THE TREASURY

Kaitohutohu Kaupapa Rawa

The Future of Tax in New Zealand

How should the tax system promote the right balance between supporting the productive economy and the speculative economy?

Treasury Tertiary Challenge 2018

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July 2018

Introduction

"*Taxes are what we pay for civilized society*" – Oliver Wendell Holmes (1927)

As the oft-quoted statement above suggests, taxation has been a fundamental component in ensuring a harmonious and economically fruitful society for as long as such societies have existed. However, despite the undoubted significance of taxation in allowing governments to provide crucial public services, any move by parliaments to raise taxation levels is consistently met with substantial public disapproval. Such moves are often viewed as benefitting the incumbent government at the expense of the wider public, and not as a means to fund expenditure projects that benefit all of society.

This simplistic, negative perception of taxes is however deeply flawed, since a country's tax structure is a significant determinant of their overall economic performance. Having an organised and easily understandable tax framework makes it simpler for individuals and businesses to operate efficiently, which thereby encourages economic development without impeding the government's ability to raise revenue and enact public policy. In contrast, a badly structured tax framework can be economically harmful, distort individual and commercial incentives, and generally undermine business interests in both the productive and speculative economy.[1] Therefore, designing a tax system that supports both the productive economy, where real economic activity occurs, and the speculative economy, where financial assets and instruments are traded, in a balanced manner, is of major national significance.

New Zealand's Current Taxation Framework

A hallmark of the current New Zealand tax framework is that it is relatively simple in comparison to other developed economies, with government revenue derived predominantly from three primary sources (*Figure 1*). These sources include a progressive, but comparatively flat and low-rate income tax system, a broadly applied value added tax of 15% on goods and services, and an internationally competitive 28% business tax. However, despite our lower marginal tax rates, the total amount of tax revenue generated by the New Zealand government is reasonably comparable to other OECD countries (*Figure 2*). This seemingly perverse relationship of lower tax rates generating higher taxation revenue reflects moves by New Zealand governments over the last 30 years to convert to a *'broad-based, low-rate'* tax system, where there are few exceptions to our three main taxes.

Before transitioning to our current taxation framework, government revenue was predominantly derived through income taxation, with New Zealand having top marginal income tax rates as high as 66% in the early 1980s.[2] Unsurprisingly, setting marginal tax rates at this elevated level resulted in widespread tax avoidance and a generally complex and inefficient taxation system. Therefore, in response to these inefficiencies, the 1980s Labour Government introduced a 10% tax on Goods and Services (GST) which was broadly applied with few exceptions. The Labour government also simultaneously reduced the top marginal income tax rate to just 33%, leaving New Zealand with a system predicated primarily upon indirect taxation of a broader tax base, an approach has remained fundamentally unchanged over the last 30 years. [3] Overall, our broad-based tax system, alongside the fact we have declined to introduce other internationally prevalent taxes such as on capital gains have helped establish New Zealand's framework as the second most competitive amongst OECD economies.[4] However, while our system is reasonably efficient, there is a potential argument that it could be more balanced and equitable, which will be discussed within this essay.

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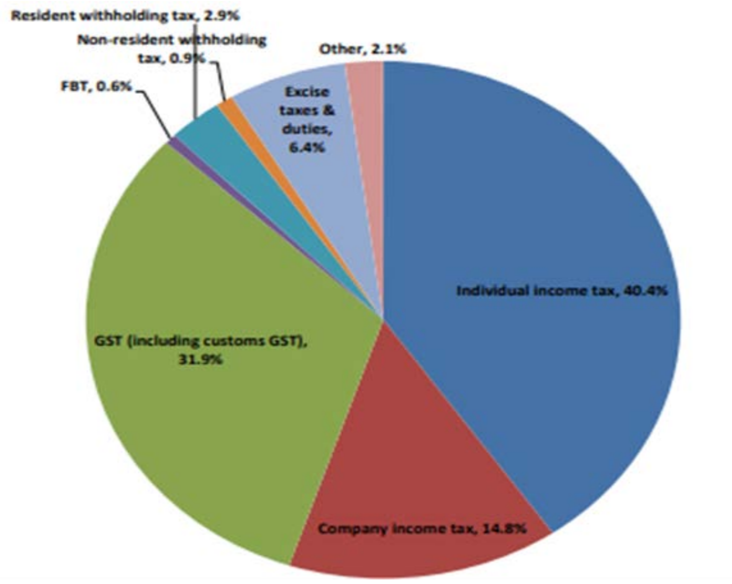
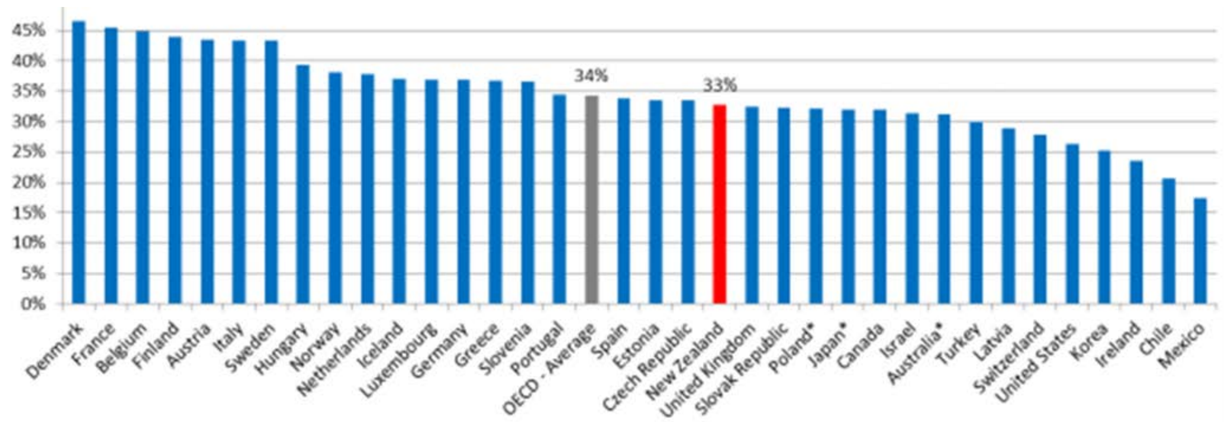
[1] (Pomerleau, Hodge, & Walczak, 2017)
[2] (James, Sawyer, & Budak, 2016)
[3] (James, Sawyer, & Budak, 2016)
[4] (Pomerleau, Hodge, & Walczak, 2017)

Figure 1: Sources of New Zealand Taxation Revenue
(June 2015 – June 2016)



Source: (below)[5]

Figure 2: Global Tax Revenue as a Percentage of Gross Domestic Product (2014)



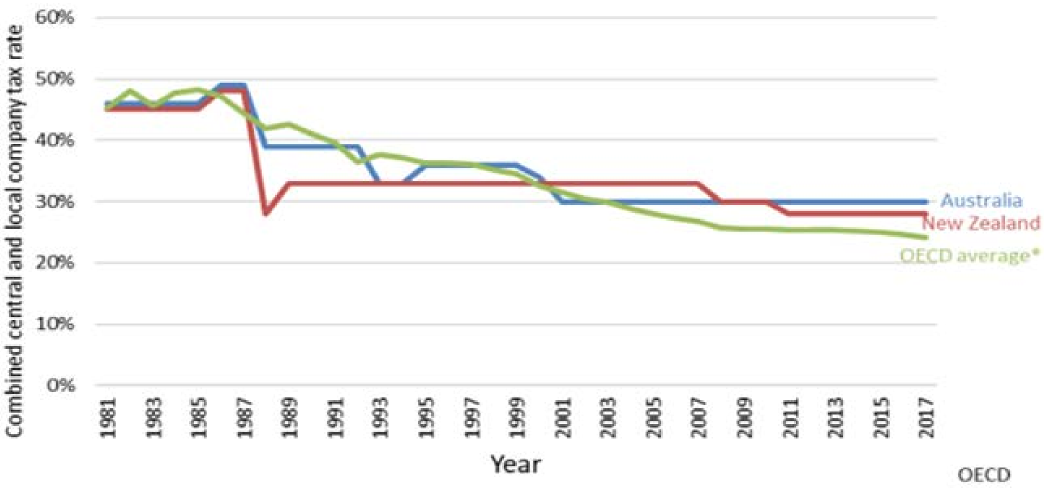
Source: (Inland Revenue , 2017)

[5] Electronic Source: https://taxpolicy.ird.govt.nz/sites/default/files/2017-other-bim-nz-tax-system.pdf

Taxes and the Productive Economy

New Zealand's relatively simple tax framework is based on the idea that *'a good tax system should collect taxes with minimum disruption to people and businesses'*.[6] This approach recognises both that a simpler tax framework generally aids economic growth, and that capital is extremely mobile within our modern, globalised society. Therefore, since companies will invest where they can earn the highest after-tax return, there has been a general trend of declining marginal tax rates across major economies over recent periods (*Figure 3*).[7]

Figure 3: Historical Trends in Statutory Company Tax Rates

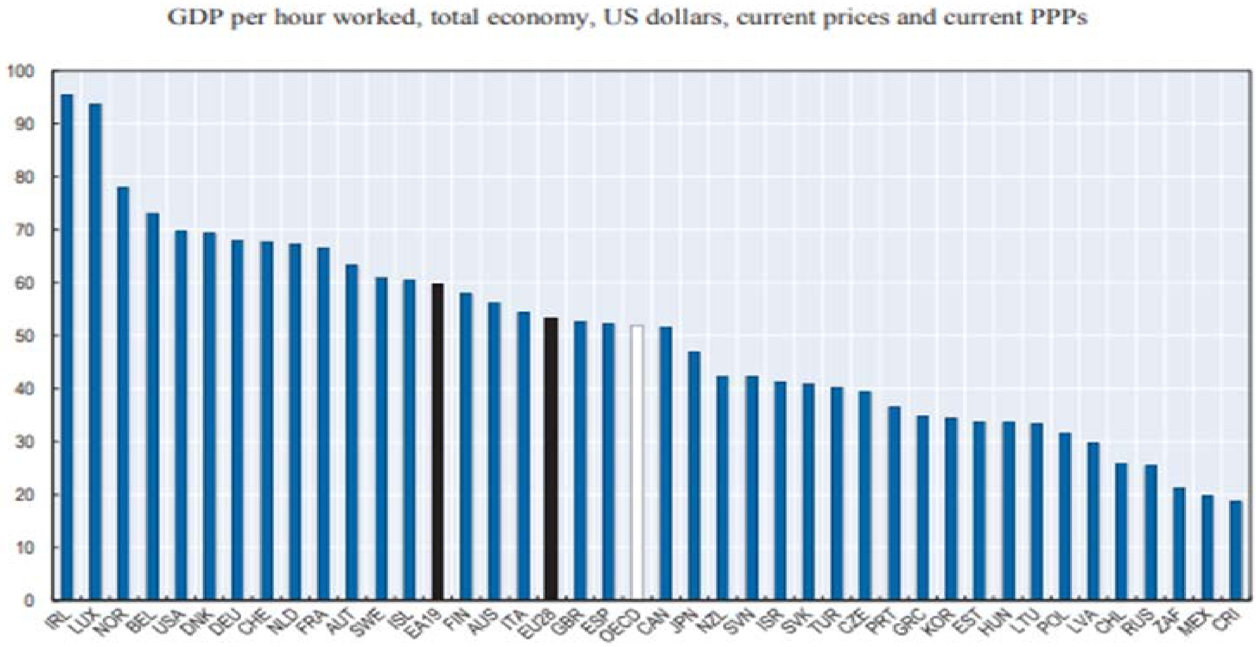


Source: (below)[8]

Maintaining an internationally competitive corporate tax rate is viewed as particularly important for New Zealand given our low relative labour productivity (*Figure 4*). Significantly, Treasury believe that a leading cause of this low productivity is our small capital-labour ratio, which is influenced by Foreign Direct Investment (FDI) levels.[9] Therefore, one widely suggested method to promote real economic growth is to lower our company tax rate, since this would supposedly increase foreign investment, and therefore increase our national capital stock.

[6] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-03/twg-subm-bgrd-paper-mar18.pdf
[7] (Pomerleau, Hodge, & Walczak, 2017)
[8] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-06/twg-appendix2-business-tax.pdf
[9] (Gemmell, 2010)

Figure 4: Global Labour Productivity (2016)



Source: (below)[10]

However, a 2015 Motu paper suggests there has been no economically significant short-run impact of recent New Zealand tax changes on aggregate investment, except for firms with low capital intensity.[11] Based on these findings Motu has suggested that *‘even substantial changes [in company tax rate] will not translate into material changes in aggregate investment rates’,*[12] meaning there would likely be minimal benefit in lowering the current 28% tax rate. This conclusion is consistent with the initial advice tendered from the recently appointed Tax Working Group (TWG). Specifically, the TWG has noted that a lowering of tax rates in 2008 and 2011 did not result in an expected increase in FDI and proved financially expensive given that profits remaining in New Zealand were subsequently taxed at a lower rate.[13] In addition, a lower tax rate in the future would incentivise increased income sheltering, and would reduce New Zealand’s ability to charge high taxes on economic rents (excessive returns), which are particularly prevalent in New Zealand due to our a geographically isolated market.[14] However, earlier Treasury analysis has also recognised that New Zealand is a small open economy which continues to have a dependence on net capital inflows, which must be balanced against these other factors [15]

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[10] Electronic Source: https://read.oecd-ilibrary.org/economics/oecd-compendium-of-productivity-indicators-2018_pdtvy-2018-en#page1

[11] (Fabling, Kneller, & Sanderson, 2015)

[12] (Fabling, Kneller, & Sanderson, 2015)

[13] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-06/twg-appendix2-business-tax.pdf

[14] (Fallow, 2018)

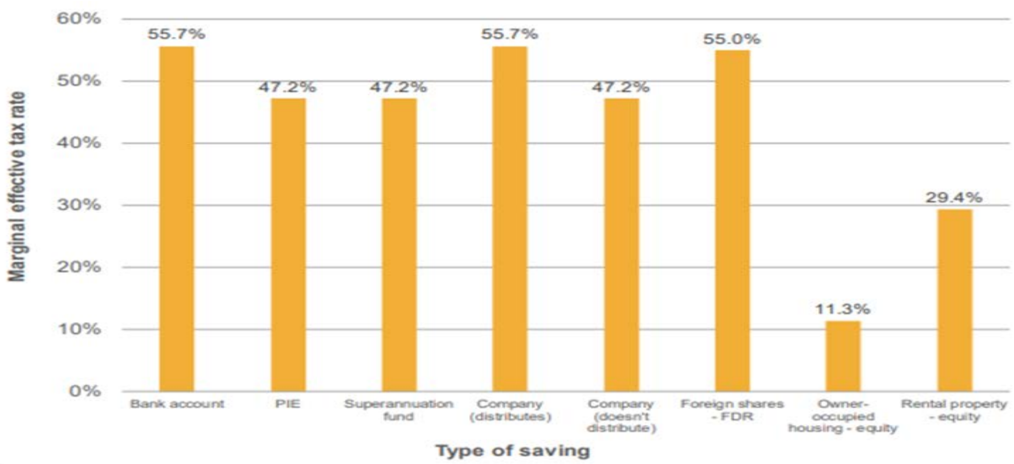
[15] (Gemmell, 2010)

Taxes and the Speculative Economy

New Zealand's taxation framework also has a significant role in supporting the speculative economy, which this essay defines as incorporating all private earnings not derived from income or other productive ventures. In relation to the speculative economy, a major issue within our current taxation framework concerns the differential treatment of certain investments, particularly real estate speculation. This has led to perceptions that the current tax framework is unjust, since it allows certain taxpayers to pay less than their fair share.

For New Zealand's broadly applied, low-rate tax framework to be effective, different investments should be taxed at equivalent marginal rates. [16] However investments in owner-occupied housing and rental properties actually incur significantly lower marginal effective tax rates compared to other investments, which face a broadly similar tax rate (*Figure 5*). New Zealand's disparate tax treatment of property investment arises due to two unique features of our system; our lack of a comprehensive capital gains tax, and our decision not to tax imputed income.[17] These attractive tax features have created unwarranted incentives for real estate speculation in the New Zealand market, which has contributed to a rapid and likely unsustainable rise in house prices over recent periods.

Figure 5: Marginal Effective Tax Rates on Savings in New Zealand



Source: (below)[18]

Overall the current lack of a capital gains tax represents a significant imbalance within our current tax framework and as significantly, is an affront to our supposedly egalitarian society. A significant argument for the introduction of capital gains taxation is that the benefits of capital gains are predominantly received by already wealthy individuals, who own a disproportionate share of capital assets. In addition, the global share of income to labour has declined over the last 30 years, creating distinct inequality between those earning capital dividends and 'the rest of society'. A capital gains tax provides an obvious mechanism to redress these issues, since the TWG predicts that revenue from capital gains taxation would be predominantly incurred by the wealthiest twenty percent of households.[19] Reforming the tax treatment of housing therefore offers an obvious mechanism to improve the balance of New Zealand's tax system.

[16] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-03/twg-subm-bgrd-paper-mar18.pdf
[17] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-05/Tax-and-Housing.pdf
[18] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-03/twg-subm-bgrd-paper-mar18.pdf
[19] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-03/twg-subm-bgrd-paper-mar18.pdf

Taxation and Inequality

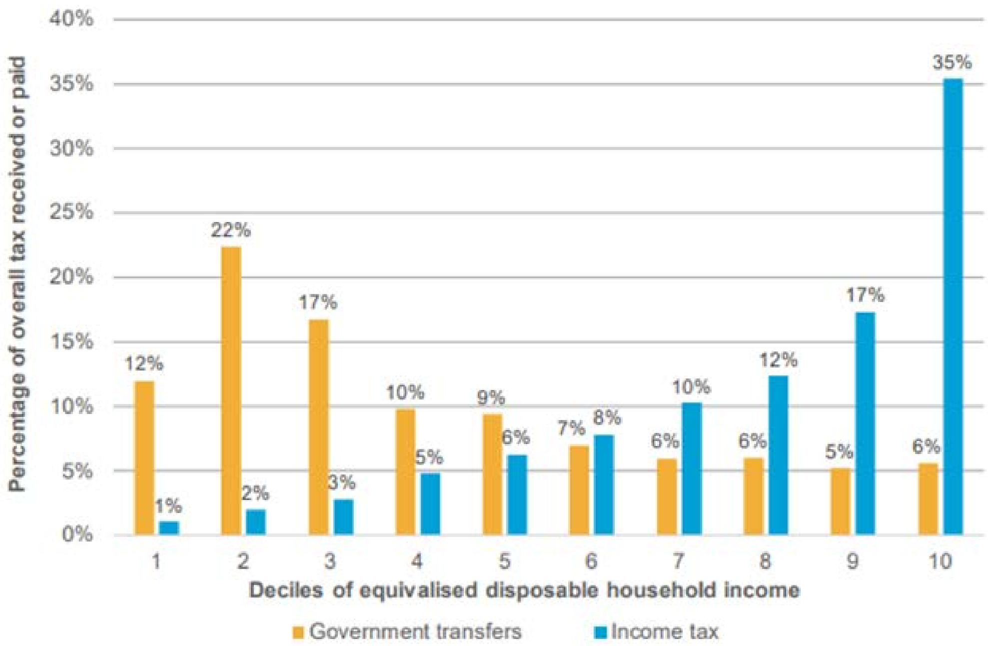
Tax policy also has a significant role in helping make New Zealand society more 'fair' and 'equitable' since standard taxation policy is progressive and involves redistributive policies that benefit lower-income individuals. Theoretically, there are two reasons why governments might intervene within private markets through measures like taxation, which are to promote efficiency, and to increase equity. However, these two outcomes are frequently in conflict, meaning there is a role for the public to determine how much efficiency they are willing to trade off to improve equity (or vice versa).

Unfortunately, individual perceptions of equity are determined by personal moral-based preferences, and there is unlikely to be a unanimous social agreement on what defines 'fair' taxation policy. Given this, typically, frameworks for determining the equity of a tax system focus on two primary concepts, *vertical equity*, the idea that higher income earners should pay a greater amount of tax, and *horizontal equity*, that people in equal positions should pay equal amounts of tax. The majority of New Zealand citizens support the concept of progressive taxation, where individuals with greater incomes pay a larger proportion of tax on the basis that it is vertically equitable.[20] The appropriate level of progressiveness is however difficult to determine, as demonstrated by the 2016 NZ Social Survey, which found that just over 50% of the public believe high-income taxes are currently too low, while the remaining proportion believe they are either appropriate or too elevated.[21] Therefore, there will be animosity towards a change in high-income tax rates, from some portions of society, regardless of its direction.

From this author's personal perspective, it seems that NZ's system could be made more progressive and equal, without incurring significant efficiency costs. At first glance, New Zealand seems to have a reasonably progressive tax system, with *Figures 6 & 7* showing that nearly half of society receive more in transfers than they pay in income tax. However, analysis in (Rashbrooke, 2013) suggests this changes when the effects of our broad-based Goods and Services Tax are considered, with the impact of GST meaning lower income individuals pay almost 30% of their income in tax, middle income individuals pay roughly 25%, and those earning $150,000 a year pay just 34%. (Rashbrooke, 2013) further suggests that if we were to include the effect of income from capital gains then it is possible that the actual tax rate imposed on some of New Zealand's highest earners would be nearly regressive. While this does not account for transfer payments, it suggests that there should be ways to make New Zealand's overall taxation system more progressive with minimal efficiency cost, which would help improve overall social equity.

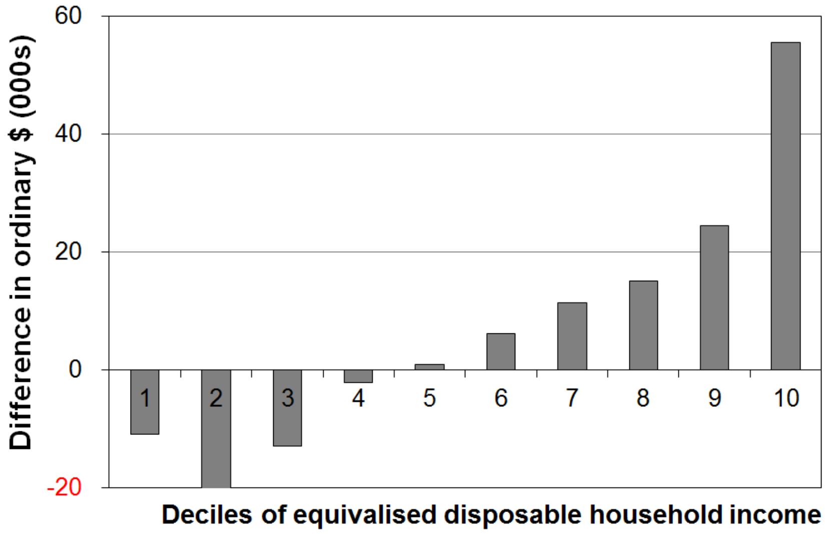
[20] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-05/Tax-and-Fairness.pdf
[21] (Grimwood, 2017)

Figure 6: Percentage of Income Tax and Transfers Across Deciles



Source: (below)[22]

Figure 7: Net Income Tax Paid Accounting for Government Tax Transfers



Source: (below)[23]

[22] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-05/Preparing-the-Tax-System-for-the-Future.pdf

[23] Electronic Source: https://www.msd.govt.nz/about-msd-and-our-work/publications-resources/monitoring/household-incomes/

Tax Policy and the Living Standards Framework

'Tax might influence and reflect the society a country both was and wanted to be' [24]

As the above quote suggests, tax policy has a role of fundamental societal importance, and generally serves as an instrument to improve social, human and natural capital, in addition to its obvious impact on economic incentives and financial capital.[25] Primarily, the tax system has a major impact on these other capitals since it helps keep society equitable, and this equality can help promote social and human capital by improving societal participation, cohesion and trust.[26]

In addition, the tax system has a significant impact on social capital, since tax depends on a working social relationship between society and the government, which the elected parliament must maintain[27] Tax incentives can also be used to influence individual and commercial behaviour in manner that improves natural and human capital, for example by providing tax credits for environmentally friendly business practices or for hiring young employees.[28]

Conclusion

This essay has outlined that there are several tax measures that could improve the balance between supporting the productive and speculative economies, including introducing a capital gains tax, and maintaining the current 28% company tax rate. Generally, these measures would provide governments with more revenue, which they could use to improve the balance of the tax system and social equity. For example, this increased revenue could be used to increase transfer payments to low-income households, reduce low bracket personal income tax rates, or promote positive social, natural and human capital outcomes. Such measures would help New Zealand develop a more balanced overall tax system, and more significantly, a society with greater equality.

Word Count: 1,998 words (excluding footnotes)

[24] (Murphy, 2015)
[25] See Treasury's Living Standards Framework for more detailed discussion of the significance of this 'four capitals' analysis
[26] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-05/Tax-and-Fairness.pdf
[27] (Murphy, 2015)
[28] Electronic Source: https://taxworkinggroup.govt.nz/sites/default/files/2018-05/TWG-Assessment-Framework.pd f

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