Tax Working Group Public Submissions Information Release

Release Document

February 2019

taxworkingroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

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

Tax working Group: Interim report.

Concerns in relation to the tentative direction of the TWG in relation to capital gains tax.

- Section 6, para. 20 Identifies the lock in effect and economic efficiency costs in terms of the role a CGT may have in constraining (distorting) savings and investment.
- Evidence that economic growth is not affected in any observable sense by the incidence or rate of CGT seems to place the theoretical burden on those linking CGT (or CGT rate increases) to costs in terms of savings, investment and lock in[1].
- In terms of qualifying Section 6, para. 20, I submit the following:
- The lock in effect is overstated. It appears to have negligible implications. If it sets demand for marginally sub-optimal investments at a level higher than a frictionless, non-distortionary market would support, it might be expected to herd *new* investment into those higher risk, higher marginal return investments, and mitigating growth implications. Further, evidence of the lock-in effect is substantially US based. As the US re-sets the asset price of inherited capital to the fair value at the point of inheritance, this substantially aggravates the lock-in effect. Moreover, the US system historically has been quite unstable, subject to numerous rule and rate changes. This further elevates the likelihood of lock-in under certain conditions. It seems more compelling as evidence for system stability, rather than against CGT *simpliciter*.
- Savings and investment: The theoretical link between CGT and the rate of CGT and investment must, presumably, have economic growth implications if it is to be presented as a substantial objection to the implementation of a CGT. As empirical evidence strongly supports the position that no such economic growth implications have been observed, we have to conclude that either a. other contributions to aggregate demand are uniformly supportive of economic growth or, more plausibly, a CGT has no implications for savings and investment. It is no less plausible that reduced investment returns will compel the taxpayer to save and invest more, to achieve a given level of future income. As the bog standard neo-classicalist runs the story, CGT reduces returns, reducing incentives to save, reducing investing, reducing capital accumulation, reducing productivity, reducing growth in salaries and wages. It has been such an intuitively compelling, 'obviously logical' argument that it is generally considered common sense. Importantly, it presupposes that the current net saver will, under a CGT, proceed to consume more currently, being satisfied with less future income, so not only do they save less, they get a lesser return on what they do save, and all to consume more than their already satisfactory (saving out of unallocated

[1] Leonard Burman and David White "Taxing Capital gains in New Zealand: Assessment and Recommendations" A Paper prepared for the Tax Working Group 2009; K. Drum, "High capital gains taxes might be actively good for the economy" 2012, http://www.motherjones.com/kevin-drum/2012/09/higher-capital-gains-taxes-might-be-actively-good-for-the-economy/, makes the case that capital gains incomes are increasing as a share of national income and, as an entrenched development since 2000, taxes must fall where the incomes falls; A. Long "Capital gains tax and its effect on investment" 2014 College of St Benedict Saint Johns University. Celebrating scholarship and creativity day, *Paper 26*, https://digitalcommons.csbju.edu/elce_cscday/26, 2014; Thomas L Hungerford "Taxes and the economy: Analysis of the top tax rates since 1945", *Congressional Research Service,* September 14, 2012.

income) level of consumption. This runs counter to central theoretical tenants regarding economic agents inclination to smooth their income.

In response to tentative proposals, please note the following concerns:

- The problems associated with the RFRM method have been raised but not fully expounded. I am not going to detail those identified already except to observe that the lower indicated necessity for accurate valuation in relation to this method is not clearly argued for. Surely, the RFRM method would effectively tax the largest part of an asset's value, assuming relatively stable asset prices but how does this translate into a benefit in terms of administrative or compliance costs? Equally, it is not clear how this lesser need would manifest practically. Would the asset-owning taxpayer be allowed to interpolate valuation changes, for example, 5 yearly valuations? It is not clear that the impost on valuation accuracy under RFRM is any lesser than, for example under an actual accruals' based system.
- Secondly, in light of the weight given in the Interim Report to economic efficiency effects, it seems likely that the uncritical acceptance of those efficiency concerns may have played too great a role in determining the RFRM preference. Beyond this, it makes the case for CGT *per se* less singularly sound than it actually is. I think the TWG should be more explicit in subsequent reports in stating that the overwhelming weight of equity and efficiency considerations lend their support to the taxation of capital gains.
- Thirdly, RFRM does not tax all income. It is unclear why the tax system should tax other than the capital gain. Conceptually, this is equivalent to taxing labour income at the level of the minimum wage, allowing that incremental human capital acquisition should go untaxed. In this sense, it seems the TWG has been too sensitive to revenue volatility in relation to variable revenue flows over the business cycle. It would be considerably more practical to impose some prudential requirement on government to use CGT receipts counter-cyclically so that they could operate as an automatic stabiliser. The argument that the RFRM would deliver the same 'risk-adjusted return' as actual capital gains is not correct. This only arises if risk is viewed narrowly as volatility. Over extended periods, risky assets have higher yields. Allowing that the government will, *de facto*, have an extensively diversified portfolio of risky assets (in the taxpayer base), idiosyncratic risk is substantially mitigated. Only if we define the differential returns as the 'rent' associated with risk, do we achieve an equality. That is just one measure of risk. It really is the risk of a trader.
- On the basis of these concerns it seems a realisation basis, based on actual values, is optimal. The risk free return method ignores a great portion of the capital gain, and provides two competing forces, one that prefers relatively lower risk income generating assets and one which favours very risky, high potential return assets. It's not clear what the net effect will be of these competing incentives.