A fairer tax system for Aotearoa New Zealand

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Overview

Ref: *CTU Monthly Economic Bulletins,* February 2019 (“What the Tax Working Group did and didn’t do”) and September 2018 (“New Zealand’s tax system: weak at reducing inequality”) at http://www.union.org.nz/category/economic-bulletin/

- The Tax Working Group
- The problem of high and continuing inequality
- Some less reported recommendations
  - *Environmental*
  - *Business taxes*
  - *Savings*
  - *Personal income tax*
  - *Understanding high wealth and income*
  - *Stopping cheating*
- Taxing the income from capital gains: “joining the modern world, tax-wise”
- Concluding remarks

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The Tax Working Group

- Set up by Government as result of Election
- Chaired by Michael Cullen, 10 other members:
  - *6 tax experts (accountants, lawyers, academic, consultant)*
  - *CE of Business NZ, Māori business woman, Ecological economist, me*
- Terms of reference
  - *"to examine further improvements in the structure, fairness and balance of the tax system"*
  - *"The following are **outside the scope** of the Working Group's review:*
    - Increasing any income tax rate or the rate of GST
    - Inheritance tax
    - Any other changes that would apply to the taxation of the family home or the land under it, and
    - The adequacy of the personal tax system and its interaction with the transfer system"
- Secretariat from Treasury and IRD, Independent Expert Advisor (Andrea Black)
- Reported back on 1 February 2019 after a year of deliberations, including two rounds of consultation
- https://taxworkinggroup.govt.nz

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Role of the tax system

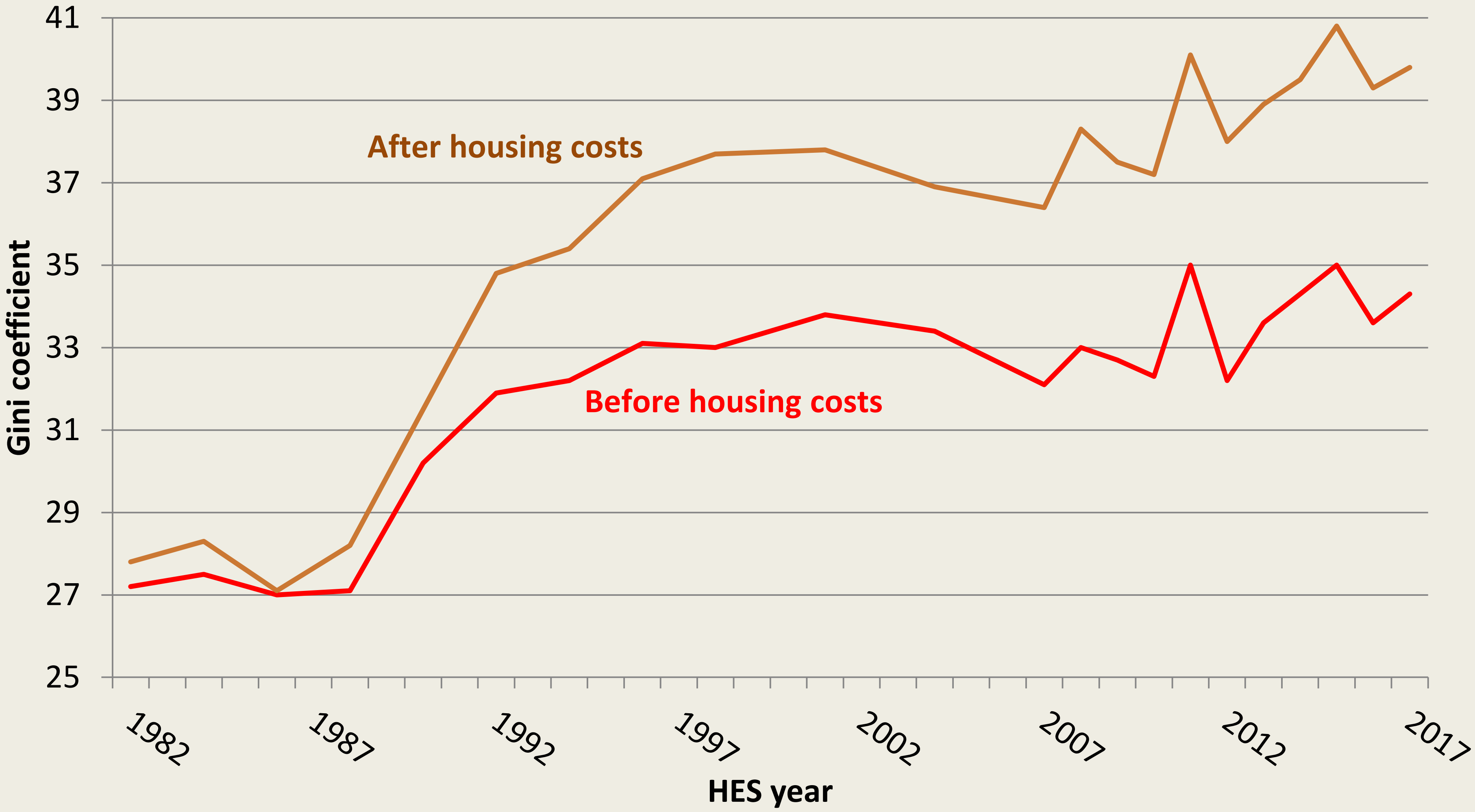
There are three main ways the tax system supports the wellbeing of New Zealanders:

- fair and efficient source of revenue
  - *Tax is the way we as a society share our resources to look after each other and our common needs.*
  - *vital for a future-focused society in order to run our public services help people when they lose jobs or suffer other misfortune, and address poverty and inequality.*
  - *increasingly important in responding to society-wide and global developments such as advancing technology and climate change which no individual can do on his or her own.*
- a means of redistribution: reducing inequality
- a policy instrument to influence behaviours

Inequality in New Zealand, 1982-2017

Gini coefficient for households

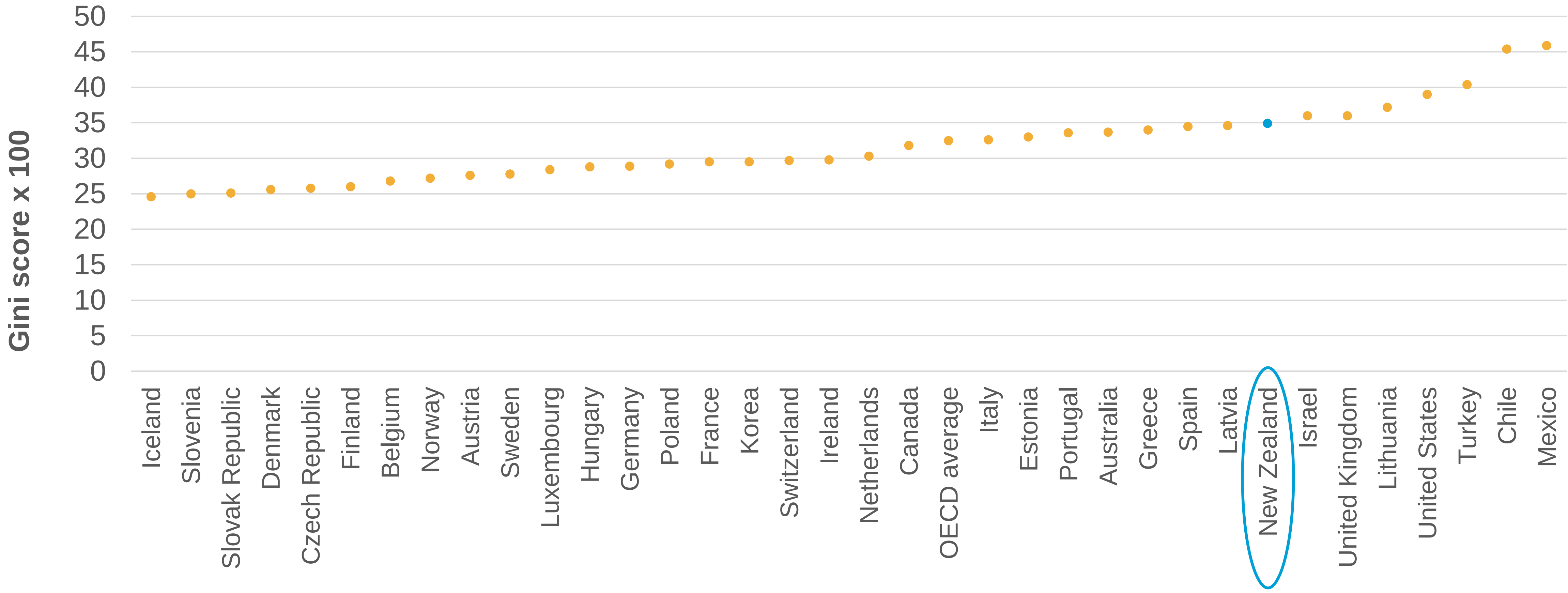
Source: Household Incomes Report 2018, MSD, Table D.9



Household income inequality in OECD countries (2014/15)

Disposable income, after taxes and transfers

Data is for 2014 and 2015 where available



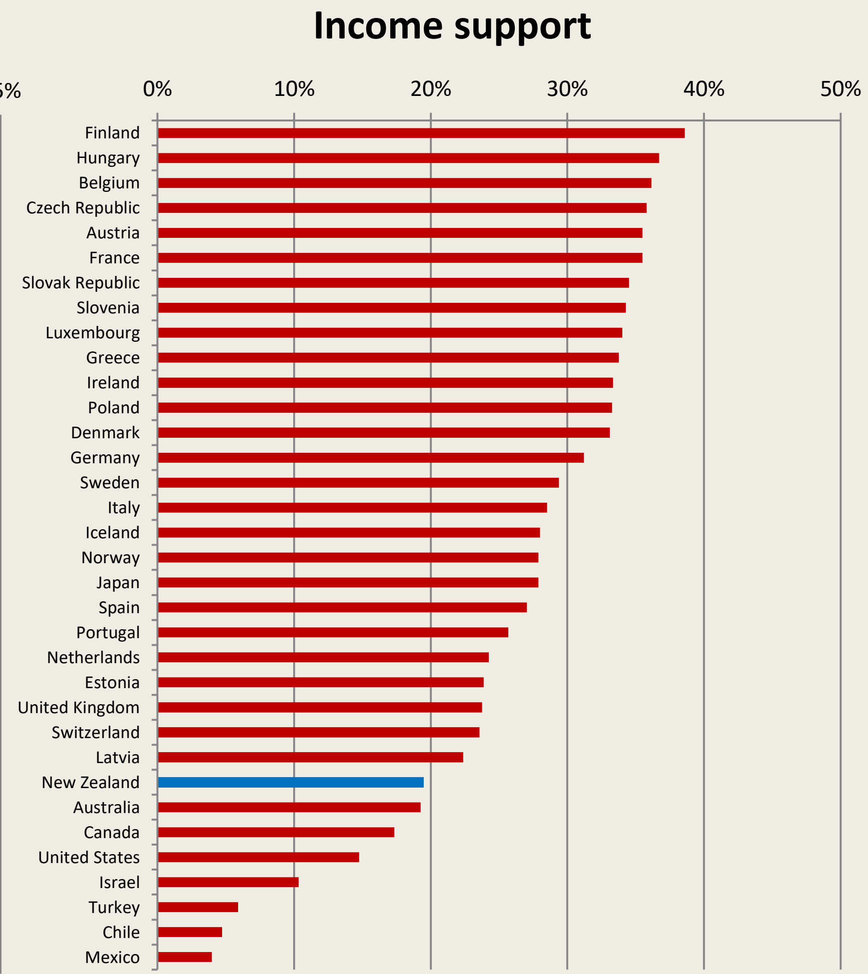
Future of Tax Submissions Background Paper, Figure 15

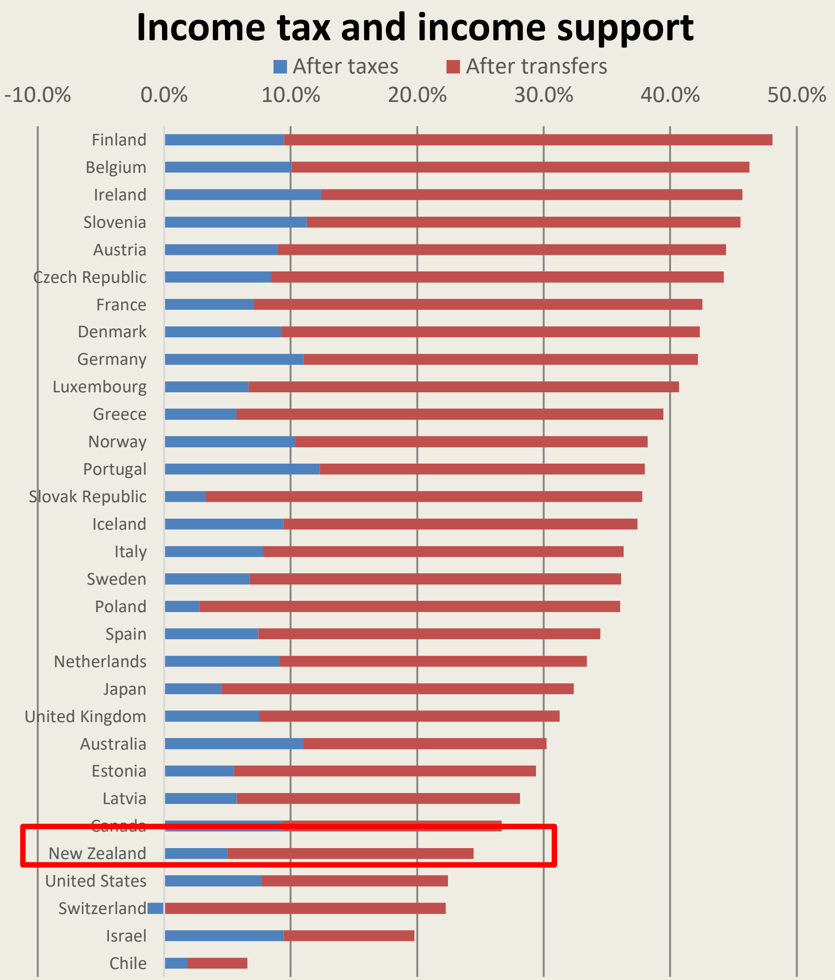
Source: OECD

Personal income taxes

How much does our tax and income support system reduce inequality?

Reduction in the Gini coefficient (2014, Chile 2015, Japan 2012). Source: OECD





Personal income taxes

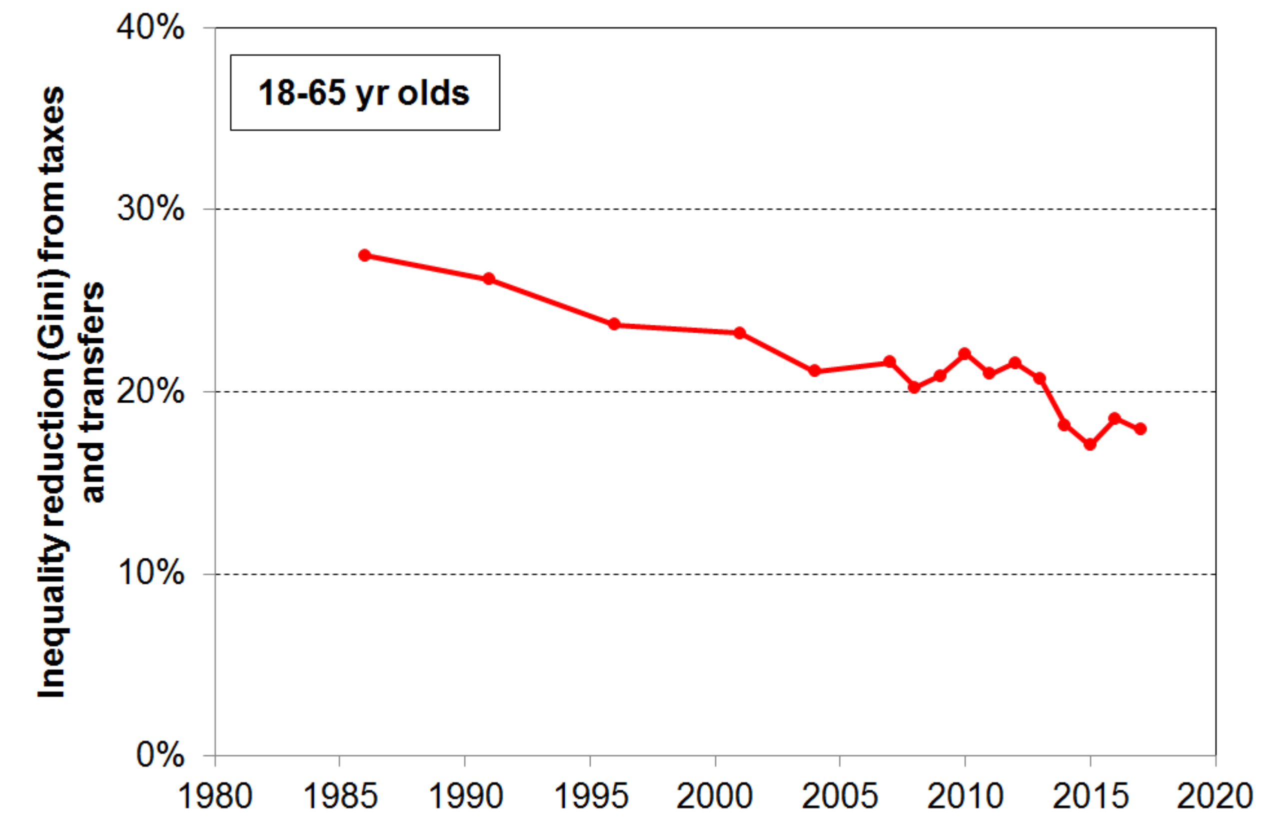
"The inequality-reducing power of the tax and transfer system on market income inequality has steadily declined for New Zealand from 27% to 17% over the last three decades, 1985 to 2015 (using the Gini)."

Household Incomes Report 2018, Bryan Perry, MSD, p.208

"[T]ax-transfer changes accounted nearly 40% of the increase in inequality" between 1988 and 2013

Did tax-transfer policy change New Zealand disposable income inequality between 1988 and 2013? Matt Nolan, 2018.

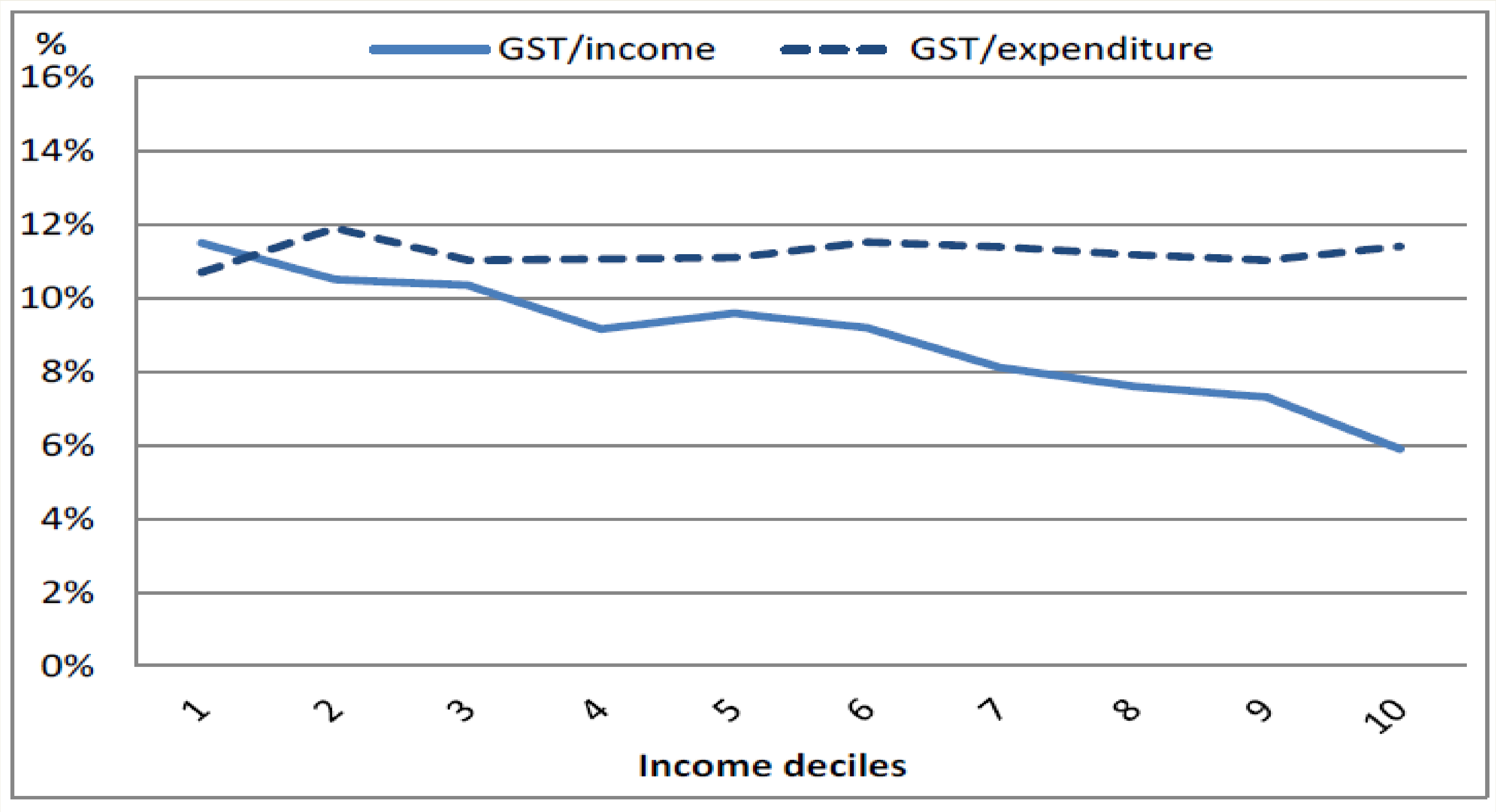
Reduction in market income inequality (Gini) from taxes and transfers for NZ working-age population



Source: Perry (2018), Figure J.15

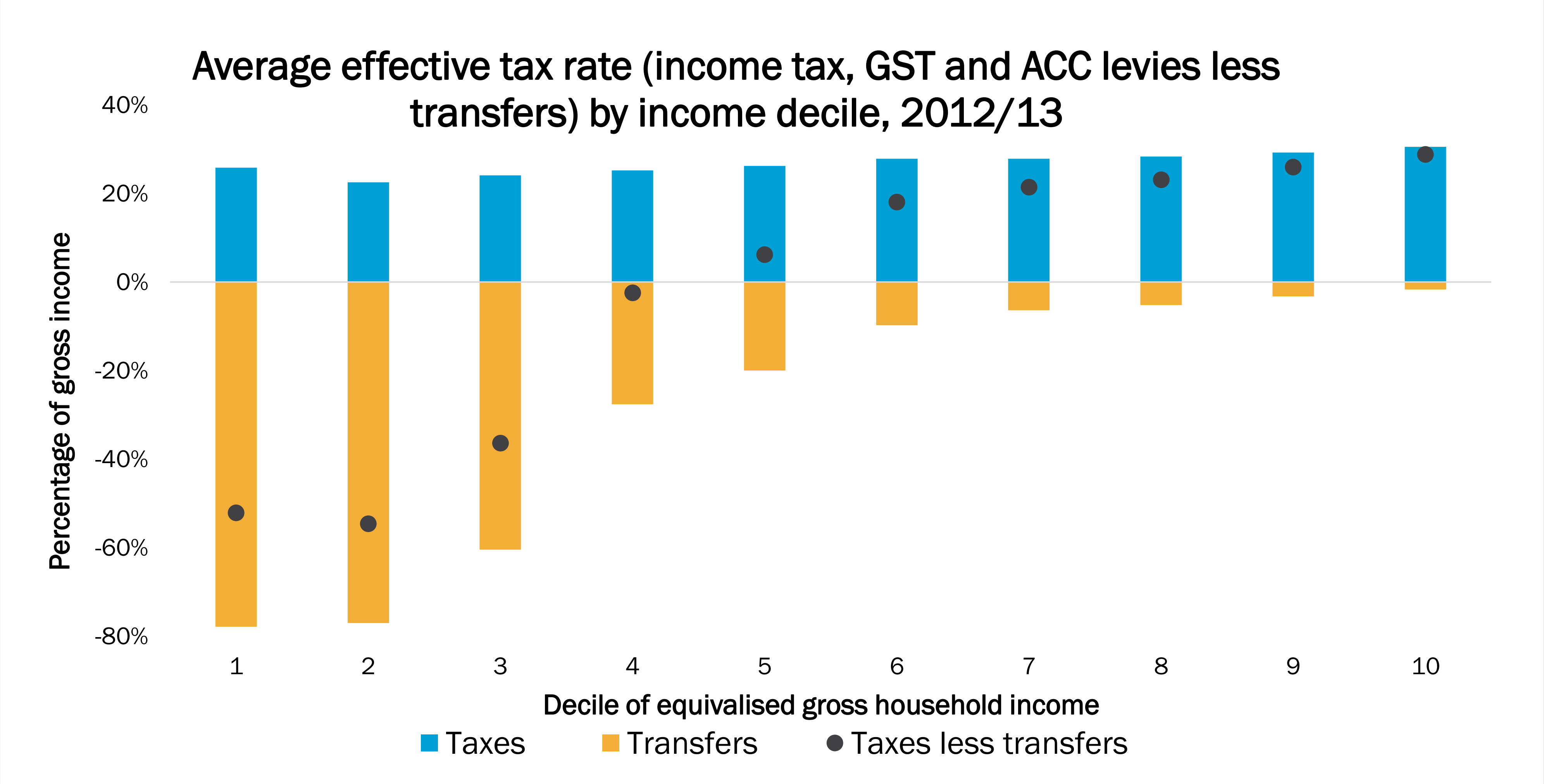
GST

Average GST paid per household



Source: GST: Background Paper for Session 2 of the Tax Working Group, p.22, available at https://taxworkinggroup.govt.nz/resources/twg-bg-gst

GST + income taxes



Sources: Quote: GST: Background Paper for Session 2 of the Tax Working Group, p.4, available at https://taxworkinggroup.govt.nz/resources/twg-bg-gst
Figure: Tax Working Group Interim report, p.17

A good place to be rich

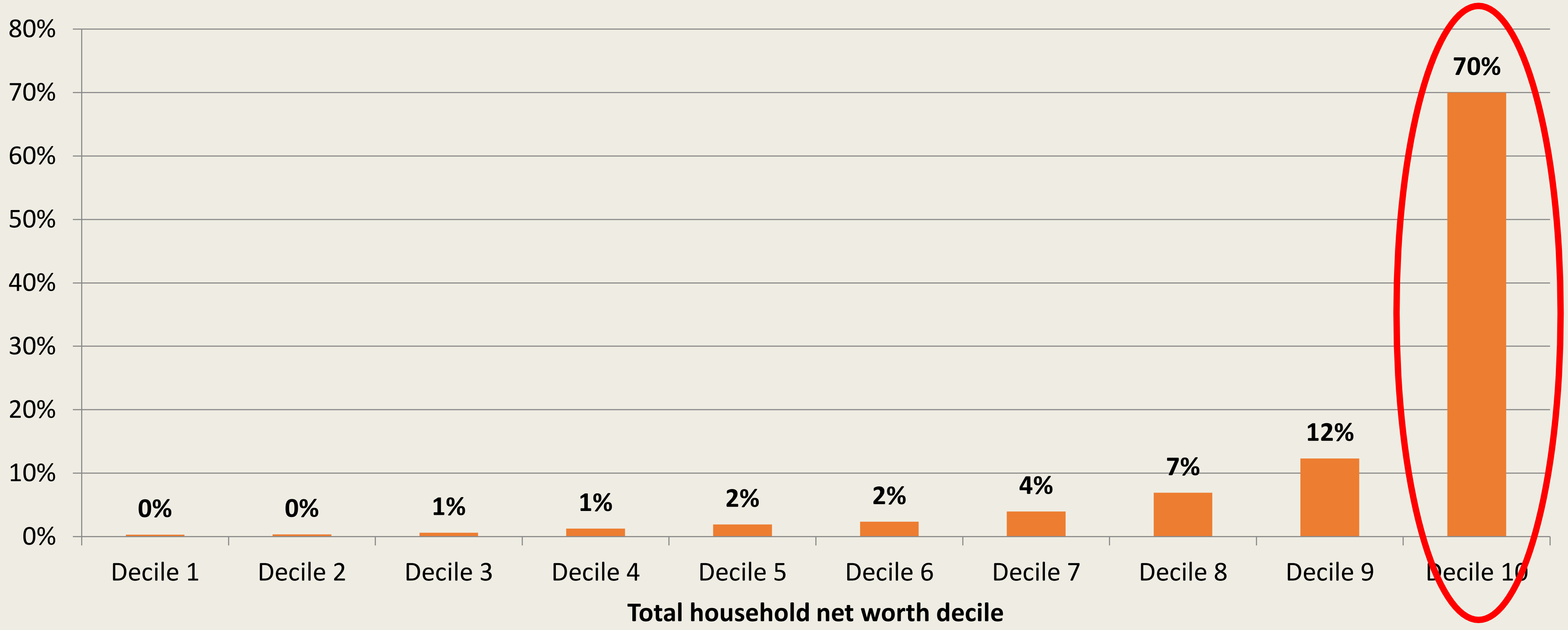
- Low top tax rate: 33%
  - sixth lowest in OECD
  - OECD average 43%
- All company tax credited back on dividends
  - “Imputation” – only Australia does the same
- Highest proportion of revenue in the OECD raised from GST
- Income from capital gains largely untaxed

Reducing inequality

- Income support could deal with poverty if it were sufficient (it is not)
- Tax is one of the most effective ways along with stronger unions/collective bargaining to reduce high income inequality
- Taxing capital gains as proposed by Tax Working Group significantly progressive

Reducing inequality

Figure 5.1: Share of household assets that could be subject to capital gains taxation, by net worth decile (2014/15)



In 2014/15, Decile 10 averaged $2.5m taxable assets per household (i.e. excluding family home, cash, deposits, household durables).

Source: Tax Working Group final report, Volume 1, p.61. Average assets calculated from Household Economic Survey, Statistics New Zealand.

Reducing inequality

Other ways to make tax system more inequality-reducing (progressive):

- Raise top personal income tax rates – but ruled out by terms of reference, and “this remains the case” according to Ministers at release of report.
- Reduce bottom tax rates or increase thresholds – what TWG suggested, but they make a only a “minor impact on income inequality”
- Land or wealth tax, GST on financial transactions – none recommended
- Inheritance tax ruled out

Reducing inequality

- As designed, the tax on income from capital gains would raise approximately $3.4 billion per year on average if now in place (additional 4.2% of revenue)
  - *Variable, probably more at present*
- Useful, but insufficient considering what is need to eradicate poverty, restore housing, health, and education, build infrastructure …
  - *Even less sufficient if in revenue-neutral package*
- If it does not succeed, it seems that high inequality and insufficient revenue will remain for many years a permanent, yet avoidable, blight on New Zealand society. Even if it succeeds, more will need to be done.

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Environmental taxes (Chapter 4)

- Long term thinking; increasingly urgent needs
- Main contribution is to propose a framework that can be used to assess whether a tax is appropriate, or it is better to regulate and/or educate (needed with a tax anyway)
  - **Favourable attributes** (responsiveness to price, revenue potential, range of possible responses)
  - **Essential attributes** (measurability, time to develop the tax, sufficient scale)
  - **Design principles** (addressing Māori rights, distributional impacts, reflect full cost of externalities, vary locally, international linkages, integrated with other policy and intertemporal fairness)
- Assessed several taxes on these criteria (Greenhouse Gases, Water pollution, Water abstraction, Solid waste and Road transport.)
- Suggests in long run “a natural capital enhancement tax” – modified form of land tax based on the idea of an environmental footprint tax.

Business taxes (Chapter 6)

- Ruled out lowering company tax rate (28%)
  - Lowered in 2008, 2010, but no evidence of economic benefits
  - Opened gap with top personal tax rate (33%), used by wealthy for tax avoidance
- Company headline tax rate among highest in OECD, but after imputation one of lowest – company tax rate almost irrelevant to local shareholders other than for avoidance.
- Proposed several changes that would reduce tax on companies, subject to revenue from taxing income from capital gains
- Supported Digital services tax on companies like Facebook and Google if critical mass do the same

Personal income tax

Taxable income	Tax rate
0 - $14,000	10.5%
$14,001 - $48,000	17.5%
$48,001 - $70,000	30%
$70,001 +	33%

- Not allowed to raise tax rates
- Recommended top tax rate should not be lowered
- Packages to help low and middle income families,
  - lowest income people best helped by welfare system
- Raise bottom threshold from $14,000
- Options given would provide net annual income gains of up to $420, $595 or $1,120
  - Largest if 17.5% rate raised to 20%
- Biggest proportional increases to most low and middle income households
- Recommended that beneficiaries should get equivalent increases

Understanding high wealth and income

- Ministers concerned that good information on very high income and wealth is scarce
- Recommended four actions:
  - bolster household income and wealth surveys so they provided better data on the wealthy ("oversampling");
  - include a question on wealth in the census;
  - Inland Revenue to regularly repeat analysis of the tax paid by high wealth individuals (see https://taxworkinggroup.govt.nz/resources/information-release-high-wealth-individuals-wealth-accumulation-review);
  - commission research on estimating the wealth of individuals.
- Also recommended greatly expanded statistical information about the tax system.

Stopping cheating

- Research estimated self-employed under-report their income by an average 20%. [1]
- Options include data matching, requiring tax to be paid on payments to contractors, and increased reporting requirements for labour income.
- “Lower the corporate veil” – penalties and personal liability for directors who are main economic owners of firm which persistently or deliberately doesn’t pay GST and PAYE
- Crown debt collection agency, with consistent rules for treatment of debtors
  - Very different enforcement standards between offending taxpayers and beneficiaries
- Better enforcement where wealthy company owners use them to avoid or evade tax
- Government to explore options to allow a wider gap between the company and top personal tax rates without opening more opportunities for such rorts.
- Ensure Inland Revenue maintains the technical and investigatory skills of its staff

[1] Cabral, A. C. G., & Gemmell, N. (2018). *Estimating Self-Employment Income-Gaps from Register and Survey Data: Evidence for New Zealand* (Working Paper No. 07/2018). Victoria University of Wellington. Available at https://chairinpublicfinance.createsend1.com/t/d-l-biydjx-l-q/

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Taxing the income from capital gains: “joining the modern world, tax-wise”

What is it?

- A capital gain is a rise in the price of an asset
- A form of income – leaves the owner more wealthy just like any other unspent income
- Taxed in general when the asset is sold – “on realisation”
    - though not possible for most managed funds – taxed on annual revaluation (“on accrual”)
- Virtually all other OECD countries have had it for many years or decades
- As a Canadian professor told Radio NZ, we would be “joining the modern world, tax-wise.”

“Joining the modern world, tax-wise”

Main reason: fairness

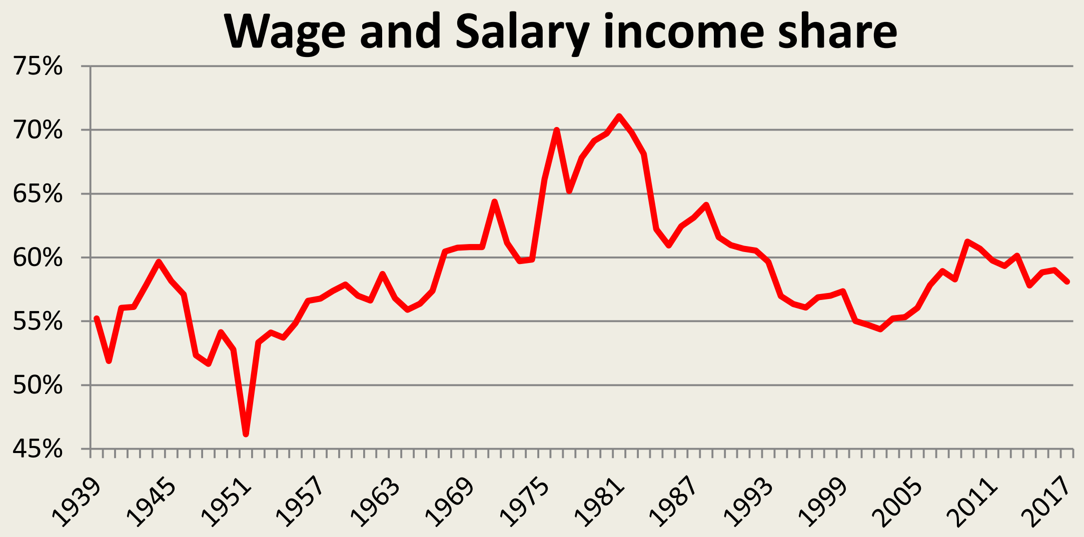
- It would reduce inequality (“vertical inequality”).
- It is just another form of income – it is unfair to treat it differently (“horizontal equity”)

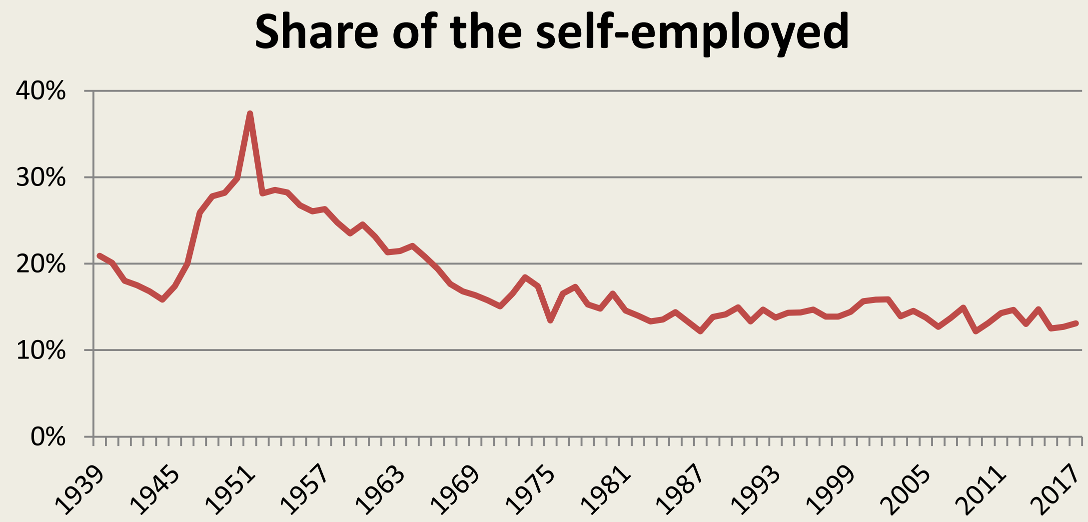
> Rewi works hard in the forestry industry. Over the last five years he has earned $250,000. He is automatically taxed close to $8,000 each year: over $40,000 over the five years.
>
> Tracy is a property investor and made $250,000 on the sale of a rental house purchased just over five years ago. She pays zero tax.
>
> *Why aren’t they taxed the same?*

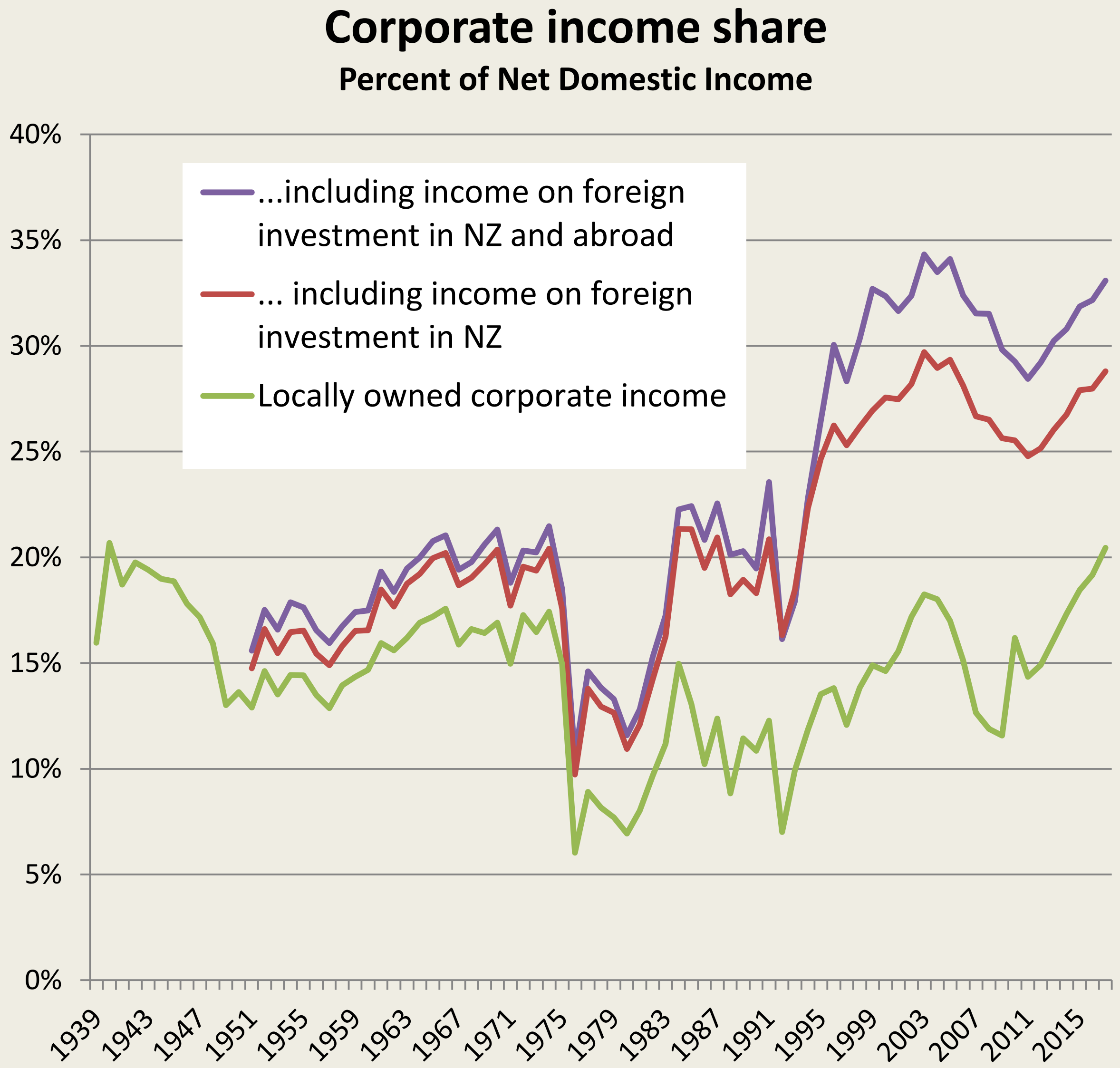
- Used by the wealthy to avoid existing taxes by converting income to capital gains
- “Future of work”: If the share of the nation’s income going to wage and salary earners continues to fall, whether due to automation, globalisation or unfair employment law, then the importance of taxing capital is only going to increase. Otherwise taxes on workers’ incomes – already pressure from these trends – will intensify.

Taxes on capital income

Why they're increasingly important







Taxing the income from capital gains: some FAQs

Will the tax hurt investment?

- We currently subsidise investment in assets that produce capital gain (e.g. land)
  - Encourages overinvestment, inflates prices rather than adding to productive capacity
  - So drag on productivity
  - Taxing all income equally encourages investment in more productive assets (allocative efficiency)
- Would it hurt other investment because it raises the effective company tax rate?
  - Unconvincing
  - Falling company taxes have not raised investment performance: not a major factor
  - The higher taxes will be paid mainly by investments with high capital gains component (e.g. land or financial assets). We want to rebalance away from these.
- Most OECD countries tax capital gains income but have better productivity than NZ

Taxing the income from capital gains: some FAQs

What will be the effect on small business?

- TWG proposed several features that greatly reduce the effect on small business unless they are renting out property or trading in shares (passive assets).
- For firms with turnover of less than $5 million it proposed
  - “Rollover” for active assets that they sell to replace them.
    - For example a farmer would be able to sell a farm and buy a larger one. A mechanic could sell a building used as a workshop to buy a larger one.
    - Tax would only be paid if the asset were sold and not replaced, when tax would be paid on the gain compared to the cost of the original asset.
  - If the business is sold at retirement, up to $500,000 capital gain would be treated like a KiwiSaver investment and be taxed at its concessionary rate.
  - If the business passed to a successor on owner’s death, tax also rolled over.
- So taxation may be deferred for decades or even generations in many cases.
- Even for property investors, the TWG suggested cancelling the proposed loss ring-fencing.

Taxing the income from capital gains: some FAQs

What will it do to rents and house prices?

- TWG concluded (p.63) that it would lead to small upward pressure on rents and downward pressure on house prices. These impacts were likely to be small.
- Not enough houses so landlords already have the power to raise rents to the maximum possible short of losing tenants -- and they do so.
    - Little room for them to raise rents further – otherwise they would have done so.
- House prices affected by much more powerful factors than tax: e.g. inadequate supply, particularly of affordable houses; demand from a rapidly growing population.
- Taxing income from capital gains is unlikely to be a silver bullet to bring down prices, but will be pushing in the right direction.
- If some property investors do sell up, the houses don't disappear: they will be bought either for the buyer's home or by another investor -- currently still buying (QV).
- Many signs it was investors who were driving prices. May help to reduce that pressure.

Taxing the income from capital gains: some FAQs

Will it lead to double taxation/deductions?

- In closely held companies the problem is relatively easily solvable
- Main problem is in groups – Australia has solutions for that, admittedly complex

What about overseas shareholders, New Zealanders holding shares overseas?

- We will still tax income from gains in land and land-rich overseas-owned companies, and permanent establishments in New Zealand
- Can't tax other assets, mainly due to double taxation treaties and difficulty in enforcement. The treaties need reviewing.
- An improvement on not taxing any of their income from capital gains.
- Has been different regime for New Zealanders holding shares overseas for some time – already potentially an advantage for some
- FDR rate could be adjusted to eliminate any bias in holding portfolio investments

Taxing the income from capital gains: some FAQs

Should capital gains be taxed at the same rate as other income?

- There is no reason to treat it differently
- We already tax income from capital gains at the same rate as other income
  - For example ‘bright line’ tax brought in by National; or when an asset is bought intending to sell
- A lower rate would leave most of the problems: tax loopholes, unfairness

  US billionaire Warren Buffet, who advocates higher taxes on the rich, complained that he was probably paying a lower tax rate than his secretary because most of his income comes from capital gains, taxed at only 20 percent, while hers came from wages.
- Treating it differently would complicate the tax system.

Taxing the income from capital gains: some FAQs

Is a capital gains tax complex?

- Yes, but put in perspective:
  - The current “simple” tax system requires 4,500 pages of mind-twisting legislation, plus regulations, court findings, IRD determinations, interpretations, rulings and double taxation treaties.
  - The other OECD countries manage it.
- Compliance costs for Australian firms were surveyed by an Australian expert.
  - Tax on capital gains relatively infrequently impacts any one taxpayer.
  - Only 2% of tax compliance costs – an average 4 hours a year – for SMEs (up to AU$50m turnover)
  - Similar percentage for large business
  - Much less for smaller businesses.
  - Income tax and GST were far more time intensive.

Taxing the income from capital gains: some FAQs

Will it be the end of 'the Kiwi bach'?

- No, sadly that dream has already ended for most people who can't even afford to buy one home, let alone two.
- We are seeing the growth of mansion-like 'holiday homes' among the wealthy.
- There is also a thin dividing line (or none at all) between a holiday home and an investment property.
  - Often rented out, perhaps through an online service like AirBnb or BookaBach.
  - Bachcare founder, Leslie Preston bemoaned the tax, not primarily because of the loss of the 'Kiwi bach' but because it could have a "detrimental impact on the amount of accommodation available for domestic and international visitors".
- Like other assets, they are untaxed until they are sold.
- It is hard to see why they should be exempted.

Taxing the income from capital gains: some FAQs

Isn't it unfair that a $350,000 rental property gets taxed but a $4 million family home in Parnell doesn't?

- Yes – but much less unfair compared to a $350,000 family home: a source of profit vs a necessity
  - TWG found rental property was greatly undertaxed – returns rely on capital gains
- Leaving the family home untaxed is the compromise that every country makes
  - otherwise it is not electorally feasible
  - it is the overall impact that must be considered.
- The TWG recognised the problem but terms of reference prevented consideration
- Did suggest putting a cap on the family home exemption (e.g. $5 million), but considered it also fell outside its terms of reference.

Taxing the income from capital gains: some FAQs

Won't the rich just avoid it?

- Of course they will try
  - Tax experts will be considering their offerings
- But IRD is highly capable of combating it (and we should ensure that can continue)
- Avoidance and evasion is nothing new
  - The complexity of our current 'simple' system (see above) is largely a reaction to it
  - It is in part because of the absence of a tax on the income from capital gains
- If we allowed avoidance and evasion to intimidate us, we would have no taxes.

Taxing the income from capital gains: some FAQs

Don't small business owners work long hours for little reward?

- Some do; others get very handsome reward for it.
- In any case, so do many wage and salary earners, but all their income is taxed.
  - Parents working several cleaning jobs, hardly seeing each other and too tired to spend quality time with their children.
  - Forestry workers working long dangerous hours in conditions like running a marathon all day.
  - Mental health nurses in understaffed critical care units working double shifts at risk of assault.

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In conclusion

- Our tax and income support systems would need major work to make them capable of reducing New Zealand's high inequality
- Taxing income from capital gains would be a step in that direction
- But there is much more that needs to be done to make our society a fairer place