

Economic Policy Centre

Pensions and Intergenerational Equity

Structuring taxes to achieve equitable and efficient outcomes.

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PIE Commentary 2023-12²

PIE highlights intergenerational equity issues. One of the clear drivers of wealth and income inequality is the structure of taxation. This commentary provides a pre-election analysis of the failures of tax reform in New Zealand and what needs to be done to restore credibility so that the New Zealand tax system better meets equity, efficiency and administrative simplicity criteria.

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ISSUES — THE CURRENT REALITY

In the early 1990s child and whānau poverty increased markedly following the introduction of a range of new economic, tax, and social policies.⁴ These reforms stressed **lower flat tax** and **user pays** policies so that the state could play a much-reduced role. While the goal of these policies was greater equity, efficiency and administrative simplicity, the New Zealand tax system today does not reflect any of these sound, traditional tax principles.

This policy brief examines why and how the tax reforms fell short of their promise and explores practical options with better outcomes. Better tax policies could also raise more

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² PIE Commentaries are opinion pieces published as contributions to public debate, and do not necessarily reflect the view of the Pensions and Intergenerational Equity Hub.

³ St John, S and O'Brien, M (2023). Structuring taxes to achieve equitable and efficient outcomes. [CPAG 2023 Policy Brief Tax](#).

⁴ This package has been called Rogernomics to reflect the role that the former Labour Minister of Finance Roger Douglas played in setting out the free market philosophy behind these changes.

revenue, not only to reduce poverty but also to fund the much-needed expenditure on climate change, healthcare and education.

In the period 1988-1990, New Zealand adopted the radical low-rate broad-base tax principles to transform its tax system. The **lower flat tax rate** was supposed to encourage work and saving, while the **broad base** required that income from all sources be included for tax, and all expenditure would be captured with a low-rate Goods and Services Tax (GST).

Unfortunately tax reforms did not result in the outcomes sought, because:

- they were not fully implemented as originally conceived (for example, they failed to include capital gains in the income base).
- opportunist governments increased GST to a very high rate over time.
- they reflected a faulty ideology.

In particular, these tax reforms were based on the user pays premise that welfare should be only for the poor. The idea was that if high income earners paid for their own social provision, high top tax rates could be reduced along with the size of the state. Low rates of tax at the top end were supposed to encourage economic growth, the benefits of which were to 'trickle down' to those less well off.

But inevitably, high tax rates shifted from the well-off to low and middle income groups, while 'trickle down' expectations failed to materialise.

Today we have not only high rates of income tax from the first dollar of income, but also many low and middle income earners face very high **effective marginal tax rates** because of tightly targeted social assistance policies.⁵ At the same time, their spending on goods and services is fully taxed at the very high GST rate of 15% with no exemptions for basics.

The New Zealand tax system has become ever more incoherent, inequitable and inefficient. As noted by the Economist ten years ago for the USA, the connection between inequality, poverty and social disruption is clear:

*The recent concentration of income gains among the most affluent is both politically dangerous and economically damaging. **The political worry is a descent into angry populism...there is growing evidence of fury.** Economist Sept 2013*

The unfairness of the low tax actually paid by the very wealthy, highlighted in recent reports by IRDⁱ and Treasuryⁱⁱ, is now widely understood by the public. As long as that

⁵ This paper does not cover the welfare system of core benefits and their abatement, but focuses on low and middle income earner families.

issue is ignored, we can expect a further loss of social cohesion, outright fury, and loss of faith in democracy itself.

BARRIERS REQUIRING POLICY ACTIONS

Equity

Well accepted tax theory suggests that those with equal income should pay equal taxes⁶ while the better-off should pay proportionately more⁷. Neither of these two aspects of equity are currently met. Equal income does not result in equal tax because part of the income of the better-off comes from untaxed capital gains, and overall, our system is far from fair or progressive.⁸

Efficiency

While all taxes have the potential to affect behaviour (for example encouraging more of the untaxed goods and activities and less of the taxed ones, economic efficiency requires that the tax system minimises these effects.⁹ High tax rates on income are very damaging to economic efficiency because they can significantly affect decisions to work and save.

The concern in the 1980s was that higher income people faced highly visible and damaging tax rates (the top tax rate was as high as 66% for a time). Unfortunately, the reforms shifted the problem from high income earners to low and middle income earners where the problem was far less visible and far more damaging.

Claw backs - Effective Marginal Tax Rates (EMTRs)

User pays policies confine welfare spending to the 'poor' but to prevent welfare going to high income people social assistance payments must reduce as extra income is earned. The claw backs of various kinds create high Effective Marginal Tax Rates (EMTRs) over long income ranges. Thus low and middle income paid workers face huge disincentives to earn extra income.

For example, take a family on a low household income of \$48,000 with one parent at home looking after the children and receiving **Working for Families** for their children. Their income does not cover their living costs, and each week after rent and other essential costs are deducted they have a serious gap in their budget.ⁱⁱⁱ

An opportunity comes up for the main earner to do some overtime and earn an extra \$10,000. As summarised in the box. this gross income is taxed at 30%, leaving \$7,000

⁶ Horizontal equity requires that those on the same income pay the same tax.

⁷ Vertical equity is subjective and assumes that it is fair for the better off to pay proportionately more tax.

⁸ A progressive tax system requires the better off to pay proportionately more tax overall.

⁹ Except where there is an intent to change behaviour eg a sugar tax is supposed to reduce its consumption

after tax, a loss of \$3,000. When IRD find out about this income they demand that 27% or \$2,700 of the caregiver's **Working for Families** is repaid. And as well, there is often an additional 12% or \$1200 demanded for student loan repayment. If the family is receiving housing assistance such as the Accommodation Supplement, they will lose another 25% or \$2500.¹⁰

Box 1 A family with dependent children and a single low wage earner, currently receiving Working for Families.	
Household income	\$48,000 (before tax)
If receives a pay rise of \$10,000	\$58,000 (before tax)
Extra gross earned income	\$10,000
PAYE on pay rise (30%)	-\$3,000
Working for Families repayment (27%)	-\$2,700
If owing student loan (12%)	-\$1,200
If receiving Accommodation Supplement, repayment of 25%	-\$2,500
Total loss because of the extra \$10,000	-\$9,400
Pay rise in hand	\$600

Thus, the \$10,000 additional gross income may leave the family better off by as little as \$600 in the hand as a result of these claw backs. Additionally, for some, because of the extra income, there may be a reduction in childcare subsidies and an increase in child support payments. The system is extremely hard for people to understand, but they are greatly discouraged that working extra hours seems to leave them no better off.

The high **EMTRs** faced by large numbers of lower paid workers penalises them for working, keeping them trapped in poverty. These highly economically inefficient and distorted rules have resulted in a very complex and convoluted system, far from the principles of efficiency, administrative simplicity and low compliance costs.

Australia has a better tax system.

In contrast, Australia did not undertake such radical reforms in the 1990s. There, the income tax system is far more progressive with the first \$18,200 earned tax-free¹¹, and Goods and Services Tax (GST) is held at a much lower rate of 10% with the exclusions of basics. Moreover, Australian tax credits for children are far more generous and the effective marginal tax rate problem far less severe.^{iv}

A wholesale adoption of the Australian system overnight is now unrealistic. However, New Zealand can and should address the failures of our system to live up to its low-rate broad base promise.

What about GST?

¹⁰ ACC levies also apply and KiwiSaver deductions.

¹¹ There is also a Low Income Earner Offset that means for those earning under \$66,000, their effective tax free threshold is A\$21,884 <https://www.superguide.com.au/how-super-works/income-tax-rates-brackets#offsets>.

New Zealand's GST is successfully broad base however it is set at a very high rate (15%) and applied to virtually everything. Inevitably these two factors result in pressure for exemptions, endangering 'the goose that lays the golden egg'. This is true especially as there are no compensating transfers to people on lower incomes specifically designed to offset the regressivity of the GST scheme.

Recently the Labour government has promised to remove GST from fresh fruit and vegetables. The high cost of revenue loss (\$510m per annum) and the regressivity of the benefits that would deliver only very small amounts only to the worst-off (far less than the average gain of \$4.25 a week) make this a highly undesirable policy.¹² Even these small average gains may not materialise if the food retailers do not pass the savings on. The simplicity and broad base approach would be compromised, and over time there will be more and more pressures for expensive and hard to administer exemptions.

A reduction in the GST rate from 15% to 10% (the Australian rate) would be desirable and might be achieved in the very long term. However, the current fiscal position is such that this loss of tax revenue would be far too expensive right now. However, if the rate is held at 15% there must be more generous compensations through tools such as **Working for Families** and the **Independent earner tax credit (IETC)**.¹³

EXTEND THE INCOME TAX BASE BY TAXING INCOME FROM HOUSING

The tax system must also raise sufficient revenue to meet the increased challenges faced by New Zealand in the 21st century including addressing the extent and depth of child and whānau poverty.

The broad base principle for the income tax system was never achieved, because the fourth Labour government (1984-1990) failed to include capital gains in the base. In particular, the deliberate under-taxation of housing income has been a major driver of NZ's inequality and poverty problem.

There are now huge inequities in the distribution of housing resources. Real estate gains accumulated tax-free over time have led to a 'landed gentry' class developing, and wide and damaging wealth inequality.^v

While a stronger progressive approach is needed, comprehensive wealth taxes and capital gains taxes are not the best way forward. These are complex policies whose development and implementation would be controversial and protracted.¹⁴ However,

¹² See [Election 2023: Labour releases hotly-anticipated tax policies, including GST off some food | Newshub](#).

¹³ For those who do not receive WFF, a small \$10 a week tax rebate applies to incomes over \$24,000 and abates between \$44,000 and \$48,000.

¹⁴ Both major political parties (Labour and National) are opposed to them

more taxation of the better-off is essential. As housing is by far the major source of lopsided wealth and misallocation of resources in New Zealand, it is a good place to start.

While interest income earned from cash in a bank is fully taxed every year, as is share market income, investing in housing as an asset has been much more generously treated. If housing was treated the same as other forms of investment income, there would be fewer incentives to use our scarce housing resources of land labour and materials for high end housing. A practical approach that includes housing income in the tax base as outlined by St John and Baucher^{vi} provides a way forward and is summarised below.

How would including housing income in the tax base work?

The total value of all residential real estate held by each individual, less registered first mortgages, would be aggregated to give net housing equity. *There would be a \$1 million exemption per owner to reflect that everyone is entitled to a basic family home.*

For example:

A couple has a home worth \$4m with a \$1m mortgage
Each person has a net equity in housing of \$1.5m
After the \$1m exemption, each has \$500,000 of net equity.
The \$500,000 is treated as if it were a term deposit in the bank earning taxable interest, taxed at the person's marginal tax rate.¹⁵

The rationale is that anyone holding net equity in housing over the minimum for a basic home (i.e. \$1m) is using housing as an investment. They expect to do better than having the money in the bank, but in practice may pay very little tax. Rather, they should be treated as if they were doing at least as well as a term deposit and taxed on the imputed income.

When houses are held in trust and companies, in most cases, the income would be taxed at the company or trust rate with no exemption. Calculated annually and pegged to the capital value of properties, this policy would not significantly affect the great majority of homeowners who have much less than \$1 million each of net equity; rather it would mainly affect those with second homes, homes deliberately left vacant (ghost houses), multiple rentals, and high value properties.

This approach would help put investment in housing on the same footing as money in the bank or in shares. Better choices for the use of scarce housing resources would follow.

¹⁵ At a rate of 1-3% this would give an income of \$5,000 to \$15,000 which if taxed at 33% would require payment to IR of \$1,650- \$4,950.

The simplicity of this approach makes it a practical way to begin to restore the “broad base” approach. It would significantly affect only the very wealthy and those whose tax rates are already at the highest level. Moreover, it is possible to implement this tax quickly using existing property valuations (standard CVs) and registered mortgages, unlike a wealth tax or land tax where the devil would be in the contentious detail.

This policy would reduce the damaging impact on our housing stock of “ghost houses” and “residential land banking”, and the base would include any accrued capital gains over time. Landlords would have an incentive to rent their houses to cover their costs rather than hold them idle for capital gains. This would result in more housing for sale or rent, benefitting those struggling in the housing market. Landlords would also benefit from the greater simplicity and reduced accountancy costs.

The extra taxable income could produce revenue for both redistribution and social investment. Importantly and critically, it will also start to give the right price signals to reduce the over-investment in luxury housing and real estate held for capital gain.

This approach is essentially a circuit breaker that can simply and quickly discourage the accumulation of housing wealth by a growing group of people. Crucially it has a sound economic rationale. By including luxury and investment housing returns that are currently under the radar, it reduces the advantages of holding housing as an untaxed investment rather than more productive investments.

RECOMMENDED POLICY ACTIONS

- A tax on an imputed income on wealth held in real estate as outlined above in this document, (rather than a Capital Gains Tax or a Land Tax or a Comprehensive Wealth Tax).
- No exemptions for GST but better recognition of the regressivity of the GST/income tax system through more generous and wage-linked tax credits, and regular adjustment of tax brackets for inflation.^{vii}
- That the Effective Marginal Tax Rates (EMTR) problem is urgently reduced by:
 - Increasing the tax threshold above which a 30% marginal tax rate applies from \$48,000 to over \$50,000.
 - Reducing the **Working for Families** abatement from 27% to 20%.
 - Raising the current threshold for **Working for Families** abatement from \$42,700 to a much higher and indexed threshold (say \$53,000 in 2023/24) and indexing to wages annually.

- Reform of Supplementary Assistance such as the Accommodation Supplement.
- Raising the threshold of student loan repayments from the current \$22,000 income to \$60,000, and establishing a loan forgiveness programme for those who stay and work in Aotearoa New Zealand.

CONCLUSION

A better tax system that generates more income will enable the social investment and redistribution necessary for intergenerational equity in the sharing of the costs of the challenges ahead. Investment in children and young people is particularly important if we are to meet the pensions and health needs of an ageing society. Lowering EMTRs on the working age population is essential to improve their incentives to work (economic efficiency). Including housing in the income tax base is not only essential to generate the necessary revenue and improve intergenerational equity but will also encourage a better use of our scarce housing resources.

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