Tax Reform in 2010

Keith Rankin, Unitec, 20 January 2010

The Government needs to be very careful before rushing into a number of tax reforms that have been signalled by the Victoria University Tax Working Group, and by many media commentators.

The first issue to note is that reductions in personal income tax rates for 2010 and 2011 were legislated for in December 2008 following commitments made to voters before the 2008 general election. These tax cuts were "postponed" in the 2009 Budget. Thus, the government's first obligation is to deliver on its election promise before considering any alternative that targets the top few percent of income recipients.

The principal source of inequity and inefficiency contained in National's 2008 tax package surrounds the Independent Earner Tax Credit, and how it was withheld from persons earning under $24,000 per year. Ironing out this wrinkle – not a technically difficult task – is the second priority for income tax. Reducing the top personal tax rate to below 37 percent is, at best, the third priority.

The principal issues the Tax Working Group have addressed are those around investment in housing – generally seen as an area of overinvestment in New Zealand in the 2000s – and those relating to New Zealand's international competitiveness as a producer and exporter.

There are some who believe that housing in general – ie including the "family home" – represents a huge tax loophole that needs to be closed so that much more of our savings is invested in ways that raise competitiveness and productivity. More politically-savvy commentators recognised that the family home is sacrosanct, and that housing taxes should therefore be targeted at "investors" (commonly used as a euphemism for speculators who treat housing essentially as a financial asset like shares).

The devil here is in the detail. For many people it makes sense to rent out the family home – ie the only home they own – while renting the home they live in. Indeed this practice should be encouraged because it is economically efficient.

A family with children will often need to live in a larger home than they can afford to buy. So it makes sense to buy a smaller family home to rent out in the meantime, with a plan to move in once the children become independent.

If you own a family home in say Papakura and get offered employment in say Takapuna, it would make good economic sense to rent out the family home, and to rent a place to live that enables you to avoid a long and stressful commute. Or if your family home is out of the Auckland region and you move to Auckland for employment, it makes good sense to hold on to the family home – renting it out – while renting in Auckland.

Where a family only owns one home, tax deductions for expenses such as mortgage interest should be the same whether or not the family is currently living in that home. Further, only the difference between rent received and rent paid should be classed as taxable income. For most of the situations I have noted, rent paid will significantly exceed rent received, so tax should not be payable.

Another consideration, noted in the report, is the general impact that any additional taxes on housing might have on the rental market. Just as a rise in rates is an increased cost to landlords that will raise the market price of rental housing, so is a rise in taxes faced by landlords. Rising rents can be expected to have a considerable impact on lower-income households, and will likely increase rates of poverty and homelessness. Further, Government would have to pay back much of the revenue received as Accommodation Supplements.

A final point to note is that there is huge pressure from certain business circles to cut company taxes – and therefore, for "consistency", top personal rates – as a way of making New Zealand goods cheaper on world markets. It's similar to the argument that competitiveness will improve with lower wages and other reductions in labour costs.

When countries or companies competitively reduce their costs in this way – actually they externalise costs by passing them onto others – it is sometimes known as "the race to the bottom". The way countries competed in the 1920s was a classic "race to the bottom" and the result was the worst global crisis capitalism has ever known; the Great Depression.

Tax reform is like walking on broken glass. Tread very warily.

=================