MUCH higher profile be given to these effects by the TWG. Ameliorative policies include **that the Government should:**

- **Shift housing assistance progressively out of AS into WFF;**
- **Undertake a comprehensive overhaul of the student loans system and immediately raise the threshold for student loan repayment to a much higher level e.g. over $50,000, and progressively write off debt;**
- **Add Best Start to WFF;**
- **Reduce the abatement rate of WFF to 20% (as still the case in Australia); and**
- **Review the child support formula.**

The use of tax measures to influence behaviour

The In-Work Tax Credit (IWTC)

Changing behaviour is a focus of the TWG and therefore it is critical that they examine the role of the IWTC. This very expensive tax credit has social objectives. The question must be asked by the TWG whether it has achieved those objectives and what are the unintended consequences.

CPAG has written extensively about this here. Also see Progressive universalisation of Working for Families a background paper prepared for CPAG (March 2018)

The IWTC has two objectives: incentivising work, and reducing child poverty. Treasury's evaluation suggested that the overall effect on work effort was negative[8]. While the IWTC was an effective anti-poverty tool for families who qualified for it, the Ministry of Social Development has claimed repeatedly that it had no effect on the child poverty in workless families[9]. Its role and design must therefore be reviewed by the TWG as it has failed to incentivise work effort and, has failed to reduce the poverty of the poorest children.

Support for consideration of a tax on sugary drinks ('health levy')

The teeth of far too many low-income children in New Zealand are in a very poor condition. Dental health is important for overall child health and too much sugar, especially in drinks, is

[7] Based on Treasury's estimates of the revenue-effects-small-tax-rate-and-tax-base-changes/. This calculation does not pretend to be more than ball park figure but it indicates that changes to the tax structure are expensive.

[8] Mercante and P. Mok(2014) Working for Families changes: The effect on labour supply in New Zealand NZ (WP 14/18), NZ Treasury

[9] See Ministry of Social Development. Household Incomes Reports since 2007. The latest is here

implicated in childhood obesity. This issue goes to the heart of policy to promote healthier eating, reduce processed food, and reduce sugar on the diet.

CPAG believes that if there is a case for tobacco and alcohol taxes, there is also a sound case for a tax on sugary drinks. While we have some concerns about the regressivity of a sugar tax, families who currently spend most on sugary drinks also have the most to gain by reducing their consumption. A well-designed tax or 'health levy' can also change producer behaviour. The recently introduced graduated tax on sugary drinks in the UK has already resulted in most producers reducing the sugar content of drinks in order to keep the price down.[10]

The **Appendix** contains some further points from Professor Toni Ashton for CPAG.

Recommendations:

- **The Government should review the purpose and design of the IWTC; and**
- **Consider a graduated tax ('health levy') on sugary drinks**

The design of transfers

Transfers should not be isolated from that of tax considerations. They are opposite sides to the same coin. Seeing them in silos in the past decade has undermined child well-being.

CPAG is aware that the Government intends transfers including WFF to be examined by the Welfare Working Group (WWG) and so is not further explored here. In the CPAG submission to the WWG it will be argued, among other things, that the income exemption for abatement of benefits needs to be at least doubled and benefits individualised.

Recommendation:

- **The Government should integrate the work of TWG with that of the WWG.**

The definition of income

The definition of income in the tax/transfer system needs to be consistent. This too is an issue for the WWG and so is not discussed in detail here.

Principles of equity and efficiency suggest that income from all sources should be treated the same. The PIE regime acts to reinforce income and wealth disparities and must be reformed.

> *"Along with the non-taxation of particular capital gains, there are other exceptions to New Zealand's general tax neutrality across different types of savings - some small concessions for retirement savings have been introduced in recent years with the*

[10] https://www.economist.com/news/britain/21739992-those-cheaper-low-sugar-offerings-stand-benefit-ditch-sugar-or-raise-prices

establishment of Portfolio Investment Entities (PIEs) and KiwiSaver, both in 2007" (TWG, 2018)

Income for WFF purposes is widely defined - see: http://www.ird.govt.nz/income-tax-individual/income-adjust/intro/iit-adjust-income.html.

For example. PIE income that is in funds that are not locked in are treated as income for WFF purposes. CPAG believes that if PIE income can be counted for WFF purposes, it should also be imputed as gross income with a deduction for PIE already paid. This will remove the benefit of the top PIE rate of 28% that goes only to those on 33% and improve equity, progressivity, efficiency and revenue.

Recommendation:

- **The Government should be consistent in definitions of income in tax and transfer systems; and**
- **Remove the advantage of the top PIE rate.**

IRD's latest simplification exercise

CPAG is alarmed that none of the objections to the IRD tax simplification project have been formally addressed. CPAG's submission: Making Tax Simpler Better Administration of Social Policy: Working for families (WFF) suggests there are many issues that must be reviewed in light of the potential of harm to children.

Real time adjustments of family income for WFF purposes may not be as helpful as IRD think. The caregivers' income for the children can fluctuate widely. Data matching with MSD around such issues as relationships without adequate appeal procedures in place are not in the interests of children.

Recommendations:

- **The Government should address the potential harms to families from data sharing and real-time adjustment of Working for Families; and**
- **Improve appeal processes.**

Miscellaneous matters regarding progressivity, etc.

CPAG acknowledges there are wider issues than can be canvassed in the time for this submission. The inability of the TWG to address the design issues of WFF is a major limitation.

New Zealand's tax system has a harsh impact on the poor, with no income tax exemption and GST at a high rate (15%) on virtually everything.

More progressivity

Over and above taxing income from assets such as housing to widen the tax base, the tax scale could be made more progressive. Increasing tax rates at the top end of the personal income tax spectrum and/or having a more progressive system of personal tax thresholds

could be used to compensate low-income earners who pay a disproportionate amount of their incomes in income tax, GST, fuel and other excise taxes.

However CPAG does anticipate this as a likely outcome of the TWG deliberations. A progressive scale like in Australia is too big jump for NZ at least in the short term. Nevertheless the tax structure, especially with such a comprehensive high rate of GST is far less progressive than desirable.

CPAG does not support *GST exemptions* for certain goods and services as a way to help low income families, but believes that a GST of 15% is far too high when it is applied so comprehensively. CPAG suggests that the TWG could usefully remind the public that low-income families must have a well-supported transfer system including WFF and other tax credits to offset the regressivity of GST and of the income tax scale itself. Negative talk about WFF - such as that it is a subsidy to employers - is not helpful.

Secondary tax

Many low-income workers who have more than one part-time job contributing to the household income are concerned that secondary tax unfairly reduces their disposable income. However, secondary tax is important to ensure protection against an end of financial year tax bill. Two part-time jobs may effectively push part of the annual income over a tax threshold, which could mean that PAYE, if paid at the same rate for both (or several) jobs would not be sufficient to cover the tax due. By paying a higher rate of tax for second and subsequent jobs, a tax refund would be the likely outcome at the end of the year instead of a bill. Deborah Russell's example here demonstrates.

Nevertheless, a high marginal tax at the point of earning the money acts as a work disincentive and is perceived negatively by those affected. The provisions already exist for those affected to be given a special tax code. Making this option more of a default option so secondary tax payers have a more appropriate marginal tax rate would be helpful.

Recommendations:

- **The Government should shift from taxing incomes to taxing wealth over time to reduce low income tax rates and improve thresholds;**
- **Improve understanding of the need for well supported and generous child tax credits; and**
- **Improve operation of secondary tax.**

Summary: a child-focussed approach

CPAG urges that a child-focused lens be applied to all the TWG deliberations. This will highlight the need for the radical reform of the taxation of housing and a reduction in wealth inequality. An individual on a given income has a higher ability to pay tax than one with children. Tax credits for children can promote horizontal equity, at least for low and middle income families. A child focus should raise the profile of tax credits that are the key mechanism by which the presence of children are acknowledged in the tax system.

Full list of recommendations:

The Government should:

- **Set up an expert group to design a net equity housing tax.**
- **Shift housing assistance progressively out of AS into WFF.**
- **Undertake a comprehensive overhaul of the student loans system and immediately raise the threshold for student loan repayment to a much higher level e.g. over $50,000, and progressively write off debt.**
- **Add Best Start to WFF.**
- **Reduce the abatement rate of WFF to 20% (as still the case in Australia).**
- **Review the child support formula.**
- **Review the purpose and design of the IWTC.**
- **Consider a graduated tax on sugary drinks.**
- **Integrate work of TWG (taxes) with that of the WWG (transfers).**
- **Be consistent in definitions of income in tax and transfer systems.**
- **Remove the advantage of the top PIE rate.**
- **Address the potential harms to families from data sharing and real-time adjustment of Working for Families.**
- **Improve appeal processes.**
- **Shift from taxing incomes to taxing wealth over time to reduce low income tax rates and improve low income tax thresholds.**
- **Improve understanding of the need for well supported and generous child tax credits.**
- **Improve operation of secondary tax.**

Appendix 1

BOX Brief notes on a tax on sugary drinks

Benefits of a tax on sugary drinks:

1. Reduces consumption of sugary drinks
2. Improves oral health, reduces obesity and other non-communicable diseases
3. Encourages producers to reduce sugar content if tax based on sugar content
4. Increases government revenue, some of which can be used to fund supporting health promotion campaigns.
5. Reinforces public health messages that the product is unhealthy or of low nutritional quality
6. Corrects for externalities, including the economic burden and social costs of obesity and poor oral health.

Desirable features

1. Introduce as part of a comprehensive strategy for improving oral health (and reducing obesity)
2. Clearly communicate the health goals of the tax
3. Characteristics:

    i. tax on beverage volume or sugar content
    ii. tax a broad range of sugary drinks
    iii. set an adequate tax rate
4. Invest some revenue in comprehensive health promotion campaign targeted towards high users which supports a switch to healthier alternatives.
5. Ensure other healthy beverages (including tap water, bottled water) are more affordable than sugary drinks
6. Monitor enforcement and the health impact over time to make any necessary adjustments

What about regressivity?

1. Consumption is elastic. Studies show that children, adolescents, low-income populations, overweight individuals and high consumers are generally more sensitive to price increases.
2. Sugary drinks provide little or no nutritional benefit: money can be spent on more nutritional food.
3. Poorer households face higher levels of health risk factors and so stand to benefit more from shifting consumption away from sugary drinks.
4. Any regressive nature of a tax could be further offset by using the revenue gained from to provide health-promotion programmes targeted to low-income groups.

Toni Ashton 11 April 2018

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