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The Capital tax debate is hotting up: Time to check out the Fair Economic Return

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One of the intractable issues regarding intergenerational equity is the taxation of income from capital. In collaboration with tax and accounting expert Terry Baucher[2], PIE has been involved in producing an approach to the untaxed accumulation of capital gains in housing that would yield immediate and significant revenue to address the many pressing problems New Zealand faces. Fair Economic Return is tailored to the individual with a suggested net equity exemption of $1 million per person so that only the top echelon of property owners would pay significant extra tax. The majority of home-owners are not affected. Details of FER have been set out in the following publications:

- The Fair Economic Return: Restoring equity to the social fabric of New Zealand. RPRC working paper 2021-1 30th June.
- The housing crisis, taxation policy: restoring equity to the social fabric of New Zealand Wednesday, Auckland University of Technology, 28th April 2021.
- The Fair Economic Return Revisited. PIE Policy Report 2022-2:
- Presentation at the housing affordability conference, EPC 9th Sept Auckland Business School, power point presentation, ppts FER 9th Sept
- NZ's housing-market drives-inequality why not just tax houses like any other income. The Conversation, 21st June 2023, also Stuff, interest.co. Republished in : A year of consequence—Essays that got the world talking, 2023 The Conversation, editors Grattan, M and Bergman J, Thames and Hudson, Australia
- Susan St John on taxing wealth – Bryan Bruce Investigates Head to head Episode 17 – or watch SusanStJohnIV2.mp4
- Fair Economic Return rather than a Capital Gains Tax, interest.co.nz, 2nd Oct 2024
- Fair Economic Return v Land Tax, PIE Policy report 2024-1

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The Capital tax debate is hotting up: Time to check out the Fair Economic Return[3]

When Terry Baucher and I wrote the first draft of our latest paper: Fair Economic Return (FER) v Land Tax, we assumed that after a 30 year plus history of bitter political squabbling, Capital Gains Tax (CGT) was permanently off the table. We saw FER and Land tax as the only two remaining contenders that were capable in the near future, of raising regular and significant annual revenue to meet our nation's very real challenges.

Let's take a step back in time. In the late 1980s, New Zealand adopted a radical broad-base low-rate approach to tax. Our tax system was lauded for years as one of the most neutral and efficient in the OECD. Today, we are no longer this poster child because the broad-base low-rate requires all income to be taxed, and we have failed to include most capital gains especially in housing. In fairness to Roger Douglas, that was his original intention. In 1990, Labour produced a solid blueprint for a comprehensive capital gains tax that included even the family home (with a modest exemption). By not implementing this plan, and then, losing the election, Labour paved the way for subsequent tax reviews to go the same way.

Thus the latest one, the 2019 Tax Working Group (TWG) Report, illustrates the pattern. The detailed design of their proposed Capital Gains Tax included land, including improvements to land (other than the family home), shares (but not portfolio investment entities (PIEs) including KiwiSaver), intangible property, and business assets. The voluminous report and background papers illustrate the vast complexities of such a tax.

This comprehensive CGT was famously rejected by PM Jacinda Ardern in 2019. Then in 2023 Labour's new leader, Chris Hipkins made the Captain's call to abandon a proposed wealth tax prior to the budget. Clearly there would be no CGT or wealth tax on Labour's watch. By 2024 National was in charge and CGT seemed truly dead and buried.

Oh how things can change. While the Coalition government is adamantly opposed to any form of CGT and Businesses are also unimpressed as they see enormous compliance and deadweight losses, Labour is now discussing CGT, wealth and a capital income tax. The Inland Revenue (IR) is asking whether New Zealand needs new types of tax, such as on capital gains and land and will invite public consultation on a new insights paper. The CEO of ANZ argues for CGT on the grounds of fairness. Max Rashbrooke writes for Spinoff claiming there are two main contenders: a capital gains tax (CGT) and a wealth tax. The voices supporting a CGT grow louder. So even after all we have been through, CGT is well and truly back on the table.

Tiresomely, once again, we will revisit what the CGT should include: is it all capital gains or just those in housing? Issues such as the valuation process and date of start, realisation or accrual, whether the family home should be excluded, how to define a family home, concessions and exemptions, how to tax when a sale is made, over what time period, inflation adjustments, what costs of capital spending on the asset to allow will take years to resolve.

As Rashbrooke says, even if we could get a CGT up and running it would take a long time for it to yield meaningful income. He also sees issues of fairness because the tax applies only on sale of the asset.

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[3] Republished from Interest.co.nz Fair Economic Return rather than a Capital Gains Tax, 2nd Oct 2024

Wealth taxes get their revenues from the wealthiest 1%. Under a CGT, by contrast, that 1% can afford not to sell their assets, and can then pass them on tax-free to their children. (To avoid that problem, a CGT would have to be buttressed, further down the line, with an inheritance tax.)

My prediction that once the details of a comprehensive CGT are exposed there will be far less public and political support. If National is re-elected, once again CGT will not see the light of day.

Of the many tax reviews I have followed since the 1980s, the one that made the most impression on me as an economist, teaching public economics and tax for over 30 years, was the 2001 Tax review under Robert McLeod. The issues paper and final report are elegantly argued within a clearly principled economics framework. Here is their important conclusion, important because 25 years later nothing has changed:

We do not consider that New Zealand should adopt a general realisations-based capital gains tax. We do not believe that such a tax would make our tax system fairer and more efficient, nor do we believe that it would lower tax avoidance or raise substantial revenue that could be used to reduce rates. Instead, such a tax would increase the complexity and costs of our system.

Using the accepted principles of tax (e.g. equity, efficiency and administrative simplicity) what did the McLeod review think should happen instead? Initially they favoured the Risk-Free Return Method to tax the net equity component of owner-occupied and rental houses. The argument is that if you have money invested in housing you must be expecting a return above what you get in a low risk bond or term deposit. The imputed return should be taxable income. But sadly, they concluded:

… that approach met with such widespread opposition that no government is likely to implement it in the near future. Unfortunately, no more viable way of making this aspect of the tax system fairer and less distortionary has been identified.

In the 2019 review discussed above, three members abstained from the comprehensive CGT recommendation. A limited form of the RFRM was favoured by the prominent tax lawyer Robin Oliver, Joanne Hodge and Kirk Hope see Minority Report of Tax Working Group, p3

…We agree that there is a strong case for extending the extent to which New Zealand taxes what are now untaxed capital gains. However, we consider that the costs of extending the tax rules in a comprehensive manner, as proposed in the Group's Final Report, would outweigh the benefits. This is a judgment call and we recognise that it is possible to reach differing views when trading off revenue, fairness, integrity, efficiency, and compliance and administrative costs impacts. In our view a comprehensive approach would impose efficiency, compliance and administrative costs that would not be outweighed by the increased revenue, fairness perceptions, and possible integrity benefits of the broader approach.

In our view the case for taxing more gains from residential rental property is clearest. This is based on advice from officials that the taxable income from such properties is low when compared with total economic returns. Comparing taxable income returned from this asset class with a rate representing a risk-free return applied to the same asset class indicates owners are relying on tax-free gains to complement their taxable returns from that investment. …. If gains from residential property are to be more fully taxed, then this could be done with some modifications by extending current rules, including the bright-line tests…

Alternatively, we consider that a simpler option could be to apply the risk-free return method, or something similar, to residential housing... Extending the tax base in this more limited way would generate much of the revenue expected from the comprehensive capital gains tax contained in Volume II. Officials estimate that some 39% of the total revenue from a capital gains tax would be from residential houses over a 10 year time period time.

In Jan 2021, Craig Elliffe, Professor of Tax Law and Policy, University of Auckland said encouragingly

My view is that pulling the tax lever is worth considering again. Susan St John has rightly raised the logic of using the Risk-Free Return Method (RFRM) as a sensible alternative. The Government's Tax Working Group in 2018/2019 carefully considered RFRM as an alternative to a comprehensive capital gains tax. Papers prepared for the Tax Working Group discussion in October 2018 disclosed that at a risk-free return rate of 3.5 per cent the estimated revenue from introducing an RFRM (in addition to the existing rules such as the bright-line provisions) would be approximately $1 billion in year one. After 10 years, by 2031, this would increase to $2 billion a year. Some landlords would pay less tax (if they had meagre interest costs and high rental returns), but there would be extra deemed income across the sector.

Elliffe noted "*numerous attractions include comparative ease of calculation and certainty of income stream for the government*."

If we can put CGT back on the table, surely we can put this RFRM idea back on the table and investigate it properly. This is what Terry Baucher and I have attempted in a series of articles that reinvent the RFRM for the 2020s. We call it the Fair Economic Return (FER).

We start by being very clear about what problem we are addressing. Untaxed accumulated capital gains in real estate have intensified the wealth divide, creating enormous chasms between the top and bottom of the wealth distribution. Far too many scarce land and building resources are sucked into high-end housing and are not available for more productive uses. Basic housing is scarce and unaffordable. The outcome is socially divisive and economically corrosive with a two-tiered society of increasing poverty and misery at one end and obscene luxury at the other.

The market mechanism or 'invisible hand' beloved of neoliberals is paralysed. Consumption by the top tier of society is fuelled by compounding untaxed capital gains, unconstrained by price. They can buy whatever they like and they can appropriate the low cost labour of others to provide their excessive consumption. The bottom end of town faces all the rigours of free market competition. For them every cent counts for the basics of life. They pay the price for fighting inflation with low wages, job insecurity, and horrendous rent rises.

But if the wealth divide is the problem, a CGT can't solve it. A CGT can apply to only future capital gains and cannot reduce the wealth gap. If the family home is exempt, and CGT applies only on realisation, little revenue will ensue, especially in the short term. Yes, a CGT might be better than doing nothing, but times call for a new more radical approach. Our three main papers on FER are listed here

- The Fair Economic Return: Restoring equity to the social fabric of New Zealand. RPRC working paper 2021-1 30th June.
- The Fair Economic Return Revisited. PIE Policy Report 2022-2:
- Fair Economic Return v Land Tax, PIE Policy report 2024-1