Hon David PARKER
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Labour

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Jean-Pierre de Raad
Chief Executive
NZ Institute of Economic Research (Inc)
P O Box 3479
Wellington 6140

Dear Jean-Pierre

NZIER report for Federated Farmers on Labour's Capital Gains Tax policy

I am writing to raise with you some concerns about the accuracy of a report that John Stephenson from your organisation has produced on our Capital Gains Tax (CGT) policy.

This June 2014 report is being used today as another attack on CGT, this time by Federated Farmers. There is a serious error in your report.

I had been aware from an August 15 2014 story in the *Bay of Plenty Times* that Federated Farmers had contracted NZIER to analyse the overall implications of a capital gains tax, water resource rental and Emission Trading Scheme for the farming sector.

TVNZ has now approached us for comment on the CGT report, and specifically the claim that the costings undertaken for us by Business and Economic Research Limited (BERL) significantly overestimated the revenue.

Mr Stephenson uses a very basic set of calculations about Australia's CGT revenue to suggest that the revenue estimates from BERL's detailed modelling are more than twice as high as the likely actual revenue.

Leaving aside the appropriateness of using a 'back of an envelope' approach like this to try to undermine the work of NZIER's professional colleagues, the Australian comparison used by Mr Stephenson is fundamentally flawed.

Mr Stephenson scales the Australian CGT revenue to New Zealand's GDP after adjusting for differences in the CGT rate, which he assumes is the main difference between Labour's proposed CGT and the Australian CGT.

The serious error made is that this downward scaling is based on comparing his estimate of the average Australian rate (25%) with our proposed 15% flat rate. Unfortunately, this is not comparing like with like.

A well-known feature of Australia's CGT is that, like some other jurisdictions, it has what is known in the literature as a 50% "inclusion rate" for its CGT. See e.g. https://www.ato.gov.au/General/Capital-gains-tax/:

> *Individuals and small businesses can generally discount a capital gain by 50% if they hold the asset for more than one year*

By contrast, we are proposing a relatively low flat rate with a 100% inclusion rate.

This error about the design of the Australian CGT impacts significantly on Mr Stephenson's revenue estimate and explains much of the differential between his figure and BERL's. (There is also a range of other differences between our CGT and the Australian one.)

I should note that there are a range of other flaws in the report:

- It claims the CGT is not worthwhile if is not used for further tax reductions. You would surely concede that debt repayment is also important. You should also be aware that our expenditure on R+D tax credits and accelerated depreciation (both tax reductions for businesses) total more than our CGT revenue in early years. Moreover, we have signalled possible tax cuts at end of second term once debt is paid down and CGT revenues grow.
- It makes the argument that CGT must be 'perfect' and include a family home – few if any countries in the world do this (a fact that the report is vague about).
- It claims we 'already have a CGT' – that is not correct; income tax on trading is paid but as you know, few rental property or farm sales are taxed on this basis.
- It claims CGT will make no difference to housing speculation – this conclusion is not credible and contradicts Westpac's finding that the Net Present Value of the next rental housing purchase is reduced by 23% under CGT . The Australian experience is also illustrative: before they had a CGT excluding the family home, Australia's home ownership rate was lower than New Zealand's. Now it is higher and ours is at a 60-year low.
- It has some basic facts about our CGT design wrong – the report claims farms do not qualify for the small business exemption which is incorrect.
- It makes a number of theoretical assertions, which, given the prevalence of realisation-based CGT (excluding family home) around the world, it should be able to back up with empirical evidence - but the report does not.
- It claims the CGT would not be progressive – this assertion is wrong, and contradicts other highly-regarded experts on CGT - e.g. Professor Len Burman of US in 2009 said that was the big loophole in our tax system. The OECD and the IMF have said similar things. We know from other countries that have a CGT, that those on the highest incomes will pay the most. In Australia, those earning more than $180,000 paid 60% of the CGT. In Canada and the United States the top 1% of taxpayers generated approximately 60% of the CGT. A current CGT rate of 0% compared to tax paid on wages, salaries and bank deposits is of course very regressive.

The BERL analysis has been publicly available for three years, as has the modelling and analysis done for the Tax Working Group by the Treasury. Your report makes no reference to the higher estimate of revenue by the Treasury (BERL specifically revised down some of Treasury's assumptions in doing its own modelling).

I am raising this issue privately with you in the first instance, as NZIER may wish to consider whether it wishes to stand behind the claims in this report about the fiscal credibility of BERL's work. You may prefer to revisit these claims before the report is formally released.

Given the claims made in this report about their 2011 work for us, we have also sent a copy of the report to BERL (under the embargo).

We await your urgent confirmation that you accept that a significant error has been made. Our understanding is that Federated Farmers, using your report, is due to criticise our CGT this evening, so we would appreciate your response as soon as possible.

Yours sincerely

Hon David Parker
Labour Deputy Leader and Finance Spokesperson