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Feedback on the Tax Working Group's Interim report

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1. Introduction

CPAG submitted to the TWG on selected topics, see here. This brief note comments on 5 main aspects of the TWG interim report.

1. We note that despite the intention of Government to place child wellbeing at the heart of policy making this focus is not evident in the tax working group report. We would urge the TWG to try to do this in the final report.
2. We are pleased that the TWG acknowledges the importance of Working for Families in achieving progressivity in a flattish income tax and comprehensive GST regime. However, we see no evidence that the WEAG are doing a thorough review of WFF and this vital mechanism for more progressivity is in danger of falling through the cracks. We think that very least the IWTC should be examined by the TWG as it is a tax instrument that is supposed to affect behavioural change (work incentive) and it has a major cost of around \$600m.
3. **The interface issues of the tax/transfer system** have produced 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 interests of the poorest children and their families.

We asked that taxes and transfers be viewed together along with issues such as the definition of income. The TWG has passed such matters to the WEAP. In the case of the IWTC we argued that " it is critical that the TWG examine the role of

the IWTC. This tax credit has social objectives that have failed the poorest children miserably.”

If the TWG are looking for a mechanism to meaningfully redistribute about \$0.5 billion joining the IWTC with the Family tax credit is cost effective as it is confined to the worst off without having negative EMTR effects.

4. We submitted that

The taxation of housing must be radically reformed to reverse the trends to growing wealth inequality, to moderate house prices, and improve affordability. Such reform is urgently required for child well-being as housing related poverty is a significant and growing cause of child poverty.

The TWG interim report has not given any sense that it is grappling with the widening of the wealth divide or measures to address the housing crisis. The accumulated tax-free gains in property have compounded over many years to greatly enrich wealthy property owners, but a CGT on future capital gains will not touch this. Moreover, even if a workable CGT could be devised, and that is highly debateable, it might come in just as capital losses are experienced and with the ability to pass losses forward not generate revenue for many years.

We urge the TWG not to regard the RFRM as some kind of strawman counterweight to a CGT, but **a serious option** that has the potential to begin to constrain and even reverse the wealth divide.

Specific comments:

We think a better name for the RFRM is the net equity (NE) tax. The principle is to treat all income from capital the same. This means treating net equity as if it had been invested on a bank deposit. Rather than a RFR which is very low- the rate should be bank deposit rate say around 4%.

The net equity (NE) approach would not replace bright line and trader tests for those making short term gains.

Para 15, p 32 states

The lack of a general tax on realised capital gains is likely to be one of the biggest reasons for horizontal inequities in the tax system. People with the same amount of income are being taxed at different rates depending on the source of the income.

We submitted that the omission of imputed rent and negative gearing allowing rental losses are greater causes of inequity. CGT is NOT the 'most feasible' way to make the system more progressive.

Para 20 states

The ability to bring capital expenditure – such as black hole expenditure or building depreciation - into the tax base if the equivalent income became taxed. This would improve the neutrality of the tax system.

The NE approach is a much simpler way- there would be no depreciation expenses to be deducted or other expenses

Para 27

the Group's view is that tax has not played a large role in the current state of New Zealand's housing market, and will be unlikely to play a large role in fixing it.

We disagree. There is a need for dramatic redistribution from the top 20% of wealth owners and without a serious tax on housing it is hard to see what other techniques can be used. CGT may not generate much revenue at all especially if housing prices cool or fall.

Para 28 states

If the Government ultimately does seek to increase the taxation of the residential property sector in whatever form, rents should be monitored. The Group's view is that the Government could consider using some of the revenue to mitigate the impact on renters (increased accommodation supplements for low income earners for example).

There is a huge limitation to using this highly tested income and asset tested tool. The NE approach may see more properties rented instead of lying idle as the owners sit back and wait for capital gains. It will reduce the incentive for negative gearing.

As noted by the TWG implementing a comprehensive CGT in NZ will have large administrative and other costs. These include an expansion of demand for tax lawyers and accountants. We hope that there are estimates of these costs including individual's costs in the final report.

Para 37 is very confusing

There are two ways of taxing capital income that have similar economic effects. Those two ways are taxing the full economic income from an asset, including revenue flows but also accruing capital gains. The alternative is not to tax the revenue or any gain but to tax instead an imputed risk-free return. This alternative is the essence of the risk-free return method of taxation. However, we note that whereas taxing full economic income taxes economic rents, the risk-free return method does not.

We disagree. These are not equivalent approaches. The revenue from NE continues in times of capital losses, even if the base is shrinking. The gains from CGT are entirely dependent on there being capital gains. The NE approach says that a person's NE should be treated as if invested in a bank deposit.

Paras 38-42 are difficult to follow

Para 42 states

Although the risk-free return tax appears to generate less revenue on average than taxing realised gains, the cost of the two streams to taxpayers, and the benefit to Government, will therefore be similar in risk-adjusted terms. Whether capital gains or losses will be realised over a future period is dependent on many factors: a shortage of land supply and low interest rates have produced increasing land values over recent years; economic shocks have also led to significant losses in share values in the past.

The comparisons can't be made like this- it depends on the tax rates used other rules and on whether capital gains are actually made.

Para 46 states:

Under a targeted approach, gains on some assets would be brought into the tax net on the basis that they are relatively easy to tax, and that including these assets will go a substantial way towards addressing the challenges we currently face

We agree and believe that a NE approach can be introduced for residential property as a starting point. This helps focus on the major problem which is the wealth divide and role of housing. The family home needs to be included with an exemption of maybe \$1 m per person so that the bulk of people with one home are not affected by the NE. The NE also does not affect young families whose mortgages are high therefore NE low, but does begin to redress the generational imbalance where older owners may have multiple mortgage free properties.

Paras 53-76 outline the true complexities of a CGT. In contrast NE overcomes the problems of; point in time valuation at the start of GCT, non-realisation of capital gains, lock-in, eliminates the need to determine what is capital enhancing expenditure compared what is repairs/depreciation of fittings and furniture, treatment of capital losses. Any owner of NZ residential real estate would be taxed on NE just as they have to pay rates

There are only 3 pages devoted to RFRM.

Para 77-95

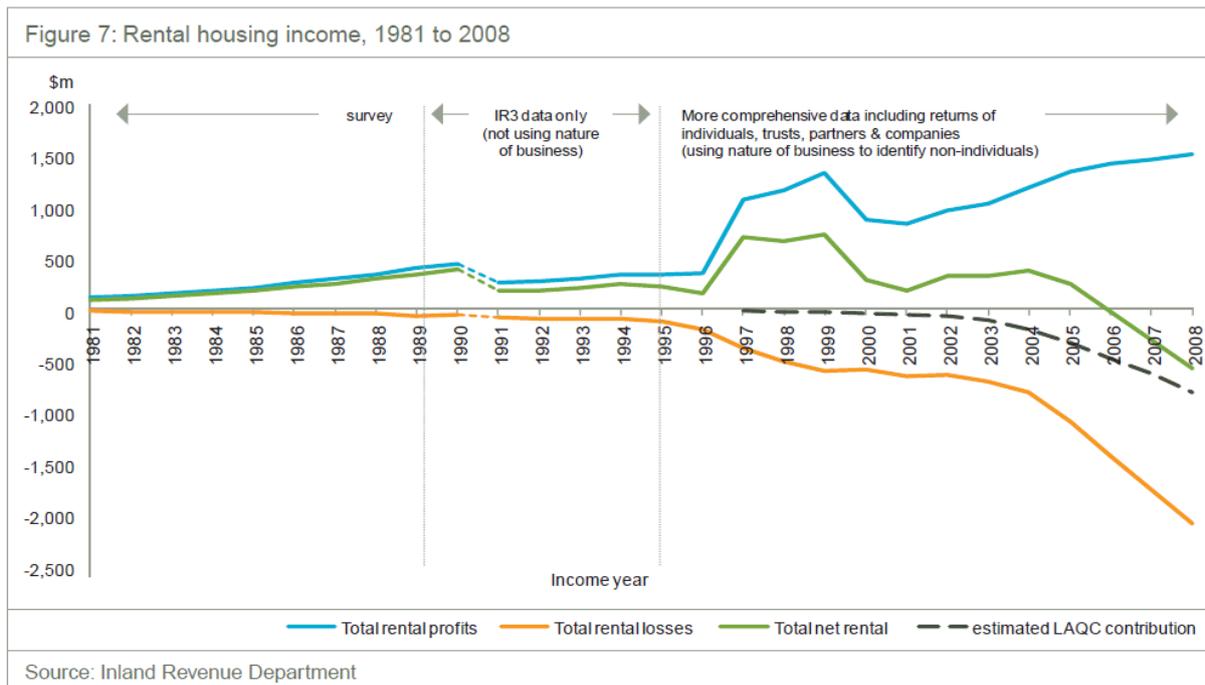
Para 86 says

The Group will consider the potential for a risk-free return method tax on residential property other than a principal residence, such as second homes and baches. However, similar disadvantages to those described above would also apply (annual market values and measuring net equity, albeit to a lesser extent). Further, residential property not producing any income (second homes, baches) would not generate cash flow to meet the annual tax liability.

It is hard to see how valuation would be a problem as CVs are readily available and updated. Too bad if there is no cash flow—it helps to encourage renting of those places and/or their disposal adding to the supply of houses. There is probably much tax avoided currently in AirB&B situations.

The NE tax could be wrapped up into a sum paid on realisation or death. We argue that bold moves are needed to begin to reverse the serious wealth gap in housing and the under-taxation of the past

It is to be hoped that the TWG will do justice for the NE approach and consider its introduction at least for residential housing. The final report needs to show how much revenue is foregone currently in the rental sector as landowners deduct full interest costs of borrowing (update the figure from TWG 2010 as shown below)



5. We also questioned the IRD’s latest simplification exercise and suggested that it

“should 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.”

We hope that the final report addresses this issue.

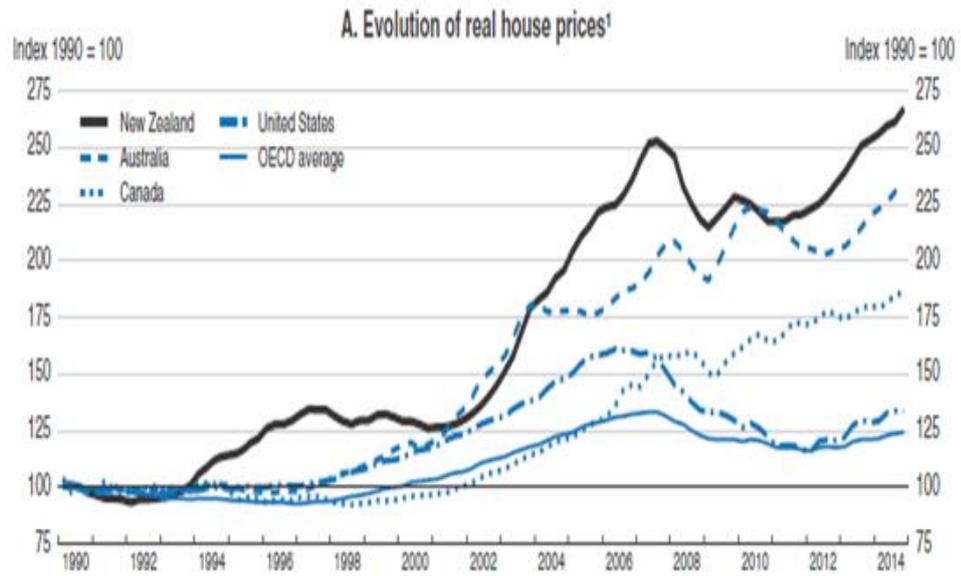
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Table 1 New Zealand's unsustainable housing bubble



(OECD 2015)

Table 2 The Economist (2017) House Price Index