The State Of New Zealand's Tax System: Group Think Is Exacerbating Our Problems

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A commentary on fairness in the
New Zealand tax system

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About this report

This report is one in a series prepared for Ann Pettifor's visit to New Zealand in September 2016. The reports provide background information on challenges facing the New Zealand economy and society, and are available on The Policy Observatory website.

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The state of New Zealand's tax system: Group think is exacerbating our problems

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The New Zealand tax system is largely robust. It taxes most forms of income and consumption at rates that are by and large perceived as fair. The overall tax take sits at about 30% of GDP, a rate that compares well with other OECD nations. Most people pay their taxes, mostly on time. That's an indicator that there is a high degree of trust in the tax system and in government in general.

This relatively benign assessment of the tax system is the one promulgated by Inland Revenue Department, most recently in its 2014 Briefing to the Income Minister of Revenue, prepared just before the most recent general election. Similar views have been expressed in Briefings for a number of years: while there are on-going challenges to the tax system, there is no imperative need for change, other than to maintain a coherent tax system in a changing world.

Tax professionals also hold similar views about the tax system. They regard it as robust and sensible. More than that, they work actively with Inland Revenue Department to maintain the system. While on occasion individual tax professionals may lobby for particular needs for their clients, for the most part they confine their lobbying to ensuring that the tax system gets it right, where 'right' is taken to mean measuring income and expenditure properly, and ensuring that all the parts of the tax system fit together well to form a coherent whole. This author has witnessed this in person as a tax policy analyst, seeing tax professionals offer constructive solutions to particular problems in the tax system which civil servants took up and eventually took through the legislative process, and seeing civil servants persuade tax professionals that the arguments they were espousing could not be sustained.

There are of course matters on which the people imposing taxation, and the people being taxed, disagree profoundly. But by and large, most people working in taxation aim to get the system right.

There are nevertheless some ongoing issues with the tax system. There is no capital gains tax, the system favours housing as an investment, and there are some occasional arbitrary concessionary tax policies.

Unlike most other countries in the world, New Zealand does not have a thorough going capital gains tax. If a taxpayer buys an asset and holds it long term, then she or he is unlikely to ever pay tax on any gain in value. There are some limited circumstances in which capital gains can be taxed: if a person is engaged in the business of buying and selling assets, then any gains are taxed under the standard income tax scale; if a person buys an asset with the intention of resale, then gains are assessable income; if a person buys a residential rental property and then sells it again within two years of purchase, any gain is assessable income. Various land sales and purchases are also caught in the income tax net. But by and large, if someone buys a asset and holds onto it, then they will not be caught by income tax.

The cost to the New Zealand government of not having a capital gains tax is considerable: in 2010, the Victoria University Tax Working Group estimated that a thorough going capital gains tax would raise $10 billion of government revenue each year when mature, and a capital gains tax excluding the family home would raise about $4 billion. New Zealand's tax take is currently about $73 billion, so even a capital gains tax excluding the family home would raise significantly more government revenue.

Raising more government revenue could in itself be a good reason for introducing a capital gains tax. However a better reason might lie in fairness.

There are comparatively few concessions in the New Zealand tax regime. Virtually all income is taxed, at rates that are more-or-less consistent across different types of business entities and forms of incomes. This is seen as an expression of horizontal fairness: people who earn the same amount of income are taxed at about the same rates, no matter what the source of their income is. But capital income is excluded. Income that is earned quickly, like salary and wages, is taxed, but income that is earned slowly, like capital gains on a house, is not. The failure to tax capital gains is a significant offence against horizontal fairness.

Most people also think that those who earn higher incomes and are wealthier should make a greater contribution to the nation's revenue. This is an idea that goes back to Adam Smith in *The Wealth of Nations* (1776):

"The subject of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue they respectively enjoy under the protection of the state."

This is usually associated with a progressive tax system: people who earn more pay a higher proportion of their "extra" income in tax. In New Zealand, this is manifested in our tax scale, where there are a number of tax brackets, and people earning over $70,000 pay 33% tax on income over that level. This is regarded as an example of vertical fairness.

People who make capital gains are usually wealthier people. They are the people who have inherited wealth, or who have higher incomes so they have been able to set some money aside, or who have enjoyed fortunate life circumstances. Less well off people, or poor people, tend to live from pay day to pay day. In New Zealand, we tax every penny that less well off people earn, but we do not tax the capital gains enjoyed by wealthier people who have the wealth to buy assets. As well as offending against horizontal fairness, the lack of a capital gains tax offends against vertical fairness. Having no capital gains tax is a significant flaw in New Zealand's tax system.

There are other concessions in the tax system. The tax rate on Portfolio Investment Entities, or PIES, is set at 28% which is lower than the top tax rate of 33%. Write down rates for bloodstock are set at faster rates than is justified by their income earning life. Cash income earned by children is not taxed. And so on. Until recently, foreigners could use New Zealand "foreign trusts" to hide assets and income from their own taxation authorities. Most of these concessions are minor, and they come about for reasons of operational or political pragmatism. They are comparatively few, especially in comparison to other OECD nations.

One major "concession" however, is not a concession at all. It is simply the working out of the principles of the tax system. All income (barring capital gains) that an individual earns is added together and then taxed in total. So if a person earns say, $50,000 from their salary, and $20,000 from a rental property, then that person would pay tax on $70,000 of income. However, if that person makes a loss on her or his rental property, then they can set that loss off against their other income. So if they earned $50,000 from their salary, but made a loss of $20,000 on their rental property, then they would offset the loss from the rental property against their salary, and pay tax only on a net income of $30,000. The tax saving is substantial. In effect, because the person pays less tax overall, other taxpayers end up subsidising their investment in a rental property.

The practice is called "negative gearing", and many tax regimes do not allow it. In some cases, the loss is simply a loss, and the investor must bear it alone. In others, the loss can be carried forward and offset against any profits earned in the future from the same activity. The effect is to ensure that the investor genuinely thinks that the investment will be profitable. However the New Zealand tax system allows full negative gearing.

Perhaps negative gearing would not be such a problem if New Zealand had a capital gains tax. The investor would carry the short term losses in the expectation that in the longer term, she or he would make a capital gain to offset the losses. The tax authority could sustain the tax concession from the short term losses, knowing that in the longer term, they would be recouped against a tax on capital gains.

However New Zealand both allows negative gearing, and does not tax capital gains. The effect is to offer a tax subsidy for investment, and then to offer a tax concession as well when the investment is realised. It is a double gain for those who have the wherewithal to invest in property in the first place.

This double subsidy has a particular edge in New Zealand at present. House prices, especially in Auckland, have been rising to extraordinary levels, and it is reasonably clear that they are driven at least in part by the preferential tax treatment given to property investors. Rents are rising too, and the effect is to make it very hard for middle and low income earners to find homes. Many of the people who are critical to our contemporary society, such as teachers, police officers and firefighters, are being shut out of affordable homes.

From a market point of view, there is no problem. The distortionary influences from the tax system are relatively modest and do not prevent the market from setting a price for housing. House prices and housing affordability are not a market failure: they are simply the result of markets working as markets do.

The lack of affordable housing is however, a significant social failure. And our tax system is aiding in that failure. The lack of a capital gains tax and the permissive approach to negative gearing are adding to the conditions that create the social failure.

What this suggests is that the collegial focus of tax officials and tax professionals on getting the system right may be mistaken. New Zealand's tax regime in itself may be internally perfect, it may be coherent, and it may exemplify a good tax system. It is not clear however, that for all its perfection, it is serving the broader New Zealand economy and society well.

The collegial agreement of tax professionals and tax officials is nowhere more obvious than in the rejection of a capital gains tax. It seems to be a generally accepted view that there should be no capital gains tax in New Zealand. Successive Briefings to the Incoming Minister have cautioned against capital gains taxes, and the 2010 Victoria University Tax Working Group, staffed by academics and tax professionals and public servants, explicitly rejected introducing one.

Perhaps some new ideas are needed within professional firms, and within the public service, to break down the cosy group think that seems to be in force. Although the common understanding and commitment to getting tax right has worked very effectively for New Zealand, especially with respect to minimising tax concessions and maximising the coherence of the tax system, it seems clear that at least in respect of taxation of housing, it is now creating wider problems.

More than that, we need to recast the tax system as a tool of the economy, and a tool that serves New Zealand more broadly. A coherent tax system with high integrity is very desirable, and it is something we should strive for. But more broadly than that, we should strive to meet New Zealand's social goals. The tax system should be a tool for achieving those goals, rather than an end in itself, to be admired for its purity.

About The Author

Deborah Russell is a lecturer in taxation at Massey University, Palmerston North, New Zealand. She holds degrees in political philosophy, and accountancy, a combination which led her to working as a tax policy analyst, as well as lecturing in philosophy, politics, business ethics and taxation. Deborah has written opinion pieces on feminism, social policy and taxation for national newspapers, and she appears regularly as a commentator on political and tax issues on radio and television. She stood as the Labour candidate for Rangitikei in the 2014 general election. She is currently working on a book on taxation and fairness in New Zealand.

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